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Geopolitics of oil and the dollar

With the shale oil revolution and the end of the petrodollar, the US is set to hit its enemies where it hurts the most — in their pockets

Ever since Saudi Arabia unleashed the "oil weapon" after the 1973 Yom Kippur war and seriously damaged the US economy, I have always wondered why it did not take over the Saudi oilfields by force? A financial newsletter which has just come across my desk provides the answer.

Its editor, Jim Rickards, in an article ("R.I.P. the petrodollar", *Strategic Intelligence*, August 2016) discloses that in February 1974, he was asked by Robert Tucker, the head of the American Foreign Policy Institute, to join him and four other foreign policy experts for a meeting with Henry Kissinger's deputy on the National Security Council, Helmut Sonnenfeldt, to discuss a possible invasion of Saudi Arabia. This would secure the oilfields, produce enough oil for Western and Japanese needs, priced at a level that would not be inflationary: To avoid worsening US stagflation and prevent any further erosion in the dollar's value.

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Meanwhile, William Simon, the deputy secretary of the Treasury, along with Kissinger and Sonnenfeldt had another plan to deal with the Saudis: The creation of the petrodollar. The Saudis would continue pricing oil in dollars, reinvesting the proceeds in US Treasuries and Eurodollar deposits. The US would stabilise the dollar so that its weakening did not erode the value of Saudi Arabia's dollar investments. The US would also sell advanced weapons to the Saudis.

The Saudi's dithered. In August 1974, President Richard Nixon resigned because of the Watergate scandal. To hasten the stalled negotiations, Kissinger got Mr Tucker to write an article titled "Oil: The Issue of American Intervention" (*Commentary*, 1 January 1975) which set out the invasion plan he and the others had discussed earlier.

Mr Tucker argued on grounds of realpolitik that, until quite recently, the oil crisis attacking vital US interests would "never have arisen because of the prevailing expectation that it would have led to armed intervention". He then disposed off arguments against intervention based on political inexpediency and morality. On the danger of the Saudi's following a scorched earth policy on their oil fields, he argued it would only take three to four months to restore production, and recommended a western strategic oil reserve to store oil for this period of possible disruption of oil supplies. Mr Tucker's article led the Saudi's to swiftly accept the petrodollar deal — with a proviso that the Saudi holdings of US Treasuries would remain a secret.

By 1978, continuing high inflation in the US led the dollar to fall by 13 per cent from its 1975 high. The Saudis retaliated by doubling oil prices between 1979 and 1980. The appointment of Paul Volcker as the chairman of the Federal Reserve to tame the US inflation by tight money led to a rise in the value of the dollar to its level when the petrodollar deal was signed. Thereafter, all the US administrations intoned the "strong dollar" mantra. The petrodollar deal stayed intact till 2010, and the dollar's role as the main reserve currency was strengthened.

The petrodollar deal was upturned by the Great Recession. To deal with the need to increase US jobs and growth in the worst recession since the Great Depression, the US gave up the "strong dollar" policy it had followed for 35 years. The cheapening dollar hit oil-dependent Russia and US Treasuries-rich China. They responded by buying gold. In the last seven years, Russia has bought more than 1,000 tonnes of gold, and China more than 3,000 tonnes. Together, they now hold more than 10 per cent of the world's gold stock. Though not subject to the risk of confiscation like their holdings of US Treasuries and other investments in the West, they are faced by the volatility of the gold price and its likely collapse from a large-scale conversion of these gold reserves into foreign currencies.

China is hoping that with the International Monetary Fund's inclusion of the yuan in the basket of currencies constituting the Special Drawring Rights (SDR), that these will provide a safer reserve asset than the dollar. Mr Rickards claims that China has "acquired billions of SDRs in secret secondary market transactions brokered by the IMF". But despite the IMF's hope that the SDR would replace the dollar as the main global reserve asset, it has not come to pass.

The main loser from the "cheap dollar" policy is Saudi Arabia. The deal that President Franklin D Roosevelt struck with King Ibn Saud aboard the *Quincy* in 1945, promising security to the Saudi dynasty in return for the free flow of oil to the West is now dead. For with its shale oil revolution, the US has the highest oil reserves in the world. It is no longer dependent on Saudi oil. Moreover, the flexibility with which shale oil drilling rigs can be taken in and out of production, the oil price is now bounded by a "shale band" of $40 to $60. (Neanda Salvaterra, *Wall Street Journal*, 24 August 2016). At this price band, the Saudi's cannot close their fiscal deficit, which is being financed by sales of their dollar assets and a proposed divestment of their crown jewel ARAMCO.

With the signing of the Iran nuclear deal President Barack Obama has signaled that Iran is the leading regional power. Whilst the release of US data on the previously secret Saudi holdings of US Treasuries and top-secret sections of the 9/11 Commission report, which reveals links between the Saudi royal family, 9/11 hijackers and Al Qaeda, shows that the US is no longer willing to allow the Saudis to use their oil wealth to finance the jihadists and the madrassas, with Wahhabi clerics fomenting religious hatred against all non-Wahhabis throughout the world.

Unlike Mr Rickards, I do not think Mr Obama's "currency war" weakening the dollar will mean the end of its primacy as a reserve currency. Instead, through the "shale band" and the end of the petrodollar, the US is on the way to hit the enemies of its values and imperium where it hurts most — in their pockets.