

Weak dollar adds to upward pressure on crude

Cheaper valuation fuels speculation even as it threatens long-term oil supply

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SAN FRANCISCO (MarketWatch) -- The dollar's tailspin since the Federal Reserve began to cut interest rates is giving an updraft to already bullish crude-oil futures, and analysts say that relationship will continue driving oil and the currency both in their current directions.

"The much larger structural story [of the oil price rise] is demand from emerging markets -- in particular, China - - but in recent months, the dollar has depreciated sharply," which has in turn pushed up crude to all-time highs, said David Powell, senior foreign exchange analyst at IDEAGlobal.

Oil is produced in dozens of countries around the world, but its standard trading unit is in dollars per barrel.

"As the dollar declines in value, so does the price of oil in non-dollar terms," said Michael Woolfolk, senior currency strategist at the Bank of New York Mellon. "Consequently, foreigners bid up the price of oil and other dollar-denominated commodities. The result is that the price of crude oil and other commodities rise in dollar terms as the dollar falls in value against other currencies."

Fueling speculation

In a simple world, one might think that oil prices and dollar demand would logically have a direct, not an inverse, relationship. People who want to buy more oil would need more dollars with which to buy it, thereby bidding up both.

But much more than that is at work behind the scenes.

While fundamental supply and demand factors still apply, investors use the futures market to hedge against anticipated trends, and their actions can ultimately affect the course of those trends.

"Dollar devaluation affects oil prices directly in the short run and indirectly in the long run. In both cases it increases oil prices," said A.F. Alhajji, a professor of energy economics at Ohio Northern University who has researched the historical relationship between the dollar and crude oil.

In the short run, said Alhajji, a cheaper dollar can fuel speculation.

"In order to maximize the benefits from their portfolio, investors buy commodities denominated in cheap dollars," he said.

In the long run, a depreciated greenback increases demand for oil even as it decreases the oil supply, he said, pushing up oil prices.

"Dollar depreciation reduces the ability of the oil producing countries and the oil companies to invest in additional capacity. Therefore, it reduces supply," Alhajji said. "A lower dollar reduces the purchasing power of the oil-producing countries and increases domestic inflation. This will lower the amount of funds available for investment in the oil sector."

If the United States is worried about the impact of rising oil prices, he added, "it can reduce oil prices by raising its dollar."

Rate cut expectations weigh

But most currency analysts don't expect a sustained dollar uptrend anytime soon, as the dollar remains pressured by speculation that the Fed isn't finished cutting rates.

Lower interest rates usually weigh on a country's currency, because they erode the return on assets denominated in the currency.

On Sept. 18, the central bank cut its federal funds rate by half a percentage point, and then followed it up with a quarter-point cut at the end of last month, bringing the benchmark to 4.5%.

Since then, the dollar has plunged while oil prices soared.

As they ponder their next stance on interest rates, Fed policy-makers have to carefully weigh the risks of slowing economic growth against the risks of inflation. Expensive oil exacerbates both, by weighing on growth even as it adds to inflationary risks by boosting the value of imports.

In testimony before Congress earlier this month, Fed Chairman Ben Bernanke said the U.S. economy faces not only the risk of a sharp slowdown from the housing market's contraction, but also an inflationary surge from sharply higher crude-oil prices and the weaker dollar. [See full story.](#)

"Overall, it looks like the U.S. dollar will remain under pressure in the near future. We will watch speculative positioning carefully to assess the potential for subsequent pull-backs, but so far there are very little signs of excesses," wrote currency analysts at Goldman Sachs Economic Research in a recent report.

"To assess the more medium-term outlook, we need to wait for better visibility about the U.S. growth and interest rate outlook," they said -- a statement that applies to the outlook for oil prices, as well. ■

Lisa Twaronite reports for MarketWatch from San Francisco.