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Strong Dollar Blunts Benefit of Oil's Price Decline

The unintended beneficiary of the dollar's surge is – Vladimir Putin

By Rob Garver,
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Many Americans have begun to feel the impact of falling oil prices, primarily at the gas pump, where the cost to fill your tank has plummeted in recent weeks. But the benefit of falling prices is partially blunted in most non-U.S. countries by a parallel phenomenon: the surging U.S. dollar.

Like most commodities traded on the global market, crude oil prices are denominated in U.S. dollars. That means that when an oil-rich emirate in the Middle East sells a barrel of oil to Japan, the transaction is settled with the exchange of payment in dollars.

The buyer typically has to exchange his own country's currency for dollars before the transaction can be settled – so when the dollar surges in value, it raises the effective price of the oil.

"If the dollar is getting strong and you are a non-dollar country, there is a little premium that is attached to the price of anything priced in dollars," said Steve Hanke, a professor of applied economics at Johns Hopkins University and a senior fellow at the Cato Institute.

Conversely, if you are a non-dollar country that exports oil, the surging dollar is good news.

The effect can sometimes be ironic. For instance, now, at a time when the U.S. and its allies are going to great lengths to hobble the Russian economy, the U.S. dollar is doing Russian President Vladimir Putin a favor, albeit a small one, by increasing the profit margin on its oil sales.

"For exporters of oil, the strong dollar does give them a little premium that they wouldn't be getting if the dollar was weak," said Hanke. He was quick to point out, however, that the drop in oil prices, from near $115 per barrel to $78 yesterday, far outweighs any boost the strong dollar may have given Russian exports.

While economic troubles in Europe suggest the dollar may remain strong for some time to come, there is a difference of opinion on the future of oil prices.

In a research note Thursday, Michelle Meyer and Lisa C. Berlin of Bank of America Merrill Lynch wrote, "Our commodity research team believes that an increase in supply is the main factor behind the latest drop in prices. They, therefore, view it to be transitory and expect OPEC to cut supply and US production growth to ease." The result, they said, should be oil prices heading north again before year-end.

On Friday, however, the International Energy Agency released a report suggesting that the decline in oil prices is not likely to slow anytime soon. The IEA said downward pressure on prices could become even greater in the first half of 2015, and suggested that the world market has entered a “new chapter” with regard to energy prices.