The Petrodollar is Either Dead or Dying

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THE MATTERHORN INTERVIEW – November 2012: Chris Cook

“The Petrodollar is Either Dead or Dying”

The internationally acknowledged energy consultant Chris Cook addresses in this exclusive interview the new IEA report; the pre-dominant factors in the oil market; his version of a commodity-based currency; why an attack on Iran is rather unlikely; and the consequence of a rising oil price for gold.

By Lars Schall

Chris Cook, 58*, is a London-born internationally acknowledged energy market strategist and an energy consultant. He is best known as the originator of the Iranian Oil Bourse project. Following an early career in fraud investigation in the UK Department of Trade & Industry, Cook was a market regulator at the Association of Futures Brokers & Dealers, and then at the International Petroleum Exchange (latterly as a Director).*

At the IPE, he developed successful new trading mechanisms such as Exchange of Futures for Swaps; Volatility Trades; and Settlement Trades. Between 1998-2000, he founded and developed NewClear, a generic transaction confirmation concept, still widely used in global markets.

Cook is a founder of the Wimpole International expert network and works mainly with Nordic Enterprise Trust to develop new partnership-based enterprise models, and related financial products and services. Moreover, he is a Senior Research Fellow at the ISRS, University College, London, and a regular contributor to Asia Times Online.

Lars Schall: Mr. Cook, am I right that you’ve looked closely at the IEA World Outlook 2012 that was published recently?

Chris Cook: Fairly closely and not uncritically!

L.S.: So what’s your take?

C.C.: As an energy organisation dominated by the interests of energy consuming nations generally, and those nations dominated by financial interests in particular, the IEA once again takes a cornucopian view, albeit moving at last from an oil cornucopia, which has worn thin, to a natural gas cornucopia.

The reason for the IEA to consistently paint rosy pictures is that it is in the interests of consumers to moderate the price expectations of producers and financial investors.

L.S.: Since the year 2000, the sharp rise in oil prices shared in the triggering of the financial crisis in 2008. What were the reasons for this increase?

C.C.: I think firstly that we have seen oil demand by consumers genuinely approaching the capability of oil producers to meet it. But from 2005 onwards we have also seen increasing market participation by investors who have been sold by investment banks on the concept of 'hedging inflation'.

That is to say, investors who wish to off-load dollar price risk in favour of commodity price risk generally and oil price risk specifically. The smarter investment banks realised that this risk profile was diametrically opposite to that of oil producers, who wish to off-load oil price risk in favour of dollar price risk, and a new breed of funds was created to enable risk transfer between producers and inflation hedgers.

L.S.: Is the oil market a free market, primarily driven by supply and demand?

C.C.: Indeed it is, but we must not completely ignore the role of inventory. The problem is that an increasing amount of that demand has not in fact been intended for consumption, but rather for holding off-market as a financial asset and an inflation hedge.

The participation of investors aiming not to make transaction profit, but rather to avoid loss, has completely destroyed the price formation of all markets in which they have become dominant.

L.S.: How important are the intermediaries in the market today?

C.C.: The intermediaries own and control the dominant market platforms lock, stock and barrel. However, since the financial markets collapsed in 2008 – and in my opinion the markets are terminally broken – we have seen an evolution taking place as the business model of market intermediaries has moved to the next 'adjacent possible'.

What we have seen is that banks and traders are increasingly starved of risk capital, and that is why we have seen the massive growth of funds where market risk is no longer with the middleman but is now with risk averse investors who have no idea that they have been mis-sold into funding correlated commodity price bubbles.

L.S.: Is one reason why the manipulation of the oil price is rather rarely discussed because of the opaque nature of the market operation?

C.C.: You have hit the nail on the head, Lars. What we have seen is a two-tier market in physical crude oil, where a substantial number of transactions go unreported with the result that financial investors opaquely own a 'Dark Inventory' of crude oil, including inventory actually still in producers' reservoirs.

L.S.: A crucial legislature in all of this seems to be the Commodity Futures Modernization Act of 2000 (CFMA). Why so?

C.C.: This statute enabled investment banks to conduct the trading techniques which were responsible for inflating market price bubbles.

L.S.: Does this market need to be reconfigured, and if so, how?

C.C.: The cause of the problem is the presence in the market of intermediaries. The good news is that the transition or reconfiguration is already going on by these middlemen to a new role as service providers facilitating direct interaction between producers and consumers.

The reason for this surprising trend is that if you are a service provider the only capital you need is that necessary for operating costs, because it is these end users who take the market risk.

L.S.: Is the oil price not just a bad, but no indicator at all of future scarcity?

C.C.: Since storage in the oil market is pretty minimal, the forward oil price has only ever had any relevance to underlying supply and demand in the very near future i.e. 3 months or so.

The rest of the oil price curve has only ever reflected financial demand, and has historically been related to the dollar yield curve, with no relationship whatever to scarcity or glut.

L.S.: Why is the demand for oil increasing, but not global oil production?

C.C.: Firstly, it is not clear to me how much of current demand is financial demand – particularly reserve building by consumer nations such as China and South Korea – and how much is genuine demand for refining.

Secondly, re production, while there is an immense amount of oil out there, I think that we are at or near a peak level of production, and that what has occurred is essentially what I have heard called 'Peak Demand' i.e. any increase in demand could not be affordably met.

L.S.: Do you think that Saudi-Arabia is able to increase its oil production the way they promised it to the world?

C.C.: No, I don't, Lars. I think the Saudis have very little spare capacity and have been indulging for some time in what I have heard described as 'Jedi Mind Tricks'.

L.S.: You spend some of your time with thinking about an oil-based global

currency. (1) Why is this important to you?

C.C.: I've always been interested in solving market problems, and a replacement for the dollar is perhaps one of the greatest market conundrums there is.

I no longer envisage an oil-based currency, because firstly, there are too many distinct qualities and grades, and secondly, very few individuals have a need for crude oil, as opposed to oil products, and therefore an oil-based currency would not be based on something with a use value to individuals.

Instead, my analysis now is that a currency based upon natural gas, which is the same (CH_4) wherever it is, and is in fairly common use by the public globally, would be a much better candidate.

L.S.: What would happen to the US dollar if the pricing of oil in that currency would stop or go back significantly?

C.C.: If oil ceased to be priced in dollars then what would happen to the dollar is clearly dependent upon the future of the relationship between the purchasing power of the dollar and that of the new unit.

L.S.: At a conference in Tehran in late 2011, you've stated that in the future we will no longer see oil priced in dollars and natural gas priced against oil, but will rather see oil and dollars priced against the energy value of a unit of natural gas. What does this mean?

C.C.: Natural gas, unlike crude oil, which comes in many types and specifications, is pretty much the same (once impurities are stripped out) wherever it is found. It is also very often measured by energy content (i.e. MMbtu).

That being so, then a unit which is returnable in payment for (say) 1 MMbtu of natural gas (i.e. a gas currency unit) would be – at least for a transitional period of a few decades – an ideal candidate for a stable store of value and benchmark pricing for exchanges of value generally.

L.S.: In that respect you're known for advocating a new system that you've called an Energy Clearing Union. Could you describe to us the mechanism behind that?

C.C.: In fact, Keynes advocated at Bretton Woods in 1944 a centrally-issued currency unit called the Bancor, to be created, issued, cleared and settled within an International Clearing Union, but what we got instead was the IMF and the World Bank.

So a Clearing Union may thought of as a legal framework within which financial obligations are created, exchanged and settled.

The approach to clearing I advocate does not envisage a central issuer where all the market risk is concentrated, but is rather a framework agreement providing a mutual guarantee of credit obligations created and issued by producers and accepted directly – 'Peer to Peer' – by consumers.

There's nothing new about such mutual insurance of risk: Protection and Indemnity (P&I) Clubs have been quietly providing mutual insurance for ship owners for 140 years, for 135 years under the same private sector management.

L.S.: How do you think about the conflict around Iran viewed from a perspective of the petrodollar? Do we see a "sinking of the petrodollar in the Persian Gulf?" (2)

C.C.: I think the Petrodollar is either dead or dying, and was always somewhat exaggerated in importance, since the value of oil, while not insignificant in international trade, is a relatively small proportion of international flows of value.

L.S.: How do view your work on the Iran Oil Bourse in retrospect?

C.C.: Firstly, it was an education in Realpolitik: secondly, it served as the basis for a considerable body of work which would never have taken place without it.

L.S.: In your view, there is little or no chance of military action against Iran. Why so?

C.C.: I believe that energy security is as important to China as it has for 100 years been for the US, and that in or around 2007, China's economic position became such that they were able to use the same threat used by the US to force Britain out of Suez in 1956.

China at that point applied a 'Mutually Assured Destruction' veto in respect of the US dollar.

So, although nuclear noise suits both Iran and Israel for different political reasons, the US will ensure that there will be no attack on Iran by Israel or anyone else.

L.S.: You stated some while ago, I quote from memory: "You can produce oil without gold, but you can't produce gold without oil." Now this sounds fairly simple, nonetheless could you elaborate on this a bit, please?

C.C.: Simply put, energy derives its value from its utility, whereas gold derives its value from its eternal stability. Moreover, if you think about it, gold – like all rare commodities becoming increasingly scarce – will require increasing amounts of energy to produce. This means that gold will become increasingly expensive in terms of an absolute unit of energy, but with no increase in the utility of gold.

L.S.: What are your thoughts on the gold market in general? Is this a market for you that's worthwhile to follow?

C.C.: I take a pragmatic view of gold. I can't live in it; heat my house with it; fuel my car with it; brush my teeth with it; or type e-mails with it; so I am not particularly interested in it other than for its beauty.

L.S.: Do you think that in the future we will see much more oil transaction

being settled in gold?

C.C.: I do not envisage gold-based currency being utilised much – although Iran at least has been settling energy transactions in gold – because of logistical issues.

But I can imagine gold being used as backing for a framework of trust agreement for the clearing of credit obligations within a Clearing Union architecture.

L.S.: Concerning the crisis of the euro, do you think it would make sense for the Europeans to look rather at the East than the West?

C.C.: The bank-centric US dollar economy is based upon a vacuum, and although there is a mighty economy behind it, I do not believe that the dollar-based system is sustainable in its current form.

L.S.: In your current work you're focused on a new generation of networked markets, which will be dis-intermediated, open, and de-centralised. Could you tell us a bit more about this?

C.C.: I believe that we are well into a one in a thousand years' transition to a new economy. What is driving this is instantaneous direct connections, and the fact that while individuals may be excluded by force from land and resources, once a person gives another an idea, he cannot take it back.

L.S.: Is the struggle for de-centralised solutions one of the main struggles in the future per se?

C.C.: The cosmic irony is that not only will there be no struggle, but that in the financial markets at least the Turkeys are actively voting for Christmas, and the transition is well under way. The existing correlated bubbles in equities, commodities and other markets – funded by 'muppets' who have been mis-sold market risk – are the evidence.

The reason for this transition, as I explained earlier, is that risk intermediaries need risk capital which is becoming scarcer by the day, whereas as risk service providers they need only sufficient capital to cover operating costs.

L.S.: One final question: Is it important that the major oil companies have interlocking directorates with the big institutions of international banking – and both have little interest to get us off our oil addiction?

C.C.: I think that major oil companies have realised for some time that banks are no longer capitalised to provide the finance capital they need, and that they must look elsewhere for that investment.

Even the most toxic of the oil majors have in my view realised – even if they may not publicly admit it – that the old market paradigm is dead, and that they must move on.

SOURCES:

(1) Compare Chris Cook: “Banking on Energy”, The Oil Drum, April 5, 2009, http://www.theoildrum.com/node/5269

(2) Pepe Escobar: “Sinking of the Petrodollar in the Persian Gulf”, TomDispatch.com, January 17, 2012, http://www.tomdispatch.com/post/175490/tomgram%3A_pepe_escobar,_sinking_the_petrodollar_in_the_persian_gulf/