Oil for dollars, and dollars for US deficit

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The Asians remain shocked and in disbelief. Just when Japan, China, Taiwan and Hong Kong had accumulated enough dollars to buy oil to keep them warm for many winters, it's all over. In broad daylight, the Americans and the Organization of Petroleum Exporting Countries (OPEC) cheered as the price of oil popped up from US$30 a barrel to more than $50.

Indeed, this jump in the price of oil increases the world's daily oil consumption bill of 84 million barrels a day to $4.2 billion, from $2.5 billion (or $1.5 trillion a year from $900 billion). The world now has to shell out an additional $600 billion a year of "lucky bucks" to oil-producing countries just to stay in motion.

The bigger shock, however, is in the devaluation of dollar holdings of US Treasury debt. The rise in oil prices guarantees that the value of the US dollar will be pushed down even further, and stay down. Now that China is the No 2 oil importer and Japan is No 3 – with the rest of Asia very thirsty for oil as well – you can understand why the Asians must find a way to protect themselves.

The US strategy for using oil to finance its deficit is, of course, brilliant. America's elected officials knew that at some point those independent foreign central banks would start getting edgy about buying more dollars to pay for the United States' war and deficits. The $650 billion trade deficit is breathing down the dollar's neck. So which central banks can the US continue to use as the fall guys to buy the dollar? Why not the Persian Gulf oil states – but where would they get the dollars to buy US Treasuries? Well, with the Chinese piling up dollars and growing like crazy, at some point the oil market had to tighten. It was only a matter of time before the Chinese would start bidding up the price of oil. The Asians, therefore, are hung out to dry when the price of oil rises because they have to spend more of their dollars on oil.

As the price of oil goes up, extra money floods into the Gulf kingdoms. With the US secretary of defense putting troops all over the ground in the Middle East, and those nimble aircraft carriers nearby and ready to deliver the "shock and awe of sudden democracy" to the Gulf monarchs, it's a sure bet that America's OPEC buddies will stash their newly found Asian lucky bucks into good old American Treasury notes.

With such a simple policy to fund its deficit for another year, it's no wonder the United States can get by without any brain power at the Treasury Department. In effect, the US and its Gulf Arab allies just pulled off the biggest central-bank heist in the history of the world. The price of oil just went up 60% or more, which really cuts down to size that $3.4 trillion of net foreign holdings of US financial assets. As a loyal American, one would like to cheer one's government's deft move to pick the pockets of our trading and financing partners. Moreover, the US gets the Arabs to fund a large share of our deficit, subsidize our interest rates, and help keep our taxes low for another year. Surely I can afford to buy another gas-guzzling sport-ute, get a rifle, and wave a flag.

The United States is extracting tribute on oil from the world. If the world wants Middle Eastern oil, it can pay for it through the Saudi branch of the US Treasury. Why do the heads of Saudi Arabia, Kuwait, Abu Dhabi, Bahrain, Qatar, etc, hold dollars? Because they want to keep the money and the power. The ruling family of Saudi Arabia controls 25% of the world oil reserves and is completely dependent on oil revenues for its survival. Tens of thousands of Saudi princes live off lavish royal stipends. Think of Arabia as a family firm. If the dollar goes down in value, the Saudi royal family still gets to keep hundreds of billions of dollars. But, if they don't buy dollars, why would the US keep them in power? It would simply not be in our interests to do so. Remember when Saddam Hussein talked about pricing Iraq's oil in euros? "Shock and awe" quietly followed.

This program of oil for dollars and dollars for the US Treasury deficit is the simple tribute that we, as the superpower, can expect. The United States is well paid for keeping the world's supply of black gold safe and available to all. Unlike the Vietnam era – when the US was trying to finance guns and butter – getting others to pay now for our guns allows us to milk the oil out of the sand and turn it into butter.

The next question will be how the Asians respond to a 60% hike in the price of oil. Please stay tuned.

Notice in the chart below there are some big, smart, anonymous dollar holders (such as hedge funds) located in the Caribbean. No one knows who they really are.

Major foreign holders of US Treasury securities (in billions of dollars)

Japan 702

Mainland China 194

England 163

Caribbean 93

Korea 68

Taiwan 59

Hong Kong 59

Total (including other countries with fewer holdings) 1,960

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