Why Oil Prices Are So High

A Weak Dollar, Bad Fed Policies and Hedge Fund Speculators

By Dr. Paul Craig Roberts
Global Research, June 12, 2008
Counterpunch.org 12 June 2008
Theme: Global Economy, Oil and Energy

How to explain the oil price? Why is it so high? Are we running out? Are supplies disrupted, or is the high price a reflection of oil company greed or OPEC greed. Are Chavez and the Saudis conspiring against us?

In my opinion, the two biggest factors in oil's high price are the weakness in the US dollar's exchange value and the liquidity that the Federal Reserve is pumping out.

The dollar is weak because of large trade and budget deficits, the closing of which is beyond American political will. As abuse wears out the US dollar's reserve currency role, sellers demand more dollars as a hedge against its declining exchange value and ultimate loss of reserve currency status.

In an effort to forestall a serious recession and further crises in derivative instruments, the Federal Reserve is pouring out liquidity that is financing speculation in oil futures contracts. Hedge funds and investment banks are restoring their impaired capital structures with profits made by speculating in highly leveraged oil future contracts, just as real estate speculators flipping contracts pushed up home prices. The oil futures bubble, too, will pop, hopefully before new derivatives are created on the basis of high oil prices.

There are other factors affecting the price of oil. The prospect of an Israeli/US attack on Iran has increased current demand in order to build stocks against disruption. No one knows the consequence of such an ill-conceived act of aggression, and the uncertainty pushes up the price of oil as the entire Middle East could be engulfed in conflagration. However, storage facilities are limited, and the impact on price of larger inventories has a limit.

Saudi Oil Minister Ali al-Naimi recently stated, "There is no justification for the current rise in prices." What the minister means is that there are no shortages or supply disruptions. He means no real reasons as distinct from speculative or psychological reasons.

The run up in oil price coincides with a period of heightened US and Israeli military aggression in the Middle East. However, the biggest jump has been in the last 18 months.

When Bush invaded Iraq in 2003, the average price of oil that year was about $27 per barrel, or about $31 in inflation adjusted 2007 dollars. The price rose another $10 in 2004 to an average annual price of $42 (in 2007 dollars), another $12 in 2005, $7 in 2006, and $4 in 2007 to $65. But in the last few months the price has more than doubled to about $135. It is difficult to explain a $70 jump in price in terms other than speculation.

Oil prices have been high in the past. Until 2008, the record monthly oil price was $104 in December 1979 (measured in December 2007 dollars). As recently as 1998 the real price of oil was lower than in 1946 when the nominal price of oil was $1.63 per barrel. During the Bush regime, the price of oil in 2007 dollars has risen from $27 to approximately $135.

Possibly, the rise in the oil price was held down, prior to the recent jump, by expectations that Democrats would eventually end the conflict and restrain Israel in the interest of Middle East peace and justice for the Palestinians.

Now that Obama has pledged allegiance to AIPAC and adopted Bush's position toward Iran, the high oil price could be a forecast that US/Israeli policy is likely to result in substantial supply disruptions. Still, the recent Israeli statements that an attack on Iran was "inevitable" only jumped the oil price about $8.

Perhaps more difficult to understand than the high price of oil are the low US long-term interest rates. US interest rates are actually below the rate of inflation, to say nothing of the imperiled exchange value of the dollar. Economists who assume rational participants in rational markets cannot explain why lenders would indefinitely accept interest rates below the rate of inflation.

Of course, Americans don't get real inflation numbers from their government and have not since the Consumer Price Index was rigged during the Clinton administration to hold down Social Security payments by denying retirees their full cost of living adjustments. According to statistician John Williams, using the pre-Clinton era measure of the CPI produces a current CPI of about 7.5%.

Understating inflation makes real GDP growth appear higher. If inflation were properly measured, the US has probably experienced no real GDP growth in the 21st century.

Williams reports that for decades political administrations have fiddled with the inflation and employment numbers to make themselves look slightly better. The cumulative effect has been to deprive these measurements of veracity. If I understand Williams, today both inflation and unemployment rates, as originally measured, are around 12 per cent.

By pumping out money in an effort to forestall recession and paper over balance sheet problems, the Federal Reserve is driving up commodity and food prices in general. Yet American real incomes are not growing. Even without jobs offshoring, US economic policy has put the bulk of the population on a path to lower living standards.

The crisis that looms for the US is the loss of world currency role. Once the dollar loses that role, the US government will not be able to finance its operations by borrowing abroad, and foreigners will cease to finance the massive US trade deficit. This crisis will eliminate the US as a world power.

Paul Craig Roberts *was Assistant Secretary of the Treasury in the Reagan administration. He was Associate Editor of the Wall Street Journal editorial page and Contributing Editor of National Review. He is coauthor of [The Tyranny of Good Intentions.](#)He can be reached at: PaulCraigRoberts@yahoo.com*

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About the author:

Paul Craig Roberts, former Assistant Secretary of the US Treasury and Associate Editor of the Wall Street Journal, has held numerous university appointments. He is a frequent contributor to Global Research. Dr. Roberts can be reached at http://paulcraigroberts.org