



# IDSS COMMENTARIES (10./2003)

*IDSS Commentaries are intended to provide timely and, where appropriate, policy relevant background and analysis of contemporary developments. The views of the authors are their own and do not represent the official position of IDSS.*

---

## **THE EURO FACTOR IN IRAQ WAR?**

J. Soedradjad Djiwandono

26 March 03

The US-led war on Iraq has raised different speculations about the real reasons behind it, chief among them being control of its vast oil resources. One that seems to be a bit far fetched, but relevant, suggests that the actual reason behind the campaign is to fight against the use of the Euro in oil exports and payments by OPEC member countries.

This paper analyses the economic rationale for the change in oil trading from USD to Euro as well as it being the argument for the US attack on Iraq. It also assesses how a USD-based world monetary and economic system would become less sustainable in the context of the present and future global economy and finance.

### **Defending dollar hegemony against Euro encroachment?**

W. Clark wrote in Independent Media Center (Jan – Feb 2003) that the real reason behind the US plan of attacking Iraq and replacing President Saddam Hussein was to discourage the use of Euro for payment of oil sales by OPEC countries and to defend against Euro encroachment of the USD hegemony in the world economic system.

The argument is based on Iraq's successful bid in asking for payment of its oil sales since end of 2000 in Euro instead of the conventional US dollar (USD). According to this argument this step was followed by Iraq's decision to convert USD 10 billion worth of its reserves into Euro. In the meantime it is reported that Iran was conducting a study to follow what Iraq did. And even though economically less meaningful North Korea also came to the decision to ask for payments in Euro for its exports.

Does this argument make sense? Of the present world oil production of 75 million barrels a day (bpd) OPEC members produce one third, while Iraq produces 2.5 million bpd or 10 per cent of OPEC's production. Iraq is reported to own 11 per cent of proven world reserves of oil, the second largest after Saudi Arab.

Despite its own huge production the US imports oil to the amount of more than 10 million bpd. With the backdrop of adverse economic impacts from the oil crises that the US experienced in the aftermath of oil crises in 1973/74, 1979/80 and 1990/91, one does not have to believe in a conspiracy theory to see the US interest in Iraq oil. At least it must be in the interest of the US government to make efforts to avoid the use of Iraq oil as a means to weaken the US economy.

Of course, those who subscribe to conspiracy theory would underline the fact that some

members of President George W. Bush administration were former executives of oil companies. These would include the senior and junior President Bush (Arabusto and Harken), Vice President Dick Cheney (Haliburton), and even the National Security Adviser Condoleeza Rice (Chevron).

However, close relation with the Saddam Hussein government are also enjoyed by big companies from France, UK and Germany. Russia is interested in recovering its huge loans to the Iraq government. And in spite of the UN economic embargo on Iraq it has been reported that corporations from Japan and China have also been actively establishing their businesses in Iraq. In short all big economic powers have economic and finance interests in Iraq.

The question remains as to why President Bush was so determined to wage war against Iraq, even after objections from its allies and public protest all over the world against it? This is when an economic rationale of controlling Iraq oil seems to make more sense, and the above argument becomes relevant.

However, how relevant is the argument that the real reason behind the attack on Iraq is to defend against the encroachment of Euro on the hegemony of USD in the world economic system? For sure, the USD has been weakening against the Euro. In 2002 USD depreciated by 15 per cent against the Euro, a trend that seems to be continuing. This happens despite the tendency for the EU economy, except some member of the so - called 'new Europe', to experience slump as well.

Whether the weakening of USD against the Euro has anything to do with Iraq decision to shift to the sale of oil in Euro and the steps taken by Iran and North Korea is difficult to prove. However, a complete shift from USD to Euro on the pricing and the payments of oil trading by OPEC countries would definitely weaken USD further. And an effort by the US government to defend against this policy would make sense.

Mr Javad Yarjani, a high ranking OPEC official in a speech delivered in Spain last year, had argued that conducting oil trading in Euro would benefit more both exporting OPEC countries and importing EU countries owing to lower price risk and exchange risk as well.

### **The USD hegemony**

To understand the reason for the defence of the USD against the encroachment of Euro, one should recall the development of the role of USD in the world economic system.

After WW II and the establishment of the Breton Woods System, i.e. International Monetary System (IMF) and the World Bank (WB), the USD naturally became the undisputed reserve and intervention currency in the world finance. The Breton Woods system was based on the premise that all currencies were pegged at a fixed value to the USD, hence it was called a *pegged and adjustable system*.

The system functioned extremely well in terms of supporting high growth of the world economy and trade for more than two decades after WW II. However, the system became unsustainable following the US extended commitments to provide security the world over, including a very expensive Vietnam War, and foreign aid. As a consequence the Breton Woods system became ineffective and ultimately it was discarded.

The period from 1973 – 1976 was an uncertain period in the world monetary system; in the world of finance it was sometime called a period without a system. Finally, in 1976 the world adopted a *floating system* during the annual meeting of the IMF and WB in Jamaica (Jamaica Agreement). The floating system was adopted all these years until the Asian financial crisis erupted in 1997. After the crisis, the world has been basically accepting a bipolar system comprising a *free-floating system and a hard pegged system*. The second one is basically a system with currencies pegged to strong currency (USD or SDR) supported by currency boards. The second one would include the pegged to strong currency supported by administrative control on foreign exchange adopted by Malaysia.

The USD has continued to play the role of reserve currency as well as intervention currency though role as intervention currency must be different in the case of a floating system as compared to a peg system. Theoretically market intervention is not called for in a free - floating system. But, countries do engage in market intervention to defend their currency in an economy officially adopting free-floating system. Likewise, theoretically countries practising floating system do not need to hold foreign reserves. But, they do. Statistics show that most economies held even larger foreign reserves despite their adherence to floating system.

If there is a change in the USD role it is in the direction of widening the use of it. In fact the world economy and finance have been operating with USD hegemony. The USD has been used in most payments for trading goods and services, including trade in oil; it has been used for payments in investment activities. In trade relation among nations the continuously increasing deficits in the US current account and the budget have been financed through capital inflows to the US. In the meantime this process has been creating a huge debt of the US economy to the world.

### **Is USD hegemony unsustainable?**

The world exchange system has been undergoing changes partly due to the tendency that the system could no longer function well in a new environment with different pattern of trade and economic relations amongst nations; decades of economic growth in production, trade and investment had changed the balance of economic and financial powers.

In the emerging balance of economic powers the US economy is still the world's largest and strongest; other economies directly and indirectly depend on it. However, unlike after WW II in the present and future globalize economy and finance the US economy is no longer the sole super power to support USD hegemony. For sure, with the recent rise of China to a trillion dollar economy, and possibly India in the not too distant future, the US economy would only be the largest and the strongest among several super powers.

With its new additional members, EU has become an economy with 450 million people and USD 9.6 trillion GDP, comparable to the US 280 million people and USD 10.5 trillion GDP. In spite of its huge problems in the last decade Japan is still an economic super power.

The US economy in the world system, despite its position as the largest and the most powerful, is not like its position in political and military terms since the collapse of the Soviet Union. The economic balance of power amongst countries has been experiencing changes after decades of economic and trade growth. The world economy and finance has also been

changing towards a borderless and globalized one.

One important implication here is that a USD hegemony does not seem to fit well in the system as described above. Within an economy the role of national currency as means of payments as well as other functions is based on legal stipulation (*fiat*) – usually in its central bank act - which its citizens accept and trust.

The world accepts and trusts USD to function like a currency within a national economy through means similar to the way the world looks at the US economy as a *safe haven*. There is some substance in this, but it is mostly based on perception. And the perception must have been undergoing changes, especially with some signals of vulnerability that the US economy seems to be harbouring, through what happened in 911, the Enron-WorldCom and other scandals, the near collapse of the stock index, and may be the war on Iraq.

With a USD hegemony that seems unsustainable in the present global economy and finance a sustainable world monetary system should be built with a view to having a balance of multi-power economy. A multipolar world international finance based on relevant currencies instead of a single currency hegemony may be in order.

*(Dr J. Soedradjad Djiwandono, a former Governor of Bank Indonesia, is a Visiting Senior Fellow at the Institute of Defence and Strategic Studies.)*