

**IMPLICATIONS OF A WEAKER DOLLAR FOR
OIL PRICES AND THE U.S. ECONOMY**

HEARING
BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED TENTH CONGRESS
SECOND SESSION

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JULY 24, 2008
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IMPLICATIONS OF A WEAKER DOLLAR FOR OIL PRICES AND THE U.S. ECONOMY

Thursday, July 24, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2:03 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Maloney, Velazquez, Sherman, Scott, Green, Cleaver, Perlmutter, Donnelly, Speier; Bachus, Paul, Jones, Shays, Capito, Barrett, McCarthy of California, and Heller.

The CHAIRMAN. The hearing will come to order.

It is a busy time. On June 24th, just before we broke for the July 4th recess, I received a letter from many of my Republican colleagues headed by the ranking member of the Monetary Policy Subcommittee, Mr. Paul, and the ranking member of the full committee, Mr. Bachus, asking for a hearing because, "Neither the Federal Reserve Bank nor the Treasury Department have been willing to take responsibility for the dollar's slide over the past several years, while American consumers have been forced to pay continuing higher prices for gasoline, etc. With this in mind, we once again urge you to consider our request to hold a Financial Services Committee hearing to examine the dollar's weakness and its effect on the price of oil."

I am not familiar with any prior requests, so I don't know how they could once again do it, but as soon as I received this, I did agree to hold a hearing. We then had a fairly short window. So it has been a busy time for us, as people know, with the bill for us yesterday. This was the best time to do it. Thursday afternoon isn't always the ideal, and I apologize for that, but given when I got this and what the schedule was, this is the best we could do, and I was glad to respond. I will put the letter, without objection, into the record.

We will now have our opening statements. In the interest of time, I am going to waive mine.

I have made it clear that this is a hearing which the Republican colleagues asked us to call, and I was glad to accommodate that. They are right; this is a very important subject. The price of energy and the interaction of the value of the dollar with the price of energy is probably as important a subject as we have. Even people who may not be fully familiar citizens with the interactivity they have would think it is very important once they focus on it.

So with that, I am going to recognize the gentleman from Texas for his opening statement.

Dr. PAUL. Thank you, Mr. Chairman. I appreciate that very much, and I appreciate you holding these hearings at our request. I think these are very important hearings and a very important subject as well.

First, I would ask unanimous consent to submit a written statement into the record. Thank you.

I think what these hearings are dealing with is the essence of inflation. Everybody knows there is inflation out there, and nobody likes it. Everybody wants to take care of it, but they don't talk a whole lot about where it comes from. But if you do a survey of economists, whether they are conservatives or liberals or monetarists or Keynesians or whatever, almost all economists recognize that inflation is related to a monetary phenomenon. And they seem to agree with that, but then they don't dwell on the monetary phenomenon; they dwell on the prices.

And today, of course, people aren't very happy with the price of oil and energy, and they talk about obscene profits and not enough drilling and too much demand in China. And these factors may well play an important role, but supply and demand of the oil is one thing, but nobody really talks about the supply and demand of the dollar. And if the dollar goes down in value, that is going to push prices up. And we don't talk about that a whole lot.

A lot of times people, when they think about this issue, they talk about an economy when it gets heated, that they have to turn it off. A heated economy is bad, so they tighten the money and raise the interest rates to turn off the heated economy. But in reality, if you have a sound, healthy economic system, and it is vibrant and heated, actually that is very good. There is a lot of growth. And what happens when you have a lot of growth is that prices go down.

So it always seems so foolish to me when people talk about a heated economy, and they look at the prices and say, well, to get the prices down, we have to penalize the economy and turn it off and turn off the spigot. And that, of course, isn't the way it works if you have a sound dollar.

That is something that I have been talking about for a long time, and I am so glad that we are able to pursue that a little bit and relate higher prices to the monetary phenomenon. And if this is the case, if everybody agrees that it has something to do with monetary policy, and we don't like the consequences which are higher prices, in many ways it is semantical, because 99 percent of the people, you talk about inflation, they think the CPI is going up. But those of us who concentrate on the monetary system say, well, inflation comes from the increase of the supply of money, artificially low interest rates, now investment and artificial financial bubbles that need to be corrected, bringing up a recession. And I think we have a chance today to talk about that issue and see the relationship between money and prices, and that just drilling isn't going to be the answer to a problem which is basically monetary.

So once again, I want to thank the chairman for holding this hearing. And I welcome the panel.

The CHAIRMAN. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

World oil is priced in dollars. But the fact is that if the dollar was at 80 cents to the euro instead of \$1.55, we would be paying a lot less at the pump. The fall of the value of the dollar has made imports more expensive, but it has also begun to revitalize our manufacturing sector and led to more manufacturing exports.

The fact is we can't really control the value of the dollar. We do some jawboning. Every other country does everything possible to lower the value of its currency; we push in the other direction, which means either they are all idiots, or we are idiots. I will bet on the latter.

The one thing we could do to influence the value of the dollar is to raise interest rates. Other than causing a recession, I don't know why we wouldn't do that.

The fact is that trying to affect the value of the dollar cannot be done easily or effectively. The value of the dollar stems from our trade policy. The theory of free trade has the vast majority of economics professors backing it. It is an elegant theory. There are facts that contradict that theory. Those facts, therefore, must be ignored.

For example, we were told that the trade deficit was the fault of the U.S. budget deficit. We had a budget surplus under Clinton; the trade deficit grew. The fact must be ignored. Tourists come into this country from Japan to my City of Los Angeles to buy Japanese goods and fly back. Under the theory of open trade, that can't exist. It must be ignored. Now Europeans are doing the same thing on the east coast. All these facts must be ignored.

The trade deficit piles up. Even if it is only a \$700 billion trade deficit versus an \$800 billion deficit, there is a trade debt as our dollars accumulate overseas. What we learned in the housing crisis is that things that can't go on forever don't; and the willingness of the rest of the world to buy U.S. dollars forever will end, perhaps in a disruptive way.

What we need is a completely different trade policy, a policy that is based on facts, a policy that reflects—I mean, we sign these wonderful agreements with—arbitration provisions with China. One of their arbitrators voted for the American company. He is now in jail, a fact that must be ignored as we continue to subscribe to, let alone enter, new trade agreements. But the trade agreements are so beautiful on paper that facts like the imprisonment of a Chinese arbitrator must be ignored.

The reality is that America is a society with a rule of law. And so, if you change the laws, change the regulations, you open our market. Other societies are not, but that fact must be ignored.

The CHAIRMAN. The gentleman from Nevada.

Mr. HELLER. Thank you, Mr. Chairman.

In deference to times and votes coming up here pretty soon, I will postpone. I am more interested in the testimony. Thank you.

The CHAIRMAN. I thank the gentleman.

The gentlewoman from West Virginia.

Mrs. CAPITO. There is pressure now.

The CHAIRMAN. There always is.

Mrs. CAPITO. I want to thank the chairman for holding this hearing. It highlights an issue, I think, of interest all across this coun-

try. I would like to say that I have a constituent who writes me quite frequently on this exact issue, and I am pleased to see that we are going to be fleshing out his concerns and getting good information. So I appreciate the chairman for moving forward with this hearing.

Thank you. I would like to submit my full statement.

The CHAIRMAN. Without objection.

The gentleman from Georgia.

Mr. SCOTT. Thank you very much, Mr. Chairman.

This is indeed a timely hearing, and I want to thank the chairman and ranking member for holding it, and I am certainly looking forward to the information that this panel will give.

First, I believe we learned the hard way that our lack of being proactive as far as investing in renewable and alternative forms of energy as well as increased conservation programs, and it is finally, finally catching up with us. We are behind the ball.

I have talked often about the example of Brazil in moving forward and having the foresight to see, and I share with the panel my own visit in Brazil and being able to get down there and seeing firsthand and spending a week or so of what they have been doing over the last few years. There is much that we can learn.

Our country has for far too long conducted itself on the notion that oil is a finite resource. You know, nowhere is this impact on oil affecting us, not only consumers at the pump, but you just look at the airline industry itself and what they are going through, and they don't have the luxury right now of moving to a basically renewable fuel as we do with our automobiles that, if we move quickly, can take some of that downward pressure off some of these industries that don't have that choice at this moment. But I believe that this current energy crisis is one where we will have to finally learn our lesson and change our ways. The price of oil continues to increase, and experts expect the trend is set to continue for the next coming year or two.

Second, oil prices have jumped nearly sevenfold since 2002, in part by a broader commodities rallies sparked by the demand from emerging economies such as India and China. If we keep going at our rate, our energy needs in the next 10 years will increase pretty close to 22 percent. China's would increase pretty close to 180 percent. And then you have India and some of the other developing nations. This is a very urgent, very critical issue.

And, third, and what we are addressing today in this panel discussion, the falling dollar, the weakening dollar and the high price of oil. It is true the American dollar's fall is a detriment to access to foreign oil. The dollar is worth less, and so oil-producing countries are requiring more money to purchase the same barrel of oil. And we know the exchange that is used is our money, it is all on the dollar.

A couple of examples: It takes close to \$1.60 to purchase a euro, and the Canadian dollar is now worth more than the U.S. dollar, whereas, for more than 3 decades, the Canadian loonie was worth quite a bit less than our own dollar.

So is the immediate cause of rising oil prices the weak dollar? That is the fundamental question we have to answer, and I look forward to that. I am interested in hearing to what extent our dis-

tinguished witnesses believe that our dollar is contributing to our oil price and supply woes.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman, for calling today's hearing, which was requested by the gentleman from Texas, Mr. Paul, and 16 other Republican members of the committee.

Mr. Chairman, at a time when the cost of gasoline is the biggest pocketbook issue for most Americans, it is important that we look at all the factors behind oil prices. Let me stop right there and say that I represent Bibb County, Alabama, where the average take-home pay is \$285 a week. I have constituents who are paying \$90 a week to put gas in their tanks, and they can't continue to do that. It is the biggest source of financial stress in my district. It is having a really devastating impact. I have constituents who tell me they are having to change their eating habits; they are having to substitute beans for meat. So this is absolutely a tremendous stress.

One of the factors is the impact of the weaker dollar and what effect it has had on the price of oil and indeed all commodities. Here they are hit with the gas prices, and then food is going up. So that is hitting them.

One recent study by the IMF suggested that if the value of the dollar had remained steady against other currencies from 2002 through the end of last year, the price of a barrel of oil would be about 25 percent less than it is today.

But make no mistake about it, our fundamental problem is with supply and demand. We are not producing enough American-made energy to meet our needs, so foreign oil producers are holding us over a barrel. And when I talk about energy, I am not talking about just oil, fossil fuels; I am talking about any kind of energy production. We need it all. We need solar, we need wind, we need nuclear. We need everything.

Federal Reserve Chairman Ben Bernanke made a statement before our committee last week that deserved more attention than it got. He said that a 1 percent increase in oil production could lower prices by 10 percent. I thought that would be headline news the next day, but I didn't see any paper report that.

In a survey I just did in my district, there was a strong opinion that with gas now at \$4 a gallon, the United States must do more to develop the abundant energy resources we have here at home. As I said, that includes our oil and natural gas reserves offshore and in Alaska. It involves nuclear, coal, wind, solar, as well as renewable fuel. And energy production is just one leg of the stool. Conservation ought to be another. We should talk about both of them and new technologies for the future. Hydrogen may be 20 years away or something, but we need that. By diversifying now through responsible exploration or licensing new nuclear power plants, just to name two examples, we ensure that Americans have renewable, affordable energy over the long run.

Mr. Chairman, in closing, high gas and energy costs are a burden for all of us, for our families, and for our schools. It is impacting local governments, businesses, and manufacturers. And they slow our economy. Congress should be devoting its full attention to the

issue, and to the extent today's hearing draws attention to that fact, it will have served a very useful purpose.

Thank you again, Mr. Chairman, for holding this hearing. I look forward to the testimonies of our distinguished gentlemen.

The CHAIRMAN. Let me make a procedural explanation in fairness to the witnesses and to the members who have asked me to call this hearing. We are about to have a vote on one amendment to the pending bill. That will last 15 minutes. And there will then be debate on the motion to recommit, which takes 12 to 13 minutes, and then a 15-minute motion to recommit.

I am prepared to stay here through the last amendment vote, so I will keep the committee in session. I would urge members, in consideration of witnesses, to go and vote right away on that first vote. If you then come back, we will have a half hour before you have to go back again. Otherwise, we lose about 40 minutes. If that is acceptable, we will begin with the statements.

We will start with Mr. Bergsten.

**STATEMENT OF C. FRED BERGSTEN, DIRECTOR, PETERSON
INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. BERGSTEN. Mr. Chairman, let me start by congratulating you and this committee for the housing bill that passed the House yesterday. You have done an enormous service for the country. I want to congratulate you and indicate great support for that.

I also want to indicate how that bill addressing the country's economic and financial problems is the perfect context in which to discuss today's issue, the exchange rate of the dollar, oil prices and the like, because they are so central to the economic and financial outlook. As I will indicate in my comments, what happens to the dollar could have a major, indeed decisive, impact on where the economy goes and the scope for policy to respond to the economic difficulties that we face. So I want to go through a quick analysis, as requested, of the dollar's impact on the economy, what it implies for policy, and a few suggestions for the committee and the Congress.

First, just so we are starting from the same place, is the dollar weak? I would say, no. The dollar is at about the level that it was in 1980, again in 1995, and we still have a very large trade deficit, as Congressman Sherman indicated. The dollar went way up from 1995 to 2002. It has come back down over the last 6 years. It is just about where it started in 1995, which is about where it was in 1980. So we have had lots of ups and downs. The dollar is certainly weaker, but it is not weak.

What about its effects? The good news, and Mr. Sherman already mentioned that, is that the weaker dollar has already contributed to a very substantial improvement in the U.S. trade balance and thus our overall economy, and it is for sure going to lead to much more improvement. Every fall of 1 percent in the trade-weighted average of the dollar tends to strengthen our trade balance by \$20 billion to \$25 billion after a lag of 2 to 3 years. Our net exports of goods and services in real terms, as included in the GDP account, have already strengthened by about \$150 billion over the last 18 months, and we can expect a like improvement of another \$150 billion or so in real GDP terms over the next 18 months or

so, for a total gain from the weaker dollar and continued growth abroad of about \$300 billion in our economy.

In fact, that sharp reduction in the external deficit has provided all of the U.S. economic growth in the 4th quarter of last year and the 1st quarter of this year, the latest quarters for which we have data. There was no increase in domestic demand during that half-year period, but net exports have been growing at an annual rate of about a percentage point of GDP. Hence, they have kept us out of recession at least to date.

This likely trade gain of about \$300 billion in real terms translates into the creation of more than 2 million jobs for the U.S. economy. Moreover, these mainly export jobs pay 15 to 20 percent more on average than the national wage.

Given the fact that domestic demand has been flat and aggregate unemployment rising, these trade gains are extremely important. What it says is that the lower dollar and the globalization of the U.S. economy are providing a major boost to our economy just when we need it. That is the good news.

The bad news is that a weaker dollar does, as several Members have already indicated, mean higher prices in the United States. Every decline of 10 percent in the average exchange rate of the dollar tends to produce a subsequent increase in the Consumer Price Index of about 1 percentage point. So the dollar, having fallen by about 25 percent over the last 6 years, we can expect something like a rise of 2 percent in the price level in the United States.

However, it is important to realize that a one-shot fall in the dollar leads to a rise in the level of prices but not to a higher rate of inflation. The inflation rate would increase permanently only if the dollar continued to decline, just as the trade balance would record further gains only if the currency were to keep falling to lower levels.

Now, as Mr. Paul and others have mentioned, concern has been expressed that the weaker dollar has been an important contributor to the sharp rise in the price of oil. Chart 2 in my handout indicates the relationship, and I would come to a simple conclusion. Historically, there has been very little correlation between the dollar and world oil prices. When the dollar declined by 30 percent back in the mid-1980's, the oil price collapsed to less than \$10 a barrel. Back when we had an upwards spike in oil prices in the early 1990's, around the time of the Iraqi invasion of Kuwait, that spike in oil prices correlated with a flat or rising dollar. Oil prices and the dollar rose together in the late 1990's.

Now, during this last period, the global price of oil, as already mentioned, has risen about sevenfold, while the dollar has fallen by only about 25 percent. This is a far higher ratio of oil price rise to dollar fall than has existed over any previous, let alone extended, period. Moreover, the price of oil has risen sharply in all currencies, including the euro and other strong currencies, not just the dollar. Other commodities, even those that don't trade on exchanges, have risen as much as or even more than oil. And even for the short run over the last 6 weeks or so, while the dollar has stabilized, the oil price continued to escalate sharply. If you want to look at the last few days, the oil prices plunged without any concomitant rise in the dollar.

So it is very hard to find any systematic correlation. I didn't bother you in my paper with regression analyses. We have tried to run regressions that throw in every possible time period, every specification. You just don't find the correlation.

Other factors in the exchange rate, which I summarized in my statement, I think explain very persuasively the change in the price of oil.

The CHAIRMAN. Mr. Bergsten, they changed the order of votes. I thought the first vote was one that I could easily miss. It is now one that I cannot miss. We may have to wait about 45 minutes. I hope you can accommodate us. I apologize, there is no way to tell. We are going to take a break.

Mr. BERGSTEN. I just have 2 more minutes in my statement when I come to what I think is the key point.

The CHAIRMAN. I apologize. I thought you were finished. It is dangerous to pause around here.

Mr. SHERMAN. Mr. Chairman, will we come back while they debate the motion to recommit?

The CHAIRMAN. We can vote on this one, which is 15 minutes; we can vote on the second one, which is 15 minutes, or we vote right away. There will then be about 40 minutes before they get back to voting. So that is what we will do.

So please finish, Mr. Bergsten.

Mr. BERGSTEN. Finally, and I think critically for this committee, the most uncertain impact of a weaker dollar relates to the foreign financing of the U.S. external deficits. Even with the trade improvements that I mentioned, we are still running annual shortfalls that will total at least \$500 billion a year. These shortfalls require us to attract foreign financing of a like amount to balance our international books.

Now, the lower dollar makes U.S. assets cheaper, and that ought to increase foreign interest in investing here. On the other hand, fears of further dollar declines could deter investors and, in fact, lead them to seek higher returns on their U.S. investments to offset that risk. The central question is, thus, foreign expectations of the future exchange rate of the dollar. This, in turn, poses the central challenge of the dollar for U.S. economic policy.

Fears of further falls in the exchange rate could lead to a flight from dollar assets, by Americans as well as foreigners, incidentally. The consequent sharp decline of the dollar if there were such a flight could force the Federal Reserve to raise policy rates to fight the incipient rise in inflation pressure right in the face of financial fragility and a soft economy.

As you well know, and I know you discussed it with Chairman Bernanke last week, the monetary authorities already face an acute policy dilemma; on the one hand a sluggish economy, on the other hand rising inflation.

The CHAIRMAN. We have a vote, so you need to move quickly.

Mr. BERGSTEN. So the conclusion is if the dollar were to fall out of bed, it would put policy in this country, particularly the Fed, in an impossible dilemma of having to raise interest rates to fight the inflationary effects of the lower dollar. Therefore, one last sentence, we may need a new policy instrument. I believe in that circumstance, we would have to consider joint intervention in the for-

eign exchange markets to keep the dollar from falling sharply without distorting monetary policy as it attempted to fight financial fragility and continued sluggishness in the economy.

[The prepared statement of Mr. Bergsten can be found on page 38 of the appendix.]

The CHAIRMAN. We are going to now go back and vote. I again apologize. As I say, they changed the order. We will go and vote. We will get at the end of that one vote. Members who want to can then take the second vote. We will then have another 40 minutes, and I think that is the best we can do. So we are in a brief recess that I hope won't be more than 15 minutes.

[Recess]

The CHAIRMAN. I now recognize Joseph Kasputys, who is the chairman and CEO of Global Insight, the offices of which are about a mile from my apartment.

**STATEMENT OF JOSEPH E. KASPUTYS, CHAIRMAN AND CEO,
GLOBAL INSIGHT, ON BEHALF OF THE COMMITTEE FOR
ECONOMIC DEVELOPMENT**

Mr. KASPUTYS. Thank you for pointing that out, Mr. Chairman. I should also say that I am here representing the Committee for Economic Development, of which I am the co-chairman, and I would like to address the questions that the committee has called this hearing about.

I would really like to point out our views on both oil and the dollar, but then go beyond that and point to our views on the role of the dollar in attracting foreign investment and the need for that foreign investment in the long term under the current policies that we find the United States following.

We all know the U.S. economy is facing some very difficult times—the subprime housing price collapse and the resulting consequences for construction, financial institutions, financial markets, and households. At the same time, we have strong demand and capacity constraints, lifting the price of oil close to \$150 a barrel, and it remains high despite some very recent downward adjustments. This has a big adverse impact on consumers, airlines, the automotive industry, and other industries as well. We have seen other commodities and food follow the same path, putting the policy-makers in the United States in the difficult position of having to fight inflation, deal with an economic slowdown, and restore the credibility of financial markets all at the same time. Some of these problems have certainly spilled over to Europe; Asia has been largely spared, although not completely untouched.

One could say that the U.S. economic difficulties we are currently experiencing, such as the subprime crisis, excessive housing prices collapsing, and the loss of confidence in U.S. financial institutions abroad, has contributed to a weaker dollar, and this in turn has contributed to higher oil prices. I would agree that there is some of that in the oil prices, but only to a minor extent.

We believe that the major factor in determining oil prices is not the current level of the dollar, but the strong demand around the world, notably of Asia, a very tight supply/demand balance between the 88 million barrels or so a day that is required to meet growing demand versus low additions to supply due to a long-term lack of

investment, natural disasters, and political problems, which often can be disruptive to oil supply.

I would note that from 2005 to today, the oil price in dollars has increased by about 233 percent; the oil price in euros has increased by about 175 percent. So we can't say that the increase in oil prices is all due to the weakness of the dollar when you look at figures like that.

One could also note that the Middle East oil exporters that have pegged their currencies for various reasons to the dollar want to maintain the real purchasing power of that dollar particularly so they can afford the imports that they buy from nondollar-based economies. In this regard, if you look at the Saudi currency over this same period, it has only depreciated by about 9 percent on a trade-weighted basis. The same thing can be said of the UAE. So it is not the depreciation of their trade-weighted currencies that is driving the oil prices.

As Mr. Bergsten has pointed out, the weak dollar did indeed help exports in 2007 and 2008. Almost all U.S. growth is now linked to exports. Our current account balance, good news, has dropped from about 6.6 percent of GDP in 2005 until recently to about 5 percent of GDP.

Is this really good news? Well, yes, it is moving in the right direction. But we still need to attract about \$1.5 billion a day to finance our current account deficit versus \$2 billion a day when the deficit was at its peak. It is still too high. The United States is continually adding to the problem in its net international investment position, which is unfavorable, and continuing to deteriorate.

Now, with oil prices in 2008, it is likely we will face an increase in the oil bill, which will more than offset the good effects of the weak dollar on our exports. We are estimating that it is about a \$90 billion swing there with a \$260 billion increase in the oil bill, more than offsetting a \$166 billion improvement in other parts of the current account.

So the current account deficit will grow again relative to the GDP, and we believe this has negative implications for the dollar, and, if continued indefinitely, could result in very undesirable consequences for the economy.

In September of last year, the Committee for Economic Development released a study entitled "Reducing the Risks from Global Imbalances." The report we produced argued that the large global imbalances are unsustainable and, if not corrected, significantly raise the risks of financial and economic instability and the adoption of protectionist trade policies. This study noted, however, that market mechanisms were likely to reduce the imbalances, but this adjustment should be facilitated by sensible and self-interested policies by the major nations involved. The study outlined actions by the United States and other involved countries that would help the process of global adjustment and a reduction of imbalances. These measures would be most effective if adopted by all the countries contributing significantly to the imbalances.

The immediate problems of the worldwide credit crunch and economic slowdown have drawn attention away from longer-term concerns about global imbalance and related economic pressures. We really think that we need to look longer term. The Federal budget

deficit and our generally low national savings rate materially contribute to a persistent current account deficit. The growth in Federal entitlement programs the way they are currently structured is only going to increase and aggravate this further. And as the United States recovers, which will probably be in the end of 2009, we think the current account deficit will begin to grow again.

So, we think there is a serious long-term structural problem where the United States is going to need to attract more foreign investment into the United States. And I am concerned with the degree to which we have been depending on nations that we trade with to recycle their dollars into low-yielding Treasuries, and now we see about \$3 trillion in surplus in the hands of countries, and about \$1 trillion of that has been placed in sovereign wealth funds. These sovereign wealth funds are beginning to be managed by professional money managers. They are going to be looking for higher yields. They may not be willing to accept the low yields of Treasury bills.

So what to do? We think, of course, the credibility of financial markets needs to be restored. And many things that started in this committee, enacted by the Congress, the stimulus that has been enacted, have all been good things, but more needs to be done on a long-term basis.

The CHAIRMAN. We need you to wrap up in about a minute.

Mr. KASPUTYS. Thank you.

Along with measures being taken to support the U.S. economy currently, we have to address the global imbalances.

We do think that oil prices will ease as world growth slows and new capacity is developed. However, the upward pressure on oil prices is more likely to be sustained longer than in previous cycles due to the very tight current oil supply and demand imbalance. Working on energy security and reducing energy dependence is really a win-win, which would help reduce the current account deficit and help the United States in many other ways.

The CED calls for more coordinated international actions to reduce imbalances. We think that in the United States, we need to deal with persistent high Federal budget deficits, and we need to take measures to raise private savings, even though near-term actions are needed to stabilize the financial situation and do come at a cost.

The CHAIRMAN. We have to take about 15 seconds. I don't mean to be rude, but I can't manufacture minutes. You have, I hope, some general conception of the time constraints, and you have to accommodate to them.

Mr. KASPUTYS. One last sentence: The United States has a key role to play in a program to reduce imbalances by putting its own house in order, predominantly including action to reduce the Federal budget deficit that exists now and under current policies will only grow; and then the United States can provide leadership with other countries to get them to cooperate in a coordinated program that will reduce our vulnerability to the high current account deficit and dependence on foreign investment.

Thank you.

[The prepared statement of Mr. Kasputys can be found on page 51 of the appendix.]

Ms. VELAZQUEZ. [presiding] Thank you.
 Our next witness is Mr. Walter J. Williams, economist,
 ShadowStats.com.

**STATEMENT OF WALTER J. WILLIAMS, ECONOMIST,
 SHADOWSTATS.COM**

Mr. WILLIAMS. Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to discuss the implications of a weaker dollar for oil prices and the domestic economy.

A weaker U.S. dollar helps to spike oil prices and otherwise generally fuels domestic inflation, reducing the purchasing power of consumers' paychecks and the real value of their assets. The underlying factors that have led to recent turmoil in the currency markets remain in play. While significant further weakness in the dollar would place additional upside pressure on oil prices and domestic inflation, it also could encourage oil producers to denominate oil prices in a currency or currencies other than the U.S. dollar, which would exacerbate U.S. inflationary pressures. Separately, further weakness in the dollar could threaten domestic financial market liquidity, complicating the systemic challenges already being addressed by the Federal Reserve.

On the plus side for the economy, a weaker dollar tends to help narrow the trade deficit. Yet the positive effects are seen primarily in commodity-like goods. Where quality and features are important to the goods and services traded, the impact is quite muted.

From the standpoint of consumer inflation, a number of factors influence prices, including the value of the dollar. A weaker dollar means that those living with dollar-denominated incomes and assets are losing purchasing power and real value against the non-dollar-denominated world. Over the long term, that lost global purchasing power tends to be reflected in domestic inflation and a parallel loss in domestic purchasing power.

For example, since March 1985, the dollar has lost 50 percent of its purchasing power against the major Western currencies, while the dollar has lost 51 percent of its domestic purchasing power to inflation. There are different ways of measuring the dollar's value.

An historically high negative correlation between movements in the dollar and oil prices suggest that the dollar weakness adds some upside pressure to oil prices. With oil denominated in dollars, dollar weakness provides an effective discount to nondollar-based economies due to the relative strength of the local currency. While dollar oil prices had nearly doubled for the year which ended June 30th, oil prices were up only 70 percent in terms of the yen and the euro.

In response, market forces tend to balance the effective discounts with upside pressure on the oil prices and dollars. Additionally, it is in the direct interest of oil producers to see upside pressure on dollar oil prices as an offset to global purchasing power being lost in weakening dollar-denominated revenues.

As to the domestic financial markets, where the U.S. trade deficit has pumped excess dollars into the global markets, a significant dollar overhang has developed particularly with foreign central banks. The investment of these holdings in the United States has

kept the domestic credit and equity markets relatively flush with liquidity. Perennial weakness in the U.S. currency, however, discourages such investment, and intensified dollar selling is a risk in the months ahead. Such selling could trigger dumping of the dollar and dollar-denominated assets. The same could result from efforts to mitigate the impact of higher oil prices with an offsetting decline in the dollar. Unless otherwise compensated for by the Federal Reserve, such action would drain liquidity from and correspondingly roil the U.S. financial markets.

The relative value of a nation's currency is a measure not only of its trade position, but also of global capital flows that mirror how the rest of the world views that nation's economic strength, financial-system integrity, and political stability. While the U.S. dollar's exchange-rate value has experienced high volatility over time, it generally has trended sharply lower during the last 4 decades, having hit historic lows in recent months against currencies such as the Japanese yen and the Swiss franc. The current circumstance results from extended periods of deliberate debasement or neglect of the U.S. currency by various Administrations and Federal Reserve Chairmen.

Contrary to popular conventional wisdom, the dollar does matter, and so does the budget deficit. The dollar issues are coming to a head. The deficits issues are related, but are still smoldering in the background.

Underlying fundamentals that drive the real relevant value of the U.S. dollar against the currencies of its major trading partners could not be much more negative. The key factors or surrogates for global market concerns include the relevant U.S. condition on trade balance, economic activity, inflation, fiscal discipline, interest rates and political systemic stability. Only interest rates and related monetary policies are quickly addressable and present. Changes there could run counter to the Federal Reserve's needs and its current efforts to promote systemic financial stability and could be somewhat counterproductive in what I contend is currently a recessionary environment.

Neglecting U.S. dollar weakness and providing nothing more than unsupported jawboning of a strong dollar policy begets further selling pressure on the dollar, promising further upside pressure on oil prices, further depreciation of U.S. consumers' purchasing power, and increased risk of a torrent of dollar dumping and resulting turmoil in the U.S. financial markets.

Thank you.

[The prepared statement of Mr. Williams can be found on page 69 of the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Williams.

Our next witness is Mr. Robert Murphy, economist, Institute for Energy Research. Welcome.

STATEMENT OF ROBERT P. MURPHY, ECONOMIST, INSTITUTE FOR ENERGY RESEARCH

Mr. MURPHY. I thank the Chair. I understand we are in a time constraint here, so I will just briefly summarize my written testimony. I am just going to talk about what the Institute for Energy

Research believes to be the causes of record oil prices and then offer some possible remedies for that.

I am an economist. You ask, why are oil prices so high? I am going to say it is because of supply and demand. On the demand side you have, as everyone has been alluding to, in the developing countries, demand for oil has been growing very rapidly from 2003 to 2007. For example, in China, petroleum consumption has increased about 8 percent per year over that period. And I want to stress that a lot of people misunderstand that, and they say, well, 8 percent a year is high, but, you know, oil has been going up a lot more than that. But the fact is China's consumption has been increasing 8 percent on average from 2003 to 2007 while oil prices were going through the ceiling.

The way to compare and say how much has the demand itself shifted in terms of its effect on the price, you would want to say, well, if oil had stayed at \$30 a barrel, which it was in 2003, how much more would China's consumption have grown? So that 8 percent figure, some people misunderstand the significance of that.

On the supply side from 2005 to 2007, world output was roughly flat. What happened was as non-OPEC production went up slightly in that period, OPEC production actually went down to almost perfectly offset it. But from the second quarter of 2007 to the present, OPEC has actually been increasing. So the last quarter we have actually had the highest-ever world output of oil, but demand just keeps increasing, so that is what has put upward pressure on oil prices.

The last component of this explanation which is relevant to today's testimony is the role of the dollar. So from June of 2007 to June of 2008, oil prices increased about 104 percent, but at the same time, if you look at the euro price—or, excuse me, the dollar price to a euro, that has increased about 16 percent, so that in a sense we can say, why did oil basically double in the last year? Well, at least 15 percent of that is solely attributable to the decline of the dollar against other currencies.

I just would remind people that oil is a fungible commodity traded on a world market. So if the dollar falls against other currencies, you might not see the price of a haircut go up right away, but you will see the price of oil go up, other things being equal, because foreign countries can sell oil to other buyers. So if the dollar falls, the dollar price of oil is going to go up.

If those are the causes, then the question is, what are the remedies? Now, just a caveat; here is an economist advising policymakers of their options. These aren't recommendations per se. There are various drawbacks to these things, environmental issues, concerns about budget deficits, what have you. But if the question is what can Congress do to bring down oil prices, here are some examples.

In terms of conventional resources, we have 37 billion barrels of crude that are off limits by the government's own estimates, offshore and onshore Federal lands. So if Congress would remove the moratorium on those, then that is barrels of oil right there that could be developed and bring down oil prices. Also, if Congress legalized oil shale development, there are some 800 billion barrels of resources available according to government estimates. That is 3

times the amount of reserves that Saudi Arabia has, so there are plenty of U.S. oil supplies. The question is just, is the government going to allow American companies to develop them?

Finally, what can the government do if it wants to raise the dollar's exchange value in the foreign exchanges? Of course, the Federal Reserve could raise the target rate, but also Congress could lower income tax rates. That increases the after-tax return to U.S. assets, and so investors around the world would tend to flock into those assets. For example, during the first Reagan Administration, after those tax cuts went through, the dollar soared on the international exchanges.

Thank you.

[The prepared statement of Mr. Murphy can be found on page 60 of the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Murphy.

Mr. Kasputys, if I may, I would like to address my first question to you. In this Administration, 7.5 years in office, the United States has run up record domestic budget deficits to pay \$800 billion for wars in Iraq and Afghanistan and a simultaneous \$1.7 trillion tax cut. How have these domestic spending initiatives contributed to the weak dollar and the resulting increase in oil prices?

Mr. KASPUTYS. Well, I think in terms of how the weak dollar has contributed to the oil prices, as I said in my statement, I really believe the weak dollar has only had a minor impact on oil prices, and we have seen oil prices increase in euro terms by a substantial amount, notwithstanding the weakness or the strength of the dollar. So there is no question in my mind but that the strong demand throughout the world, particularly in developing countries, as has been pointed out by other witnesses, with supply being very slow to come on line and subject to many disruptions, has had a great deal to do with the rise in oil prices. I think this is on a path of being corrected.

To address your question, though, in terms of how have the continual very large budget deficits affected the dollar, I believe they have affected it adversely. The budget deficit, combined with a relatively low private savings rate, means that we are also running a very large current account deficit. We are consuming a lot more than we are producing. If we are going to consume more than we produce, we have to buy it overseas. If we buy it overseas, we have to pay the bill. More and more dollars are winding up in the hands of other countries, and it contributes to a general weakening of the dollar.

Ms. VELAZQUEZ. Thank you.

Mr. Bergsten, many economists estimate that nearly 40 percent of the increased price American consumers are paying for oil is attributable to the weak dollar. Clearly, this leaves a significant amount of room for other factors that have also contributed to the price increase. Can you comment on how much the continued instability in the Middle East and the uncertainty of U.S.-Iranian relations have contributed to the increasing oil prices?

Mr. BERGSTEN. I very much doubt the premise of the question that anything like 40 percent of the rise in the oil price is due to the lower dollar. I indicated in my statement that the relationships just don't support that at all. Mr. Murphy suggested 15 percent

over the last year. If you take his methodology and look over the last 6 years, the dollar has come down 25 percent. The oil price has gone up 600 percent. So that means you could attribute maybe 3 or 4 percent of the total to the dollar.

As far as the security premium due to Iran and other geopolitical factors are concerned, estimates range all over the lot from \$10 to \$50 a barrel in the price. That would be about 10 percent to considerably more than that. There clearly is a geopolitical premium, a security risk in the oil price. I don't think any economic or political science methodology exists that can quantify it, but it is not insignificant.

As with all these other explanations, the question is what to do about it. And if anybody has a good idea for what to do about the Iranian nuclear problem that would take it off the agenda, I would certainly like to hear it, and it would help, among other things, in tempering the oil price.

Ms. VELAZQUEZ. Thank you.

Mr. Williams, would you like to comment?

Mr. WILLIAMS. Yes. Relationships and these factors change over time. The effect of the falling dollar on oil prices is a factor, among many others. The supply factors are dominant—supply and demand factors are dominant over time. But what we have seen in the last year has been increasingly unstable financial markets. Most recently you have had problems with the banking system, actions taken by the Fed to stabilize that circumstance, and those actions have intensified concerns in the currency markets that have led to having selling pressure on the dollar. It has made foreign investors very uncomfortable, and because of that discomfort, because of the extreme volatility, I think you have seen also an intensified relationship between the movement in the dollar and oil.

Ms. VELAZQUEZ. Thank you, Mr. Williams.

Mr. Paul.

Dr. PAUL. Thank you, Madam Chairwoman.

My question is directed toward Mr. Williams and Mr. Murphy. It has to do with talking a little bit more about the weak dollar. I think everybody is talking about a weak dollar having an effect, some say a lot, and some say less, on the prices.

But my basic assumption is that—and I don't think it is hard to argue that if you create a lot of new dollars, the value has to go down, unless some people argue, well, production is up, we might be able to, you know, stave off some price increases. But if the money supply goes up rapidly, and if we increase the money supply by 2 or 3 times immediately, the value of that money is going to go down, and prices will go up.

Of course, the subject we are dealing with today is, does the money supply increase? Has the money supply been increasing? You know, in 1971, there was some restraint on the Federal Reserve to create money out of thin air; not much restraint, but there was some.

Tell me a little bit about what is happening not only with oil, but commodities, because in one sense we are talking about oil, but we are really talking about the value of the dollar related to commodities. What has happened with the money supply since 1971, and how has that affected our prices? Is this significant or not? And,

you know, how should we measure this? There was a time that we measured this by M3, the total money supply.

The Fed creates money to help the politicians cover up their debt. They monetize debt. And then we have fractional-reserve banking. And then when all that happens, we used to measure it, and it was called M3. But we don't even have this. And some people would still like that to have that number and think about the relationship, all this money, prices today specifically dealing with the price of oil.

Could you expand a little bit on that, on this pressure we put on the Fed to monetize debt and fractional-reserve banking, what has happened to the money supply? Is M3 important? What is this relationship?

Mr. WILLIAMS. Sure. What has happened over time, and indeed with the general monetary theory, the definition of inflation is basically an increase in money. If you look at the traditional equation on it, it has a level of money times its velocity—times velocity, which is the number of times the money turns over in the broad economy, equals the nominal GDP before inflation adjustment, which is effectively a constant dollar measure, a physical measure of the economy plus the measure of inflation, so that the inflation, if you reworked the formula, is pretty much a function of the growth of the money supply and velocity.

Unfortunately, it is very difficult to come up with meaningful measures that fit into the theory. I believe the theory is correct. I think that has been demonstrated over time. But I will contend that you do not have a measure of the GDP and the GDP implicit price deflator or even a measure of the money supply that actually fully reflects or accounts for everything that is happening in the world. It is very difficult to move from theory to the real world.

In terms of M3, though, that has been the broadest measure over time. The Fed stopped publishing it a couple of years ago. I have continued to track it, estimate it, largely using Federal Reserve numbers. What we are seeing right now is an M3 as the broadest measure, which I believe is the best predictor of inflation, is up as of June, year to year, 15.8 percent, very close to 16 percent, and that is off its peak of 17.4 percent back in April, but shy of the current period. The last time you saw anything close to that was back in June of 1971 when M3 growth on a year-over-year basis hit 16.4 percent. That was 2 months before President Nixon closed the gold window and imposed wage and price controls.

Now, if you want to predict inflation using the money supply, it is difficult to do it from a traditional theoretical standpoint. Over the last 25 years, I have worked in terms of coming up with practical ways of predicting inflation interest rates and economic activity using a variety of indicators that have leading relationships with what I am trying to predict. I found over time that with the money supply, the broadest pressure you can use would generally give you the best result in terms of what is going to happen to inflation. And what we are seeing with M3 right now suggests that where the official CPI is being reported year over year at about 5.0 percent could be in double digits.

Ms. VELAZQUEZ. Time has expired.

Mr. Sherman.

Mr. SHERMAN. Yes. First a couple of questions for the record that I would like you to respond to in writing. One is, how do we achieve a sudden one-time-only decline in the value of the dollar without having a fear of further declines?

The second question is for Mr. Murphy, and that is, you suggest that by reducing taxes on investment, that will cause the dollar to strengthen. I am assuming that you are guessing that decline in taxing on investment would be matched in an increase in taxes on labor or some sort of magical harmless cuts in expenditure; or alternatively, are you saying that a cut in taxes on investment would have a strengthening effect on the dollar that would massively outweigh the weakening effect of an increase in the Federal deficit?

Now the questions to deal with orally. I have a question for which I am hoping each panelist can provide me a one-word answer. As the ranking member pointed out in his opening statement, I asked Mr. Bernanke when he was here last week about the price elasticity of oil, and he put forward the idea that a 1 percent decline in demand or a 1 percent increase in supply would result in a 10 percent change in the price. I would ask each of you to just give me your best number. I know it is an unfair question. I know there are lots of caveats. But all things remaining equal, a 1 percent increase in supply or decrease in demand would have an effect on supply of what percent?

Mr. BERGSTEN. The 10 percent, I think, is okay, but over an extended period of time, it is very low, that response, that price elasticity is very low in the short run. And anything like a 10 percent change would have to take place over an extended period of time.

Mr. KASPUTYS. I am not sure I can give you a one-word answer other than I agree with what Mr. Bergsten said. If we had a 1 percent increase in supply, right away it would be very significant because it would take out a lot of the fear of a real shortage by—

Mr. SHERMAN. Would a 1 percent decline in demand have the same effect? I mean, supply and demand rules would say yes, but you may be—

Mr. KASPUTYS. No, because we can see the supply. We are not sure when the demand is going to emerge. You can have China come back in very quickly based on policies.

Mr. SHERMAN. So you would need to see a decline in demand that was structural and unlikely to be changed back?

Mr. KASPUTYS. I agree. Yes.

Mr. SHERMAN. Just as an increase in supply would have to be a new, producing oil well, not just a sudden sell from the SPRO.

Mr. KASPUTYS. A structural change.

Mr. SHERMAN. Structural long-term change is not—

Mr. KASPUTYS. It is really net spare capacity. What you want to look at is net spare capacity worldwide.

Mr. SHERMAN. Okay. Next.

Mr. WILLIAMS. Well, you have had 10 percent swings both to the upside and downside, more than that in the last month or so, and that is really a significant shift in production.

Mr. SHERMAN. That is just wild speculation.

Mr. WILLIAMS. I know; 1 percent relative gain in supply versus demand certainly is a positive. I can't put a hard number on it. Ten percent might be fine, but, again, it is a very volatile number.

Mr. MURPHY. Yes, I would go with most of what they said. Right now, a 1 percent increase would roughly double or more than double world spare capacity. So, yes, that would have a tremendous effect, 10.378 percent.

Mr. SHERMAN. 10.378. I like that precision. And we are all talking here about a world price. We are talking about world demand and world supply. A change of supply or demand in just one country would—oh, might have a much smaller effect on the world.

I would also point out that—is my time expired?

Ms. VELAZQUEZ. Almost.

Mr. SHERMAN. I would also point out that we consume 25 percent of the world's oil, and we produce roughly 5 percent, so a decline in our consumption would have a much more dramatic impact than an increase in our production. That is to say, a 1 percent decline in our usage of 21 million barrels per day would have a much bigger impact than a 1 percent increase in our 5 million barrels per day.

Do I have time for one more question?

Ms. VELAZQUEZ. No.

Mr. SHERMAN. No, I don't.

Ms. VELAZQUEZ. Your time has expired.

Mr. Shays.

Mr. SHAYS. I thank the gentlelady for conducting this hearing.

And, gentlemen, thank you for being here.

I went through an epiphany, frankly, after Hurricane Katrina, realizing there were so many wells in the coastal area, the refineries, the fact that 11 States allow gas to come up to my State of Connecticut. And I hear a debate in my own State about, we are not going to have a line come through the State of Connecticut because it is going to help New York. Thank God there are people who allow energy to come to us domestically.

But let me just say this as well in terms of internationally. We have Canada that is drilling right off its coast, Newfoundland, all along its coast, and I am told that at least 400,000 homes are heated by natural gas that comes from Canada. One, is that correct? And, two, tell me the negative impact of their mining and drilling off their coast on the Atlantic seaboard. Mr. Williams or Mr. Murphy?

Mr. WILLIAMS. I am not familiar with the imports of natural gas from Canada, so I really can't give you an answer.

Mr. SHAYS. Mr. Murphy, can you jump in there?

Mr. MURPHY. I can't definitively confirm that, but those numbers do sound plausible. And to my knowledge, there have been no adverse impacts environmental from that.

Mr. BERGSTEN. Can I just add that Canada is the largest energy supplier to the United States, not Saudi Arabia.

Mr. SHAYS. But, you know, when I look at the map, there is just this line. It is the border. And there is the sense that the field may go all the way down past New York. And it just seems to me—what I wrestled with, I understood why we didn't want to go after our reserves when we continue to waste so much energy. So I took the view that until we started to conserve, until we started to say we are going to do renewable, solar, wind, geothermal, biomass, I am not mining these reserves. But I am at a sense where we have it

now, and we are starting to do that, and it seems to me that the way we are going to deal with this problem is to do all of the above, nuclear power and off the coast and so on. Yes, sir.

Mr. KASPUTYS. I first got involved with energy in the late 1960's and early 1970's. At that time, people were convinced there was no further natural gas to be found in the lower 48 States. Since then we have found a great deal. And I think there is more to be found, both oil and gas, and we should look for it. We should look for substitutes. We should look for alternatives. Let us hope that Mexico becomes better at exploiting their oil resources, because that would be a good source for the United States.

Mr. SHAYS. Thank you.

But the bottom line is you had England and Norway say, we can mine the oil and natural gas in the North Sea. It had a huge impact on its economy, on its balance of trades and so on. So as an environmentalist, obviously I am concerned. But we are getting the oil from other places and the natural gas where they are delivering it. We are saying to Saudi Arabia, you need to produce more, and yet we are saying, no, no, no, no. And it just strikes me as getting to the point of absurdity.

The bottom line—did you want to say something, Mr. Williams?

Mr. WILLIAMS. Generally, along the lines that you are discussing, I have looked at the situation in the Gulf. You mentioned Hurricane Katrina. If you had a Katrina-sized storm go across the oil-producing fields there and hit the refinery area, you would see a doubling in gasoline prices almost overnight.

Mr. SHAYS. Right.

Mr. WILLIAMS. You need to diversify the fields and refinery facilities domestically.

Mr. SHAYS. You are making a point I just want to emphasize. You are saying if we are going to get it from only one part of the United States, we are taking a huge risk. So you are not just saying diversify from oil to nuclear power or natural gas or coal or whatever, you are saying, don't get all of it from one area.

Mr. WILLIAMS. Yes.

Mr. SHAYS. Thank you. I yield back.

Ms. VELAZQUEZ. Yes. Your time has expired.

The committee will recess. We have a vote on the Floor. It will take approximately 10 or 15 minutes, and we will resume right after.

[Recess]

Mr. GREEN. [presiding] Please come to order. The hearing will resume. As you can see, I have grown a beard since I started this hearing this morning. And for edification purposes, the witnesses are not required to remain in their seats the entirety of the time that we are in recess.

Mr. BERGSTEN. Now you tell us.

Mr. GREEN. I know it is a bit late, but if we have one more recess, perhaps you will get to take advantage of it.

Friends, thank you for your patience. Let me start by asking you about the Strategic Petroleum Reserve and a release of oil from the Reserve. Let's start with our first witness. Can you give me some indication as to how this will impact the price of oil? And if it is a significant impact, I am going to assume that it may have some

positive impact on the dollar. I ask that you be as terse as possible because I have a few more questions.

Mr. BERGSTEN. It has been a mistake for the Administration to continue adding to the SPRO as the oil price soared. Selling from the SPRO would be very constructive in helping bring oil prices down.

Mr. GREEN. Thank you, sir.

Mr. KASPUTYS. I think if we started to sell from the SPRO, we would have a short-term favorable impact on oil prices, but they would quickly return to market levels.

Mr. WILLIAMS. I agree that it would help on the downside for the shorter term. The problem is that the Reserves are designed for some kind of a catastrophic event. We are still looking at somewhat normal market forces here, and you always have the potential of a catastrophic event where, if you drain those reserves, it would make the impact all the worse.

Mr. MURPHY. Yes. I would just echo those remarks. It certainly increases the supply, and the market price goes down. There are only 2 to 3 months' net imports in there, and if something happens in the Middle East, you might want to have the supply for that reason.

Mr. GREEN. What could we do in addition to the release of that oil to have a continued impact on the price of oil by helping with the demand side?

Mr. MURPHY. Do you want me to just focus on the demand side?

Mr. GREEN. Well, assuming that we release the oil from the SPRO, what, in addition to that, should we do?

Mr. MURPHY. My personal view would be that you would allow for energy companies to explore offshore and onshore Federal areas that currently are leased.

Mr. GREEN. If we do this, the exploration does not have an immediate impact. Let us assume for a moment that it will have an impact, notwithstanding the fact that we import far more than we can generate by drilling. What will we do to have an immediate impact on the price? Because this is a question that the people I meet in my district ask me: What are we going to do about oil prices now? We know that we can release from the SPRO, and that will have an impact right away, hopefully. What else can we do right now?

Mr. MURPHY. Well, I just would challenge the premise of that, that what happens is—so it is true that if you allow for offshore drilling, that physically won't hit the market for 7 to 10 years, but what would happen then is producers right now with excess capacity, knowing there is going to be more competition in the future, would increase production. And we saw when President Bush lifted the more—executive side of the moratorium, that week alone prices fell almost \$16. There were other things going on in the news, but I think that certainly had an impact.

Another example, Saudi Arabia, in May, refused to increase—

Mr. GREEN. Before I go to another person, and I appreciate your comment, let me just add one more thing. If you say that this is—and many of you have said this—this is demand-driven by virtue of China and other countries desiring more, that demand does not seem to be subsiding for oil. And if this continues to be oil-based, and the demand continues to escalate, are you confident that what

you are saying about the speculative aspect of this causing the prices to decline?

Mr. MURPHY. What I am saying, though, is not purely speculative. Like I said, Saudi Arabia did in May refuse to increase; when President Bush asked them a month later, they reversed themselves. And I think partly why they did that is the political climate here changed, and they realized it is much more likely that there are going to be a million barrels or what have you extra down the road.

Mr. GREEN. Ten years down the road?

Mr. MURPHY. Yes. So pump more now.

Mr. GREEN. Let us go to Mr. Williams.

Mr. WILLIAMS. I don't see much that can be done to give you a quick fix on the gasoline price. Indeed, you need to increase domestic production, you need to develop alternate energy sources. Over time, that will help. But over the short term, outside of the Strategic Oil Reserves, I don't see anything.

Mr. GREEN. We will hear from our next witness. That is Mr. Kasputys.

Mr. KASPUTYS. I don't really think there is a quick fix that we can do. We are all somewhat stunned when we see oil going up very close to \$150 and not knowing where it might stop. As I said in my remarks, I think it is generated principally by a supply and demand balance problem. The things that we can do are all longer-term things, like encouraging conservation. We might selectively put on certain taxes. I know it is very controversial. But I think seeing gasoline at \$4 is not altogether bad, provided we can take actions to alleviate the impact on low-income people. And we can continue to work on conservation and alternate energy and fully developing the resources that we have. They are all largely long-term fixes.

Mr. BERGSTEN. I am more optimistic than my colleagues. I think there are at least a couple of things you can do in the short run. One is SPRO sales. It would depend on how much and for how prolonged a period of time, but if you were prepared to announce an ongoing program, even if modest sales but continuing over several months, I think you could break some of the speculative psychology that is always in these markets. I am not charging speculators but saying that in any of these financial markets, when there is a bandwagon trend, the axiom in the markets is "the trend is your friend." When the price is going up, people buy and push it up further. And there is always a speculative froth. Prices came down in the last few days; maybe some of that has now been terminated. But I think you could break some of that with ongoing substantial sales out of the SPRO.

The other thing that you can do in the short run, and it was done a bit after Hurricane Katrina, is to relax some of the environmental regulations. Some of the environmental regulations that are promulgated by EPA limit the scope for U.S. refineries to convert certain types of crude oil into refined product. That is one reason the refinery shortage has been an important part of this whole problem. It is the reason also why we couldn't import more. So environmental regulations, if you want a short-run answer, look at that, too.

Mr. GREEN. All right. We will now hear from Mr. McCarthy for 5 minutes.

Mr. MCCARTHY OF CALIFORNIA. Thank you, Mr. Chairman.

A question for Mr. Murphy. I think it was last week when Federal Reserve Chairman Bernanke was here for his testimony; I believe it was my colleague from California, Mr. Sherman, who asked him a question, and the Federal Reserve Chairman stated that a 1 percent increase in supply could lower prices by as much as 10 percent. Given when I listened to your testimony, talking about supply and demand, demand rise in China, and India and the Middle East, it is going so rapidly, do you agree with Mr. Bernanke that relatively small increases in supply would have a significant impact on hypersensitive markets?

Mr. MURPHY. Yes, I would agree. Everyone realizes that the oil market is very price-inelastic, meaning even as prices have gone way up, people haven't cut back consumption very much. So it works in the opposite direction that if you increase the available product even what seems to be a small amount, that could have a dramatic effect in the short run.

Mr. MCCARTHY OF CALIFORNIA. Would you also then agree that a small drop in supply—the pipeline problem in Nigeria, a strike in Brazil, a statement by someone in the Middle East—has the same but opposite effect?

Mr. MURPHY. Right. Spare capacity right now is about 1.5 million barrels, so anything like that could really drive up the price of oil.

Mr. MCCARTHY OF CALIFORNIA. I appreciate that.

And following up from what the Federal Reserve Chairman said, his estimate of 1 percent would increase—in supply would lower prices by 10 percent. If I take the information based upon the Energy Information Administration, the recent worldwide daily production is about 865,000 barrels would be 1 percent. I rather talk about 1 million barrels. It is easier for me. I am from Bakersfield, so I have to read my numbers a little bit.

But I had an interesting weekend last weekend. I flew out with a delegation. We went to Golden, Colorado, and we toured the National Renewable Energy Laboratory there, solar and wind, and drove some of the cars as well, the hybrids. Then we went up to Alaska, went to ANWR. And I went and toured throughout there, went into the pipelines, seeing that in 1989, we put 2.2 million barrels a day down there. Now we are only doing 700,000 barrels down there. But I went over to ANWR where we are talking about using 1/100 percent of the 19 million acres, just 2,000 acres. And they say they could do a million barrels a day underneath there if we were able to start drilling there.

And what is interesting to me—and I was talking to another Congressman, Congressman Jack Kingston, and he recently asked the Energy Information Administration for an estimate on what the impact of prices would be if we had an additional 1 million barrels produced a day of productive capacity. That is right there in ANWR right next to where we are currently producing. In the response to Mr. Kingston's question, the Energy Information Administration estimates that if we were to bring another 1 million barrels of oil each day online, prices could be expected to drop by as much as \$20 a barrel. Let me state that again: 1 million barrels

of additional oil produced a day in ANWR, which we could do, would drop prices by \$20 a barrel or about 50 cents a gallon.

Mr. Chairman, I ask unanimous consent to submit the Energy Information letter to be included in the record.

Mr. GREEN. Without objection, yes.

Mr. MCCARTHY OF CALIFORNIA. But the one thing in listening to all this, supply and demand. And touring the renewables in Golden, Colorado, I have in my district the windmills, the 4th largest. We put the windmills up where the wind blows. I also have the Mojave Desert where we have solar. We put the solar panels up where the sun shines.

Isn't it rational to drill for oil where the oil is? And the one thing I have found in this process with technology of how far we have advanced, when I went to one of the platforms which they drilled in the 1970's—we flew over one that is called Alpine, a fresher, a newer one, that, as you flew over it, there are no roads to this platform. They only built a little landing strip. So instead of taking 64 acres, they took 6 acres. Instead of drilling down and having to do it numerous times, they go down and they go out 8 miles.

One of the most interesting facts on the pipeline, how it went from 2 million barrels a day to 700,000, if we do nothing, we use 15 percent of the oil per year. So it only gets worse. Demand continues to rise, and supply goes down if you don't look for exploration. So from this weekend, I had a real eye-opening experience, and listening to what the Federal Reserve Chairman said, 1 percent supply, 10 percent reduction; listening to what the Energy Administration said, that if we did 1 million barrels, which we could do with ANWR, we would lower the price by \$20 a barrel, 50 cents a gallon.

I really think, Mr. Chairman, now is the time to do it, and the American people desire it and request that we are able to have a vote on this on the Floor of the Congress. I think this is the direction we should go. We can't wait around much longer. I think it is kind of all of the above we can do, from the wind in Golden Colorado, putting it out to where the wind blows, to where the sun shines, to where the oil is. Having a complex all-of-the-above board, I think, would really put America to American energy policy. And I yield back.

Mr. GREEN. The gentleman yields back.

We will now hear from the subcommittee chairwoman, Mrs. Maloney.

Mrs. MALONEY. I thank my friend for yielding.

Dr. Bergsten, you have talked about how the U.S. dollar needs to continue to fall to restore balance with our trading partners. For years now we have imported far more than we export, which has led to sharp job losses in manufacturing. And since manufacturing employment peaked in 1998, we have lost over 4 million manufacturing jobs. Shouldn't we focus our economic policy on making our goods competitive in the international market?

Mr. BERGSTEN. We absolutely should, but I suggest in my statement today that the best way to do that is to make sure that the dollar is at a competitive level. The dollar has come down by about 25 percent on average over the last 6 years. We are now in the midst of an improvement of about \$300 billion in our trade account,

and as I indicated in my statement, that is creating about 2 million jobs in the U.S. economy, most of them in manufacturing. So we are actually in the process right now of recouping a substantial number of those jobs that were lost. Part of that job loss was the overvalued dollar and a big increase in the trade deficit. With the dollar having come back down not quite as far as it should, but most of the way, we are in the midst of a trade-led resumption of manufacturing jobs.

I made the point in my statement that the entirety of U.S. output growth over the last 6 months has come from improvements in our trade balance. As you look out to next year, 2009, the OECD has predicted that almost all U.S. economic growth in terms of output and job creation is going to be export expansion and further reduction in our trade deficit. So we are right now in the process that you talked about, and, to me, that is by far the most encouraging component of the economy.

Mrs. MALONEY. It is now clear to many of us that for the past decade our economic growth has been bubble-driven, first with the stock bubble in the late 1990's and then with the housing bubble in the 2000's. At the same time, we have doubled a large trade deficit and lost millions of manufacturing jobs. Do you think it is possible that the reason that our economy over the last decade became so dependent on bubble-driven consumer spending and debt was because of our trade imbalances?

Mr. BERGSTEN. I think there is a two-way relationship between the trade imbalance and the domestic bubble problems. On the one hand, the big trade deficit means we have to borrow huge amounts of money from abroad. That moves us into debt, but in the short run, it keeps our interest rates lower than they would otherwise be. That added to the propensity of the economy to have bubbles, particularly the interest-related bubble that we are now experiencing in housing.

How much that effect is, is hard to say. Some people argue that the capital inflow from abroad kept U.S. interest rates 25 basis points lower. Some would say it is higher, 50 to 75 basis points. It wasn't the major factor in low interest rates and the housing bubble, but it was certainly a factor.

On the other hand, a more powerful relationship was the very rapid increase in U.S. consumer demand over this period, which sucked in a lot of imports. Another factor was the big Federal budget deficit, which put pressure on the economy, led to excess demand, more than we could produce at home, and added to the budget deficit. That in turn has now brought the dollar back down.

But I want to again emphasize, because you started by talking about the doubling of the trade deficit, it actually more than doubled over the period 1995 to 2006, but it is now coming down very sharply. In real terms, it has come down about 2 percent of GDP. It will probably come down another couple of percent over the next year or so.

The reduction in dollar terms is not as great because of the higher oil prices. There is a tricky technical difference between the trade deficit in nominal dollar terms and the trade deficit in real volume terms. I won't go into that unless you want me to. But in the terms that count for output and job creation, we are in the

midst of an export boom, and that is the only thing literally keeping the economy out of recession over this last year.

Mrs. MALONEY. Finally, my time is running out. The dollar has been falling relative to other major currencies such as the euro, but not as much relative to the Chinese yuan. Now, the United States continues to have a large trade deficit with China as we import stuff from China far more than we export. And what do you think is the proper relationship of the yuan to the dollar, and how do you think we can get there?

Mr. BERGSTEN. We published a new study on that at my institute just yesterday. The conclusion of that is that the Chinese currency needs to rise by at least 30 percent against the dollar to bring their surplus down to even a reasonable level. It still would be pretty high. It is now over 11 percent of their GDP. It needs to come down a lot. The Chinese could permit that to happen quite easily.

The reason that the Chinese currency has been so weak is flat out manipulation of the exchange rate by the Chinese authorities. They have been intervening massively in the currency markets, to the tune of \$50 billion per month, and that has depressed the price of their currency. It has kept the dollar overvalued against the Chinese renminbi. By simply backing away from their intervention policy, the Chinese could permit their currency to rise to an appropriate level, which would be considerably higher than it is now.

Mrs. MALONEY. My time has expired. Thank you, Mr. Chairman.

Mr. GREEN. Thank you.

Mr. Cleaver will be recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

This will be to any of you who would choose to respond.

There is talk about a hope for a release of oil from the Strategic Petroleum Reserve. In 1991, I think, was the last time gasoline prices dropped 30-something percent. We had a different price from the beginning, however. I spoke with an economist yesterday who said that if we did, in fact, go into the Reserve, and prices did not drop, that it would be devastating to the dollar and to the U.S. economy. Do you agree or disagree? Anyone can answer.

Mr. BERGSTEN. I don't think it would be devastating. I am pretty confident, as were others on the panel earlier, that sales from the SPRO would bring some relief to oil prices. Keep in mind that the Administration has been continuing to buy for the Reserve despite the passage of legislation to halt the build-up of SPRO reserves. The Administration, at least until very recently, has continued to buy under contracts that had existed before the legislation that had to be honored.

If you went from buying to selling, you would get a double effect. You would stop the upward pressure from the buying, and you would generate downward pressure from the selling. So it wouldn't be like going from zero to minus one. It would be going from plus one to minus one.

I looked at the numbers. In the week which ended June 27th, which happened to be the last week I had numbers for, there were 140,000 barrels per day added to the SPRO, just less than a month ago. On the ratios we were talking about before, a million barrels a day leads to a drop of \$20 in the oil price. That alone would be

a couple of dollars on the oil price right there. So if you added to that some sales, I think you would get a lot of bang for your buck.

Mr. KASPUTYS. If I might, my view of sales from the SPRO would indeed have a short-term impact on oil prices, but it would be transitory. We wouldn't really have permanently fixed anything.

Mr. CLEAVER. No. I understand that.

Mr. KASPUTYS. So prices would go back to where the market wanted them once those sales were over. We would certainly have a break in psychology, with short-term impact, but you are not really addressing any fundamental problem by doing that.

Mr. BERGSTEN. Can I just challenge that in the sense that I don't think it is inconsistent with what Joe said. Sales from the SPRO, even if done on, say, a 3-month basis, I mean, you could—the Administration could announce a program of sales of so much per day for a 3-month program. It is not just a one-shot, short-term thing, which happened in the case of Iraq in 1991 and again after Katrina. There were some sales out of the SPRO after Katrina, but they were very small, only for a couple of days. You could do much more than that for 2 months, 3 months, even 6 months, and calibrate the amount. It would not run down the total to a level that would obviate the strategic purpose. But as Joe just said, I think it could break some of the market psychology, which, at least until very recently, has been that everything goes up. And there is a lot of speculative froth in that. There is a lot of "trend is your friend" thinking, a lot of market momentum activity the traders always respond to.

So if your sales could kind of turn the tide even for the short run, I think it could have some significant lasting impact. It is certainly a measure to consider. And keep in mind, as I said, you are moving from purchases to sales. You get a double impact.

Mr. KASPUTYS. I don't disagree with what you said, but if I could just respond to that. At the end of the period of 3 or 6 months of sales from the SPRO, at that point you have a smaller SPRO, so you have a greater degree of vulnerability, and that can figure into the psychology of the pricing of the oil markets as well.

Mr. CLEAVER. Well, Japan has the second largest reserve. What if they dropped it at the same time?

Mr. BERGSTEN. Yes. If we were going to do it, we should try to mobilize not only Japan, but others in the International Energy Agency. I presume you are aware that in the OECD there is an IEA, an International Energy Agency, set up after the oil shocks in the 1970's to coordinate the consuming nations' efforts to counter the OPEC cartel.

Under that IEA arrangement, each country takes on a commitment to build its own SPR. So all of the member countries in the IEA, like Japan, all the Europeans and others, have strategic reserves. If we want to maximize the impact on the world price, what we should obviously do is go to all of them and see if they would join us in sales from our respective SPRs. That would then multiply the effect we are talking about just from sales from our own national SPR. That would be particularly powerful in psychological terms because it would mean that all of the oil-importing countries were acting together.

Mr. CLEAVER. It is still short term.

Mr. BERGSTEN. It still would have a short-term effect. But again, I would argue then you would have an even more powerful psychological effect that could turn the market momentum.

Mr. CLEAVER. Mr. Williams.

Mr. WILLIAMS. Congressman, I believe your question was, what if the market didn't respond?

Mr. CLEAVER. Yes.

Mr. WILLIAMS. And indeed, where you would expect the market to respond, albeit short term regardless of however you play it out, that would be devastating to market psychology because that is the one area I think that people increasingly are looking at as something the government could do to provide some immediate relief. And if it didn't, it would have a sharply negative effect on the markets. I would expect that it would provide some relief. But answering your question, if it didn't, yes, I think that would be negative for the markets.

Mr. CLEAVER. That was the proposition of the economists.

Mr. Murphy.

Mr. MURPHY. And it is ironic that they are arguing with each other, and I am going to disagree with him now.

Just to very quickly answer your question, yes, it is conceivable. Suppose they go ahead and say, we are going to sell more, and then war breaks out with Iran the same day, obviously, gas prices are probably going to go through the roof. And so, in a sense, you could say, oh, we sold from the SPR, and it didn't make gas prices go down. But I think the people in the market, the traders would know what was guiding their decisions, and so they would understand what offsetting factor there was. So, no, I don't think it would be devastating if that were to happen, because people would realize what was the offsetting factor.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. GREEN. The Chair now recognizes Ms. Speier for 5 minutes.

Ms. SPEIER. Thank you, Mr. Chairman.

This would be a question for all the panelists.

You have heard a lot of questioning in the last couple of hours about what we can do to try and bring the cost of gasoline down. Mr. McCarthy, who has since left, my colleague from California, was talking about the importance of drilling in ANWR because it could have a 50-cent-per-gallon impact.

I have a different idea that I would like to explore with you, and that is good old conservation. There is a movement of which I am a part right now to reduce the national speed limit from 65 or 70 miles an hour to 60 miles an hour. And when we did that back in the 1970's, and there were studies done by the National Science Foundation and by the Department of Energy, for every mile over 60, there was a decrease in efficiency by about 1 percent. And it was estimated that, presuming you were going 70 miles an hour and now you are going to drop down to 60 miles an hour, that you could see a savings per gallon of gas of about 45 cents a gallon, presuming gas is now at 4.50 a gallon; something that would be immediate, something that would have a double effect, I think, because not only would you be using less gas, but you are reducing the demand and increasing the supply.

Now, you are the economists. I would like to hear your response to that.

Mr. KASPUTYS. Well, can I say that the impact of conservation on energy consumption has actually been phenomenal over the last 30 years. We are far less dependent per unit of GDP on energy than we were at the time of the Arab oil embargo of October of 1973, which was a huge wake-up call. And since that time, lots of conservation initiatives have been undertaken, and they have made a material difference. And if we had not done those, we would be in much worse shape than we are today; probably we would be looking at \$250 to \$300 oil if you could buy it at all. So I think there is still tremendous potential in conservation in many forms.

That specific one could have an impact. It depends on how much regulation we want to put up with. But, generally, yes, conservation is something that is still under exploited.

Mr. BERGSTEN. You have my vote unambiguously. And you might have added that you will save some lives, too.

Ms. SPEIER. Well, the study by the National Science Foundation suggests 2,000 to 4,000 lives a year are saved.

Mr. MURPHY. My reaction would just be that, yes, there are all sorts of measures people could take. Also, educating the public as to inflating their tires properly, and things like that.

My only concern would be to educate people and let them make those tradeoffs themselves, because of course, the downside is you are driving longer; you don't get to your destination. So there is a trade-off. And the Institute for Energy Research typically would like consumers to be able to make those decisions once they have the information.

Ms. SPEIER. Well, aren't we paying for a trade-off now that Bear Stearns has gone sideways? I mean, we create all these opportunities for less regulation, and when we do, oftentimes, we are paying for it down the road in very Draconian ways. That is rhetorical.

Mr. WILLIAMS. It would have the effect that you are hoping for in terms of reducing gasoline prices. The issue I think is, other than that, I mean, I was around when the last—

Ms. SPEIER. So was I; I was waiting in those lines just like you were, probably.

Mr. WILLIAMS. We do have—and I can remember that, generally, it was not too popular with the populous. And in fact, when the system began to unwind and go back to the over-55 speeds, the general reaction I saw was that—gut reaction, anecdotal evidence—people who drove a lot were generally quite pleased to see that. So I think the issues are more indeed in terms of what you want the government imposing upon the individual. In terms of having the effect that you would like, yes, you would have that effect.

Ms. SPEIER. Let me just suggest that even the American Trucking Association now supports this proposition, which was not the case back in the mid-1970's. But it is affecting all of their bottom lines. And UPS, for one, not only is requiring all their drivers to drive 55 miles an hour, but they can only make right turns now. No longer can they make left turns because they have been able to document that doing so costs a lot of money in terms of gasoline consumption.

Mr. BERGSTEN. UPS and the Postal Service are doing the same thing—no left turns.

The people who object to your proposal on the grounds that it adds regulation to the economy, and recall the gas lines of the 1970's and link that to regulation, I think miss a simple point. There were overregulation problems that led to the gas lines; but they were overregulation problems on the supply side. They were price controls on energy, oil, and natural gas that we had in this country which distorted our markets badly and deterred output. And then we tried to regulate the distribution of gasoline and other products when the oil crises hit. Those were regulations, as I say, on the supply side of the market, and they had the predictable negative effects on supply.

You are trying to limit demand through a regulatory device, and that is very different. And I would think that a combination of market incentives, which we have already got with the higher price, plus improved CAFE standards, the kind of thing you are talking about, are all very desirable in this context.

Ms. SPEIER. Mr. Chairman, thank you.

Mr. GREEN. Thank you. I will allow the answer. You were about to answer, sir?

Mr. KASPUTYS. I would like to make one other comment.

In my company, I have about 130 people that do nothing but study the automotive market. And the current price of oil and gasoline is roiling the automotive market. It is changing consumer behavior very rapidly. You are absolutely right to be focusing on the automobile. There is much more that can be done, and to some degree, it is really encouraging to see how quickly consumer tastes are changing to force some change that we have tried to get through legislation and through regulation for a long time. But I think maybe the consumer is really going to demand it this time, and I think you are absolutely in the right place to look.

Mr. CLEAVER. Will the gentlewoman yield?

I am not opposed to what you were saying. Yesterday, I just read—I can't remember the exact statistic.

Mr. GREEN. Mr. Cleaver, the time has expired for the lady, but if you have a unanimous consent request for an additional 1 minute; I think Mr. Sherman is going to have a unanimous consent request. So perhaps we will have a second round, and that way we will get to your concerns, Mr. Cleaver, and perhaps the lady might have additional concerns as well.

So at this time, without objection, we will have a second round. And let's limit it to maybe 3 minutes as opposed to 5 minutes.

Mr. SHERMAN. I will try to talk quickly.

First, I want to commend Chairman Frank for holding these hearings at the request of roughly a dozen Republicans, none of whom are here at the present time.

I want to comment that the things we can do to lower oil prices have different time horizons. If we can do something on the psychology, that takes effect at a frenetic pace. If we deal with the SPR, that puts oil on the market within days. If we deal with conservation, some of that takes place within days, as people decide in my district to use public transit even though it is inconvenient; sometimes months; sometimes years, as they adjust their behavior.

But in terms of production, there we are talking either years or decades between when you take an action and when oil is actually on the market, with the exception of the Saudis, who have some oil fields ready to go. I am not saying they could turn on the spigot in a week, but they certainly could in a month.

I would like to shift to the issue of speculation being part of the cost. And this could be either motivated by either evil speculators or by people afraid of Middle East political developments, however you want to characterize it. It occurs to me that somebody sold an oil future for August 2008 oil 4 years ago. They probably priced that at \$50, \$60 a barrel, if my memory serves me.

There is a lot of buying and selling of oil futures that don't have a physical effect that I can ascertain. That is to say, today a certain number of barrels will be produced, physically, and taken to refineries. Today a certain number of barrels will be demanded, physically, not by speculators who don't actually burn in their tank.

So I figure that the most important thing for me is, how much oil is going to the refinery in my area and at what price? And how much is being demanded by people in my area? And if that price is too high, then the supply and demand in my area at least will push the price down.

I may be a little vague in formulating the question here, but how is it that speculators can affect not the price of some futures commodity, which is a security, but rather can affect the price of oil, which you would think would be set by physical supply and demand, how much oil is there available to burn today, and how much do they demand it? And I want to put aside for a moment the one group of folks that I know can affect the price, and that is anyone who can afford the physical product, and that is the Saudis by not opening their spigot.

Can anybody explain to me why today's physical supply and physical demand is not where to look in terms of the price I will be paying at the pump?

Mr. MURPHY. If I may, sir, you are right. The mechanism through which speculation in theory could affect the spot price—

Mr. SHERMAN. If I can interrupt you, there was speculation in silver where somebody just hoarded the silver, and it was in their warehouse. But with the exception of Saudis undeveloped oil fields, I don't know anybody who is hoarding oil except, I guess, our SPR.

Mr. GREEN. The gentleman's time has expired. However, we will hear the answers.

Mr. MURPHY. I will be very brief. You are right. In theory, what will happen is the speculators, by buying futures contracts, push up the futures price. That would give people an incentive to buy at the low spot, store it, and then sell it. But what we have seen over the last year is that inventories have actually been declining, and so that is why the CFTC and others have said that they don't think excessive speculation is what is driving the recent spike in oil prices.

Mr. SHERMAN. Does anyone else have an answer?

Mr. GREEN. We will allow you to answer.

Mr. BERGSTEN. I think it depends a little bit on what you call speculation. One person's speculation may be another person's investment. You mentioned a couple of categories. There is a third

category. People who are worried about inflation, who are worried about stability of prices, and that produces what is often called a flight to commodities as an investment alternative to traditional currency-based investments or financial assets. That flight to commodities, which I think we have seen some signs of over the last year or two, can add something to the price, even if those people don't take physical delivery. They may buy spot. That is adding to the demand for the market on that given day. And at least most of the energy experts that I have talked to and whose views I respect would add that as a modest but nevertheless noticeable element in the overall picture.

Mr. GREEN. I want to thank the witnesses for being so generous with their time.

We have two additional members who would like to ask questions.

Mr. Cleaver, do you yield?

Mr. CLEAVER. I will yield, Mr. Chairman.

Mr. GREEN. Then we will go back to Mrs. Speier for an additional 3 minutes.

Ms. SPEIER. Thank you, Mr. Chairman.

In this speculation market, many of us received from one of the carriers, maybe all the airline carriers sent this out to their e-mail list, basically saying: Send a letter to Congress. Tell them to deal with the commodities market and create some semblance of sanity there.

One of the points in the letter suggested that a barrel of oil trades 23 times before it gets to the end user. And, understandably, the airlines are concerned about the cost of jet fuel. So they believe that there is too much speculation going on, that it is being driven by Wall Street, and that there needs to be some strictures put in place so that the cost of jet fuel is not artificially raised beyond the pocketbooks of the airline industry.

Do you have any comments on that?

Mr. WILLIAMS. It is, to a certain extent, still supply and demand. The airlines themselves are speculators in this field. They cover their exposures by buying futures contracts on oil or on jet fuel.

But one factor that has come in here, and it actually comes back to the original concept of the hearing, is that we have seen an extraordinary period of time in the last several months where the markets have been unstable. The financial system has been a little bit on the edge. The Federal Reserve has been working to maintain stability of the banking system. And as all these different actions have been taking place and all the stories keep floating around, people have gotten very nervous about what might be happening. You have seen some flight from the dollar. People don't want to necessarily be in dollar assets, or they are afraid that maybe there is going to be inflation, and the actions that are being taken to prop up the system are inflationary. So that because of these factors and because of the weakness in the dollar that you don't necessarily want to be holding the currency-related assets, that there has been some movement in the commodities as a way of protecting your wealth, of protecting your assets.

I will contend that it is very difficult to tell the difference between a speculator who is, using the term very loosely, who is in

there buying contracts because he is hoping to protect his wealth, and an airline that is in there speculating, buying contracts to protect its costs. So it is a difficult issue to address.

There is some effect there, but again, the dollar, the weakness of the system, global concerns about the financial stability in the United States, have been more factors behind driving the oil prices higher than any pure speculation per se.

Mr. KASPUTYS. I think, if I may, the use of futures contracts, which can be bought, sold, traded, is a very important tool to consumers of energy in industrial and corporate organizations, airlines, and even in the energy industry. I am all for transparency, but I would not be for regulating it or limiting it. I think futures contracts are an important tool. It is a useful tool. Yes, it will, at inflection points, tend to accelerate the rate of change, but it can go down just as rapidly as it goes up.

Mr. BERGSTEN. I would add one other point on that. It really goes to Mr. Sherman's question, what is speculation? One reason economists tend to think that speculation in the narrow sense does not have much market effect is it is very temporary. People will buy today, sell tomorrow.

But there is an alternative interpretation, which is that commodities and oil, in particular, have now become an asset class for investors, that 5 years ago, maybe even 3 years ago, there was really no asset class included in the normal portfolio of investments, which was oil or commodities more broadly.

Now, for some of the reasons we have stated—Mr. Williams just did, I did earlier—people may now believe they should put some modest percent, 5 percent, even 10 percent of their total investment portfolio into “real assets,” meaning commodities: some energy, some gold, some other commodities.

To the extent that is a permanent change, from 0 to 10 percent, as part of investment portfolios kind of normalized across the financial community, that would be a permanent increase in demand for that kind of asset and could therefore have a more lasting effect.

Mr. GREEN. Thank you for your responses.

The Chair will note that some members may have additional questions for the panel which they would like to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses and to place their responses in the record.

Before adjourning, on behalf of the chairman, the ranking member, and all of the members of the committee, we want to thank you for your patience today and for your indulgence.

Again, the hearing is now adjourned.

[Whereupon, at 4:42 p.m., the hearing was adjourned.]

A P P E N D I X

July 24, 2008

**Opening Statement of Ranking Member Spencer
Bachus**
**Full Committee Hearing “Implications of a Weaker Dollar for Oil
Prices and the U.S. Economy”**
July 24, 2008

Thank you, Mr. Chairman, for calling today’s hearing, which was requested by the gentleman from Texas, Mr. Paul and 16 other Republican Members of the Committee, including myself.

Mr. Chairman, at a time when the cost of gasoline is the biggest pocketbook issue for most Americans, it’s important that we look at all of the factors behind rising oil prices. That certainly includes the impact that a weaker dollar has had on oil and, indeed, all commodities. One recent study by the International Monetary Fund suggested that if the value of the dollar had remained steady against other currencies from 2002 through the end of last year, the price of a barrel of oil would be about 25 percent less lower than it is today..

But make no mistake about it: our fundamental problem is with supply and demand. We are not producing enough American-made energy to meet our needs, so foreign oil producers are holding us over a barrel.

Federal Reserve Chairman Ben Bernanke made a statement before our Committee last week that deserved much more attention than it got. He said that a 1% increase in oil production could lower prices by 10%.

In a survey I just did in my district, there was very strong opinion that with gas now at \$4 a gallon, the U.S. must do more to develop the abundant energy resources we have here at home. That includes our oil and natural gas reserves offshore and in Alaska. It involves nuclear, coal, wind, and solar, as well as renewable fuels, conservation, and technologies of the future like hydrogen.

By diversifying now - through responsible exploration or licensing new nuclear power plants, just to name two examples – we’ll ensure that Americans will have reliable, affordable energy over the long run.

Our constituents are demanding that Congress act. In Bibb County in my district the average per capita income is \$16,217 or \$312 a week before taxes. Some 58.8% of the workers have jobs outside the county and must drive to their jobs. A recent gas receipt from my district came out to \$89 to fill up a tank. When you are spending \$89 every few days just to get to work, that doesn’t leave much to take care of the other needs of your family.

In closing, Mr. Chairman, high gas and energy costs are a burden on everyone – families, schools, businesses, and manufacturers – and they slow our economy. Congress should be devoting its full attention to this issue and to the extent today’s hearing draws attention to that fact, it will have served a very useful purpose.

Thank you again, Mr. Chairman, for accommodating our request for a hearing, and I look forward to the testimony of our distinguished witnesses.

THE DOLLAR AND THE US ECONOMY

C. Fred Bergsten¹
Director, Peterson Institute for International Economics

before the
Committee on Financial Services
US House of Representatives

July 24, 2008

The dollar rose by a real trade-weighted average of about 40 percent from 1995 to early 2002, contributing to a sharp increase in US current account deficits that ultimately reached unsustainable levels of almost \$800 billion and exceeded 6 percent of GDP. Since early 2002, the dollar has reversed this earlier rise and is back to where the large swing began over a decade ago (see Chart 1).

These fluctuations mirror to a remarkably similar extent the previous largest swing of the dollar, in the 1980s, when it rose by about 50 percent during the first half of the decade and then fell by an equivalent amount during 1985-87. The dollar is now at a very similar level to where it stood in both 1980 and 1995. It is certainly weaker today than it was six years ago but no weaker than in those earlier periods. With the United States still running very large external deficits, the dollar at present can hardly be characterized as “weak.”²

¹ C. Fred Bergsten has been Director of the Peterson Institute for International Economics since its creation in 1981. He was formerly Assistant Secretary of the Treasury for International Affairs (1977-81) and Assistant for International Economic Affairs to the National Security Council (1969-71). His 38 books include *Dollar Adjustment: How Far? Against What?* (2004), *Dollar Overvaluation and the World Economy* (2003) and *The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy* (2nd edition, 1996).

² Indeed, an alternative approach to measuring the real value of the dollar that highlights the importance of growing trade with low-cost developing countries such as China implies that the dollar's broad value in real terms is still well above the 1980 and 1995 lows. See Charles Thomas, Jaime Marquez, and Sean Fahle, “Measuring U.S. International Relative Prices: A WARP View of the World,” International Finance Discussion Paper No. 917, Board of Governors of the Federal Reserve System, 2008.

There are two noteworthy features of the latest decline of the dollar in addition to its substantial magnitude. The first is its gradual and orderly nature over a period that now exceeds six years. There has been no free fall of the exchange rate nor hard landing of the US economy.

The second is its skewed geographical composition. The great bulk of the dollar's fall has occurred against currencies which have been permitted to fluctuate freely in the markets, most notably the euro and other European currencies (pound, Swiss franc, etc.) along with the Canadian and Australian dollars. By contrast, several of the major Asian countries, most notably China but several others as well, have intervened heavily in the currency markets to limit the rise of their exchange rates, which thus remain substantially undervalued. The yen also remains substantially undervalued though Japan has not intervened overtly for over four years.

Our Peterson Institute for International Economics has just published a comprehensive analysis of "fundamental equilibrium exchange rates" for the dollar and about three dozen of the world's major currencies³. It concludes that the dollar has already declined almost enough to reduce the US global current account deficit to a sustainable level of 3 percent of GDP, from its peak above 6 percent and about 5 percent now, and may in fact have overshot modestly on the downside against the euro and a few others. Further upward adjustments of 20-30 percent against the dollar are still needed for China, Japan and several other surplus countries to reach equilibrium, however, which would produce a "final decline" of another 5-10 percent for the trade-weighted dollar. Market exchange rates could of course significantly overshoot (or undershoot) these calculated target levels (which are summarized in table 1).

³ William R. Cline, and John Williamson, "New Estimates of Fundamental Equilibrium Exchange Rates," Policy Brief 08-7, Peterson Institute for International Economics, Washington, DC, July 2008. All our estimates assume that the countries adopt policies to maintain internal balance, i.e., full employment with price stability.

The Impact on the US Economy

A weaker dollar reduces the prices of US products to foreigners and increases the prices of foreign products (and domestically produced substitutes for them) to Americans. It has a similar impact on the prices of financial assets. It therefore has three important effects on the US economy:

- it strengthens our international competitiveness and contributes to the necessary reduction in our large trade and current account deficits, generating additional output and employment in the United States;
- it increases the level of prices in the United States; and
- it may affect foreign investment in the United States and thus our ability to finance our large external imbalances.

The good news is that the weaker dollar has already contributed to substantial improvement in the US trade balance and will clearly lead to much more improvement. Every fall of 1 percent in the trade-weighted dollar tends to strengthen our current account position by \$20-25 billion after a lag of two to three years (as long as other economic policies support the adjustment). Our “net exports of goods and services” in real terms, as included in the GDP accounts, have strengthened by about \$150 billion, expressed as an annual rate from 2006 through the first half of this year. We can expect a further improvement of like magnitude over the next eighteen months or so.⁴

This sharp reduction in the external deficit in real terms has provided all of our (very modest) economic growth during the final quarter of 2007 and first quarter of 2008. There was

⁴ The current account in nominal dollars has not gained nearly as much because of the sharp rise in the price of oil imports, discussed below.

no increase in domestic demand over those six months but net exports grew by an annual rate of about 1 percent of GDP. Hence they have kept the US economy out of recession, at least to date.⁵ The OECD's new global forecast for 2008-09 posits that 80 percent of total US expansion during that period will come from further gains in our international trade position.

This likely trade gain of about \$300 billion in real terms translates into the creation of more than 2 million jobs in the tradable goods sector of the US economy.⁶ Moreover, these export jobs pay 15-20 percent more than the national average wage. With domestic demand flat and the aggregate unemployment rate rising, such trade gains are extremely important. The lower dollar and globalization are providing a major boost for the economy just when we need it.⁷

The bad news is that a weaker dollar means higher prices in the United States. Every decline of 10 percent in the dollar tends to produce a subsequent increase in the CPI of about 1 percentage point. Hence the fall of 25 percent in our exchange rate over the past six years could be expected to produce a rise of 2-2½ points in the level of US prices.

It is important to realize, however, that a one-shot fall in the dollar leads to a rise in the level of prices but not to a higher rate of inflation on a continuing basis. The inflation rate would increase permanently only if the dollar continued to decline, just as the trade balance would record further gains only if the currency were to keep falling to lower (and even more competitive) levels.

⁵ C. Fred Bergsten, "Trade Has Saved America from Recession," *Financial Times* July 1, 2008. The other key factor is the continuing robust economic growth in the rest of the world, especially in emerging market economies.

⁶ Using the standard ratio of 7,500 jobs per \$1 billion of exports calculated by the Department of Commerce.

⁷ The steady deterioration of the current account balance during 1995-2005 likewise reduced output and employment in the tradable goods sector. During most of that period, however, US domestic demand expanded rapidly and thus the unemployment rate declined steadily to below 4 percent in the late 1990s and near that level again as recently as last year.

Concern has nevertheless been expressed that the weaker dollar of the past five years has been an important contributor to the sharp rise in the price of oil. Since oil is generally priced in dollars, one might expect the exchange rate to have little effect on the price of imported oil. However, OPEC and other producers clearly seek to offset their losses of real income from a falling dollar by seeking to raise the nominal price of the commodity. Thus a falling dollar may be associated with a rising dollar price of oil just as it is associated with a rising dollar price of other imported commodities.

Historically, however, there has been very little correlation between the dollar and world oil prices (Chart 2). In fact, the sharp inverse correlation that is the focus of current attention can only be observed during some parts of the period from about 2003 to the present. When the dollar declined by over 30 percent in 1985-87, for example, the oil price collapsed to less than \$10 per barrel – its first large correction after the two oil shocks of the 1970s. The sharp if short-lived upward spike in oil in 1990-91, around the Iraqi invasion of Kuwait, correlated with a flat or rising dollar. Oil and the dollar rose together at the end of the 1990s. Energy economist Philip Verleger notes that “(any) mechanism that links the movement of oil prices and the dollar has never been satisfactorily explained...Certainly no one to date has advanced a coherent theory for their coincident movement.”⁸ He and others suggest that the recent coincidence between the two derives primarily from a common cause: market fears of renewed inflation.

During this latest period, the global price of oil has risen about seven-fold – from around \$20 per barrel as recently as 2002 to a recent high above \$140 per barrel – while the dollar has fallen by “only” 25 percent. This is a far higher ratio of oil price rise to dollar fall than has

⁸ Philip Verleger, “The Oil-Dollar Link,” *The International Economy* Spring 2008. Similar analyses, throwing doubt on any systematic causal relationship from the dollar to oil prices, have recently been published by three private banks: “Quantifying the USD-Oil Link,” Barclays Capital, 11 July 2008; “Dollar and Oil—Which is the Chicken and Which is the Egg?” Commerzbank Corporates and Markets Economic Research, 18 July 2008; and “FX Pulse,” Morgan Stanley, 17 July 2008.

existed over any previous, let alone extended, period. Moreover, the price of oil has risen sharply in all currencies rather than just the dollar. Other commodities, even those that do not trade on organized exchanges, have risen as much or even more than oil. Even for the very short run, the dollar has stabilized over the last six weeks or so while the oil price continued to escalate until very recently.

These relationships clearly indicate the dominance of factors other than the exchange rate:

- world demand for oil has grown twice as fast over the latest five-year period (2003-07) as over the previous five years;
- “aggregate supply disruptions” (most notably Nigeria, Venezuela, Iran, Mexico) have taken two to three million barrels per day off the market fairly consistently;
- the cost of finding new supplies has doubled over the past four years, slowing the production response; and
- a “flight to commodities” reflects growing worldwide fears of inflation (and perhaps a common cause of the oil price rise and the dollar decline).⁹

Concern has also been expressed that OPEC, or at least some major oil exporters, might stop denominating their oil sales in dollars. In economic terms, this would make absolutely no difference; the sellers can alter their prices however they want regardless of whether they denominate in dollars, euros or something else. Iran in fact shifted to euros some time ago with no noticeable impact.

Having said that, a dramatic announcement by OPEC (or perhaps even Saudi Arabia alone) that it was shifting away from dollars could have a substantial psychological effect on the currency (and perhaps other) markets. Such an effect might be magnified if the Saudis, or the

⁹ This analysis is drawn from Daniel Yergin, “Oil at the Break Point,” testimony to the Joint Economic Committee of the Congress, June 25, 2008.

Gulf Cooperation Council members more broadly, also (or instead) decided to stop pegging their currencies to the dollar. Kuwait has already done so, and the others should do so as well, both to ward off imported inflation and to reduce their own very large current account surpluses.¹⁰ The only step of this type that would have major substantive effects, however, would be decisions by large oil exporters – who are also large reserve holders – to sell their dollar holdings or not buy any more. This takes us to the final effect of the weaker dollar on the US economy.

The most uncertain impact of a weaker dollar relates to foreign financing of the US external deficits. Even with the improvements noted above, the United States will still be running annual current account deficits of around \$500 billion (3-4 percent of GDP) for some time. This will require us to continue attracting a net capital inflow of a like amount from the rest of the world. This in turn generates a further increase in the net foreign debt of the United States, which reached about \$2.5 trillion at the end of 2007 and is by far the largest of any country in the world (although it still amounts to less than 20 percent of our GDP and is thus not worrisome by most international standards).

The lower dollar makes US assets cheaper for foreigners and thus should increase their interest in investing here. So should the prospect of further reductions in the US current account deficit and an eventual stabilization of the ratio of our net foreign debt to GDP. On the other hand, fears of further dollar declines could deter investors and in fact lead them to seek higher returns to offset that risk.¹¹ The central question is thus foreign expectations of the future exchange rate of the dollar.

¹⁰ Brad Setser, "The Case for Exchange Rate Flexibility in Oil-Exporting Economies," Policy Brief 07-8, Peterson Institute for International Economics, Washington, DC, November 2007.

¹¹ There is little risk, however, that China or Saudi Arabia or other large reserve holders will "dump" their dollars and trigger a free fall of the currency. Since they could not possibly divest anything like all their dollars at the same time, doing so would sharply devalue their very large remaining holdings and thus shoot themselves in the foot financially. It would also stamp them as international pariahs for disrupting global financial markets and the world economy, which none of them want. The more likely prospect is that they will diversify away from the dollar

The Dollar and US Economic Policy

This in turn poses the central challenge of the dollar for US economic policy. Fears of further falls in the exchange rate could lead to a flight from dollar assets (by Americans as well as foreigners). The consequent sharp depreciation of the dollar could force the Federal Reserve to raise policy rates to fight the incipient rise in inflationary pressures; the higher interest rates would of course also help attract the essential financing for our continuing large external deficits. The monetary authorities already face an acute policy dilemma, as the economy remains both sluggish and susceptible to inflationary pressure, but a sharp dollar fall (or even acute fears thereof) would make it much worse. This problem will be yet even more severe if the economy weakens further and financial fragility again intensifies, in which case the Federal Reserve's likely desire to ease further could be severely constrained by the risk of a dollar collapse.

As noted above, our analysis suggests that the dollar is now fairly close to its equilibrium level. The remaining correction can be achieved through appreciation of a few (mainly Asian) currencies rather than any further generalized decline of the dollar. It is thus extremely important for the global economy and systemic financial stability that China, Japan and the other large surplus countries with undervalued exchange rates complete their adjustments in an orderly manner that commands market confidence.

It is nevertheless quite possible that market sentiment will remain bearish on the dollar, particularly if our economy remains sluggish and the gap between US and foreign interest rates widens in favor of the latter as the European Central Bank and other monetary authorities raise

gradually and over time by accumulating larger shares of euros and other assets at the margin as their reserves continue to grow.

their policy rates to respond to inflationary pressures. This will be especially true if the markets perceive the Federal Reserve as “soft on inflation,” particularly relative to its counterparts abroad.

In this circumstance, the United States would need another policy instrument to enable it to counter concerns over the dollar without altering monetary policy in a direction that would exacerbate the problems of the domestic economy. The chief possibility is direct intervention in the currency markets. The specific techniques can range from “jawboning” or “oral intervention,” which our authorities have in fact already begun to deploy over the last several months with some success in stabilizing the dollar, to direct purchases of dollars for other currencies to limit (or even stop) any renewed slide. The Federal Reserve traditionally neutralizes the impact of such intervention on the US money supply to keep it from altering the chosen course of monetary policy; hence it is called “sterilized intervention.”

The Bush Administration has never intervened in the currency markets in its 7½ years in office. Hence intervention to support the dollar would have an enormous shock effect on market psychology and would almost certainly be quite effective in strengthening sentiment toward the dollar.¹² This is particularly true since it would surely intervene in concert with at least the other G-7 countries whose currencies have already become a bit overvalued with respect to the dollar (which excludes Japan).

Conclusion

As the Congress and the country as a whole continue to grapple with the housing and financial crises, the exchange rate of the dollar could play a critical role in both the evolution of the basic problem and the needed policy responses. A renewed fall of the dollar, especially if it were sharp and substantial, could deepen the housing crisis and the weakening of the economy

¹² The Clinton Administration disliked intervention too but all three episodes in which it used the tool – to strengthen the dollar in 1995, to strengthen the yen in 1998 and to strengthen the euro in 2000 – were quite successful.

by pushing up prices and interest rates (with the offsetting further improvement in the trade balance occurring only with a considerable time lag of 2-3 years). Efforts to ease monetary policy in response to a renewed slide in the economy and/or further financial fragility would be severely hampered because doing so could exacerbate the dollar's weakness and trigger still more inflation and even greater upward pressure on interest rates.

It may therefore be necessary to consider including new policy measures, particularly currency intervention, in the strategy for responding to the crisis. I applaud the Committee for addressing this underappreciated dimension of the issue and hope my remarks will contribute to fashioning a constructive response to it.

Chart 1

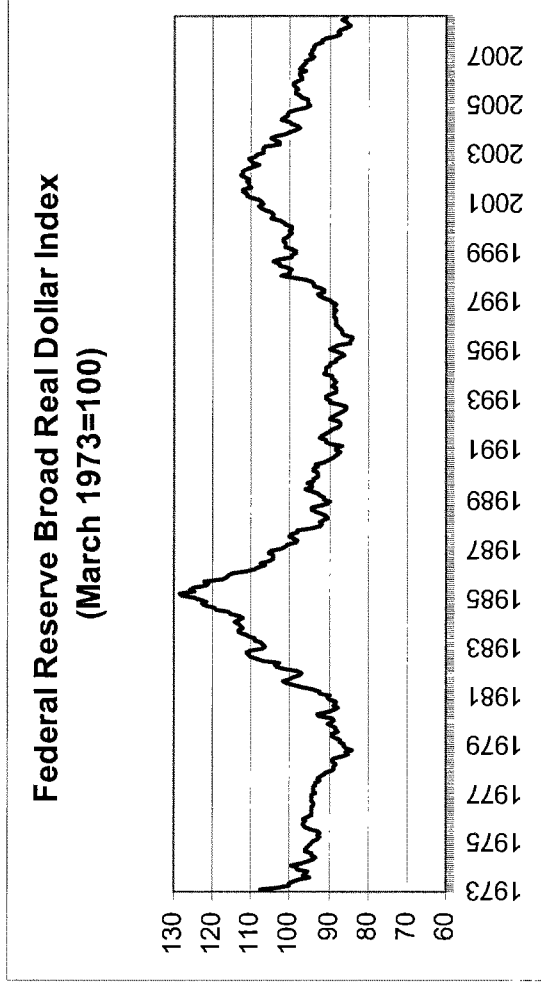


Chart 2

THE U.S. DOLLAR AND THE OIL PRICE

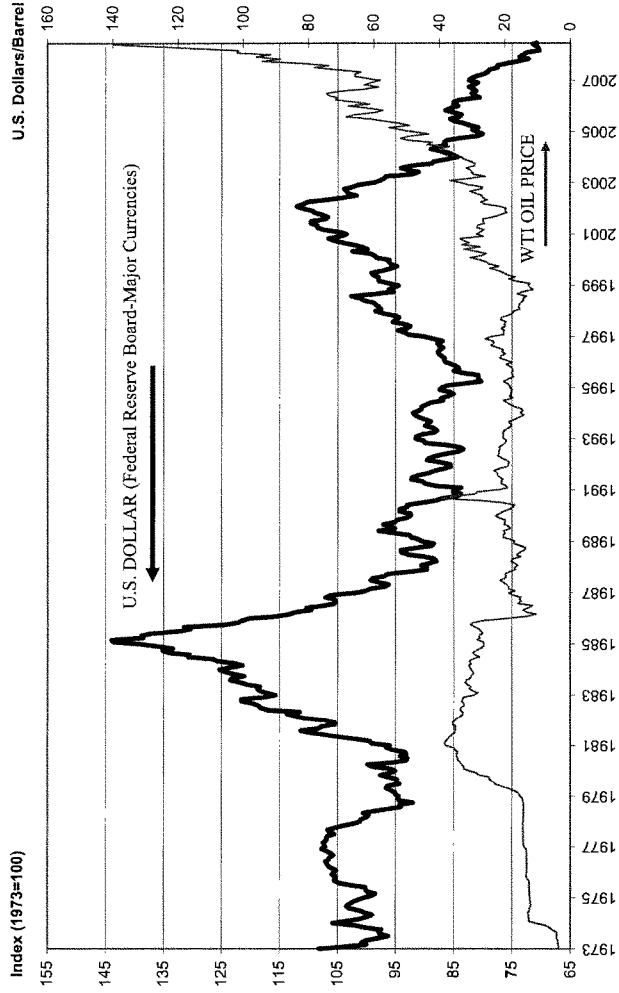


Table 1 Currency realignments needed to reach fundamental equilibrium exchange rates (FEERs)

Country/region	Percent change from base ^a		Currency level against the dollar		
	Trade-weighted average	Bilateral vs. the dollar	FEER equivalent	July 1-15, 2008	Percent change needed
Industrial countries					
Canada	-4.1	-1.5	1.02	1.01	-0.6
Euro area ^b	-7.2	-0.2	1.47	1.58	-7.0
Japan	5.7	19.0	90.1	106.5	18.2
Switzerland	21.4	23.9	0.88	1.02	16.3
United Kingdom ^b	-6.6	-2.5	1.91	1.98	-3.7
United States	-8.6	0.0	1.00	1.00	0.0
Developing Asia					
China	18.4	31.5	5.45	6.85	25.7
Korea	-3.5	11.2	850	1,024	20.5
Malaysia	12.3	30.7	2.47	3.25	31.8
Singapore	24.7	41.2	1.00	1.36	36.2
Taiwan	9.0	26.0	25.1	30.4	21.2
Other developing					
Mexico	-0.4	2.0	10.6	10.3	-2.5
Poland	-8.6	-6.1	2.59	2.10	-19.1
South Africa	-14.6	-6.7	8.21	7.73	-5.9
Turkey	-13.0	-8.5	1.32	1.23	-7.0

a. February 2008

b. Dollars per currency unit



**U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515**

**Testimony for the Committee on Financial Services on the
Implications of a Weaker Dollar for Oil Prices and the U.S. Economy**

2:00 p.m. July 24, 2008
Room 2128 Rayburn House Office Building

OIL, THE DOLLAR, GLOBAL IMBALANCES, AND THE U.S. ECONOMY

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1 **OIL, THE DOLLAR, GLOBAL IMBALANCES, AND THE U.S. ECONOMY**

2 Even as the housing collapse and related sub-prime crisis have slowed the real U.S.
3 economy and weighed on the value of the dollar, oil prices have flirted with \$150 per barrel and
4 remain high despite recent downward adjustments. The resulting risks to the U.S. economy are
5 serious. Other factors being equal, a falling dollar increases the prices of all imports, thus
6 threatening more rapid inflation, and limiting the flexibility of the Federal Reserve to reduce
7 interest rates. Meanwhile, higher oil prices drain U.S. consumers' wallets, and compound the
8 impact of the credit crunch in slowing the economy and delaying recovery. The same higher oil
9 prices also afflict other developed non-oil-producing nations, and thus could spread the
10 economic slowdown around the world. In this regard, we should note that the price of oil has
11 increased in Euros quite significantly, making clear that more costly petroleum is not only the
12 product of our own weaker currency, but is driven by more basic supply/demand factors that will
13 endure for some time. With these adverse but seemingly contradictory developments, monetary
14 and fiscal policy makers the world over face a near-term balancing act to retain their hard-won
15 credibility in maintaining price stability while avoiding a painful loss of economic output and
16 employment.

17 Still, as difficult and as important as these near-term macroeconomic challenges may be,
18 this nation and the world must maintain a focus on the longer-term fundamentals that will
19 determine prosperity beyond the current slowdown. The oil price is a startling reminder of
20 another potential crisis that was overlooked while everyone watched the financial meltdown: the
21 continuing enormous imbalances in the global economy. While some progress was made in
22 reducing the U.S. current account deficit in 2007 as a more competitive dollar gave a welcome
23 boost to exports, the rising oil price has pushed these imbalances into growing again. So as I
24 address the current economic environment, I want to guide your attention toward a longer-term
25 challenge facing fiscal and monetary policymakers, both in the U.S. and in other countries.

26 Let us begin by taking a moment to review the large international imbalances that
27 threaten longer-term economic stability and prosperity.

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28 These imbalances have been most acute in the surpluses of Asian manufacturers, notably
29 China and Japan, and the oil exporting countries, whose surpluses are now growing. On the
30 other side of the fence has been the United States, with a persistent outsized deficit, along with
31 certain other countries with large deficits relative to their GDP, such as the U.K., Australia and
32 New Zealand.

33 It is understandable that the credit crunch and weakening economy have diverted
34 attention from the global imbalances. The U.S. current account deficit, after growing painfully
35 for a decade, has stabilized, at least for now. That deficit in the first quarter of 2008 was 5.0
36 percent of GDP, too large to be sustained, but below its peak of 6.6 percent at the end of 2005.
37 For the United States, the adjustment process has begun to work as advertised: a dollar
38 depreciation of 23 percent since mid-2002 and the slowing of U.S. growth relative to the growth
39 of our trading partners brought a surge in exports and dampened the growth of non-oil imports.
40 Indeed, the current account deficit may fall further relative to GDP if the economy slides into
41 recession – although this is hardly a desirable means of adjustment.

42 Still, record oil prices show that this is not the time to declare victory over international
43 imbalances. Indeed, in spite of a stabilized U.S. current account deficit, in absolute terms global
44 imbalances remain extremely large. Because these imbalances are now overlaid on the crisis in
45 U.S. and European credit markets and a weakening U.S. economy, the risks of global financial
46 and economic disorder are increasing as well.

47 In September 2007, the Committee for Economic Development (CED) released a study
48 entitled *Reducing the Risks from Global Imbalances*. The report argued that the large
49 imbalances are unsustainable and, if not corrected, significantly raise the risks of financial and
50 economic instability and the adoption of protectionist trade policies. This study noted, however,
51 that market mechanisms were likely to reduce the imbalances, but this adjustment should be
52 facilitated by sensible (and self-interested) policies by the major nations involved. The study
53 outlined actions by the United States, China, the European Community, Japan, and the oil
54 exporters that would help the process of global adjustment and a reduction of imbalances. These

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55 measures would be most effective if adopted by all the countries contributing significantly to the
56 imbalances.

57 The immediate problems of the worldwide credit crunch and economic slowdown have
58 drawn attention away from the longer-term concerns about global imbalances and related
59 economic pressures. The U.S. current account deficit has improved somewhat, and the direct
60 increase in the current account surpluses of oil exporters has drawn less attention than the impact
61 of the sharp rise in oil prices on economies dependent on oil imports. Unfortunately, we have
62 yet to see any significant new adjustment policies being adopted by the major surplus and deficit
63 countries, and certainly no coordinated international actions, with the modest narrowing of
64 global imbalances more due to short-term market conditions rather than structural change.
65 Unfortunately, the recent improvement in the US current account deficit has not been caused by
66 reductions in energy and Asian exporting countries' surpluses. Rather, it seems more likely that
67 we will witness a widening of deficits of the trading partners of these countries, just spreading
68 the imbalance problem rather than resolving it. Thus, despite the thinning of a few nearby
69 clouds, there is no weakening of the imbalances storm front on the horizon. In fact, there are
70 important reasons to believe that the vulnerability of the United States, and increasingly other oil
71 importing countries, to global imbalances may worsen significantly in the coming years. There
72 are several reasons for this concern.

73 First, the U.S. federal budget deficit and our generally low overall national savings rate
74 lead to a persistent current account deficit. At its historic peak, the current account deficit
75 required the United States to attract roughly \$2.0 billion dollars a day to finance this deficit. Due
76 to the weakening of the U.S. economy, and the weakening of the dollar, this need to finance the
77 current account deficit has now dropped to \$1.5 billion per day, even with the higher price for
78 imported oil. This amount may indeed go lower, but will continue to be significant for the
79 foreseeable future. Exchange rate adjustment, including further weakening of the dollar, should
80 eventually restore equilibrium, but policy actions would be desirable to facilitate adjustment and
81 reduce the risk of a dollar crash in response to economic or financial shocks before the
82 adjustment process is completed. I personally believe that the adjustment will be less risky and

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83 less painful with affirmative and collective global policy action rather than leaving exchange
84 rates alone to do the job.

85 Second, the growth of federal entitlement programs, particularly healthcare and social
86 security, will lead to ever higher federal budget deficits without either restructuring the programs
87 themselves, or paying significantly higher taxes, or a combination of the two. Failing to address
88 this will contribute to still greater current account deficits, a larger need for foreign financing,
89 and a weaker dollar.

90 Third, the current account deficit can be expected to climb further once the United States
91 recovers from the current slow growth or recessionary period. I believe that we can expect such
92 a recovery to begin in the second half of 2009. The impact of such a recovery on the dollar will
93 be mixed, with the negative aspects for the dollar of a higher current account deficit offset by
94 foreign investors finding the United States a more attractive destination for their funds.

95 Without policy change, therefore, the outlook is that total foreign indebtedness as a
96 percentage of GDP will climb steadily in the future. This means that the cost of servicing this
97 debt will be a growing burden on the U.S. economy and a weight on the dollar. Accompanying
98 this, we can expect some increase in long-term bond yields over current levels, as the U.S. needs
99 to attract more foreign capital but foreign investors face the prospect of receiving returns on such
100 investment in depreciating dollars. Equally significantly, there is a question of intergenerational
101 equity, as future generations must bear the debt burdens that result from the consumption of the
102 current generation.

103 As just noted, the dollar can be expected to stay relatively weak in the long term unless
104 we are willing to face somewhat higher interest costs to increase its attractiveness as an
105 investment vehicle. A weaker dollar will "import" more inflation into the U.S. economy through
106 higher prices for foreign goods and services. Offsetting this negative impact, exporting sectors
107 of the economy will benefit by becoming more cost-competitive. In fact, exports now account
108 for practically all the growth in GDP over the past several quarters. It is due to a weaker dollar
109 and stronger exports that the current account deficit narrowed in 2007 for the first time in many

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110 years. However, a wider deficit is expected in 2008, with a \$261 billion increase in the oil
111 import bill more than offsetting a \$166 billion improvement in the rest of the current account.

112 The spread in foreign central bank rates versus the United States has also contributed to
113 downward pressure on the dollar, especially relative to the Euro. This will be alleviated as the
114 Fed begins to raise rates, probably in the beginning of 2009, reducing the now 2-1/4 percent gap
115 between the federal funds rate and the European Central Bank's policy rate.

116 The weaker dollar has contributed somewhat in the short term to the high prices paid for
117 oil and other imported commodities. As one factor, most Middle East oil exporters
118 have continued to peg their currencies to the dollar and want, at a minimum, to maintain the real
119 value of the prices received for their oil to finance their own imports from other regions of the
120 world. However, as a trade-weighted basis, the Saudi Rial has only depreciated by 9% since
121 2005. The Saudis may have wanted higher prices for oil for other reasons, but the depreciation
122 of their own dollar-pegged currency cannot be responsible for much of today's high oil prices.
123 While the weak dollar can be a short-term contributor to higher prices for oil and other
124 commodities, most of the recent price increases are a function of supply and demand. This can
125 be illustrated by the increases in Euro prices for commodities. The price of oil in Euros has
126 increased by about 175 percent since the beginning of 2005, which is not too far behind the 233
127 percent increase in dollars. So we should not assume that the value of the dollar is the main
128 culprit or that an increase in the dollar would significantly reverse the pressure that oil and other
129 commodities exert on the overall U.S. price level.

130 The current credit strains in U.S. financial markets, and foreign investor concerns about
131 the risks associated with U.S. financial institutions and securities, also contribute to a weaker
132 dollar. It is imperative that stability and investor confidence be restored in U.S. financial
133 markets so that the United States can continue to attract foreign capital at reasonable rates –
134 which is needed to finance U.S. deficits. Many of the government actions taken recently, such as
135 Fed lending to securities firms, Fannie Mae and Freddie Mac, are appropriate and do contribute
136 to restoring needed stability and confidence. However, it should be remembered that by these

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137 actions, the federal government, which is already running a large deficit, has further increased its
138 exposure.

139 In the past, the U.S. capital account has helped to offset the financing cost of the current
140 account deficit. This is due to the fact that the United States earns more on its
141 foreign investments than foreign investors earn on their investments in the United States, since
142 much of the latter is in low-yielding U.S. Treasury securities. However, this U.S. advantage is
143 shrinking and could disappear altogether in the future. One threat to this favorable margin is the
144 establishment of sovereign wealth funds. Because of persistent imbalances, some \$3 trillion in
145 surplus dollars are held by other countries, and up to now, approximately \$1 trillion of these
146 funds have been placed in some 40 sovereign wealth funds. These funds, often handled by
147 professional money managers, may not be content to recycle dollars into Treasury securities, but
148 are likely to seek higher returns, both in the U.S. and elsewhere. Such trends will surely be
149 negative for the dollar.

150 So what to do? First, and most immediately, the credibility of U.S. financial markets
151 must be restored to attract the substantial foreign capital needed to finance the U.S. current
152 account deficit without a steep rise in interest rates or an even lower dollar. All participants in
153 the U.S. financial markets must address the impairments of the past, restore their capital bases,
154 and establish better risk controls in their borrowing and lending practices. This must be done
155 immediately, completely, and transparently and should be accompanied by more effective
156 regulatory oversight. The steps taken thus far by many banks to write-off losses and obtain new
157 sources of capital, both from U.S. and foreign sources have been helpful and necessary, but I
158 believe more needs to be done.

159 To accompany such private actions, the Federal Reserve has appropriately provided
160 additional liquidity to prevent recent financial problems from causing even deeper and long-
161 lasting damage to financial markets and the real economy, which could cost jobs and income in
162 the United States and abroad. The Fed's interest rate cuts of 325 basis points starting last
163 September and recent liquidity facilities for financial institutions have been key. Appropriately,
164 the Congress and the Administration moved quickly to put in place temporary fiscal stimulus in

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165 the range of one percent of GDP. These monetary and fiscal actions have helped to put a floor
166 under the economy, although the U.S. still faces a difficult period into 2009 now that most of the
167 stimulus is behind us. Indeed, the economy still risks dipping into recessionary territory over the
168 next several quarters.

169 Further action by policymakers everywhere will probably be needed to limit the depth
170 and duration of the current slowdown. This will require the Fed, the European Central Bank
171 (which raised rates earlier this month), and other central banks to make further difficult choices
172 between limiting economic and social damage and controlling inflation. These choices must be
173 made carefully, because the weaker dollar and higher oil and other commodity prices will sustain
174 the threat of inflation, especially for the United States and countries with currencies pegged to
175 the dollar. We cannot afford to sacrifice the strong central bank credibility, established slowly
176 and painfully over many years, that has supported sustained economic growth with low inflation.

177 Along with the measures taken to support the U.S. economy, we must also address global
178 imbalances. The U.S. fiscal stimulus, while certainly needed to counter the recession, will
179 contribute to increasing the current account deficit. Further, as the U.S. economy recovers, the
180 trade and current account deficits are likely to grow again. Mitigating this, the imbalances
181 caused by high prices of oil and commodities should also fall at some point; commodities
182 regularly go through such cycles as demand and supply shift. Oil prices should ease as world
183 growth slows and new capacity is developed. However, upward pressure on oil prices is more
184 likely to be sustained longer than in previous cycles, due to the current tight oil supply-and-
185 demand balance, numerous barriers to supply growth and the relentless increases in China's
186 energy consumption. Finally, and most fundamentally, whether the recent shifting of global
187 imbalances is temporary or not, the United States cannot afford to ignore its large current
188 account deficit. Persistent current account deficits have taken the U.S. net international
189 investment position to well over \$2 trillion, approximately 16% of GDP and climbing. As this
190 U.S. net foreign debt grows in relation to the economy, and as the cost of servicing this debt
191 increases, there certainly could be more downward pressure on the dollar. Just to summarize
192 some key points:

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- 193 • Even with an economic slowdown and a big drop in the dollar, the U.S. imbalance has
194 only improved modestly because of high oil prices;
- 195 • The rise in oil prices means that the imbalance problem is spreading to additional
196 countries, making the resolution of the global imbalance problem even more difficult;
- 197 • Coordinated international action to reduce imbalances would be desirable to facilitate
198 adjustment;
- 199 • We must not ignore the need to cut the federal budget deficit and raise private savings
200 over the longer-term, even though near-term actions are needed to stabilize the financial
201 situation and deal with high oil prices.

202 As CED recommended some months ago, a sound agenda must include: a credible
203 commitment by the United States to a *long-term* path of fiscal balance and increased national
204 saving; accelerated financial sector reforms and domestic consumption growth in China;
205 additional structural reforms in Europe and Japan; and further exchange rate adjustments or
206 greater rate flexibility in Asian and oil-exporting economies. With the U.S. economy weak,
207 countries with trade surpluses with the United States should stimulate their own domestic
208 demand. This would both mitigate the effect of lower exports to the United States and contribute
209 to the longer-term adjustment of global imbalances. And, needless to say, the United States must
210 reduce its demand for oil, both through efficiency measures and the development of alternatives,
211 as a matter of national and economic security. The United States has a key role to play in any
212 program to reduce imbalances: It must put its own house in order – prominently including
213 serious action to reduce the excessive federal budget deficits that exist now and under current
214 policies will only continue to grow. The U.S. must also provide the leadership needed to
215 encourage other countries to implement policies that will contribute to global adjustment. These
216 key tasks should be high on the agenda of both the current administration and the next U.S.
217 president.

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Written Testimony of
Robert P. Murphy, Institute for Energy Research
Before the
House Committee on Financial Services
On the Matter of
Oil Prices and the U.S. Dollar
July 24, 2008

1. About IER: The Institute for Energy Research (IER) is a not-for-profit organization that conducts intensive research and analysis on the functions, operations, and government regulation of global energy markets. IER maintains that freely-functioning energy markets provide the most efficient and effective solutions to today's energy and environmental challenges and, as such, are critical to the well-being of individuals and society.

Founded in 1989 from a predecessor nonprofit organization, IER is a public foundation under Section 501(c)(3) of the Internal Revenue Code and is funded entirely by contributions from individuals, foundations and corporations. Headquartered in Washington, D.C., IER supports public policies that simultaneously promote the welfare of energy consumers, energy entrepreneurs, and taxpayers.

2. Robert P. Murphy Resumé: Robert Murphy earned his Ph.D. in economics from New York University in 2003. From 2003 – 2006 he taught economics at Hillsdale College. After three years of teaching, Murphy left academia for the private sector, taking a job with Laffer Investments, headed by Arthur Laffer. In this capacity, Murphy maintained and improved stock selection models, and also helped write research papers for clients. One of the Dr. Laffer's main interests in this period was oil prices.

In the summer of 2007 Murphy joined IER as an economist. His academic research has focused on climate change economics, specifically the proper discount rate to use when evaluating mitigation policies. He has also given several public

presentations on the oil industry, dealing with such issues as record oil prices, windfall profits taxes, and offshore drilling. In addition, Murphy has prepared studies for IER dealing with oil and food prices, the effects of ethanol on gasoline prices, and the role of institutional speculation in oil markets.

3. The Causes of Record Oil Prices: The American public is growing increasingly frustrated with record gasoline prices, compelling policy makers to determine their causes and, if possible, to implement measures that will attempt to bring relief. Below I quickly discuss three popular theories—“peak oil,” speculation, and the greed of “Big Oil”—that have been suggested as the cause of higher gasoline prices, but dismiss them because the data do not support these explanations. Afterwards I offer a more convincing explanation, namely that record oil prices are due to stagnant supply (caused by institutional restrictions on production), booming demand among developing economies, and a weak U.S. dollar.

a) “Peak Oil” Not Supported by the Data: Many analysts, most notably Matthew Simmons,¹ have argued that the world has reached its maximum rate of oil extraction, and that this physical scarcity is the ultimate cause for record oil prices. According to this viewpoint, in the long term oil prices have nowhere to go but up, because even as new deposits are found to replace existing ones as they are depleted, the new finds will impose higher recovery costs per barrel.

I reject the peak oil theory insofar as it refers to technological limits on human ingenuity. The world currently has over 1.3 trillion barrels of proven reserves of crude oil,² enough to last almost 43 years at the 2007 average world consumption rate.³ Yet this figure is misleading, because oil producers only have the incentive to locate additional oil deposits as the known reserves are depleted. At any given moment, a household only has, say, a month’s worth of groceries in the pantry, and a similar pattern holds true for world oil reserves. To illustrate this phenomenon, I note that in 1980, proven reserves were fewer than 645 billion barrels, which at that time represented 28 years’ worth of oil, given the prevailing rate of consumption.⁴ Many alarmists had declared the end of the fossil fuel era during the energy crises of the 1970s, but in the 28

years since 1980, the world has more than doubled its proven oil reserves, and in fact has discovered oil at a faster rate than its growth in annual consumption. This has increased the world's cushion of proven reserves from 28 to 43 years' worth of oil, calculated at the 1980 and 2007 rates of consumption.

I wish to emphasize that the "proven reserves" concept is not merely an engineering or geological one, but also an economic concept. Embedded in the definition is the requirement of a 90 percent probability that these barrels can be profitably brought to market, given known technologies and relevant market prices. If we broaden our definition to include deposits of petroleum that can more likely than not be brought to market, at some point in the future, with sufficient technological development, then the world currently has literally centuries' worth of oil resources available for exploitation, should the need arise.⁵

The peak oil theory, however, refers not to total reserves but rather to extraction rates, i.e. how many barrels of crude per day can be delivered to the market. Yet even here the evidence shows no reason for pessimism. It is true that average world output fell slightly from 84.6 million barrels per day in 2005 down to 84.5 million barrels in 2007. By itself, this fact appears to lend credence to the peak oil theory.

However, world output in the first quarter of 2008 averaged 85.6 million barrels per day, an all-time record. And even the stagnant total output from 2005 through 2007 is misleading, because OPEC nations reduced their output during this period to almost perfectly counterbalance increases from non-OPEC producers. In the first quarter of 2008, OPEC nations produced 36.8 million barrels per day, another all-time record high.⁶

In conclusion, the world currently has a record amount of proven oil reserves, and is extracting them at a record rate. It would be impossible to refute the peak oil theory any more decisively; what more can the oil market do, than break all previous records? It is true that supply growth has not kept pace with demand growth, and—to anticipate our later conclusions—this is the cause of record oil prices. But the constraints on supply are political, not technological or physical.

b) Speculators Not to Blame for Record Oil Prices: Many experts have recently testified before Congress on the role played by institutional investors, such as hedge and mutual funds, in the recent jump in oil prices.⁷ However, many economists argue that the data do not support this explanation. If oil prices were truly being held by as much as \$70 per barrel above the level justified by the fundamentals, then it follows that we would see a large surplus in the oil market. That is to say, at an overpricing of up to \$70 per barrel, producers would be delivering far more barrels to market than end users would be willing to purchase at such inflated prices.

Although it is possible for speculators to induce such an outcome, it would result in a growing supply of oil inventory. There is no such pattern in the data. According to the EIA, U.S. commercial stocks have moved within historic norms during the last two years.⁸ Faced with this awkward fact, those promulgating the speculator theory argue that OPEC producers have scaled back their output, in effect hoarding barrels under the sand, where they are not counted as part of inventories. Yet here too, the evidence does not fit the explanation. From the second quarter of 2007 through the present, OPEC output has steadily increased in every quarter, precisely when oil prices experienced their most rapid spike.⁹

c) “Big Oil” Greed Not the Cause of Record Prices: To many citizens, it seems that the ultimate explanation for high oil and gasoline prices is the greed of large oil companies. After all, they have been earning record profits precisely as citizens have been paying record prices.

In fact, the causality runs in the opposite direction. There are large upfront costs to explore for new oil and natural gas deposits, drill wells, and establish the additional infrastructure necessary to bring new product to market. As the market price of oil increases, some of the variable costs increase, but much of the total cost has already been sunk at that point. Therefore, profit margins are high during periods of high oil prices, and low during periods of low oil prices. The important point is that the price of oil is set by supply and demand on the world market. If—as many cynics apparently believe—oil executives truly had the power to arbitrarily set prices in order to achieve (astronomical) profit targets, why was the price of oil roughly \$31 back in 2003? The

desire for oil companies to earn large profits was surely as strong five years ago as it is today.

It is also relevant that the nine largest privately held oil companies control only 4 percent of the world's proven oil reserves; if anyone is to blame for high oil prices, it seems "Big Governments" are a more likely culprit than "Big Oil." A final observation on oil industry profits is that they are admittedly large in absolute terms, but this is because the sales volume is so large. In the first quarter of 2008, the major oil and natural gas companies earned 7.4 cents in net income per every dollar in sales. This is lower than the profit margin in some other industries, such as 25.9 cents in pharmaceuticals and medicines, 17.8 cents in beverages and tobacco products, and 7.6 cents per dollar in all manufacturing.¹⁰ Oil companies are earning record profits because their product is in very high demand, not because they are exploiting their customers.

In conclusion, the peak oil theory, the speculator theory, and the greed of "Big Oil" theory of record oil prices all have some supporting evidence, as well as glib proponents. But the balance of the evidence does not support these explanations. In the following sections I lay out a more straightforward story involving the more mundane issues of supply and demand, as well as the weakening U.S. dollar.

d) Stagnant Supply Coupled With Booming Demand Lead to Record Prices: Above I have summarized the facts on oil production. Although it is at record levels through the first quarter of 2008, earlier OPEC cutbacks had kept total world output roughly flat from 2005 through 2007.

During this period, oil consumption grew rapidly among developing countries, most notably China. From 2003 to 2007, China—the largest oil consumer in the world, after the United States—experienced an 8 percent annualized growth in its consumption of oil. Many commentators dismiss Chinese demand as an important factor, because after all, oil prices have certainly risen much more quickly than 8 percent per year. However, Chinese oil consumption has risen at such high levels *in spite of* more than a doubling of oil prices during this four-year period. (In contrast, Italy, Japan, and Germany all experienced greater than a 2 percent annual *decline* in oil consumption over this same four years, while the U.S. experienced a 0.8 percent annualized increase.)¹¹ In

order to gauge the actual shift in the Chinese appetite for oil, and its effects on the price of oil, one would need to estimate how quickly its consumption would have risen, had oil prices remained at their 2003 average of \$31 per barrel.

e) The Role of the Weakening U.S. Dollar: Oil is a highly fungible commodity traded on a world market. As such, changes in the exchange rate between the U.S. dollar and other currencies translate immediately into the spot price of crude, quoted in U.S. dollars. When the dollar falls against the euro, for example, the dollar-price of haircuts in Texas may not rise in response. But the dollar-price of a barrel of crude will, because oil can easily be diverted to other paying customers in response to fluctuating currency values.

From mid-June of 2007 through mid-June of 2008, the spot price of West Texas Intermediate crude rose from \$66 to \$135 per barrel, a 104 percent increase. But during the same period, the price of a euro rose from \$1.33 to \$1.54, almost a 16 percent increase. In this sense, fully 15 percent of the doubling of oil prices over the last year, is due entirely to the depreciation of the U.S. dollar against foreign currencies.

Beyond this direct linkage, some observers suggest that part of the recent boom in commodity prices is due to investor angst over future monetary policy. According to this view, oil prices have been driven not merely by the direct depreciation of the dollar, but also because investors are rushing to liquid commodities, such as oil and gold, in response to the credit crisis and the unprecedented interventions of the Federal Reserve. If an investor believes that the Fed and Treasury are willing to do whatever it takes to rescue ailing banks and a stagnant economy—despite year-over-year CPI increases of more than 5 percent—then a larger exposure to commodity indexes is a rational response.

The table below illustrates the strongest argument for this theory, namely that year-over-year oil prices were actually falling from January through August of 2007, and did not begin their meteoric ascent until the Federal Reserve cut its target rate in September.

Table 1
West Texas Intermediate Crude Spot Prices
(monthly averages, source: EIA¹²)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	65.49	61.63	62.69	69.44	70.84	70.95	74.41	73.04	63.80	58.89	59.08	61.96
2007	54.51	59.28	60.44	63.98	63.45	67.49	74.12	72.36	79.91	85.80	94.77	91.69
2008	92.97	95.39	105.45	112.58	125.40	133.88						

However, I should point out that this last argument is a variant of the speculative bubble theory. Because oil inventories (at least in the U.S.) have not grown significantly from September 2007 through the present, and because there appears to be no strategic cutback in oil production during this period, it is unlikely that a large portion of the sharp rise in oil prices in the last nine months can be attributed to investor anxiety over future economic conditions, because of the falling dollar or even a new war in the Middle East. Notwithstanding the evidence of Table 1 and the chronology of world events, I still maintain that fundamental forces are the true explanation of oil prices. However, my explanation includes the “fundamental” depreciation of the dollar which is not speculation, but a fact.

4. Possible Remedies for Record Oil Prices: In conclusion I list several possible remedies to bring down oil prices. I stress that these are not recommendations per se; there are possibly undesirable budgetary, macroeconomic, and environmental consequences for each of the remedies listed. My role as an economist is simply to inform the committee of its options. In the end, policy makers will have to weigh the benefits and costs of the following, as well as other, possible solutions to our present situation.

a) Enact Policies to Strengthen the U.S. Dollar: The long-term strength of the U.S. dollar is the responsibility of the Federal Reserve. If the goal were an appreciating dollar and correspondingly lower oil prices, the Fed would raise its target for the federal funds rate, which in turn would raise yields in general on dollar-denominated assets. If foreign investors believed the policy shift were permanent, they would increase their holdings of U.S. assets, driving up the dollar on the foreign exchanges. Besides Fed

policy, the federal government could also promote the dollar by cutting income tax rates, which would increase the after-tax return on U.S. assets and hence promote their attractiveness to investors. The Reagan tax cuts in the early 1980s went hand in hand with a soaring dollar.

b) Remove Federal Prohibitions on ANWR and OCS Oil Development, as Well as Oil Shale Leasing: According to federal government estimates, there are currently some 18 billion barrels in the Outer Continental Shelf (OCS),¹³ as well as an additional 19 billion barrels on federal lands,¹⁴ of crude oil resources that are off-limits to energy producers because of federal prohibitions. These numbers are likely to be extremely conservative, as producers have had little reason to explore without legal permission to develop these resources.

Besides actual prohibitions, there are also legal and other impediments brought by environmental groups and others to hinder development of oil resources on federal lands. Currently, less than 3 percent of the federal OCS is leased for energy exploration, and less than 6 percent of the onshore federal lands (over 2 billion acres), forcing exploration into a small fraction of our potential reserves.¹⁵ Government policies should seek to attract private capital to explore the government's lands to ascertain the extent of our resource potential, about which little is actually known.

Regarding oil shale, the Department of Energy estimates that the U.S. possesses some 800 billion barrels of recoverable oil,¹⁶ over three times the proven crude reserves of Saudi Arabia. However, current law forbids commercial leasing of this vast potential source of domestic energy, such that no commercial enterprise has the incentive to invest capital in this unconventional source.

Allowing the development of these domestic oil resources would not only increase world output of crude, but could significantly increase the world's spare pumping capacity, which members of industry argue is an important determinant of prices. For example, the EIA estimates 2008 spare capacity in OPEC producers at 1.55 million barrels per day.¹⁷ This is a very tight margin, where a major disruption to production anywhere in the world (Iran, Nigeria, Venezuela, etc.) could render supply unable to meet world demand. In this context, the mean estimated ANWR maximum

production rate of 780,000 barrels per day is more significant than many critics believe. (The low and high estimates of maximum ANWR production are 510,000 and 1.45 million barrels per day, respectively.)¹⁸

Finally, given the topic of today's hearing, I note that the connection between oil prices and the U.S. dollar is complex. Changes in the dollar's strength against other currencies are immediately reflected in the world price of oil, quoted in dollars, as explained earlier. However, to the extent that the United States increases domestic output and reduces its imports of foreign oil, a significant source of downward pressure on the dollar is weakened. Other things equal, removing federal restrictions on domestic oil production should lead to lower oil prices and a stronger dollar.

¹ Simmons, Matthew. *Twilight in the Desert: The Coming Saudi Oil Shock and the World Economy*. Hoboken, N.J.: John Wiley & Sons, 2005.

² Proven reserves data available from the EIA at:

<http://www.eia.doe.gov/pub/international/iealf/crudeoilreserves.xls>. Data accessed on July 20, 2008.

³ The 2007 rate of world petroleum consumption available at: <http://www.eia.doe.gov/emeu/ipsr/t17.xls>. Accessed July 20, 2008.

⁴ The 1980 rate of world petroleum consumption available at: <http://www.eia.doe.gov/emeu/ipsr/t46.xls>. Accessed July 20, 2008.

⁵ Bradley, Jr., Robert and Richard Fulmer. *Energy: The Master Resource*. Dubuque, Iowa: Kendall/Hunt Publishing, 2004. Available online at: <http://www.instituteforenergyresearch.org/2008/07/18/energy-the-master-resource/>.

⁶ Oil production rates available at: <http://www.eia.doe.gov/emeu/ipsr/t21.xls>. Accessed July 20, 2008.

⁷ See for example the testimony of hedge fund manager Michael Masters, available at: <http://hsgac.senate.gov/public/ files/052008Masters.pdf>.

⁸ Commercial stock data available at: <http://tonto.eia.doe.gov/dnav/pet/hist/mtstus1m.htm>. Accessed July 20, 2008.

⁹ OPEC output data available at: <http://www.eia.doe.gov/emeu/ipsr/t21.xls>. Accessed July 20, 2008.

¹⁰ Earnings statistics from the American Petroleum Institute, available at: http://api.org/statistics/earnings/upload/earnings_perspective.pdf. Accessed July 21, 2008.

¹¹ Data on 2003 and 2007 consumption available through the pull-down menu at: <http://tonto.eia.doe.gov/country/index.cfm>. Accessed July 20, 2008.

¹² WTI spot prices available at: http://tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_m.htm. Accessed July 21, 2008.

¹³ Data on OCS resources that are currently off-limits available at: <http://www.eia.doe.gov/oiaf/aeo/otheranalysis/ongr.html>. Accessed July 21, 2008.

¹⁴ Data on crude resources located on off-limits onshore federal lands available at: http://www.blm.gov/wo/st/en/prog/energy/oil_and_gas/EPCA_III/EPCA_III_faq.html. Accessed July 21, 2008.

¹⁵ Statistics on leased lands available at: <http://www.instituteforenergyresearch.org/2008/06/25/truth-about-ocs/>.

¹⁶ Estimate of oil shale reserves at: <http://ostseis.anl.gov/guide/oilshale/index.cfm>. Accessed July 21, 2008.

¹⁷ EIA estimate of OPEC spare capacity available at: <http://www.eia.doe.gov/emeu/steo/pub/3ctab.pdf>. Accessed July 21, 2008.

¹⁸ Estimates of ANWR production rates available at: <http://www.eia.doe.gov/oiaf/servicrpt/anwr/results.html>. Accessed July 21, 2008.

Testimony

Walter J. Williams, economist, ShadowStats.com

**Before the Committee on Financial Services, United States House of Representatives
"Implications of a Weaker Dollar for Oil Prices and the U.S. Economy"
July 24, 2008, 2:00 p.m.**

Implications of a Weaker Dollar for Oil Prices and the U.S. Economy

Chairman Frank, Ranking Member Bachus and members of the Committee, thank you for the opportunity to discuss the implications of a weaker dollar for oil prices and the domestic economy.

A weaker U.S. dollar¹ helps to spike oil prices and otherwise generally fuels domestic inflation, reducing the purchasing power of consumers' paychecks and the real value of their assets. The underlying factors that have led to recent turmoil in the currency markets remain in play. While significant further weakness in the dollar would place additional upside pressure on oil prices and domestic inflation, it also could encourage oil producers to denominate oil prices in a currency or currencies other than the U.S. dollar. Such would exacerbate U.S. inflationary pressures. Separately, further weakness in the dollar could threaten domestic financial-market liquidity, complicating the systemic challenges already being addressed by the Federal Reserve.

On the plus side for the economy, a weaker dollar tends to help narrow the trade deficit. Yet, the positive effects are seen primarily in commodity-like goods. Where quality and features are important to the goods and services traded, the impact is quite muted.

From the standpoint of consumer inflation, a number of factors influence prices, including the value of the dollar. A weaker dollar means that those living with dollar-denominated incomes and assets are losing purchasing power and real value against the non-dollar denominated world. Over the long-term, that lost global purchasing power tends to be reflected in domestic inflation and a parallel loss in domestic purchasing power. For example, since March 1985, the dollar has lost 50% of its purchasing power against the major Western currencies, while the dollar has lost 51% of its domestic purchasing power to inflation.

An historically high negative correlation between movements in the dollar and oil prices suggests that dollar weakness adds upside pressure to oil prices. With oil denominated in dollars, dollar weakness provides an effective discount to non-dollar-based economies, due to the relative strength of the local currency. While dollar oil prices had nearly doubled for the year ended June 30th, oil prices were up only 70% in terms of the yen and euro.

In response, market forces tend to balance the effective discounts with upside pressure on oil prices in dollars. Additionally, it is in the direct interest of oil producers to see upside pressure on dollar oil prices as an offset to global purchasing power being lost in weakening dollar-denominated revenues.

¹ All dollar references are to the U.S. dollar unless otherwise specified.

Testimony, Walter J. Williams, Committee on Financial Services, United States House of Representatives
 "Implications of a Weaker Dollar for Oil Prices and the U.S. Economy," July 24, 2008

As to the domestic financial markets, where the U.S. trade deficit has pumped excess dollars into the global markets, a significant dollar overhang has developed, particularly with foreign central banks. The investment of these holdings in the United States has kept the domestic credit and equity markets relatively flush with liquidity. Perennial weakness in the U.S. currency, however, discourages such investment, and intensified dollar selling is a risk in the months ahead. Such selling could trigger dumping of the dollar and dollar-denominated assets. The same could result from efforts to mitigate the impact of higher oil prices with an offsetting decline in the dollar. Unless otherwise compensated for by the Federal Reserve, such action would drain liquidity from and correspondingly roil the U.S. financial markets.

The relative value of a nation's currency is a measure not only of its trade position, but also of global capital flows that mirror how the rest of the world views that nation's economic strength, financial-system integrity and political stability. While the U.S. dollar's exchange-rate value has experienced high volatility over time, it generally has trended sharply lower during the last four decades, having hit historic lows in recent months against key currencies such as the Japanese yen and Swiss franc.

The current circumstance results from extended periods of deliberate debasement or neglect of the U.S. currency by various administrations and Federal Reserve chairmen. Contrary to popular conventional wisdom, the dollar does matter, and so does the budget deficit. The dollar issues are coming to a head. The deficit issues are related but still are smoldering in the background.

Underlying fundamentals that drive the relative value of the U.S. dollar, against the currencies of its major trading partners, could not be much more negative. The key factors, or surrogates for global market concerns, include the relative U.S. conditions on trade balance, economic activity, inflation, fiscal discipline, interest rates and political/systemic stability. Only interest rates and related monetary policies are quickly addressable at present. Changes there could run counter to the Federal Reserve's needs in its current efforts to promote systemic financial stability, and could be somewhat counterproductive in what I contend currently is a recessionary environment.

Neglecting U.S. dollar weakness, or providing nothing more than unsupported jawboning of a "strong dollar" policy, begets further selling pressure on the dollar, promising further upside pressure on oil prices, further depreciation of U.S. consumers' purchasing power, and increased risk of a torrent of dollar dumping and resulting turmoil in the U.S. financial markets.

Thank you.

Expanded Detail

Dollar Weakness Feeds Inflation

As of June 2008, the dollar had lost 50% of its value since March 1985, against the major Western currencies.² In the same period, the dollar lost 51% of its domestic purchasing power due to inflation.³ A

² The Federal Reserve's Major Currencies Trade-Weighted Dollar Index hit a near-term monthly-average peak in March 1985 of 143.91, versus 71.42 in June 2008.

³ Bureau of Labor Statistics' CPI-U (not seasonally adjusted) stood at 106.4 in March 1985, 218.8 in June 2008.

Testimony, Walter J. Williams, Committee on Financial Services, United States House of Representatives
 "Implications of a Weaker Dollar for Oil Prices and the U.S. Economy," July 24, 2008

decline in the exchange-rate value of the U.S. dollar directly reflects a loss of global purchasing power for those receiving their income or holding their assets denominated in dollars.

Prices of imported products (including oil) tend to rise, adding to domestic inflation pressures. The reasons for rising dollar oil prices resulting from dollar weakness are discussed below. While a variety of factors impact the popularly followed U.S. consumer inflation numbers, over time, the loss of global purchasing power due to a weak domestic currency eventually tends to manifest itself in a parallel loss of domestic purchasing power.

Oil Prices Impacted by the Dollar

Oil prices are driven by a variety of supply and demand issues, including significant cartel-controlled production. With global oil priced in terms of dollars, significant changes in the value of the dollar also have flow-through impact on the price of oil.

Consider, for example, conditions as they stood at June 30, 2008, with the price of oil at \$140.00 per barrel, up by 98% from the year before. The dollar, however, had declined in value over the same period by 14% versus both the euro and the Japanese yen, with the effect of the price of oil being up by just 70% in terms of both the euro and the yen.⁴ Market forces tend to balance the differential with some further upside pressure on dollar-denominated oil prices.

Separately, from the standpoint of oil producers, who find that their dollar-denominated revenues are losing their purchasing power, higher dollar-denominated oil prices are a desired offset.

The current oil price problem in many ways is a dollar problem -- tied to the weakness of the U.S. currency. Over the last 10 years, there has been a negative correlation of 83% between monthly average dollar value and oil prices, meaning that oil prices have tended to move in the opposite direction of the dollar (i.e., a weak dollar means strong oil prices).⁵

Having oil priced in U.S. dollars is a positive for the greenback, as such increases demand for holdings of the U.S. currency. At some point, however, continued dollar depreciation might force oil producers to abandon oil pricing based in dollars. The broad effect of that would be intensified dollar selling pressures and an inflation spike in the United States, with the energy-inflation impact much mitigated in the non-dollar world.

High Oil Prices Risk Triggering Dollar Dumping

High oil prices raise the potential of some foreign holders of U.S. dollars selling the greenback in order to lower their effective petroleum costs.

Overhanging the markets for a number of years has been the question as to when the major holders of excess U.S. dollars in the global financial system might look to liquidate those holdings. An opportunity for that dumping is at hand. Most central banks recognize that their unwanted dollar hoards likely are going to generate long-term losses, but the strong oil market has opened up an opportunity to mitigate

⁴ Respective June 30, 2008 and 2007 values: West Texas Intermediate spot \$140.00 per barrel and \$70.69 per barrel (Wall Street Journal); euro = \$1.5748 and \$1.3520 and dollar = ¥106.17 and ¥123.39 (Federal Reserve Board).

⁵ The Federal Reserve's Major Currencies Trade-Weighted Dollar Index versus West Texas Intermediate spot prices.

Testimony, Walter J. Williams, Committee on Financial Services, United States House of Representatives
 "Implications of a Weaker Dollar for Oil Prices and the U.S. Economy," July 24, 2008

some of those losses. For the rest of the world, dollar dumping now could reduce inflation risks outside the United States.

With oil prices off their recent peak -- shy of \$150 per barrel -- but still well over \$100 per barrel, serious inflation consequences are in store for those economies that have been propping the greenback against their own domestic currencies, either by not selling unwanted dollar holdings or by intervening in the markets to maintain the dollar's relative market value. From a perspective outside the United States, an offset to oil-price-based inflation risk is available in dollar depreciation, which reduces the cost of oil in the currency of the oil-purchasing country. The effects of a declining dollar, however, still do tend to boost dollar-based oil prices further, but not fully, in something of a self-feeding cycle, as discussed earlier.

Weak-Dollar Risks for U.S. Financial Markets

The value of the U.S. dollar should be of significant concern to the Administration and to the Federal Reserve for reasons beyond the implications for inflation. If selling of the greenback intensifies sharply, the effects on the domestic financial system and markets could be severely negative. The influx of foreign capital enjoyed by the U.S. markets in recent years has kept the domestic markets flush with liquidity, funding roughly 80% of Treasury debt issuance as well as a significant portion of new corporate capital needs.

A reversal of those flows would drain liquidity from the system. Such would have the potential of crashing the various U.S. markets, if the Fed did not move otherwise to re-liquefy the system. The Fed and the U.S. Treasury have to have a serious interest in major holders of the U.S. dollar continuing to hold their dollars and dollar-denominated assets. Continued weakness in the dollar and a further spike in oil prices, again, run the risk of triggering a general exit from the dollar and dollar-denominated assets, spiking U.S. interest rates and potentially savaging the U.S. financial markets.

Dollar Fundamentals

In terms of underlying fundamentals that drive, or act as surrogates for concerns that drive relative currency values, the U.S. dollar's portfolio could not be much worse. Against major trading partners, consider the United States' relative positions:

- Trade Balance (Negative): Despite recently reported narrowing of the monthly trade deficit, the U.S. trade shortfall remains unprecedented in its relative global magnitude.
- Economic Activity (Negative): U.S. business conditions are deteriorating, with the economy clearly in a recession in all but formal declaration of same.
- Inflation (Negative): U.S. inflation has risen sharply, with the CPI-U up 5.0% year-to-year as of June; broad money growth is highest since 1971; double-digit inflation is possible by early 2009.
- Fiscal Discipline (Negative): The already expanding U.S. federal budget deficit likely will be worse than expected, thanks to the developing recession.
- Interest Rates (Negative): U.S. interest rates are low, with Federal Reserve policy perceived to be on hold per current market expectations.
- Political/Systemic Stability (Negative): The President's approval rating (currently low) is a fair indicator of currency trends; the banking crisis is a negative.

Options for Strengthening the Dollar

Testimony, Walter J. Williams, Committee on Financial Services, United States House of Representatives
"Implications of a Weaker Dollar for Oil Prices and the U.S. Economy," July 24, 2008

Jawboning and central bank intervention (covert or overt) in support of the dollar have been seen irregularly, but neither action has lasting impact. Of the above fundamentals, only interest rates and monetary policy effects on inflation could be addressed quickly. Yet, raising interest rates or constricting money growth might be counterproductive to the Federal Reserve's efforts in stabilizing the financial system and somewhat counterproductive in the current recession.

Changes in the trade, economic and fiscal factors would require major policy shifts that generally would be long-term in nature before broad impact would be seen. The issues of political and systemic stability tend to flow from the other factors.

Neglecting U.S. dollar weakness, or providing nothing more than unsupported jawboning of a "strong dollar" policy, begets further selling pressure on the greenback, promising further depreciation of U.S. consumers' purchasing power, and offering increased risk of a torrent of dollar dumping and resulting turmoil in the U.S. financial markets.

###

Congress of the United States
Washington, DC 20515

June 24, 2008

Chairman Barney Frank
House Committee on Financial Services
2129 Rayburn HOB
Washington, DC 20515

Dear Chairman Frank:


We are writing to express our concerns about the rising price of oil and request that you hold a hearing of the Financial Services Committee to examine the relationship between the price of oil and the weakness of the US dollar. The price of oil is currently among the most pressing issues to American workers. Congress should be examining all factors contributing to the high cost of oil, and monetary policy is one of the key factors in the run-up in price.

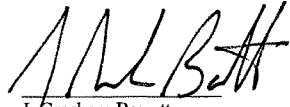
Since the beginning of 2008, the dollar price of oil has risen 39%, while the euro price of oil has risen only 30%. If foreign countries were not forced to hold large dollar reserves in order to enable the purchase of oil on international markets, the rise in the dollar price of oil would undoubtedly have been far higher. Had the dollar matched the euro's purchasing power over the past three years, consumers would today be paying more than 80 cents less per gallon of gasoline.

Neither the Federal Reserve nor the Treasury Department have been willing to take responsibility for the dollar's slide over the past several years, while American consumers have been forced to pay continually higher prices for gasoline, heating oil, and numerous other imported products upon which Americans depend. With this in mind, we once again urge you to consider our request to hold a Financial Services Committee hearing to examine the dollar's weakness and its effects on the price of oil. American consumers cannot afford to allow continued lax Congressional oversight of the Federal Reserve and the Treasury Department's duties as stewards of the dollar, especially since the dollar is a major factor in the skyrocketing price of oil.

Sincerely,


Ron Paul

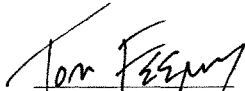

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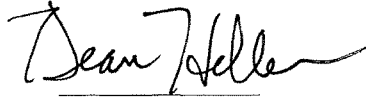

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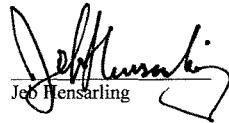

Michael N. Castle

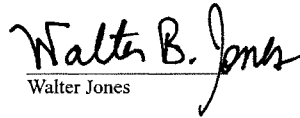

Tom Feeney


Scott Garrett



Jim Gerlach

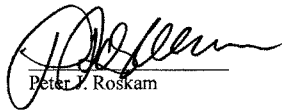

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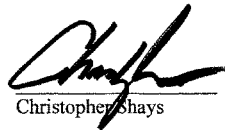

Joe Manchin



Walter Jones


Thaddeus McCotter


Randy Neugebauer


Peter J. Roskam


Christopher Shays


Frank Lucas

Financial Services Committee Hearing
"Implications of a Weaker Dollar for Oil Prices and the US Economy"
Wednesday, July 24, 2008

RESPONSES TO WRITTEN QUESTIONS
FROM REPRESENTATIVE BARRETT

Mr. Joseph E. Kasputys, Chairman and CEO, Global Insight,
on behalf of the Committee for Economic Development:

1. I come from a district that relies on a manufacturing base for jobs, and their success is a major priority for me. Therefore, I'm particularly concerned about the competing effects of dollar strength and the price of oil, especially as it relates to our manufacturers' ability to compete in the global marketplace.
 - a. I see a number of competing forces at work. On one hand, a weaker dollar makes our exports more competitive. Yet, on the other, that same weaker dollar drives up the price of oil, raising their costs and potentially hurting domestic demand.

i. **Q:** Is there a way that we can balance these concerns, keeping in mind the inflationary pressures from rising energy prices?

A: As noted in my statement, the weaker dollar has had relatively little influence on the price of oil. While significant and sudden changes in the level of the dollar may have a short-term and transitory impact on oil prices, the large increases we have experienced have been caused by rapid growth in demand, especially in emerging markets. Due largely to long-term under investment, which has also been impeded by regulation, the growth in supply has not kept pace, resulting in minimal spare capacity.

The weakening dollar is a separate matter, and is largely caused by the large annual US current account deficit and steadily growing unfavorable net international investment position. The US has now put nearly 3 and one-half trillion dollars into foreign hands. A weaker dollar will make all imports more expensive, especially those from countries whose currencies are not pegged to the dollar. An overly weak dollar and large foreign indebtedness leaves the US vulnerable to financial crises and more dependent on the actions of foreign holders of dollars.

It is true that the weakening of the dollar has helped to make certain US exports, especially from the manufacturing sector, more competitive internationally. While this is a good outcome, it is a consequence of the US perennially consuming more than it produces, which is not a healthy long-run situation. It would be far better to reduce the current account deficit by raising national savings. This would in turn

raise investment, leading to more technology leadership, higher productivity and a healthy manufacturing sector in the long run. The biggest step to take in raising national savings is to reduce the Federal budget deficit.

- ii. **Q:** Would pro-growth policies that allow the economy to grow better help us reach a healthy balance and remove some need to worry about the strength of the dollar?

A: Yes. There would be more people working, reducing the cost of social services and increasing tax revenues. Corporate profits and corporate tax payments would also be larger. This would contribute to reducing the Federal budget deficit and allow higher personal savings. Please also see the response to the previous question

- b. How would a move towards energy independence affect the many forces at work affecting dollar strength, inflation, and our trade balance, especially given concerns about inflation?

A: Reducing dependence on imported energy would not just cut the trade deficit and lower the current account deficit, but it would also make the entire US economy less vulnerable to potential inflationary pressures from oil and other energy imports. Equally important, high increases in energy prices can and do cause consumers to spend less in other areas, creating economic dislocations in certain sectors of the economy. Energy conservation, including improving productivity of energy use, should be at the forefront of efforts to achieve energy independence, since conservation has the added benefit of reducing greenhouse gas emissions, which is an important measure in addressing global warming.

2. Many experts have predicted that the federal government would enjoy considerable profits from the royalties if we opened up ANWR and OCS.

- a. **Q:** If these royalties were collected by the Treasury, what are some of the effects that we might see on the strength of the American economy?
- i. **Q:** How would these royalties affect the strength of the dollar and America's trade balance?

A: Assuming these royalties were not used to justify higher Federal spending, such royalties would contribute to cutting the Federal budget deficit and raising national savings, which in turn would cut the trade deficit and help to strengthen the dollar.

- ii. **Q:** Do you see any geopolitical advantages these royalties would bring if we opened up ANWR and OCS to drilling?

A: The royalties per se would only have the geopolitical advantages inherent in the benefits enumerated in the response to the previous question. To the extent drilling in the ANWR and OCS lead to less dependence on oil and other energy imports, this would have the added advantage of reducing the degree to which US policy needs to take account of maintaining the flow of such imports, allowing the US more flexibility in dealing with oil exporting countries such as Russia and the Middle East.

3. It is clear that rising oil prices have had a slowing effect on the American economy, and this hearing has reinforced the fact that the price of oil has very complex macroeconomic effects.
- a. Without major structural changes, can the American economy continue to grow at a healthy rate with oil and gasoline at their current prices?
- i. **Q:** How much have high energy prices impeded American economic growth?

A: Using oil prices (WTI) as an example, the price of oil per barrel averaged in the \$60-\$70 range until rising to an average of \$75.20 per barrel in the third quarter of 2007 and \$90.50 per barrel in the fourth quarter. This was followed by the more dramatic increases to \$97.90 per barrel in the first quarter and \$123.80 per barrel in the second quarter, which represented nearly double over the same quarter in 2007. Using its macroeconomic model of the United States, Global Insight estimates that the rise in prices that has been experienced since early 2007 has cut GDP growth by approximately two-tenths to four-tenths of one percent,

- ii. **Q:** What might a growth pattern for the American economy look like with sustained high commodity prices?

A: If oil, food and other commodities were to sustain recent peak levels indefinitely, the US would probably experience two to three negative quarters, i.e., a recession, followed by two to three quarters of below trend growth, with GDP in this latter period two to four tenths below a baseline projection.

- iii. **Q:** Given that Federal Reserve Chairman Ben Bernanke indicated last week in his testimony to this Committee that a 1 percent increase in oil supply could lead to a 10 percent drop in oil prices, do you think that a commitment by the federal government to allow oil exploration in ANWR and the OCS could have a significant effect on economic growth?

A: All other factors being equal, lower oil prices would contribute to higher economic growth. If oil exploration in the ANWR and OCS resulted in significant new discoveries that could be extracted at competitive costs, this would provide additional domestic supply. We should recognize that it will take a number of years before significant production could be realized from these areas, but the sooner we begin, the sooner this can happen. Once available, such additional supply would contribute to US growth in three ways: 1) by adding to domestic production, 2) by helping to reduce energy prices, and 3) by reducing oil imports.

###

**Response to Representative Barrett,
Regarding Follow-Up Questions Concerning
Robert Murphy's 7/24/08 Testimony Before
House Committee on Financial Services
On the Matter of
Oil Prices and the U.S. Dollar**

October, 2008

The following is Robert Murphy's responses to the follow-up questions mailed by Representative J. Gresham Barrett. The following answers reflect Murphy's personal views as an economist, and do not necessarily reflect the views of the Institute for Energy Research. Rep. Barrett's questions appear in italics, and are followed by Murphy's answers.

1) I come from a district that relies on a manufacturing base for jobs, and their success is a major priority for me. Therefore, I'm particularly concerned about the competing effects of dollar strength and the price of oil, especially as it relates to our manufacturers' ability to compete in the global marketplace.

** I see a number of competing forces at work. On one hand, a weaker dollar makes our exports more competitive. Yet, on the other, that same weaker dollar drives up the price of oil, raising their costs and potentially hurting domestic demand.*

→ Is there a way that we can balance these concerns, keeping in mind the inflationary pressures from rising energy prices?

Murphy: It is true that, other things equal, a weaker dollar makes exports more competitive. After all, if a product costs \$1000 in US stores, and one euro exchanges for \$1.25, then that American product costs Europeans 800 euros. If the dollar depreciates so that one euro now costs \$1.50, then the American product only costs 667 euros. Thus the weakening of the dollar, other things equal, makes American products cheaper from

foreigners' viewpoints, and they will tend to buy more. This process leads people to say that a weak dollar helps exporters.

However, this can be a very misleading analysis, because other things will *not* remain equal, depending on what is causing the dollar to depreciate. For example, if the Federal Reserve expands the money supply, this will (a) cause dollar-prices on U.S. price tags to increase, and (b) cause the dollar to fall against other currencies on the foreign exchanges. To continue our example from above, if the American product rises in price from \$1000 to \$1200, then it will still end up costing Europeans 800 euros ($\$1200 / \1.50 per euro) to buy it, even though the dollar falls against the euro.

In general, trade flows are determined by comparative advantage, not by monetary policy. Most economists would argue that in the long-run, central banks should aim for domestic price stability and exchange rate stability. In the extreme, if every central bank tried to stimulate their export sector through currency debasement, this policy wouldn't be successful; it would only increase volatility in prices and make it harder for consumers and firms to plan for the future.

→ Would pro-growth policies that allow the economy to grow better help us reach a healthy balance and remove some need to worry about the strength of the dollar?

Yes, pro-growth policies (such as marginal tax rate reductions, regulatory relief, and expanded domestic energy production) would spur the economy and allow people to see the false dichotomy between a strong dollar and a strong economy. As I argued above, any "stimulus" from currency debasement is fleeting at best, and really just stimulates some businesses at the expense of others (in particular, those which import materials from abroad for their operations).

** How would a move towards energy independence affect the many forces at work affecting dollar strength, inflation, and our trade balance, especially given concerns about inflation?*

If “a move towards energy independence” simply means the relaxation of federal prohibitions on OCS and ANWR energy development—in contrast to new government subsidies for non-fossil fuels—then the effects would be straightforward: By increasing US production of oil and natural gas, Americans would import less oil from abroad. This would reduce the trade deficit, and increase the strength of the dollar on the foreign exchanges. This would make imported goods cheaper, thus lowering domestic price inflation. Besides the effect working through the dollar and international trade, opening up OCS and ANWR production would also tame domestic price inflation directly, by lowering gasoline prices.

2) Many experts have predicted that the federal government would enjoy considerable profits from the royalties if we opened up ANWR and the OCS.

** If these royalties were collected by the Treasury, what are some of the effects that we might see on the strength of the American economy?*

→ How would these royalties affect the strength of the dollar and America's trade balance?

→ Do you see any geopolitical advantages these royalties would bring if we opened up ANWR and OCS to drilling?

To be clear, I want to reiterate that opening up ANWR and the OCS would shower benefits in the form of new jobs, lower energy prices, and a stronger dollar. However, we can't say what the benefit of increased revenues to the Treasury per se would be, without knowing what the government did with the windfall. For example, if the government used the royalties to fund programs with little value, then the funds would obviously be squandered, and we shouldn't count them as an *extra* benefit from ANWR and OCS production.

On the other hand, if the government simply used the extra revenues to reduce its budget deficit—i.e. if the government maintained its original level of spending, even in light of the extra money flowing in—then this would strengthen the economy through reduced interest rates. By reducing the need for the government to borrow as much money, savings would be freed up for entrepreneurs to borrow and invest in the private sector.

Regarding geopolitical advantages, I cannot comment because my training is in economics.

3) It is clear that rising oil prices have had a slowing effect on the American economy, and this hearing has reinforced the fact that the price of oil has very complex macroeconomic effects.

** Without major structural changes, can the American economy continue to grow at a healthy rate with oil and gasoline at their current prices?*

** How much have high energy prices impeded American economic growth?*

** What might a growth pattern for the American economy look like with sustained high commodity prices?*

** Given that Federal Reserve Chairman Ben Bernanke indicated last week in his testimony to this Committee that a 1 percent increase in oil supply could lead to a 10 percent drop in oil prices, do you think that a commitment by the federal government to allow oil exploration in ANWR and the OCS could have a significant effect on economic growth?*

When this question was posed, oil prices were considerably higher than they at the time of my answer. In the spirit of the question, then, I would answer yes, if oil prices remained at levels of \$120 per barrel or higher, that that would have led to significant adjustments in the U.S. economy. Not only would consumers have gradually shifted away from SUVs and other vehicles with low fuel economy, but businesses too would have altered their distribution plans. Firms that previously imported raw materials and unfinished goods from abroad—taking advantage of cheap labor—would have shifted out of this, as higher shipping costs reduced the advantages.

As far as *rates* of GDP growth, a permanent increase in energy prices would probably only lead to stagnation for a few years, while the economy adjusted. After that recalibration, growth rates could return to normal levels. Thus, higher energy prices would make the country permanently poorer, but that would manifest itself in very low growth for a few years initially, and then a resumption to normal growth rates. In any given future year, GDP would be lower than it would have been with low energy prices, but future *rates* of GDP *growth* would not necessarily be lower, because GDP would be growing from a depressed level in year X to a larger level in year X+1.

To repeat my earlier statements, yes, opening up ANWR and OCS to development would lower energy prices and spur US economic growth. Americans (and the rest of the world, on average) would be richer.



Department of Energy
Washington, DC 20585

July 2, 2008

The Honorable Jack Kingston
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Kingston:

This is in response to your letter of May 28, 2008, which requests an estimate of what the impact on oil prices would be if an additional 1 million barrels per day of crude oil productive capacity were brought online today.

Your letter specifically asks that this estimate be based on the same methodology and set of circumstances and assumptions underlying my response to a question at a March 4, 2008, hearing of the Senate Energy and Natural Resources Committee regarding the impact on prices of adding oil to the Strategic Petroleum Reserve (SPR). At the hearing, I stated EIA staff had estimated that, holding other factors constant, an unanticipated generic fill program adding 100,000 barrels per day to the SPR over the first 10 months of 2008 could increase oil prices by about \$2 per barrel over that same period.

Applying the same methodology to the hypothetical scenario of bringing 1 million barrels of crude oil productive capacity online today, prices could be expected to decline by up to \$20 per barrel. This price drop reflects the significant price change needed to absorb increased supply in the short run. It should be noted that, while the immediate addition of 1 million barrels per day of unanticipated new productive capacity would significantly affect prices, an addition of this size typically involves years of planning and development activity. Also, it is assumed in the hypothetical scenario above that there would be no offsetting response in other OPEC or non-OPEC production or in other planned projects to add productive capacity and no changes in inventory levels.

I hope this information is of assistance to you. If you have further questions, please do not hesitate to contact me or your staff may contact Glen Sweetnam at 202-586-2188.

Sincerely,

A handwritten signature in black ink that reads "Guy F. Caruso".

Guy F. Caruso
Administrator
Energy Information Administration



Printed with soy ink on recycled paper

