A Peek Behind the Price at the Pump

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FROM Capitol Hill to Wall Street to the campaign trail, the recent surge in oil prices is quickly threatening to supplant the mortgage crisis as the country's leading economic issue. Last week, prices for crude set another record, finishing at $125.96 a barrel on Friday, while gasoline prices closed in on $4 a gallon.

Skip to next paragraph

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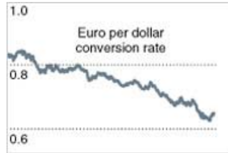

Graphic

Weaker Dollar, Higher Cost

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But even as the presidential candidates debate whether to cut federal gas taxes this summer and legislators look at other ways to ease prices at the pump, a harder-to-control factor is emerging as a main reason behind the increase in energy costs: the sinking dollar.

While no one disputes that China and other emerging economies are craving more crude, the stunning rise of oil from $62 a year ago is hard to explain as only a matter of supply and demand. After all, analysts have noted adequate inventories.

Over the same period, the dollar has declined nearly 15 percent against the euro, and the jump in oil prices "is very much driven by the dollar," says Roger Diwan, a managing director at PFC Energy, a consulting firm in Washington.

Simply put, buying oil has become a way for hedge funds, pension funds and other institutional investors to offset their exposure to dollar-based assets like United States stocks and bonds, Mr. Diwan says. And many traders have followed the market's momentum, aggravating the trend.

"The problem is that the market for dollar-denominated assets is orders of magnitude bigger than the oil market," Mr. Diwan says, so this hedging can have a disproportionate effect on oil prices. "It's like a lake and a pond, and the lake is overflowing into the pond."

While it's hard to pinpoint the impact, it's clear that money has been pouring into commodities over the last five years. In the first quarter of 2008 alone, commodity assets under management rose $30 billion, to $225 billion, according to estimates by Barclays Capital.

Much of that increase can be attributed to simple price appreciation, but five years ago, total commodity assets under management equaled just $20 billion, according to Barclays.

The dollar's weakness isn't affecting just oil. Other commodities that are priced in dollars — like wheat, rice and other foodstuffs — are also soaring, with ramifications felt worldwide.

"I don't think there's any doubt that the devaluation of the dollar is having an impact on all global commodities, including oil," says James E. Newsome, president of the New York Mercantile Exchange, where energy and metals are traded.

While critics say that short-term investors — some would call them "speculators" — drive up prices unfairly or manipulate the market, Mr. Newsome doesn't buy it. "The dollar has become a fundamental," he says. "And the floor of the exchange is littered with former funds and traders who tried to bet against fundamentals and failed."

Based on more traditional fundamentals like the cost of finding, producing and shipping crude, oil should be in the mid-$60s, says William H. Brown III, an independent energy consultant in Chappaqua, N.Y., who monitors investment flows in the energy sector. "I'm not blaming anyone," he says, "but this price is hard to justify."

In Washington, however, the blame game has begun. In a speech on May 1, Senator Jeff Bingaman, the New Mexico Democrat who is chairman of the Energy and Natural Resources Committee, cited the weak dollar, as well as the role of "speculators" on commodity exchanges.

And last Wednesday, Senate Democrats proposed legislation that, among other things, would impose substantially higher margin requirements on oil traders, in an effort to dampen speculation.

That might take some air out of the overblown oil market — and help drivers more than a gas-tax holiday would this summer. But it faces fierce opposition from industry advocates like Mr. Newsome, who formerly led the Commodity Futures Trading Commission, which regulates the Nymex and other exchanges.

"The margin issue is one I'm very emotional about because it has absolutely nothing to do with the price of oil," says Mr. Newsome, previewing arguments that are likely to dominate the debate over links between Wall Street and energy prices in the next few months.

The argument over whether traders are to blame for high energy prices has lasted for years, but it has intensified of late. Raising margin requirements — even temporarily — might be worth a try and might at least settle this dispute.