



# The U.S. Trade Deficit, the Dollar, and the Price of Oil

**James K. Jackson**  
Specialist in International Trade and Finance

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## Summary

Rapid changes in the price of oil and the impact of such price changes on economies around the globe have attracted considerable attention. In mid-2008 as the price of oil rose to unprecedented heights and then dropped sharply, the international exchange value of the dollar fell and then rose relative to a broad basket of currencies. For some, these two events seem to indicate a cause and effect relationship between changes in the price of oil and changes in the value of the dollar. Despite common perceptions that there is a direct cause and effect relationship between changes in the international exchange value of the dollar and the price of oil, an analysis of data during recent periods indicates that changes in the price of oil are driven by changes in the demand for oil that is different from the supply of oil, rather than changes in the value of the dollar. The rapid increase in oil prices in early 2011 reflects rising demand for oil and other commodities and uncertainty in global markets keyed to political turmoil in North Africa and the Middle East.

This report analyzes the relationship between the dollar and the price of oil and how the two might interact. While the data do not support a strong cause and effect relationship between the value of the dollar and the price of oil, there likely are various channels through which changes in the price of oil and in the value of the dollar may be indirectly correlated. The data also indicate that an increase in the demand for crude oil that exceeded the increase in the supply of oil and a laggardly pace in oil production capacity likely are among the main factors behind the sharp run up in the price of oil that occurred during the first seven months of 2008. Changes in oil prices also affect the U.S. trade deficit. That impact of oil prices on the trade deficit lessened in 2009 and 2010 as the price of oil plummeted and as a drop in economic activity reduced demand for oil imports. A more rapid pace of economic growth in many of the developing economies in 2011 exerted upward pressure on oil prices that will translate into a higher U.S. trade deficit in 2011. This report provides an assessment of the impact a range of prices of imported oil could have on the U.S. trade deficit.

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## Overview

To most observers, it seems apparent that the rise in the price of oil<sup>1</sup> and the decline in the exchange value of the dollar often are interconnected events, or that there is some cause and effect relationship between the two.<sup>2</sup> Since oil is priced in dollars, this line of reasoning goes, as the exchange value of the dollar declines, the purchasing power of oil producers also falls, which, in turn, prods oil producers to reduce their supplies to the market in order to push up the market price of oil and restore their purchasing power. This line of thinking is not unreasonable, considering various incidents, most notably 1973 and 1979, in which the price of oil rose sharply in response to actions taken by members of the Organization of Petroleum Exporting Countries (OPEC)<sup>3</sup> group of oil producers to increase the market price of oil. Indeed, OPEC's stated objective is to coordinate and unify petroleum policies among OPEC Countries, in order to secure "fair and stable prices for petroleum producers; an efficient, economic and regular supply of petroleum to consuming nations; and a fair return on capital to those investing in the industry."

After reaching nearly \$147 per barrel in August 2008, the price per barrel of oil dropped to less than \$40 per barrel by year-end 2008, before rising again through May 2011 to reach as high as \$120 per barrel at times. In response to the drop in oil prices in 2008, OPEC announced cuts in production on three occasions: a cut of 500,000 barrels per day announced on September 1, 2008,<sup>4</sup> a cut of 1.5 million barrels per day announced on October 25, 2008, and a cut of 2.2 million barrels per day announced on December 17, 2008. In February 2011, Saudi Arabia increased oil production to calm market fears over political unrest in North Africa and the Middle East, particularly concerns over the impact political turmoil on Libya could have on oil production there.

An analysis of the data indicates that fluctuations in the price of oil that have been experienced since 2006 have not been driven primarily by a reduction in world supplies. Instead, the changes in oil prices reflect a number of factors, including the slow-paced growth in oil production; an increase in demand, most notably among the developing countries, that has outpaced the increase in supply; and more recently market concerns related to political turmoil. Changes in the international exchange value of the dollar, however, likely reflect a number of factors, including changes in the demand for and supply of capital within the U.S. economy, the relative rate of return on interest-sensitive assets, and expectations about the performance of the U.S. economy. At the same time, some observers have argued that oil market speculators played an important role in pushing up oil prices so quickly in 2008.<sup>5</sup> A report issued on September 11, 2008, by the Commodity Futures Trading Commission (CFTC), however, concluded that market speculators probably were not responsible for the rise in oil prices.<sup>6</sup>

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<sup>1</sup> CRS Report RL33521, *Gasoline Prices: Causes of Volatility and Congressional Response*, by Carl E. Behrens and Carol Glover.

<sup>2</sup> Merriman, Jane, "Weak Dollar Central to Oil Price Boom," *Reuters*, September 26, 2007.

<sup>3</sup> OPEC is comprised of Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE, and Venezuela.

<sup>4</sup> Reed, Stanley, "How Real is OPEC's Production Cut?" *BusinessWeek*, September 11, 2008.

<sup>5</sup> Masters, Michael W., Testimony before the Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008.

<sup>6</sup> Mufson, Steven, "Speculators Did Not Raise Oil Prices, Regulator Says," *The Washington Post*, September 12, 2008, p. D1; *Staff Report on Commodity Swap Dealers & Index Traders With Commission Recommendations*, Commodity (continued...)

While data on exchange rates and on oil prices do not support the case for a strong cause and effect relationship between the value of the dollar and the price of oil, there are a number of channels through which changes in the price of oil and changes in the value of the dollar may be indirectly correlated. In fact, an increase in the price of oil to offset the loss of purchasing power that is associated with a depreciation in the value of the dollar can spark a chain of events that could blunt or even nullify the rise in oil prices.

The pervasive nature of such commodities as oil, which serve as essential components in economic growth, means that changes in the prices of those commodities affect the prices of a broad range of goods, services, and economic activities.<sup>7</sup> Indeed, according to the Census Bureau, increases in the price of imported oil were a major factor in rising consumer prices in the United States in the first six months of 2008. Similarly, rising oil prices in late 2010 and early 2011 have pushed up the prices of other commodities. Rising consumer and commodity prices undermine the exchange value of the dollar relative to other currencies and reduce the real incomes of consumers, which can lead to a lower rate of economic growth. Slower economic growth, in turn, lowers the demand for oil, thereby putting downward pressure on the price of oil, as occurred in 2009.<sup>8</sup> Expectations about future economic growth and, therefore, about the demand for crude oil, also can affect a broad range of investment decisions that might affect expectations about the value of the dollar. The interaction between the price of oil and the value of the dollar is complicated further by the way changes in the price of oil can affect the economic performance of other nations and, therefore, have an impact on their respective currencies.<sup>9</sup>

Oil is also highly unique, because it has few substitutes. The long lag times that are required to bring new fields on line and the prominent role oil-related products occupy in the economy mean that oil defies some common notions of market supply and demand. For consumers, there are few short-term available substitutes when gasoline prices spike, given the difficulty involved in switching sources of energy. This lack of substitutes means that consumer demand is quite unresponsive to short-term changes in the price of oil. The International Monetary Fund (IMF) has estimated that among the developed economies, represented by the Organization for Economic Cooperation and Development (OECD),<sup>10</sup> and non-OECD economies a 10% increase in oil prices leads to a reduction in oil demand of only 0.2%, as indicated in **Table 1**. Economists term such responsiveness as “elasticity,” or the rate at which consumer demand changes relative to a change in prices. According to these estimates, the long-term price elasticity rises to 0.7% after 20 years for a 10% increase in oil prices. Income elasticities, however, indicate that a 10% increase in income is associated with a 6.8% increase in oil demand over the short run. Long-term, though, the income elasticity for oil drops to 2.9%, indicating that the world economy is slowly substituting away from oil. These estimates indicate that changes in oil prices, regardless of the source, have little impact on oil demand in the short run. However, the fact that the income elasticity for oil is higher in the short run than in the long run suggests that the demand for oil in

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(...continued)

Futures Trading Commission, September 2008.

<sup>7</sup> CRS Report RL31608, *The Effects of Oil Shocks on the Economy: A Review of the Empirical Evidence*, by Marc Labonte.

<sup>8</sup> Clifford, Catherine, *Oil at 5-month Low on Shrinking Demand*. CNNMoney.com., September 5, 2008; Barr, Colin, *Why Cheaper Oil Signals Trouble*. CNNMoney.com. September 4, 2008.

<sup>9</sup> Dougherty, Carter, “Fears of European Slowdown Weaken the Euro.” *The New York Times*, August 9, 2008.

<sup>10</sup> For additional information about the OECD, see CRS Report RS21128, *The Organization for Economic Cooperation and Development*, by James K. Jackson.

the U.S. economy is more responsive to changes in national income and, therefore to policies that can affect national income. In addition, the response of oil demand to an income shock, such as during the economic recession of 2008-2009, may result in overshooting, or that demand may fluctuate more than would be expected under normal conditions, with swings in oil prices until market conditions stabilize.

**Table I. Oil Demand Price and Income Elasticities**

	Short-term elasticity		Long-term elasticity	
	Price	Income	Price	Income
Combined OECD and non-OECD	-0.019	0.685	-0.072	0.294
OECD (developed economies)	-0.025	0.671	-0.093	0.243
Non-OECD (developing economies)	-0.007	0.711	-0.035	0.385

**Source:** *World Economic Outlook*, International Monetary Fund, April 2011, p. 97.

According to Global Insight,<sup>11</sup> a number of factors worked to put upward pressure on oil prices in 2007 and during the first half of 2008. These factors include both supply and demand issues as well as geopolitical troubles in various countries, particularly Nigeria and Iran, that created uncertainties in the market concerning the stability of oil supplies. A low rate of growth in oil supplies relative to a higher rate of growth in the demand for oil has been cited as the most important market factor behind the rise in oil prices. Saudi Arabia agreed to increase its production of oil by 300,000 barrels per day in May 2008 and by an additional 200,000 barrels per day in July 2008. Also, price movements in the oil market apparently were exaggerated somewhat by trading in the oil futures market, and other producers, especially non-OPEC producers, who had not increased their supply as had been projected. On the demand side, continued strong growth in the demand for oil in Asia and the Middle East pushed the total demand for oil to rise at a pace that has been faster than the rise in supplies. Demand in the Middle East rose at double-digit rates as a result of a boom in construction and oil consumption. In Asia, demand for oil grew rapidly in China, where the government subsidized the price of oil to consumers and the government stockpiled oil to use as substitute for coal in the Beijing area during the Olympics to reduce the level of air pollution.

Similarly, a number of factors worked to push up the prices of crude oil in early 2011. Global demand for oil remained high in 2011, especially among the non-developed economies, but high prices were expected to crimp demand in the later part of the year. On the supply side, production outages in Libya and continued political and social unrest in the Middle East increased concerns over the reliability of supplies, despite increased production from Saudi Arabia, the United Arab Emirates, and Kuwait.<sup>12</sup>

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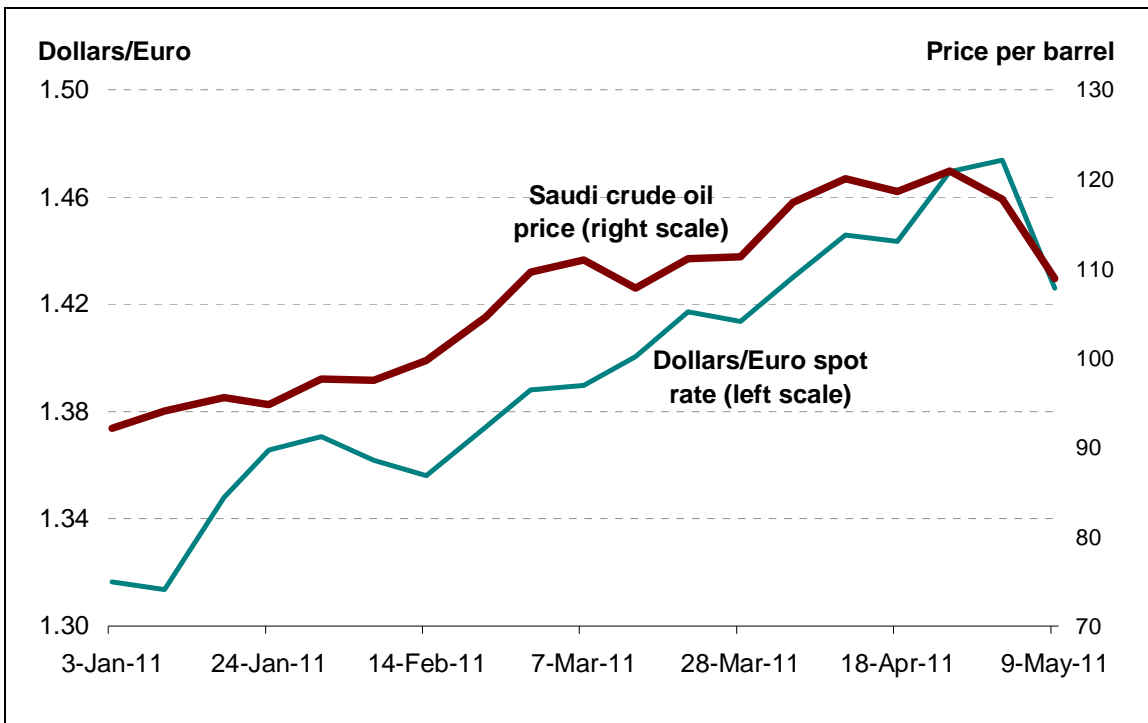
<sup>11</sup> *Market Analysis: Forecast Highlights*, Global Insight, July 1, 2008.

<sup>12</sup> *Oil Market Report*, International Energy Agency, April 12, 2011.

## The Dollar and the Price of Oil

For many observers, there seems to be a direct cause and effect relationship between the depreciation in the international exchange value of the dollar and the rise in the price of oil. These observers argue that because oil is priced in dollars, a depreciation in the international exchange value for the dollar against other major currencies erodes the purchasing power of oil producers. As **Figure 1** indicates, a rise in the price of oil during the January 2011 to mid-May 2011 period on a weekly basis generally has been accompanied by a depreciation in the value of the dollar relative to the Euro. In this figure, the price of oil is represented by the price of Saudi Arabian light crude, expressed in dollars per barrel, and the value of the dollar is marked relative to the Euro, expressed in dollars per Euro, so that a rise in the value of the dollar/euro rate denotes a depreciation in the value of the dollar, since more dollars are required to purchase Euros. The two sets of data generally appear to move in the same direction, however the magnitude of the movements is not correctly represented in this type of presentation. **Figure 2** shows the same data as Figure 1, although the data have been converted to index numbers so they can be represented on the same scale. As a result, it is clear that movements in the price of crude oil span a greater range than the more limited range that was experienced by the dollar/Euro exchange rate and raises questions about the relationship between movements in the price of oil and the international exchange value of the dollar. Given the limited ability of producers to increase oil supplies in the short run, large swings in the price of oil as a result of changes in market conditions (or expectations about market conditions) are not surprising.

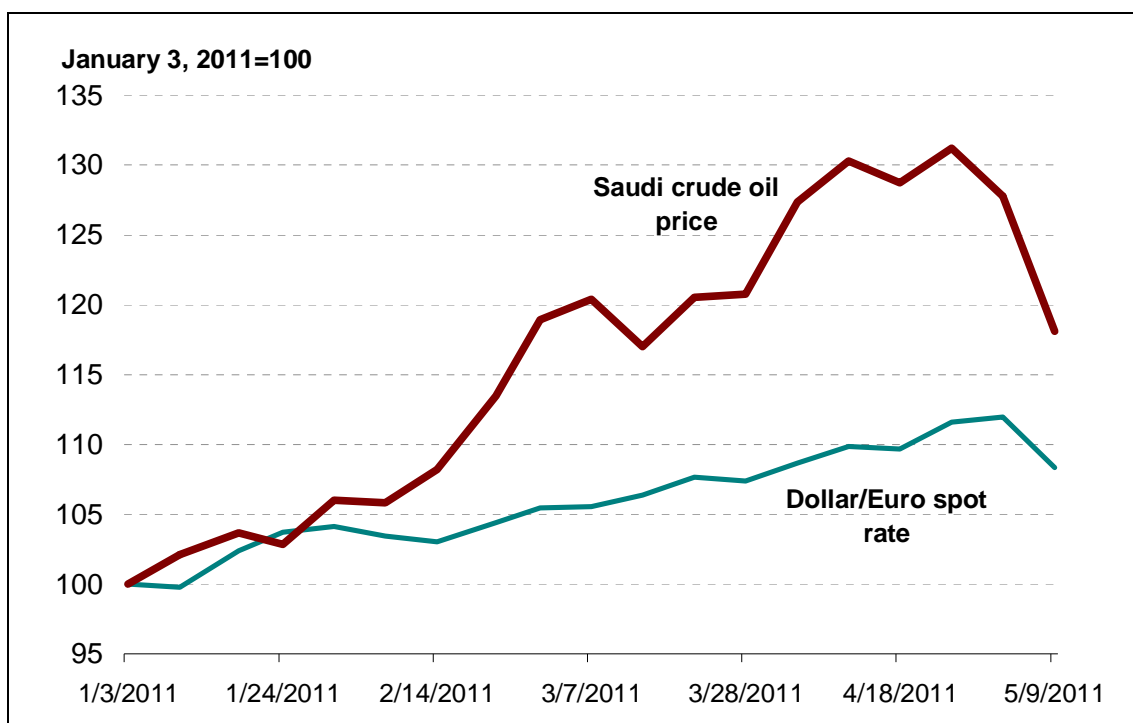
**Figure 1. The Dollar/Euro Rate and the Price of Crude Oil, January-May 2011**



Source: Federal Reserve and the Energy Information Administration.



Figure 2. Index of the Dollar/Euro Rate and the Price of Crude Oil



Source: Federal Reserve and the Energy Information Administration.

The IMF has identified three channels through which a change in the value of the dollar can affect a broad range of commodity prices, including the price of oil. A change in the value of the dollar can affect commodity prices through (1) purchasing power and cost channels; (2) asset channels in which changes in the value of the dollar affect the return on dollar-denominated financial assets; and (3) a combination of effects, including changes in monetary policy.<sup>13</sup> As a result of these three effects, the IMF also estimates that among various commodities, the linkage between changes in the value of the dollar and changes in commodity prices is especially strong for oil and gold, because they are more suitable as a “store of value,” or as a hedge against inflation.<sup>14</sup> One explanation for this relationship is that oil market participants and speculators may have adopted a rough rule of thumb over time concerning changes in the value of the dollar and subsequent changes in the price of oil and vice versa. As a consequence, the statistical relationship between the two has been strengthened over time, because market participants have acted on this informal rule. In late 2010 and early 2011, however, the rise in commodity prices, including the price of oil, do not appear to be related to the value of the dollar, since commodity prices rose significantly in terms of all major currencies.

The past actions of OPEC oil producers may also have tended to strengthen the apparent linkage between changes in the value of the dollar and changes in the price of oil as the producers have acted in concert to adjust their output in order to alter the world price of oil. OPEC accounts for just over 40% of the world output of crude oil, and the coordinated actions of its members can

<sup>13</sup> *World Economic Outlook*, the International Monetary Fund, April 2008. P. 46-50.

<sup>14</sup> The IMF estimates that a 1 percent real depreciation in the value of the dollar would result in an increase of greater than 1 percent in the price of oil over two years. *Ibid.*, p. 50.

affect world oil prices. In addition, one of OPEC's stated goals is to secure a "fair and stable price" for the oil the member countries produce; it is not unreasonable to assume that OPEC members would respond to a loss in the purchasing power of the dollar by reducing their overall level of production, or holding down the rate of increase in production in order to raise the market price of oil.<sup>15</sup>

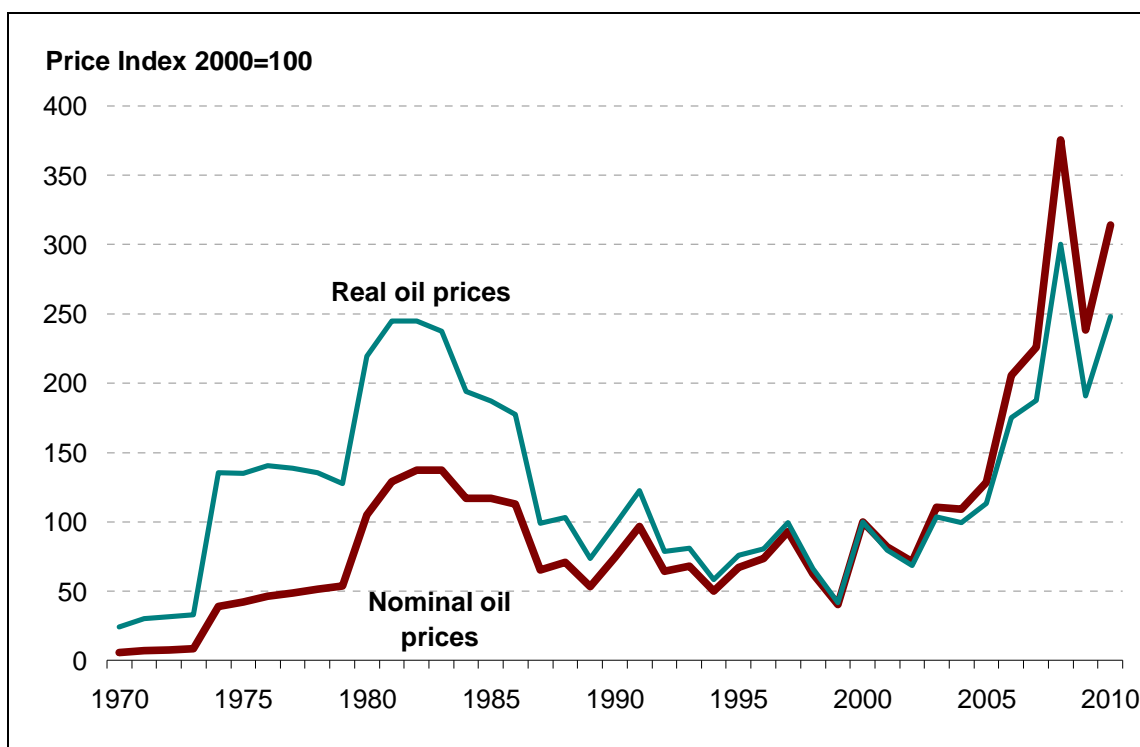
#### Real and Nominal Oil Prices

Figure 3 shows indexes of the nominal and real (adjusted for inflation) indexes of the price of crude oil from 1970 to 2010. The figure shows the 1973 and 1979 price increases and the slide in the real price of oil between 1980 and 1999. The indexes show the stark rise in real oil prices in the 1970s as OPEC oil producers pushed up crude oil prices. Over the next decade, however, real prices slowly moved downward to more moderate levels, due in part to an increase in crude oil production by non-OPEC producers. Naturally, nominal prices increased in the 1970s as a result of the rise in oil prices, but nominal prices rose at a slower pace than real prices as national governments focused economic policies on constraining inflation. Both real and nominal oil prices began rising in 1999 as a result of an agreement signed in 1998 between OPEC members and such non-OPEC producers as Mexico, Norway, Oman, and the Russian Federation to reduce their supplies of oil. While OPEC's production of crude oil declined by about 4% in 1999 from that produced in 1998, production in 2000 increased by 6% to reach an average of 28 million barrels per day. From 2000 to 2002, OPEC's production of crude oil fell by about 9.5% to 25.6 million barrels per day. After 2002, OPEC's crude oil production has increased every year, reaching an average of 33.9 million barrels per day in 2009.

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<sup>15</sup> According to standard economic theory, a reduction in the market supply of a good relative to a given level of demand will result in a higher market price for the good since the market demand would be chasing a smaller number of goods (supply), which would tend to bid up the market price of the good.

Figure 3. Real and Nominal Crude Oil Price Indexes, 1970-2010



Source: CRS, Energy Information Administration.

Data through the fourth quarter of 2010 show that the real price of crude oil began rising during the first quarter of 2009 and rose steadily throughout the period, reaching an average price of about two-thirds of that reached during the peak period in 2008. On an annual basis, the average price of oil, as measured by the spot price of Brent crude,<sup>16</sup> rose from an average price of \$54.42 per barrel in 2005 to an average of \$96.85 per barrel in 2008, or an increase of 78% in nominal terms. During the same period, the dollar depreciated about 10% in real terms as measured against a broad basket of currencies.<sup>17</sup> From January 2008 to July 2008, the real price of oil increased by another 38%, while the real broad dollar index depreciated by 1.7%. Relative to other major currencies, the dollar depreciated about 7% against the Euro in real, or price adjusted, terms on average from 2005 to 2008 and about 5.6% in the January to July period in 2008. Relative to the Yen, the average value of the dollar depreciated about 15% between 2005 and 2008 in real terms, and depreciated about 5% against the Yen in the first seven months of 2008. Against the British Pound, the dollar depreciated about 8% in real terms between 2005 and 2008, and fell by about 3% in value in real terms in the first seven months of 2008. From 2009 through 2010, the dollar has appreciated slightly against a broad basket of currencies in real terms and against the pound and the euro, but depreciated against the yen in real terms.

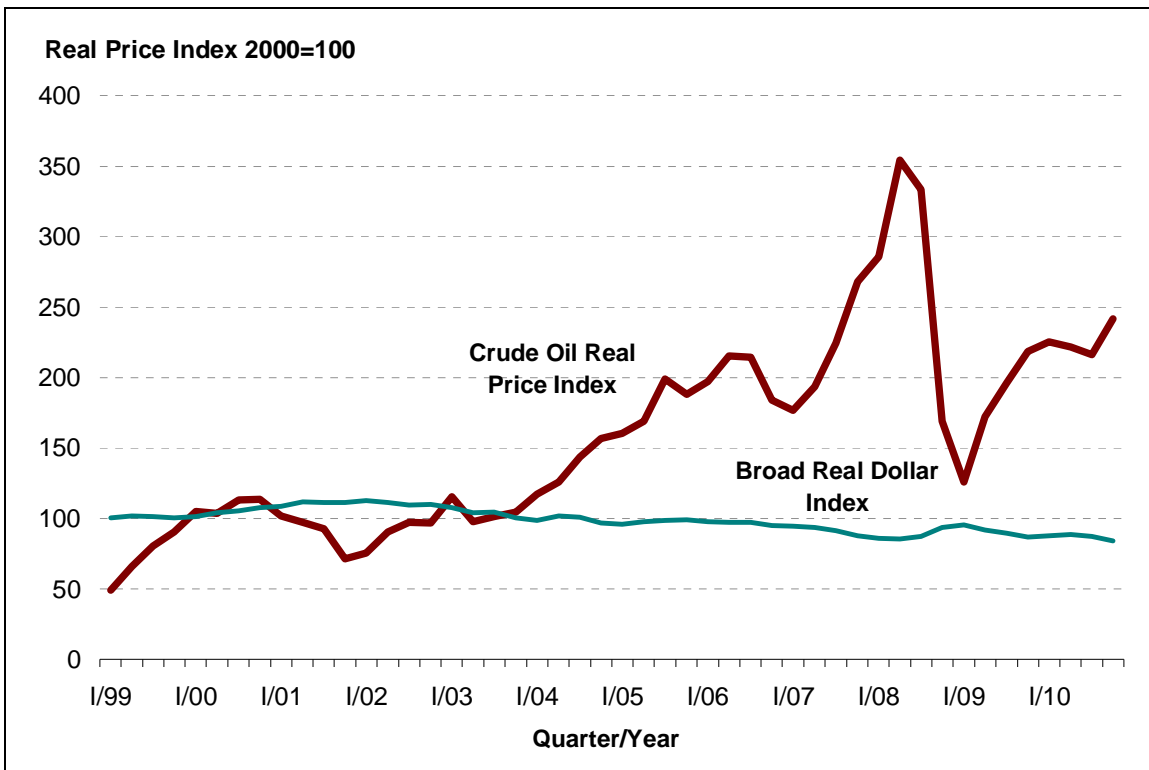
<sup>16</sup> Brent crude is the largest classification of crude oil. It is used to price two-thirds of internationally traded crude oil supplies.

<sup>17</sup> The broad dollar index is an index of the currencies of 26 largest U.S. trading partners weighted by the importance of the country as a trading partner. For additional information, see Loretan, Mico, Indexes of the Foreign Exchange Value of the Dollar, *Federal Reserve Bulletin*, Winter 2005. P. 1-8.

## Major Currencies

**Figure 4, Figure 5, Figure 6, and Figure 7** display indexes of the dollar relative to other currencies in real terms and an index of the price of oil, also expressed in real terms, from the first quarter of 1999 through the fourth quarter of 2010. **Figure 4** shows the real broad dollar index, or an index of the dollar per a unit of a grouping of 26 currencies in real terms compared with an index of the real price of crude oil. A decline in the dollar index signifies a depreciation in the value of the dollar relative to the broad group of other currencies. The data cast doubt on the argument that the price of oil responded to offset the depreciation of the dollar. Compared with the currencies of the 26 largest U.S. trading partners, the dollar has fluctuated slightly in real terms, compared with large swings in the real price of oil.

**Figure 4. Crude Oil Real Price Index and Broad Real Dollar Index, 1999-2010**



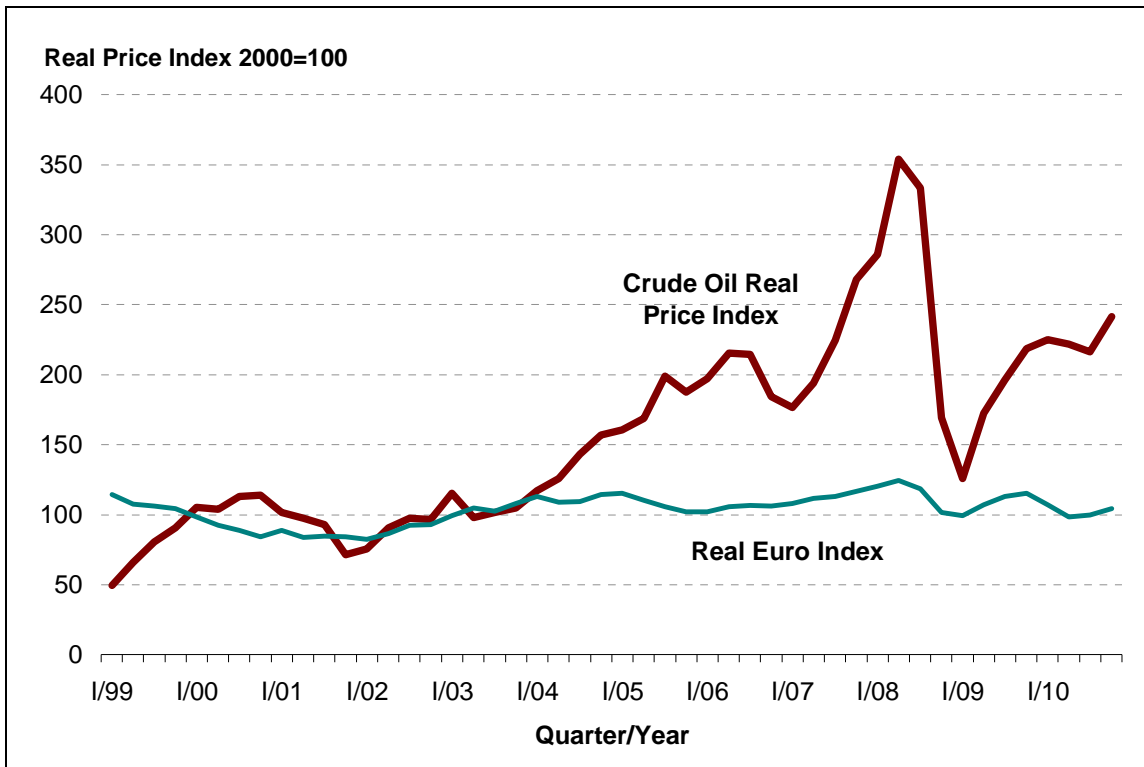
**Source:** Federal Reserve, Energy Information Administration.

The devaluation of the dollar against the Euro from early 2006 to the end of 2008 led some observers to speculate that oil producers would attempt to raise the price of oil to compensate for the devalued purchasing power of the dollar relative to the Euro and that a devalued dollar would be a disincentive for producers to explore and drill for new wells because of the loss of purchasing power. In addition, the devalued dollar makes oil cheaper for the Euro-area countries and, therefore, oil consumption in the euro area should increase with an appreciation of the euro. The decline in the exchange value of the dollar relative to the Euro also prompted some observers to argue that oil should be priced in a currency other than the dollar.

Data through fourth quarter 2010, however, do not support the contention that Euro-area countries increased their consumption of oil any faster than did the United States due to the drop in the

price of oil that resulted from an appreciation of the euro relative to the dollar. Also, after some initial adjustment, pricing oil in Euros, or some other currency, rather than in dollars would appear to have no real effect on the demand and supply of oil in the market. Between the third quarter of 2009 and the third quarter of 2010, as the Euro generally depreciated relative to the dollar, oil consumption of oil in Europe rose by 2.9% compared with an increase in consumption by the United States of 4.1%. Pricing oil in dollars facilitates the smooth functioning of the oil market, because the dollar is the most widely used currency in the world for pricing, or invoicing trade, which facilitates the cross-border comparison of goods and services.<sup>18</sup> **Figure 5** shows an index of crude oil prices in real terms and dollars per Euro in real terms, so that a rise in the dollar/Euro index signifies an appreciation in the Euro relative to the dollar, or a depreciation in the value of the dollar. The data support the argument that any loss in oil producers' purchasing power arising from a depreciation in the value of the dollar relative to the Euro was offset by a larger increase in the price of oil, which may well provide an incentive to oil producers to expand their drilling and exploration activities.

**Figure 5. Crude Oil Real Price Index and Real Dollar/Euro Index, 1999-2010**



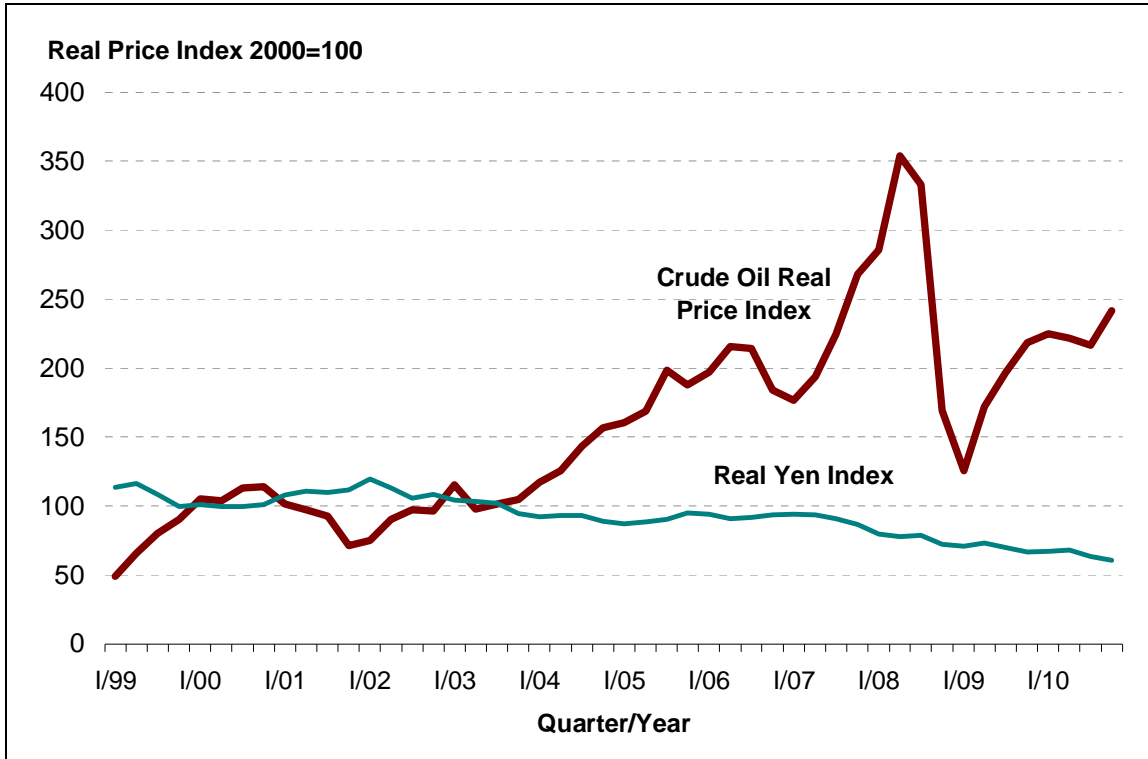
**Source:** Federal Reserve, Energy Information Administration.

Similar trends are seen in movements in the value of the dollar relative to the Yen and the British Pound. **Figure 6** shows the index of the Yen per dollar exchange rate, expressed in real terms and the index of the real price of crude oil. In this figure, a decline in the index indicates an appreciation in the value of the Yen relative to the dollar, since fewer Yen are required to buy a

<sup>18</sup> Goldberg, Linda S., and Cedric Tille, *The International Role of the Dollar and Trade Balance Adjustment*, NBER Working Paper 12495, August 2006; and Goldberg, Linda S., and Cedric Tille, *Macroeconomic Interdependence and the International Role of the Dollar*, NBER Working Paper 13820, February 2008.

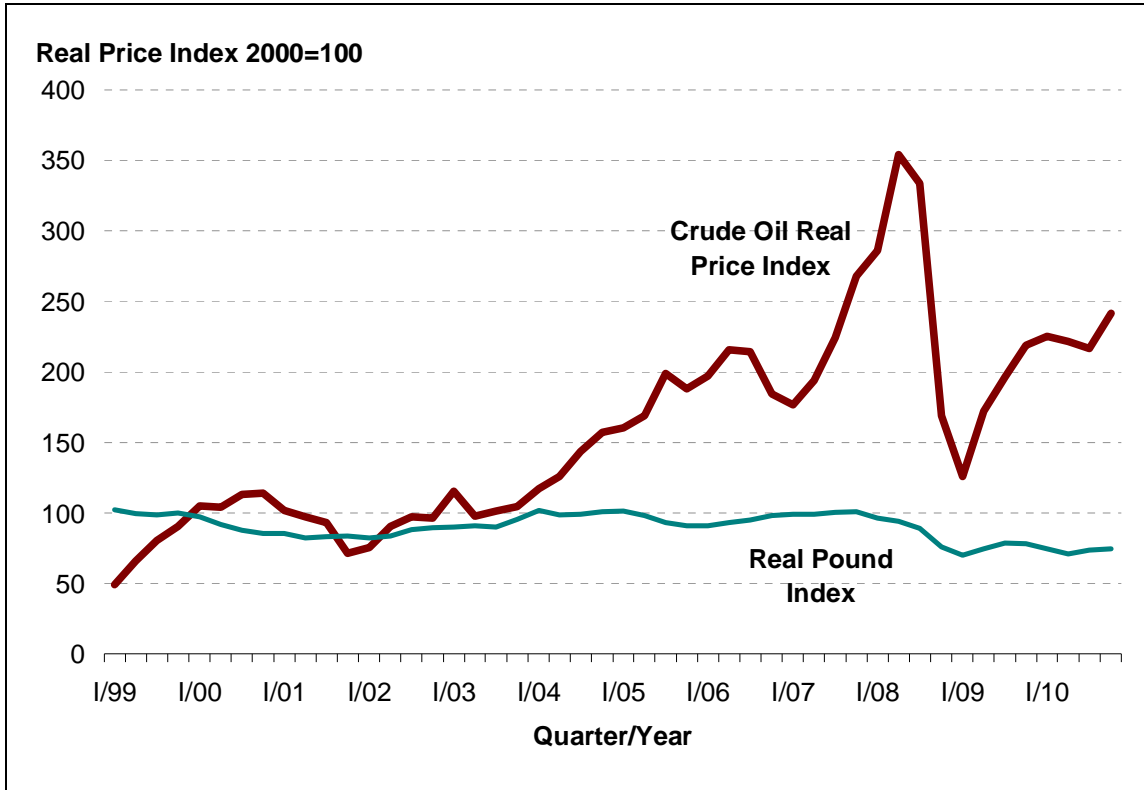
dollar. **Figure 7** shows the index for dollars per Pounds expressed in real terms and the index for real crude oil prices. In this case, a rise in the dollar/Pound index indicates an appreciation in the value of the Pound, since more dollars would be required to purchase a Pound. In both cases, the relative movement in the real prices of foreign currency against the dollar has been small relative to the increase in the real price of crude oil since 2004.

**Figure 6. Crude Oil Real Price Index and Real Yen/Dollar Index, 1999-2010**



Source: Federal Reserve, Energy Information Administration.

Figure 7. Crude Oil Real Price index and Real Dollar/Pound Index, 1999-2010



Source: Federal Reserve, Energy Information Administration.

## The Price of Oil

As indicated previously, the OPEC cartel of oil producers has acted in concert on occasion to alter the supply of oil in the market in order to affect the price of oil and, therefore, the export earnings of its members. In practice, OPEC oil producers, or other oil producers for that matter, do not attempt to set the price of oil directly, but attempt to alter the supply of oil in the market relative to a given level of expected demand and then rely on the market to search out the corresponding price. The price of oil, then, reflects the actual level of demand and supply in the market, which is reflected in the spot, or current, market, and the price of oil is affected by expectations about demand and supply conditions and about production capacity, reflected in the futures market. In addition, during times of economic or political instability, investors may well trade such commodities as oil that they calculate will generate a return on their investment that exceeds such traditional financial investments as stocks, bonds, or government securities.

## Oil Exchanges

Similar to other commodities, oil is traded on specialized commodities exchanges. Most of this trading is conducted by licensed brokers, who act on behalf of clients to buy and sell oil on the

spot market and in the futures and options markets.<sup>19</sup> The major futures exchanges for oil are the Intercontinental Exchange, located in London, which acquired the International Petroleum Exchange in 2001, and the New York Mercantile Exchange (NYMEX). The New York Exchange states that it is the world's largest physical commodity futures exchange. The NYMEX operates on the bid-ask system in which buy and sell transactions are executed between floor brokers. In this process, buyers compete with each other by bidding up prices and sellers compete by bidding prices down. Such markets are identified as price discovery markets, because the price of the futures contract is determined through open bids. Futures contracts are firm commitments to make or accept delivery of a specified quantity and quality of a commodity during a specified month in the future at a price agreed upon at the time the contract is made. In the commodities exchanges, futures contracts are traded in standardized units in a highly visible, extremely competitive continuous open auction. The NYMEX reports that less than 1% of all oil futures contracts take physical delivery; the remainder are settled by cash payments.

Although relatively little physical quantities of oil change hands in futures markets, the markets serve as important sources of information about market conditions and provide mechanisms for determining the price of oil in the global energy market. As a result, oil prices that are determined in the futures market are useful in at least three ways.<sup>20</sup> First, since the futures markets are conducted in full public view, a broad assortment of traders, including producers, commercial users, speculators, and financial institutions, make financial and production decisions based on the prices that are determined in the market. Second, the prices that are generated in the futures markets are publicly available and are used as reference points for physical trades in oil. Third, because the markets are conducted on a bid-ask system with floor brokers, the prices react quickly to new information about the supply and demand factors that are expected to influence the price of oil.

Futures and options contracts are used by both buyers and sellers to reduce the risks inherent in trading commodities.<sup>21</sup> Factors that might cause an abrupt change in supply, demand, and price such as international politics, war, changing economic patterns, and structural changes within the energy industry have created uncertainty about market conditions. Such uncertainty, in turn, leads to volatility in the market and creates risk for the market participants. The futures price, then, represents the current market opinion of what the commodity will be worth at some time in the future. Since the future price of a commodity can not be known with any certainty, buyers and sellers attempt to lock in prices and profit margins in advance through the use of futures and options contracts in order to hedge, or to reduce, their risks. The purpose of the hedge is to avoid the risk of an abrupt change in market conditions and prices that could result in major losses for buyers and sellers.

Since the spot price and the futures market price do not have a perfect relationship, there will always be the potential for some profit or loss. Hedging, then, reduces exposure to risk for a buyer or a seller by shifting part of the risk associated with the market price of a commodity to investors who are willing to accept the risk in exchange for a profit opportunity. As indicated above, most traders do not take physical delivery of the commodities they are trading, but hope to profit by correctly anticipating future price trends, which some observers argue has been a factor

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<sup>19</sup> For additional information, see CRS Report RL34555, *Speculation and Energy Prices: Legislative Responses*, by Mark Jickling and Lynn J. Cunningham.

<sup>20</sup> CRS Report RS22918, *Primer on Energy Derivatives and Their Regulation*, by Mark Jickling.

<sup>21</sup> *A Guide to Energy Hedging*. New York Mercantile Exchange.



in driving high and volatile prices. Concerns over the impact of such trading on the oil market spurred a number of legislative proposals during the 110<sup>th</sup> Congress.<sup>22</sup>

Unlike a futures contract, an options contract conveys a right, but not an obligation, to engage in a transaction. There are two types of options, calls and puts. A call conveys the right, but not the obligation, to the one holding the option to purchase the underlying futures contract at a specified price up to a certain time. A put gives the owner of the option the right, but not the obligation, to sell the underlying futures contract at a specified price up to a certain time. A call is purchased when investors anticipate a rise in prices and a put is bought when investors expect neutral or falling prices. When options are used in combination with futures contracts, investors can develop strategies that cover virtually any risk profile, time horizon, or cost consideration.

## **Oil Demand and Supply**

The data in **Table 2** show the world demand and supply of petroleum in millions of barrels a day on average by major area from 2006 through 2010, including estimates of the four quarters of 2011. As indicated in **Figure 8**, between 2006 and 2010, the demand for oil, or consumption, among all consumers increased by 2.9%, rising from an average of 86.3 million barrels per day in 2006 to an average of 88.8 million barrels per day in 2010. Data for 2010 indicate that world demand for oil rose by about 1% over the 2009 amount as economic growth began recovering from the financial crisis and the global economic recession. In 2010, the demand for oil among the developed economies increased by 0.8% and demand increased by 8.3% among the developing economies. The developed economies, represented by the members of the OECD, accounted for about half of world demand for oil. As a group, these developed economies decreased their demand for oil every year between 2007 and 2010. Oil demand fell in most countries and areas in 2008 as the pace of global economic activity slowed from the faster pace in 2007. On average, oil demand among OECD countries fell by 3.6% between 2007 and 2008, compared with a 3.6% increase in demand among non-OECD countries over the same period. During the 2006-2010 period, demand for oil by the developed OECD countries fell by 6.6% and by 7.0% in the United States. Among the developing countries, oil demand between 2006 and 2010 increased by 18.4%, led by a 30.6% increase in demand by China, although such demand started from a low base.

During the 2006-2010 period, oil supplies fell by 12.5% among the developed countries, or falling by about twice as much as the demand for oil among the developed countries, effectively increasing their demand for oil on world markets. During the same five-year period, oil supplies among the developing countries increased by 0.9%, led by an increase in supplies by developing countries other than OPEC countries and Russia.

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<sup>22</sup> *Ibid.*

**Table 2. World Oil Demand and Supply, 2006-2011**  
(million barrels per day)

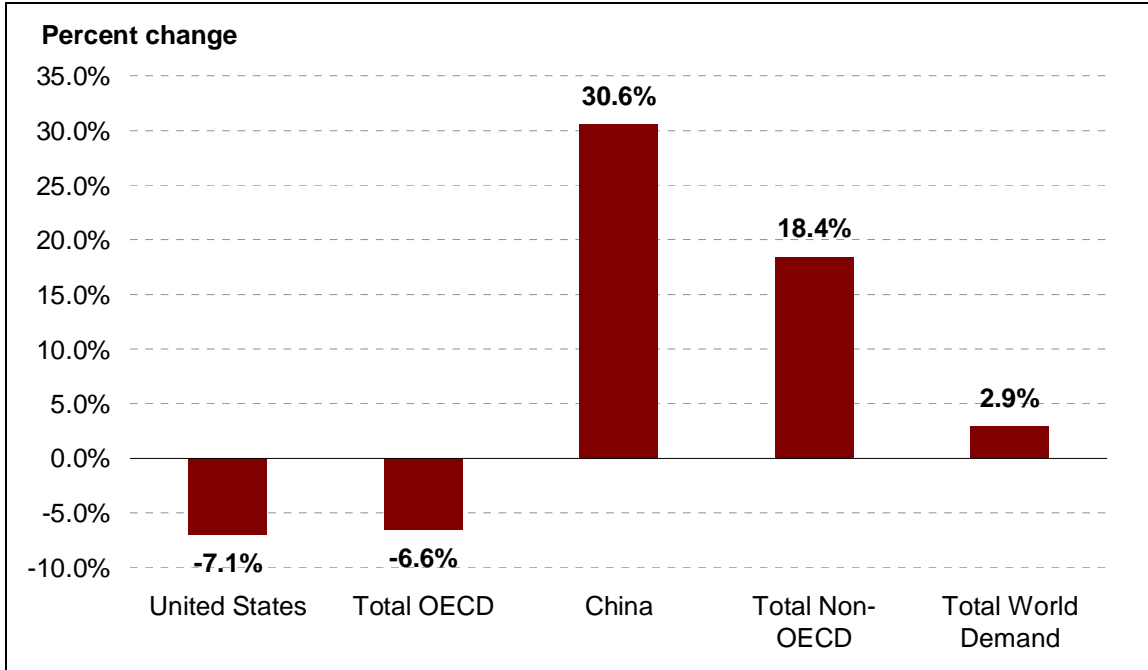
	2006	2007	2008	2009	2010	2011 (est.)				
	Annual Average					Quarter				
	1 <sup>st</sup>	2 <sup>nd</sup>	3 <sup>rd</sup>	4 <sup>th</sup>						
<b>Petroleum (Oil) Demand</b>										
OECD										
United States	20.69	20.68	19.50	18.77	19.23	19.25	18.97	19.47	19.23	
Other OECD	15.63	28.44	28.05	26.95	26.87	27.03	26.15	26.96	27.44	
<b>Total OECD</b>	<b>49.34</b>	<b>49.59</b>	<b>47.87</b>	<b>45.72</b>	<b>46.10</b>	<b>46.28</b>	<b>45.12</b>	<b>46.43</b>	<b>46.67</b>	
Non-OECD										
China	7.20	7.58	7.83	8.32	9.40	9.85	10.02	9.88	10.14	
Former U.S.S.R.	4.21	4.27	4.35	4.21	4.30	4.30	4.22	4.46	4.46	
Other Non-OECD	23.88	24.84	25.72	26.08	28.10	28.34	29.05	29.26	28.96	
<b>Total Non-OECD</b>	<b>35.29</b>	<b>36.70</b>	<b>37.90</b>	<b>38.60</b>	<b>41.80</b>	<b>42.49</b>	<b>43.29</b>	<b>43.60</b>	<b>43.56</b>	
<b>Total World Demand</b>	<b>84.62</b>	<b>86.29</b>	<b>85.78</b>	<b>84.33</b>	<b>87.90</b>	<b>88.77</b>	<b>88.41</b>	<b>90.03</b>	<b>90.23</b>	
<b>Petroleum (Oil) Supply</b>										
OECD										
United States	8.33	8.46	8.51	9.14	10.7	11.0	10.7	10.8	11.0	
Other OECD	13.26	13.03	12.43	11.95	8.2	8.2	8.1	8.0	8.2	
<b>Total OECD</b>	<b>21.59</b>	<b>21.48</b>	<b>20.95</b>	<b>21.09</b>	<b>18.9</b>	<b>19.2</b>	<b>18.8</b>	<b>18.8</b>	<b>19.2</b>	
Non-OECD										
OPEC	35.83	34.39	35.71	33.87	34.5	35.5	NA	NA	NA	
Former U.S.S.R.	12.16	12.61	12.53	12.91	13.6	13.7	NA	NA	NA	
Other Non-OECD	15.02	16.07	16.32	16.52	20.30	20.30	NA	NA	NA	
<b>Total Non-OECD</b>	<b>63.01</b>	<b>63.06</b>	<b>64.56</b>	<b>63.30</b>	<b>68.40</b>	<b>69.50</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	
<b>Total World Supply</b>	<b>84.60</b>	<b>84.54</b>	<b>85.51</b>	<b>84.39</b>	<b>87.3</b>	<b>88.7</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	
<b>Difference (demand less supply)</b>	<b>0.02</b>	<b>1.75</b>	<b>0.27</b>	<b>-0.05</b>	<b>-0.60</b>	<b>-0.07</b>	<b>NA</b>	<b>NA</b>	<b>NA</b>	

**Source:** *International Petroleum Monthly*, December, 2010. Energy Information Administration. Table 2.1; *Oil Market Report*, International Energy Agency, April 12, 2011, Table 1.

**Figure 9** shows that world oil supplies fell by 2.8% over the period from 2005 to 2009, or by less than the increase in the world demand for oil. During this period, oil supplies provided by U.S. producers increased by nearly 10%, while oil production in other developed countries fell by 3.9%. At the same time, OPEC producers decreased their supply of oil by 6.2%, mostly during the 2008-2009 period, and oil suppliers from other developing countries increased their supplies by 0.9%. The shortfall between the change in demand and the change in supply was met by oil that had been held in stocks elsewhere. The rising demand likely was an important factor in

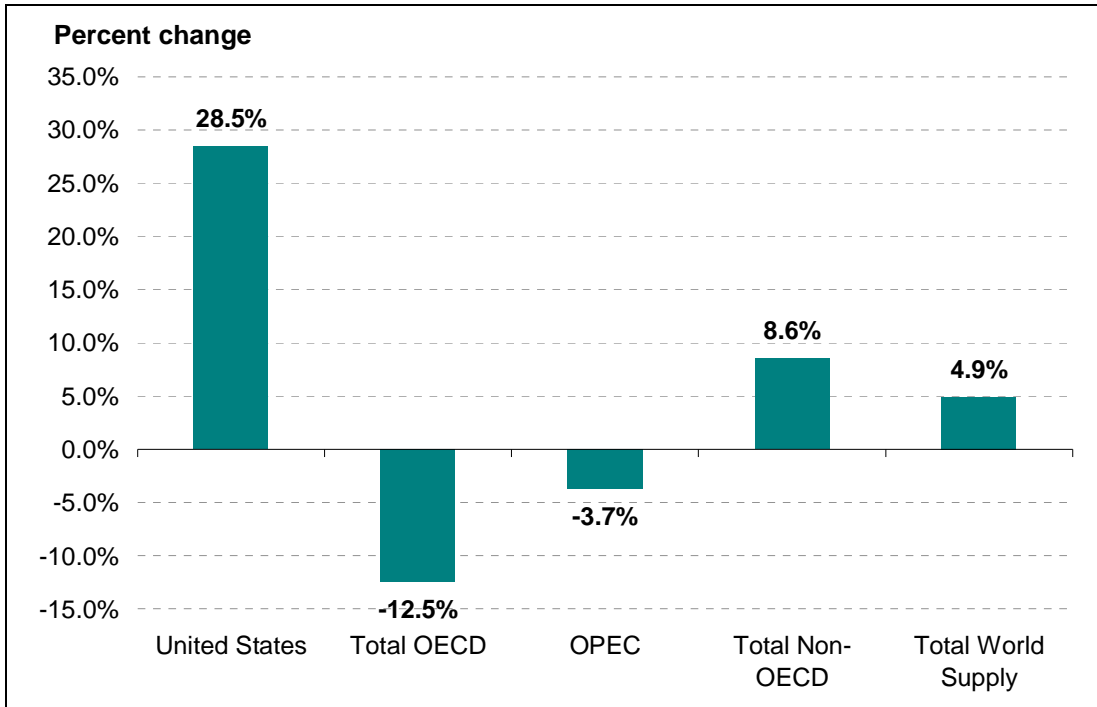
pushing up the price of oil in the market and likely affected the pricing expectations of oil brokers and traders in the futures market.

**Figure 8. Change in Oil Demand by Major Area, 2006 to 2010**



Source: Energy Information Administration.

Figure 9. Change in Oil Supply by Major Area, 2006 to 2010



Source: Energy Information Administration.

## The International Exchange Value of the Dollar

Although attention has focused on the international exchange value of the dollar for many years, the general depreciation of the dollar since 2006 has drawn particular attention. As previously stated, some observers have argued that the rise in the price of oil has occurred in part to offset the decline in the purchasing power of oil producers as a result of the depreciation of the dollar against other major currencies. According to standard economic theory, the international exchange value of the dollar is determined by a complex interplay of demand for and supply of goods and capital within the U.S. economy and the demand for and supply of dollars in international currency markets. While dollar-related transactions generally are independent of those transactions that determine the market price of oil, there may be channels through which movements in the price of oil and changes in the value of the dollar may have spillover effects. This is especially true for the price of oil, which has a far-ranging impact on the performance of the U.S. economy and on global flows of dollars. Over time, such a connection may have become more stylized in the minds of some observers who may link changes in the price of oil to changes in the value of the dollar and vice versa. Such global capital flows, in turn, are facilitated by liberalized international capital markets and floating exchange rates, which greatly expand the amount of capital flows between countries. These flows also have sparked growth in the development and the use of financial instruments that are designed to ease the international trade of currencies and to provide investors, corporations, and financial services providers with a hedge against unpredictable changes in the value of currencies.

## Capital Flows

Capital inflows also help bridge the gap in the United States between the amount of credit demanded and the domestic supply of funds. A shortfall in the domestic supply of credit relative to domestic demands for those funds tends to raise domestic interest rates and draws in capital from abroad. Those inflows, in turn, help to keep U.S. interest rates below the level they likely would reach without the inflows. The necessity to attract capital inflows, however, has complicated the conduct of economic policy. As the Federal Reserve has lowered interest rates on credit in order to stimulate economic activity and stem a slowdown in the economy, the lower interest rates have blunted capital inflows as foreign investors have sought assets in other markets where relative interest rates are higher.

Capital inflows, however, do allow the United States to spend beyond its means, including financing its trade deficit, because foreigners have been willing to lend to the United States in the form of exchanging goods, represented by U.S. imports, for such U.S. assets as stocks, bonds, and U.S. Treasury securities. Such inflows put upward pressure on the dollar, because demand for U.S. assets, such as financial securities, translates into demand for the dollar, since U.S. securities are denominated in dollars. As demand for the dollar rises or falls according to overall demand for dollar-denominated assets, the value of the dollar changes. These exchange rate changes, in turn, have secondary effects on the prices of U.S. and foreign goods, which tend to alter the U.S. trade balance. In addition, an increase in the U.S. rate of inflation tends to undermine the value of the dollar relative to other currencies, which tends to shift demand from the dollar to other currencies. At times, foreign governments have intervened in international capital markets to acquire the dollar directly or to acquire Treasury securities in order to strengthen the value of the dollar against particular currencies.

## U.S. Financial Balance

The most common way of measuring capital inflows is through the U.S. balance of payments accounts. According to standard economic theory, macroeconomic developments in the U.S. economy are the major driving forces behind the magnitudes of capital flows, because the macroeconomic factors determine the overall demand for and supply of credit in the economy. Naturally, these macroeconomic conditions can be affected by changes in the price of oil, or by changes in macroeconomic policies. To the extent that changes in the price of oil alter the basic savings-investment relationship in the economy, such price changes could have long-lasting impact on the economy and on the trade balance.

One way of viewing the interaction between capital inflows and the domestic demand and supply of funds is through the domestic flow of funds accounts. These accounts measure financial flows across sectors of the economy, tracking funds as they move from those sectors that supply the capital through intermediaries to sectors that use the capital to acquire physical and financial assets.<sup>23</sup> **Table 3** shows the major accounts in the net flow of funds in the U.S. economy from 1996 through the third quarter of 2010. The net flows show the overall financial position by sector, whether that sector is a net supplier or a net user of financial capital in the economy. Since

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<sup>23</sup> Teplin, Albert M., *The U.S. Flows of Funds Accounts and Their Uses*, *Federal Reserve Bulletin*, July 2001, pp. 431-441.

the demand for funds in the economy as a whole must equal the supply of funds, a deficit in one sector must be offset by a surplus in another sector.

**Table 3. Flow of Funds of the U.S. Economy, 1996-2010**  
(billions of dollars)

Year	Households	Businesses	Government			ROW
			Total	State and Local	Federal	
1996	175.2	19.8	-196.8	-1.2	-195.6	137.9
1997	47.4	-18.3	-116.6	-47.5	-69.1	219.6
1998	128.0	-45.7	64.8	48.8	16.0	75.0
1999	-132.7	-62.6	115.3	9.9	105.4	231.7
2000	-371.0	-82.9	252.5	54.5	198.0	476.3
2001	-494.4	-82.9	233.4	35.4	198.0	485.4
2002	-304.0	8.7	-382.6	-95.6	-287.0	501.7
2003	-79.3	30.3	-546.3	-70.4	-476.4	529.4
2004	-67.9	136.8	-468.1	-33.0	-436.1	530.0
2005	-466.5	-44.8	-373.1	7.3	-380.4	712.1
2006	-512.2	-231.1	-188.9	76.1	-265.0	807.4
2007	70.5	-285.1	-345.0	-1.7	-343.3	638.5
2008	619.1	-1,003.1	-914.9	-137.3	-777.6	583.9
2009	273.8	211.9	-1,399.9	-85.1	-1,314.8	215.9
2010 I	392.5	262.0	-1,445.1	-39.5	-1,405.6	138.7
2010 II	1,091.0	12.6	-1,814.9	-48.4	-1,766.5	146.3
2010 III	252.7	181.9	-1,079.3	14.8	-1,094.1	259.4

**Source:** Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2010, December 9, 2010.

**Note:** Negative values indicate a net inflow of funds, or that the demand for funds in that sector was greater than the supply of funds provided by that sector.

Generally, the household sector, or individuals, provides funds to the economy, because individuals save part of their income, while the business sector uses those funds to invest in plant and equipment that, in turn, serve as the building blocks for the production of additional goods and services. The government sector (the combination of federal, state, and local governments) can be either a net supplier of funds or a net user, depending on whether the sector is running a surplus or a deficit, respectively. The interplay within the economy between saving and investment, or the supply and uses of funds, tends to affect domestic interest rates, which move to equate the demand and supply of funds. Shifts in the interest rate also tend to attract capital from abroad, denoted by the rest of the world (ROW).

From 1999 until late in 2006, the household sector was dissaving, as individuals spent more than they earned. Part of this dissaving was offset by the government sector, which experienced a surplus from 1998 to 2001. As a result of the large household dissaving, however, the economy as

a whole experienced a gap between domestic saving and investment that was filled with large capital inflows. Those inflows were particularly large in nominal terms from 2000 to 2008, as household dissaving continued and as government sector surpluses turned to historically large deficits in nominal terms. Such inflows kept interest rates below the level they would have reached without the inflows, but they put added pressure on the international exchange value of the dollar during that period.

In 2008 and 2009, capital inflows fell sharply, reflecting the global financial crisis and economic recession and the associated drop in international trade. This drop in capital inflows reflected a shift by households from dissaving to saving as concerns over the economy, with an attendant large loss in personal wealth, spurred households to pare back their consumption expenditures and to increase their personal savings. The business sector also shifted from a net supplier of funds in 2007 to a net consumer of funds as investments declined, again reflecting tight credit conditions and the drop in the rate of economic growth in the economy in 2008 and 2009. Both the federal government and state and local governments experienced a deterioration in their accounts as these sectors of the economy experienced large net deficits, reflecting the slowing rate of growth in the U.S. economy. The decrease in capital inflows combined with the slowing rate of economic growth and concerns about the stability of the financial services sector likely placed downward pressure on the exchange value of the dollar, or a devaluation of the dollar.

## Foreign Exchange Market

International factors also affect the value of the dollar. The dollar is heavily traded in financial markets around the globe and, at times, plays the role of a global currency. Disruptions in this role have important implications for the United States and for the smooth functioning of the international financial system. This prominent role means that the exchange value of the dollar often acts as a mechanism for transmitting economic and political news and events across national borders, including expectations about the performance of the economy and concerns about the impact of such supply factors as the rise in the price of oil. While such a role helps facilitate a broad range of international economic and financial activities, it also means that the dollar's exchange value can vary greatly on a daily or weekly basis as it is buffeted by international events.

A triennial survey of the world's leading central banks conducted by the Bank for International Settlements in April 2010 indicates that the *daily* trading of foreign currencies through traditional foreign exchange markets<sup>24</sup> totals about \$4 trillion, up from the \$3.3 trillion reported in the previous survey conducted in 2007, as indicated in **Table 4**. In addition to the traditional foreign exchange market, the over-the-counter (OTC)<sup>25</sup> foreign exchange derivatives market reported that daily turnover of interest rate and non-traditional foreign exchange derivatives contracts reached \$2.1 trillion in April 2010. The combined amount of \$6.1 trillion for daily foreign exchange trading in the traditional and OTC markets is more than three times the *annual* amount of U.S. exports of goods and services. The data also indicate that 85% of the global foreign exchange

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<sup>24</sup> Traditional foreign exchange markets are organized exchanges which trade primarily in foreign exchange futures and options contracts where the terms and condition of the contracts are standardized.

<sup>25</sup> The over-the-counter foreign exchange derivatives market is an informal market consisting of dealers who custom-tailor agreements to meet the specific needs regarding maturity, payments intervals or other terms that allow the contracts to meet specific requirements for risk.

turnover is in U.S. dollars, slightly lower than the 85.6% share reported in a similar survey conducted in 2007.<sup>26</sup>

**Table 4. Foreign Exchange Market Turnover**  
(Daily averages in April of the year indicated, billions of U.S. dollars)

	1995	1998	2001	2004	2007	2010
<b>Foreign Exchange Market Turnover</b>						
Instrument						
Spot transactions	494	568	386	631	1,005	1,490
Outright forwards	97	128	130	209	362	475
Foreign exchange swaps	546	734	656	954	1,714	1,765
Reporting gaps	53	61	28	107	129	NA
Total "traditional" turnover	1,190	1,527	1,239	1,934	3,324	3,981
<b>Over the Counter Derivatives Market Turnover</b>						
Foreign exchange instruments		97	87	140	291	NA
Interest rate instruments		265	489	1,025	1,686	2,083
Reporting gaps		13	19	55	113	NA
Total OTC turnover		375	575	1,220	1,990	2,083
<b>Total market turnover</b>	1,190	1,865	1,775	3,100	5,300	6,064
<b>United States</b>						
Foreign exchange turnover	244	351	254	461	664	817
OTC derivatives turnover		90	135	355	607	659
Total	244	441	389	816	1,271	1,506

**Source:** Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2010. Bank for International Settlement, September 2010.

## The U.S. Trade Deficit

Rising oil prices add to the Nation's trade deficit and boost the rate of change in wholesale and consumer prices, as long as the oil price increases are not offset by actions by the Federal Reserve to tighten the money supply.<sup>27</sup> According to data published by the Census Bureau of the Department of Commerce,<sup>28</sup> the prices of petroleum products over the past year have varied considerably, at times rising faster than the change in demand for those products. As a result, the price increases of imported energy-related petroleum products worsened the U.S. trade deficit in 2006,- 2008 and again in 2010. This rising cost of oil added an estimated \$120 billion in 2008 and

<sup>26</sup> *Triennial Central Bank Survey: Foreign Exchange and Derivatives Market Activity in 2010*. Bank for International Settlement, September 2010. pp. 1-2. A copy of the report is available at <http://www.bis.org/publ/rpfx07.pdf>

<sup>27</sup> *Consumer Price Index: January 2011*, The Bureau of Labor Statistics. P. 1.

<sup>28</sup> Census Bureau, Department of Commerce. Report FT900, *U.S. International Trade in Goods and Services*, February 11, 2011. Table 17. The report and supporting tables are available at [http://www.census.gov/foreign-trade/Press-Release/current\\_press\\_release/ftdpress.pdf](http://www.census.gov/foreign-trade/Press-Release/current_press_release/ftdpress.pdf).



\$80 billion in 2010.<sup>29</sup> As previously indicated, the overall U.S. demand for oil changes little with even large changes in the price of oil, so that changes in the price of imported oil are reflected in the U.S. balance of payments. As a result, increases in the price of imported oil translate into larger merchandise trade deficits, because changes in the demand for oil relative to changes in the price of oil are slight, even with large increases in the price of imported oil, and because oil imports account for a large share of U.S. imports.

Changes in oil prices also affect the cost of a broad range of goods, services, and economic activities and the changes can affect the real discretionary incomes of consumers, which has an impact on the rate of economic growth. A lower rate of economic growth, as was experienced in late 2008 and in 2009, reduces demand for oil and the price of oil falls to equate supply and demand, assuming that the supply of oil remains constant. The trade deficit also represents a transfer of wealth from the United States to the oil producers. This transfer of wealth reduces the real discretionary incomes of U.S. consumers. To the extent that the additional accumulation of wealth abroad is returned to the United States as payments for additional U.S. exports or to acquire such assets as securities or U.S. businesses, some of the negative effects could be mitigated. The data in **Table 5** provide estimates of the impact different prices for imported crude oil could have on the annual U.S. trade deficit. The table also provides estimates for the increase in the trade deficit if the amount, or the volume, of imported oil declined by 3% or rose by 3% on an annual basis, as a result of changes in the demand for oil.

According to the Census Bureau, the United States imported 4.28 billion barrels of energy-related petroleum products in 2010. Energy-related petroleum products is a term used by the Census Bureau that includes crude oil, petroleum preparations, and liquefied propane and butane gas. Crude oil comprises the largest share by far within this broad category of energy-related imports. At an average price of \$74.66 per barrel, imported petroleum products cost \$323 billion dollars in 2010. After subtracting U.S. exports of petroleum products, the U.S. trade deficit in petroleum products was \$265 billion, or 41% of the total trade deficit in 2010 of \$646 billion. At an average price of \$80 per barrel in 2011 and assuming that the amount, or the volume, of petroleum products the United States imports does not change, the U.S. trade deficit in oil in 2011 would increase by \$18 billion over the deficit recorded in 2010. At an average price of \$100 per barrel in 2011, the cost of imported petroleum would add \$104 billion to the annual trade deficit. Naturally, should import volumes decrease as a result of greater energy conservation or a lower rate of economic growth, the addition to the annual trade deficit would be less. If import volumes fell by 3% at a time when the average price of imported petroleum products was \$100 per barrel, the addition to the annual trade deficit would be \$91 billion. Should import volumes increase by 3% and oil prices rise, the deficit would increase as well.

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<sup>29</sup> For additional information, see CRS Report RS22204, *U.S. Trade Deficit and the Impact of Changing Oil Prices*, by James K. Jackson.

**Table 5. Estimates of the Impact on the U.S. Trade Deficit Associated With Various Prices for Crude Oil and Changes in Oil Import Volumes**

	2010		2011			
	(Actual values)		Estimated values			
	Quantity (billions of barrels)	Value (billions of dollars)	Price per barrel			
Price per barrel		\$74.66	\$70.00	\$80.00	\$90.00	\$100.00
Crude oil imports	3.38	\$252.18	\$236.44	\$270.22	\$303.99	\$337.77
Total energy-related Petroleum Products imports	4.28	\$323.63	\$299.49	\$342.28	\$385.06	\$427.85
Change in trade deficit (in \$billions)			\$-24.16	\$18.65	\$61.43	\$104.22
<b>With 3 percent reduction in import volumes</b>						
Crude oil imports			\$229.35	\$262.11	\$294.87	\$327.64
Total energy-related Petroleum Products imports			\$290.51	\$332.01	\$373.51	\$415.01
Change in trade deficit (in \$billions)			\$-33.12	\$8.38	\$49.88	\$91.38
<b>With 3 percent increase in import volumes</b>						
Crude oil imports			\$243.53	\$278.32	\$313.11	\$347.90
Total energy-related Petroleum Products imports			\$308.48	\$352.55	\$396.61	\$440.68
Change in trade deficit (in \$billions)			\$-15.15	\$28.92	\$72.98	\$117.05

**Source:** U.S. International Trade in Goods and Services February 2011, Census Bureau. Estimates developed by CRS.

## Conclusions

Despite common perceptions that there is a direct cause and effect relationship between changes in the international exchange value of the dollar and the price of oil, an analysis of recent data indicates that the rise in the price of oil is being driven by an increase in demand that is exceeding the increase in supply and by political turmoil in North Africa and the Middle East. Attempts by oil producers to raise the market price of oil in order to offset the loss of purchasing power of a depreciating dollar likely would find those efforts blunted partially or in whole by the repercussions of the rise in oil prices. Increases in oil prices tend to push up prices among a broad range of goods, services, and economic activities due to the ubiquitous presence of oil as a source of energy. In addition, higher relative rates of inflation tend to undermine the exchange value of the dollar relative to other currencies, devaluing the dollar relative to other currencies and reducing the purchasing power of the dollar. Domestically, rising commodity prices reduce real incomes and lower the overall level of consumption. In turn, lower consumption reduces economic growth, which would tend to reduce the demand for oil and lead ultimately to a lower market price for oil.

The relationship between the dollar and the price of oil is complicated by the impact the price of oil can have on the rate of inflation and the rate of economic growth in the United States, the rate of economic growth and the rate of inflation in other countries, and effects on foreign currencies. For instance, rising oil prices not only raise the price of energy in the United States, but in countries around the globe. Rising prices, in turn, tend to undermine the purchasing power of national currencies. Depending on the level of domestic dependency on foreign oil, the impact of changes in oil prices can vary. Concerns over rising prices in Europe and the prospect of slowing economic growth in the Euro zone countries have tended to push down the exchange value of the Euro relative to the dollar.<sup>30</sup>

Upward pressure on the market price of crude oil also can come from market participants and investors who are bidding up the price of oil in an effort to invest in commodities that they calculate will generate a rate of return that exceeds that of traditional financial investments. With demand for crude oil rising faster than supplies, it is difficult for the market to determine what the future price of crude oil might be, which provides a climate that is susceptible to speculation, although there is no clear evidence that such speculation has been a major factor in the rise in crude oil prices since 2006.

Over the long run, a sustained increase in the price of energy imports could permanently alter the composition of the nation's merchandise trade deficit. Some of the impact of higher oil prices, however, could be offset if some of the dollars are returned to the U.S. economy through increased purchases of U.S. goods and services or through purchases of such other assets as securities of U.S. businesses. Some of the return in dollars likely will come through sovereign wealth funds (SWFs), or funds controlled and managed by foreign governments, as foreign exchange reserves boost the dollar holdings of such funds. Such investments likely will add to concerns about the national security implications of foreign acquisitions of U.S. firms, especially by foreign governments, and to concerns about the growing share of outstanding U.S. Treasury securities that are owned by foreigners. Over the long run it is possible for the economy to adjust to the higher prices of energy imports by improving its energy efficiency, finding alternative sources of energy, or searching out additional supplies of energy. Increased pressure is already being applied to Congress to assist in this process.

The sharp rise in prices of energy imports experienced since mid-2010 is increasing the U.S. rate of inflation and could have a slightly negative impact on the rate of economic growth in 2011. This could pose a number of policy issues for Congress. A slowdown in the rate of economic growth in the United States will lessen the demand for energy imports and could help restrain the prices of energy imports, but likely put additional pressure on the budgets at the state, local, and federal levels of government. Other important factors will be the length of political turmoil in North Africa and the Middle East, the potential impact of Atlantic hurricanes, flooding along the Mississippi river, and the impact other natural disasters could have on the production of crude oil in the Gulf of Mexico and on oil refineries. Most immediately, higher prices for energy imports will worsen the nation's merchandise trade deficit, add to inflationary pressures, and have a disproportionate impact on the energy-intensive sectors of the economy and on households on fixed incomes.

For Congress, the increase in the nation's merchandise trade deficit could add to existing inflationary pressures and complicate efforts to stimulate the economy should the rate of

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<sup>30</sup> Dougherty, Fears of European Slowdown Weaken the Euro.

economic growth slow down. In particular, Congress, through its direct role in making economic policy and its oversight role over the Federal Reserve, could face the dilemma of rising inflation, which generally is treated by raising interest rates to tighten credit, and a slowing rate of economic growth, which is usually addressed by lowering interest rates to stimulate investment. A sharp rise in the trade deficit could also add to pressures for Congress to examine the causes of the deficit and to address the underlying factors that are generating that deficit. In addition, the rise in prices of energy imports could add to concerns about the nation's reliance on foreign supplies for energy imports and capital inflows and add impetus to examining the nation's energy strategy.

## **Author Contact Information**

James K. Jackson  
Specialist in International Trade and Finance  
jjackson@crs.loc.gov, 7-7751