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Dollar bears in for shock if US cuts energy imports

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The future of the dollar is more likely to be determined in the shale gas and oilfields of Dakota and Texas than in the sovereign wealth funds of Asia and the Middle East. This is because striking new technological developments are set to transform America's energy supplies, significantly improving the US balance of payments and the long-term outlook for the greenback.

The US's current account deficit has been a longstanding drag on the dollar. At the height of the credit boom in 2006, it reached $800bn or 6 per cent of gross domestic product. Though the deficit has halved as the credit crunch has lowered imports, it still stands at 3 per cent of GDP, largely because the US, like the eurozone, Japan, China and India, remains a major energy importer, with annual net foreign oil purchases of $300bn a year. As the US economy slowly recovers, the International Monetary Fund expects the US current account deficit to start rising again. That would lead to foreign central banks accumulating greater reserves of dollars.

But such straight-line forecasts are likely to be challenged as the US's shale gas and "tight oil" reserves are commercially exploited over the next few years. The US has vast reserves of shale gas but, until recently, energy companies were unable to tap the gas trapped in shale rock. Now, through hydraulic fracturing or 'fracking', US reserves of economically available gas supplies have started to rise sharply.

Already the ratio of US gas reserves to annual production has increased from eight years to 12 years. This may not appear substantial when compared to other regions of the world. Qatar, for example, has proven gas reserves well above 100 years of current production. But fracking may allow the US to soon count up to one hundred years of gas reserves relative to current production. That would lead to a major shift in the US's energy outlook.

In addition the exploitation of tight oilfields through new technology is increasing the US's domestic oil production relative to imports. This marks a

significant departure from the past three decades, when the share of US oil consumption accounted for by foreign supplies rose from around 30 per cent in the 1980s to over 65 per cent by the time the credit crunch began in 2007. In 2010 imports had already declined to 61 per cent of total US oil consumption and are set to decrease further.

More strikingly, the US is starting to export oil again given its increased domestic oil production. Ten years ago, US oil exports were less than 10 per cent of the country's oil imports. Now they are close to 20 per cent of US imports as local oil output surges. For example, North Dakota yielded more than 500,000 barrels of oil a day at the end of last year, exceeding the production of Opec member Ecuador.

There remain significant environmental concerns regarding the use of fracking to exploit shale gas in commercial quantities. But if America is able to dramatically increase its energy reserves, then it can reduce its reliance on foreign supplies – particularly from volatile regions such as the Middle East.

Over time this would engineer a sharp improvement in the US current account deficit. As the US's net oil import position accounts for the lion's share of its balance of payments deficit, increased domestic production has the potential to reduce the US current account deficit from 3 per cent of GDP to lower levels, or even send it into a surplus over the next decade.

The US economy last ran a current account surplus at the start of the 1990s. If the US is able to return to a similar position over the next few years owing to reduced energy imports, it would have three important consequences for financial markets and the global economy.

First, in the foreign exchange markets, the dollar would continue its recovery against the euro and other major currencies that began during the financial crisis of 2008. Consensus forecasts that the greenback will keep on depreciating to rebalance America's current account deficit will need to be torn up.

Second, the negative relationship between oil prices and the dollar would break down. China and India are still likely to be large consumers of Middle East energy but significantly reduced US foreign oil purchases will limit the growth of the region's sovereign wealth funds. As a result, their dollar-diversifying activities, heightened when oil prices rise, will be constrained in future.

Third, stronger growth in the US on the back of a more balanced economy would call into question the Fed's current stance of keeping monetary policy super-loose.

Thus the conventional wisdom of an ever-weakening greenback is likely to become obsolete. Over the next decade, the currency is set to benefit from the US's reduced reliance on foreign energy. That will be a positive shock for US consumers and companies and a negative shock for long-term dollar bears.

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