Economy

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Is the Value of the US Dollar Driving Oil Prices?

Master's Thesis

Bibliographic information published by the German National Library:

The German National Library lists this publication in the National Bibliography; detailed bibliographic data are available on the Internet at http://dnb.dnb.de .

Imprint:

ISBN: 9783668434554

This book at GRIN:

https://www.grin.com/document/358681

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GRIN Verlag

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Master of Science in Economics
University of Edinburgh

August 2012

Abstract

As an invoice currency the US dollar is frequently cited to cause changes in real oil prices through a demand and supply channel. The aim of this paper is to shed more light on whether the US dollar is driving oil prices. In order to do so, we incorporate the bivariate relationship in a broader demand and supply framework in which real oil prices are determined by demand and supply factors. We find cointegration among the variables involved and that the value of the US dollar is a significant part in the long-run relationship. The causal links within the long-run relationship are examined using the procedure suggested by Toda & Yamamoto (1995) to test for Granger causality in the presence of I(1) variables. The results show that no causal effect of the US dollar on oil prices can be found. This contradicts the view that the US dollar is driving real oil prices. There is even evidence that none of the fundamentals is causing real oil prices. Moreover, real oil prices are found to have an indirect causal effect on the US dollar. This contradicts standard models such as the Krugman (1983) model which suggest a direct link.