

## **The End of US Petrodollar Hegemony?**

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This paper explores an under-researched aspect of US prestige, power, and strategy, namely, the pricing of oil in US dollars since 1973. US petrodollar hegemony has enabled the United States to run large current account deficits and to borrow and consume while other countries have had to save and invest. It has contributed to a rise in living standards in the United States that would otherwise not have been possible. It has allowed the US to dominate global energy markets.

Some commentators, such as Doug Stokes (2014), see little sign of this situation changing. In 2012, for instance, there was still high demand for US treasuries yielding 0% interest, because US dollar-denominated securities were widely seen as a secure store of value and medium of exchange. At that time, the Chinese yuan, which was not convertible and was not allowed outside China before 2004, was not seen as a potential competitor, at least not for many decades.

Nevertheless, there are signs that several countries are intent on ditching the dollar. The fact that Iraq and Libya both suffered regime change after challenging US petrodollar hegemony has not deterred Iran from pricing oil in Euros since 2016. Russia recently began selling oil to China in exchange for yuan-denominated gold futures contracts. Venezuela now refuses to accept US dollars as payment for its oil.

In March this year, China opened a new oil futures market, to be coordinated through a new stock exchange, the Shanghai International Energy Exchange. The new oil contract, priced in renminbi, is the first Chinese futures product that can be traded by overseas entities without a presence in China, representing Beijing's latest step in promoting the global use of its currency.

In what follows, I want to give a very brief history of the petrodollar, then discuss the challenges that have arisen to the petrodollar, the limitations of those challenges, and possible wider ramifications should those challenges continue to mount.

### **The Origins of the Petrodollar**

In October 1973, the Organisation of Petroleum Exporting Countries (OPEC) announced an oil embargo in response to the Yom Kippur War and the price of oil duly went up 400 percent. Western economies were plunged into a period of stagflation in which workers' wages could not keep pace with the high inflation being driven by the oil price spike.

The United States responded by offering arms and military protection to OPEC states in exchange for pricing oil exclusively in US dollars and recycling surplus oil proceeds in US government debt securities. This arrangement, finalized by early 1975, expressed the United States' continued geopolitical dominance and restored the status of the US dollar as the world reserve currency following the crisis of Bretton Woods and the decoupling of the dollar from gold in 1971.

Because all modern industrialized economies rely on oil, the pricing of oil in US dollars makes all net importers of oil dependent on the dollar. But whereas other countries have to sell goods and services in order to acquire the US dollars needed to buy oil, the US can simply print more money. This is known as seigniorage privilege.

Whereas other countries have to save in order to finance deficits, petrodollar arrangements have allowed the US to run a current account deficit (the value of imports exceeds the value of exports) every year since 1976, financed by guaranteed purchases of government debt. In 1980, the US went from being the world's largest creditor to the world's largest debtor.

Persistent US current account deficits raised central bank reserves in other countries without causing a fall in those of the US. The result was a massive surge in world central bank reserves, which in turn permitted a multiplied expansion of credit and the financialized casino capitalism we see today.

Countries earning surplus dollars from their exports still have little choice but to invest those dollars in US Treasury bonds and other US securities. This amounts to a guaranteed form of debt financing for the US. No matter how much money the US wants to borrow, it can always find a willing lender. The US national debt recently topped \$21 trillion.

Around two thirds of the world's money and trade is now denominated in US dollars. The sheer volume of US dollars in circulation makes it hard to imagine any serious alternative to the dollar as the world reserve currency.

### **Challenges to the Petrodollar**

Nevertheless, challenges to the petrodollar have been mounting for some time.

In November 2000, Iraq began selling oil in euros, priced its oil for food at the UN in euros, and converted its \$10 billion reserve fund at the UN to euros. In March 2003 it was invaded by the United States, and its oil was once again priced in dollars.

In 2006, Syria switched the primary hard currency used for foreign goods and services from the US dollar to the euro in a bid to make it less vulnerable to pressure from Washington. In 2007,

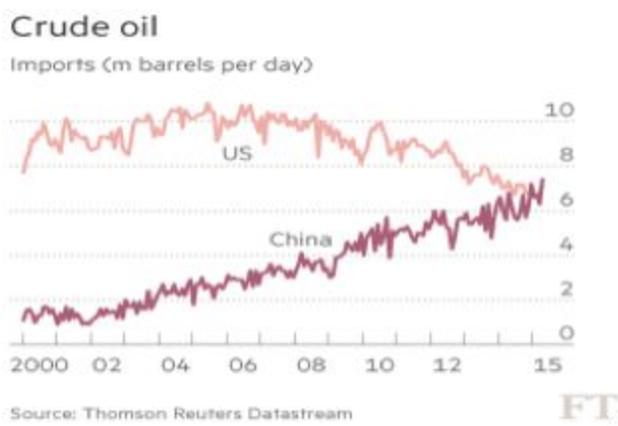
the *New Yorker* published an article by Seymour Hersh claiming to expose a US-Israeli-Saudi conspiracy to overthrow Assad.

In 2009, Colonel Gaddafi proposed a gold-backed pan-African currency, the golden dinar, in which to price oil sales. He also mooted African alternatives to the US-dominated International Monetary Fund and World Bank and refused to join AFRICOM, the US imperial command centre for Africa launched in 2007. He was killed following the NATO invasion of Libya in 2011. A notable feature of the Libyan war was the rebels formed their own central bank in Benghazi even as the fighting was still going on, highlighting the importance of currency arrangements to the conflict.

In 2012/13, Washington imposed sanctions on Iran over its nuclear programme, using the SWIFT international bank clearing system (through which virtually every international banking transaction passes) in order to freeze \$100 billion of Iranian overseas assets and cripple Iran's ability to export oil. Iran nevertheless managed to evade the sanctions by selling oil to India and receiving payment in gold, mediated by Turkey. It also began accepting payment in yuan for its oil and gas exports.

In 2014, the US imposed sanctions on Russia over Crimea, with some US Congressmen calling for Russia to be suspended from SWIFT. The European Parliament adopted a resolution that such an option should at least be considered. Russia and Iran signed a five-year bilateral trade deal worth \$20 billion involving the sale of Iranian oil not priced in US dollars. In the third quarter of 2014, Russia purchased more gold (55 tonnes) than all the world's other central banks combined.

In 2015 China surpassed the US in its share of world trade - historically a key indicator of a coming power shift in international order. It also overtook the United States as the world's largest importer of crude oil, as the US became a net exporter on the back of the shale oil revolution. Goldman Sachs issued a forecast predicting that Chinese GDP would overtake that of the US by 2030.



In April 2015, Qatar opened the Middle East's first centre for clearing transactions in yuan.

In May 2015, China set up the state-run Gold Investment Fund, the world's largest physical gold fund. It promises to support gold mining projects in Belt and Road Initiative countries in order to boost their capacity to back their currencies with gold. Potentially the largest infrastructure and investment project in history, the Belt and Road Initiative, announced in 2013, aims to boost trade between 68 mostly Eurasian countries by building high-speed rail links, bridges, ports, motorways, pipelines, and other linkages between them.

In October 2015, the China international payments system (CIPS) was launched in Shanghai, giving China the capacity to make international payments independently of the US-dominated SWIFT system in the event of the US using SWIFT to impose sanctions.

In January 2016 the Asian Infrastructure Investment Bank opened in Beijing. It represents an alternative to the the IMF, World Bank and Asian Development Bank, which China claims are dominated by US, European and Japanese interests. The bank is a major step towards securing international financing for the Belt and Road Initiative.

In April 2016 the Shanghai Gold Exchange was established as an international center for trading gold in yuan. China also introduced a daily yuan-denominated price fix on gold as an alternative to the dominant London gold fix, which has been long accused of artificially suppressing the gold price.

In October 2016 the renminbi became the fifth currency to be added to the IMF's special drawing rights basket, enhancing its position as a global currency and China's position within the world economy. The Bank of China launched billboards at major airports advertising the renminbi as "the world currency."

In March 2017, the Russian Central Bank opened its first overseas office in Beijing with a view to phasing in a new gold-backed standard of trade between the two countries. In a bilateral \$400 billion pipeline deal, China paid for the pipeline with yuan treasury bonds, then for Russian oil in yuan-denominated gold futures contracts on the Shanghai Gold Exchange.

In June 2017 the European Central Bank converted 500 million euros worth of US dollar reserves to yuan.

In September 2017, Venezuela, which had previously entered into a barter arrangement with Cuba (oil for doctors) in order to avoid transacting in US dollars, stopped accepting dollars for oil and instead began pricing oil in euros.

In October 2017 China announced a new "payment vs. payment" (PVP) system allowing for direct settlement of bilateral trade between China and Russia. It was announced that similar PVP systems would be established for yuan transactions with other currencies involved in the

Belt and Road initiative, holding out the possibility of a large-scale currency zone independent of the dollar.

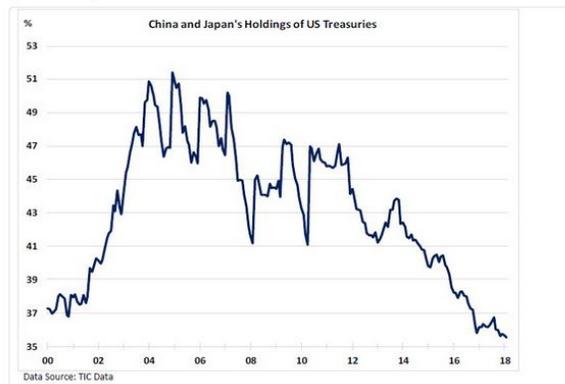
In January 2018, Pakistan announced it would replace the dollar with yuan for bilateral trade with China. On the very same day (4th January), the US placed Pakistan on the watch list for religious freedom violations.

As of March 2018, the Central Bank of Russia had purchased gold for 38 consecutive months, accumulating 683 tonnes and demonstrating a clear commitment to growing gold reserves. It has been suggested that Russia and China are gradually moving towards establishing a new gold-backed currency as a challenger to the US dollar. While Russia has been growing its gold reserves, it has been significantly scaling back on its US treasury holdings:



China and Japan, too, have cut back significantly on their US treasury holdings, which as a proportion of total foreign holdings of US debt are now at their lowest level since 2000:

China & Japan's holdings of US debt , as a share of total foreign holdings of Treasuries, has fallen to its lowest level since 2000 (35.5%)



In the first quarter of 2018 China ran a current-account deficit, its first since joining the World Trade Organisation in 2001:



In order to fund the deficit, China has the option of selling more bonds to foreign investors. As noted by the *Economist*, “By itself this would not be enough to make the yuan go global. Investors would need more faith in China’s institutions. But technically, the conditions would be ripe for the yuan’s emergence as a more credible rival to the dollar.”

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Also in March, Iran banned the use of the US dollar in all trade transactions, having already begun pricing oil in euros in 2016. The following month, Tehran announced that it would start reporting foreign currency amounts in euros rather than US dollars. In response, the US and Israeli governments and corporate media claimed Iran was lying about its nuclear weapons development and branded it the top state sponsor of terrorism. In May 2018, Trump tore up the Iran nuclear deal, causing trading volumes in the Shanghai oil futures contract to spike on speculation that Iran would turn to China for its oil exports.

Last month, China allowed overseas investors to trade iron ore futures, the second commodity futures contract to be made available to foreign investors after the oil futures contract launched in March. Meanwhile, the London Metal Exchange announced plans to introduce yuan-denominated metal products. Its Chief Executive, Matthew Chamberlain, claimed, “At present, investors are trading our products in US dollars. We would definitely like to explore the possibility of launching products denominated in offshore renminbi.”

Beijing now appears to want to establish the yuan in *physical* oil markets. China's state-owned oil refiner Sinopec, for instance, has already signed a Middle East import deal priced off the Shanghai oil futures contract instead of Brent or West Texas.

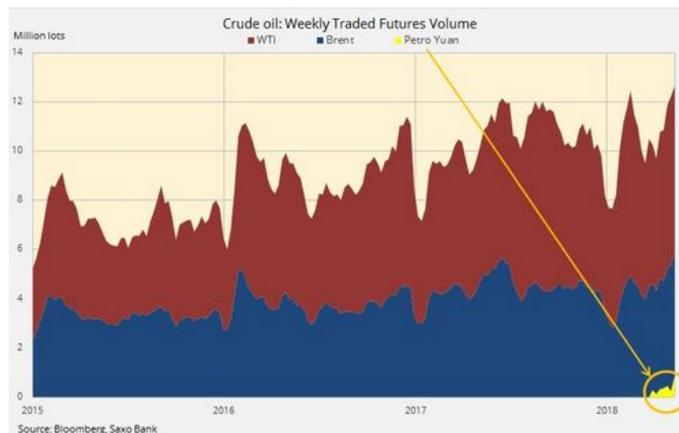
China is putting pressure on the world's largest oil exporter, Saudi Arabia, to start selling oil in yuan. It made that proposal in July 2017 following almost a decade of cutting back on Saudi oil imports. Should the Saudis switch their allegiance to China, other oil exporting states may follow suit.

China appears to be moving towards being able to print renminbi for all commodity imports. If successful, this will reduce China's risk of a balance of payments crisis as well as its need to hold US treasury bonds. It would give China something akin to the seigniorage privilege enjoyed by the United States, albeit on a much smaller scale, at least to begin with.

### Limitations of the Petroyuan

Although the Shanghai oil futures contract does represent a new challenge to the petrodollar that will displease the United States, it remains a relatively small challenge at this stage.

The main oil benchmarks are still determined in London and New York, and if we look at the challenge of the Shanghai futures contract to Brent and West Texas contracts, we see it is still very small (only 7 percent of market share):



It is also the case that the Shanghai oil futures contract is only for the delivery of a specific type of crude oil, namely, the high-sulphur type mostly consumed by Chinese refineries, and not for world oil supplies more generally.

Furthermore, any challenge to the petrodollar system rests not only on trade but also on the Chinese financial system, which presently is a long way off being able to present a real

challenge to Wall Street. China's capital controls and pegging of the yuan undermine its ability to act as an international settlement currency, let alone a world reserve currency.

In the worst case scenario, the new oil futures contract will act as just another opportunity for investors to pile into a new investment vehicle, only for a heavily rigged market to crash around their ears. It would hardly be the first time this has happened in China, where the commodities futures market overheated in 2016, prompting government intervention in the form of higher fees, tighter regulations, and restricted trading hours. Commodities futures volumes quickly reverted to the mean, and the same could happen to the Shanghai oil futures contract:

