global china pulse.

01
24

SCAMMED: DISSECTING CYBER SLAVERY IN SOUTH EAST ASIA

This text is taken from *Global China Pulse*: Volume 3, Issue 1, 2024.

Petroyuan

Source: Global China Pulse (CC), additional credits Damien Goodyear (CC), from Flickr.com

The Petroyuan's Challenge to Dollar Hegemony

Monique TAYLOR

The launch of yuan-denominated crude oil futures in 2018 marked a significant step in the renminbi's internationalisation, offering an alternative to the US dollar in the global energy trade. The historical context of the petrodollar system—established through an agreement between the United States and Saudi Arabia in the mid-1970s—further entrenched and sustained the US dollar's status as the global reserve currency after the collapse of the Bretton Woods system. The emergence of the petroyuan reflects China's ambition to challenge the longstanding dominance of the petrodollar, underscoring the shift towards a more multipolar world. While the petroyuan is unlikely to displace the dollar, its introduction reflects broader geopolitical and economic reconfigurations, potentially adding complexity and friction to global financial and energy transactions.

On 26 March 2018, a milestone in the renminbi's journey towards internationalisation was reached at the Shanghai International Energy Exchange with the launch of yuan-denominated crude oil futures contracts. The introduction of 'petroyuan' futures contracts represents not just an alternative currency for trade in global energy markets, but also a statement of China's ambition to elevate the status of its currency, the renminbi, challenging the longstanding dominance of the US dollar (petrodollar). Through these oil futures, China aims to establish a Chinese global oil price benchmark reflective of its own market conditions alongside existing international crude oil benchmarks like Brent Crude (originating in the North Sea) and West Texas Intermediate, both of which are priced in US dollars (The Economist 2018). Situated at the intersection of global finance, international trade, and geopolitics, the emergence of the petroyuan reflects and reinforces a more general shift to multipolarity in the international system. Rather than outright displacement of the petrodollar, the petroyuan could give rise to a degree of fragmentation in international oil pricing and settlement. Such fragmentation could lead to higher transaction costs and market volatility and amplify geopolitical tensions due to this reconfiguration of global economic power that has the potential to erode the stability provided by a single hegemonic currency.

The Petrodollar System

The US dollar's reserve currency status became deeply intertwined with the petrodollar system from the time of the latter's emergence in the mid-1970s. After the collapse of the Bretton Woods system in the early 1970s and the 1973 oil embargo by the Organization of the Petroleum Exporting Countries (OPEC)—in retaliation for US military aid to Israel during the Yom Kippur War—the US Nixon administration negotiated with Saudi Arabia for the kingdom to price and sell its oil exclusively in US dollars and purchase US Treasury bonds in exchange for military aid and technology. The goal was to 'neutralize crude oil as an economic weapon and find a way to persuade a hostile kingdom to finance America's widening deficit with its newfound petrodollar wealth' (Wong 2016). Saudi King Faisal bin Abdulaziz Al Saud demanded that Saudi Arabia's vast US Treasury purchases, also known as 'petrodollar recycling', remain secret, to avoid political backlash. While it was known that oil-rich countries invested in US securities, the scale of Saudi investments remained undisclosed until a 2016 *Freedom of Information Act* request by *Bloomberg News* revealed the exact figures (Wong 2016). The Treasury had maintained the confidentiality of Saudi holdings by grouping them with other regional data in its reports.

The deal struck between the United States and Saudi Arabia solidified the dollar's dominance in international oil markets. Other OPEC members followed suit, by pricing their oil exports in dollars, largely because Saudi Arabia is the de facto leader of OPEC. Hence the petrodollar quickly became the de facto currency for the global oil trade. There are distinct benefits of having a uniform pricing mechanism such as the petrodollar, as it simplifies transactions, reduces exchange rate risks, and fosters a more integrated global oil market. Given the centrality of oil to both developed and developing economies, countries around the world must hold US dollars to conduct these transactions. This supports the US dollar's value by sustaining consistent global demand for it, thus reinforcing its role as the hegemonic reserve currency held by central banks worldwide. Further entrenching the dollar's global financial dominance was the phenomenon of petrodollar recycling, whereby the oil export revenues of oil-exporting countries were either deposited in Western banks or invested in US Treasury securities, which provided a valuable source of capital for the US economy (Spiro 1999). This also allowed the United States to finance its current account deficits more easily and borrow at lower interest rates.

The ability of the US to finance its current account deficits in this way is an 'exorbitant privilege' that stems from the dollar's role as the world's primary reserve currency. The postwar monetary order that was established at the Bretton Woods Conference, held in the US state of New Hampshire in 1944, initially maintained the US dollar's role as the primary currency through a system of fixed exchange rates between member countries and convertibility between the US dollar and gold at a rate of 35 USD per ounce (providing a stable value for the dollar). Although the collapse of the Bretton Woods system brought an end to gold convertibility and fixed exchange rates, the emergence of the petrodollar system in the 1970s provided a new basis for the dollar's international dominance within the emerging neoliberal monetary framework (Selva 2017).

While the United States is conferred significant privileges by its global reserve currency status, there is also an argument to be made that dollar dominance provides the overarching global public good of hegemonic currency stability. In the field of International Political Economy, hegemonic stability theory, as advanced by Kindleberger (1973), posits that the global economic order is the most stable when a single country, the hegemon, dominates. This dominance is both military and economic, as the hegemon uses a full spectrum of resources to create and maintain a stable and open international system that is conducive to trade and investment. Conversely, according to hegemonic stability theory, the absence of a hegemon causes instability and disorder, leading to fragmentation, trade wars, ineffective global economic institutions, and decreases in international economic cooperation.

Eichengreen (2011) offers an alternative perspective, arguing that the shift from a hegemonic to multipolar currency order, in which multiple currencies serve as international reserves, is not only inevitable in the long run, but also advantageous. Challenging Kindleberger's view that stability hinges on a hegemonic currency, Eichengreen claims that reliance on a single currency makes the global economy vulnerable to the monetary policies of the issuing country, the United States. In contrast, a diversified currency system reduces the impact of any single country's economic policies, allowing for a more balanced distribution of economic power. However, this view tends to underestimate the political implications, as the transition to multipolarity in the global currency order will reflect geopolitical shifts and rivalries, which could lead to competition and tensions around the use and promotion of different currencies. A multipolar currency system would also increase the complexity of international financial management and coordination and require higher levels of global economic cooperation. Put simply, it would lead to increased transactional friction in global trade and serve to potentially diminish the economic hegemonic power of the United States—a strategic objective of the Chinese Communist Party.

Rise of the Petroyuan

There have been attempts in recent decades to either move away from or challenge petrodollars. For instance, in 2000, Iraq under Saddam Hussein made the short-lived decision to switch its oil trading currency from US dollars—the 'currency of the enemy'—to the euro (Islam 2003). There have also been some bilateral oil trade agreements for which countries used their own currencies instead of the US dollar, and both India and Russia introduced crude oil futures denominated in petrorupees and petrorubles, in 2006 and 2016, respectively, with disappointing results (Katsomitros 2018). In contrast, China's establishment of yuan-denominated oil futures contracts represents a more credible step towards providing a systemic alternative to petrodollars for international oil transactions. The petroyuan is in a much stronger position than the petrorupee or petroruble due to China's substantial economic leverage, critical role in global trade and oil markets (it is the world's largest oil importer), and strategic use of state power to enhance its economic position. Given China's drive to internationalise the renminbi, the petroyuan is likely to be supported through effective statist instruments. For instance, Beijing could compel state-owned enterprises to purchase oil in yuan-denominated contracts and may pressure foreign oil companies and governments to do so, especially in the context of the Belt and Road Initiative (Katsomitros 2018).

By encouraging countries to use petroyuan for international oil transactions, China aims to increase global usage of its currency, which is a step towards making the renminbi a major global reserve currency and capturing the economic and strategic benefits that come with this. One of the main benefits for China would be to decrease its reliance on the US dollar in trade and finance, simultaneously enhancing its international influence; a globally accepted yuan would reflect and augment China's economic power and political influence. For Chinese companies and trading partners, conducting transactions in yuan eliminates the need to convert currencies, thus reducing transaction costs and exchange rate risks, making Chinese goods and services more competitive internationally.

Furthermore, the internationalisation of the renminbi expands China's monetary policy autonomy, lessening concerns about exchange rate fluctuations against the US dollar, and would encourage foreign investment in Chinese stocks and bonds, contributing to a more liquid and mature domestic financial market. It would also lower borrowing costs for the Chinese Government and Chinese companies, as central banks worldwide would hold significant quantities of yuan in their foreign exchange reserves. Finally, in an increasingly fraught geopolitical context, having an alternative to the US dollar for international transactions would provide China and its trading partners with a mechanism to circumvent financial sanctions or trade barriers imposed by the United States and others.

The integration of the petroyuan into financial markets through yuan-denominated oil futures contracts was designed to encourage international traders and investors to use the yuan for oil transactions. These contracts allow buyers and sellers of crude oil to lock in prices for future delivery in yuan rather than in US dollars. The petroyuan is also being promoted in international oil trade settlements, which hinge on bilateral agreements—for instance, China–Russia oil transactions. The time appears to be ripe for Beijing to actively push for the use of the petroyuan in international oil markets. Outside the Western liberal economic order, de-dollarisation—the desire to escape dollar dominance—has accelerated in the wake of Russia's invasion of Ukraine. For example, the BRICS countries (Brazil, Russia, India, China, and South Africa) have been discussing ways to reduce their dependence on the dollar. According to Wade (2024), the weaponisation of the dollar and the dollar payments system in recent years to sanction US enemies such as Russia, Iran, North Korea, China, Afghanistan, Venezuela, and Cuba is incentivising this move away from the US dollar by those who think they might be subject to the same punishment.

Shifting Sands in the Kingdom

As the linchpin of the petrodollar system, Saudi Arabia has been pricing its oil exclusively in US dollars for 50 years. In 2022 Riyadh openly stated, for the first time, that it would consider selling its oil in other currencies (Pereira 2023). According to the *Wall Street Journal*, 'The Saudi move could chip away at the supremacy of the US dollar in the international financial system, which Washington has relied on for decades to print Treasury bills it uses to finance its budget deficit' (Said and Kalin 2022). This reconsideration by Saudi Arabia emerges amid its growing disenchantment with US security assurances—notably, America's tepid support for Saudi intervention in the Yemen civil war, and the Biden administration's attempt to revive the Iran nuclear deal. These developments, along with Saudi Arabia's inclination to join the BRICS grouping, suggest a strategic re-evaluation of its economic and diplomatic relationships.

In a landmark state visit to Riyadh in December 2022 to attend the first China–Arab Summit and the China–Gulf Cooperation Council Summit, Chinese President Xi Jinping not only strengthened ties with Saudi Arabia, but also extended his country's diplomatic outreach to other Gulf states and leaders across the Arab League, encompassing the Persian Gulf, Levant, and Africa (Dahan and Yaakoubi 2022). This series of high-level meetings culminated in the signing of numerous economic and investment agreements. Regional security issues were also discussed, along with energy cooperation and, importantly, the potential use of the petroyuan for China–Saudi oil transactions (Dahan and Yaakoubi 2022). Since China purchases more than one-quarter of the oil that Saudi Arabia exports, a transition to petroyuan payments could significantly enhance the renminbi's global stature. At this stage Saudi Arabia has only stated that it is seriously entertaining the possibility of accepting the petroyuan for oil. Beyond Saudi Arabia, China has engaged with several other Gulf states such as the United Arab Emirates and Qatar in a similarly multifaceted manner, laying the groundwork for increased use of the yuan in oil trading and other transactions. China's strategy is part of the push not only for yuan internationalisation, but also to strengthen economic ties more broadly and secure its energy needs.

Russia's use of the petroyuan increased significantly after its invasion of Ukraine and the economic sanctions imposed by Western countries in response. These sanctions include removing Russian banks from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) international financial messaging system, prompting Russia to rely on alternative transaction mechanisms. In 2022, the yuan's share of Russia's import settlements rose to 23 per cent from 4 per cent, with imports of Russian oil, gas, coal, and metals mostly settled in yuan instead of dollars (Chen 2023; Reuters 2023). Again, the war in Ukraine has provided an opening for China to position the renminbi as an attractive alternative for regimes that are not aligned with the United States or may be at risk of sanctions; Russia, Iran, and Venezuela are classic cases, with the other countries within the BRICS groupings, the Gulf states, and even Indonesia showing increasing levels of interest in using the petroyuan for their oil trade.

Fragmentation Rather than Dollar Displacement

The US dollar's dominance in the global financial system is a reflection not just of economic might but also of a complex web of path dependencies, institutional frameworks, and geopolitical alliances that have established and entrenched its centrality over decades. This position supports the dollar's role in global finance, international trade, and as a reserve currency, creating a significant barrier to attempts by other currencies to displace the US dollar. Yet, the petroyuan presents a potential turning point. Although 80 per cent of global oil sales continue to be transacted in petrodollars, a shift in currency preference could occur if the oil-exporting countries, many of which are reassessing their ties to the Western liberal economic order or are already aligned with China, decide to reduce the risk of dollar exposure and join the yuan bloc. Such a move, already in its nascent stage, could alter the landscape, eroding the petrodollar system and accelerating geopolitical realignments. Rather than displacement of the dollar, a more likely scenario is that the petroyuan introduces a degree of multipolarity and fragmentation into global finance.

The use of the petroyuan between China and its trade partners has some distinct benefits, such as lower transaction costs as they are streamlined through direct currency exchange, reducing the need for intermediaries and currency conversions. However, there are less-beneficial implications of the rise of the petroyuan for energy markets at the global level. Specifically, the establishment of a Chinese oil price benchmark creates fragmentation in oil pricing. This fragmentation could lead to increased volatility and complexity in global energy markets, as traders and investors navigate multiple pricing benchmarks and seek to arbitrage the price differentials that would arise in a fragmented market of multipolar pricing mechanisms. For example, higher transaction costs may cause oil traders and companies to deal with multiple currencies for transactions, resulting in increased costs related to currency conversion. The shift towards the petroyuan could undermine the transparency and liquidity associated with the petrodollar system, given the relatively closed nature of China's financial markets and its capital control regime. The result would be greater oil market volatility and higher transaction costs across a fragmented global market. Such scenarios are consistent with hegemonic stability theory, which suggests that a single hegemon provides more predictable, efficient, open, and stable conditions for global trade and finance. Under a fragmented and multipolar financial system there are competing standards, which lead to uncertainty and adjustment costs, especially against the backdrop of hostile geopolitics, as states and markets adapt to new arrangements.

In addition to the entrenched dominance of the petrodollar, the petroyuan faces significant barriers to its widespread adoption in international oil markets—barriers that stem from the broader challenges of the renminbi's internationalisation. China's capital controls and the yuan's limited convertibility present significant limitations for countries engaged in oil trading, as they require the ability to freely convert large quantities of yuan into other currencies. Despite occasional capital control relaxations aimed at encouraging foreign investment, Chinese authorities are reluctant to remove these controls, instead prioritising their ability to manage financial markets and prevent capital outflows. Hence, China's yuan lacks the liquidity and convertibility of the dollar—an intractable obstacle at present for the broader acceptance of the petroyuan.

Green Transition and Currency Innovations

Another question that arises out of this discussion is whether the global oil market and petrodollar system continue to occupy such a central role in the US dollar–based global financial order, given the shift to renewable energy that is under way, along with the emergence of technological advances such as digital currencies. In theory, the green transition would reduce the importance of global oil markets, potentially leading to a reduction in the reserves of US dollars held worldwide. It would also undermine the petrodollar recycling mechanism that has historically supported US government debt, thereby diminishing the dollar's dominance. However, this is something that, if it does transpire, will play out slowly over many decades. Despite the growth in renewable energy sources, oil continues to play a crucial role in numerous essential sectors and daily applications without viable green alternatives, including aviation, maritime shipping, various industrial processes, the production of bitumen for roads, as well as petrochemicals for plastics, fertilisers, detergents, synthetic fibres, and rubber. Moreover, for the foreseeable future oil will remain central to the maintenance and operation of an effective military capable of projecting power internationally. In this context, China's quest to internationalise the renminbi through the petroyuan initiative is a logical choice, even as the global energy landscape evolves.

The emergence of cryptocurrencies such as Bitcoin presents a novel possibility for international oil transactions. In theory, they offer an alternative to traditional fiat currencies that could enable countries to bypass the dollar in international trade. This would appeal to countries that are keen to reduce their reliance on the US dollar. However, cryptocurrencies are notorious for their high volatility, which introduces significant risk into the strategically important oil market. A shift to cryptocurrencies on a significant scale would also be operationally challenging as the current global financial infrastructure is deeply entrenched in supporting transactions in fiat currencies—namely, US dollars. There is also a host of regulatory, legal, and security issues associated with cryptocurrencies that introduce too much complexity, uncertainty, and risk, making their potential adoption for oil transactions impractical.

Central bank digital currencies (CBDCs)—still in their infancy—could present a challenge to the petrodollar system in the more distant future. The transition would be gradual and depend on the extent to which CBDCs are adopted (at present CBDCs are only in the pilot phase in select countries) and accepted in international trade—a multi-decade proposition. Thinking ahead, functional and widely accepted CBDCs could facilitate more direct and efficient cross-border transactions by bypassing the traditional banking system and reducing the need for intermediary currencies like the US dollar. However, for now and the foreseeable future, the petrodollar system and the US dollar as the world's primary reserve currency are here to stay. While it is possible for the renminbi to make certain inroads and for the petroyuan to become a currency used by some countries in the international oil trade, the overall impact is likely to be marginal. Nonetheless, it is important to think about the potentially negative effects that the introduction of fragmentation, for instance, in oil pricing, can have on markets. ●

Acknowledgement: This work has received funding from the European Union's Horizon Europe coordination and support action 101079069 — EUVIP — HORIZON-WIDERA-2021-ACCESS-03.

Disclaimer: This work was funded by the European Union. Views and opinions expressed are however those of the author only and do not necessarily reflect those of the European Union or the European Research Executive Agency (REA). Neither the European Union nor the granting authority can be held responsible for them.