The Petro-yuan: A Momentous Game Changer for the Global Energy Markets, the Global Economy & Sanctions

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See footnotes at end of text

The 26th of March 2018 will go in history as the most momentous day for the United States' economy, China's economy and the petrodollar and also for China's status as an economic superpower. In that day China launched its yuan-denominated crude oil futures in Shanghai thus challenging the petrodollar for dominance in the global oil market. And in that very day 15.4 million barrels of crude for delivery in September 2018 changed hands over two and a half hours—the length of the first-day trading session for the contract[1]

Exactly one week after China launched its crude oil futures, the petro-yuan surpassed Brent trading volume (see Chart1). How long will it take it before overtaking the petrodollar?

The truth of the matter is that China does not plan to allow the U.S. financial system to dominate the world indefinitely. Right now, China is the number one exporter on the globe and the largest crude oil importer in the world and also the world's biggest economy with a GDP of $23.57 trillion in 2017 (compared to $19.38 trillion for the U.S.), based on purchasing power parity (PPP).[2]

The Chinese would like to see global currency usage reflect this shift in global economic power. At the moment, most global trade is conducted in U.S. dollars and more than 60% of all global foreign exchange reserves are held in U.S. dollars. This gives the United States an enormous built-in advantage.

Today, the U.S. financial system is the core of the global financial system. Because nearly everybody uses the U.S. dollar to buy oil and to trade with one another, this creates a tremendous demand for U.S. dollars around the planet.

So if the U.S. financial system is the core of the global financial system, then U.S. debt is "the core of the core. Unfortunately, U.S. debt is growing far more rapidly than GDP is, and therefore it is completely and totally unsustainable.

The Chinese understand what is going on, and when the dust settles they plan to be the last ones standing. In fact, they have already got the ball rolling with the launch of their crude oil futures contract.

Moreover, China has entered into a very large currency swap agreement with the euro zone that is considered a huge step toward establishing the yuan as a major international currency. This agreement reduces the share of the U.S. dollar in trade between China and Europe.[3]

How Big a Threat Is the Petro-yuan to the Petrodollar?

The petro-yuan could be a death blow for an already weakened U.S. dollar and the emergence of the yuan as the dominant world currency.

Back in 2015, the first of a number of strikes against the petrodollar was dealt by Russia. Gazprom Neft, the third-largest oil producer in Russia, decided to move away from the dollar towards the yuan and other Asian currencies. Iran followed suit the same year using the yuan for payment for Iranian oil.[4]

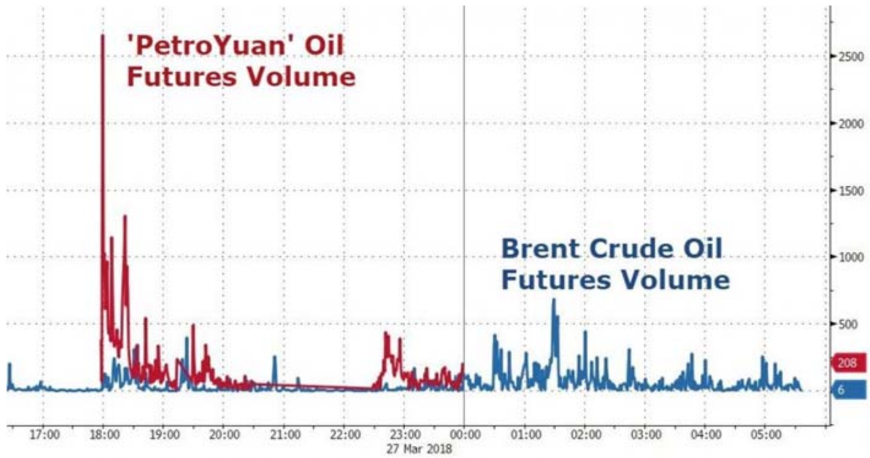


Chart 1
Source: Courtesy of Oilprice.com (accessed on 2 April 2018).

Another blow hit the petrodollar in 2017 when China became the world's largest importer of crude oil (see Chart 2).

With major oil exporters finally having a viable way to circumvent the petrodollar system, the U.S. economy could soon encounter severely troubled waters. First of all, the dollar's value depends massively on its use as an oil trade medium. When that is diminished, we will likely see a strong and steady decline in the dollar's value.

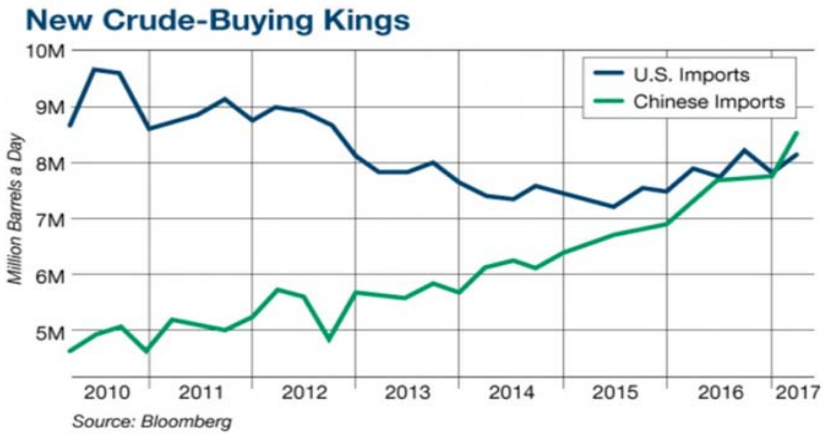


Chart 2

The petrodollar is backed by Treasuries so it can help fuel U.S. deficit spending. Take that away and the U.S. economy will be in trouble leading to a devaluation of the dollar. Contrast this with a petro-yuan convertible to gold.

The launching of the petro-yuan could be a "wake up call" for the United States. Moving oil trade out of the petrodollar into the petro-yuan could take initially between $600 billion and $1000 billion worth of transactions out of the petrodollar.[5]

Will the Petrodollar Survive the Petro-yuan?

At the very least, if the dollar's future role diminishes, then there will be surplus dollars, which unless they are withdrawn from circulation entirely, will result in a lower dollar on the foreign exchanges. While it is possible for the U.S. Federal Reserve to contract the quantity of dollars circulating around, it would also have to discourage and even reverse the expansion of bank credit, which would be judged by central bankers to be economic suicide. For that to occur, the U.S. Government itself would also have to move firmly and rapidly towards eliminating its budget deficit. But that is being deliberately increased by the Trump administration instead.[6]

The Bretton Woods agreement, designed to make the dollar appear "as good as gold", ended in 1971 with the discarding of the international gold standard by the Nixon administration. Today the ratio of an ounce of gold to the dollar has moved to about 1:1350 from the post-war rate of 1:35, a huge loss of the dollar's purchasing power.[7]

Since the Nixon shock in 1971, the Americans have been adept at perpetuating the myth of the mighty dollar, insisting gold now has no monetary role at all. By cutting a deal with the Saudis in 1973, Nixon ensured that oil, and in consequence all other commodities, would be priced in dollars.

That was until now. Once the process starts, triggered perhaps by the petrodollar's loss of its trade settlement monopoly, it is possible that the dollar could initially lose between a third and a half of its purchasing power against a basket of commodities, and a similar amount against the yuan.

With the petro-yuan a reality now, China will, in effect, be making a claim to global oil reserves. That would definitely be against American interests as the "black gold" has been practically backing the U.S. dollar as well as a humungous U.S. debt.[8]

On the other hand, Russia has been ever more willing to back the idea of global trade independent of the dollar. Also, the the BRICS alliance (Brazil, Russia, India, China & South Africa) is already targeting the dollar-dominated world of trade and economics.[9]

Russia and China have stepped up their alliance to a level where the Russian ruble is an acceptable tender at many places in China while other countries such as Iran and Venezuela will use the petro-yuan to undermine the petrodollar and reduce the impact of U.S. sanctions on their economies.[10]

China has effectively cornered the gold market in support of the petro-yuan (see Chart 3).

The petrodollar system breaking

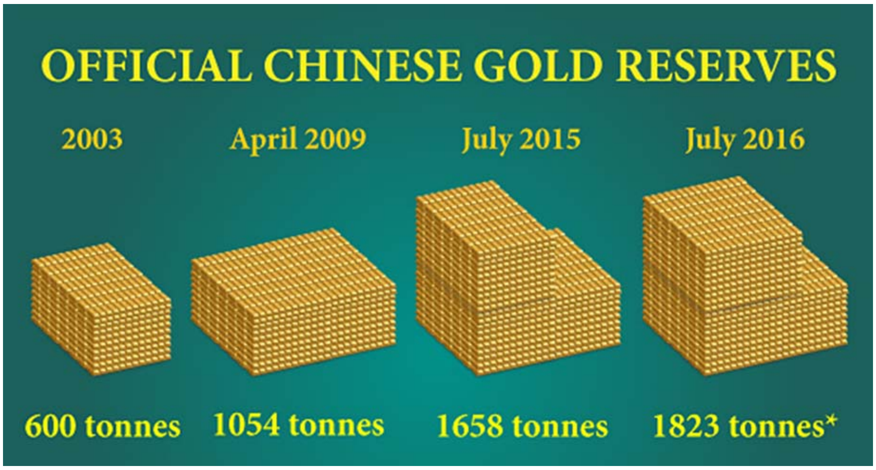


Chart 3 Chinese Official Gold Reserves, 2003-2006
Source: Chinese Gold Market Infographic, Bullion Star.

down, where oil is no longer paid for in dollars internationally, essentially would be the death knell to the U.S. dollar as the global reserve currency. A decreasing demand for the petrodollar would result in an increase in interest rates of U.S. bonds, a rise which would cause severe budgetary issues to the U.S.. It would also decrease significantly the effect of U.S. sanctions.

A petro-yuan fully convertible to gold on the Shanghai and Hong Kong exchanges would certainly support what may very well become "Oil for Gold" or "Petro-yuan for Gold".

Could the Petro-yuan Unseat the Petrodolar

It won't be easy to unseat the petrodollar without the participation of some major oil producers like Russia and Saudi Arabia. Between them Saudi Arabia and Russia account for 26% of global oil production and 25% of oil exports. Russia is already on board along with Iran and Venezuela.[11]

China is now trying to persuade Saudi Arabia to start accepting the petro-yuan for its crude oil. If the Chinese succeed, other oil exporters could follow suit.

On balance, I think Saudi Arabia will compromise by accepting the petro-yuan for oil exported to China and the Asia-Pacific countries whilst continuing to accept the petrodollar for exports to the European Union (EU) and the United States. Even such a compromise will still tip the balance in favour of the petro-yuan since 75% of Saudi oil exports go to China and the Asia-Pacific region.

A Looming Trade War between China & the United States

The launching of the crude oil benchmark on the Shanghai exchange could mark the beginning of the end of the petrodollar. The United States is not going to take this potential threat lying down.

The imposition of tariffs on Chinese goods could be viewed as the first shots in the petro-yuan/petrodollar war of attrition. If a trade war between China and the United States erupts, China will not run from a fight with the United States and will retaliate by imposing its own sanctions on U.S. exports. And to punish the United States financially, China could also offload its holdings of U.S. Treasury bills estimated at $1.3 trillion.[12]

Oil prices could be dragged down over fears of a brewing trade war. The case for oil going higher largely hinges on exceptionally strong demand projected to grow in 2018 by 1.7-2.0 million barrels a day (mbd), a robust economy and a virtual re-balancing of the global oil market. A trade war would upset the oil market's bullish sentiments.

The International Energy Agency (IEA) said in a new report that a U.S.-China trade war could result in a reduction in global oil demand by an estimated 690,000 barrels a day (b/d).[13]

Chinese officials expressed a desire to avoid a trade war, but China might not hold its fire forever against a White House reportedly preparing new tariffs on China as it tries to step up the pressure on Beijing. The U.S. is also reported to be drawing up prohibitions on Chinese investment in advanced U.S. technology, "whether by acquisition, joint ventures, licensing or any other arrangement," the Wall Street Journal reported.[14]

Nobody wins in a game of tit-for-tat tariffs. In a war of escalation, both sides would find it hard to back off. But the U.S. has more to lose. The Chinese economy today is highly integrated with the world economy. The U.S. is a large but declining market. If its trade threats have no effect, it will lose credibility as a hegemonic power.[15]

In time, President Trump will realize that China will not bend the knee before him and stop his trade war against it and let the petro-yuan and the petrodollar find their niches in a global oil market estimated at $14 trillion. This is far better than damaging the global economy and themselves by a trade war.

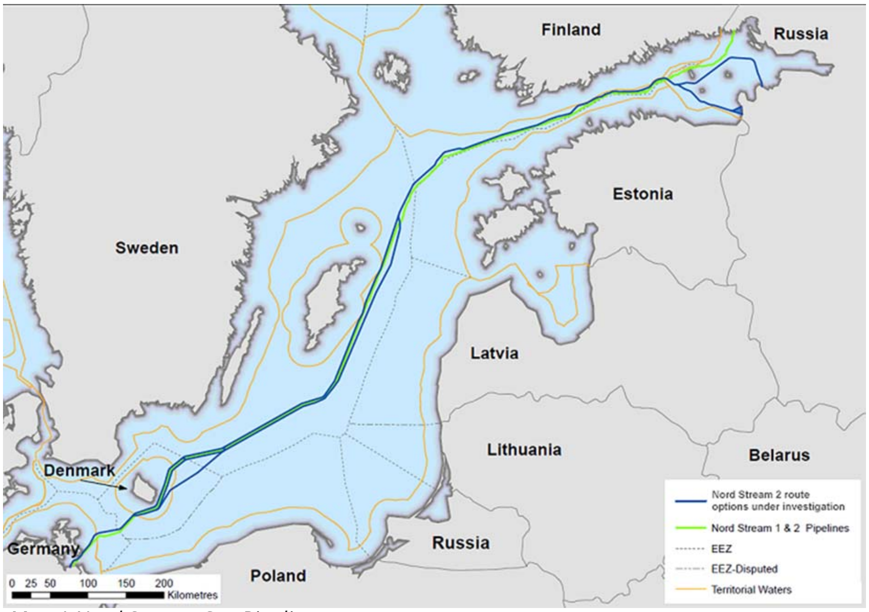
Impact of the Petro-yuan on Sanctions

The petro-yuan will help decrease significantly the effect of U.S. sanctions on Russia, Iran and Venezuela. It provides a viable way for major oil exporters to circumvent the petrodollar system.

Russia

In imposing new sanctions on Russia, the U.S. Congress aimed to punish Russia for its alleged meddling in the U.S. elections in 2016. Still, these sanctions were mostly motivated by U.S. self-interest and geopolitics.[16]

The target of these sanctions as in the previous ones is Russian banks and companies as well as Russian oil and gas projects. The new law tightens some of those limits a bit – for instance, U.S. companies can't participate in any energy project in which Russian entities have a stake of 33%



Map 1 Nord Stream Gas Pipeline

or more.[17] This certainly applies to the U.S. oil giant Exxon Mobil's involvement in the Russian Arctic with its Russian counterpart Rosneft.[18]

However, the most contentious issue could well be the sanctions on pipelines such as Nord Stream II whose construction will start in 2018 and will be finished by the end of 2019.[19]

Nord Stream II, with dual lines totalling 55 bcm/y capacity, would traverse the Baltic Sea along a route parallel to the existing Nord Stream I (also 55 bcm/y capacity) eventually providing up to 110 bcm/y of Russian gas supplies to Germany and the North-West European gas market (see Map 1).

The U.S. has always been opposed to Nord Stream II, which it views as Russia's attempt to tighten its hold on Europe's energy supplies.

Some in the European Union (EU) have accused the U.S. of wanting to displace Russia as a gas supplier to Europe. While there is some truth in this, U.S. LNG can't compete with Russian gas supplies to Europe.

Currently, Russia supplies almost 40% of the gas consumed by the EU. With the decline of domestic resources, this amount is likely to increase.

Germany receives 57% of its natural gas and 35% of its crude oil from Russia. This is one reason Germany has been an outspoken critic of the recent U.S. sanctions. Germany supports the construction of Nord Stream II. The pipeline would help safeguard German energy security and needs.

Germany fully approved Nord Stream 2 at the end of March this year, and is confident that the approvals from the other four countries (Finland, Sweden, Denmark & Russia) along the route of the pipeline will come soon. In April, Finland granted the first of two approvals for the project. Germany views Nord Stream 2 as a necessary piece of infrastructure and that whatever the political sentiment towards Russia in Europe, economies need fuel.[20]

Iran

It is very probable that President Trump will pull out of the Iran nuclear deal and re-impose sanctions on Iran on the 12th of May this year.

Obviously, much of the focus will be on the immediate impact on Iran's oil supply. A report from Columbia University's Centre on Global Energy Policy from March 2018 predicted that U.S. action to re-impose sanctions might knock 400,000 to 500,000 b/d of Iranian oil exports within a year.[21]

However, contrary to claims by Colombia University, Iran will not lose a single barrel of oil exports from U.S. sanctions. The reason the pre-nuclear deal sanctions against Iranian oil exports were effective was because of two things: one the imposition of sanctions by the EU on insurance companies ensuring Iran's oil cargoes, and the other the United States sanctions on banks dealing with Iran.

The EU is not going to re-impose sanctions on Iran and Iran will be using the petro-yuan as payment for its oil exports thus neutralizing U.S. sanctions on banking.

And while the re-introduction of sanctions might scare away western investment, it can't stop China's and Russia's investment in Iran's oil and gas industry.

Venezuela

If the U.S. expands sanctions on Venezuela to include the oil industry and restricts U.S. exports of oil products such as naphtha that are crucial for diluting Venezuela's extra-heavy oil, oil production in the country sitting on the world's largest oil reserves, would further suffer.[22]

And despite U.S. sanctions, neither Venezuela's economy nor its oil industry will collapse now or in the future because China and Russia, who extended billions of dollars to Venezuela, have a vested interest in not letting this happen.

And since the bulk of Venezuela's oil

exports go now to China, it is logical that Venezuela will accept the petro-yuan for payment thus nullifying U.S. sanctions.

In addition to the petro-yuan, Venezuela will accept payment for its oil in its own cryptocurrency--El Petro—which will be backed by more than 5.3 billion barrels of oil supporting $267 billion worth of financial instruments.[23]

Conclusions

The Petro-yuan could prove to be a momentous game changer for the global energy markets, the global economy and the effectiveness of U.S. sanctions.

It is probable that the yuan will emerge as the world's top reserve currency within the next decade with the petro-yuan dominating global oil trade.

Footnotes

[1] Irina Slav, "China's Oil Futures Launch with a Bang" Oilprice.com, March 26, 2018, accessed on 26 March 2018.

[2] World Bank data.

[3] Mamdouh G Salameh, "Has the Petrodollar Had Its Day?"(UASEE Working Paper Series No: 15-216, 24 June 2015).

[4] Zerohedge, "China Prepares Death Blow to the Dollar" Oilprice.com, 24 March, 201, accessed on 24 March 2018.

[5] Total value of the combined oil exports of Russia, Iran and Venezuela and China's crude oil imports based on oil price of $70/barrel.

[6] Zerohedge, "Will the Dollar Survive the Petro-yuan? Oilprice.com, 14January 2018, accessed on 14 January 2018.

[7] Ibid.,

[8] Saad Awan,"Petro-yuan" Pakistan Today, 24 February 2018, accesses at www.pakistantoday.com.pk/2018/02/24/petro-yuan on 28 March 2018.

[9] Ibid.,

[10] Ibid.,

[11] BP Statistical Review of World Energy, June 2017, pp.14-15 & pp.24-25.

[12] Michael Austin, "China Won't Run from a Fight with Trump" (An article published by the American Enterprise Institute (AEI), Washington DC, January 28, 2017).

[13] Tom Kool, "Geopolitical Risk Sends Oil Soaring", Oilprice.com, 12 April, 2018, accessed on 13 April, 2018.

[14] Ibid.,

[15] Marie Kasperek, "How the U.S. & China Could End This "tit-for-tat" Trade War", published by Market Watch on the 6th of April, 2018.

[16] Mamdouh G Salameh, "U.S. Sanctions on Russia: Geopolitics, Pipelines & U.S. Self-interest" (An article published by IAEE Energy Forum, fourth quarter 2017).

[17] Joel Parshall, "U.S. Sanctions Hit New Russian Projects, Add Uncertainty", Journal of Petroleum Technology (JPT), 8 August, 2017.

[18] Mamdouh G Salameh, "Is U.S. Oil Giant ExxonMobil Trying to Evade U.S. Sanctions on Russia" (An article posted by the Research Centre for Energy Management (RCEM) on the 11th of May, 2017).

[19] Ibid.,

[20] Irina Slav, "Germany Brushes Aside Trump Criticism of Nord Stream 2" Oilprice.com April 8, 2018, accessed on 12 April 2018.

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[22] Tsvetana Paraskova, "Venezuelan Oil Production Could FurtherCollapse on New U.S. Sanctions", Oilprice.com, February 2018, accessed on 12 April, 2018.

[23] Tsvetana Paraskova, "Venezuela to Launch Oil-Backed Petro Cryptocurrency within Days" Oilprice.com, December 29, 2017, accessed on12 April, 2018.

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