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The Rise of the Petro*yuan* and the Slow Erosion of Dollar Hegemony

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For seventy years, one of the critical foundations of American power has been the dollar's standing as the world's most important currency. For the last forty years, a pillar of dollar primacy has been the greenback's dominant role in international energy markets. Today, China is leveraging its rise as an economic power, and as the most important incremental market for hydrocarbon exporters in the Persian Gulf and the former Soviet Union to circumscribe dollar dominance in global energy – with potentially profound ramifications for America's strategic position.

Since World War II, America's geopolitical supremacy has rested not only on military might, but also on the dollar's standing as the world's leading transactional and reserve currency. Economically, dollar primacy extracts "seignorage" – the difference between the cost of printing money and its value – from other countries, and minimises U.S. firms' exchange rate risk. Its real importance, though, is strategic: dollar primacy lets America cover its chronic current account and fiscal deficits by issuing more of its own currency – precisely how Washington has funded its hard power projection for over half a century.

Since the 1970s, a pillar of dollar primacy has been the greenback's role as the dominant currency in which oil and gas are priced, and in which international hydrocarbon sales are invoiced and settled. This helps keep worldwide dollar demand high. It also feeds energy producers' accumulation of dollar surpluses that reinforce the dollar's standing as the world's premier reserve asset, and that can be "recycled" into the U.S. economy to cover American deficits.

Many assume that the dollar's prominence in energy markets derives from its wider status as the world's foremost transactional and reserve currency. But the dollar's role in these markets is neither natural nor a function of its broader dominance. Rather, it was engineered by U.S. policymakers after the Bretton Woods monetary order collapsed in the early 1970s, ending the initial version of dollar primacy ("dollar hegemony 1.0"). Linking the dollar to international oil trading was key to creating a new version of dollar primacy ("dollar hegemony 2.0") – and, by extension, in financing another forty years of American hegemony.

Gold and Dollar Hegemony 1.0

Dollar primacy was first enshrined at the 1944 Bretton Woods conference, where America's non-communist allies acceded to Washington's blueprint for a postwar international monetary order. Britain's delegation – headed by Lord Keynes – and virtually every other participating country, save the United States, favoured creating a new multilateral currency through the fledgling International Monetary Fund (IMF) as the chief source of global liquidity. But this would have thwarted American ambitions for a dollar-centered monetary order. Even though almost all participants preferred the multilateral option, America's overwhelming relative power ensured that, in the end, its preferences prevailed. So, under the Bretton Woods gold exchange standard, the dollar was pegged to gold and other currencies were pegged to the dollar, making it the main form of international liquidity.

There was, however, a fatal contradiction in Washington's dollar-based vision. The only way America could diffuse enough dollars to meet worldwide liquidity needs was by running open-ended current account deficits. As Western Europe and Japan recovered and regained competitiveness, these deficits grew. Throw in America's own burgeoning demand for dollars – to fund rising consumption, welfare state expansion, and global power projection – and the U.S. money supply soon exceeded U.S. gold reserves. From the 1950s, Washington worked to persuade or coerce foreign dollar holders not to exchange greenbacks for gold. But insolvency could be staved off for only so long: in August 1971, President Nixon suspended dollar-gold convertibility, ending the gold exchange standard; by 1973, fixed exchange rates were gone, too.

These events raised fundamental questions about the long-term soundness of a dollar-based monetary order. To preserve its role as chief provider of international liquidity, the U.S. would have to continue running current account deficits. But those deficits were ballooning, for Washington's abandonment of Bretton Woods intersected with two other watershed developments: America became a net oil importer in the early 1970s; and the assertion of market power by key members of the Organization of Petroleum Exporting Countries (OPEC) in 1973-1974 caused a 500% increase in oil prices, exacerbating the strain on the U.S. balance of payments. With the link between the dollar and gold severed and exchange rates no longer fixed, the prospect of ever-larger U.S. deficits aggravated concerns about the dollar's long-term value.

These concerns had special resonance for major oil producers. Oil going to international markets has been priced in dollars, at least since the 1920s – but, for decades, sterling was used at least as frequently as dollars in order to settle transnational oil purchases, even after the dollar had replaced sterling as the world's preeminent trade and reserve currency. As long as sterling was pegged to the dollar and the dollar was "as good as gold," this was economically viable. But, after Washington abandoned dollar-gold convertibility and the world transitioned from fixed to floating exchange rates, the currency regime for oil trading was up for grabs. With the end of dollar-gold convertibility, America's major allies in the Persian Gulf – the Shah's Iran, Kuwait, and Saudi Arabia – came to favour shifting OPEC's pricing system, from denominating prices in dollars to denominating them in a basket of currencies.

In this environment, several of America's European allies revived the idea (first broached by Keynes at Bretton Woods) of providing international liquidity in the form of an IMF-issued, multilaterally-governed currency – so-called "Special Drawing Rights" (SDRs). After rising oil prices engorged their current accounts, Saudi Arabia and other Gulf Arab allies of the United States pushed for OPEC to begin invoicing in SDRs. They also endorsed European proposals to recycle petrodollar surpluses through the IMF, in order to encourage its emergence as the main post-Bretton Woods provider of international liquidity. That would have meant Washington could not continue to print as many dollars, as it wanted to support rising consumption, mushrooming welfare expenditures, and sustained global power projection. To avert this, American policymakers had to find new ways to incentivise foreigners to continue holding ever-larger surpluses of what were now fiat dollars.

Oil and Dollar Hegemony 2.0

To this end, U.S. administrations from the mid-1970s devised two strategies. One was to maximise demand for dollars as a transactional currency. The other was to reverse Bretton Woods' restrictions on transnational capital flows; with financial liberalisation, America could leverage the breadth and depth of its capital markets, and it could cover its chronic current account and fiscal deficits by attracting foreign capital at relatively low cost. Forging strong links between hydrocarbon sales and the dollar proved critical on both fronts.

To forge such links, Washington effectively extorted its Gulf Arab allies, quietly conditioning U.S. guarantees of their security to their willingness to financially help the United States. Reneging on pledges to its European and Japanese partners, the Ford administration clandestinely pushed Saudi Arabia and other Gulf Arab producers to recycle substantial parts of their petrodollar surpluses into the U.S. economy through private (largely U.S.) intermediaries, rather than through the IMF. The Ford administration also elicited Gulf Arab support for Washington's strained finances, reaching secret deals with Saudi Arabia and the United Arab Emirates for their central banks to buy large volumes of U.S. Treasury securities outside normal auction processes. These commitments helped Washington prevent the IMF from supplanting the United States as the main provider of international liquidity; they also gave a crucial early boost to Washington's ambitions to finance U.S. deficits by recycling foreign dollar surpluses *via* private capital markets and purchases of U.S. government securities.

A few years later, the Carter administration struck another secret deal with the Saudis, whereby Riyadh committed to exert its influence to ensure that OPEC continued pricing oil in dollars. OPEC's commitment to the dollar as the invoice currency for international oil sales was key to broader embrace of the dollar as the oil market's reigning transactional currency. As OPEC's administered price system collapsed in the mid-1980s, the Reagan administration encouraged universalised dollar invoicing for cross-border oil sales on new oil exchanges in London and New York. Nearly universal pricing of oil – and, later on, gas – in dollars has bolstered the likelihood that hydrocarbon sales will not just be denominated in dollars, but settled in them as well, generating ongoing support for worldwide dollar demand.

In short, these bargains were instrumental in creating "dollar hegemony 2.0." And they have largely held up, despite periodic Gulf Arab dissatisfaction with America's Middle East policy, more fundamental U.S. estrangement from other major Gulf producers (Saddam Hussein's Iraq and the Islamic Republic of Iran), and a flurry of interest in the "petro–Euro" in the early 2000s. The Saudis, especially, have vigorously defended exclusive pricing of oil in dollars. While Saudi Arabia and other major energy producers now accept payment for their oil exports in other major currencies, the larger share of the world's hydrocarbon sales continue to be settled in dollars, perpetuating the greenback's status as the world's top transactional currency. Saudi Arabia and other Gulf Arab producers have supplemented their support for the oil-dollar nexus with ample purchases of advanced U.S. weapons; most have also pegged their currencies to the dollar – a commitment which senior Saudi officials describe as "strategic." While the dollar's share of global reserves has dropped, Gulf Arab petrodollar recycling helps keep it the world's leading reserve currency.

The China Challenge

Still, history and logic caution that current practices are not set in stone. With the rise of the "petro*yuan*," movement towards a less dollar-centric currency regime in international energy markets – with potentially serious implications for the dollar's broader standing – is already underway.

As China has emerged as a major player on the global energy scene, it has also embarked on an extended campaign to internationalise its currency. A rising share of China's external trade is being denominated and settled in renminbi; issuance of renminbi-denominated financial instruments is growing. China is pursuing a protracted process of capital account liberalisation essential to full *renminbi* internationalisation, and is allowing more exchange rate flexibility for the *yuan*. The People's Bank of China (PBOC) now has swap arrangements with over thirty other central banks – meaning that *renminbi* already effectively functions as a reserve currency.

Chinese policymakers appreciate the "advantages of incumbency" the dollar enjoys; their aim is not for *renminbi* to replace dollars, but to position the *yuan* alongside the greenback as a transactional and reserve currency. Besides economic benefits (e.g., lowering Chinese businesses' foreign exchange costs), Beijing wants – for strategic reasons – to slow further growth of its enormous dollar reserves. China has watched America's increasing propensity to cut off countries from the U.S. financial system as a foreign policy tool, and worries about Washington trying to leverage it this way; *renminbi* internationalisation can mitigate such vulnerability. More broadly, Beijing understands the importance of dollar dominance to American power; by chipping away at it, China can contain excessive U.S. unilateralism.

China has long incorporated financial instruments into its efforts to access foreign hydrocarbons. Now Beijing wants major energy producers to accept *renminbi* as a transactional currency – including to settle Chinese hydrocarbon purchases – and incorporate *renminbi* in their central bank reserves. Producers have reason to be receptive. China is, for the vastly foreseeable future, the main incremental market for hydrocarbon producers in the Persian Gulf and former Soviet Union. Widespread expectations of long-term *yuan* appreciation make accumulating *renminbi* reserves a "no brainer" in terms of portfolio diversification. And, as America is increasingly viewed as a hegemon in relative decline, China is seen as the preeminent rising power. Even for Gulf Arab states long reliant on Washington as their ultimate security guarantor, this makes closer ties to Beijing an imperative strategic hedge. For Russia, deteriorating relations with the United States impel deeper cooperation with China, against what both Moscow and Beijing consider a declining, yet still dangerously flailing and over-reactive, America.

For several years, China has paid for some of its oil imports from Iran with *renminbi*; in 2012, the PBOC and the UAE Central Bank set up a $5.5 billion currency swap, setting the stage for settling Chinese oil imports from Abu Dhabi in *renminbi* – an important expansion of petro*yuan* use in the Persian Gulf. The $400 billion Sino-Russian gas deal that was concluded this year apparently provides for settling Chinese purchases of Russian gas in*renminbi*; if fully realised, this would mean an appreciable role for *renminbi* in transnational gas transactions.

Looking ahead, use of *renminbi* to settle international hydrocarbon sales will surely increase, accelerating the decline of American influence in key energy-producing regions. It will also make it marginally harder for Washington to finance what China and other rising powers consider overly interventionist foreign policies – a prospect America's political class has hardly begun to ponder.