Oil and the dollar’s hegemony

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WHEN the Covid-19 pandemic struck a few years ago, it caused tremendous upheaval in the workings of the global economy. The Russo-Ukraine war has only added to the misery. Many analysts see it as a turning point in history for several reasons.

One specific area of interest is energy, especially trade in oil. Recently, two possible oil trades have raised eyebrows — Saudi Arabia reportedly willing to accept payment in yuan for oil bought by China, and India’s attempt to buy oil from Russia in rubles.

What’s the significance of this?

For context, oil is the world’s most-traded commodity, with the annual trade volume hovering around $14-15 trillion. If it can be traded not in dollars, then perhaps it could signal the end of the dollar’s hegemony over world trade.

What are the likely chances of such a scenario becoming a reality? The following lines offer brief insights.

Despite the financial panic of 2007, wars, Covid-19 and Trump, the dollar retains its dominance.

It is not for the first time that China has tried buying oil in its own currency. An attempt was made in 2018, which coincided with the introduction of Chinese crude oil futures (a financial contract) in Shanghai (the other two price benchmarks are Brent and West Texas). These contracts were to be traded in yuan. It didn’t materialise, however.

A primary motive, as Goldman Sachs and others noted, was to internationalise the use of the yuan. This brings us to the topic of internationalising a currency. Briefly put, there are several advantages of such a move. First, trading in a currency that a country can print is much easier. Gradually, as a currency comes to be increasingly used in trade, it also tends to assume the form of a valuable asset. Other countries then make it part of their foreign exchange reserves. And then there are ‘seigniorage’ profits to be had — that is, profits from printing money.

A lot also depends on the size of the economy, and China possesses a large one. However, what it does not possess is the depth, liquidity and standing of US financial markets that have been built over time. Aside from forming the largest economy, US financial markets are the most liquid, reliable and innovative. The US has never defaulted on its debt. Not to mention that it doesn’t foresee substantial shifts in its value against other currencies — it keeps its purchasing power largely intact, making the dollar a ‘sound currency’.

This makes the dollar a highly sought-after asset. And here’s the smartest thing: most dollars in the world make it back to the US, as countries and investors prefer US Treasuries at ultra cheap rates, thus helping the US sustain consumption and expenditure at a meagre cost.

To replace the dollar, or lessen its sway, China will have to take certain measures, like bringing more transparency to its own financial markets and policymaking. It is highly unlikely to happen soon. Additionally, China will have to offload more than $1tr investment in US Treasuries to signal its trust in its own currency as a valuable asset. I doubt that will happen anytime soon (in 2019, China’s dollar denominated assets — foreign direct investment, foreign exchange reserves, US Treasuries, loans — were estimated to be above $6tr. There’s no indication that its dollar wealth has decreased).

At this moment, the yuan forms only 2.4 per cent of global reserves — the dollar is 55pc — and hardly constitutes 5pc of the nearly $6tr foreign exchange market, dominated by the dollar.

For Saudi Arabia, it won’t be easy to move away from the dollar — 80pc of all oil transactions are denominated in dollars, which means that it will have to find buyers willing to pay in yuan rather than in dollars.

Also, its currency is ‘pegged’ to the dollar, meaning that the US central bank runs its monetary policy. Ditching the dollar without going off the peg would imply a lower value of its own currency, creating substantial issues for a country with around $150 billion in imports. Also, would the 200 countries exporting to Saudi Arabia accept the yuan or riyal as payment rather than the dollar? Highly unlikely!

Considering this, what’s up with all the talk of un-dollarising oil?

Beyond economics, there are political and personal reasons at play. In Saudi Arabia’s case, there is antagonism between Saudi Crown Prince Mohammed bin Salman and US President Joe Biden. In a recent interview, the prince indicated that if Biden did not like him, he did not like Biden either. Similarly, in the case of India and Russia, both countries have been vocal proponents of a multipolar world, including lessening, or doing away with, the dollar’s hegemony. The Russo-Ukraine war has only deepened their resolve. America tried to pressurise India to vote against Russia but in vain. India approached Russia for a petro deal in either rubles or rupees, signalling its displeasure to Washington. (Russia is willing to sell at a good discount.)

A few other aspects will help readers understand the global financial system and its complexities. Russia, in a bid to lessen the dollar’s sway, has been swelling its coffers with gold. At this moment, it has 2,300 tons of gold worth $140bn. The problem is that nobody wants to trade in gold. Given the financial sanctions imposed on Russia, it now constitutes a useless pile, simply occupying space in the official vault.

In contrast, despite the great financial panic of 2007, limitless wars, Covid-19 and Donald Trump, the dollar has not budged from its dominance. This primarily owes to the world's trust in America's economy and financial markets, a trust largely based on the strength of the country's institutions, especially its central bank and treasury department. No other country aspires such confidence when it comes to institutional strength. For countries like Pakistan, it is a lesson in why institutions should be kept away from politics.

The gist of all this is that the present global trade system built around the dollar will not be easy to dislodge, at least not anytime soon.

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