TFP

the advisor

Spring 2022

Weaponised

One of the cornerstones of the past fifty years has been the financial architecture based on the 'petrodollar'. This is where oil producers sell their product to the world in exchange for US dollars. These dollars are then invested in dollar-denominated assets and markets, explicitly supporting the US dollar as the world's main reserve currency. Most commodities are also priced in dollars.

Many nations - from allies such as France, to the non-aligned such as India, to hostile states such as China and Russia - chafe under this financial system. The dollar's dominance is now being openly challenged as the world bifurcates into pro and anti dollar factions.

In response to the brutal invasion of Ukraine, America has weaponised the dollar against Russia. The confiscation of the Russian Central Bank's dollar denominated assets has demonstrated just how hazardous it is to rely on the use of dollars.

As a rejoinder to the sanctions imposed, the Russian central bank officially tied the rouble to the price of gold bullion, at RUB5,000 per gram (approx.US$62) and has insisted all "unfriendly" countries must purchase its gas in roubles or in gold. Europe, which gets about 40% of its gas from Russia, balks at this demand. With sanctions escalating, Russia has further signalled its intention to accept only roubles for all the commodities it exports (including wheat, nickel, aluminium, enriched uranium & neon). The rouble promptly rallied against the dollar.

Meanwhile, China has agreed to take Russian oil and coal and to pay in roubles. China is also in talks with Saudi Arabia to price its oil sales to China in yuan. China buys more than 25% of the oil that Saudi Arabia exports, and if priced in yuan, those sales could set the Chinese currency on a path to becoming a global reserve currency alternative.

In a 1974 deal with the Nixon administration that included security guarantees for the kingdom, the Saudis have traded oil exclusively in dollars. The Saudis have grown increasingly unhappy with the Americans. The Saudis are upset over the lack of American support for their intervention in the Yemen civil war, over the Biden administration's attempt to strike a nuclear deal with Iran, and over the precipitous US withdrawal from Afghanistan last year. President Biden's "pariah" comments, for the killing of Saudi journalist Jamal Khashoggi, has not helped matters. It appears that the Saudis no longer put much stock in American "security guarantees" and are instead pivoting towards China.

Roughly 80% of global oil sales are made in dollars. Saudi Arabia exported $56bn of energy to China in 2019. This is a fraction of the $2.6tn global oil market but China's oil imports have swelled over the last thirty years in line with its expanding economy. A shift to a 'petroyuan' system could knock the petrodollar's dominance of the global oil market.

The dynamics have also changed. There are deepening ties between the Saudis and China. China has been courting the kingdom for years, helping the Saudis build their own ballistic missile systems, consulting on a nuclear programme and investing in Crown Prince Mohammed bin Salman's favourite domestic projects.

Meanwhile the American economic relationship has with the Saudis has waned. The US is now one of the world's top oil producers, a notable reversal from the 1980s when it imported 2 million barrels per day of Saudi crude. In 2021, Saudi Arabia was China's top crude supplier, selling 1.8 million barrels per day, followed by Russia at 1.6 million barrels per day, according to data from China's General Administration of Customs.

Contracting oil sales in other currencies could undermine the Saudi government's fiscal outlook. Because the Saudis' currency, the riyal, is pegged to USD, it would also open itself up to foreign exchange volatility by using the yuan. Some economists opine moving away from dollar-denominated oil sales would diversify the kingdom's revenue base and could eventually lead it to repeg the riyal to a basket of currencies. For the time being, oil will continue to be reference-priced in US dollars.

1401 - 675 West Hastings Street, Vancouver, BC V6B 1N2, Canada Phone: (604) 687-5884 Fax: (604) 681-9694 Email: admin@investwell.ca

Weaponised (cont'd)

If the transition away from the dollar has begun, the move could tempt other producers to price their Chinese exports in yuan as well.

While Russian sanctions are sending commodity prices ever higher, China has quietly taken advantage of the Western scramble to secure resources. China has been approaching other "non-aligned" petrodollar clients, who are also rich in resources, to offer them a currency alternative. Beijing is now actively promoting the yuan and pushing to dethrone the dollar as the main global reserve currency.

The yuan, however, has not caught on with international investors because Beijing keeps a tight control of it. China's financial system is still relatively undeveloped, its currency is not fully convertible and the country lacks a true rule of law. The yuan is far from providing what the dollar provides.

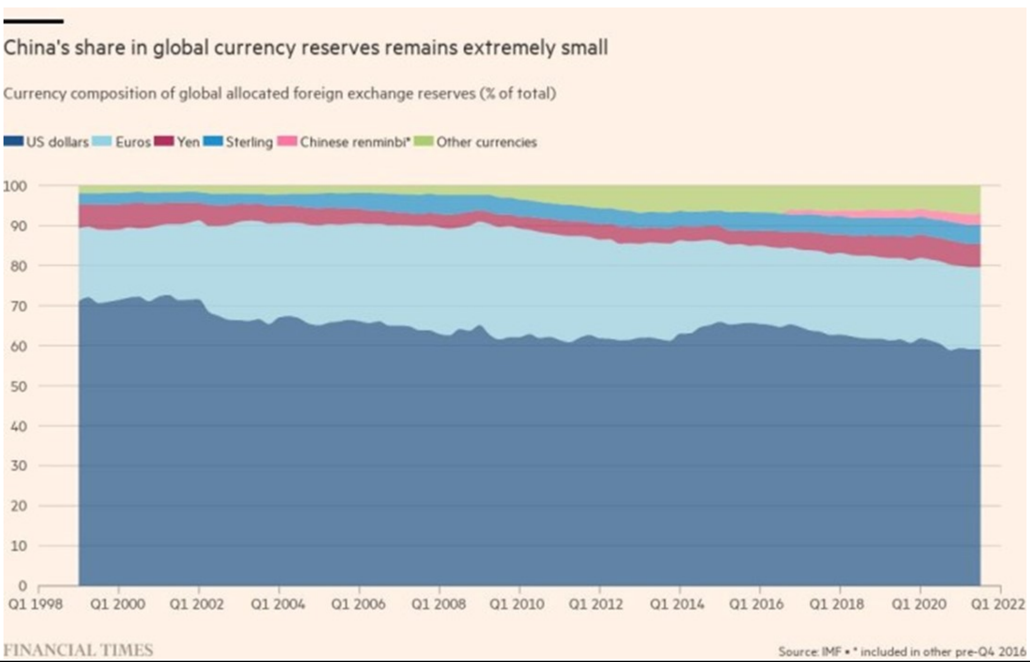
In addition, while ... "holders of the dollar and other leading western currencies might fear [American] sanctions, they must surely be aware of what the Chinese government might do to them, should they displease it. As important, the Chinese state knows that an internationalised currency requires open financial markets, but that would radically weaken its control over China's economy and society."[1]

The idea of a new global reserve currency is not new. Earlier this month Zoltan Pozsar of Credit Suisse, wrote in his latest note "we are witnessing the birth of Bretton Woods III – a new world (monetary) order … centred around commodity-based currencies in the East that will likely weaken the Eurodollar system and also contribute to inflationary forces in the West."[2]

As inflationary forces surge, there are indications of a shift to physical commodities being used as trade settlement. Cargoes are still priced in US dollars but, allegedly, de facto barter is already taking place to circumvent the global dollar system and Western sanctions.

Nevertheless, we are not yet seeing the much-touted global switch to holding reserves in "commodity-backed" currencies. That will require a game-changing economic policy shift or a geopolitical event. The first is seen as theoretically possible if politically unlikely; the latter as perhaps strategically inevitable, but not necessarily to the dollar's disadvantage.

The dollar still has a lot going for it.



A global reserve currency must possess the following traits: as a unit of account, as a medium of exchange, and as a store of value.

As a method of accounting, no other global currency offers the scale of US markets or its 'network effect'.

As a means of exchange the USD is the common denominator. The USD is welcomed globally, and its high liquidity means low transaction costs. The same is not true for any other potential alternative currencies.

Where the dollar suffers though is a store of value. It has lost roughly 85% of its purchasing power since the Americans went off the gold standard in 1971.

But what is the alternative? As of today, there is no single global currency that could replace the dollar as the leading reserve currency.

What of the collateral damage from Western sanctions? Though largely self-inflicted, one victim appears to be the yen. By capping the 10 year government bond at 0.25% the Bank of Japan has committed itself to unlimited intervention. Hence, the yen has fallen some 20% against the dollar. As a net importer of food, energy and other commodities, life has become awfully expensive. Despite it being undervalued, it is plausible the yen could drop much lower from here.[3]

A bigger question then emerges: how will Japan's latest devaluation impact China?

Might the dollar's weaponisation actually circle round to bite China?

Sources:

1. Martin Wolf, "A New World of Currency Disorder Looms" Financial Times, 22 March 2022

2. Dan Runkivicious, "After This War Is Over, Money Will Never Be The Same', Forbes,10 March 2022

3. "Yen at Risk of Explosive Downward Spiral with Kuroda trapped", Zerohedge, 30 March 2022

4. Chart this page, Martin Wolf, "A New World of Currency Disorder Looms" Financial Times, 22 March 2022