FOR PROFESSIONAL INVESTORS – 13 April 2022

Chi on China

THE RENMINBI'S CREEPING INTERNATIONALISATION: THE BOILING FROG FABLE

The secret of getting ahead is getting started.

Mark Twain

SUMMARY

- China's recent efforts to revive talks with Saudi Arabia on pricing crude oil in renminbi have increased the market's focus on moves to internationalise the renminbi and promote the usage of the Chinese cross-border payments system.
- If major oil producing countries were to price some oil trades in renminbi, other countries may follow. This could sharply increase the volume and scope of using the renminbi in international payments, threatening the US dollar's status as a global currency in the longer term.
- No one expects China to displace the dollar-centric global financial system anytime soon. But continued renminbi internationalisation will force changes in the global financial system, allowing renminbi assets to become a class of its own, slowly but surely.

China has recently revived talks with Saudi Arabia on settling some oil trades in renminbi. The talks followed China's initiatives to promote the usage of renminbi for oil trades since 2018. It has set up a local oil futures exchange with contracts denominated in renminbi. Many market players see this as China's first step towards gradually shifting the global oil trade to the renminbi from the US dollar, thus creating the 'petro-yuan'. Meanwhile, the Russo-Ukrainian crisis has raised the possibility of Russia trading oil with China using the renminbi instead of USD.

If Saudi Arabia and Russia were to work with China, the amount of renminbi-denominated oil trades could rise sharply and transactions could go through China's payments system, the Cross-border Interbank Payments

System (or CIPS), at the expense of US dollar and the SWIFT system. This would be a serious challenge to the US dollar system as, arguably, the dollar's global reserve currency status is largely based on its importance in the energy and commodity markets.

LINCHPIN OF DOLLAR SUPREMACY

One of the staples of the past four decades, and an anchor sustaining the dollar's global reserve currency status, was a global financial system based on the petro-dollar. This was a world in which oil producers would sell their products to the US and the rest of the world for dollars. They would recycle the proceeds into dollar-denominated assets by investing in dollar-bloc markets, thus propping up the dollar as the world's reserve currency. This has made the oil market, and by extension the global commodity market, a linchpin for sustaining the US as the world's undisputed financial superpower. If that linchpin were to fall away, the dollar's status would start to crumble.

With China slowly challenging the dollar, Saudi acceptance of renminbi in oil trades could help chip away at the supremacy of the dollar by gradually weakening that linchpin. The question is whether Saudi Arabia would want to do that when it is also a major US ally.

Arguably, Saudi Arabia has an incentive to get closer to China, although it also has to balance this with its US interests. It has become increasingly unhappy with US security commitments to defend the kingdom, as the Wall Street Journal reported recently. Meanwhile, China has strengthened its relationship with Saudi Arabia in recent years by increasing investment in, and military cooperation with, the kingdom.[1]

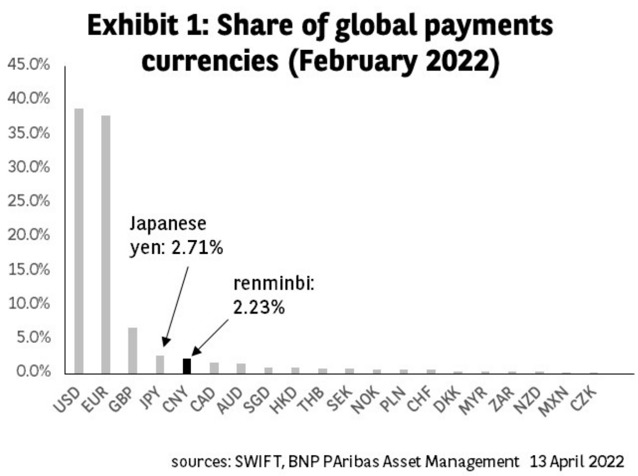
One way for Saudi Arabia to balance its interests between China and the US would be to trade oil with China (and probably also with Asia) in renminbi using CIPS, while trading oil with the rest of the world in US dollars via SWIFT. Saudi has had spasmodic talks with China on renminbi-priced oil contracts since 2018. These discussions have accelerated since March amid rising geopolitical tensions.

THE PETRO-YUAN'S THREAT

How big a threat will the petro-yuan be to the dollar-based payments system? It is impossible to give an accurate answer at this stage as it will take time for the petro-yuan oil talks to conclude. We may get some clues from public information on the relationships and oil trades between China and other major oil producers.

Some market players initially estimated that switching the oil trade from the dollar to the renminbi could move USD 600 billion to USD 1 trillion worth of transactions out of the dollar a month.[2] Let us take the mid-point of USD 800 billion. Now consider the SWIFT data on global payments currencies. In February 2022 (the latest data available at the time of writing), the renminbi was ranked the fifth most-widely-used currency for global payments, accounting for 2.23% of the total (Exhibit 1).

Since about USD 5 trillion worth of payment messages moves through SWIFT worldwide every day, or USD 100 trillion a month (based on an average of 20 working days per month), the renminbi's 2.23% would amount to about USD 2.23 trillion a month. If we add the USD 800 billion of oil trade that would be settled in renminbi, the yuan's share of global payments would rise to a little over 3% in the SWIFT system. Although this would be an increase of 0.8 percentage points only, it would displace the Japanese yen and become the fourth most-widely-used global currency.



The impact on CIPS would be more dramatic. According to the CIPS website, the Chinese system processed about USD 61 billion worth of payment messages a day this February, or USD 12.2 trillion a month. Adding USD 800 billion would boost its payment processing capacity by almost 7% to USD 13 trillion a month.

However, it could go further. If Saudi Arabia and Russia start to use renminbi for oil trade, other countries would likely follow. At this point, Russia, Iran, Venezuela and Indonesia are already settling some of their oil trades with China in renminbi. The volume, and the scope of using renminbi for international payments, could grow as more countries diversify out of US dollar risk.

LIKE THE BOILING FROG

Of course, no one expects the petro-yuan to displace the petro-dollar and the dollar-based payments system anytime soon. The process is like the boiling frog fable, which is already reflected in the slow erosion of the US dollar's share in the global foreign reserve pool from almost 80% in the 1990s to less than 60% now. There are indeed strong theoretical and practical reasons to expect the renminbi's challenge to the US dollar hegemony to be a drawn-out process.

To make the renminbi attractive for payments, China will need to liberalise its financial markets and its capital account. In practice, this means allowing foreigners to trade Chinese assets without capital or bureaucratic controls. While China has been liberalising its capital account for years, the pace has been slow. Given China's large debt overhang (with the debt-to-GDP ratio estimated at 284% in 2021), liberalising its capital account quickly would risk a debt-currency crisis pulling the rug from under the Chinese system.

A major obstacle is that several major oil and gas producers in the Middle East have currencies pegged to the US dollar, including Saudi Arabia, the United Arab Emirates, Oman, and Qatar. Kuwait's currency is pegged to a basket of currencies dominated by the dollar. These pegs acted as a stability anchor for these countries when the US was the world's largest oil importer.

With China replacing the US as the world's largest oil importer, it is challenging this stability anchor and, hence, the sustainability of these currency pegs. Nevertheless, inertia could keep these pegs intact for a long time, especially when paying for oil in renminbi – or any currency other than the dollar – raises a foreign exchange risk that these oil-producing countries have not faced in decades. Moreover, despite years of financial reforms, China still does not have a large derivatives market to provide sufficient tools for hedging renminbi exchange risk.

Ultimately, China needs to establish the renminbi's global credibility for it to gain acceptance. However, it appears that China's disruption of the future global payments system is likely an emerging reality even before the renminbi becomes a global currency.[3]

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[2] "*The Petro-yuan: A Momentous Game Changer for the Global Energy Markets, the Global Economy and Sanctions.*" By M. G. Salameh, International Association for Energy Economics, IAEE Energy Forum, Third Quarter, pp.29 – pp.33. Retrieved from http://www.iaee.org/en/publications/newsletterdl.aspx?id=748

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[3] See "*Chi on China: The Great Instability of Digital Disruption (IV): Breaking Up the Global Payments System*", 10 March 2022.

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