A Profound Game Changer

Coming soon.

BY CHRIS LEUNG

One of our predictions after the 19th Party Congress in October 2017 was the impending establishment of a petro-CNY system backed by gold. Evolving economic and geopolitical forces may well hasten this dynamic.

China is not only the largest exporter in the world. Its imports are the second-largest as well. China is the biggest net importer of oil in the world, surpassing the United States and Germany in 2016. For oil producers such as the Gulf states, Russia, and Venezuela, there is hardly any buyer as important as China. Settlement of oil in the Chinese yuan (CNY) is a natural course of development from Beijing's perspective.

THE RUSSIAN ANGLE

Sanctions on Russia by the United States since the Ukraine crisis have led to one important unintended consequence: They sped up wider acceptance of the CNY by Russian energy companies. Russia's fourth-largest oil producer in 2017, Gazprom Neft (the oil arm of state gas giant Gazprom), has been settling its entire crude sales (one-third of total oil sales) to China in CNY since 2015. Since the start of 2015, Gazprom Neft has been selling all of its oil exports through the East Siberia Pacific Ocean pipeline to China in renminbi. The second ESPO pipeline will be in operation by the end of 2018, with an annual capacity of fifteen million tonnes.

China is also exerting its influence via an acquisition strategy. CEFC China Energy recently acquired 14.2 percent of Russia's largest oil producer Rosneft for about US$9 billion. As part of the deal, thirteen million tonnes of Russian crude will be sold to the Chinese conglomerate per

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year, starting in 2018. That equates to 260,000 barrels per day, about 5 percent of Rosneft's output and one-quarter of China's monthly imports from Russia. And the deal would eventually rise to forty-two million tonnes (840,000 barrels per day). A substantial part of these crude sales, if not all, will likely be settled in CNY given the growing alliance between Beijing and Moscow.

In fact, a closed-loop petro-CNY system has already been working between China and Russia for some time, with Russian companies delivering oil products to China and using CNY as settlement currency. Russian companies either save or spend the CNY on Chinese goods and services. This system helps to relieve industrial overcapacity by creating long-term demand for Chinese-made capital goods. For instance, China Railway Group won the contract for the construction of Moscow-Kazan rail in 2017.

Moscow's alienation from the West will only strengthen its tie with Beijing. Bilateral trade settled in CNY may easily extend into natural gas and agricultural products. The "Power of Siberia," a 3,000-kilometer gas pipeline, will reach Russia's border with China in December 2019. The pipeline is the realization of a thirty-year, US$400 billion deal that will deliver more than 1.16 trillion cubic meters of gas. The sheer size of consumption, which currently ranks third-largest in the world in 2017, provides Beijing with considerable bargaining power over the choice of currency settlement. The International Energy Agency projects global gas demand growing 1.6 percent annually until 2022, with China making up 40 percent of the growth.

NOW COMES THE MIDDLE EAST

The next tactical move for China is to enlarge the closed loop with more prominent members. The best is to persuade Saudi Arabia to accept settlement of oil exports in CNY. The prevailing economic and political situation is also driving the Saudis to deepen ties with Beijing as a strategic hedge. Presently, China's three top oil suppliers are Russia, Saudi Arabia, and Angola. They are followed by Iran, Iraq, and Oman. In the past few years, Russia's oil exports to China have risen from 5 percent to 15 percent of total exports, primarily because transactions are already settled in CNY. To compare, Saudi Arabia's share of Chinese imports has dropped from over 20 percent in 2008 to 12 percent now. In fact, oil imports from Saudi Arabia only increased 0.1 percent year-to-date November 2017 and fell 7.8 percent year-over-year. Given its acute fiscal difficulties, Saudi Arabia in our view would be keen to secure stronger oil trading ties with China.

Saudi Arabia lost export share to China for several reasons. First, it must comply with OPEC's production cut agreement. Second, Russian export capacity in Eastern Siberia is closer to Asian markets. And last, lighter crudes produced by Russia have become more competitive against heavy crudes from Saudi Arabia. These challenges are structural in nature.

Reversing such a trend is difficult, but what if Saudi Arabia begins settling some of their oil transactions in CNY

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The Role of Gold

Gold is a key element of the petro-CNY system. It is important to make offshore yuan convertible into gold since the availability of investible assets is vital in safeguarding the interest of CNY recipients. That partially explains the tactful accumulation of gold reserves by China, which have jumped almost threefold since 2007 in tandem with the growing bilateral oil trade.

Russia has already set up a branch of the Bank of Russia in Beijing. Technically, Russia can use its yuan proceeds to buy gold via the Shanghai Gold Exchange. It is also reported that China will soon launch crude oil future contracts priced in CNY. If China succeeds in getting Russia and Saudi Arabia to join its petro-CNY initiative, the implications for global economies and markets could be profound. Not only would this be a game changer for the dynamics of the oil trade, but the geopolitical balance could tilt as well. Some countries may be able to bypass economic sanctions under the U.S. dollar system, thereby weakening the United States' economic prowess.

—C. Leung

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with Beijing? This is a looming possibility. As early as 2012, the People's Bank of China and the United Arab Emirates Central Bank set up a US$5.5 billion currency swap, setting the stage for footing the bill for Chinese oil imports from Abu Dhabi in CNY.

Indeed, diplomatic and economic ties between China and Saudi Arabia have been strengthening since 2016. Leaders of both countries have already made no less than four official visits in the past two years. While this may be largely rhetoric, there seems to be synergy between China's Belt and Road Initiative and the "Saudi Vision 2030" roadmap. This potential bilateral deal is reportedly worth as much as US$70 billion with a strong focus on oil.

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Saudi Aramco is currently preparing what is potentially the largest initial public offering in financial history. The valuation of it ranges from US$1 trillion to $2 trillion. Offering 5 percent of the company for IPO is equivalent to US$50 billion to $100 billion. Potential Chinese strategic investors include PetroChina and Sinopec, which were reportedly interested in acquiring the complete offer. If this happens, it could possibly lead to the cancellation of the IPO. Elsewhere, Saudi Aramco looks set to work with Chinese state enterprises, such as Norinco and Aerosun Corporation, in projects such as oil refinery, construction of chemical plants, oil pipelines, and more. Saudi Arabia and the Emirate of Sharjah have also recently announced plans to raise funds directly in China's onshore Panda bond market.

THE ROLE OF GOLD

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Related to this, alternative settlement systems are being deepened. China launched the Cross-border Interbank Payment System (CIPS) in 2015 as an alternative to the SWIFT (Society for Worldwide Interbank Financial Telecommunication). The system has become the main channel of cross-border CNY payment in the past two years. At the end of 2017, CIPS direct participants reached 31 and its indirect participants stood at 677, covering 87 countries and regions. That includes VTB, the second-largest bank in Russia.

Moreover, the key elements of the requisite institutional infrastructure are already in place. The US$40 billion Silk Road Fund backed by China's foreign exchange reserves, the Export-Import Bank of China, and China Development Bank are all such platforms. The aim is to encourage Chinese state-owned enterprises to predominantly invest in infrastructure projects in Eurasia, while nudging participating countries toward using CNY as the currency of settlement.

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It is reported that Pakistan, an important strategic partner in the Belt and Road Initiative, is taking related measures to establish the CNY as the settlement currency for bilateral trade and investment transactions with China. In recent months, the State Bank of Pakistan has introduced regulations pertaining to letter of credit issuances and granted authorization for local banks to open CNY accounts—moves that facilitate CNY settlements. The Bank of China recently opened its first branch in Karachi, Pakistan's largest city. Likewise, the Industrial and Commercial Bank of China's Karachi branch has also been allowed to set up local CNY settlement and clearing platforms.

INTERNATIONALIZATION

The building blocks are in place for CNY's internationalization. The petro-CNY system backed by gold or sovereign bonds does not require full CNY convertibility to function. As such, China always retains full control of the capital account while effectively accelerating the pace of RMB internationalization. In the initial phase, the new architecture primarily serves the interests of state-owned enterprises within the system. It will take a longer time for the private sector to completely accept RMB as a settlement currency. Another challenge is the adequacy of gold reserves to sustain the system over time.

Gold is meant to be an insurance for CNY recipients in the initial phase of building the new architecture. For the petro-CNY system to run more smoothly over time, recipients will be hungry for "investible assets" for the CNY on their hands. Thus, China should also concurrently accelerate the pace of liberalizing the domestic bond market.

While the launch of Bond Connect last year provides overseas investors with a more efficient channel to invest onshore, the response has been lukewarm due to perceived high credit risk and the absence of hedging instruments such as access to onshore bond futures and interest rate swaps. Meanwhile, block trades are not allowed under Bond Connect. This may pose a constraint for sovereign wealth funds looking to do sizeable trade for portfolio allocation purposes.

Yet this is precisely the point—that higher risks translate into higher rates. Bond yields in China must be notably higher than those offered by the United States, European Union, and Japan. The key is to leverage foreign participation in the domestic bond market to impose better credit discipline on the issuers such as state-owned enterprises and debt-ridden local governments.

Some may argue the whole CNY internationalization agenda is an elusive concept. But the fact is that it is proceeding swiftly. After all, the greatest constant in history is that everything changes. ◆