A Self-Induced Challenge to the US Dollar (Part 2)

Mushtaq Khan[1] & Danish Hyder, October 13, 2017

The US and the Iranian nuclear deal

President Trump's September 19th UN speech is noteworthy for his thoughts about the Iranian regime. In it, Iran was attacked for being a sham democracy; for masterminding terrorist activities in the Middle East; for provoking the war in Yemen & Syria; for its uncompromising attitude towards Israel; and for suppressing the will of its people. Trump condemned the Iranian nuclear deal (co-authored and co-signed in 2015 by France, Britain, Russia, China & Germany) as the worst and most embarrassing agreement the US has ever signed.

In his speech the next day, the Iranian President, Hassan Rouhani, slammed the US President for being a rogue entrant to global politics, and described his speech as "baseless" and "unfit" for the UN General Assembly. He categorically stated that Iran would not walk away from the nuclear deal, but if the deal was to fall apart, there would be consequences.

With the world already facing a nuclear standoff in the Korean peninsula (Part 1, October 2nd), President Trump is scheduled to certify Iran's compliance before October 15th. His rhetoric so far, suggests that Trump will signal his dissatisfaction with the Iranian nuclear deal, which means the decision to scrap the deal will pass to the US Congress. While members of the P5+1 are hoping the US government doesn't unilaterally step away from the agreement, we are not optimistic. Even before the deal was struck, US lawmakers were wary of easing sanctions. In our view, President Trump's decision not to certify Iran's compliance, will be followed by congressional support to scrap the Iranian deal.[2]

The likely response from Iran is to announce a resumption of its "peaceful" nuclear and "defensive" missile programs. Furthermore, sensing that US financial sanctions will be imposed, Iran may announce that it is no longer willing to deal in Dollars for its trade flows. Despite the resilience of Iran's economy after more than three decades of economic sanctions, Iran's economy has gained from the lifting of sanctions in 2015. This improvement will suffer once US sanctions are re-imposed, which is the end-goal of a harder US stance on Iran.[3] [4]

President Trump's decision is likely to sour relations between members of the P5+1 and the US. It appears likely that China and Russia (and perhaps Germany and France) will continue trading with Iran. However, this may not be possible as most trade transactions are conducted in US Dollars, and if US

[1] The author would like to thank Hanif Akhai (ex-SBP), Shehzad Naqvi (ex-Citigroup) & Salim Raza (ex-SBP) for several free-ranging discussions on the issues discussed in this paper.

[2] It has been said that after President Trump refuses to certify, he will ask Congress not to immediately impose US sanctions, but to expand the limits on Iran's behavior to include support for terrorism, regional interference and its ballistic missile program. While the UK, France and even Germany may agree, it is unlikely that China and Russia will be willing to renegotiate. With significant investments in Iran, the issue is whether these two countries, can do anything meaningful to counter the US. As discussed later, the power of the sanctions hinges on blocking banking transactions with Iran, which is the domain of the US.

[3] Arguments have been made that Iran's economic strength will empower the country to step up its support for groups that the US has categorized as terrorist groups (e.g. Hezbollah; the Houthi rebels; the Syrian government; and Shia militant groups in the Middle East). A more prosperous Iran is viewed with concern by pro-Israel US policymakers.

[4] In our view, it is not the sanctions per se that will hurt Iran, but the likely hesitation of global banks to intermediate with Iranian counterparties if President Trump decertifies the Iranian deal. So while Congress has 60 days to rule on whether to scrap the nuclear deal, the challenges for Iran could start even without the US authorities taking any specific step.

sanctions target global banks that intermediate with Iran, this could cut off Iran from global trade (even if these transactions are not conducted in Dollars).

Why the US dominates global trade

Conventional wisdom about how US sanctions work, and how countries like China & Russia could retaliate, is generally mistaken. This is because the mechanics of international trade (based on banking services) and the US Dollar's dominance over global trade, gives the US significant policy clout. Hence, the jurisdiction of US laws over global banks, needs to be better understood.

It is a stylized fact (or market legend) that in 1974 the US and Saudi Arabia agreed that all Arab oil exports would only be transacted in US Dollars, in exchange for US protection for participating countries (primarily the GCC). This shored up global demand for Dollars, which was necessary after President Nixon went off the gold-standard in 1971.[5] As oil is the most heavily traded commodity in the world, this created consistent demand for Dollars and generated what is known as petrodollars after the first oil shock in 1973. Most of these Dollar balances were invested back in the US.[6]

To better understand why a particular sovereign currency becomes a universally accepted currency, a simple analogy is helpful. Let's assume a group of individuals produce goods (and services) and rely on trading amongst themselves, to consume other goods (and services). The *unit of account* that is used (the transacting currency) must have several qualities for it to become the preferred *medium of exchange*:

1. It must be available, but in a controlled and predictable manner;
2. It must be acceptable to all individuals in the group;
3. It must retain its value so that individuals are comfortable holding balances of this currency; and
4. There must be a mechanism whereby payments for the exchange of goods (and services) from one individual to another, are done in a credible, safe and efficient manner. In modern trade, importers and exporters do not transact directly with each other, but through intermediating banks.

The first three qualities are well known to economists, but the fourth is less familiar. Given the size of the US economy, the depth and credibility of the US banking system, the payment technology created for Dollar transactions, the fine pricing available for US Dollar transactions[7]; and the fact that a key item that is traded (oil) is only transacted in Dollars, the Dollar is the universal currency of choice.

The next point to consider is availability. Since bilateral trade is rarely done in the form of barter (i.e. Saudi Arabia only sells oil to the US when it needs US warplanes or wheat), trading countries always maintain a reserve of Dollars to pay for imports, as and when they need to. This is why all central banks hold Dollars either in the form of cash (that can be remitted immediately) or Dollar instruments (US T-bills/bonds that can be converted into cash quickly). The Dollar currency market is the deepest in the world (i.e. availability is guaranteed), while the market for US government paper (US T-bills/bonds) is the most liquid in the world. Coupled with the finer pricing available for Dollar transactions, this means using the Dollar is the most efficient means to transact global trade.

It is important at this point to understand *Dollar clearing*. When an importer writes a Dollar check in favor of the exporter, this check is encashed (cleared) and deposited into the exporter's Dollar account in

[5] This meant that President Nixon's decision forced people to shift from the motto "in Gold we trust" to "in Dollar we trust".
[6] One must realize that global currency markets only cater to a handful of sovereign currencies (the US Dollar, Sterling, Yen, Euro and Swiss Franc), and global trade relies primarily on Dollars.
[7] This refers to the very small (tight) bid-offer quotes that are available in Dollars, which other hard currencies cannot match. This means that traders prefer the Dollar as they get the best (most market determined) price for what they sell or what they want to buy. Hence, even a Japanese importer who wants to buy German automobiles, would prefer to conduct the entire transaction in US dollars, even though both countries have hard currencies (the Euro and the Yen).

a Dollar clearing (or correspondent) bank. By definition, Dollar clearing banks are generally based in NYC, but always operate under the jurisdiction of US laws. Hence, an inter-country Dollar check may not be cleared if the US government deems it inappropriate, even if the two transacting parties are known to each other, and the payer (importer) has sufficient funds. This means, that the US can unilaterally block any trade transaction that is denominated in Dollars.

Furthermore, the threat of falling afoul of US regulators can be debilitating to an intermediating bank, which needs to maintain its global rating to operate. Such banks will always err on the side of caution. For example, if the US decides that all Dollar-based trade transactions with Iran are to be blocked (i.e. not cleared), this will certainly discourage any reputable banks from dealing with Iran (or Iranian banks) in Dollars. If the US authorities suggest that even non-Dollar transactions will be monitored, banks will shy away. This effectively means that Iran could be barred from all formal trade transactions that use commercial banks.[8]

There is another side to this story, which is better understood using another analogy. **Figure 1** shows a marketplace, where all trading countries come to buy and sell their goods (and services). Since the US owns this marketplace, and provides the legal & financial infrastructure for transacting, it effectively manages/monitors global trade. Other than the lack of an alternate marketplace, most countries prefer coming to the Dollar marketplace as the US is the world's largest consumer. Countries are keen to secure a share of this lucrative export market. So while Japan trades directly with France, they both export and import from the US; hence, it makes more sense to conduct all trade transactions via Dollars, even if the movement of goods is outside the US.

As the world's largest net consumer, the US always runs an external deficit. This means the US Fed pays for its external deficits by creating (printing) Dollars, which all trading partners are more than willing to accept. This means that each year the total supply of Dollars increases, which is required for it to be a universal currency (as trade volumes increase, central banks the world over must hold larger Dollar balances). This puts the US in an enviable position: the Dollar's dominance in global trade allows the US to consume more than it produces, so as to increase the supply of Dollars, which in turn enhances the Dollar's role. Many would argue that this increases US indebtedness and weakens the US, but even this fact needs proper interpretation.

As shown in **Figure 1**, each country trades and accumulates Dollar balances for the surplus it runs against the US. These balances are held as cash or in US government paper. One way to visualize this, is to say that at the end of the trading day, a country takes its larger Dollar balances and checks them into the US Bank (the Dollar-based global financial system). The next day, the country avails its Dollar balances and begins trading again. So while China and Germany accumulate Dollar balances, these are invested in Dollar instruments. Even if China were to sell some of its Dollar holdings for (say) Euros, the party selling the Euro (say a German manufacturer) will receive the Dollars.

[8] This does not mean that all trade with Iran will cease. With banks hesitant about dealing with Iran, the latter will have little choice but to rely on less reputable banks or informal payment systems. This means poor pricing; large margins charged by intermediating banks, and the possibility of contractual failures (if the intermediating bank or counterparty reneges on the trade agreement). So while trade with Iran could still take place, it will not be able to develop or thrive, as it would for non-sanctioned countries.

Figure 1: The Dollar Dominated Global Marketplace

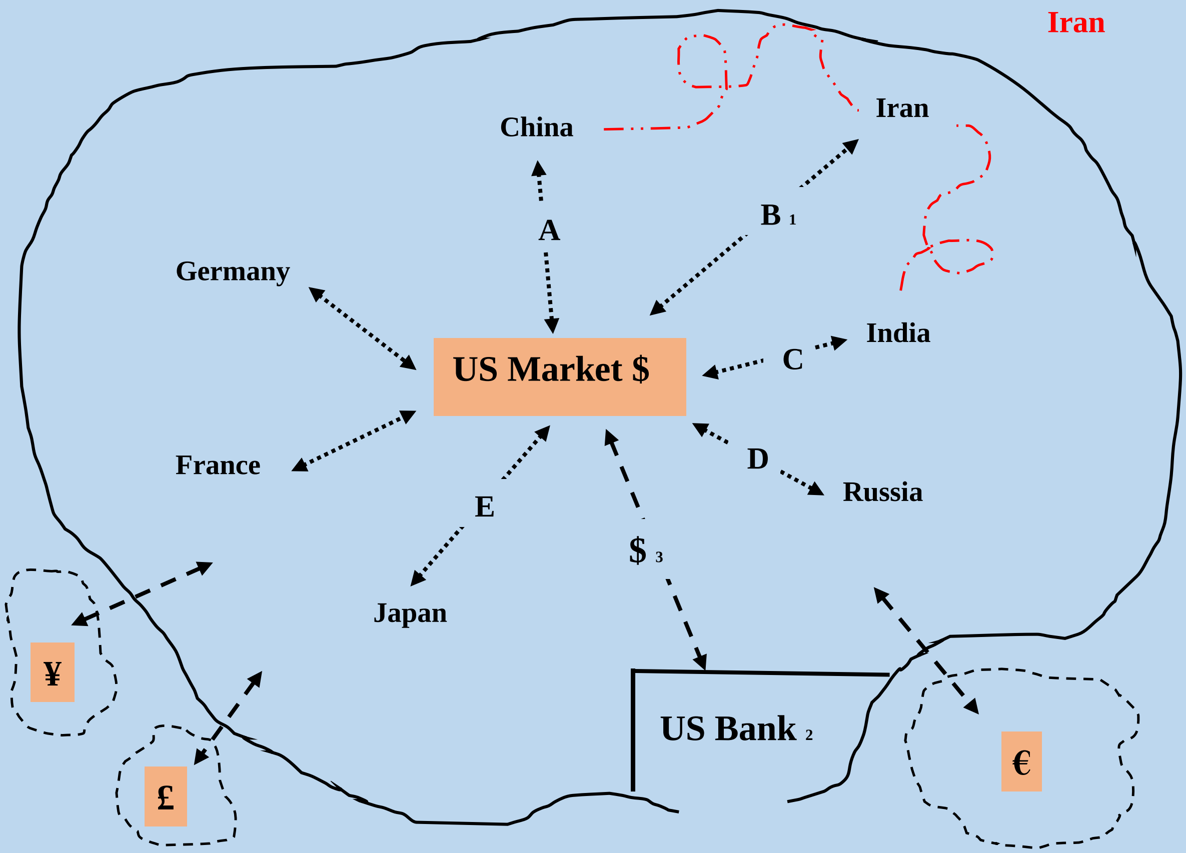
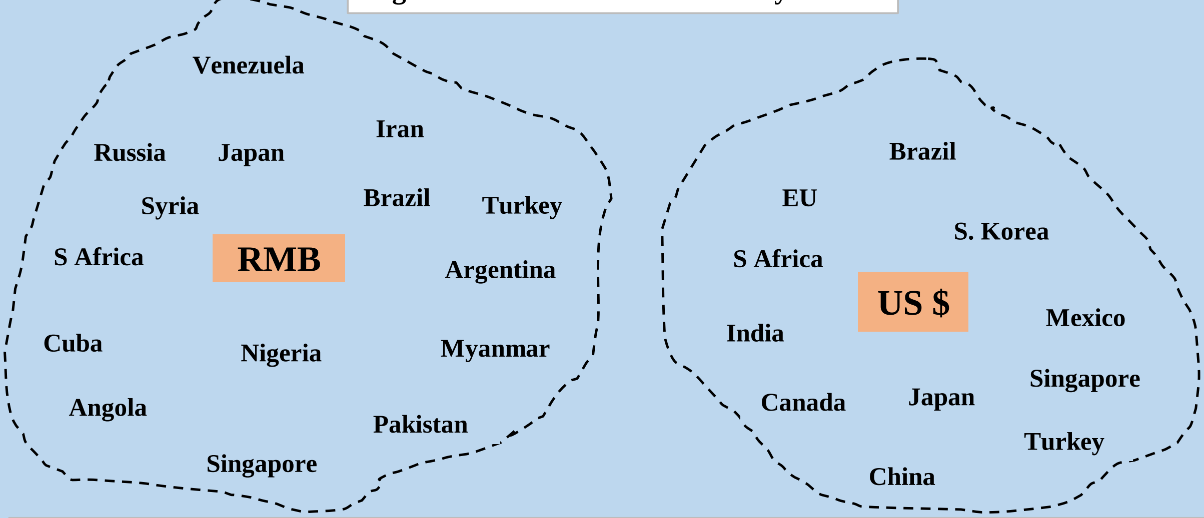


Figure 2: Non-Exclusive Currency Zones



1. Bank (B) could be told to exit the $ marketplace, which puts Iran outside the marketplace. Iran could try to solicit the services of Banks (A, C, D) to skirt US sanctions, but this depnds on the appetite of these banks, and also how strictly the US authorities will monitor banks that continue dealing with Iran.
2. US trade partners keep their supluses in $-denominated assets (either cash or US govt. paper).
3. $s invested in US paper can be used to drive US consumption, which means the money generated by trade partners and placed in US paper, is used to feed US demand for imports.

Figure 2 shows that some countries would be operating in both currency zones, while some retain a stronger presence in one of these two mutually inclusive currency zones (note: China deals in $, but US only in $).

In effect, Dollars don't disappear after they have been issued, and the greater the volume of Dollars injected into the global system, the more dominant the Dollar becomes. This means that most countries are vested in US Dollars.

Some people say that China should simply offload its holdings of Dollars as a warning to the US, either sell Dollars spot or sell US paper. However, they must realize that if the Dollar loses value, this will directly impact China's own asset valuation.

Orthodox economic theory to the rescue?

It is not easy to get one's head around what appears to be a lop-sided and unfair deal. We have a consumer (US) who can continue to consume by effortlessly printing the universal currency (without limit it would appear). This consumer's growing indebtedness is not really a burden either, as foreign creditors will not stop lending knowing that his demand keeps the creditor (& producer) in business. For example, if China stops lending to the US, this will increase US interest rates, which in turn reduces US demand for Chinese exports. This will not only result in unemployment in China, but could also hurt the value of China's Dollar assets.

And all the while, as the Dollar becomes even more firmly entrenched in global trade, the ability of the US to exclude any country from its marketplace increases (in **Figure 1**, Iran is thrown out of the Dollar marketplace). In our view, it is the Dollar's dominance that tips the balance of power towards the largest consumer and borrower (the US) over the largest producer and creditor (China).

Having said this, Econ 101 introduces the concept of equilibrium in any market. If one country is a net exporter, the other countries (collectively) have to be net importers. It also states that growing macro imbalances (external, fiscal and debt accumulation) cannot go on indefinitely as the growing financial imbalance will eventually lead to hyperinflation and/or default. In other words, even if a country gets its start as an exporter (and eventually becomes the global factory – China), it cannot remain an exporter indefinitely, as it will accumulate mounting financial balances from the largest importer (the US). This lop-sided relationship is not sustainable.

The market has a solution: the Dollar should weaken against the RMB. This means Chinese exports to the US would fall, while US exports to China should increase.[9] This translates into a fall in US consumption and an increase in China's domestic consumption. In effect, these currencies would keep adjusting till the external balance between the two countries disappears. At least, that is the theory.

Since we feel that China is unsettled with the latent US power over global trade, it needs to change its economic orientation to reduce its dependency on US demand, which makes it vulnerable to US policy. Similarly, the US would have to shift away from its consumption-based strategy, and move towards manufacturing.

It is important to state that this change in economic orientation (for both the US and China) is a daunting and disruptive exercise. From a commercial perspective, it would be a mistake to change something that is working quite well. However, when faced with the financial vulnerability of countries that seek to ally themselves with China, this adjustment towards an economic equilibrium makes sense.

[9] One must realize that trade in goods and services (often called current account transactions) dominates or results in capital account transactions (investment in financial assets, companies and/or real estate). More simply, it is the generation of current account surpluses that allow for capital flows across countries. If trade in goods and services were to collapse in the world, so would capital flows between countries.

As shown in **Figure 2**, there is a pattern in the countries that are likely to gravitate towards the RMB; either they have already been targeted by the US, or are likely to be targeted by the US, or they intend to step up their trade with China. On the other hand, looking at the US, President Trump has broken with the globalized approach of post-WW2 US presidents, and is openly nationalist in his economic agenda.

While the US effort to reduce its trade deficit with China will increase the price of imported Chinese goods, it will open up the opportunity to invigorate US manufacturing. This may appear regressive (poor quality goods that are more expensive than Chinese imports), but economic *efficiency* may have to take a back seat to *equity*. A trade regime that narrows the China-US trade imbalance, is likely to hurt US corporates and the top 1%, while Trump's base could be galvanized by the *Made in America* political slogan. In a sense, a sharp reduction in China-US trade may actually suit President Trump, and his base.

The Tipping Point

Let's return to the showdown expected on October 15th. Say President Trump announces that he will not verify the Iranian nuclear deal, which is subsequently ratified by Congress. Iran retaliates by stating that it will no longer transact in US Dollars. China announces the launch of the RMB-denominated oil future on the Shanghai Commodity Exchange (**Box 1** explains how this instrument could work).[10] Iran announces that it will avail this instrument as it avoids the Dollar, as well as global banking intermediaries. Russia and Angola, who are large oil exporters to China, may also state that they will use the RMB instrument. Other sanctioned countries like Venezuela, Myanmar and Cuba, could also join the RMB currency zone.

In terms of how this could play out, we could imagine China setting up a "stall" outside the Dollar marketplace in **Figure 1**. It finds a customer in Iran, Russia and Angola, but the product offering is limited to oil, and the RMB oil future is of a given size. Depending on how these future contracts are settled, and how many other countries approach the Chinese stall seeking viable non-Dollar alternatives for *their* exports, this could trigger a gradual shift away from Dollar-based trade, starting initially with primary commodities.

It must be understood that offering RMB futures is not a shift towards capital account convertibility. In other words, this does not mean that any country (or foreign individual) can buy RMB and invest freely in China; nor does it allow Chinese citizens to invest freely overseas. What it appears to do, is to shift China's import payment to RMB, with the understanding that the recipient of the RMB (the exporter) be given the option of paying for Chinese imports in RMB.[11] This is a very selective opening up of the RMB market, which in our view, does not even qualify as partial capital account convertibility.

In a world that has witnessed repeated instances of financial instability triggered by flashfloods of foreign capital, we do not think the PBoC (or the Chinese authorities) is even *interested* in moving towards capital account convertibility. Instead of risking global currency turmoil, China is perhaps only looking to create an RMB currency zone that attracts countries that seek closer economic/financial ties with China. The latter would want to insulate these countries from possible US retaliation, as this could

[10] China has been reaching out to its trade partners to conduct trade transactions without going through the US Dollar since 2008. RMB currency swaps started in December 2008, when PBoC swapped RMB worth 360 billion with the South Korean central bank. This was done to settle bilateral trade flows in their respective sovereign currencies, without using the Dollar as an intermediary. Since then, PBoC has conducted swaps worth 3.2 trillion RMB with 33 countries. Not surprisingly, the largest swap was done with Hong Kong, followed by South Korea. Furthermore, the central banks of China and Russia have just created a payment versus payment (PVP) system that allows these two countries to settle trade transactions without using the US Dollar.

[11] We assume that for countries that avail RMB for their exports, the PBoC would give them the option to place their funds in Chinese government paper.

undermine China’s economic strategy going forward. This is especially relevant for China’s *One Belt, One Road* initiative, which seeks to involve a large number of Asian and European countries.

Box 1: How a RMB-denominated *oil future* (convertible into gold) actually works

Unlike previous attempts to promote the use of the RMB, the RMB oil future is not country specific, and targets the most important commodity imported by China. It therefore signals greater ambition than the RMB currency swaps.

China has also taken serious steps to make the gold convertibility option, more credible. In April 2017, the Shanghai Gold Fix officially began, which has two distinct advantages over the existing global benchmark – the London Gold Fix: (1) the Shanghai Gold Fix will announce a daily gold price in RMB; and (2) the Shanghai Gold Fix will actually deal with gold bullion (i.e. traders will be able to avail physical delivery of gold bullion). Furthermore, it has been reported that both Russia and China have been aggressively building their gold reserves.

In terms of the RMB-denominated future, this is a simplified assessment:

A commodity future is a regulated contract between a buyer of the commodity, and a seller. It states that on a specified date in the future, both parties will execute their part of the agreement (at the prevailing spot price) for the commodity. Hence, a 3-month RMB-denominated oil future is an agreement by the oil buyer (A) to purchase oil from an exporter (B), for shipment 3-months in the future. At the settlement date, the regulator determines the spot oil price, the prevailing RMB/$ parity, and informs A that it must pay a specific sum of RMB to B. It also means the oil seller B has the option, to demand payment in gold bullion from A.

This implies several things: (1) the oil importer (A) has ready access to RMB and gold; (2) the oil importer (A) prefers paying in RMB (or gold) rather than paying in Dollars; (3) that the oil exporter (B) prefers RMB (and gold) to being paid in US Dollars; and (4) since this *oil future* is a tradable instrument on the Shanghai Commodity Exchange, the Regulatory authority (in this market) must guarantee compliance of both counterparties, which means only credible parties would be able to bid for this instrument (a known oil exporter). Since financial settlement is in RMB, this would take place in Shanghai.

Adding more texture, let’s assume party A is a state-owned Chinese oil refining company, and party B is the state-owned Iranian oil exporting company. Clearly, company A would rely on the PBoC for access to gold, while company B would surrender either RMB (or gold) to the Iranian central bank.

A final point about demand for the RMB. While a country like Iran would prefer RMB because it could lose access to the Dollar marketplace (see **Figure 1**), others would be tempted by a currency that is backed by gold. As countries get comfortable holding RMB (to use as payment for Chinese imports, or to invest in Chinese government paper), the use of the gold option will recede. This creates RMB demand that will eat into Dollar demand. Potential clients for this instrument are Iran; Nigeria & Angola (home to significant Chinese investments); Venezuela (already targeted by the US); and Kazakhstan (a close Russian ally). For natural gas, Russia, Iran & Qatar are dominant players, who would be willing to diversify away from the Dollar.

Managing the adjustment

With the selective availability of RMB, and the pipeline of similar instruments, we expect China's economic allies (countries hosting significant Chinese investments, or those that trade heavily with China) to shift their orientation towards the RMB. To keep this transition smooth and predictable, the Chinese authorities could use the launch of the RMB-denominated oil future to announce its economic/currency outlook:

- To create demand for RMB commodity futures, China could announce the following: (1) that recipient countries could use the RMB to import from China; (2) they could invest their RMB balances in Chinese government paper; and (3) give the recipient the option of converting part of its RMB balances into gold;
- It could announce a pipeline of other RMB-denominated futures/forwards for oil and other commodities, so that potential commodity exporters (to China) could plan ahead;
- To reduce China's exposure to the US Dollar, the PBoC could announce that it would prefer to get paid for its exports in currencies other than the Dollar; and finally,
- As an indication of China's strategy for the future, the Chinese government may state that it needs to reorient its domestic economy so as to reduce its trade surpluses – this would entail a gradual (and measured) appreciation of the RMB/$. This could also defuse criticism that China has intentionally kept the RMB weak to promote its exports.

We assume that China's policymakers have two goals: (1) to create a separate currency zone that protects its economic allies; and (2) to change the orientation of its domestic economy so that China is no longer driven by the need to export.

Depending on the scale of the shift towards the RMB (which can be managed), the Dollar should weaken against other hard currencies and the RMB. Since this should also reduce Chinese appetite for US government paper, it would put upward pressure on US interest rates. This means a simultaneous weakening of the Dollar, an increase in US inflation and a rise in US interest rates. In the larger scheme of things, this is *exactly* what is needed for the US to reduce its external deficit with China. As US interest rates increase, the resulting fiscal squeeze would hit discretionary US government spending, which will further reduce US aggregate demand.

There would be hard changes for China as well. The appreciating RMB will reduce inflation and make household debt heavier. This could be compounded by the loss of manufacturing jobs, as China adjusts to fewer exports to the US. With a weakening Dollar and an official stance to reduce China's exposure to the Dollar, we expect PBoC to be stricter about capital outflows by resident Chinese. As stated earlier, China's policymakers have realized they must encourage domestic consumption, and push Chinese households to save less. A cut in China's interest rates and steps to discourage speculation in real estate (a form of forced saving and investment), could shift Chinese focus towards consumption, especially imported consumer products.

Conclusion

The US role in shaping the global economy since the end of WW2, may be at an end. This comes from a combination of an over-extended US (now under very different management), and a China that seeks to supplement its economic clout with regional integration (OBOR). We have argued that the trade imbalance between the two economic giants is no longer sustainable, which has more to do with geo-political compulsions than economic stresses. We also think Iran's economic isolation could be the trigger that challenges the US Dollar.

The path ahead for China and the US will not be easy. Both countries will have to reorient their respective economies to move towards a more balanced coexistence. We do not foresee an end to the US Dollar as a universal currency, but we do see more binding limits on how the US government can use the Dollar to punish individual countries. We see China changing the rules of global trade by customizing its currency market in a calibrated manner. We also see capital controls remaining in place (perhaps becoming more restrictive), and the world moving away from free-trade globalization.

This transition may appear unrealistic. However, there may be political appetite for this change. First, there is President Trump and his nationalist economic agenda, which may embrace restricted trade flows (with China) and a revival in America's industrial base. Then we have China, which has to show everyone that it cannot remain the factory of the world, and therefore adjusts its currency accordingly. In effect, the transition to a bipolar world order is managed by China, but guided by market forces.

