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Outlook for the petro-yuan and implications for GCC monetary policy

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EXECUTIVE SUMMARY

This report assesses the extent to which the renminbi (RMB) could displace the dollar as the reference currency for Sino-Gulf hydrocarbon trade over the coming years.

While RMB-internationalization has been a long-held objective of Chinese authorities, they have been largely unsuccessful in displacing the dollar as the de-facto international trade currency, largely due to domestic financial constraints that have prevented reforms. This has dampened the appetite of global exporters to China to be paid in RMB, resulting in the Chinese currency's inability to grow its share of international payments. For Gulf hydrocarbon exporters, reluctance to accept renminbi against oil has also been driven in consideration of the strategic partnership with the United States and the latter's role as the security guarantor for the Gulf: oil for yuan could set a global precedent, undermining the dollar's role, negatively affecting the US economy, and possibly jeopardizing the security relationship.

However, the past few years have witnessed major developments which could upend the status quo: GCC hydrocarbon exports are increasingly concentrated in Asia; doubts are growing on the sustainability of US monetary policy and by extension the dollar; and more importantly, barriers to RMB internationalization are being gradually lifted, through a combination of structural reforms and a change in China's economic landscape. As GCC policymakers are increasingly finding themselves caught in the middle of a tug of war between the two major superpowers, they must tread carefully. Yet China's insistence to pay for oil in RMB is likely to grow and hence, they should prepare for this eventuality. While this would likely upset the United States and potentially undermine the dollar to some extent, we argue that the US would nevertheless maintain its role as the Gulf's security guarantor, given this serves first and foremost its own interests. As such, in the context of a waning security rationale for the continued existence of the petrodollar and a declining faith in the US dollar, GCC States may not have much to lose from switching to renminbi-denominated oil trade, provided the right risk-mitigation mechanisms are in place.

To prepare for such a scenario, GCC policymakers should:

- Review their foreign reserve strategy in light of expected global trade flows, in particular against global hydrocarbon demand scenarios
- Closely monitor the pace of China's financial reforms and measures taken to stimulate RMB internationalization, in particular with regards to relaxing barriers to capital flows and the development of cross-border financial regulations
- Develop hedging strategies to minimize impact of a potential USD devaluation that could be triggered by RMB-denominated oil trade
- Assess implications on the dollar-peg and determine how Gulf currencies could be realigned towards a basket of currencies beyond the dollar

1. Dollar, oil and the GCC: a marriage of convenience

The US Dollar dominates global payments and remains the prime reserve currency of central banks globally. Most traded goods are priced in USD, from basic commodities including hydrocarbons to consumer goods and services. Dollars from countries with current account surpluses have typically been invested in American Treasuries, providing stable returns for investors while financing America's deficit. Dollar receipts have also been invested by sovereign wealth funds in equities, primarily in America but also abroad.

The combination of the dollar's convertibility, the dollar's stability, and America's economic strength and openness have been the determining factors in convincing hydrocarbon sellers and buyers to transact in dollars. The dollar's global role was formally established through the Bretton Woods Agreement at the outset of World War II, when all major currencies were pegged to the dollar, and the dollar was backed by gold. In parallel, major oil producer Saudi Arabia had agreed to denominate oil contracts in gold since the 1930s, and with the dollar being backed by gold, the American currency was as good as bullion. This formally established the dollar as the de-facto currency to trade oil, a practice that was adopted by OPEC members[1].

Bretton Woods unraveled in 1971 when, unable to manage its growing liabilities, President Nixon broke the "gold standard", in effect letting international markets set the dollar's value and floating the price of gold. To avoid a decline in real oil prices (gold-based), OPEC members resorted to setting a higher price for oil in dollar terms. This period also corresponded to the peak and subsequent decline in US oil production (1970-2008) prompting the United States to massively ramp up its oil imports, from less than 500m barrels per year in 1970 to almost 2,500m barrels per year by 1977[2], with Gulf States as the main suppliers. As a result, Arab producers accumulated significant trade surpluses in dollars that were subsequently funneled into the American economy. In the 1980s, America's role as a security guarantor to Saudi Arabia and to the Arab Gulf States more generally led to a closer integration of interests, involving energy supplies against economic and military cooperation. It also led Gulf States to peg their currencies to the dollar as a means to stabilize their own currencies, providing more predictability to investors. As of today, all GCC countries but Kuwait have fully pegged their currencies to the dollar (Kuwait switched to a basket of currencies in 2007 but the USD remains the dominant currency within it, for 70% to 80% of its value).

The USD's position as the de-facto global reserve currency provides economic and political advantages to America. USD stability and the broad use of the USD to pay for goods and services globally has boosted America's ability to attract foreign capital including surplus of foreign governments invested in US Treasuries. In turn this has enabled the US to get away with running a current account deficit, as it has been continuously funded with foreign savings. The USD's primacy also enables the Federal Reserve to influence the global economy. In "setting" interest rates, the Fed influences the value of the USD which has ripple effects for countries with dollar-denominated debt and businesses that rely on exports and imports.

Politically, dollar dominance gives the United States the ability to use its currency as a foreign policy tool through financial sanctions. All USD denominated trades are cleared by correspondent banks with accounts at the Federal Reserve. To fight money laundering and terrorism financing, as well as hamper all transactions by people, companies and states deemed to be enemies of the US, all banks must report their USD transactions and provide the US Treasury with the origin of their dollars. Individuals and companies that come under sanctions by the US Treasury become barred from banks and unable to trade in USDs, irrespective of whether the United States is a party to the trade or not (as an origin or destination). US-imposed financial sanctions have generally benefited Gulf producers as it has limited energy commodity exports by some of the Gulf States' competitors on the one hand (e.g. Iran, Venezuela, Russia) and arguably been used as a security deterrent in the case of Iran.

2. The dollar today: shaken but still dominant

The "imminent" decline of the dollar has been a recurring topic of discussion in the media and a frequent research subject in academia ever since the introduction of the Euro. While the introduction of the European unified currency did reduce the dollar's role, the latter remains a major currency for international trade and the dominant global reserve currency. Although China now accounts for around 14% of global trade[3] (against around 11% for the US[4]), the renminbi (RMB)[5], China's official currency, lags other major currencies: as of December 2020, it accounted for slightly less than 2% of global payments, ranking fifth after the USD (39%), EUR (37%), GBP (7%) and JPY (4%)[6]. As seen in Figure 1, the renminbi's share of international payments significantly increased in the first half of the last decade but has remained constant since despite China's significantly higher growth in global trade compared to the one of the United States.

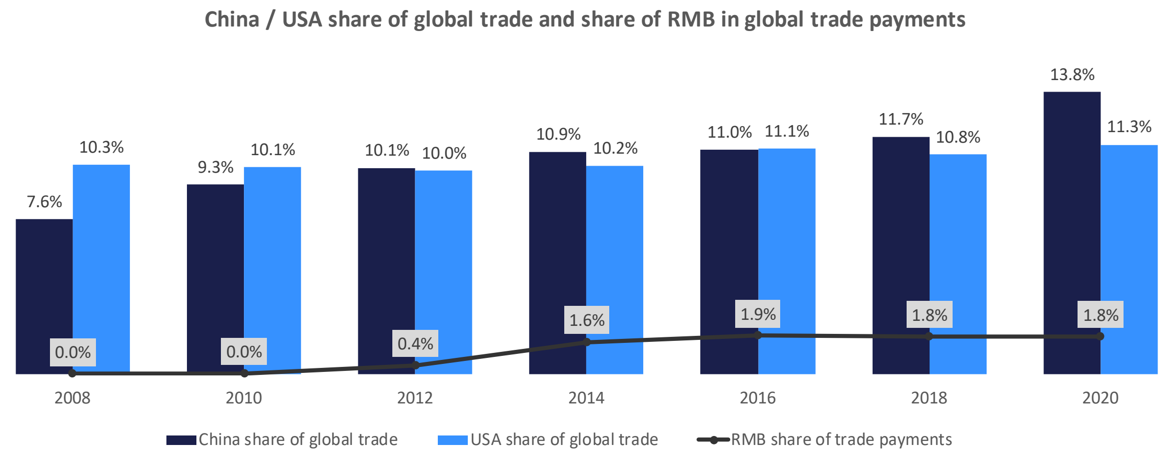

Figure 1: Evolution of RMB use in international payments against evolution of China's share of global trade by value. Sources: World Bank, US Census Bureau, Fitch Ratings, Chinese General Administration of Customs, SWIFT

As the USD remains a favored currency for trade, the USD also dominates foreign currency holdings of central banks across the globe. At the end of Q3 2020, USD and EUR foreign currency holdings had a share of 60.9% and 20.5% respectively, while the RMB amounted for only 2.1% of total currency reserves in line with its share of global trade payments[7].

While there is no direct causation between USD-denominated trade in hydrocarbons and the strength of the American economy, a switch to another currency for trade would likely weaken it: with fewer surplus dollars to park in US Treasuries, debt financing would become costlier for America and the dollar being less in demand would lose value. This is not lost on oil producers. In 2019, Washington's intention to penalize OPEC states for raising oil prices through curbing output (the "NOPEC Act") was reportedly met with threats by some OPEC members to sell oil in currencies other than the dollar[8]. The bill was never passed.

For GCC States, there is an intrinsic link between the currency used for oil trade and the dollar peg. Should they start receiving fewer dollars, there will be fewer USD reserves to maintain the peg, justifying a diversification. This issue is particularly salient in the current context of depressed energy prices where foreign reserves are being drawn on to finance the fiscal deficit.

3. Upending the status quo: why this time may be different

Three major factors could upend the use of the dollar for oil & gas trade: (1) Demand for GCC hydrocarbons shifting from West to East; (2) Growing doubts on the sustainability of America's monetary policy; (3) China removing barriers to RMB internationalization. We provide below a high-level assessment of each of those factors.

i. Shift in demand for GCC hydrocarbons

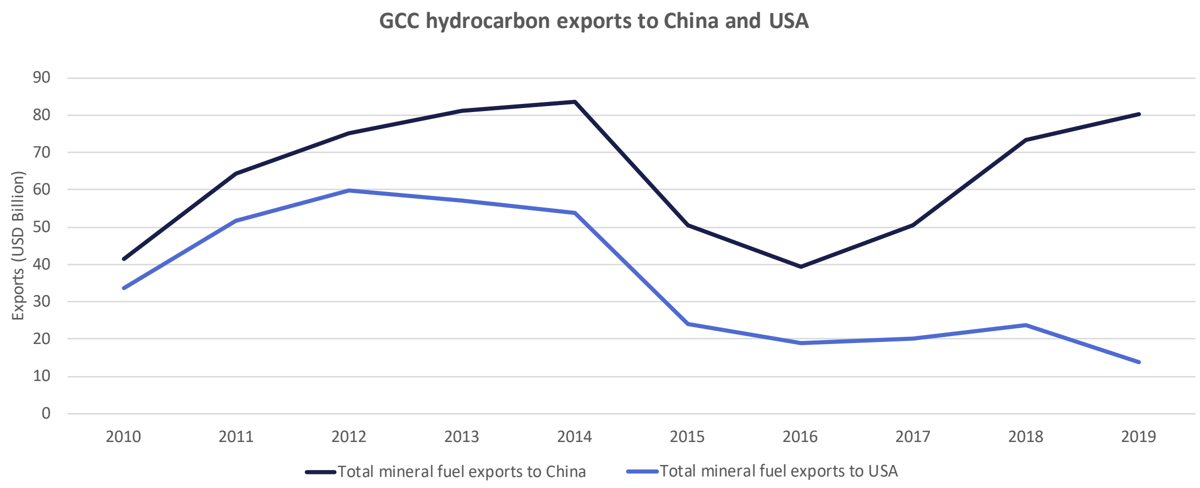

Figure 2: Mineral fuel exports to China and USA originating from 5 key GCC producing countries (KSA, UAE, Kuwait, Oman, Qatar). Source: compiled based on data from Observatory of Economic Complexity (2010-2018), EIA (2019), WorldsTopExports (2019)

US energy imports from the Gulf have dwindled following the sharp increase in domestic shale gas and oil production, to the extent that the US is now one of the largest energy exporters[9], supplying some of the same markets as Gulf countries. In 2019, US imports of mineral fuels from the Gulf had fallen to less than USD 14 Billion, a drop of more than 75% from the 2012 high of USD 60 Billion[10]. US crude oil and petro-leum product imports from Saudi Arabia are representative of this larger drop: in November 2020, the US imported just 286,000 bbd, a figure unseen since October 1985[11]. In January 2021, Bloomberg reported the first week in 35 years with zero imports of Saudi crude oil delivered to American shores[12].

At the same time, China is occupying center stage in energy purchases from the Gulf. China's economic boom has propelled it to the first global position in crude oil imports, with a share of close to 23% in 2019[13], when it imported more than 10 million barrels per day of which 1.7 million from Saudi Arabia[14]. Collectively, GCC hydrocarbon exports to China are now six times higher than what they are to the United States, against a roughly equal balance back in 2010 (Figure 2).

With an increased concentration of hydrocarbon exports to China, GCC exporters are naturally growing their political dependence. In such a context, it could be envisaged that China will have a stronger negotiating position if and when it seeks to pay for its oil imports in renminbi rather than US Dollars. The fact that it has already asked a major GCC producer and exporter for such an arrange-ment[15] is reason enough to expect more forceful similar requests in the future.

ii. Doubts on the sustainability of US monetary policy

At the time of writing, the US Federal Reserve's balance sheet stands at USD 7.4 Trillion[16], more than three times what it was a decade ago. The liberal "printing" of dollars has raised fears of a devaluation of the greenback against other currencies, a fear that has grown more salient following the monetary policy adopted in response to the Covid-19 pandemic. Low interest rates in US Treasuries have been a further argument for bearish dollar sentiment, with China's 10-year government bond offering three times the yield of its American equivalent at the time of writing.

The value of the dollar cannot, however, be inferred from looking at the evolution of dollar stock in isolation. The first consideration is whether the growth in dollar stock has been paired with a commensurate growth in US economic output and inflation. According to Figure 3, evolution of GDP and M2 dollar stock (representing the amount of dollar money in circulation) was in lockstep between 1981 and 2008. A first decoupling occurred at the time of the Global Financial Crisis of 2008, with M2 growing at a faster rate than GDP. A third decoupling occurred following the Fed's quantitative easing in 2020, further growing the gap between M2 and GDP. While this has not yet been followed by a marked change in inflation, there are growing concerns it may make itself felt over the next couple of years. As for the USD Index, it is on a long-term downward trend, approaching the levels of 2008.

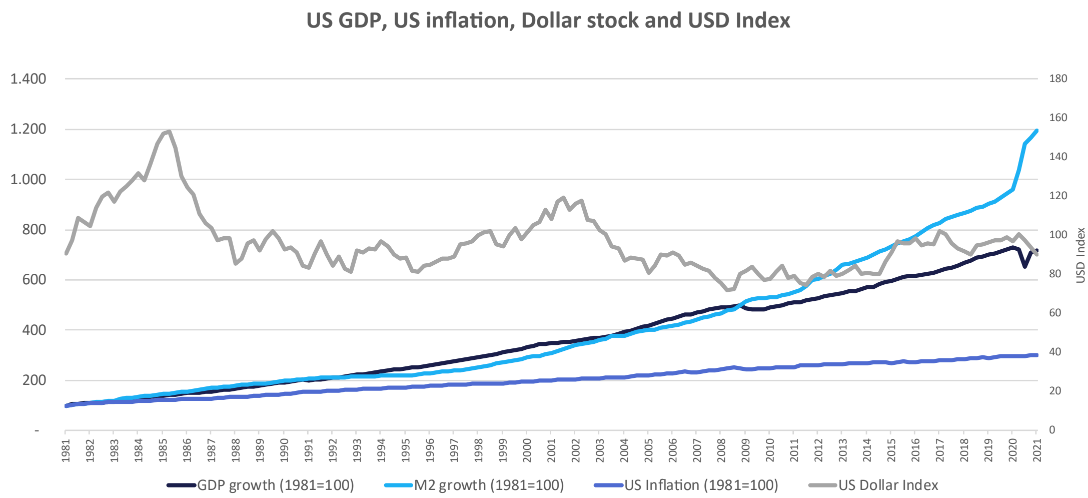

Figure 3: Evolution of US GDP, US urban inflation, M2 dollar stock, overlaid with evolution of USD Index. Source: Federal Reserve Bank of St. Louis Economic Research, Yahoo Finance

Yet despite the growing divergence between M2 and US GDP, the dollar has so far remained resilient. Global trade and dollar dominance means dollars flow to global markets. This flow has been further boosted by the Fed's actions during the pandemic, with the latter opening fourteen dollar-liquidity swap lines in March 2020 and extending dollar liquidity to 170 foreign central banks against their US Treasury bonds[17]. Dollar demand appears to continue unabated among emerging and developed economies, on the back of their willingness to pay a premium for what they still perceive to be a safe currency[18]. Finally, the global monetary response to the pandemic has also played a role in the USD Index's relative stability, the latter being a weighted average of select major currencies which have also seen a boost in liquidity following the purchase programs of central banks in Europe, Japan and the UK.

Here again, there is no specific economically or mathematically defined threshold which determines when the dollar ceases to be considered a safe and convenient asset to hold on to. There has however been much speculation on the impact of political decisions aimed at undermining the primacy of the dollar. A substantial amount of US debt is owed to foreign creditors who have historically purchased US Treasuries, viewed as low risk and therefore a safe investment to park trade surplus dollars. Economic nationalism has led some countries to divest from US government debt, arguing that their holdings are supporting US global hegemony. Case in point with Russia, which between December 2017 and December 2018 sold close to USD 90 BN of its US Treasury holdings[19]. As President Putin made clear, this was an intentional measure for Russia to "free itself from the dollar's burden" and raise the level of Russia's "economic sovereignty" in the process[20]. With less than USD 5 BN in US Treasuries, Russia has now become an insignificant holder[21]. While less openly vocal about its intentions, China has also reduced its exposure to US debt over the last years but remains the largest holder after Japan with more than USD 1 Trillion in US Treasuries, corresponding to around 14% of total foreign holdings. The argument raised by some analysts is that a coordinated effort to walk away from continued investment in US debt would inflict significant economic pain to the United States. Rather than debating the validity of the argument, it is worth asking whether this would be a realistic scenario: if China was to sell its assets all at once, a major implication would be a devaluation of the dollar on global markets, including against the RMB. RMB appreciation would make Chinese goods more expensive and therefore significantly reduce exports to the United States which is currently China's top trading partner. What needs to be assessed therefore is to what extent China can afford RMB appreciation versus the USD. We consider this question in the following sub-section.

iii. Gradual lifting of barriers to RMB-internationalization

USD dominance has major drawbacks for China. Importing goods and services requires Chinese companies to exchange their renminbis into dollars, representing an exchange cost and to some extent an exchange risk (mitigated by the renminbi's managed exchanged rate against the dollar). China's contribution to financing the US deficit is also politically hard to swallow as tensions for global supremacy grow, despite making sense from a fiscal and monetary policy aspect. Finally, China views America's global economic influence as an unfair advantage, whether through its ability to impose unilateral financial sanctions, or through its influence at the World Bank and the IMF where it holds veto power[22].

Actively promoting the renminbi as an international currency has been a Chinese policy since at least the end of the 2008 Global Financial Crisis. Several initiatives have been conducted to this effect, including signing RMB swap line agreements with 36 foreign Central Banks[23]; setting up a native international payment system to compete with SWIFT in 2015, the Cross-Border Interbank Payment and Clearing (CIPS)[24]; or getting the RMB included in the IMF's Special Drawing Rights basket in 2016[25]; China has also established a trading center for RMB-denominated oil futures, the Shanghai International Energy Exchange (INE) in 2018[26].

Despite some successes in growing the currency's role for international payments, progress to internationalization has been limited. China's capital controls are the main culprit. Set up to prevent uncontrollable inflows and outflows of currency that could destabilize the economy, they ensure China is able to control how much the RMB appreciates or depreciates. The combination of maintaining a (loose) dollar peg and keeping capital accounts closed allows China to set its own interest rates, rather than having to follow those of the US Fed, thus providing more leeway for the People's Bank of China to intervene in times of economic busts and booms. These controls have dampened investors' confidence in their ability to repatriate funds. More fundamentally, they have prevented foreign exporters to China from accepting payments in RMB from the moment they cannot be easily converted or confidently reinvested in the Chinese economy.

Recent developments may signal things are about to change. For one, China's economy has been reducing its reliance on exports since 2006. Representing more than 37% of GDP in 2007, exports accounted for less than half of that by the end of 2019. While it is too early to tell whether the renewed growth in domestic consumption since 2010 is the beginning of a long-term trend (Figure 4), there is no ambiguity that this is the objective: China is expected to prioritize the expansion of its domestic economy in the 14th Five Year Plan (2021-2025)[27]. Reduced reliance on exports should reduce the urge to prevent the renminbi's appreciation (to some extent) which should in turn remove currency stability concerns among RMB holders.

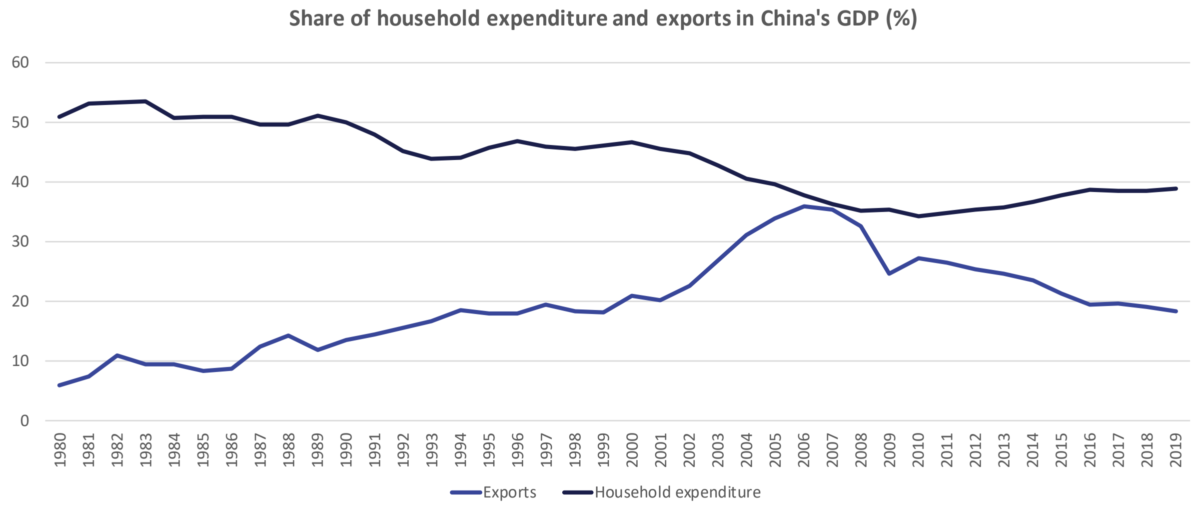

Figure 4: Evolution of China's GDP Composition in terms of final consumption and exports.
Source: World Bank

Other initiatives to internationalize the renminbi include the launch of a "Digital Yuan" backed by the People's Bank of China, which is expected to spur cross-border payments, particularly in the Belt and Road Initiative countries, by making such payments faster and less costly. China is also continuing to liberalize its capital markets and the legal regime related to foreign investment. In 2019, restrictions on market entry for certain industries was lifted, while the Foreign Investment Law of 2020 made business set-up and capital repatriation easier[28]. In the same year access to China's financial markets was further opened for foreign financial institutions, which saw the inclusion of Chinese equities and bonds into major global indices. Since February 2021, trade settlements and fund transfers in RMB have been simplified[29]. Going forward, the intention remains to continue opening the capital account and China's broader financial sector, as outlined by China's foreign exchange regulator in early January 2021[30].

Some of these measures appear to have bore fruit. According to UNCTAD, 2020 saw China secure the largest FDI inflows, outranking the USA. In a year when FDI into China increased by more than 15% year on year, FDI to the United States dropped by close to 50%, from $251 Billion to $134 Billion[31]. More generally, China has proved to be particularly resilient in the face of the pandemic, being the only major economy demonstrating GDP growth in 2020 with minimum fiscal and monetary stimulus. Recent projections by the Centre for Economics and Business Research, a UK think-tank, see China becoming the largest global economy by 2028[32]. These measures combined with further liberalization are bound to erode the USD's dominance as a reserve currency, in line with the predictions of Morgan Stanley which sees the RMB rise to between 5% and 10% of global foreign exchange reserve assets by 2030, versus the current 2%[33].

4. The Gulf security factor and balancing the US relationship

Until now, GCC countries have accepted to trade their flexibility to set monetary policy for currency stability; and they have accepted to continue getting paid in USD for their dominant exports (hydrocarbons), knowing that their surplus dollars are getting invested in one of the most dynamic economies (the US).

China has already requested some major oil exporters in the Gulf if they would accept oil payment in renminbi. They have refused, citing risks to the strategic partnership with the United States as the main reason[34]. Indeed, the role of the United States as the guarantor of Gulf security is crucial for GCC hydrocarbon exporters given, among others, the tensions with Iran. Persistent security concerns require continued and significant expenses on military hardware, maintenance, and training, which are bound to be provided by the United States given compatibility requirements with existing systems and platforms. There is also a widespread belief that starting to trade oil in another currency than the dollar will significantly deflate the latter. For Dr. Yaqoub Al Abdullah, Assistant Professor of Finance at Kuwait University, the United States would never allow such a move by Gulf States[35].

Our view is that America's role in the Gulf is largely unconditional. While America's energy independence has been touted as the driver of what was once coined its "Pivot to Asia", this should not be interpreted as a geostrategic refocus away from the Middle East. The region remains key for the United States, driven by an array of factors including guaranteeing Israel's security and to a lesser extent sustaining a market for lucrative arms sales. But above all, Gulf hydrocarbon exporters are key to America, its allies and competitors alike. Any disruption to Gulf oil flows can have major effects on oil prices, affecting the global economy including the American economy. In this context, the United States cannot risk disruptions to global supplies. With OPEC projecting oil demand to increase by around 10% between 2019 and 2045[36], ensuring oil keeps flowing from the Gulf to the world is set to remain a priority of the United States. And if there was any doubt, the Biden administration has recently reiterated its commitment to Gulf security[37]. There is also no viable alternative. Europe suffers from the absence of an integrated military capability, despite the aspirations of some for a continental military force. China, for its part, is unlikely to take on the role of a Gulf security guarantor, given it seeks to diversify its energy sources away from the Gulf[38] and given its history of refusing to be involved in naval patrols in the Gulf[39]. Its ambivalent position regarding Iran also makes it unlikely to be considered a trusted party by GCC States. To use Obama's terminology, China will continue to "free-ride" on the back of America, accessing hydrocarbon supplies from both the Arab and Persian[40] shores of the Gulf while the US Navy continues to foot the security bill.

There is also little America could do to counter a move to price oil in RMB. On the one hand, the Biden administration marks America's ostensible return to self-righteousness and with it, a potentially less permissive attitude towards the perceived human rights or foreign policy excesses of Gulf States. However, while the United States could well raise its concerns in these areas as a retribution for a change in the oil trading currency, it has limited wiggle-room: any harsh penalties imposed by the US on Gulf States would give further arguments to those advocating an even closer relation with China. And the arguments abound: China has a massive economic potential, the yield of its treasuries are currently thrice the US level, and the pace of reform of its capital markets is accelerating. We also see limited chances of Gulf-held US Treasuries being frozen as this would set an unacceptable precedent that could greatly undermine the American economy.

China undoubtedly is aware of these constraints. Its insistence on paying for Gulf oil with RMBs could grow and would leave little negotiation room for exporters, especially if it is able to further diversify supply. We assess how this scenario would unfold in the next section.

5. Preparing for a plausible scenario: RMB denominated oil trade

We assess the plausibility of RMB denominated oil trade, the implications it would have for a GCC State using Saudi Arabia by way of example, and how the scenario would unfold. As is made apparent in the description below, the outcome is the necessity to review the USD peg in favor of a broader currency basket including the RMB.

Plausibility:
High plausibility, given China has already requested to pay for oil in RMB. Saudi Arabia's relatively high dependency on China for oil exports, and the fact that China has alternatives (Russia, Venezuela, Iran, the United States itself, plus some shale reserves in the Tarim basin in Xinjiang province) gives it means of pressure. With Russia having divested from most of its US Treasury holdings, Russia may accept to be paid in RMB, putting more pressure on other exporters to follow suit.

Saudi Arabia's position:
As described earlier, accepting Chinese demands could risk undermining the strategic partnership with the USA, given (a) fewer investments in US Treasuries by Saudi Arabia; (b) setting a precedent for other oil exporters to use another currency than the dollar. This would deflate the dollar, making the import of Chinese and other non-USD denominated foreign goods and services more expensive given the USD-pegged Saudi Riyal. Resulting imported inflation would reduce spending power of citizens, who would seek higher salaries. Given the sheer size of the public sector, this would put significant fiscal pressure on the government, should it acquiesce to increase salaries and welfare, worsening the existing fiscal deficit. Saudi Arabia would also reconsider the economic rationale for continuing to hold US Treasuries itself if a long-term downward trend is expected in the USD. This would warrant a review of the dollar peg towards a more diversified basket which would include the RMB.

How the scenario would unfold:
Were trade terms between buyers and sellers be referenced in RMB, all the parties involved would need to hold RMBs in their accounts. The share of RMBs held in Chinese banks and offshore centers would grow. Since China alone imports around 10 million b/d of oil[41], the RMB-based Shanghai International Energy Exchange would become a major international market, at par with the London Brent based market. The trading of future oil and gas deliveries could be based on either Iranian, Saudi or Iraqi crude, and Qatar LNG for natural gas. It could also change the indexes used by the Saudis and the other Gulf producers, especially Iraq: oil pricing to the Far East is currently based on the DME Oman index (USD), as well as the USD prices reported by S&P out of Dubai. If oil was to be quoted in RMB, the Shanghai RMB reference price would become the major index for sale of crude to China and could also start being used by buyers in Japan and Korea (for instance, in a first place to cover positions in RMB even if contracts are in USD, and eventually leading to more physical contracts in RMB). Such volumes of transactions would give the RMB oil transactions a life of their own, with the USD playing catch up in the Asian market. Ultimately, the price of oil and gas would become unrelated to the USD dollar. As Gulf Central Banks would become major holders of RMBs, their influence on American and European exporters would grow. Rather than receiving goods and services quotes in USD or Euros, they would be able to request RMB denominated prices to match the balances which GCC States and GCC state-owned companies selling to China would have. In turn this would force Gulf importers to buy RMBs to settle their Letters of Credit.

This would put further pressure on the USD. The RMB would likely appreciate versus the USD and EUR, benefiting American and European manufacturers relative to Chinese products, but also hemming in the US treasury's ability to manage its trade deficit and how it manages its debt, ultimately substantially increasing its borrowing costs. It would also imply that the USD cash reserves of the Gulf states and Gulf institutions decline in favor of RMB, thereby limiting their availability for international debtors. In particular this would limit the USD-pegged GCC currencies, which would have to consider changing their peg to a basket of currencies more reflective of their trade patterns, i.e. include in the peg a large percentage of RMBs. With a reduced reliance on the dollar, Gulf States would have more leeway to control interest rates and set a more independent monetary policy. Therefore, an internationalization of the RMB would require the financial institutions of the Gulf to evaluate extensively the economic impact on their economies.

The Way Forward

Caught between the two superpowers of China and the United States, Gulf States should continue balancing their relationship with each for as long as possible. In the short-term, they are unlikely to have to make a binary choice. When it comes to hydrocarbon trade, there could be a middle ground which accommodates the requirements of China while maintaining their strategic partnership with the United States. Given the sizeable imports the GCC has from China, a first step could be to limit the amount of hydrocarbon sales in RMB to cover RMB-denominated import needs. This would minimize the excess holdings of RMBs, removing currency risk. Currency futures could be used to further hedge against RMB fluctuations, especially important if the RMB was to become a free-floating currency down the road. RMB reserves would nevertheless become a necessity for GCC States. In the current context of significant fiscal deficits and a drawdown in USD denominated reserves, it is likely that such a development would give further impetus to reviewing the dollar peg.

As such, accepting to trade oil in RMB should be an outcome which needs to be carefully planned and prepared for. We outline below what this entails in terms of preparatory measures.

- Assess current and expected trade flows with the major trading blocs (including the United States, Europe, China, and the Asian countries constituting the larger Regional Comprehensive Economic Partnership (RCEP)) to guide the future strategy for foreign reserves. Such an assessment should be conducted for the long-term, accounting for the policies of partner countries notably in terms of carbon neutrality and the implication this will have on their oil and gas imports.
- Estimate requirements for RMB reserves under different scenarios for hydrocarbon exports to China and Asia, and under different scenarios of goods and services import requirements from China. These will determine the volume of RMB outflows required and what portion of those can be covered by inflows from RMB-denominated hydrocarbon sales.
- Assess the monetary and fiscal impact of a partial realignment with RMB as a reserve currency, with regards to the value of the USD, the GCC USD denominated investments currently held, inflation, and FDI prospects.
- Define under which conditions / thresholds a review of the dollar peg would be required, and how a new peg could be defined, in particular the currency mix that could be followed.
- Closely monitor China's capital market reforms and monetary policy, to ensure any impact on the USD can be anticipated early enough to minimize disruptions in the domestic monetary policy of GCC states.

While there is much to be done, GCC policymakers have the benefit of time being to some extent on their side, at least until China starts pressing for RMB-denominated oil payments.

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