Rodney's Take

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The Yuan Starts Nipping at the Dollar

Last week, the Chinese completed the first liquified natural gas (LNG) transaction on the Shanghai Petroleum and Natural Gas Exchange to be settled in yuan. Chinese state oil and gas company CNOOC (China National Offshore Oil Corporation) imported 65,000 tons of LNG from the United Arab Emirates to the exchange, which subsequently sold the gas to TotalEnergies, a French energy supermajor.

In the scheme of global daily energy transactions, this one was tiny. But it sets a precedent that doesn't bode well for the exorbitant privilege we enjoy with the greenback.

As I wrote in the *Rodney Johnson Report* last year, since the 1970s, the U.S. has benefited by providing security for Middle Eastern countries in exchange for their pledge to denominate energy transactions in dollars. This guaranteed a steady stream of dollar buyers who needed the buck to buy oil, which the Middle Eastern countries then used to invest around the world. With the U.S. distancing itself from our long-time Middle Eastern allies over the last two years, this relationship was sure to fray—and, of course, the Chinese are standing at the ready to pick up the slack.

As the Shanghai exchange increases trade, international players will need fewer dollars, which eventually will weigh on the value of the dollar and push interest rates higher. This won't happen in the next year or two, but it's on the horizon.

It's not surprising that it's happening, it's surprising that the first client was French. Et tu, Brute?

While we did ourselves no favors by dressing down the Saudis and others in recent years, the Russian invasion of Ukraine is more likely than anything else to have brought this transition forward. Everyone knew that Europeans banning Russian energy trading simply would lead to workarounds, which again, China (along with India) is only too happy to provide. The Chinese take delivery of Russian energy, either directly or through surrogates, and then mix it with existing supply and call it "blended." At that point, the Russian provenance falls away and the energy is ready to be sold to European clients or anyone else. The controls on Russian energy sales exist only in the minds of Western politicians.

Once the door to the Shanghai Exchange is open, it's unlikely to close, but it won't be all sunshine and roses for those choosing to take their business to the Middle Kingdom. China maintains tight controls on its financial system, including on the flow of currency. Anyone who commits to use yuan to buy LNG, gas, oil, or diesel puts themselves at the mercy of a possible adverse financial decision by the People's Bank of China (PBoC), which is controlled by the Chinese Communist Party. U.S. leaders might badmouth other nations and leaders, but they don't devalue the currency whenever they feel like it or turn the screws on short sellers in the Hong Kong market.

And then there's the question of what the yuan is worth in the first place.

While governments, institutions, and investors around the world decide the value of the dollar through trading, the PBoC sets a trading range every day for the yuan. And that range is expressed in dollars (such as 6.86 to 6.88 yuan per dollar). If the Chinese want to strengthen their currency, they set a lower limit, so that it takes fewer yuan to buy a dollar, and vice versa. While the Chinese consider their current economic condition when setting currency exchange rates, because they set their exchange against the dollar, they must also evaluate the strength or weakness of the dollar at the same time. Clients who use the Shanghai exchange to add diversity to their portfolios might not be getting such a good deal.

International trading partners might try cryptos to avoid country bias, but the swings are so wild as to make that untenable. After 50 years without it, we could be on the cusp of bringing back trade based in that barbaric metal, gold.

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Got a question or comment? You can contact us at info@hsdent.com.