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Has the Petrodollar Had Its Day?

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Dr Salameh has presented papers to numerous international energy conferences on the economics and geopolitics of oil and energy and has been frequently invited to lecture on these topics at universities around the world. He has written three books on oil: **"Is a Third Oil Crisis Inevitable?"** (published in London in April 1990), **" Jordan's Energy Prospects & Needs to the Year 2010: The Economic Viability of Extracting Oil from Shale"** (published in London in October 1998) and " **Over a Barrel"** (Published in the UK in June 2004) as well as numerous research papers published in international Oil and Energy Journals. Dr Salameh has undertaken research assignments for the US Department of Energy, the World Bank, the Institute of Energy Economics in Japan, the Indian Government, OPEC, the Canadian Energy Research Institute, Boston University working on the Encyclopedia of Energy and also the Handbook of Energy and the government of Jordan among others. He regularly appears on TV to discuss oil prices and other developments in the global oil market.

Dr Salameh is a member of many International Institutes and Associations including the International Association for Energy Economics (IAEE) in the US, the British Institute of Energy Economics, the International Energy Foundation in Canada, the International Institute for Strategic Studies (IISS) in London, and the Royal Institute of International Affairs (RIIA) in London. He is also an advisor to the Oil Depletion Analysis Centre (ODAC), London.

Has the Petrodollar Had Its Day?

By

Dr Mamdouh G Salameh*

Abstract

The petrodollar came into existence in 1973 in the wake of the collapse of the international gold standard which was created in the aftermath of World War II under the Bretton Woods agreements. These agreements also established the US dollar as the reserve currency of the world. The Nixon Administration understood that the collapse of the gold standard system would cause a decline in the global demand for the US dollar. Maintaining demand for the US dollar was vital for the United States' economy. So the United States under Nixon struck a deal in 1973 with Saudi Arabia. Under the terms of the deal, the Saudis would agree to price all of their oil exports in US dollars exclusively and be open to investing their surplus oil proceeds in US debt securities. In return, the United States offered weapons and protection of Saudi oilfields from neighbouring countries including Israel. For the Americans, the petrodollar increases demand for the dollar and also for US debt securities and allows the US to buy oil with a currency it can print at will. In 1975, all of the OPEC nations agreed to follow suit. Maintaining the petrodollar is America's primary goal. Everything else is secondary. This paper will deal with the actions, incentives, and related consequences that the United States has created through its attempts to maintain global hegemony through the petrodollar. It will examine the latest challenges facing the petrodollar and how the petrodollar system influences the United States' foreign policy. The paper will conclude that the petrodollar has had its day and that it will be a matter of time before it becomes redundant with huge repercussions for the US economy and the global economy.

Key Words: Petrodollar, Yuan, Reserve Currency, Inflation, Federal Reserve.

Introduction

The petrodollar came into existence in 1973 in the wake of the collapse of the international gold standard which was created in the aftermath of World War II under the Bretton Woods agreements. These agreements also established the US dollar as the reserve currency of the world. Former president Richard Nixon and his then foreign secretary Henry Kissinger understood that the collapse of the gold standard system would cause a decline in the global demand for the US dollar.

Maintaining that "artificial dollar demand" was vital for the United States' economy. So the United States under Nixon struck a deal in 1973 with Saudi Arabia under which every barrel of oil purchased from the Saudis would be denominated in US dollars only. Any country that sought to purchase oil from Saudi Arabia would be required to first exchange its own national currency for dollars. Under the terms of the deal, the Saudis would agree to price all of their oil exports in US dollars

exclusively and be open to investing their surplus oil proceeds in US debt securities. In exchange, the United States offered weapons and protection of Saudi oilfields from neighbouring countries including Israel.

For the Americans, the petrodollar increases demand for the dollar and also for US debt securities and allows the US to buy oil with a currency it can print at will. Maintaining the petrodollar is America's primary goal. Everything else is secondary. Without it, the US dollar would collapse. **1**

In 1975, all of the OPEC nations agreed to follow suit. However, as the US dollar continued to lose purchasing power, several oil-producing nations began to question the wisdom of accepting increasingly worthless paper currency for their own oil exports. Today, several countries have attempted to move away from the petrodollar, or already moved away. Examples include Iraq under Saddam Hussein, Iran, Syria and Venezuela. Additionally, other nations are choosing to use their own currencies for oil like China, Russia and India. The petrodollar created an immediate demand for US dollar around the globe thus enhancing its artificial value. And of course, as global oil demand increased, so did the demand for the dollar. As more countries continue to move away from the petrodollar, massive inflationary pressures could be expected to strike the US economy. **2**

What is Petrodollar?

The Petrodollar is the money that oil-exporting nations receive from selling their oil in US dollar-denominated currency which is deposited into Western banks. The term was first coined by Egyptian-born American economist, Professor Ibrahim M Oweiss of Georgetown University in a pioneering work on petrodollar surpluses in 1974. **3**

Under the Bretton Woods agreements, the US Dollar was pegged at a fixed rate to gold. This made the US dollar completely convertible into gold at a fixed rate of $35 per ounce within the global economic community. This international convertibility into gold allayed concerns about the fixed rate regime and created a sense of financial security among nations in pegging their currencies' value to the dollar. After all, the Bretton Woods arrangements provided an escape hatch: if a particular nation no longer felt comfortable with the dollar, they could easily convert their dollars holdings into gold. This arrangement helped restore a much-needed stability in the financial system. But it also created a strong global demand for US dollars as the preferred medium of exchange (see Figure 1).

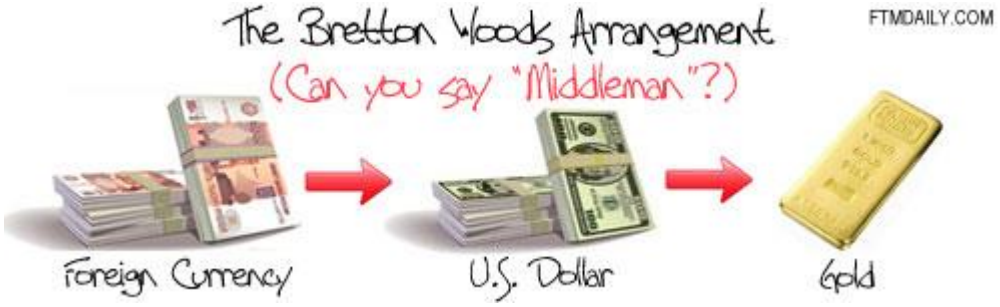
And along with this growing demand for US Dollars came the need for a larger supply of dollars.

The United States government benefits from a global demand for US dollars. How? It's because a global demand for dollars gives the Federal government a "permission" to print more. Is it a coincidence that printing dollars is the US government's preferred method of dealing with its economic problems?

One has to remember that Washington only has four basic ways to solve its economic problems: (1) Increase revenue by raising taxes; (2) Cut spending by

reducing benefits; (3) Borrow money through the issuance of government bonds and (4) Print money.

Figure 1



Source: Courtesy of Jerry Robinson, FTM Daily.com.

Raising taxes and making meaningful spending cuts can be political suicide. Borrowing money is a politically convenient option, but you can only borrow so much. That leaves the final option of printing money. Printing money requires no immediate sacrifice and no spending cuts. However, printing more money than is needed can lead to inflation. Therefore, if a country can somehow generate a global demand for its currency, it will have a "permission" to print more money. Understanding this "permission" concept will be important as we continue.

Finally, the primary beneficiary of an increased global demand for the US Dollar is America's central bank, the Federal Reserve. To put it simply, the Federal Reserve has a clear vested interest in maintaining a stable and growing global demand for US Dollars because they create them and then earn profit from them with interest rates which they set themselves.

In summary, the American consumer, the Federal government, and the Federal Reserve all benefit to varying degrees from a global demand for US Dollars. There is an old saying that goes, "He who holds the gold makes the rules." This statement has never been truer than in the case of America in the post–World War II era. By the end of the war, nearly 80% of the world's gold was sitting in US vaults, and the U.S. Dollar had officially become the world's undisputed reserve currency. **4**

As a result of the Bretton Woods arrangements, the dollar was considered to be "as safe as gold."

A study of the United States economy in the post-World War II era demonstrates that this was a time of dramatic economic growth and expansion. By the late 1960's, however, the American economy was under major pressure. Deficit spending in Washington was uncontrollable as former US President Lyndon B. Johnson began to realize his dream of the "Great Society." Meanwhile, an expensive and unpopular war in Vietnam funded by record deficit spending led some nations to question the economic underpinnings of America. Vietnam, the Great Society, and deficit Spending undermined the gold standard.

By 1971, as America's trade deficits increased and its domestic spending soared, the perceived economic stability of the United States was being publicly challenged by

many nations around the globe. Foreign nations could sense the severe economic difficulties mounting in Washington as the United States was under financial pressure at home and abroad. According to most estimates, the Vietnam War had a price tag in excess of $200 billion. This mounting debt, plus other debts incurred through a series of poor fiscal and monetary policies, was highly problematic given America's global monetary role. **5**

But it was not America's financial issues that most concerned the international economic community. Instead, it was the growing imbalance of US gold reserves to debt levels that was most alarming.

The United States had accumulated large amounts of new debts but did not have the money to pay for them. Making matters worse, US gold reserves were at all-time lows as nation after nation began requesting gold in exchange for their dollar holdings. It was almost as if foreign nations could see the writing on the wall for the end of the Bretton Woods arrangements.

As 1971 progressed, so did foreign demand for US gold. Foreign central banks began cashing in their excess dollars in exchange for the safety of gold. As nations lined up to exchange their dollar holdings for Washington's gold, the United States realized that the game was over.

Soon the United States was bleeding gold. Washington knew that the system was no longer viable, and certainly not sustainable. But what could they do to stem the crisis? There were only two options. The first option would require that Washington immediately reduce its massive spending and dramatically reduce its existing debts. This option could possibly restore confidence in the long-term viability of the US economy. The second option would be to increase the dollar price of gold to accurately reflect the new economic realities. There was an inherent difficulty in both of these options that made them unacceptable to the United States at the time. They both required fiscal restraint and economic responsibility. Then, as now, there was very little appetite for reducing consumption or changing the American way of life for the sake of "sacrifice" or "responsibility."

On August 15, 1971, under the leadership of former President Nixon, Washington chose to maintain its reckless consumption and debt patterns by detaching the US Dollar from its convertibility into gold. By "closing the gold window," Nixon destroyed the final vestiges of the international gold standard. Nixon's decision effectively ended the practice of exchanging dollars for gold as directed under the Bretton Woods agreements. It was in the year 1971, that the US dollar officially abandoned the gold standard and was declared a purely "fiat" currency, a currency which derives its value from its sponsoring government and is issued and accepted by decree. **6**

By "closing the gold window," Washington had not only affected American economic policy but also global economic policy. Under the international gold standard of Bretton Woods, all currencies derived their value from the value of the dollar. And the dollar derived its value from the fixed price of its gold reserves. But when the dollar's value was detached from gold, it became what economists call a "floating" currency". Put simply, a "floating" currency is a currency that is not fixed in value.

Like any commodity, the dollar could be affected by the market forces of supply and demand. When the dollar became a “floating” currency, the rest of the world’s currencies, which had been previously fixed to the dollar, suddenly became “floating” currencies as well.

In this new era of floating currencies, the US Federal Reserve had finally freed itself from the constraint of a gold standard. Now, the US dollar could be printed at will — without the worry of not having enough gold reserves to back up new currency production. And while this new-found monetary freedom would alleviate pressure on America’s gold reserves, there were other concerns. One major concern that Washington had was regarding a potential shift in global demand for the US dollar. With the dollar no longer convertible into gold, would demand for the dollar by foreign nations remain the same, or would it fall?

The second concern had to do with America’s extravagant spending habits. Under the international gold standard of Bretton Woods, foreign nations gladly held US debt securities, as they were denominated in gold-backed US dollars. Would foreign nations still be eager to hold America’s debts despite the fact that these debts were denominated by a heavily indebted paper currency? Once one understands this “dollars for oil” arrangement, it becomes easier to get a better understanding of what motivates America’s foreign policy.

Dollars for Oil Replace Dollars for Gold

Like previous governments before it, America had figured out how to "game" the global reserve currency system for its own benefit, leaving foreign nations in an economically vulnerable position. Instead of seeking solutions to the global economic imbalances that had been created by America's excessive deficits, Washington's primary concern was how to gain an even greater stranglehold on the global economy.

In order to ensure their economic hegemony, and thereby preserve an increasing demand for the dollar, the Washington elites needed a plan. And in order for this plan to succeed, it would require that the artificial dollar demand that had been lost in the wake of the gold standard collapse be replaced through some other mechanism. That plan came in the form of the petrodollar system.

The Primary Benefits of the Petrodollar for the United States

The petrodollar system has proven tremendously beneficial to the US economy. In addition to creating a marketplace for affordable imported goods from countries who need US dollars, there are more specific benefits. In essence, America receives a double loan out of every global oil transaction.

The petrodollar system provides at least three immediate benefits to the United States. It increases global demand for US dollars. It also increases global demand for US debt securities and it gives the United States the ability to buy oil with a currency it can print at will. Let's briefly examine each one of these benefits.

One of the most brilliant aspects of the petrodollar system was requesting that oil producing nations take their excess oil profits and place them into US debt securities. This system would later become known as "***petrodollar recycling***" as coined by Henry Kissinger. Through their exclusive use of dollars for oil transactions, and then depositing their excess profits into American debt securities, the petrodollar system is a "dream come true" for a spendthrift government like the United States.

Another major benefit of the petrodollar system has to do with the actual purchase of oil itself. With oil priced in US dollars, America can literally print money to buy oil and then have the oil producers hold the debt that was created by printing the money in the first place. What other nation, besides America, can print money to buy oil?

Petrodollars & Petrodollar Surpluses

Since petrodollars and petrodollar surpluses are by definition denominated in US dollars, then purchasing power is dependent on the US rate of inflation and the rate at which the U.S. dollar is exchanged by other currencies in international money markets. It follows that whenever economic or other factors affect the US dollar, petrodollars will be affected to the same magnitude. The link, therefore, between the US dollar and petrodollar surpluses, in particular, has significant economic, political, and other implications.

First, the placement of petrodollar surpluses of the Arab oil exporting nations in the United States may be regarded politically as *hostage capital*. **7** In the event of a major political conflict between the United States and an Arab oil-exporting nation, the former with all its military might can confiscate or freeze these assets or otherwise limit their use. The US government resorted to such weapons twice in the l980s against Iranian and Libyan assets. It follows, therefore, that governments placing their petrodollar surpluses in the United States may lose part of their economic and political independence. Consequently, the more petrodollar surpluses are placed in the United States by a certain oil-exporting nation, the less independent such a nation becomes.

Second, an oil-exporting country can have petrodollar surpluses only if its absorptive capacity is less than its earnings from the sale of' oil for any particular period of time. It follows, therefore, that petrodollar surpluses depend on oil prices, volumes exported, and the nation's absorptive capacity.

Third, petrodollar surpluses do not represent *real wealth* but rather are a vehicle by which the latter can be acquired. If kept in liquid form such as paper dollars, their purchasing power will gradually be eroded by inflation and adverse foreign exchange rates. Both are affected in the United States by a host of economic variables such money supply, interest rates, marginal productivity and balance-of-payments deficit. Therefore, the purchasing power of petrodollar surpluses belonging, for example, to Arab oil-exporting nations is determined by factors that are not in the control of these countries. **8**

Fourth, efficient allocation of petrodollars for internal investments could increase the productive capacity of an oil-exporting nation and may work to its relative advantage.

However, dependency on imported consumer goods promotes the export of limited oil resources that could have been otherwise used for internal capital development.

Fifth, the economic development of an oil-exporting nation is based on the conversion of its oil resources into other assets such as wealth-creating projects, diversification, education, technology, infrastructure, and other forms of real wealth, that is, real capital stock. An optimum conversion rate is achieved when oil is pumped at a level that can maximize the conversion process. By pumping oil in excess of an optimum production rate, the Arab Gulf oil-producing countries accumulated petrodollar surpluses until 1981. After that the petrodollar surpluses have turned into deficits. That was the time when Sheikh Ahmad Zaki Yamani flooded the global oil market with oil causing the oil price to collapse to around $10/barrel. It is worth noting that the difference between the volume of oil actually supplied and the volume that should have been supplied in observance of standard microeconomic theory is in fact *a subsidy granted, in real terms,* to oil-importing nations such as the United States, Germany, France, and Japan. **9**

Allocation of Petrodollar Surpluses

The bulk of petrodollar surpluses is held either in US treasury bills and other short-term instruments or in American and Western European banks. Petrodollar surpluses have also been used to increase the official reserves of the oil-exporting countries at both the International Monetary Fund and the International Bank for Reconstruction and Development.

Petrodollar surpluses have been recycled by commercial banks in the United States and other industrialized nations as well as by international institutions. By drawing against petrodollar surpluses as deposits or certificates of deposits, banks were able to expand their volume of lending. For bankers the most obvious clients were the developing countries, mainly in Latin America, such as Mexico, Brazil, and Argentina.

According to US Treasury information, petrodollar surpluses have turned into deficits since 1982. There are three main reasons for this turn of events: increase in imports by oil-exporting nations; reduction in the demand for oil, particularly from OPEC; and the oil glut which led to a reduction in its price.

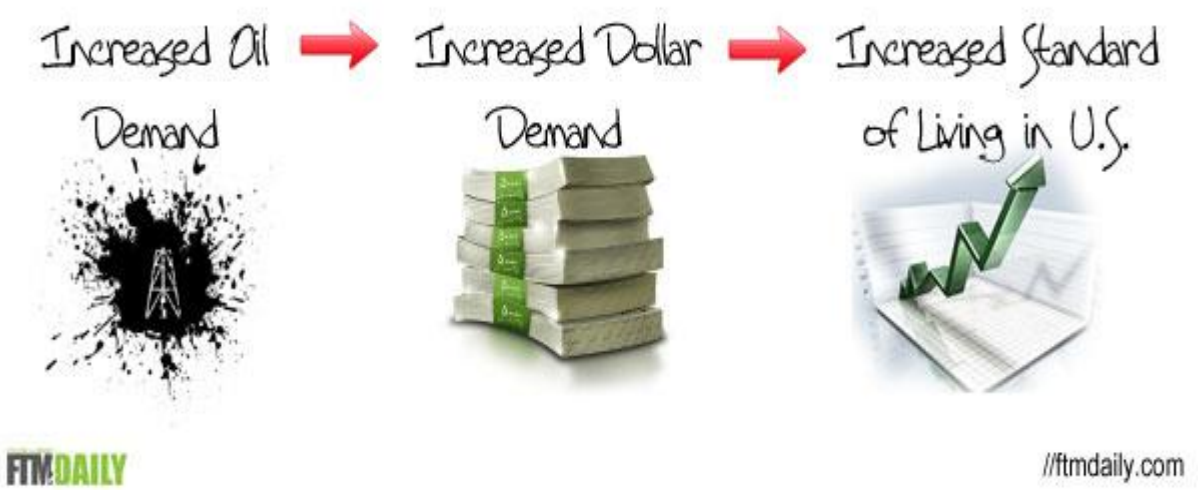
The Petrodollar Wars: Iraq & Libya

The world currently consumes 92 million barrels of oil per day (mbd) and this is projected to rise to 97 mbd by 2020. And thanks to the petrodollar system, growing global demand for oil leads to an increase in US dollar demand. This artificial demand for US dollars has provided remarkable benefits for the US economy. It has also required the Federal Reserve to keep the dollar in plentiful supply (see Figure 2).

On September 11, 2001, America’s relations with the Middle East would be altered forever. The tragic events of that day still live on in the memory of the world.

Interestingly, just five hours after American Airlines Flight 77 crashed into the Pentagon, former US Secretary of Defence Donald Rumsfeld began ordering his staff to develop plans for a strike on Iraq despite the fact that there was absolutely no evidence linking the country, or its leader Saddam Hussein, to the 9/11 attacks. **10**

Figure 2



Source: Courtesy of FTMdaily.com

On September 12, 2001, despite zero evidence against Iraq, Defence Secretary Rumsfeld proposed to former president George W. Bush that Iraq should be "a principal target of the first round in the war against terrorism." Bush, along with his other advisors, including Deputy Secretary of Defence Paul Wolfowitz, strongly supported the idea that Iraq should be included in their attack plans.

In fact, Washington had already been preparing for an invasion of Iraq. The Los Angeles Times reported that one year prior to the attacks of 9/11, the US began in April 2000 constructing Al Adid, a billion-dollar military base in Qatar with a 15,000-foot long runway. What was Washington's stated justification for the new Al Adid base, and other similar ones in the Gulf region? Preparedness for renewed action against Iraq.**11**

It would later be revealed that an invasion of Iraq was at the top of the Bush administration's agenda only 10 days after his inauguration, which was a full eight months before 9/11. **12**

So why Iraq? Why the rush to war with a country that so obviously had no connection with the events of 9/11?

On September 24, 2000, Saddam Hussein allegedly emerged from a meeting of his cabinet and proclaimed that Iraq would soon switch its oil export transactions from

the petrodollar to the euro. By 2002, Saddam had fully converted to a petroeuro – in essence, dumping the dollar. On March 19, 2003, George W. Bush announced the commencement of a full scale invasion of Iraq.

Saddam's bold threat to the petrodollar system had invited the full force and fury of the US military onto his country. Or was America's stated purpose to "liberate" the Iraqi people from a brutal regime actually a clever guise for making an example of a nation which dared threaten the existing petrodollar system? However, it would be naïve to assume that this was the real reason for the invasion of Iraq in 2003. The real reason was oil. **13** Even Alan Greenspan the former chairman of the Federal Reserve Board for 17 years, concurs. **14**

It should be noted that Iraq's proven oil reserves are considered to be among the largest in the world. Some experts believe that Iraq's oilfields, many of which have yet to be exploited, will catapult Iraq above Saudi Arabia in total proven oil reserves in the coming years.

The petrodollar has caused much ire for many nations due to the power it gave the US. Interestingly, anyone who challenged the petrodollar did not fair well.

In Libya, US-backed rebels toppled Muammar Gaddafi who proposed a gold-backed African currency that would be traded for African oil. Moreover, Russian president Putin is under scrutiny for his push towards a Yuan-Ruble oil trading system. **15**

Defending the Petrodollar System

A simple examination of America's foreign policy efforts in the wake of the 'oil shock' of 1973 and in the ensuing foundation of the petrodollar system in the mid-1970s, makes it painstakingly clear to any casual political observer that a central goal of Washington has been to control global oil supplies, specifically in the Middle East.

After the 1973 'oil shock', former president Nixon warned US citizens "that American military intervention to protect vital oil supplies" in the region, was a strong possibility.

On 23 January 1980, former US president Jimmy Carter proclaimed in his State of the Union Address the "Carter Doctrine" which stated that the United States would use military force if necessary to defend its national interests in the Persian Gulf.

By January 1, 1983, the United States created the Central Command (CENTCOM) with the stated mission of acting as a deterrent (primarily against the Soviets) and to help maintain regional stability and the flow of oil from the Arab Gulf to the United States and other western allies (see Figure 3). After all, maintaining a global order dependent upon a "dollars for oil" system is no cheap task and requires careful monitoring and oversight of the world's oil supplies.

Figure 3

Putin's Revenge: Russia is Actually Abandoning the Petrodollar

Sanctions were imposed on Russia after its intrusion into the Ukraine in February 2014 and the ensuing annexation of the Crimea. Even before sanctions were introduced, Russia was already in the process of reorienting its energy posture to Asia in view of the growth in energy demand in that continent and the likely stagnation or decline of demand in Europe over the next few decades. **16**

Angered by the sanctions, the Russians began considering action against the United States. They are actually making a move against the petrodollar. It appears that they are quite serious about their de-dollarization strategy. The largest natural gas producer on the planet, Gazprom, has signed agreements with some of their biggest customers to switch payments for natural gas from US dollars to euros. And Gazprom would have never done this without the full approval of the Russian government which holds a majority stake in Gazprom. **17** When you are talking about Gazprom, you are talking about a company that is absolutely massive. It holds 18% of the proven natural gas reserves of the entire world, and it is also a very large oil producer. So for Gazprom to make a move like this is extremely significant. **18**

When Barack Obama decided to slap some meaningless economic sanctions on Russia a while back, he probably figured that the world would forget about them soon after. But the Russians do not forget, and they certainly do not forgive.
At this point the Russians are turning their back on the United States, and that includes the US dollar. What Gazprom is now doing has the potential to really shake up the global financial landscape.

Gazprom Neft had signed additional agreements with consumers on a possible switch from dollars to euros for payments under contracts. Nine out of ten consumers had agreed to switch to euros. **19**

And Gazprom is not the only big company in Russia that is moving away from the US dollar. According to Russia Today TV (RT), other large Russian corporations are moving to other currencies as well.

Russia will start settling more contracts in Asian currencies, especially the Chinese yuan in order to lessen its dependence on the dollar market. Diversifying trade accounts from dollars to the Chinese yuan and other Asian currencies such as the Hong Kong dollar and Singapore dollar has been a part of Russia's pivot towards Asian as tension with Europe and the US remain strained over Russia's action in Ukraine.

And expanding the use of non-dollar currencies is one of the main things that major Russian banks are working on right now. Russia's large exposure to the dollar subjects it to more market volatility in times of crisis. There is no reason why you have to settle trade you do with Japan in dollars.

Meanwhile, Russians have been pulling money out of US banks at an unprecedented pace. In March 2014, without waiting for the sanction spiral to kick in, Russians yanked their money out of US banks. Deposits by Russians in US banks suddenly plunged from $21.6 billion to $8.4 billion in one month. They'd learned their lesson in Cyprus the hard way: get your money out while you still can before it gets confiscated.**20**

What we are witnessing right now is just a turning point. The effects won't be felt right away. But this is definitely another element in the "perfect storm" that is starting to brew for the US economy.

China and Russia are together moving to create a parallel financial system, disentangled from the Western financial system. It includes creating entities such as the Asian Development Bank. One of the principal tools in the hands of Washington to control the global system has always been the International Monetary Fund (IMF).

Nations have to go to the IMF to ask for financial help when in difficulties, but recently it was China – and not the IMF – which bailed out Venezuela and Argentina and provided financial support to Russia when their currencies came under pressure. The IMF and the World Bank were no longer at the centre of the global financial order. They are being displaced by China. **21**

China Is Also Making A Move Against the US Dollar

There are indications that the Chinese are now accelerating their long-term plan to dethrone the US dollar. The truth of the matter is that China does not plan to allow the US financial system to dominate the world indefinitely. Right now, China is the number one exporter on the globe and the largest crude oil importer in the world. And soon it will have the largest economy in the world.

The Chinese would like to see global currency usage reflect this shift in global economic power. At the moment, most global trade is conducted in US dollars and more than 60% of all global foreign exchange reserves are held in US dollars. This gives the United States an enormous built-in advantage but thanks to decades of incredibly bad decisions, this advantage is starting to erode. China has begun to publicly worry about the level of US debt. Chinese officials have publicly threatened to stop buying any more US debt and have started to aggressively make currency swap agreements with other major global powers and, furthermore, China has been accumulating unprecedented amounts of gold. All of these moves are setting up the moment in the future when China will completely pull the rug out from under the US dollar.

Unfortunately for the United States, the US debt spiral cannot go on indefinitely. US debt is growing far more rapidly than GDP is, and therefore the debt is completely and totally unsustainable.

The Chinese understand what is going on, and when the dust settles they plan to be the last ones standing. In the aftermath of a US currency collapse, China anticipates having the largest economy on the planet, more gold than anyone else, and a respected international currency that the rest of the globe will be able to use to conduct international trade.

China has just entered into a very large currency swap agreement with the euro zone that is considered a huge step toward establishing the yuan as a major world currency. This agreement will result in a lot less US dollars being used in trade between China and Europe.

China is the largest producer of gold in the world, and it has also been importing an absolutely massive amount of gold from other nations. But instead of slowing down, the Chinese appear to be accelerating their gold buying. There are many who are convinced that China eventually plans to back the yuan with gold and try to make it the number one alternative to the US dollar. **22** This could have devastating effects on the US economy. Demand for the US dollar and US debt would drop like a rock, and prices would soar. If the rest of the world (led by China) starts to reject the US dollar, it would result in a massive tsunami of currency coming back to the US and a very painful adjustment in US standard of living. Today, most US currency is actually used outside of the United States.

Oil-rich Nations Are Selling off Their Petrodollar Assets

In the heady days of the commodity boom, oil-rich nations accumulated billions of dollars which they invested in US debt and other securities. Now that oil prices have

dropped by half to just over $50 a barrel, Saudi Arabia and other oil-rich nations are fast drawing down those “petrodollar” reserves.

This is the first time in 20 years that OPEC nations will be sucking liquidity out of the market rather than adding to it through investments. **23**

Saudi Arabia, the world’s largest oil producer, is a prime example of the swiftness and magnitude of the selloff: its foreign exchange reserves fell by $20.2 billion in February 2015 alone, the biggest monthly drop in at least 15 years according to data from the Saudi Arabian Monetary Agency. That’s almost double the drop after the financial crisis in early 2009 when oil prices plunged and Riyadh consumed $11.6 billion of its reserves in a single month. **24**

A concomitant drop in foreign reserves revealed in data from national central banks and the IMF, is affecting nations from oil producer Oman to copper-rich Chile. Algeria, one of the world’s top natural gas exporters, saw its funds fall by $11.6 billion in January, the largest monthly drop in a quarter of century. At that rate, it will empty the reserves in 15 months.**25**

OPEC members are expected to earn $380 billion selling their oil this year, according to US estimates. That represents a $350 billion drop from 2014 -- the largest one-year decline in history.

Are the Petrodollar’s Days Numbered?

Today, the geopolitical sands of the Middle East are rapidly shifting. The faltering strategic regional position of Saudi Arabia, the rise of Iran (which is not part of the petrodollar system), failed US interventions, Russia’s increasing power as an energy giant and the emergence of the BRICS nations (which offer the potential of future alternative economic/security arrangements) all affect the sustainability of the petrodollar system.

One needs also to be aware of what Vladimir Putin is doing. Putin would like nothing more than to sabotage the petrodollar, and he’s forging alliances across the world that he hopes will help him achieve his goal. At the same time, one should also watch the deteriorating relationship between the US and Saudi Arabia.

The Saudis are furious at what they perceive to be the US not holding up its end of the petrodollar deal. They believe that as part of the US commitment to keep the region safe for the Kingdom, the US should have attacked its regional rivals Syria and Iran by now. And they may feel they are no longer obliged to uphold their part of the deal, namely selling their oil only in US dollars. They’re already heavily involved with China and could also tilt toward Russia. Oil traded in rubles or yuans could be the future result.

The US is really not importing much Arab oil anymore. If that were the case, it’s really hard to see why the Arabs would continue to price their oil in dollars, especially that their biggest customers would be China, Japan and other Asia-Pacific countries that have no particular reason to deal in dollars.

The petrodollar system breaking down, where oil is no longer paid for in dollars internationally, essentially would be the death knell to the US dollar as the global reserve currency. It means the US may not be able to borrow with great ease anymore, and it means that the US Treasury market is set for an out-of-control interest rate spiral.

As it is, the Arab oil-producing nations have more dollars than they know what to do with. By one expert estimate, some $8–10 trillion in currency balances lie in Middle Eastern hands, much of it in dollars. How long will they want to keep all those dollars lying around especially when the Asia-Pacific region now accounts for one-third of global oil consumption and the US only 20%? **26**

Meanwhile, the world's leading oil importer -China- is doing its part to undermine the petrodollar. Last November brought word the Shanghai Futures Exchange was thinking about pricing its new crude oil futures contract in both yuan and dollars, with the aim of making that contract the new Asian benchmark.

But while the Arabs fret about the value of their dollars and the Chinese move actively to diversify away from the dollar it might be the Russians who will deliver the final blow.

The chaos that one day will ensue from the United States' 44-year experiment with worldwide fiat money will require a return to money of real value. The US will know that day is approaching when oil-producing countries demand gold, or its equivalent, for their oil rather than dollars. **27**

This is critically important, because once the dollar loses its coveted reserve status, the consequences will be dire for Americans. At that moment, Washington will become sufficiently desperate to enforce the radical measures that governments throughout world history have always implemented when their currencies were under threat.

Conclusions

Since 1980, America has devolved from being the world's greatest creditor nation to the world's largest debtor nation. But thanks to the massive artificial demand for US dollars and government debt made possible by the petrodollar system, America could still continue its spending spree, reckless wars, and record deficits.

At one point in America's history, the country's largest export was a variety of manufactured goods. Today, America's largest export is the US dollar. And the dollar costs the United States practically nothing to print. How long will it be before the nations of the world figure out that the petrodollar game is over. This shift is being accelerated by joint Chinese/Russian efforts to dethrone the US dollar as a reserve currency and also as the currency for global trade and oil transactions. Even Saudi Arabia now acknowledges the eventual end of the petrodollar probably by 2032. They are planning to invest a total of $109 bn in solar energy with the aim of becoming an exporter of solar electricity.

And while the US economy with its great power of innovation and inherent strengths, could support a powerful currency, it certainly can't support the very many trillions of dollars circulating around the world.

It is probable that the Chinese yuan will emerge as the world's reserve currency within the next two decades backed by gold, currency swap agreements, real purchasing power and Russian oil and natural gas reserves.

Footnotes

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A Short Biography

Dr Mamdouh G. Salameh is an international oil economist, a consultant for the World Bank in Washington D.C. on oil and energy and also a technical expert with the United Nations Industrial Development Organization (UNIDO) in

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Dr Salameh has presented papers to numerous international energy conferences on the economics and geopolitics of oil and energy and has been frequently invited to lecture on these topics at universities around the world. He has written three books on oil: **"Is a Third Oil Crisis Inevitable?"** (published in London in April 1990), **" Jordan's Energy Prospects & Needs to the Year 2010: The Economic Viability of Extracting Oil from Shale"** (published in London in October 1998) and " **Over a Barrel"** (Published in the UK in June 2004) as well as numerous research papers published in international Oil and Energy Journals. Dr Salameh has undertaken research assignments for the US Department of Energy, the World Bank, the Institute of Energy Economics in Japan, the Indian Government, OPEC, the Canadian Energy Research Institute, Boston University working on the Encyclopedia of Energy and also the Handbook of Energy and the government of Jordan among others. He regularly appears on TV to discuss oil prices and other developments in the global oil market.

Dr Salameh is a member of many International Institutes and Associations including the International Association for Energy Economics (IAEE) in the US, the British Institute of Energy Economics, the International Energy Foundation in Canada, the International Institute for Strategic Studies (IISS) in London, and the Royal Institute of International Affairs (RIIA) in London. He is also an advisor to the Oil Depletion Analysis Centre (ODAC), London.