Petroyuan

The shape of things to come

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RMB-denominated oil contracts will begin trading for the first time in Shanghai on March 26. We believe that in the long term this will ultimately change how oil is traded globally, create a Petroyuan currency flow, increase the role of the RMB as a global trading currency, and compel investors to up their allocations to Chinese financial assets.

**Why now?**

From March 26, seven oil grades will be tradeable on the Shanghai International Energy Exchange (INE), allowing Chinese buyers to buy forward in RMB. Since INE is based in Shanghai’s Free Trade Zone (FTZ), foreign traders will be allowed to trade in the market.

China passed the US as the world’s largest oil consumer in 2016. Accordingly, China wants to pay for its huge import bill in its own currency (RMB) rather than USD.

More importantly, however, China wants the new oil trading plan to promote RMB internationalization, i.e. forcing wider adoption of the RMB as a global trading currency, and switching to RMB payments for major imports is part of this process.

The emergence of Petroyuan - RMB-denominated revenues collected by the world’s largest oil producers - is a natural development from this process.

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**Exhibit 1: China Oil Consumption (1,000 Barrels per Day), 1965-2016**


**Exhibit 2: US & China Crude Oil Imports (1,000 Barrels per Day), 2003-2016**

- Source: Bloomberg, March 2018
Oil trading in RMB is as much about politics as practicality.

The 2008 Global Financial Crisis (GFC) taught the world and China that an over-reliance on key commodities priced in USD can be risky. When USD prices of key commodities rose following the GFC, higher food and energy import bills risked supply security, something a country like China can’t afford.

As well as protecting food and energy security, China wants a more active role in global politics and the global economy. As the world’s second largest economy, it wants global systems, like oil trading, to reflect China’s status.

Historically the US has been the dominant oil consumer, and oil trading reflects this because it is priced in USD. In the 1970s, Saudi Arabia and the US bilaterally negotiated oil trade settlement in USD and this gave birth to the Petrodollar world we still live in today.

This way of trading has given the US what’s been described as an ‘exorbitant privilege’ – where oil exporters recycle their dollar receipts back into US financial markets, keeping US interest rates low and supporting persistent current account deficits.

But that’s about to change – especially now that China has become the largest global oil consumer. China’s role is only expected to increase, since BP forecasts annual demand will grow 30.6% to 753 million tons per year in 2040, while the US will likely reduce their reliance on oil imports by developing domestic shale oil capacity.

As the dominant customer, particularly for major oil exporters like Russia, Venezuela, Iraq, Iran, and Saudi Arabia, China’s market means leverage, and many of these suppliers have either already agreed to price their sales to China in RMB, or are actively considering it.

If, or rather when, China’s total oil import bill gets priced in RMB, that’s going to create large piles of RMB reserves in oil exporting countries that will either be spent on Chinese exports, or recycled into China’s financial markets, giving China much more heft in the global economy.

This will have two principal effects: increased demand for RMB assets and a switch out of the USD for trading purposes, which will likely undermine the United States’ dominant role in the global economy and create a sea change in global asset allocation to China’s financial markets.

And that’s why the launch of oil trading contracts in RMB really matters.

The Petroyuan – why it really matters
Will this new system change the way oil is traded globally?

Probably not in the short term. Traders can’t move RMB freely in and out of the Shanghai commodity exchanges yet. That said, it’s unclear how much of a roadblock this is given that INE will be based in the Shanghai FTZ.

Also, even with exchange convertibility, international investors and resource trading companies need to build up enough confidence in the INE as a trading hub. That requires time and, crucially, the tried, tested, and extensive data infrastructure to support the market, which China doesn’t have right now.

That said, in the longer term, we believe that RMB oil trading will shift the structure of the global oil market, provided two things happen.

Firstly, China will have to remove, or substantially reduce, capital controls for RMB-priced oil trading to take off and allow global commodity trading houses access to the INE.

We think this is already in process, although happening gradually, based on recent policies to make the RMB more market-determined and ease rules on foreign banks’ RMB businesses.

China’s other landmark changes, like giving institutional investors direct access to the Chinese bond market, expanding access via the Bond Connect program in 2017, and launching the Shanghai and Shenzhen Stock Connect links with Hong Kong, show the government is intent on the necessary reforms to open the economy to international investors.

Secondly, China’s oil trading partners, like Saudi Arabia, Russia, and Iran, will have to agree to accept RMB for their oil exports to China. This is also taking shape because Russia already accepts RMB for oil exports, as does Iran, and we expect Saudi Arabia to soon begin invoicing China in RMB.
What does this mean for investors?

Clearly, post the decade of WTO entry and integrating itself into the global trading environment, China is now integrating itself more closely with the global financial system.

Importantly, China is attempting to expand its influence in the global economy. It’s already the world’s biggest trading country, has the largest forex reserves, boasts the world’s biggest consumer market, and consumes the majority of the world’s commodities.

Pricing oil in RMB and running a trading hub out of Shanghai is consistent with these steps, and will promote RMB internationalization.

We’re confident that ongoing reforms, plus China’s leverage with its suppliers to impose RMB pricing, will create a Petroyuan that will drive demand for assets on China’s financial markets.

**It’s time to consider RMB assets as long-term investments.**

China has already taken important steps to offer global investors direct access to onshore asset markets.

And global institutional investors are taking the hint, increasing their China holdings of onshore bonds threefold between Jan 2014 and December 2017.

On top of this, we’re anticipating China’s onshore bond markets will be included in global bond benchmark indices within the next 18 months.

When that happens, we’re expecting a major reallocation of capital into China’s onshore bond markets. This follows on from other key milestones, like the IMF’s inclusion of the RMB in its SDR basket, foreign central banks announcing FX reserve allocations to RMB, and the inclusion of Chinese equity markets in MSCI benchmarks.

With these trends in mind, plus the impact of Petroyuan, we believe China’s onshore bond market makes for an attractive investment, particularly in Chinese government bonds.

Yields on a typical RMB aggregate bond fund, currently yield around 4.75%, offering, in our view, excellent value relative to many developed markets, and mean an attractive carry trade compared to options in the US, Europe, and Japan.

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**Who we are**
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\(^1\) Data as of 31 March 2017  
\(^2\) Thereof around 1,200 from Corporate Center  Data as of 31 December 2016