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Xi's Petroyuan Dream Gets New Life From Trump's War in Iran (1)

By Bloomberg News

(Bloomberg) -- The war in Iran is spurring a fresh wave of enthusiasm over prospects for China's currency to more effectively rival the US dollar.

Although still dwarfed by the greenback in international trade, the yuan saw an uptick in demand after Iran took control of the Strait of Hormuz and began accepting payments in China's currency to allow freighters to sail through safely. Even as the Trump administration began to blockade Iranian ports after peace talks collapsed over the weekend, the war more broadly has revived talk of a "petroyuan" — a concept President Xi Jinping advocated with little success on a 2022 trip to the Middle East.



President Xi Jinping, center, greeted by Prince Faisal bin Bandar bin Abdulaziz, Governor of Riyadh, on Dec. 7, 2022.

A Chinese government-affiliated scholar last week said the volume of yuan-denominated crude oil has picked up due to the conflict, while official media reported that the nation's Cross-Border Interbank Payment System (CIPS) recently recorded a single-day transaction record of 1.22 trillion yuan (\$179 billion), surpassing the 1 trillion mark for the first time. Deutsche Bank AG strategist Mallika Sachdeva captured the sentiment in a recent note, saying the war "could be remembered as a key catalyst for erosion in petrodollar dominance, and the beginnings of the petroyuan."

The German bank isn't alone in seeing the logic behind a shift to pricing oil in the currency of the world's largest crude importer. China's economic ties with the Middle East have steadily tightened, with Communist Party officials developing an oil-trading infrastructure in Shanghai that includes futures contracts. They've also expanded the CIPS system and have explored an international digital currency platform that includes Mideast partners.

Yuan payments and receipts between China and the Middle East reached 1.1 trillion yuan in 2024, rising at an annual speed of 53% since 2020, according to latest official data. The majority of the transactions involved securities rather than goods, which made up just 18% of the total.

“The Middle East conflicts will certainly increase the incentive to use renminbi in oil trade, especially in the developing world,” said Chi Lo, senior Asia Pacific market strategist at BNP Paribas Asset Management. “But they will not prompt a paradigm shift, because there is no competitor that can replace the dollar for quite some time.”

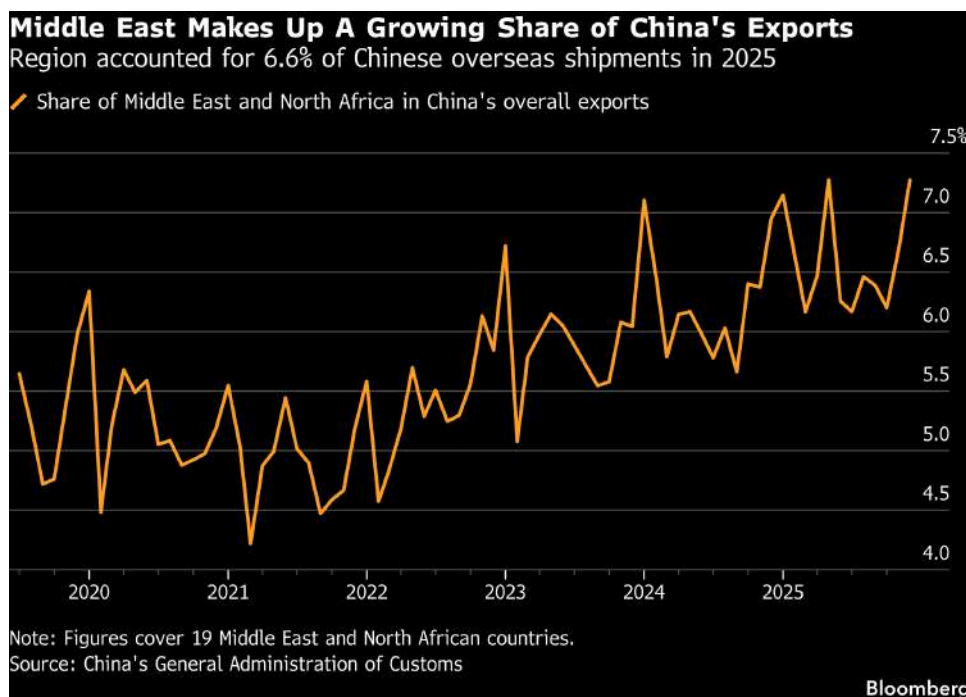


The stakes are high. Crude oil accounts for a fifth of global trade denominated in the greenback, and a shift in its pricing and settlement could lead to a more fragmented picture that erodes the dollar’s dominance in the global monetary system. A number of emerging economies are already looking to reduce their reliance on a currency increasingly weaponized by the US.

Still, the long-term impact of the conflict on oil pricing will take time to discern — and many analysts remain skeptical about the yuan’s ability to challenge the dollar anytime soon. US President Donald Trump’s blockade of Iran’s ports shows the formidable wall of ongoing challenges facing the “petroyuan,” which would see the Chinese currency used widely in the global oil trade beyond US sanctioned-countries that have few other options.

“The Trump administration is wary about the implications of yuan’s increased usage in oil trade and they can’t afford to let this happen,” said Hui Feng, co-author of *The Rise of the People’s Bank of China* and a senior lecturer at Australia’s Griffith University. “We don’t know the final outcome of the war yet, but it’s extremely unlikely to see any positive gain for the yuan.”

The greenback’s appeal originally stemmed from a 1974 deal between the US and Saudi Arabia to price and settle oil in dollars, with Riyadh agreeing to recycle its export earnings into US Treasuries. At the time, China was reeling from Mao Zedong’s Cultural Revolution and the nation had yet to experience its economic miracle.



Half a century later, yuan financing is steadily rising as China's economy expands, with more countries and foreign companies tapping the nation's bond market to raise funds. Even so, the amount is still small compared with the US, offering oil-surplus nations a relative dearth of easily investable financial assets to park their earnings.

Chinese authorities are also worried about instability from hot-money flows. They've been loath to let markets work on their own, sometimes moving to restrict trading and even curb pricing information — actions not typically seen in major international markets. Overseas funds held less than 5% of Chinese government bonds as of February, lowest share since 2017.

And while transactions via the yuan-based CIPS network are hitting new highs, they are a small fraction of the \$2 trillion in average daily volume of dollar payments via the US-controlled CHIPS network, or the Clearing House Interbank Payments System.

For Saudi Arabia and other Gulf Cooperation Council nations, shifting toward yuan payments could weaken the foundation for their currencies' pegs to the dollar — a major step into the unknown after decades of stability. Such a move would also risk angering Trump, who's threatened nations in the past with moving away from the greenback.



Eswar Prasad

“The concept of the petroyuan remains a long shot in terms of boosting the yuan’s importance in global payments,” said Eswar Prasad, a professor at Cornell University and former head of the International Monetary Fund’s China division. “Even if some oil transactions were to be denominated and settled in yuan in order to escape financial or other types of sanctions, this is hardly likely to amount to a game changer in terms of the global currency landscape.”

As far as global commodity settlements go, Zhu Zhaoyi, executive director of the Middle East Institute at Peking University’s HSBC Business School, predicted that the dollar’s share will decline to about 70% from the current 80% over the next five years. The yuan’s share may go from 4%-5% up to 8%-10%, he said.

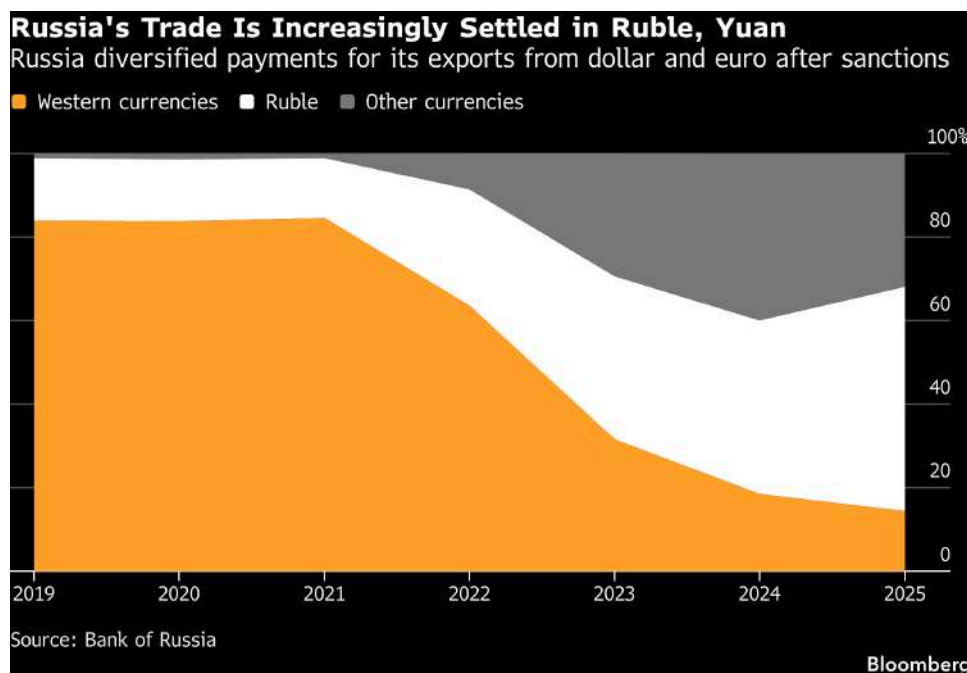
A key element slowing down the process is Beijing’s reluctance to embrace free flows of money in and out of its currency. Authorities continue to manage the yuan, and have allowed only modest growth in offshore trading. Offshore yuan liquidity measured by deposits was at 1.6 trillion yuan (\$234 billion) as of March last year, according to PBOC data — a fraction of the more than \$15 trillion in offshore dollar-denominated assets.

“The lack of a fully convertible currency will be a deterrent on using the proceeds to invest in Chinese yuan denominated onshore assets,” said Edward Bell, acting group head of research and chief economist at Emirates NBD Bank PJSC, Dubai’s largest bank. “That’s a risk that doesn’t exist with the US dollar.”

Even so, China is increasingly seen as well-positioned for the future, as Trump’s handling of the conflict raises questions about American commitments to long-standing allies, a dynamic that hardly burnishes the greenback’s appeal over time. In a sign of investor confidence in China’s relative resilience against the oil shock, the Chinese yuan has outperformed all Asian peers and G-10 currencies since the war broke out.

Within China, there’s growing recognition that the global environment is improving for expanding the yuan’s international reach. Former People’s Bank of China Governor Zhou Xiaochuan this month called it a “golden window” for pushing for the yuan’s internationalization, as US policies weakened the dollar’s credibility. He called on policymakers to seize the opportunity to make the yuan flow more freely across the border.

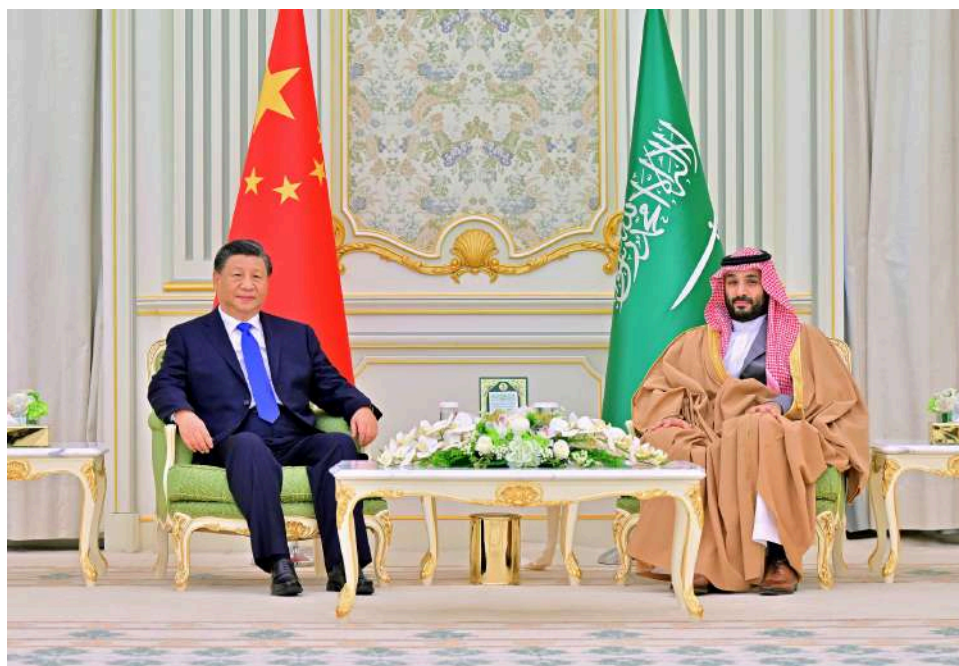
China's current focus is to push for its own payments for crude imports to be settled in yuan, according to a person familiar with the government's thinking. China has no desire to shift oil trade among other countries to its currency or to replace the dollar in areas beyond its own bilateral trade, said the person, who asking not to be named because they weren't authorized to speak publicly.



So far, the yuan's growing footprint in the commodities world is led by sanctioned economies. Almost all of the bilateral trade between Russia and China is settled in yuan or ruble, a Russian official said last year. That includes about 563 billion yuan (\$81.8 billion) worth of Chinese imports of fossil fuel, according to customs data.

Much of the progress has also been in settling individual trades in yuan, a step well short of the pricing shift that a true petroyuan would require — one in which oil benchmarks themselves move away from the dollar. Yuan-denominated oil futures began trading at the Shanghai International Energy Exchange in 2018, but the daily transaction volume at about 170,000 contracts is only a fraction of the more than 1 million for WTI futures.

Still, for China, it's a long game with no deadline. History shows it tends to take a long time for any currency to gain dominance in the global system, as network effects make it difficult to switch out of the existing setup. While Britain's economy was already smaller than that of the US as of 1900, sterling retained its primacy in the world until the 1940s.



President Xi Jinping with Saudi Crown Prince Mohammed bin Salman in Riyadh, on Dec. 8, 2022.

China's demonstrated strategy is to steadily push for the use of the yuan in trade while putting in place the necessary payment infrastructure. In 2023, China settled liquefied natural gas imports in yuan for the first time, on the Shanghai Petroleum and Natural Gas Exchange, involving supply from the United Arab Emirates.

That year also saw the first cross-border crude oil transaction in digital yuan. Last year, First Abu Dhabi Bank became the first Middle East direct participant in the CIPS.

"Prior to the Iran conflict, some Gulf states already felt the need to broaden their economic diplomacy by exploring ways to conduct trade in non-dollar currencies," said Charles Chang, S&P Global Ratings' managing director and Greater China country lead for corporate ratings. "If the Iran conflict amplifies such feelings, more Gulf states may be willing to accept more 'petroyuan' over time."
(Updates with additional details in seventh to last paragraph.)

--With assistance from Yongchang Chin, Paul Abelsky and Laura Davison.

To contact Bloomberg News staff for this story:
Charlie Zhu in Shanghai at qzhu46@bloomberg.net;
Yujing Liu in Beijing at yliu1718@bloomberg.net;
Qizi Sun in Beijing at qsun62@bloomberg.net;
Andrey Biryukov in Dubai at abiryukov5@bloomberg.net;
Wenjin Lv in Shanghai at wlv8@bloomberg.net;
Heng Xie in London at hxie34@bloomberg.net

To contact the editors responsible for this story:
Alan Wong at awong478@bloomberg.net
Christopher Anstey, Daniel Ten Kate