



What Iran means for the dollar: a perfect storm for the petrodollar

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The long-term legacy of the Iran conflict for the dollar could be the way it tests the foundations of the petrodollar regime. If fault lines are further exposed, there could be significant downstream effects to the dollar's use in global trade and savings, and the dollar's role as the world's reserve currency.

The world saves in dollars in large part because it pays in dollars. The dollar's dominance in cross-border trade is arguably built on the petrodollar: globally traded oil is priced and invoiced in USD. This arrangement can be traced to a deal struck in 1974 where Saudi Arabia agreed to price oil in USD and invest surpluses in USD assets, in exchange for US security guarantees. Because oil is a core input to global manufacturing and transport, there is a natural incentive for global value chains to dollarize, and global surpluses to accumulate in USD.

The foundations of the petrodollar regime have been under pressure even before this conflict. Most Middle East oil is now sold to Asia not the US; sanctioned oil from Russia and Iran has already been trading off dollar rails; Saudi Arabia has been localizing defence, and experimenting with forms of non-dollar payment infrastructure such as Project mBridge.

The current conflict may expose further fault lines, by challenging the US security umbrella for Gulf infrastructure and the maritime security for global trade in oil. Damage to Gulf economies could encourage an unwind in their foreign asset savings held largely in dollars. In this context, reports that the passage for ships through the Strait of Hormuz may be granted in exchange for oil payments in yuan should be closely followed. The conflict could be remembered as a key catalyst for erosion in petrodollar dominance, and the beginnings of the petroyuan.

A bigger risk could come if the world begins to move away from globally traded oil and gas itself, to more resilient sources of energy including domestically available fuels, renewable energy, and nuclear power. The energy choices of the Global South, Europe and North Asia will be key to track. A move away from oil could be as powerful as the pressure to price it in other currencies.

A world that becomes more self-sufficient in defence and energy would also be a world that holds less USD reserves. The huge strategic importance of the Middle East to the dollar's role as the world's reserve currency should not be underestimated. The current conflict may be the perfect storm for the petrodollar.

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The dollar is the world's reserve currency for a very simple reason: the world pays for global goods and services in dollars and is willing to save resulting surpluses in dollar assets. From 1945-1971, the dollar was "backed" by gold – namely, global central banks were able to exchange \$35 for 1 oz at the Fed. This was the foundation of the international monetary system known as Bretton Woods. In 1971, the US broke the dollar's link to gold. Since then, the dollar has been in a purely fiat regime – one that is backed by the sovereign credit worthiness of the US and willingness of the world to save in its debt.

Enduring support for the fiat dollar arguably comes from the dominance of the dollar in the pricing of cross-border trade. Globally traded goods and services are largely priced in USD, with payments exchanged over US controlled payment rails. Global surpluses are thus built in USD and mostly invested back into US assets. Corporates are incentivized to save and borrow in the currency of their payables and receivables, banking systems are dollarized, and central banks save in dollars to act as effective lenders of last resort. This drives demand for USD reserves. See more on this link [here](#).

A crucial anchor to this system is the petrodollar: the fact that most globally traded oil is priced and invoiced in dollars. Because oil is so central to global manufacturing processes – from petrochemicals, fertilizers and transport, to running factories and offices – companies are incentivized to price end products in dollars as a natural currency hedge to a key cost. This is a big reason global goods and services are priced and traded in US dollars.

The reason oil is priced in dollars can be traced back to the 1974 petrodollar arrangement between the US and Saudi Arabia. In simple terms, Saudi Arabia agreed to price its oil exports in USD and invest oil surpluses into US Treasuries. In exchange, the US provided security guarantees and military protection. The rest of the GCC followed. Structural foreign demand for US debt lowered the funding costs of the US government, acting as an indirect means of payment for the security umbrella extended to the region. To the extent that this arrangement supported broader global invoicing and saving in USD, it has been crucial to the USD's role as the world's reserve currency.

The current conflict has arguably shaken some core foundations of the petrodollar regime: the security-for-oil-pricing arrangement. US military assets and bases in the Gulf have come under attack in the war. Oil infrastructure in the Gulf has also been hit. And the US ability to provide the maritime security to ensure the global flow of oil has been challenged with the closure of Hormuz. The US security umbrella has been fundamentally tested.

The legacy of this conflict for the dollar could be the ways in which it tests the foundations of the petrodollar regime. In the long-run, if the world uses less oil, the Gulf draws more deeply on existing dollar savings, if the Gulf moves closer to Asia in its trade and investment relationships, and eventually prices less oil in dollars – there could be significant downstream effects to the dollar's usage in global trade and savings.

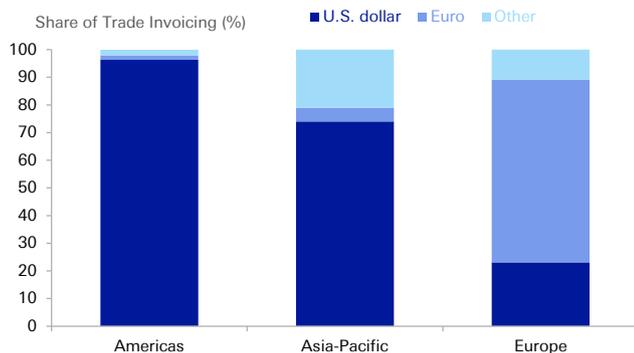


The system was already under threat: many changes have been afoot

A lot had already begun to change before the US-Israel-Iran war broke out. We highlight a few key shifts that were underway:

1. **The US was no longer the biggest buyer of Middle East oil.** With the shale revolution making the US energy independent, Saudi Arabia had been selling more than four times as much oil to China as to US. 85% of Middle East crude oil goes to Asia. This already introduced a fundamental instability with reports that China was keen for more oil to be invoiced in yuan.
2. **Saudi Arabia was already looking to localize more of its own defence.** Under Vision 2030, Saudi Arabia had been targeting an increase in the domestic content of military spending to 50%, looking to reduce dependence on foreign imported arms.
3. **Saudi Arabia had joined Project mBridge and signed FX swap lines with China.** Project mBridge is an initiative involving the PBOC, HKMA, Bank of Thailand, and the central banks of the UAE and Saudi Arabia. It uses blockchain technology to facilitate payments in the central bank digital currencies of each country. Crucially it does not depend on USD correspondent banking or SWIFT, and is at the minimum viable stage. The rails to transact outside of the dollar have already been built.
4. **Sanctions on Russia and Iran meant significant oil trade was already taking place outside of dollar rails.** Sales of Russian and Iranian oil have been priced and transacted in a range of local currencies from ruble, yuan, rupee with non-dollar payment infrastructure having been used.

Figure 1: The dominance of the dollar in cross-border trade has a lot to do with the petrodollar



Source : Deutsche Bank, Federal Reserve

Figure 2: There were already signs of instability to petrodollar foundations: Saudi Arabia sells four times as much oil to China now as to the US



Source : Deutsche Bank, CEIC



The conflict has introduced new sources of instability for the petrodollar

First, the US security umbrella is being tested with Gulf economies facing attacks on US bases, oil fields and infrastructure in a war that began with US military action in the region. Aside from the Gulf, pain has arguably been disproportionately felt by traditional US allies: Europe, Japan and Korea that are large energy importers exposed to the Straits.

Second, direct diplomacy rather than US-led maritime security has been the conduit for oil to pass through the Strait of Hormuz. Select tankers heading for China, India and Japan have been allowed passage. Bilateral relations have served countries.

Third, and crucially there have been reports that Iran is negotiating with eight countries to allow passage of ships through the Strait of Hormuz if oil payments are paid in yuan ([The Telegraph](#), [CNN](#), [Asia Times](#), [Chosun](#)). This adds further credence to the enormous power of oil pricing. The conflict could be the catalyst for erosion in petrodollar dominance and the beginnings of the petroyuan.

To be sure, there are numerous mitigants to consider. While the US is no longer the biggest global buyer of oil, it may well be on track to be the world's biggest supplier. As we argued in our [earlier piece](#), if the US controlled the entire Western Hemisphere's oil – either directly or by proxy – it would have more reserves than OPEC, putting it in a better position to set the terms of global oil trade.

In a best-case scenario, the dollar could remain the dominant currency for oil trade if the US controls a majority of the world's supply, although further development of reserves would be required to produce surpluses sufficient to be the world's biggest *tradeable* supplier.

In a worst case scenario, one may see a fracturing of global oil pricing along trade routes and corridors. One might imagine Middle East oil passing through the Straits of Hormuz to Asia being priced in yuan, while oil from the Western Hemisphere sold across the Atlantic and Pacific to historical US allies may be priced in USD.

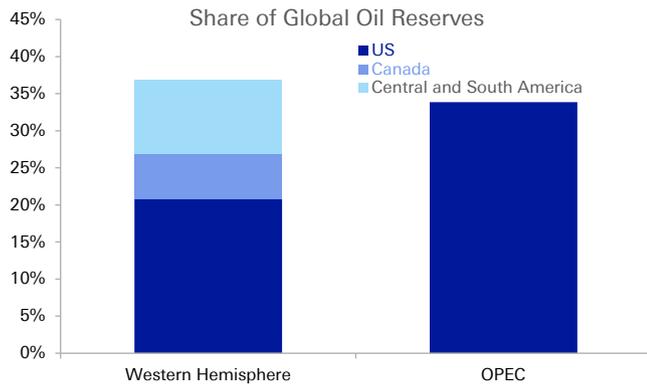
Another important mitigant is that Gulf economies are very invested in the USD. The GCC runs USD pegs that are backed by enormous USD savings. To maintain pegs, it makes sense for them to add weight with USD receivables. Any sign of moving away from USD revenues could invite self-fulfilling attacks on pegs.

However, the Gulf may need to unwind dollar savings due to this crisis itself. The war has already led to damage of oil and civil infrastructure in Gulf economies. Escalation or a prolonged conflict could worsen this (see [here](#) for what's at stake for Gulf economies and [here](#) for our take on escalation risks). Hydrocarbon economies could suffer both from near-term hits to physical production and reduced long-term demand for fossil fuels (more below). Moreover, services sectors such as finance, tourism, aviation may face scarring if there remains an overhang of security risk. All of this could mean Gulf economies need to redeploy more of their externally held dollar savings domestically to support local economies and potentially reorient diversification programs to a different regional climate. To be sure, reserves are plentiful: the MENA region has roughly USD2tn in central bank managed reserves, and around USD6tn in sovereign wealth funds, according to Global SWF. But if USD



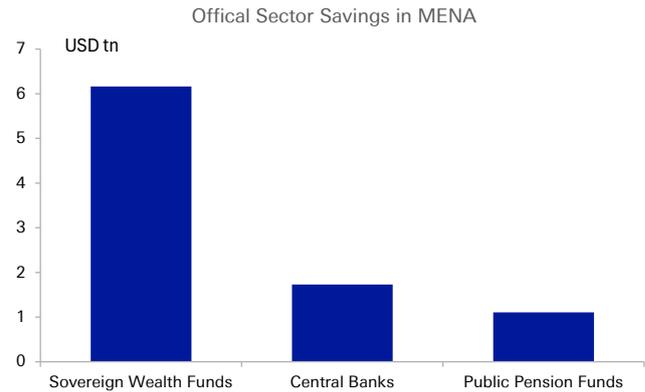
savings are being drawn down for domestic investments, this could reduce the hurdle to other currency changes.

Figure 3: If the US controlled Western Hemispheric oil, it would have more reserves than all of OPEC



Source : Deutsche Bank, Energy Institute

Figure 4: A majority of the Gulf region's savings are held in sovereign wealth funds



Source : Deutsche Bank, Global SWF

Perhaps the biggest long-term risk comes not just from the Gulf moving away from dollar pricing, but if the world begins to move away from oil itself to which we turn next.

Bigger energy shifts could be in the offing: the world may diversify away from traded fossil fuels to domestic energy

There are many parallels between now and the 1970s. Most obviously: we have now seen a second major oil and gas shock this decade. In the 1970s, the 1973 oil embargo was followed by the 1979 Iranian Revolution, while this time, Russia's invasion of Ukraine (2022) has been followed by the ongoing US-Israel-Iran war. Global prices may remain structurally higher beyond the end of the current conflict if production facilities in the Gulf are materially damaged. And the historic weaponization of the Straits could introduce more risk premium into energy that moves on ships. Increasing self-sufficiency and domestic resilience would make sense even if oil prices came down.

The 1973 oil embargo by Arab nations on Western economies motivated big energy shifts in efficiency, diversification, and reserve building. It accelerated the development of alternative oil sources in Canada, Gulf of Mexico, Alaska, and the North Sea that helped the OECD diversify away from Middle East oil. It also led to the creation of Strategic Petroleum Reserves, and created the political will for initial investments in renewable and nuclear power.

The US may see the least change. Unlike the 1970s, the US is now energy independent in oil & gas. US industry will not be hurt immediately in the way that economies not receiving physical oil will be, and US oil producers will benefit. While there could be a consumption shock from higher pump prices, the US arguably retains the option of an export ban to manage domestic prices. WTI-Brent-Oman spreads already reflect the very different prices being paid around the world. The US growth impact is thus the most ambiguous and likely the least negative (see [here](#) and [here](#)). This should mean the US remains relatively more invested in fossil fuels.



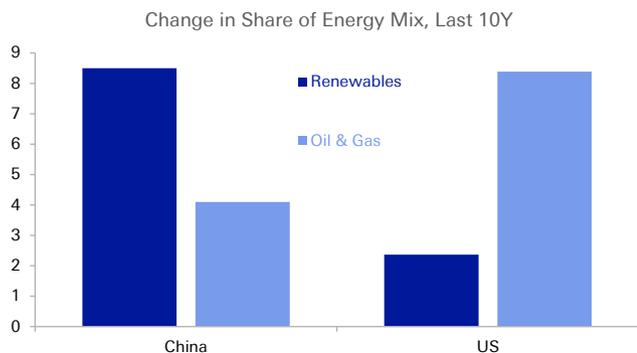
But energy-dependent regions like Europe, Asia and many parts of the Global South – that are facing multiple threats to global trade in fossil fuels – arguably have three key options:

- **The first option is to source more fossil fuels domestically.** Regions that have the ability to explore and develop more of their own oil and gas may be more motivated to do so, from the UK to Brazil, while Europe and parts of Asia may also turn back to domestic sources of coal. Even if the world does not move away from fossil fuels, global trade in it could well decline, and this is what matters for FX.
- **The second option is to double down on renewable energy.** Renewables are far more appealing on relative cost today than they were in the 1970s, due to the enormous industrial build out in China. China produces 80% of world’s solar panels, 70% of the wind turbines, and 70% of lithium batteries ([Science](#)). China’s overcapacity may well have been strategic, with China now extremely well placed to supply into new demand. Many Global South economies could accelerate this shift. But ultimately, this second option also comes with new dependencies on a mostly single industrial actor.
- **Genuine energy independence may only be created by a third option: nuclear power.** One could perhaps expect a significant focus on this in Europe, Japan (see [here](#)), and South Korea – traditional US allies. Just like their defence buildouts, nuclear power will have very long multi-year lead times but could have very significant FX implications.

To be sure, there will be limits to how much the world can fully move away from oil. Many industries rely on the fractionalization of oil for manufacturing. And as we have argued in our [earlier work](#), oil is crucial to militaries: while passenger cars can run on electricity - military jets, tanks and navy ships are likely to be powered by oil for a long time. Nevertheless, there is scope for greater parts of the energy mix to transition to more reliable, secure, and potentially cheaper sources of energy. If the world shifts away from globally traded oil and gas, to more domestic sources of fuel, renewable or nuclear power, the most obvious long-term impact would be reduced oil and gas deficits in Europe and North Asia, and reduced energy surpluses in the Middle East. Reduced global oil trade would also create more room for pricing of goods and services to shift away from the USD.

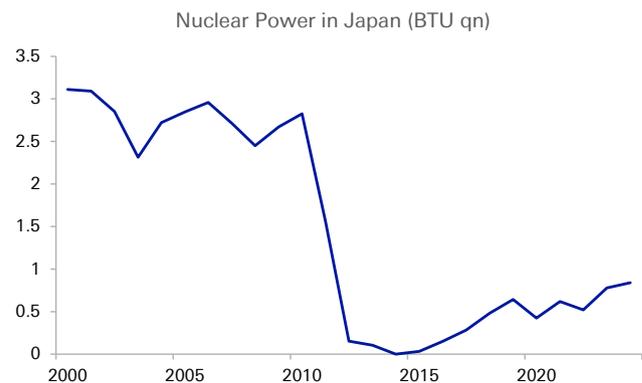
The move away from oil could be as powerful as the pressure to price it in other currencies. The petrodollar system could be at risk from both the ‘petro’ and the ‘dollar’ legs.

Figure 5: China has been leaning more towards renewable energy, while the US has been doubling down on fossil fuels



Source : Deutsche Bank, CEIC, IEA

Figure 6: Japan and Europe could ramp back up on nuclear power to build more energy independence



Source : Deutsche Bank, CEIC



Conclusion: What does this all mean for the dollar?

In the near term, we have [argued](#) that US energy independence might be worth some safe-haven premium on the dollar. The US is the only major economic region in the world that is both energy independent and is itself far from a battleground. However, there have been important offsetting factors from growing US fiscal risk around greater military spending, to the unwind of UST holdings in Asia and the Middle East to defend currencies (see pieces [here](#) and [here](#)) which mean the dollar has not strengthened much in this crisis even in the short term.

The more interesting and lasting impact of this crisis on the dollar could be on the long-term foundations, namely the willingness of the world to price traded goods and services in dollars and to save resulting surpluses in dollar assets.

The foundations of the petrodollar regime were under pressure even before this conflict. There were already signs of instability to the long-standing arrangement to price GCC oil in dollars in exchange for security: most Middle East oil is sold to Asia now not the US; sanctioned oil has already been trading off dollar rails; Saudi Arabia has been localizing defence and experimenting with non-dollar payment rails alongside other Global South central banks.

The current conflict may have exposed further fault lines, by challenging the US security umbrella for Gulf infrastructure, the maritime security for global trade in oil, and encouraging a potential unwind in Gulf dollar savings. In this context, reports that the passage of ships through the Strait of Hormuz may be granted in exchange for oil payments in yuan should be closely followed. The conflict could be the catalyst for erosion in petrodollar dominance and the beginnings of the petroyuan.

A bigger risk perhaps comes if the world begins to move away from globally traded oil and gas itself, to more resilient sources of energy from domestically available fuels, renewable energy, and nuclear power. The energy choices of the Global South, Europe and North Asia will be particularly crucial to track. The move away from oil could be as powerful as the pressure to price it in other currencies.

A world that is looking to become more self-sufficient in defence and energy would also likely be a world that will hold less USD reserves. If economic security is now a key part of national security, building greater energy resilience should be seen as complementary to the increased focus on defence spending. Reserves hitherto held in foreign assets will increasingly be needed to build domestic capacity that supports strategic autonomy (see [here](#) and [here](#)). Future surpluses could themselves reduce and be accumulated less in dollars. These are long-term dollar negatives.

The huge strategic importance of the Middle East to the dollar's role as the world's reserve currency should not be underestimated. The current conflict may be the perfect storm for the petrodollar.



Thematic FX Framework Pieces

This note is part of a broader series of thematic FX notes that explores the evolving nexus between payments, energy and defence as key pillars to the dollar's long-term status. Other FX pieces that can be read alongside this include:

[FX Special Report: What Venezuela has to do with the dollar](#)

[FX Special Report: What do stablecoins mean for dollar dominance?](#)

[FX Special Report: Who can come home?](#)

[FX Special Report: The geopolitics of reserves: shifting security alliances will matter for the USD](#)

[EM Special Publication: Geoeconomics 101: implications for the dollar, emerging markets and beyond](#)

[FX Blog: On defense spending, bond markets, home bias & the yen](#)

[EM Blog: Iran - a further impetus away from recycling savings to the US?](#)



Appendix 1

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