

Petrodollar: The Middle East and the USD's Geopolitical Might

Iranian retaliatory strikes on Gulf states following US-Israeli attacks have strained US-Gulf relations and left some observers questioning whether the conflict could mark the end of the US Dollar's (USD) supremacy. At the heart of this debate lies the concept of the petrodollar. The petrodollar refers to an agreement whereby Gulf oil would be traded in USD in exchange for US security provision. To understand the petrodollar, the ensuing section will look at the historical inception and significance of the petrodollar before examining arguments for the petrodollar's resilience or decline.

The Inception and Power of the Petrodollar

The petrodollar followed a 1974 agreement between the US and Saudi Arabia, which was soon followed by other Gulf states. In exchange for US military protection, Gulf states sold their oil in USD. Ever since, the petrodollar has been linked to the USD's global dominance. But what makes the petrodollar such a powerful financial instrument?

The petrodollar is so powerful because it promotes the USD as the primary reserve currency, which is held by central banks to pay for debt and stabilise currencies. For context, oil is crucial to all economies, and the Gulf states are major oil producers. Hence, if Gulf oil is traded in USD, it becomes convenient to conduct other trades in USD as well. Consequently, the petrodollar helped establish the USD's use in global trade and as a reserve currency, resulting in two distinct benefits for the US. First, given the USD's ubiquity, there are more creditors available for the US to borrow from, driving down interest rates on US debt. Second, USD dominance in trade enhances the effectiveness of US financial sanctions.

The Decline of the Petrodollar?

The US-Iran war might weaken the petrodollar in two ways. First, facing Iranian retaliation for a US-Israeli attack on Iran, Gulf states may increasingly question the US's ability to provide security for the Gulf states. This would erode the very bargain that gave rise to the petrodollar in the 1970s. Second, as oil prices rise, non-Gulf states might seek alternative energy sources, reducing the importance of oil and, by implication, the dominance of the USD.

Petrodollar: Continuing Resilience?

Despite the abovementioned scepticism, Gulf states still hold a substantial amount of their savings in USD. Hence, if they were to abandon the USD for oil trade entirely, the USD's subsequent loss of value would reduce their own savings. This means Gulf states should have some interest in upholding the petrodollar and securing the USD's value. Moreover, the US is the world's largest oil producer. Hence, with US oil continuing to be traded in USD, the USD's future prevalence might be ensured.

Uncertain Future

As the future of the Middle East lies in limbo, so does the future of the petrodollar. But irrespective of how the future might turn out, one thing seems certain: the future of US power in the region will be closely tied to the petrodollar.

Further Reading

Deutsche Bank Research Institute. (2026, March 24). What Iran means for the dollar: A perfect storm for the petrodollar.

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