Confluence
INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

By Bill O'Grady

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The Ukraine War and the Path of Globalization

There are decades where nothing happens; and there are weeks where decades happen.
–Vladimir Lenin

Over the coming weeks, we will be analyzing the impact of the war in Ukraine. Clearly, the situation is highly fluid[1] and projections on how the future will be affected by the war must be tempered with the fact that conditions will certainly change.

In this report, we will focus on the economic sanctions and their effects on globalization. As the conflict has evolved, Western nations have moved quickly to implement serious sanctions on Russia that will likely have far-reaching effects not just on the Russian economy but also on global trade and investment.

Our report begins with the sanctions on the Russian Central Bank and the impact on its foreign reserves; the discussion includes an analysis of Russian policies designed to accumulate reserves. From there, we project how reserve managers address the risk unveiled by the sanctions, including how nations view trade and development. Using this information, we examine how this change will affect globalization and what impact these changes will have on the economy, inflation, and markets. A look at the role of cryptocurrencies is also included. Finally, we close with potential market ramifications.

Sanctioning the Russian Central Bank

When the invasion began on Thursday, February 24, the initial round of sanctions was modest. The S.W.I.F.T. network remained open to Russia and the oil and gas sector was carved out from sanctions. These initial actions suggested that the West was not prepared to make serious sacrifices on behalf of Ukraine. However, as the weekend progressed, the brave actions of Ukraine to fend off the Russian assault turned sentiment and by Sunday, February 27, the sanctions were broadly extended to include selective exclusion from the S.W.I.F.T. network. In addition, historically neutral states like Switzerland joined the effort. Our focus will be on the sanctions applied directly on the Russian Central Bank.

It has been well advertised that Russia has been building its foreign reserves. After the Russian debt default in 1998, policymakers deliberately took steps to build reserves. In the case of Russia, building reserves was initially designed to avoid the "Dutch disease" that often occurs with commodity exporters. As the Netherlands discovered when it became a major natural gas exporter, the accumulation of hard currencies from the commodity trade can boost the exchange rate and make other exports uncompetitive. Alexey Kudrin, the Russian finance minister from 2000 to 2011, created a system that included a sovereign wealth fund to absorb the hard currency inflows to prevent ruble (RUB) appreciation. That wealth fund was

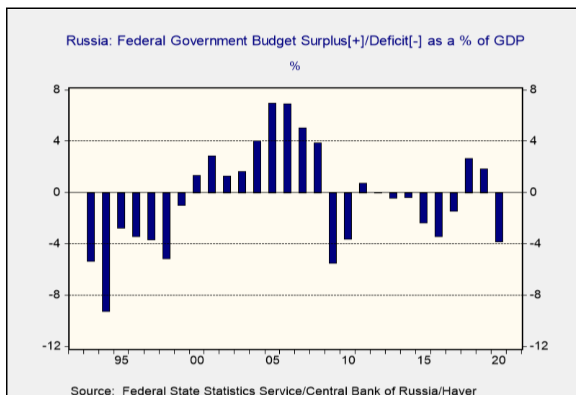
[1] For comments on how the war is unfolding, we recommend monitoring our *Daily Comment*.

part of the rapid rise in foreign reserves shown on the chart below.

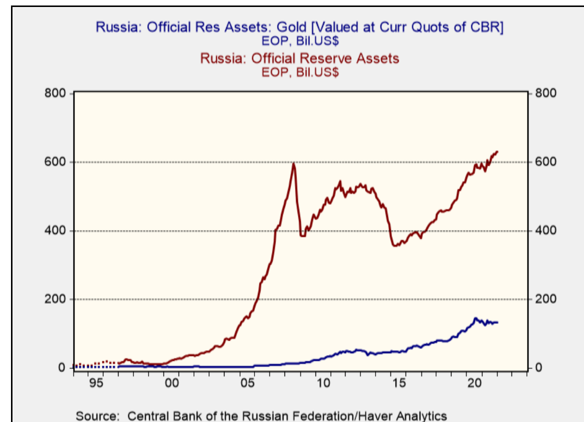
The savings balance identity shows how this process works:

0= (I-S) + (G-Tx) + (X-M)

Investment less saving details the domestic savings balance, government spending less taxes shows the public savings balance, and exports less imports is the foreign savings balance.



This chart shows Russia's fiscal balance; since 2000, the average balance is in surplus by 0.8% of GDP. On average, it has run a balanced budget. In effect, Russia has been engaging in austerity; by mostly running a balanced fiscal budget along with an undervalued exchange rate,[2] which has depressed consumption, as the above identity indicates, exports must exceed imports. And, since 1998, this has indeed held true. Russia's current account has been in surplus.

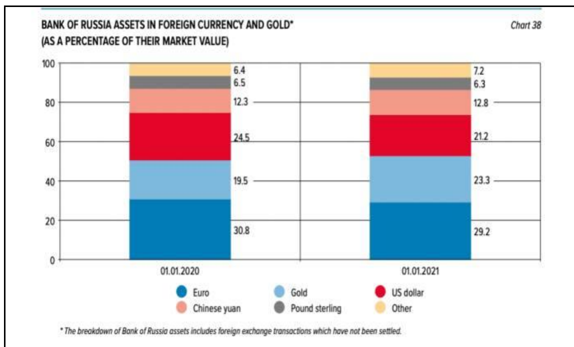


Its current reserves are at a record high. Note the decline in 2014; this decline was a consequence of Russia's annexation of Crimea and its incusion into eastern Ukraine. The military action led to a selloff in the ruble (RUB); the Russian Central Bank intervened to support the RUB, and reserves fell in response.

As we have detailed, Russia's economic policy is designed to generate foreign reserves. However, the rebuilding of foreign reserves since the invasion of Crimea was a hint that Russia was increasing its foreign reserves to respond to Western sanctions, an early indication that Moscow was at least preparing for the possibility that it would engage in behaviors that would trigger a Western response.

An unusual feature of this reserve build was a studious attempt to avoid U.S. dollar (USD) exposure. On average, about 60% of the world's foreign reserves are held in dollars. As of January 1, only 21.2% of Russia's reserves were held in USD assets.

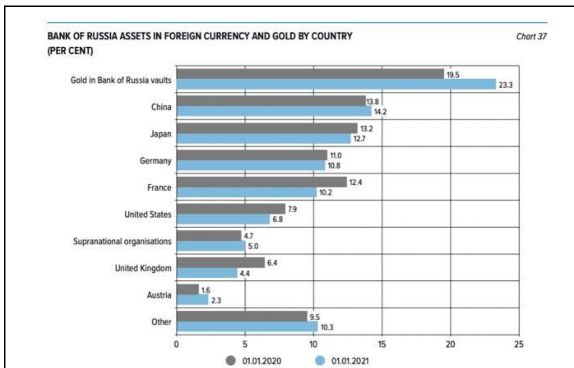
[2] We estimate Russia's purchasing power parity exchange rate at 51.22 RUB/USD as of January 2022.



(Source: *Financial Times*)

The Chinese yuan represents about 2.0% of global foreign exchange reserves but 12.8% of Russia's reserves. Finally, about 19.3% of foreign reserves are held in the EU's euro (EUR), but Russia had 29.2% in EUR.[3]

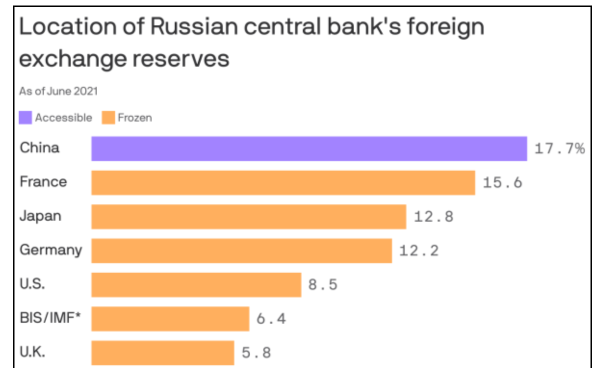
There is a tendency to view foreign reserves as a pile of money or securities held in the country. But, in a globalized world, that is a misconception. Most non-gold foreign reserves are held in sovereign securities at central banks around the world.



(Source: *Financial Times*)

About $311.3 billion of Russia's foreign reserves are held in securities. To turn those reserves into money the central bank can use, it needs to sell those securities and have the proceeds credited to the central bank. That process is now short-circuited.

Note in the above graph the first set of bars which show Russia's gold holdings held in the country. This level is unusually high, further evidence that Moscow was attempting to isolate itself from sanctions. Most countries hold their gold in London or New York because it's easier to sell the gold and transfer the proceeds in these financial centers. The good news for Russia is that this gold will likely be safe from sanctions; the bad news is that it will be more difficult to sell in quantity. The gold market, outside of the financial centers, isn't all that liquid and thus the value of this gold hoard is less than meets the eye.[4] Obviously, it could sell the gold to its citizens for RUB, but the central bank can make its own RUB; it needs hard currency which is likely in limited supply in Russia. At the same time, gold has a universal allure and anonymous transfer. If Russia is prepared to sell below market, it will, at some point, find a buyer, most likely China.



(Source: Axios)

This chart provides a short-hand look at the impact of freezing Russia's forex reserves. The China holdings likely have limited benefit; they probably can only be used to buy Chinese goods and services. And even with Beijing, there may be limits to financing assistance. After all, China does a lot of business with Europe and the U.S. and will try to avoid getting caught up in the sanctions effort.

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[3] See the IMF's COFER report for details.

[4] This paper offers a primer on the institutional processes of selling gold.

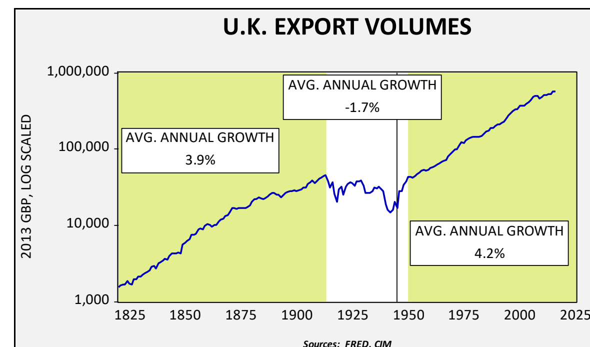
Over the weekend of February 26-27, Russians raced to ATMs to withdraw cash. Some likely had foreign currency accounts with which they would try to secure cash. The jump in the demand for cash puts the central bank in a quandary. Because the central bank can create RUB, it can simply print money to meet the demand; however, that will increase the supply of money and likely lead to inflation. So far, the reaction has been to dramatically increase interest rates in a bid to encourage Russians to hold RUB deposits. In addition, exporters who are paid in hard currency are being required to deposit these currencies with the central bank. Despite this action, the RUB has been depreciating against the USD.

It has been noted that there are some loopholes in the sanctions; not all Russian banks have been excluded from the S.W.I.F.T. network and some energy transactions are expected to be permitted. However, once sanctions are put in place, firms can sometimes "self-sanction." Due to concerns about sanctions changing in the future, or uncertainty about how sanctions rules will be enforced, firms will simply decide that doing any business with the sanctioned country isn't worth the risk. And so, we may find that even with permitted transactions, it could be difficult for Russia to transact business.

If Russia believed that its foreign reserves would serve as a bulwark against Western sanctions, this was clearly a mistake. Sanctions on the Russian central bank have dramatically reduced the liquidity of their reserves. Western actions remind us of the plot from the James Bond movie *Goldfinger*, where Auric Goldfinger plotted to detonate a small nuclear weapon inside the gold vault at Fort Knox to render the supply radioactive and thus unsellable.[5] To a great extent, the West has dramatically undermined the value of Russian foreign reserves in a manner Goldfinger could appreciate.

Globalization and the Dollar

There have been two major expansions of globalization over the past 200 years. The first began around 1820 with the industrial revolution in Britain and lasted until WWI. The second began around 1950 and continues to the present day. In both cases, the expansion of trade and interdependence relied on the global public goods provided by a hegemon.



Using real U.K. export volumes as a proxy for global trade, we see that real export growth averaged 3.9% per year from 1825 to 1914. It fell into the late 1940s by 1.7% per year; since 1948, it has increased by 4.2% per year. The hegemon provides global security, which reduces the disruption of major wars, and a reserve currency, which creates a unit of account to universalize trade.[6] In the absence of a reserve currency, trade becomes bilateral; you only trade with a nation if you have reciprocal needs. But, with a functioning hegemon, nations can run deficits and surpluses with various nations

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[5] One thing Goldfinger may not have counted on is that the world could have simply agreed to create swaps of the radioactive gold and treat the swaps as if they were the equivalent of a physical transfer.

[6] The bulk of world trade today is priced in dollars.

and settle those accounts in the reserve currency.

Another service provided by the hegemon is a reserve asset. When nations run a trade surplus, they accumulate foreign claims. Like saving in the domestic economy, these funds need a "home" until they are spent. Under British hegemony, the gold standard prevailed; claims were held either in gold or in British bonds. After WWII, during American hegemony, there have been two regimes. The first was during the Bretton Woods era, which was a dollar/gold standard. After President Nixon ended that paradigm, a dollar/Treasury standard evolved.

The sanctions on the Russian central bank are a cautionary tale for reserve managers. The dollar and Treasuries are the most commonly held reserve assets, with the euro and euro-denominated financial instruments next. The Russian situation shows that if there is a serious deterioration of relations with the West, it is possible that reserves could be effectively lost.

The potential undermining of confidence in a reliable reserve currency could have several effects. First, it could end the use of export promotion for economic development. The other model, mostly discredited in the past decades, is import substitution; it might make a comeback. Import substitution has mostly been abandoned because it was less effective. For example, it makes little sense to build a car industry from scratch when a nation can simply encourage foreign direct investment to build out such infrastructure. However, without a reliable reserve currency, it is unclear what reserve managers should hold as saving from running a trade surplus. Second, it could be quite bullish for gold. Perry Mehring describes two forms of money, "inside money," which are financial assets on a spectrum of liquidity (currency being most liquid and forms of financial securities having degrees of "moneyness" in other forms), and "outside money," which is non-liability backed money, such as gold. However, the desire to hold gold may depend on the ability of the Russian central bank to repo its gold holdings. If it turns out that gold can be isolated from global markets just like financial assets, the allure could fade. Third, it might boost commodity prices. If reserve managers conclude that there is liquidity risk with dollar, euro, or yuan assets, they may begin holding crude oil, grains, industrial metals, etc. as savings. Obviously, such holdings entail costs and may be difficult to turn into liquidity, but they would offer some element of safety as they could be consumed if a nation becomes isolated by sanctions.

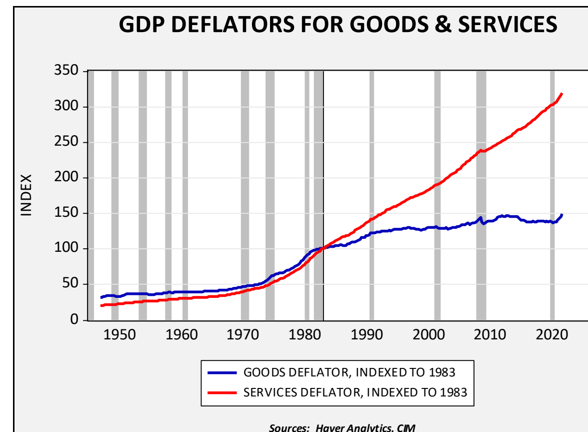
Since the end of the Cold War, the global financial system has mostly been unified through the dollar system. Anyone holding dollars has a wide array of financial assets, along with goods and services, at their disposal. We suspect as long as nations enjoy positive relations with Washington, the benefits of holding dollar assets in reserves haven't changed. On the other hand, the Russian situation (and Iran's experience in recent years) reflects the level of U.S. financial power if relations deteriorate.

Where the fault lines are likely to emerge is between the U.S. and China. On the one hand, Chinese reserve managers must be looking at their hoard of Treasuries with concern. These assets could be rendered useless, as the Russian situation shows. At the same time, Beijing will have an incentive to push trading partners to begin invoicing in Chinese yuan (CNY) to avoid dollar risk. It would not be inconceivable to

see nations that have deep economic relations with both China and the U.S. (Japan and South Korea are good examples) decide to run twin reserve accounts, one holding USD and the other CNY. During the Cold War, there was a dollar bloc, used in the Free World, and a RUB bloc, used behind the iron curtain. There was little trade between the blocs with the exception of energy, which remained dollar denominated.[7] However, a CNY/USD world would be quite different; China has a dynamic economy, and the U.S. and China are deeply intertwined economically. The potential for a fracture in the world's currency system is high.

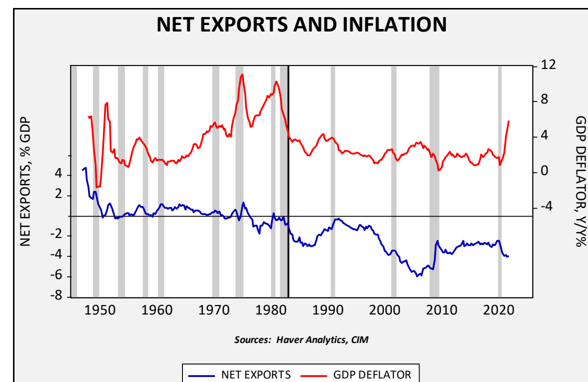
The Inflation Story

The potential impacts from deglobalization on the world economy and financial markets are enormous. As we noted above, globalization has been expanding since 1950, but the expansion accelerated with the Reagan/Thatcher revolution in the late 1970s. Richard Baldwin[8] makes a strong case that, since 1990, technology has allowed complex manufacturing processes to be sited nearly anywhere in the world. In effect, this expanded the labor force available to businesses and helped contain inflation.



On this chart, we have indexed the U.S. GDP deflators for consumer goods and services. From 1947 to 1983, goods inflation grew by a compound annual growth rate of 3.3%; services rose by 4.6%. After 1983, goods rose by 1.3%, while services rose by 3.6%. The data after 1990 are even more illustrative; goods inflation rose by 0.7%, while services inflation rose by 2.7%. Services are less tradable internationally and thus are less susceptible to globalization.

A key factor that supported globalization was America's willingness to accept trade deficits. If the world wanted to build foreign reserves and the dollar/Treasuries were the preferred reserve asset, then the logical conclusion was that the U.S. had to run persistent trade deficits.



From 1947 to 1982, net exports relative to GDP averaged 0.2%. The GDP price

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[7] Russia was a supplier of energy and thus used the energy trade to accumulate dollars.

[8] Baldwin, Richard. (2016). *The Great Convergence: Information Technology and the New Globalization*. Cambridge, MA: Harvard University Press.

deflator, the widest measure of inflation, averaged 4.1% with a standard deviation of 2.9%. From 1983 to the present, net exports relative to GDP averaged -2.9% and inflation averaged 2.3% with a 0.9% standard deviation. Globalization, which was mostly responsible for negative net exports after 1982, also led to lower inflation with less inflation volatility.

From 1995 until 2013, world foreign reserves grew from $1.3 trillion to nearly $12.0 trillion. Growth has stalled since. The growth in foreign reserves is tied to the persistence of negative net exports for the U.S.

The statement below is the identity of exchange:

Money x Velocity = Price x Quantity

It can be described as the money supply multiplied by the speed it turns over is equal to the goods and services provided to the economy multiplied by the price level. Globalization has led to increases in quantity. By expanding quantity, the economy has been able to manage rapid increases in the money supply without significant increases in price levels.

The recent spike in inflation is due to a combination of a rapid expansion of the money supply and a curtailment of quantity caused by supply chain issues. The Federal Reserve is poised to take steps to reduce money growth and there are hopes that the waning pandemic will improve quantity. However, the potential for a disruption of global trade brought by uncertainty surrounding the reserve asset could make quantity constraints longer lasting, perhaps permanent. If that becomes the case, quantity could remain constrained or, worse, become even more constrained, forcing the Federal Reserve (and perhaps other central banks) to either (a) rapidly tighten monetary policy to contain inflation, or (b) only moderately tighten and tolerate higher inflation.

What About Crypto?

As the crisis unfolds, one area we have been watching is cryptocurrencies. Western policymakers are pressuring the crypto exchanges to avoid processing Russian transfers to prevent capital flight. So far, the exchanges have been reluctant to freeze such activity, even after Ukrainian officials pleaded with the exchange managers to do so. There has been evidence of rising crypto activity, although major cryptocurrencies have mostly been rangebound since the war began.

Even before the war, there was increasing concern about the lack of regulation of cryptocurrencies. Regulators worried that a run in the crypto space could bleed into the traditional financial sector and trigger a crisis. The reluctance of crypto exchanges to participate in sanctions raises the risk that regulators will move to increase regulatory scrutiny. The idea that money can be separated from political and social systems was a dream of the creators of cryptocurrencies. Increasingly, that goal may prove to be unattainable.

Ramifications

The sanctions attached to Russia's central bank is the first time the U.S. and others have applied such measures to a large nation's financial system. The impact of these actions is still unclear. In our earlier research, we have noted before that political support for globalization in the West has been waning. Populist movements on both the left and right have elements that oppose free trade, the free flow of capital, and immigration. Up until now, these

movements have not been strong enough to reverse global integration.

But, oftentimes in history, events occur that accelerate trends already in place. The pandemic revealed the fragility of global supply chains. And now, the Ukraine War appears to be segregating the world into at least two spheres. Restricting trade flows and uncertainty surrounding the availability of reserve currencies will likely reduce global trade.

If our analysis of the path of globalization is correct, we will likely see higher inflation in future years. The use of technology will offset some of the losses caused by deglobalization but probably not all. Deglobalization will very likely improve labor power in the coming years, which will likely depress profit margins.

Central banks, including the Federal Reserve, will be forced to choose between inflation control and supporting growth. Given the current levels of leverage in global financial markets, the ability of central banks to enforce austerity will be limited.

In such an environment, bond laddering along with allocations to commodities and related equities are reasonable responses. Overall, a less globalized world is one less friendly to capital, meaning that investors will face a daunting task of allocating capital in the future.

Bill O'Grady
March 14, 2022

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