Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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The Russians Respond

In mid-March, we wrote a report detailing the effects of financial sanctions on Russia. And now, about six weeks later, we are seeing the response from Russia. As we noted in our earlier report, Western sanctions on Russia were extensive. Although something similar was deployed against Iran, never before had such sanctions been used against a major country.

The initial response from the financial markets was swift; the ruble (RUB) plunged. However, over the past couple of weeks, the RUB/USD has recovered all of the initial losses. It should be noted that some of the recovery is due to capital controls as Moscow has made it very difficult to move money out of Russia. Exporters who acquire hard currency are required to turn 80% over to the Russian Central Bank. The bank also lifted interest rates to 20%, yet recently reduced its policy rate to 17%. But perhaps the most radical action the government has taken is to demand payment for energy in RUB.

In this report, we will begin with examining the concept of money and the complications that international trade creates, including a discussion of the reserve currency concept. Using this construct, we will apply it to the specific case of Russia. Our contention is that the dollar/Treasury reserve system is, at best, being tested, and at worst, unraveling. We will also include comments about emerging reserve currency blocs and conclude with potential market ramifications.

The Power of Money

In many respects, the structures that are most familiar to us often escape scrutiny. That is the gist of this famous joke:

> *There are these two young fish swimming along and they happen to meet an older fish swimming the other way, who nods at them and says, "Morning, boys. How's the water?" The two young fish swim on for a bit, and then eventually one of them looks over at the other and goes, "What the hell is water?"*
>
> *− David Foster Wallace*

We tend to not only take money for granted but we all *know* what money is...until we start to think about it in greater depth. One of our narratives on this topic is the following:

You are in the downtown of any major American city at midnight. In your possession is a $100 bill, a C$20 note, a credit card, bitcoin, and an American Gold Eagle coin. You need to buy gas; which is the closest to money?

All five are money in one or more senses, but the "Benjamin" will not likely be accepted because filling stations don't want large denomination bills. The Canadian dollar note might be accepted if you are on the U.S./Canadian border, but it isn't likely to be accepted at par (meaning the prevailing market exchange rate). The bitcoin isn't readily tradeable. Gold is considered "real money" by many people, but it's unlikely the station would accept it, or if it did, it certainly wouldn't accept it at market value. The most cash-like instrument you are carrying is the credit card, which isn't "money" in the strictest sense, but credit. However, often the line between money and credit is blurry. In our example, the convenience store would most likely accept the credit card without incident, whereas all the other forms of "money" could be a problem.

Every Money & Banking course in economics defines money as:

1. A Medium of Exchange
2. A Store of Value
3. A Unit of Account

However, these definitions merely tell us what money *does*; they do not tell us what money *is*. Essentially, money is a social construct. Nations have traditionally used money as an element of sovereignty. One of the tenets of Modern Monetary Theory is that money is defined as what the state accepts for the payment of taxes. However, the emergence of privately issued cryptocurrencies suggests there is more to money than mere state endorsement. Acceptance for transactions is clearly one element of money, but confidence in the currency may be even more important.

Money and International Trade

Money is a remarkable invention. It serves as a universal means of payment for consumers to exchange any good or service as long as the price can be afforded. And it allows the consumer to wait, to hold money, for future purchases. Although money tends to work well within a country, the situation is a bit more complicated for trade. Foreign currency isn't readily accepted as a medium of exchange in most nations.[1] If a nation sells an item to a foreigner and receives the currency of that nation, but the currency isn't widely accepted, then the foreigner can only buy something from the nation that he made the transaction with. We describe this issue in the following narrative:

A chocolatier in Paraguay wants to buy a ton of cocoa beans from a dealer in the Ivory Coast. The dealer quotes the buyer a price of $2,600 a ton. The chocolatier tells the dealer, "I don't have U.S. dollars, but I do have Paraguay guarani, a beautiful currency with pictures of various Paraguarí historical figures." The dealer doesn't want to insult his buyer, but he also doesn't want a currency with limited exchange value. Thus, he insists on U.S. dollars for payment.[2]

Why does the dealer want U.S. dollars? Because with dollars in hand he has access to most of the world's goods and services given the near universal acceptance of the currency. If he decides to hold the dollars as savings, he will have deep and liquid financial markets available to him as well. With guarani, he is likely limited to buying goods only from Paraguay and perhaps other South American nations, and the availability of financial markets is decidedly less as well.

The U.S. dollar's reserve currency status means the currency and the key reserve asset, Treasuries, are arguably America's most important export. Globalization requires a hegemon to provide general security. It protects trade routes and keeps

[1] On the other hand, in nations where inflation is rampant, savings is often held in foreign currencies.

[2] We won't discuss how the Paraguarí chocolatier acquires dollars, but the short answer is that he either sells his wares to an American or he borrows dollars from a bank. This is why the reserve currency nation tends to run persistent trade deficits; the world needs that currency and a trade surplus with the reserve currency nation is the surest way to secure that currency.

wars from expanding. On the financial side, as noted above, the reserve currency nation provides the currency by running persistent current account deficits and the reserve asset, which in the current case is Treasuries.

Sanctioning the Russian Central Bank

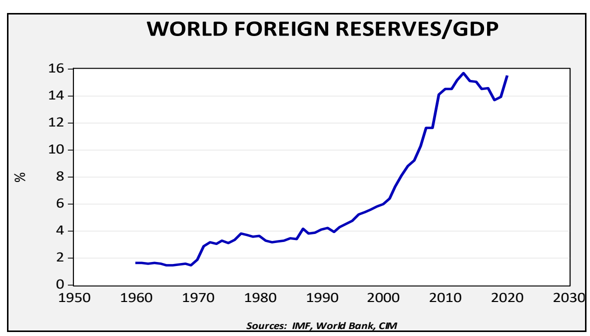
As we noted in our recent *Bi-Weekly Geopolitical Report*, the West has heavily sanctioned the Russian Central Bank to the point where the majority of its foreign reserves are frozen because they cannot be liquified without "touching" the Western financial system. This leads to an interesting problem—under most circumstances, Russia prefers to acquire hard currencies for selling energy to Europe. Russia attempted to diversify its foreign reserves away from U.S. dollars by holding euros and gold. However, in the wake of the Ukrainian invasion, euro-denominated assets were frozen as well, and gold has also become hard to liquidate.

So, Russia has found itself in an unusual situation where European nations paid for Russian energy that was exempt from sanctions in euros…which it couldn't spend. Moscow then began to demand that Europe pay for oil and gas with RUB. This demand has multiple facets. First, one goal the Kremlin has is to divide the EU and NATO to make it easier to expand its influence into eastern and central Europe. Forcing EU nations to work with the Russian central bank means these nations would be effectively breaking sanctions. Second, by demanding RUB, the currency has appreciated from the massive decline it had suffered after the conflict started. Third, it isn't hard to imagine a situation where Russia simply uses the RUB as a unit of account but demands the EU "pay" for oil and gas through a form of barter. For example, whatever the RUB cost of semiconductors or drilling equipment, the EU would provide in exchange for oil and gas. In the absence of a reserve currency, nations can still exchange goods and services through barter. Transactions such as these are not efficient, but it would mean that Russia would actually be paid with something of value.

A System at Risk

It is sometimes said that the mirror image of supply chains are payment chains. In other words, the flow of goods and services in international trade also includes payment flows. Having a set of universal currencies to denominate trade will facilitate these supply chains. That doesn't mean a nation can't have a series of bilateral exchange mechanisms but relying on these sorts of relationships alone tends to limit the extent of supply chains.

Globalization began to accelerate in the early 1990s. The combination of the expansion of the internet and the end of the Cold War allowed businesses in the developed world to move operations to areas of the world that offered the best return. In other words, globalization signaled to firms that they should optimize to efficiency and disregard other factors. And, in the wake of the Asian Financial Crisis, emerging nations built up their foreign reserves to offer them protection from financial issue. The result was a massive rise in foreign reserves.



The actions taken against Russia call into question the value of these assets. If the U.S. and allies can effectively render these assets valueless, the basic payment flows that support trade flows are now in question.

Reports from China suggest they didn't see the freezing of foreign reserves coming.

> *"We are shocked," Yu Yongding, a prominent economist and former adviser to the People's Bank of China, told Nikkei Asia, referring to the freezing of Russia's reserves, "We never expected that the U.S. would freeze a country's foreign currency reserves one day. And this action has fundamentally undermined national credibility in the international monetary system..."*

This quote encapsulates the problem created by the freezing of Russia's foreign reserves. It's going to take a while before the world adjusts to this new reality. One obvious scenario is a bipolar world, where some nations align with the U.S. and others with China. World Bank President Malpass suggested that nations should consider diversifying their supply chains from China. Treasury Secretary Yellen warned nations against trying to avoid this choice. One "carrot" she held out for nations joining the U.S. dollar bloc is the "friend-shoring" of supply chains. In other words, production wouldn't necessarily all return to the U.S., but would move to nations aligned in the dollar bloc.

There are three items we are watching to see how this situation evolves. The first is if we have a bipolar or tripolar world. With Ukraine, the initial reaction suggested that Europe would remain closely aligned with the U.S. However, European geopolitics has never fully resolved the German Problem. Germany is the strongest nation in the continent but has not been strong enough to dominate it. The inability to resolve the role of Germany in Europe led to two world wars. During the Cold War, the problem was resolved by dividing Germany. But the issue returned with reunification. Germany allowed itself to become dependent on Russian energy. Perhaps even more perplexing is the German narrative explaining that the end of the Cold War was its policy for engaging in trade. The policy was known as *Wandel durch Handel*, which is the German term for using trade with authoritarian governments to turn them in favor of democracy. Germany's relations with both Russia and China are driven by this concept. There is no guarantee that a German-led Europe could become a third bloc that tries to maintain ties to the dollar and yuan blocs.

The second item is that many nations will be loath to choose any of the blocs. These non-aligned nations would then likely need to carry at least two or three different reserve currencies. That would make the reserves less protective at any given time because it would be possible that one part of the reserves could be frozen if the country does something one of the bloc leaders doesn't like.

The third item is that the U.S. understood that once Bretton Woods ended, the U.S. would need to run persistent trade deficits to supply the reserve currency to the world. That decision has had detrimental effects on parts of the U.S. economy that compete with imported goods. It isn't obvious that the other emerging bloc leaders would do the same. China uses capital controls and thus would have to allow foreigners easy access to China's debt market. Such access would leave them vulnerable to foreign financial flows. At the same time, there is a growing trade with commodities denominated in CNY, suggesting increasing comfort with making the CNY a reserve currency. Germany has created a Eurozone that runs large current account surpluses; if that doesn't change, it's hard to see how a euro bloc could emerge.

The most likely scenario we see evolving is that nations will tend to align with one bloc and use something akin to barter with the other bloc(s). Much like the situation Russia finds itself in now, receiving euros or dollars for payment that can't be used makes little sense. And forcing the acceptance of their own currency for trade isn't necessarily helpful if it simply exchanges the foreign currency for its own. The real gain from trade would be to acquire "stuff."

What About Default?

Russia has been able to make payments on U.S. dollar-denominated bonds, but the outlook that they can do so going forward is in doubt. Standard and Poor's (SPGI, USD, 390.12) is signaling that Russia is in "selective default." Russia has paid some obligations in RUB, which is why default was declared. It appears that Russia has the dollars to pay its debt, but the issue is that the U.S. Treasury has made it nearly impossible to make payments, thus triggering the default. Default could be a major event; Russia did default on RUB debt in 1998 but hasn't defaulted on foreign currency debt since the 1917 October Revolution. An open default could lead to additional hostile actions. We might see the U.S. seize Russian reserve assets held in the U.S. In any event, a default could lead to unexpected financial stress; for example, the credit default swaps market could be affected. In some respects, the issue of Russia's dollar debt is similar to the energy situation in Europe. In both cases, it looks likely that a default will occur, and Europe will curtail its purchases of Russian oil and gas. But both sides want the other to take the step and leave the other blameless.

And If That's Not Enough

Although military activity isn't the focus of this report, we do note that China has been aggressively expanding its nuclear weapons capabilities. Russia made provocative steps in the early stages of the Ukraine War by increasing Russia's nuclear forces alert status. China may feel it needs a larger deterrent nuclear force if it decides to take control of Taiwan.

Ramifications

As globalization becomes regionalization, we will likely see a decline in overall trade. This development will make the world less efficient and raise price levels. Central banks will have to choose between taking steps to maintain current inflation targets, which likely means lower growth potential, or accepting a higher inflation rate, taking the risk of currency depreciation and higher nominal interest rates.

As we noted in the most recent *Asset Allocation Weekly*, Japan, faced with this issue, has decided to engage in yield curve control, effectively signaling that it will accept higher inflation. The hawkish tone being set by the Federal Reserve suggests, for now, that the Fed intends to defend the current inflation target.

Persistent low inflation rewards investors who take duration risk. In bonds, that means being invested at the long end of the yield curve. In equities, low inflation supports growth stocks.

As inflation rises, investors need to consider shorter-duration investments. That would mean fixed income holdings at the shorter end of the yield curve. In equities, value stocks and dividend payers, which tend to be shorter duration, would be favored. Of course, commodities, which will likely be used, at least in some degree, as foreign reserves, should also be favored.

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Confluence Investment Management LLC

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