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The Ukraine war and remaking of the world order

By Angelo Katsoras

While the world is rightly focused on the tragic events unfolding in Ukraine, investors must analyze how this conflict will reshape the global geopolitical landscape for many years to come.

A surprisingly unified West has imposed unprecedented financial sanctions against Russia. In addition, Western companies have left Russia in droves, some because of the sanctions, others to avoid the risk of a public backlash. The combined impact of these measures has devastated the Russian economy.

The necessity of these sanctions is not in doubt. However, they will have an unintended consequence: Many countries will likely seek to develop alternative financial systems and supply chains. This will add momentum to the trend of the world splitting into competing economic blocs.

The continued reconfiguration of global supply chains

Because of China-U.S. trade tensions and the pandemic, many corporations and governments had already made long-term plans to diversify supply chains and re-shore production in key sectors in order to break their reliance on geopolitical rivals for key goods. Russia's invasion of Ukraine will accelerate this trend.

One example of how recent sanctions will further rejig supply chains are U.S. restrictions on Russia's ability to purchase such things as microchips, advanced machinery, and airplane parts. These measures apply not just to goods made in America, but also to those made in other countries with American technology.¹ While China will no doubt step in to replace America in some of these areas, it cannot yet produce latest-generation semiconductors or provide spare parts for Western-made aircraft.

It is important to note, also, that it will take Western countries many years to find or develop alternative sources for many of Russia's commodity exports, particularly in the mineral sector. The International Energy Agency estimated that it takes more than 16 years on average to move mining projects from the discovery to the production phase.² Europe has been an especially large consumer of Russian commodities, including copper, nickel, palladium, and titanium.

The weaponization of finance

The West has essentially made it illegal to deal with most Russian banks, though carve-outs have been provided for certain commodities. Nevertheless, fear of a public backlash and the risk that Russian counterparts could have ties to sanctioned oligarchs have led many Western energy companies and banks to no longer purchase or finance the purchase of Russian oil and gas.

The measure that has hit hardest so far has been the decision to freeze a significant percentage of Russia's foreign reserves. After getting slapped with sanctions back in 2014 for annexing Crimea and parts of eastern Ukraine, Russia tried to sanction-proof its economy by building up reserves worth \$630 billion and reducing its USD holdings. The strategy, however, had one major blind spot. About 50% of Russia's reserves are in banks in countries that have barred Russia's central bank from tapping into them.³ Russia cannot use these assets to support its currency or stimulate its economy.

Russia's central bank can still access the 13% of the reserves it holds in Chinese yuan. However, moving these reserves out of China would require first converting them into a Western currency (e.g., USD or euros), which is something no Western bank will do.⁴

Given that Russia still needs U.S. dollars to pay for one-third of its imports, its inability to get a hold of the currency is a growing problem. Indeed, 60% of its imports from China are cleared using greenbacks.⁵

¹ "Western sanctions on Russia are like none the world has seen," The Economist, March 5, 2022

² "The Role of Critical Minerals in Clean Energy Transitions," IEA, May 2021

³ "Banks are stopping Putin from tapping a \$630 billion war chest Russia stockpiled before invading Ukraine," Fortune, March 3, 2022

⁴ "Will China fund Moscow's war chest as Western sanctions bite?" Politico, February 28, 2022

⁵ "Vladimir Putin's Fortress Russia is crumbling," The Economist, March 5, 2022

Alarm bells ringing in China

The freezing of Russia's foreign reserves and the major hit on its economy have no doubt set off alarm bells in China that its \$3.3 trillion foreign currency reserves, the world's largest, is vulnerable to similar measures. While the exact composition of China's reserves is considered to be a state secret, in 2019, the government revealed that USD assets accounted for 58% of the total in 2014, down from 79% in 2005.⁶

In an effort to bypass the Western banking system, China will likely step-up efforts to develop its alternative payment system and digital currency. Unlike electronic transactions today, those involving digital currencies could theoretically be made between two parties (i.e., central banks) without an intermediary, such as a central clearing platform.

China's Cross-Border Interbank Payment System has been touted as a potential alternative to Swift. Launched in 2015, it largely handles yuan-denominated trades between China and the rest of the world. Since late last year, it has been handling just 13,000 transactions a day on average. By comparison, SWIFT, the dominant system for cross-border payments between banks, processes more than 40 million messages daily.⁷

Even before events in Ukraine, China and the United States had already been taking measures to begin limiting financial ties. In China, companies with significant amounts of data now require government approval before trading their shares abroad. In the United States, the law provides for the delisting of companies that refuse to have their audits inspected by regulatory authorities for three consecutive years, beginning in 2024. China considers audit documents to be state secrets.

Tighter commodity markets, particularly in the agriculture sector

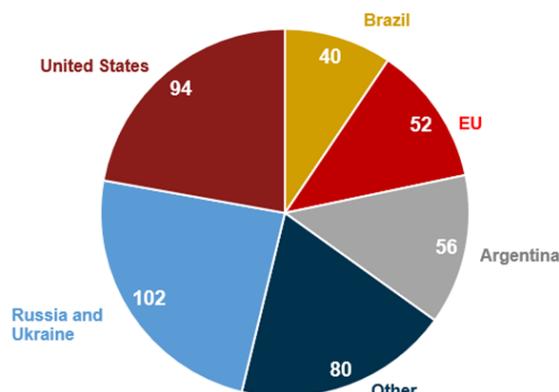
Russia and Ukraine are key producers in the agriculture sector. Case in point: The two countries account for about 18% and 10%, respectively, of the world's wheat exports. Oleg Ustenko, an economic adviser to the President of Ukraine, stated: "The regular window for starting field work [for spring sowing] is the first 10 days of March, and planting needs to be fully completed in the last week of April." This means that the longer the conflict lasts, the more harvests will suffer.

While Russian farmers are not located in a war zone, they have been negatively impacted by a spike in lending and insurance rates, not to mention global shipping boycotts. Furthermore, their exports usually ship from Ukrainian ports now in the conflict zone.

The region is also a major supplier of potash, a crucial input for fertilizers. Russia and Belarus together account for one-third of the world's exports of this commodity. In early March, Russia's trade and industry ministry recommended that the country's fertilizer producers temporarily halt exports. Brazil, for example, relies on imports for 80% of its fertilizer requirements.⁸

World: Distribution of global grains trade

Millions of tons, 2021-22 estimates, wheat and coarse grains



NBF Economics and Strategy (data via Bloomberg)

⁶ "China gives up two of its best-kept forex reserve secrets," South China Morning Post, July 19, 2019

⁷ "Why China's Banks Won't Come to Russia's Rescue," Wall Street Journal, March 4, 2021

⁸ "For Brazil, a Bad Year Could Get Worse," Geopolitical Futures, October 20, 2021



The last time that wheat prices spiked to present-day levels was in 2007–08. Food-related protests broke out then in nearly 40 countries. What's more, a jump in grain prices in 2009–10 is widely regarded as one of the triggers of the Arab Spring uprisings in the Middle East.⁹ High prices could lead to pressure for countries to reduce their use of biofuels made from food crops. In the United States, about 40% of corn production goes toward ethanol.¹⁰

Even before the Ukraine crisis, rising prices and a growing reliance on food imports had prompted China to increase its food stockpiles to very high levels. The U.S. Department of Agriculture estimated that China accounts for 69% of the world's corn reserves, 60% of its rice reserves, and 51% of its wheat reserves.¹¹ In early March, China's agriculture minister warned that conditions for this year's winter wheat crop could be the worst in history thanks to heavy rains.¹²

Europe's energy supply bottleneck

The fact that the EU is transitioning to green energy while heavily dependent on energy imports leaves it vulnerable on several fronts, particularly when it comes to confronting Russia. Europe buys roughly 25% of its oil, 50% of its coal, and about 40% of its gas from Moscow.¹³

The EU is trying to reduce this dependence by doing things such as speeding up the development of renewable energy systems and liquefied natural gas installations. The problem is that this will still take many years. For example, it will take at least three years to complete the two LNG terminals that the German government ordered immediately following Russia's invasion of Ukraine. Over the long term, Europe also faces the risk of going from being reliant on oil and gas imports to becoming dependent on imports of minerals and other inputs required to build and maintain its green energy infrastructure.

China's Russia dilemma

Prior to the outbreak of hostilities, China might well have thought that it stood to benefit from a prolonged period of tension between Russia and the West. It could have assumed that such tension would shift America's focus away from China and, at the same time, push Russia deeper into China's economic sphere of influence.

However, the longer this war drags, the greater the risk for China in the form of higher commodity prices and slowing global economy. This in addition to challenges that predate the conflict, such as its struggling real estate sector, which makes an estimated 25% of GDP, and the impact of a zero COVID policy.

Under these circumstances, the last thing China needs is to face the risk of retaliation from the newly unified leaders of its two largest export markets and sources of technology, the European Union and the United States, for, say, helping Russia bypass sanctions. China's trade with Russia was \$147 billion in 2021, compared to \$828 billion and \$756 billion for the EU and the US., respectively.¹⁴ A more unified West could also make it much more difficult for China to advance its long-term geopolitical agenda in the areas of trade and investment.

Some analysts are holding out hope that all of these factors will motivate China to pressure Russia to simply declare victory and end the conflict.

⁹ "Food crisis looms as Ukrainian wheat shipments grind to halt," Financial Times, March 6, 2022

¹⁰ "Midwest farmers look to plow through Biden's electric-vehicle push," Forbes, May 4, 2021

¹¹ "China hoards over half the world's grain, pushing up global prices," Nikkei Asian Review, December 23, 2021

¹² "China agriculture minister says winter wheat condition could be worst in history," Reuters, March 6, 2022

¹³ "Europe Needs to Cut Energy Demand. Now." Bloomberg, March 8, 2022

¹⁴ "The rising cost of China's friendship with Russia," Financial Times, March 9, 2022

Conclusion

The war in Ukraine is speeding up the creation of two major economic blocs set on becoming less dependent one on the other. One is led by the United States, the other by China. Russia will have no choice but to join China's economic bloc as a junior partner and adopt its rules and standards.

Even if the war was to end relatively soon and some sanctions were lifted, companies and countries will remain wary of doing business in Russia for the foreseeable future.

China and the United States already have separate internet, GPS, and payments systems. They also have conflicting financial regulations. The freezing of Russia's foreign currency reserves will hasten China's push to create a financial market infrastructure less exposed to potential Western financial sanctions. This could include reducing its holdings in Western currencies and buying more gold or even more commodities.

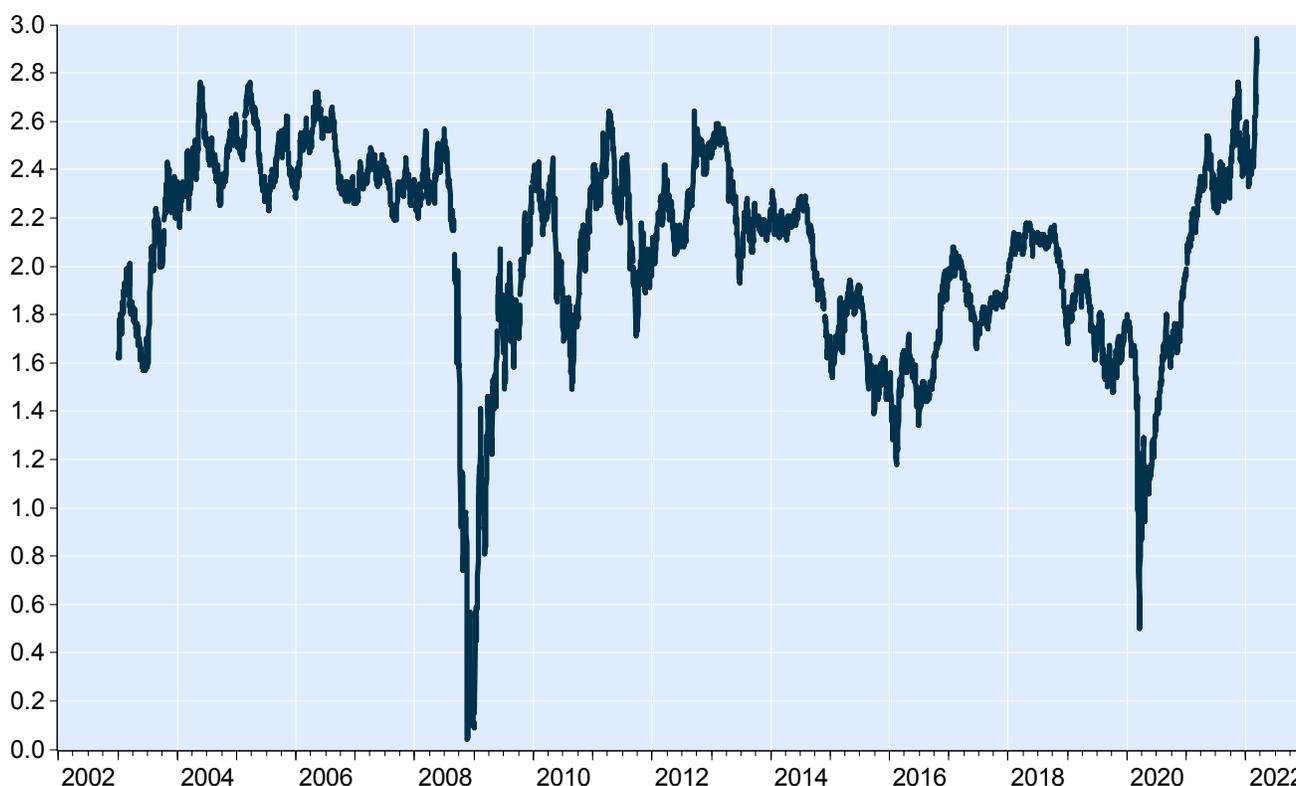
India, for its part, will be torn by the situation. On the one hand, it enjoys a close relationship with Russia, its top military equipment provider; on the other, its relationship with China has often been strained. Consequently, India will attempt to stay neutral and thus not be overly beholden to either economic bloc. Further, India's growing importance as a geopolitical counterweight to China in Asia will make the West reluctant to impose heavy penalties for breaking sanctions against Russia.

The efficiencies gained over the last many years by narrowing the production of key components to a small group of the most efficient suppliers will increasingly take a back seat to ensuring security of supply. While reshoring certain supply chains will eventually help in this regard, producing components in multiple locations for regional markets will reduce economies of scale and add to costs. In this new landscape, companies in sectors deemed strategic will be at increased risk of losing access to markets located in competing economic blocs, as each zone looks to build up its own capacity.

Finally, the massive exodus of companies from the Russian market has set a precedent that could force companies to take similar actions in response to geopolitical tensions and alleged human rights abuses in other regions.

All of the above are consistent with a trading range for U.S. CPI inflation that is likely to remain above its average of last decade for the foreseeable future. The breakeven rate on ten-year TIPS is nearing 3% for the first time since China joined the WTO.

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