De-Dollarising Nexus: A Mirage

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TAKSHASHILA RESEARCH NOTE 2022-04

V 1.0, 16-March-2022

Executive Summary

- Russia’s economy is experiencing an unprecedented downturn ushered in by economic sanctions, restrictions and high-tech export controls, which are causing the Rouble to depreciate and may cause high levels of inflation. In turn these will significantly erode Russia’s wealth and isolate it from the global economy.

- Russia’s mitigation and retaliatory measures have not had a significantly reassuring effect, and it is uncertain if they can avoid a financial collapse.

- Major Russian financial institutions’ isolation from worldwide standards like the SWIFT payments messaging service and the freezing of significant forex reserves belonging to Russia’s central bank will drive Russia to rely increasingly on China. Attempts to create a rival trading bloc may be made, but the historical precedent and current indicators don’t project it as feasible yet.

- While Russia and China may be able to convince some of their trade partners to switch some percentage of their FOREX reserves to alternative currencies and adopt alternative mechanisms for exchange, a lot of uncertainty exists about the long term sustainability of these alternative mechanisms.

Introduction

In response to Russia’s military operation in Ukraine, led by the US and European Union (EU) member states, the G7 nations have agreed to co-ordinate several severe economic measures against Russia. The new economic sanctions, restrictions and high-tech export controls have ushered in an unprecedented economic downturn in the Russian economy. With the Rouble getting devalued and a significant portion of Central Bank of Russia’s forex reserves being frozen, Russia is facing the threat of high inflation and maybe even hyperinflation in the medium run, divestment by foreign entities and wholesale wealth erosion in the long run.[1] [2]

In the immediate lead up to the imposition of sanctions and restrictions, Chinese banks and financial institutions have been hesitant and unwilling to transact with Russian entities on the US treasury’s Specially Designated(SDN) List.[3] The tendency to loath interaction with SDN listed entities is common for banks across countries, and Indian banks have also reacted similarly.[4] These banks fear secondary sanctions imposed by the US on them for flouting restrictions as defined under imposed sanctions.

With the uncertainty and lack of specifics on the newly imposed restrictions, Russia's commodity exports, especially in hydrocarbons, are also struggling to find buyers.[5] China could help by absorbing a significant chunk of energy exports, but can't replace the EU as a consumer or trading partner, as China imports almost 6.7% of Russia's natural gas and 15.4% of crude oil exports compared to the EU, which receives 60% of all Russian oil and 72% of Russia's Natural Gas exports.[6] [7] [8] [9] Furthermore, going by precedent, Russia's economic cooperation with China is very lopsided, with China reciprocating little of Russia's initiatives. A clear example of this lopsided cooperation is the adoption rate of China's payments messaging service Cross Border Interbank Payments System (CIPS), to which over 23 Russian banks have subscribed. Meanwhile, only one Chinese bank has signed up for Russia's equivalent System for Transfer of Financial Messages (SPFS). China is also likely to insist on conducting the transactions and any financing predominantly in the Yuan, as a key strategic goal for China is to make Renminbi a reserve currency alongside the US Dollar.

While China and Russia have indeed made some substantial progress in reducing the share of payments settled in their bilateral trade, they still rely on the Euro more than Yuan or Rouble. For the Russian side, the reason for choosing Euro is its relative strength compared to the Rouble and not being as affected by volatility and geopolitical developments, thus preserving the denominated wealth far more resiliently.

Crypto Currencies and CBDCs

Russia and China have both sought to ban and discourage the use and mining of private cryptocurrencies, citing both financial stability and security concerns.[10] [11] The two have instead chosen to adopt blockchain technologies for their central bank-issued-and-regulated digital currencies.[12] These Central Bank Digital Currencies (CBDC)s have no inherent advantage compared to electronically transferred denominated sums in paper fiat currency counterparts as far as international trade is concerned. As a tool to circumvent sanctions, CBDCs could be theoretically effective in avoiding the US banking system. However, the willingness of another party to accept the CBDC may not always be certain. The value of a currency, whether it be digital or paper, comes from it being widely accepted, which is an uncertain variable at this juncture.[13]

Furthermore, holding CBDCs issued by an isolated and sanctioned nation may not be a desirable prospect. The pariah status of the sanctioned states limits the holder of the CBDC to only conducting transactions with either the issuing states or a small number of other states who might also accept it. Depending on the international political environment, the holders and accommodators of the pariah nation's CBDCs could also be at the receiving end of secondary sanctions by the international community, further reducing their desirability.

The exchange rate volatility and other associated risks will still apply to Russian and Chinese or any other CBDCs, thus, they make little sense in revolutionising the paradigm of international trade in their current form. The CBDCs could be used to settle a limited set of transactions, for instance, India's defence deals with Russia, which are not a regular day on day or month on month feature.

Reliability, Deficits & FOREX

The Foreign Exchange (FOREX) reserves of a country are critical to its ability to conduct international trade, but they also play a role in storing value. Forex reserves are purposely kept in good quality liquid financial assets which can be reliably used without hurdles, as opposed to physical assets like gold, which would have to be sold to get a denominated sum in the desired currency.

While Russia and China may be able to convince some of their trade partners to switch some percentage of their FOREX reserves to alternative currencies and adopt alternative mechanisms for exchange, this would not guarantee that these would be seen as a great instrument to preserve wealth.

Due to the sheer fiscal momentum and historical precedent, the Euro, US Dollar and to some extent, Japanese Yen enjoy a generally favourable reception as assets to preserve wealth in. To match, let alone surpass the status of these currencies would be a tall order for the Yuan even with the rise of China as a peer competitor to the US.

By holding a currency as Forex reserves, the central bank buys bonds and bills issued by the government of another country. Furthermore, a suitable forex reserve currency should belong to a country with a significant current account deficit, meaning its liabilities should be higher than its assets - making it a debtor by choice. In the Balance of Payments Accounts, a persistent trade deficit reflects that a country is importing more than its exporting and drawing from the fundamental (savings) identity in macroeconomics, a trade deficit implies a domestic savings deficit as well.[i]

Without getting into the mathematical formulae, higher imports would mean higher consumption by the residents, implying lower savings (savings are left over from income after consumption). From the Balance of Payments accounting, a current account deficit has to be financed by a capital account surplus, as in the case of the US.

The world is happy to lend to the United States because of the trust in the government and the economy (apart from its military), which allows it to consume more than it produces. In fact, the persistent current account deficit of the US provides global liquidity in this manner.

[i]The national income accounting (fundamental) identity equates total income in the country (GDP) to its constituent parts, which is consumption, investment, government expenditure and net exports. A part of this identity establishes the relationship between savings and investment and exports and imports. Savings (private and public) minus Investment must equal imports minus exports (S – I = M – X). This should intuitively make sense as well, as consumers import more than they export, their savings reduces. This, in turn, will have to be financed by external savings, which is foreigners investing in the country (buying debt or equity or central banks buying US bonds) and these are recorded as capital account or financial account surplus.

China has been running a current account surplus for decades. Broadly, the Chinese economy cannot be the net supplier of liquid assets, at least not without a fundamental restructuring of its overall macro model.

Another important reason that prevents central banks around the world from holding the Yuan as a primary reserve currency is the absence of capital account convertibility in China. Capital account convertibility allows investors to freely convert their Yuan holdings to other currencies and vice versa for financial transactions. Due to significant capital controls, investors cannot be assured that they can exit the country at a time of their choosing without government intervention. In times of crisis, the Chinese government can readily impose heavy restrictions on Yuan convertibility, which can harm private investors and central banks alike.

Russia’s Divergences with China

Russia and China have reservations in taking their economic cooperation further because of structural issues and distinct national interests and priorities. Russia has until now adopted a protectionist mindset where it has stopped foreign entities from controlling a majority stake in any of its prised state corporations across sectors.[14] This ensures that the policy directives from the Kremlin and elite are followed, and corporations cater only to the Russian national and financial interests.[15] Despite this reluctance to hand over control, Russia increasingly looks to China for capital flows and borrowing but rarely secures as much as it sets out to and in the sectors and projects it desires.

China, for its part, broadly treats Russia as nothing more than another trade partner and prioritises the import of commodities and lends capital to projects which can fulfil the needs of its own economy.[16] The share of energy imports from Russia is a significant chunk of their bilateral trade, and so are other natural resources that Russia exports like timber, metals and minerals etc. China has selectively provided financing and investment for projects like Yamal LNG that benefits its own domestic industry with much-needed natural gas supplies.[17] However, China also engages with Australia, South East Asian, South American and West Asian states for energy imports, so it has not developed a crippling dependence on Russian supplies, unlike much of Europe.[18] China also exports much needed high-tech components and precision machine tools to Russia, which are important to its industrial and military-technical sectors - import of equipment for which has been curtailed by western sanctions from other sources like the US and EU.[19]

However, the share of other commodities like agro products is a more volatile area, with recent highs and some less recent dips and frictions. With concerns over transmission of COVID from import of pollack from the Russian Far East, China put restrictions which caused significant damage to Russia’s fisheries sector.[20] A similar case was observed with Russian wheat exports to China which were restricted after concerns over fungal infections were raised. Both the pollack and wheat import restrictions have now been eased by China, but the long time that they were in effect demonstrates that Russia holds no special status or gets significant special concessions.[21]

India

India has made a significant effort to facilitate transactions with Russia, especially in settling payments for defence deals. According to the deputy ambassador of Russia in India, Roman Babushkin, as quoted in a 2019 media report, Russia and India have settled their bilateral trade in their national currencies, the Rupee and Rouble, for upwards of 30% of all settled payments.[22] In the wake of the new sanctions on Russia, India has started exploring more options to settle payments with Russia.[23] Including coordinating consultations with its private sector banks and studying the feasibility of reusing moderately successful measures it applied to mitigate risks while trading with another heavily sanctioned nation, Iran. Just like when dealing with Iran, designating special bank branches which have minimal exposure to the US dollar and the US banking nexus might work but carries the inherent risk of secondary sanctions and potential fallout in India's relationship with the US.

Conclusion

Several structural and divergent interests exist in the Russia-China bi-lateral trade relationship. China and its financial institutions remain unwilling to both treat Russia with any special regard or completely de-couple with the US banking nexus in favour of Russia. These trends show that a credible contending rival trading bloc to the US and its allies is unlikely to emerge. Mere gimmicks and novelties like alternate payments messaging services and CBDCs are unlikely to have a disproportionate impact that can facilitate a de-dollarised financial nexus to emerge between Russia and China, let alone other states aligned with them.

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