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G-7 Sanctions Accelerate China-Russia Axis

Bill Campbell | March 2022

Since the Feb. 24 invasion of Ukraine by Russia, the West has moved forward with a series of severe sanctions aimed to exact an economic toll on Russia in order to force Moscow to stop the invasion. These sanctions will inflict damage on the Russian economy, but unintended and counterproductive consequences are already rising. First, the sanctions are worsening the outlooks for risk markets, growth and inflation outside of Russia. Second, the world has seen how quickly the West was able to freeze Russia's G-7 assets. Some countries might look to diversify away from G-7 holdings in favor of assets beyond the long arm of G-7 law. Finally, to counter the sanctions, Russia and China will accelerate their geopolitical, financial and economic linkages. It remains unlikely that the current sanctions will deter Russia from pursuing its objective to prevent Ukraine from moving more into the spheres of the European Union (EU) and NATO, as Russian President Vladimir Putin views either outcome as an existential threat. To summarize, while sanctions are questionable as a deterrent to Russian aggression, they will quicken the emergence of a bipolar world with the Western economies at one pole and China-Russia at the other.

The Conflict and Near-Term Economic Impacts

Russia has a strategic interest in preventing Ukraine from joining the EU or NATO, which in Moscow's eyes rises to the level of an existential stake and overrides any concern of reprisals from NATO.

I believe the conflict can be analyzed through three different lenses, and each brings into focus distinct implications. First, the conflict itself may determine if this crisis stays a global systemic risk or can migrate down to an issue that is more regional and trade linked. If the conflict is seen as spilling over into other countries, or if other nations are seen as entering the conflict in Ukraine, systemic risk will increase. If on the other hand, a stalemate ensues with fighting contained to Ukraine, we can start to differentiate between assets that are directly linked to the conflict and those that are not. For links to the conflict, we should take note that Russia and Ukraine play a very substantial role in global commodity markets. The links are not only in energy markets, where Russia supplies Europe with about a quarter of its oil needs and about 40% of its natural gas needs, but also in metals (titanium, nickel, palladium) and agriculture.

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Given Russia's strategic position in the global commodity supply chain, participants in the commodity markets will remain highly concerned about supply and prices. The sanctions have already caused disruptions to Russian energy supplies as many off-takers and transporters of Russian crude oil are holding off on shipments from Russia due to concerns that energy could be the next sector that is quickly sanctioned. Given the conflict is expected to continue for the foreseeable future, it remains likely that inflation rates will remain higher for longer across the globe.

The breakout of the war in Ukraine has introduced a tremendous amount of uncertainty around global growth forecasts for this year. Before Russia invaded, the global growth outlook was robust, and in some countries the outlooks were better than the outlook for the U.S. Outside Europe, China is starting to stimulate, which should help countries that export to China. The European Central Bank (ECB) has forecast eurozone growth of 4.2% in 2022 and 2.9% in 2023, whereas the Federal Reserve forecasts U.S. growth of 4.0% this year and 2.2% next year. When the ECB Governing Council meets on March 10, I think it is highly likely that it will revise down its 2022 and 2023 growth forecasts. Higher energy prices and increased uncertainty will weigh on global economic activity for the foreseeable future, running the risk of becoming a negative feedback loop that must be monitored closely.

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The sanctions so far have already taken a bite out of the Russian economy, but the energy sector carve-out is a glaring hole, enabling Russia to continue to receive revenues from energy sales. The Central Bank of Russia is now requiring exporters to repatriate 80% of their export profits to the central bank. This allows Russia to rebuild reserves to support its economy and war efforts. We might very well see further sanctions on the energy sector, but Russia supplying about 25% of the EU's oil and over 40% of the EU's natural gas makes it less likely that Europe will impose energy-sector sanctions due to their large economic impact.

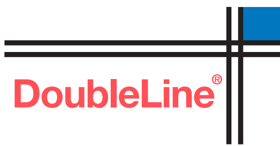
The China-Russia Alliance

Since the outbreak of the crisis in Ukraine, China has refused to condemn Russia's actions. To be sure, China is starting to become more cautious. Beijing has put out guidelines to large domestic banks to try to limit some credit exposures to Russia. China has tried to remain neutral due to the threat of facing retaliation from the West if it were to help Russia evade current sanctions.

Several aspects of the Western sanctions, however, appear to push ties between Russia and China much closer. The currency restrictions and banking sector sanctions make it clear to all nations their own vulnerability to such measures. This might cause some governments to rethink the mix of their currency reserves.

Until recently, sovereign states have had no real alternative to U.S. dollar and the euro settlement for global trade. The international messaging system SWIFT has been at the center of global financial transactions, accounting for an average 42 million global financial messages per day, according to the SWIFT Institute. The threat of SWIFT sanctions on Russia in 2014 caused the Russian and Chinese central banks to develop their own alternative financial messaging systems. Russia's alternative is the System for Transfer of Financial Messages (SFPS), and the Chinese have a similar system, the China International Payment System (CIPS). The Chinese also have started to increase the use of their digital currency and electronic payments system for international trade. Given the severe sanctions now in place, increased usage of these alternative systems is likely. While increased settlement outside SWIFT is starting with China-Russia transactions, this probably will spread to more transactions between other countries that want a backup to a system that can be so quickly weaponized by the West.

China and Russia hold meaningful positions in global supply chains, and if the two countries integrate more closely, other countries that engage in trade with China and Russia will likely be pulled deeper into Moscow and Beijing's sphere of influence. I expect China and Russia to push for trade settlement on a bilateral basis with their trading partners to avoid the use of the dollar or euro. China has been developing its digital currency for international payments and settlements, and with the bolstering of the Russian SFPS system, we are likely to see a new mechanism for global trade and financial settlement.

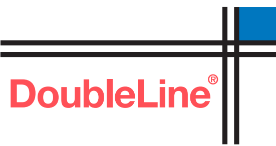


In addition, the West has sanctioned the Russian Central Bank foreign currency reserves and the Russian banking system by removing their ability to settle transactions in the U.S. dollar and other G-7 currencies: the euro, the Japanese yen, the Canadian dollar and the U.K.'s pound. These sanctions are severe and will likely have impacts well beyond the borders of Russia. To date, most of the world's currency reserves are held in G-7 countries, but many nations' trading relationships do not reflect this reserve mix. In fact, the U.S. only accounts for about 16% of the world's GDP but accounts for about 60% of the world's currency reserves. Countries might start to choose to hold their currency reserves in closer proportion to their bilateral trading relationships, diversifying their holdings away from the G-7 currencies after seeing how quickly the West froze the assets of the Russian Central Bank.

The medium-term implication of these sanctions could very likely be much closer economic and geopolitical relationships between China and Russia. Even before Russia's invasion of Ukraine, Russia and China signed a very large energy deal at the beginning of the Olympic Games. Russian energy giant Gazprom announced it will increase its natural gas exports to China and start a pipeline for additional deliveries in the future. Another Russian energy firm, Rosneft, announced a similar deal to continue to supply oil to China via Kazakhstan.

It is also notable that China has refrained from condemning the invasion. Although Beijing recently told its large state banks to be cautious in providing credit to Russian entities, this was due to the risk of Western sanctions widening to China if the Chinese are seen as helping Russia evade its current sanctions rather than any response to the Russian invasion. For the time being, China is unlikely to make any bold moves, as President Xi Jinping later this year is up for reappointment to an unprecedented third term in office. Until this event, I think Beijing will maintain its more neutral stance. It will be very interesting to see China's actions after the 20th People's Congress this October frees President Xi to pursue his domestic political focus.

There has been a lot of speculation about China and Russia decoupling from the West and forming a new economic bloc. I think that this sanction regime will speed up this integration over the medium term. As China and Russia move closer, their trade and financial flows will reorient away from Western countries and markets. Countries often make geopolitical decisions based at least in part on their important trading partners. In the near term, non-Western/non-G-7 countries with large commercial linkages to China, Russia or both cannot afford to ignore the risk of provoking sanctions if they are perceived as enabling circumvention of those placed on Russia. But coming out of this crisis, investors should be on the lookout for the new geopolitical, trade and economic linkages countries decide to form when Russia and China move to closer financial, economic and geopolitical integration. ■



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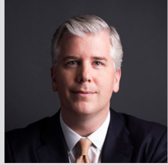

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G-7 (Group of Seven) – Forum of the seven countries with the world's largest developed economies whose government leaders meet annually on international economic and monetary issues. The member countries are: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

North Atlantic Treaty Organization (NATO) – The North Atlantic Treaty Organization is a military alliance formed by treaty among the governments of 28 European countries and the United States and Canada. Under the terms of the North Atlantic Alliance, the members agree to their mutual defense in the event of an attack by any external party. The European members of NATO are Albania, Belgium (home to NATO's headquarters), Bulgaria, Croatia, Czech Republic, Denmark, Estonia, France, Germany, Greece, Hungary, Iceland, Italy, Latvia, Lithuania, Luxembourg, Montenegro, the Netherlands, North Macedonia, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Turkey and the United Kingdom.

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