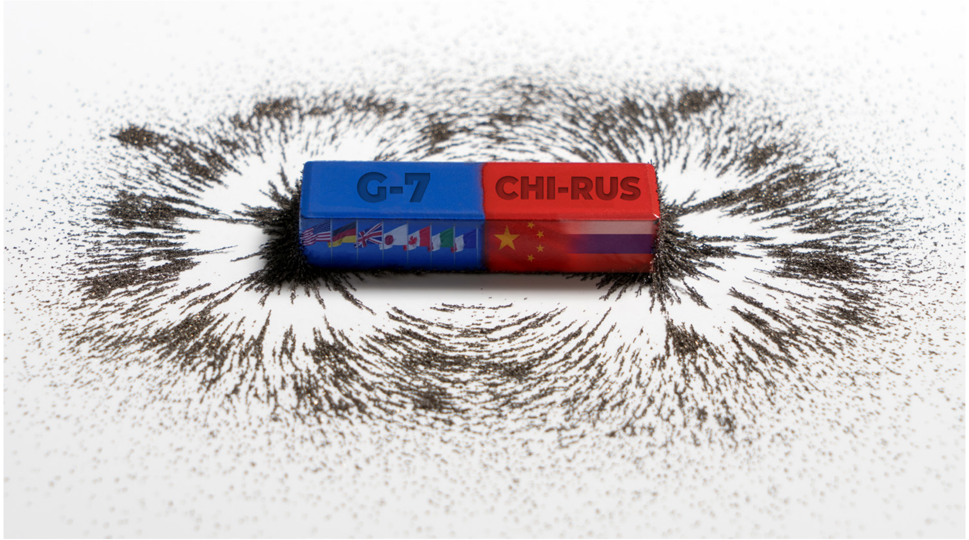
The Ruble as Weatherglass of a Competing Trade-and-Finance Axis

Bill Campbell | August 2022



The sanctions imposed by the G-7 countries on Russia in the wake of the Russian invasion of Ukraine raised high expectations among Western leaders. U.S. President Joe Biden declared on March 8, "We are enforcing the most significant package of economic sanctions in history, and it's causing significant damage to Russia's economy. It has caused the Russian economy to, quite frankly, crater."[1] In a March 26 tweet, the president crowed, "As a result of our unprecedented sanctions, the ruble was almost immediately reduced to rubble."[2] Today, while confronted with recession, Russia nonetheless has largely taken these sanctions in stride. On the war front, viewed from a tactical perspective, Moscow has continued military actions in Ukraine, gaining territory and disappointing a spate of optimistic Western predictions in the process.[3] The Kremlin also has turned the tables on Europe by holding the continent hostage due to its dependence on Russian energy. On the strategic front, Russia is enlarging trade and financial relationships with China, India and other Asian economies as it looks to secure its economic and geopolitical future.

Russia is home to a mountain of natural resources that the country has used to gain wealth and influence around the globe as one of the largest exporters of commodities. For decades, Western countries have invested in Russia to source energy, agriculture, fertilizer and other raw materials. This created a dependence in the West on these supplies from Russia and put Russia in a position of strength when Moscow decided to invade Ukraine. In fact, the sanctions imposed by the West on Russia might be inflicting more damage to the West than to these measures' intended target. As I noted in a previous paper, those sanctions accelerated the development of a Beijing-Moscow trade-and-finance axis.[4] In light of Russian resilience, including the strength of Russia's currency and current account surplus, the China-Russia axis has gained credibility as an exemplar to other sovereign governments seeking alternatives to a world order once dominated by the G-7 countries.

Western sanctions against Russia have not only failed to work as intended, they also have accelerated trends in global trade and finance to the disadvantage of the West. Investors should keep these developments on their radar, as resulting opportunities in emerging markets and infrastructure projects are likely to become more apparent in the quarters and years ahead.

Sanctions and Energy Prices

A series of coordinated G-7 sanctions put in place on Russia since the invasion of Ukraine has frozen Russia out of the Western global financial networks for almost all transactions expect for energy. The fatal flaw in the construction of these sanctions was the exclusion of Russian energy exports. This has allowed the Russian government to continue strategically vital sales of natural gas, oil and coal. The sanctions have allowed Russia to further strengthen its current account balance as the price of energy has soared well past the financial impact that might have occurred from any decrease in export volume. Russia's current account surplus totaled $138.5 billion by the end of the first six months (January-June) of 2022. This compares to $39.7 billion at the end of the first six months of 2021. *(Figure 1)* As noted by Central Bank of the Russian Federation (CBR), the current account surplus was expanded by a significant growth in exports and a decline in imports.

Russia Current Account Balance

(6 mo chg, $ Bln) December 31, 2007 through June 30, 2022

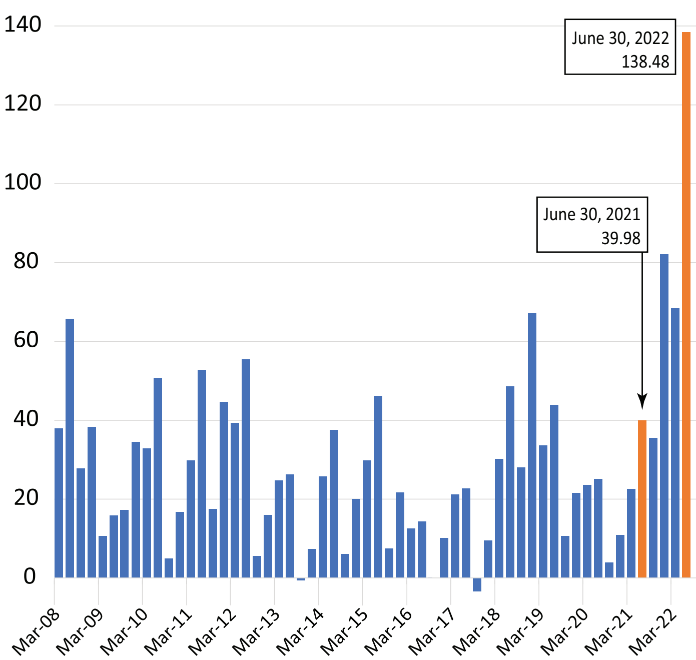


Figure 1
Source: DoubleLine, Bloomberg

In the months following the invasion of Ukraine, global energy prices skyrocketed, especially energy prices paid by Europe. As Russia accounts for a significant portion of the energy needs of Europe and indeed the world, the result was windfall profits to Russian energy exporters in the form of foreign currency payments. At the same time, sanctions by the West on the Russian economy have brought about a severe contraction in imports of goods and services to Russia, as the sanctions have frozen the Russian banking system out of the Western financial system. This will likely keep imports constrained in the foreseeable future. To be sure, the sanctions have had an impact on the domestic Russian economy, as retail sales in Russia dropped about 10% year-over-year in May, reflecting the recessionary headwinds facing the country. This drop in domestic consumption has resulted in a dynamic whereby Russians' demand for foreign currency has plummeted while they continue to receive a large supply of foreign currency via revenues from the commodity-exporting companies. Moreover, a report from the Centre for Research on Energy and Clean Air estimates that Russia earned €93 billion in revenue from fossil fuel exports in the first 100 days of the war (Feb. 24 to June 3).[5]

Central Bank of the Russian Federation: Playing to the Ruble's Strength

On Feb. 28, the CBR implemented rules for exporting companies in Russia, mandating the conversion of their export proceeds from foreign currency back into rubles. When the rule was implemented, the CBR required exporting companies to convert 80% of their foreign currency revenues back into rubles. The goal was to help stabilize the sell-off in the currency. From mid-March through May, the ruble not only recovered the losses experienced at the start of the Ukraine crisis but appreciated beyond the levels it traded at prior to the crisis. This program was so successful that the CBR on May 23 was able to relax the percentage of revenues required to be converted from 80% down to 50%. The ruble has remained well supported since that time. *(Figures 2, 3)*

Russia's Resilient Ruble | December 31, 2021 through July 31, 2022

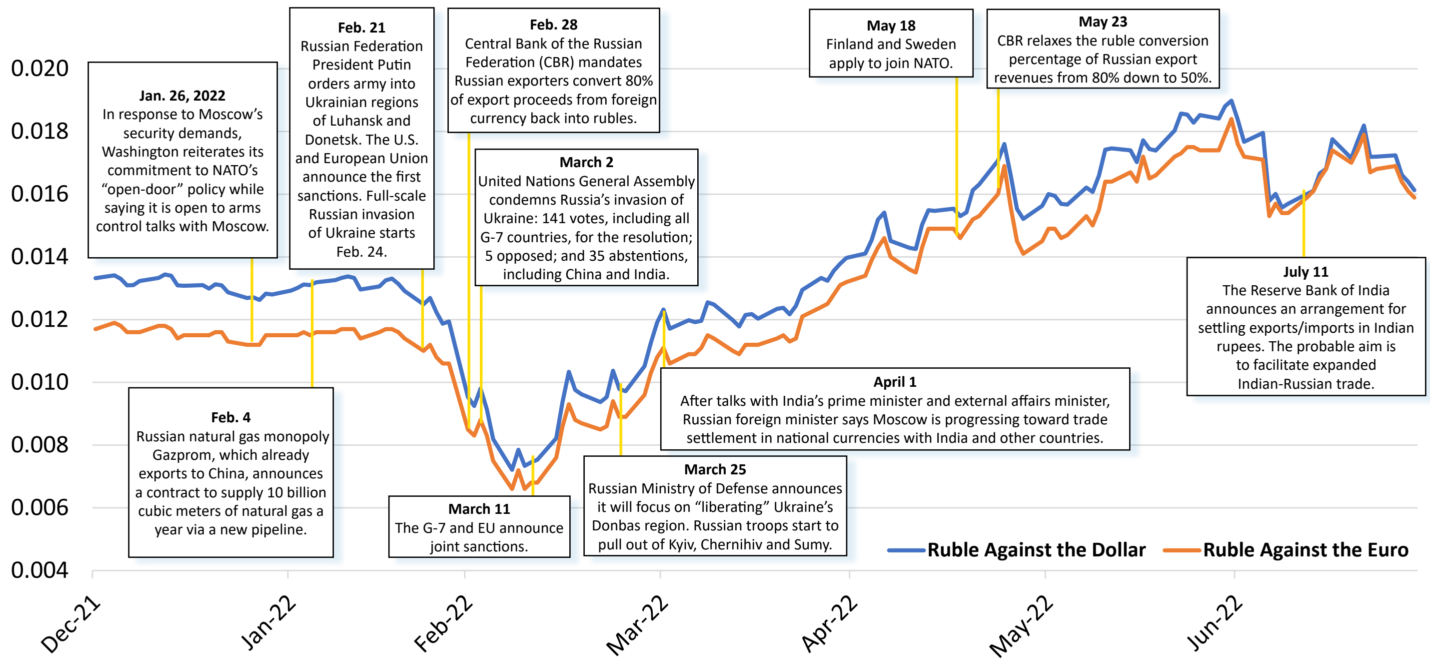


Figure 2
Source: DoubleLine, Bloomberg, various news reports

2021: In January, Ukraine President Volodymyr Zelensky appeals to U.S. President Joe Biden to permit Ukraine to join NATO. In the spring, Russia begins massing troops near Ukraine's borders in what it says are training exercises. On Dec. 7, Biden warns of sweeping Western sanctions against Russia if it invades Ukraine. Dec. 17, Moscow demands that NATO withdraw forces from Eastern Europe and commit to never admitting Ukraine as a member.

Ruble in Multiyear Highs vs. Dollar, Euro
Jan 1, 2019 through August 2, 2022

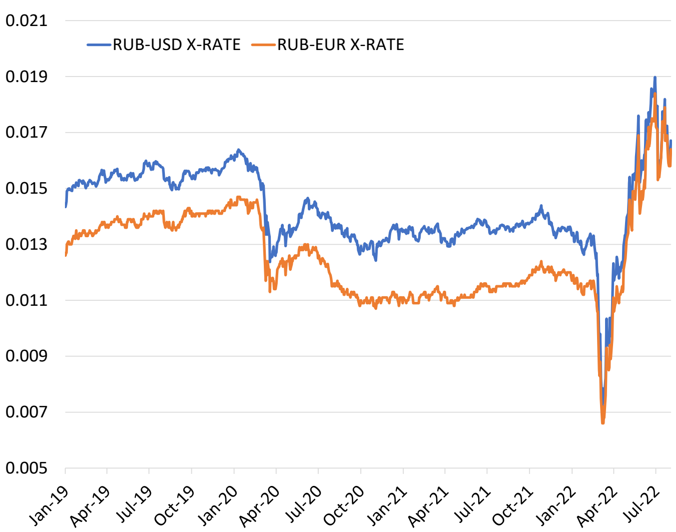


Figure 3
Source: DoubleLine, Bloomberg

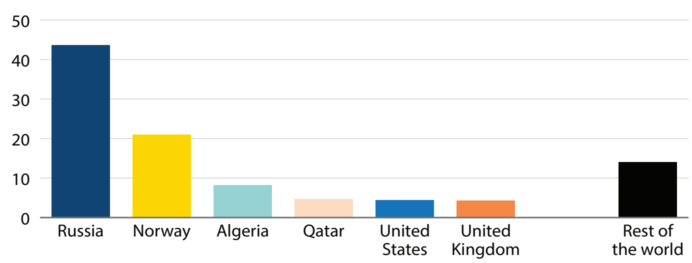
This currency strength, the direct result of a supply-demand imbalance in the ruble produced by the sanctions, should have been foreseen by G-7 policymakers. In fact, Russia not only is resource rich, she also has the extraction and supply chains needed to bring those resources to global markets. Those advantages have put Russia in a position to stem even Western sanctions. For the foreseeable future, I believe Moscow can pursue its policies in Ukraine, undeterred by the G-7 sanctions. In fact, Russia's majority state-owned energy exporter, PJSC Gazprom, on July 25 announced a further reduction in the flow of natural gas through the Nord Stream 1 pipeline to half of the already-reduced volume. This will put into question the ability of Germany and other European Union (EU) countries to make it through the winter without having to resort to electricity blackouts. For the sanctions to achieve the stated goal of softening Moscow's commitment to the invasion, I believe Western democracies, especially those of Europe, would need the political will to incur severe economic and political consequences at home.

The Long Game

To be sure, the West is trying to find ways to end its dependence on Russia's supplies of energy. The EU imports around 4.5 million barrels per day of crude oil from Russia, two-thirds of which are delivered by tankers. *(Figure 4)* EU leaders have reached an agreement to embargo maritime oil shipments from Russia through a ban on insurance on seaborne Russian oil shipments. EU Council President Charles Michel said the agreement covers more than two-thirds of oil imports from Russia. Ursula von der Leyen, the head of the EU's executive branch, said the punitive move will effectively cut around 90% of oil imports from Russia to the EU by the end of 2022. Natural gas dependence, however, remains problematic. Russia accounts for about 40% of the natural gas imports of the EU. The EU recently agreed to expedite a 15% reduction in natural gas usage across the region, but that will be easier said than done. Originally scheduled to begin in 2023, the new agreement, announced on July 26, was supposed to start, in principle, almost immediately.

2020 EU Imports Share by Origin
(% share of all extra-EU imports)

Natural Gas (in cubic meters)



Crude Oil (in tonnage)

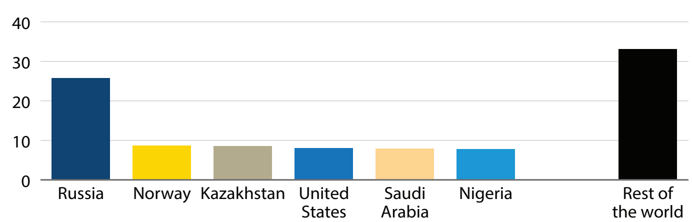


Figure 4
Source: Eurostat

Despite these efforts, it will take years for Europe to rewire its energy infrastructure away from Russian oil and, more importantly, Russian natural gas. In fact, the new agreement provides opt-out provisions for countries that are highly dependent on Russian natural gas.

The Russians are not sitting idle, however. They are using this time to adjust their exports to "more friendly" countries that will be less willing to sanction their exports. Examples of new energy-export partners for Russia are China and India, the world's second and sixth largest economies by GDP. Even before the Ukraine conflict, increased energy shipments, and other expansions and innovations in trade cooperation were already underway among these countries. In December 2019, the Power of Siberia 1 pipeline turned on, starting one of the largest Russia-China liquid natural gas (LNG) pipelines to date. At that time, Gazprom announced by "2023, nearly 40% of Chinese gas demand growth will be met through Russian gas from Power of Siberia."[6] Plans for a second Russia-China pipeline were announced Feb. 4 when Putin was attending the Winter Olympics in Beijing. The Power of Siberia 2 pipeline will divert gas from Russia's Yamal field, which currently accounts for about a third of Russian LNG exports to Europe. The new pipeline is expected to have about the same capacity as the Nord Stream 2 gas pipeline from Yamal to Germany, which has already been constructed but now is unlikely to enter service.

The adjustments go beyond commodity exports. Russia is rewiring its financial ties to "more friendly nations" as well. For example, it is widely believed that the CBR is now intervening in the currency market to slow down the pace of the ruble's appreciation. Russia appears to be taking a more strategic framework in rebuilding its reserve assets. Reuters has reported that Russia's purchases of Chinese yuan have grown eightfold since May 20. The sanctions effectively confiscated the majority of the CBR foreign currency assets. Thus, Moscow's shift to holding foreign currencies of "more friendly nations" will likely be a durable regime.

On July 11, the Reserve Bank of India (RBI) announced an arrangement for invoicing, payment and settlement of exports/imports in Indian rupees, probably to facilitate expanded trade with Russia. This new system with the RBI enables a bilateral ruble-rupee payment system between the two countries. I discussed the coming proliferation of such bilateral arrangements, bypassing the U.S. dollar, in a paper last year, as the world moves to a more a multipolar order, with the two strongest axes being the G-7 and China-Russia.[7] To no one's surprise, New Delhi has chartered a foreign policy in coordination with its imports of Russian energy and military arms. The Indian foreign ministry has refused to back U.S. and EU sanctions over the Ukraine conflict and has emphasized its engagement to stable economic relations with Russia.[8] India was among 35 nations, including China, that abstained in a March 2 vote in which the U.N. General Assembly voted 141 for, five against to condemn Russia's invasion of Ukraine.

The government of the world's largest democracy by population also was among 58 nations to abstain on April 7 when 93 nations in the General Assembly adopted a resolution, over 24 voting against, to suspend Russia from the U.N. Human Rights Council.[9]

The Great Realignment: Cui Bono?

Europe and Russia are embarking on a massive realignment in their energy and trade structures over the coming years as they seek to bring an end to their mutual co-dependence. Such a transformation would necessitate an immense infrastructure build-out. Russia will continue to focus on energy transportation infrastructure to new markets such as China and the rest of Asia. Europe will need to build out LNG ports, and refining and energy storage capabilities. The net beneficiaries from this new infrastructure will be industrial metals and economies that extract and export the raw materials for these Eurasia infrastructure build-outs.

Today, the world is worried about an impending recession caused by inflation and tightening financial conditions under hawkish central bank policies aimed at addressing that inflation. Industrial metals and emerging markets have faced these challenges, but these markets stand to benefit when the European and Russian energy infrastructure projects get underway. Given that energy infrastructure is not only of strategic importance but also a national security issue for these regions, these projects will likely be prioritized even in a challenging macroeconomic environment. Investors should sharpen their pencils now to be ready to benefit from these secular shifts.

Deepening trade and financial linkages between China and Russia are creating a rival political and economic pole to the G-7. I think it is likely that other nations, especially emerging markets with substantial trade ties to Russia and China, will become parties to this axis, with Beijing as the senior member. As economic and financial connections between China and Russia continue to grow, emerging market countries will need to decide if their own economic and financial linkages are more tied to China or to the West. As noted in my previous paper, a multipolar world, already emerging before Russia's invasion of Ukraine, has been accelerated by the G-7's sanctions against Moscow.[10] Within that multipolar world, some countries will face the binary choice of a net alignment with the West or China, as in the case of Iran's alignment with the latter. Others will endeavor to steer a course between both axes, as in the case of India. In any event, for many governments, G-7 alignment will no longer be a default setting. Russia's resilience in defiance of some of the most severe sanctions the West has ever imposed demonstrates the viability of the Sino-Russo axis for all to see. ■

Endnotes

[1] Remarks by President Biden Announcing U.S. Ban on Imports of Russian Oil, Liquefied Natural Gas, and Coal, White House, March 8, 2022. https://www.whitehouse.gov/briefing-room/speeches-remarks/2022/03/08/remarks-by-president-biden-announcing-u-s-ban-on-imports-of-russian-oil-liquefied-natural-gas-and-coal/

[2] President Biden @POTUS, March 26, 2022. https://twitter.com/potus/status/1507842574865866763

[3] "Has Russia Reached Its 'Culminating Point' in Ukraine?" Russia Matters, Harvard Kennedy School Belfer Center for Science and International Affairs, July 20, 2022. https://www.russiamatters.org/blog/has-russia-reached-its-culminating-point-ukraine

[4] "G-7 Sanctions Accelerate China-Russia Axis," Bill Campbell, March 8, 2022, DoubleLine.com. https://doubleline.com/wp-content/uploads/G-7-Sanctions-Accelerate-China-Russia-Axis_Bill-Campbell-3-8-22.pdf

[5] "Financing Putin's war: Fossil fuel imports from Russia in the first 100 days of the invasion," Centre for Research on Energy and Clean Air, June 13, 2022. https://energyandcleanair.org/wp/wp-content/uploads/2022/06/Financing-Putins-war-100-days_20220613.pdf

[6] "Russia, China agree 30-year gas deal via new pipeline, to settle in euros," Reuters, Feb. 4, 2022. https://www.reuters.com/world/asia-pacific/exclusive-russia-china-agree-30-year-gas-deal-using-new-pipeline-source-2022-02-04/

[7] "Taking Aim at the U.S. Dollar, the World Builds a Multipolar Trade-and-Payments Order," Bill Campbell, January 2021. https://doubleline.com/wp-content/uploads/Taking-Aim-at-the-Dollar-in-a-Multipolar-Order-January-2021.pdf

[8] "India's position on unilateral sanctions hasn't changed a bit: Ministry of External Affairs," The Hindu, April 29, 2022. https://www.thehindu.com/news/national/indias-position-on-unilateral-sanctions-hasnt-changed-a-bit-ministry-of-external-affairs/article65364521.ece

[9] All the BRICs, the four largest emerging market economies, declined to support Russia's suspension from the Human Rights Council: China and Russia voted against, Brazil and India abstained.

[10] Taking Aim at the U.S. Dollar, the World Builds a Multipolar Trade-and-Payments Order," Bill Campbell, January 2021. https://doubleline.com/wp-content/uploads/Taking-Aim-at-the-Dollar-in-a-Multipolar-Order-January-2021.pdf

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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.