Putin’s Options

Description

There’s no doubt that the financial sanctions put on Russia by the U.S., the U.K., EU members and others are the most severe ever imposed. The U.S. Treasury has announced 15 separate sanctions programs in recent days and no doubt more are on the way.

The targets of these sanctions include Russian banks, Russian stocks and bonds and various payment channels. Most significantly, the U.S. froze the accounts of the Central Bank of Russia. That’s the first time a major central bank’s assets have been frozen since the Cold War, and possibly ever.

Yet the financial attacks on Russia go far beyond official sanctions.

Numerous private companies including Microsoft, Exxon Mobil, Shell and some major airlines have ceased their business activities in Russia. Visa and Mastercard have stopped accepting credit card charges from Russia. Google and Apple have turned off the mobile payment apps on phones held by Russian citizens.

Shipping giant Maersk has stopped its vessels from unloading or taking cargo from Russian ports. Stock index funds are pushing Russian companies out of their indexes and the Norwegian sovereign wealth fund is divesting Russian stocks. The list of public and private embargoes and boycotts goes on.

The financial impact on Russia will be extreme. The Russian economy may be expected to collapse by 20% or more in the first half of 2022, an amount comparable to the economic collapses in the second quarter of 2020 during the first lockdown stage of the pandemic.

The Sanctions Boomerang

But Russia has not stood still. The Central Bank of Russia imposed capital controls so that Russian companies cannot pay interest or principal on international debts. That means those loans and bonds may soon go into default.

Many such securities may be stuffed into 401(k) plans of Americans under the umbrella of “emerging markets” funds or ETFs. Even more important is the possibility that interbank lending may start to dry up as Russian banks are frozen and Western banks reduce leverage and shrink balance sheets in order to reduce risk.

This will lead to defaults in the West and could even mark the beginning of a global liquidity crisis that can only be contained by Federal Reserve currency swap lines, like we saw in the early stages of the pandemic when markets were collapsing.

But even that technique may not work since there are no swap arrangements in place between the Fed and the Central Bank of Russia. The shooting war may or may not be over soon, but the financial war has just started and will continue after the shooting stops.

For that matter, a global financial panic may emerge even before the shooting stops. We all see what’s happening on the surface. Here’s what you don’t see: Someone is on the wrong side of every one of those trades. Hedge funds and banks are losing billions and are sinking. It takes about a week for bodies to float to the surface.

And foreign investors who try to sell Russian companies will find that their sales are blocked. Russia imposed capital controls so that Russian borrowers cannot pay their creditors in dollars or euros.

So yes, sanctions will hurt Russia. But like a boomerang, those same sanctions can hurt the U.S. economy, which is on shaky ground as it is.

It’s almost like cutting off your nose to spite your face.

Russia Still Has Options

And Russia can work around the sanctions to obtain at least some access to the global financial system. The main loophole is that Russia may still receive dollar payments for oil and natural gas. Those payments may be frozen inside the central bank, but they can still be received and added to Russia’s reserves.

Russia can also transact outside the SWIFT messaging system using older technologies such as telex and internet channels outside of SWIFT. Russians can also transact through Chinese and other banks that have not joined the sanctions.

Also, Russia’s official media report that Putin seeks to establish a ban on the export of certain products and raw materials outside the country by the end of 2022.

Besides oil and natural gas, Russia exports substantial amounts of food crops and precious metals used in industrial production like aluminum, titanium, palladium, platinum, nickel, cobalt and copper.

This is the most important move yet. Consumers are familiar with the retail end of the supply chain. But they aren't as familiar with the input end. If you can't source the raw materials, you can producefinished goods.

For example, the farmers who grow food and raise livestock and the butchers and food processors who prepare that output into meat, poultry, bread and dairy products are not the source of the supply; they are intermediaries. The source of the supply chain is in fertilizers made from chemicals, especially nitrogen and phosphate.

Any break or bottleneck anywhere in this supply chain will result in either higher prices or empty shelves at the consumer end.

If Russian nitrogen exports are diminished and prices soar, that has a global impact including on U.S. farms. The impact of higher fertilizer prices does not stop with grain. Most grains are used not for direct consumption by humans but as feed grains for livestock. That means the fertilizer price increase will flow through to meat, poultry, eggs and dairy products.

These breaks are already occurring. Russia and Ukraine together provide more than 25% of the wheat supply in world trade and 20% of global corn sales. Ukrainian exports are already in disarray because of the war and Russian exports are being handicapped by the sanctions.

Don't Forget About Russia's Gold

Finally, Russia has $150 billion in official physical gold bullion. This gold cannot easily be sold or bartered, but it can be leased or used as collateral for hard-currency loans.

The latest dumb idea out of Washington is to freeze Russian gold. But the gold is physical and it's inside Russia. The only way to freeze it is to leave it outside in the winter. You can freeze dollar-sale proceeds, but Russia's a buyer not a seller. It can buy gold directly from Russian mines.

And Russia can use parallel loan structures (which haven't been used much since the 1970s) where a lender inside Russia can also be a borrower outside Russia in a separate transaction with the obligations netted out.

None of this is efficient relative to a normally functioning system, but it does work. The bottom line is that the Russian economy will muddle through despite the sanctions, although with higher costs, more risk and less liquidity.

The main point for investors to understand is the damage will not be confined to Russia. These inefficiencies and this illiquidity will ripple out to all parts of the global financial system.

Investors should prepare now with larger allocations to cash and gold and by reducing stock market exposure. It's a good idea to build up your own liquidity before the wave of defaults and margin calls hits home.

Regards,

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for *The Daily Reckoning*

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Category

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