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War and Currency Statecraft

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War cuts new financial channels.

What are G7 policymakers, rates traders, and strategists to do when threats to the unipolar world order are coming from every angle. They should definitely not ignore the threats, but they still do. How could they not? For two generations, we did not have to discount geopolitical risks. Since the end of WWII, the only Great Power conflict investors really had to deal with was the Cold War, and since the conclusion of the Cold War, the world enjoyed a unipolar "moment" – the U.S. was the undisputed hegemon, globalization was the economic order, and the U.S. dollar was the currency of choice. But today, geopolitics has reared its ugly head again: for the first time since WWII, there is a formidable challenger to the existing world order, and for the first time in its young history, the U.S. is facing off against an economically equal or, by some measures, superior adversary.

China is proactively writing a new set of rules as it replays the "Great Game" (see here), creating a new type of globalization with new institutions like the Belt and Road Initiative, BRICS+, and the SCO. Global warming is helping Russia add an "artic suspender" (see here) to China's Belt and Road vision, and China, while under lockdown, forged a special relationship not just with Russia but all of OPEC+ (see here). And as Pippa Malmgren recently noted, commodity-rich Africa is now also a frontier in what I called the quest for "commodity encumbrance".

One Belt, One Road (and an Artic Suspender) means…

…One World, Two Systems. Maybe not in these words, but I am sure you have heard these themes before and that you are aware of them. And if you are…

…you should stop pretending that this means *nothing* for the U.S. dollar or demand for Treasury securities. If the world is going from unipolar to multipolar; if the world is gradually drifting from "one world, one system" (globalization) to "one world, two systems" (friendshoring and Belt and Road); and if the G20 is seemingly splitting into the "G7 + Australia", "BRICS+", and "the non-aligned", it's impossible that this split won't affect the international monetary system…

Indeed, "G7 + Australia" is being challenged by the "original" BRICS plus the "+" – Turkey, Saudi Arabia, and Argentina. Recently, the first two of these countries started to apply to become members of BRICS, and the "non-aligned countries" of Indonesia, Mexico, and South Korea matter for different reasons: first, Indonesia wants a "lithium OPEC", Mexico nationalized lithium mining, and South Korea – snubbed by AUKUS – was "told" to uphold the "Three Nos" policy.

The G20 is becoming the "G7 + Australia" = 8 countries on one side, and "BRICS + new applicants + the thematically aligned" = 11 countries on the other. 8 + 11 = 19. The remaining member, the European Union (EU), is perhaps the most directly affected by this global "split". Indeed, we've come quite a long way from the family photo of the 2017 G20 Summit (see here): Chancellor Merkel, dressed in red and grey, is flanked by BRICS heads of state on both sides – President Jacob Zuma and President Jair Bolsonaro on her right and President Xi Jinping and President Vladimir Putin on her left – strikingly, President Trump and President Macron on the outer edge of the family picture.

Back then, the big deal about the G20 Summit was President Trump's one hour, off-the-record conversation with President Putin and the seating arrangement at the dinner table (see here), but in retrospect, and in light of this year's events, the significance of that G20 family photo was those surrounding the chancellor.

Since then, the EU crashed out of Russia's "gas orbit" but remains in China's economic orbit, and the BRICS embarked on "BRICSpansion" in other directions:

Argentina and Iran applied already, as did Algeria (see here, here, and here), and as noted above, Saudi Arabia and Turkey are planning to apply, while Egypt – a neighbor of Saudi Arabia across the Gulf of Aqaba and neighbor of MBS's signature city of NEOM project – is also planning to apply next year (see here).

Based on this list of attendees from the Ministry of Foreign Affairs of the PRC, many attendees of this year's dialogue of foreign ministers between BRICS and emerging markets and developing countries have either formally applied or are in the process of applying to BRICS+. We have yet to hear from Indonesia, Thailand, Kazakhstan, the UAE, Nigeria, or Senegal (all attendees), but as I noted here, 2023 will be pivotal for BRICS: after a Covid-induced hiatus, China plans to host the third Belt and Road Forum (the "WEF" of the East) in March or April 2023 (see here). I expect formal applications to come in by then.

The map in this article is quite important to "internalize" because it is a map that Zbigniew Brzezinski specifically warned against in his classic foreign policy booklet, *The Grand Chessboard*. Therein, on page 32 of the first edition, Brzezinski shows a map that shows the world upside down (the Southern Hemisphere atop and the Northern Hemisphere at the bottom), and Brzezinski notes the following:

"*how the U.S. manages Eurasia is critical. Eurasia is the globe's largest continent and is geopolitically axial. A power that dominates Eurasia would control two of the world's three most advanced and economically productive regions. A mere glance at the map also suggests that control over Eurasia would almost automatically entail Africa's subordination, rendering the Western Hemisphere and Oceania geopolitically peripheral [to Eurasia]. […] Eurasia is thus the chessboard on which the struggle for global primacy continues to be played…"*

So that's that: when "BRICSpansion" is understood from the perspective of Brzezinski's framework, you'll then have a good idea as to why Great Power conflict matters for your portfolio. Because paraphrasing Sir Halford Mackinder:

"*whoever encumbers commodities and controls the factories rules inflation, whoever rules inflation controls interest rates, and whoever controls interest rates controls the level of the stock market and financial wealth more generally*"…

…which clarifies that Great Power conflict, BRICSpansion, "BRICS coin", and commodity encumbrance portend nothing good for your 60/40 portfolio. Adapt!

Why am I going Ian Bremmer on you? After all, I am just a "plumber", not a geostrategic expert. I agree. But with geopolitics, I'll take you to places that a geostrategic expert won't: to the deepest depths of the global financial system…

…where I see nothing good brewing.

The ugly part of BRICSpansion is that the one thing that the BRICS are most aligned on is the de-dollarization of their fast-growing, bilateral trade flows, and so "BRICSpansion = more de-dollarization". The map of BRICSpansion here, together with the map of Brzezinski's "nightmare" above (do read the book), suggests that the drive to de-dollarize intra-BRICS trade and soon intra-BRICS+ trade will speed up. Don't tell me that doesn't threaten the dollar's supremacy, or that it won't hurt the "exorbitant privilege". "Our currency, your problem" – pushed too far with sanctions – boomeranged. Secretary Jack Lew was right when in 2016 he said that "*the more we condition the use of the dollar and our financial system on adherence to U.S. foreign policy, the more the risk of migration to other currencies and other financial systems in the grows*". Indeed.

Today, the migration Secretary Lew warned about is on with full force, and Brad Setser's recent blog, "*The New Geopolitics of Global Finance*", describes how the flows have changed. Among current and aspiring BRICS members, current account surpluses are at a record, but dollars aren't being put into Treasuries but are used for geopolitical ends – China, Russia, and Saudi Arabia are becoming bankers to EM countries dealing with crushing dollar debts: Russia is funding Turkey, China is funding Russia (see graph 5.4 here), the Saudis and the GCC are providing more financing to Egypt than the IMF, and China and Saudi Arabia are providing funds to Pakistan as per Brad's blog.

These are all new dynamics for the U.S. dollar system, so let's pay attention: the flows that Brad highlights means that current account surplus countries are putting a greater distance between themselves and the U.S. Treasury and the western financial system. By "deflecting" dollar inflows, they are weaponizing the U.S. dollar as well to secure foreign policy wins in the new "Great Game" at the expense of the G7. And "deflection" is the anteroom of de-dollarization: our starting point to understand de-dollarization should be a book by Zoe Liu and Mihaela Papa, *Can the BRICS De-Dollarize the Global Financial System*, which we discussed in our previous dispatch. The book was published just before the outbreak of the war in Ukraine and highlights the "plumbing" that's been put in place by the BRICS countries to de-dollarize their trade relationships. Since the outbreak of the war and the freezing of Russia's FX reserves, both current and aspiring BRICS members sped up their de-dollarization efforts:

India rupee settlement mechanism draws interest from more nations

India, UAE in talks for rupee-dirham denominated bilateral trade

Russia is seeking oil payments from India in UAE dirhams

These are all headlines from this year (2022) involving a BRICS member (India) that arguably has the best relations with the G7. Regarding the renminbi settlement of oil and gas, we know that Russia and Iran have been accepting renminbi since 2021 and 2022, respectively, and in light of the China-GCC Summit, we discussed the birth of the petroyuan at length in our prior dispatch (see here). Meanwhile, President Lula is back in Brazil, which will give de-dollarization further momentum: according to the book by Liu and Papa, for President Lula, "*BRICS was not created to be an instrument of defense, but to be an instrument of attack. So we [have] our own currency to become independent from the U.S. dollar in our trade relations*". And President Lula went on:

"*[President] Obama called me, telling me, 'Are you creating a new currency, a new euro?' I said, 'No, I'm just trying to get rid of the U.S. dollar… I'm just trying not to be dependent'*". My point is that next year and beyond…

…the U.S. dollar and Treasury securities will likely be dealing with issues they never had to deal with before: less demand, not more; more competition, not less.

De-dollarization is about to accelerate from here…

I am currently reading Chapter 9 of Perry Mehrling's "*Money and Empire*", and as Perry notes, Kindleberger understood war to be a "doula" to financial innovation (doula is my word, not Perry's or Charlie's): "*war is a hothouse and places enormous strain on resources, which finance is used to mobilize. […] Financial innovation occurs in wartime. […] War both cuts off old connections in trade and finance and [drives] the fashioning of new. War cuts new channels*".

For the record, Perry and I totally disagree about the future of the U.S. dollar (listen to our debate on Bloomberg's Odd Lots here), but in light of Perry's quote of Kindleberger above, BRICSpansion, and all that I wrote about above, I can't help but disagree even more strongly with Perry on the future of the dollar.

I wonder what Kindleberger's take would be...

Let's add CBDCs to our discussion, which are growing like kudzu…

The Nature Conservancy warns that "*kudzu looks innocent, but the invasive, "mile-a-minute" plant easily overtakes abandoned homes and telephone poles*".

Replace "abandoned homes" with sanctioned countries and all of OPEC+ (see here), and "telephone poles" with the PBoC's swap line network and notice: according to an interactive map published by the *Council of Foreign Relations* (see the map at the bottom of the page here), developed economy swap lines are basically there to provide unlimited backstop cross-border portfolio hedges, and developed economy to emerging market swap lines are limited and temporary and serve to backstop neighbors (Mexico), financial centers (Singapore), and countries with U.S. troops (South Korea). China's swap lines on the other hand span what Halford Mackinder called the "World-Island", that is all of Europe, all of Eurasia, big chunks of Africa, and, as per the China-GCC Summit, the Middle East is next (see here). Brzezinski and Kindleberger would be very upset.

Kindleberger especially, since the PBoC seems to be working hard on becoming an international lender of last resort that is geographically far more diverse than the Federal Reserve, and not only that, but an international lender of last resort that, through renminbi swap lines, aims to foster trade and real economic activity, not "merely" portfolio hedges to "nurse" decades of accumulated trade surpluses.

For the Fed, the swap lines are about backstopping the past (past surpluses). For the PBoC, the swap lines are about underwriting the future ("Lend-Lease").

That's a big difference. Now back to CBDCs and kudzu…

The last time I saw a reference to kudzu was during the Great Financial Crisis when a journalist referred to AAA CDOs growing like kudzu. Back then, private AAA debt crowded out public AAA debt, which nearly killed the banking system.

Today, CBDCs are interweaving BRICS central banks to replicate the global correspondent banking system that the U.S. dollar system runs on, with potentially lethal consequences for the dollar's supremacy. As the dollar became weaponized, momentum for CBDCs sped up: China obviously has one; India has one too; Brazil and Russia will launch one by 2024; and South Africa is a bit behind but "*recognizes the value of having one*", and one might assume it will get fast-track help from fellow members of the BRICS club. Furthermore, among the aspiring BRICS members, the UAE already has one, and under "Project Aber", the UAE and Saudi Arabia are exploring a "*single dual-issued digital currency*" for domestic and cross-border settlement between their countries. I am certain NEOM will use that digital currency too, and maybe all of the GCC will adopt is as its digital currency as well. If the UAE and Saudi Arabia are working on a dual-issued CBDC, that CBDC will likely be in the cards for the *entire* GCC.

Add to that President Xi's "ask" for renminbi settlement of oil and gas in exchange for transformative investments ("*new paradigm*"; see here and here), and you can see how "Project Aber" and an e-petroyuan threaten the petrodollar.

And then there is President Xi's reference to…

…the "m-CBDC Bridge project" that the BIS calls Project mBridge (see here; words may have been mixed up, but the two projects are definitely the same), which recreates the correspondent banking system from scratch by interlinking central banks through CBDCs. The Fed should be most careful with CBDCs: the might of the dollar runs through the global, hierarchical network of G-SIBs and correspondent banks that the swap lines were built to support during stress.

The last thing we need is the Fed to hasten the demise of that hierarchy with the launch of its own CBDC. As Kindleberger used to say, "*governments propose, markets dispose*", and if Kindleberger ran the Federal Reserve today, I think he'd advocate for the preservation of the network of private banks and private dealers that have been spreading the dollar globally like kudzu since the end of WWII…

Don't fix what's not broken…

…the U.S. dollar system (among friends and allies) is fine as it is. Understand that the global East and South are going the CBDC route because the U.S. dollar was weaponized through the weaponization of the network of balance sheets that enables the dollar system. Like the Army and Navy are the arms of the state, the G7 central banks, banks, and dealers (all G-SIBs) that took part in freezing Russia's FX reserves became the instruments of weaponizing the U.S. dollar…

…and hence arms of the state in what we can bravely call a total financial war.

Naturally, those who believe to be at risk of being sanctioned by the U.S. are trying to build something from scratch: not with the Fed atop, but the PBoC; not Fedwire, CHIPS, and SWIFT as separate systems, but CIPS as one system; not a network of G7 G-SIB banks, but a network of BRICS central banks; and not referencing the dollar in all FX transactions, but linking end-points directly (that is, why should someone in Hungary who has to pay someone in Singapore go through a chain of transactions and intermediaries that involve selling HUF for EUR, EUR for USD, and USD for SGD, when CBDCs allow the sale of HUF for SGD directly). CBDCs and the idea of replicating "the U.S. dollar network" with a network of central banks via CBDCs is revolutionary. Project mBridge is just the beginning, but it tells us the shape of things to come. For the Fed, I'd just reiterate: don't fix what's not broken. CBDCs are an existential threat. Don't hasten the downtrend of the use of the dollar by dismantling "the hierarchy" through the launch of a regulated liability network. CBDCs won't fix the crypto "problem", so do not do CBDCs just to tame the fallout from FTX and all that…

The crypto crowd wants not something that's digital *per se*, but something the Fed won't print, and let's face it, dollars, digital or not, will again be printed soon – that's certainly one message from the "BRICSpansion" and de-dollarization trends above. More QE is *a-comin'*… – there are many big problems ahead. We have a regulated liability network already. It's called the bloody banking system.

In a total financial war, central banks of the collective West should not fall into the trap of "CBDC-envy". Recognize what you need and what you don't need: if the State Department is working on pulling the G7 closer together, and the Pentagon is pulling NATO closer together, the last thing the Federal Reserve should do is to tear the network apart – the network of private balance sheets that dollar system runs on – with a CBDC. We have a digital system already – I am fine holding a checking account at a bank and I function perfectly fine with a copy of my credit card on Amazon and my bank account on Venmo to buy the stuff I need. To emphasize: crypto is about the distaste for QE, not an appetite for digital cash *per se*, and the regulated liability network of the Fed offers digital cash, not "un-printable" money. In the U.S. we don't need a CBDC.

Now back to the opening question:

what is a G7 rates strategist – *yours truly* – to do when geopolitical trends are set to shape dollar funding and rates markets, and a total financial war and a total war for commodities (that is, the encumbrance of commodities, see here) has been and will remain a driver of price action. As Perry channels Kindleberger, "*war cuts new channels*", and as I have warned about at length above, this year, the "BRICS+" appear to have accelerated the pace of cutting "*new channels*"…

To better serve, I'm going to adapt…

…and to better serve your investors, you should adapt too.

Starting next year, my money dispatches will fall into three distinct categories:

First, similar to my essays since the outbreak of the war in Ukraine this year, I will be writing some long, thematic dispatches that will explore geopolitics, commodities, and inflation and eventually define what Bretton Woods III means.

Second, returning to past habits, I will resume writing Global Money Dispatches, which will continue to explore money markets, G-SIBs, and balance sheet trends. But I'll resume these dispatches keeping in mind that over the next five years, the way the "*ancien régime monétaire*" will trade will be heavily influenced by the rollout of a CBDC-based monetary system and de-dollarization in the East. I think this period will be similar to the rollout of Basel III, which also changed the way funding markets traded and served up a few curveballs along the way.

Third, I'll launch a new series of dispatches, the Bretton Woods III Dispatches, a series that will track the BRICS' progress to build a new financial order. Once again, what regulators did to rates markets via the rollout of Basel III, BRICS heads of state will repeat with BRICSpansion, de-dollarization, and BRICS "coin". But the process won't be as transparent as Basel III was, and even with Basel III, despite full transparency, we didn't always do our homework, which led to system-wide constraints, bottlenecks, and basis blowups at times. Still, Basel III was friendly currency statecraft. CBDCs will be the "hostile" cousin…

Importantly, the new dispatches will come with new monitors to track the evolution of Bretton Woods III through prices and quantities. I realize that none of my pieces this year had charts in them. They were "framework" essays to "imagine the future". I think I now have a good idea of what the future looks like…

…so monitors are coming next.

The world is splitting in two. So is the monetary system. The dollar is at a crossroads.

When I think of the dollar, I think of Jean-Claud Van Damme's voiceover during his "epic split" (see here): preserving the dollar's hegemony will be an "epic feat"; like speedbumps for Van Damme, BRICS mean pain for "Jean-Claude Van Dollar".

Have a happy and healthy 2023…

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