Has the US Finally Succeeded in Choking Off Russia's Biggest Trade Lifeline?

Description

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With the threat of secondary sanctions being felt acutely by Chinese banks, Washington may be winning a single battle – but in an economic war being decisively lost.

The resilience of the Russian economy in the face of harsh Western sanctions sent those cheering the rise of multipolarity into victory laps. And it has been a huge embarrassment to the West. But Russia's burgeoning problem settling payments with China demonstrates that this resilience isn't without setbacks.

This past June, the US Treasury put the local banks of countries that trade with Russia in the crosshairs for secondary sanctions. The legal foundation for measures against companies or individuals found trading with sanctioned entities was originally implemented back in December, but it was in June that Washington expanded this framework and sent strong signals that this time it was serious. These threats were felt particularly acutely in China, Russia's largest trade partner.

What happened and when

It started with the big state-owned Chinese banks, which began shying away from dealing with Russia at the beginning of the year. But there were always smaller, regional banks, which were seen as less exposed to the Western financial system, which would take their place. For a while, it seemed these banks would carry the day. But now even these institutions have followed suit.

By the summer, Chinese banks were rejecting and returning about 80% of Russian payments made in

Chinese yuan, Kommersant reported in late July. **An article in Izvestia from mid-August claimed that things were even worse: 98% of Chinese banks were refusing to take direct yuan payments from Russia.**

The result has been delayed and disrupted payments for many Russian importers. **A Reuters report from last week discusses how transactions with Russia are being shut down *"en masse"* and billions of yuan worth of payments are being held up, according to a government source.**

"At that moment, all cross-border payments to China stopped. We found solutions, but it took about three weeks, which is a very long time, trade volumes fell drastically during that time," the government source told Reuters.

Many Russian businesses have had to use various chains of intermediaries in third countries to handle their transactions, which has driven up both costs and processing times. The problems have mostly affected smaller companies doing business in consumer goods. Bilateral arrangements for large companies – such as Russian commodity exporters – appear to mostly still function, although there have been some hiccups there, too.

Meanwhile, the tighter restrictions have led to a drying up of yuan liquidity in the Russian market. In other words, it has become harder and more expensive for Russian companies needing yuan to get ahold of the currency. Given how much of Russia's trade now takes place in the Chinese currency, this is certainly an issue.

The cost of raising yuan for one day (overnight rate) on the Moscow Exchange has exploded. The situation had actually begun deteriorating at the end of August. On August 30, the final business day of the month, the overnight rate surged from 8.5% per annum to 42.2%. Bankers explained this as elevated demand at the end of the month. But this week – already in the new month – the rate only kept rising, reaching an unprecedented 212% on Wednesday, before coming down somewhat. Such market behavior points to an acute yuan liquidity deficit. It has also pushed the ruble to its lowest level against the Chinese currency since April.

As a result of the squeeze, more and more firms are having to turn on a regular basis to a channel previously used as a last resort – expensive swaps with the Russian central bank (whereby entities post rubles as collateral in exchange for yuan). At the start of September, Russian banks raised a record 35 billion yuan through this facility, well up from the 20 billion daily average in August and 10 billion average in June. Essentially, the Bank of Russia is being forced to fill the gap left by Chinese private banks operating in Russia.

Banks are now calling on the Russian central bank to increase the offer of yuan through swaps. *"I think the central bank can do something. They hopefully understand the need to increase the liquidity offer through swaps,"* said Andrei Kostin, CEO of state lender VTB, emphasizing that exporters, many of whom are paid in yuan, should sell more of the Chinese currency into the market as well.

The problems with payments this year have already affected imports, although the current figures come with a lag and do not reflect the most recent surge in yuan costs. Russian imports from China dropped by more than 1% to $62 billion over the first seven months of this year, according to official Chinese data. **Russia's central bank forecast that the country's total imports of goods and services will fall by as much as 3% this year.** But it will be important to watch how the figures for

China’s exports to Russia – whether direct or transshipped through other countries – shape up the rest of the year in light of the surging transaction costs.

In the short term, of course, a certain amount of friction will continue to be experienced. Alex Isakov, a US-based Russia analyst, told Bloomberg that *“Russia’s yuan money market hasn’t recovered, which suggests that Russian banks are struggling to find reliable workarounds.”* The Russian central bank will almost certainly have to play a larger role, and exporters will probably also step in to provide liquidity. But there is no quick and easy fix.

In making sense of these issues, first of all, it is important to note that this problem is well understood in Russia and is freely discussed, including at the highest levels of government and in the media. No façade is being erected; there is no attempt to suppress this story. **It’s been on the front pages of the Russian financial press.**

It also bears keeping in mind that Russia-China trade is not exactly collapsing. In fact, despite the problems, turnover actually grew overall by 1.6% in the first half of this year. More importantly, the experience of the last few years has shown that whatever headwinds emerge end up being a strong driver of change.

In this context, a comment made by Russian economist and presidential aide Maksim Oreshkin this week at the Eastern Economic Forum in Vladivostok is important. Responding to a journalist’s questions about the payment issues, he said: *“There is a problem with payments, but, as we have seen over the past years, any type of problem leads to new financial innovations, to the appearance of new payment methods.”*

This is not just empty rhetoric or the face-saving cliché of a Russian official. It’s exactly what’s happening. As Business Insider admitted, the West’s tightening sanctions are pressuring Russia, *“but Moscow keeps finding ways to keep the country’s economy going.“* A number of initiatives are afoot.

What solutions may be forthcoming

In July, China’s ambassador to Russia, Zhang Hanhui, floated the possibility of cooperating via Russia’s Mir payment system, stating that Russian and Chinese institutions were studying the possibility. While China would likely not view the Mir system as a long-term solution, it could be a stop-gap measure. Such rhetoric also demonstrates the seriousness that the Chinese side is bringing to the task of finding a solution to the roadblocks thrown up by Washington.

Meanwhile, in a significant policy shift, Russia earlier this summer embraced the use of cryptocurrencies for international settlements. In commenting on the regulator’s softening stance toward digital assets, Bank of Russia Governor Elvira Nabiullina emphasized the need to embrace new financial technologies to navigate the current challenges.

Thinking longer-term, Anatoly Aksakov, who chairs the State Duma committee on financial markets, recently touched on what will almost certainly be a key element of the future financial landscape – central bank digital currencies (CBDCs) – which are like cryptocurrencies but backed by central banks. Both Russia and China have been at the forefront of pioneering such infrastructure.

However, Aksakov, who has spoken about CBDCs before, has been careful not to oversell the initiative, saying earlier: *“Fundamentally, there are few countries that have made serious progress in using national digital currencies. This is why technologically they are simply not ready to launch a digital currency in mutual settlements with other countries.“* Nevertheless, he is optimistic, predicting that CBDC settlements *“will be common practice within five years.”*

He is not alone in thinking so. More than half of the world’s central banks are either studying or already developing CBDCs, according to the IMF. As these CBDCs become increasingly interlinked it would essentially recreate the network of correspondent banks that underpins the current system. Such a CBDC-based network, buffeted by bilateral currency swap lines, would enable central banks to serve as intermediaries for currency flows between local banking systems.

Legendary analyst Zoltan Pozsar, who sees CBDCs as likely to revolutionize the financial landscape, explains that instead of correspondent banks – which form the backbone of the Western financial system – there will be what he calls *“correspondent central banks.”* This means that transactions that were previously dealt with between commercial banks in two different countries, for example, will be settled at the level of those countries’ central banks.

This is important because it is precisely commercial banks that are on the front lines of enforcing sanctions. They have both the responsibility and the authority to block transactions involving restricted entities. But what if these banks are entirely removed from cross-border trade? Would the US resort to sanctioning the central banks of countries trading with Russia?

Certainly, as Aksakov and many others admit, a large-scale CBDC-based system won’t be rolled out next week. Such infrastructure will require strong cooperation among central banks and use of a single technical platform, or some kind of unified clearing system. None of those are presently in place; but nor are they impossible to create. The Bank for International Settlements, an international institution owned by member central banks, is already overseeing testing of a CBDC platform for wholesale cross-border payments.

Washington’s Pyrrhic victory

Let’s come back to the issue at hand and try to get a sense of what it all means. The West has been deeply frustrated by its inability to put a significant dent in the Russian economy. Having doubled and tripled down on its approach, it is now treating Russia’s payment problems as confirmation that sanctions, if applied rigorously enough, can have the intended effect. Washington apparently feels that treading all over other nations’ sovereignty is a reasonable tradeoff for the benefit of pushing up the transaction costs for Russian businesses and proving that the yuan hasn’t achieved the stature of the dollar.

Furthermore, some Western commentators are pointing out with glee that for all the rhetoric of the *“friendship without limits”* between Moscow and Beijing, when forced to choose between doing business with Russia and retaining access to the Western financial system, China is choosing the latter. But those celebrating China ostensibly coming to heel over the sanctions don't want to acknowledge that it is a choice made under duress. China would prefer to trade freely with both the West and Russia and deeply resents being hindered in doing so. Chinese officials have stated as much on numerous occasions. The US is behaving like a jealous lover who has locked the object of his affection in the basement and then claims that her not fleeing is a sign of devotion.

That Western commentators and officials can only see the Russia-China relationship through the lens of power dynamics – looking for signs that China could be abusing its 'junior' partner – says more about the Western fixation on one-sided relationships than about the true state of things. China is a sovereign nation that is naturally looking out for its interests, and Russia expects nothing less of it. There are no hard feelings. As cliché as it sounds, it really is a relationship defined by mutual respect for sovereignty. In the current situation, Beijing has to act pragmatically, but the erosion of goodwill toward the US this episode is producing in Beijing will find its outlet.

It is also argued that the huge disparity in interest rates between Russia and China points to the fact that the two countries' economies are fundamentally misaligned. This is an exaggeration but insofar as it contains a kernel of truth, it is largely an artificially imposed misalignment and one that should prove temporary, especially once Russian rates eventually come down. The Russian and Chinese economies are actually quite complementary.

So are the travails with payments a victory for US sanctions? Yes, undeniably. But it is a rather short-sighted and ephemeral victory. It is a single battle won in an economic war being decisively lost. Far from a demonstration of strength, Washington's overbearing meddling in the trade relations of sovereign nations across the globe is more akin to burning the furniture to keep warm. It will eventually be self-defeating.

The fading hegemon still has a few trump cards it can play with some effect – and it is playing them now. But every time it does, it brings closer the day in which those cards will be rendered obsolete.