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SPP ROUNDTABLE BULLETIN

UKRAINE: CHALLENGES FOR CENTRAL BANKS[1]

Introduction

The war in Ukraine has cast a dark shadow over the global political and economic order. The application of sanctions to payments, central banks and commercial banks, and national reserves – the weaponization of finance – entails the incursion of politics into the operation of the international monetary system in a way that may have momentous long-term consequences for central banks.

This note considers the impact of sanctions on the operation of the international financial system; how central banks have responded or may respond; and the potential longer-term impact on their mandates.

It concludes that

- In the short-term the dollar will remain the principal reserve currency and the fulcrum of the international payment and settlements system. No other money – bullion, specie, fiat, cyber or crypto – can rival it at present in terms of the depth, continuity and liquidity of its markets or the speed and convenience for settling transactions.
- In the longer term the use of financial sanctions could well provide added momentum to technological and political forces that are fostering the emergence of distinct and separate geopolitical blocs and financial ecosystems

The successful operation of the international monetary system requires the provision of public goods. The formation of geopolitical blocks would erode the enormous gains from economic integration witnessed in recent decades and create hurdles for addressing existential threats such as those wrought by climate change.

Sanctions and the operation of the international financial system

The use of sanctions and its close cousin, reparations, in connection with war, is neither new nor uncommon. There have been over 700 instances since World War II. While sanctions do succeed in affecting the target countries, they are often partially circumvented because of the fungibility of goods and money. Equally and importantly, they have the potential to damage those who impose the sanctions. The prospect of energy shortages in Europe is but one example. In that context, although the US may be broadly neutral economically with higher

[1] Synopsis of themes considered at a roundtable discussion on 23/06/22. The views expressed do not necessarily reflect those of the participants. Roundtable discussions take place semi-annually. Participants have included Vitor Constancio, Jacques de Larosière, Erkki Liikanen, Donald Kohn, Guillermo Ortiz, Andrew Sheng, Masaaki Shirakawa and Dr Zeti Aziz. The discussions are moderated by Dr Gavin Bingham and Sir Andrew Large.

exports of gas offsetting other factors, it seems that Europe is being damaged economically as a result of higher gas prices, whilst Russia is more neutral as lower sales volumes of gas are balanced by higher prices also helping to support their currency.

What is different in the case of Ukraine is the nature and scope of the sanctions. Traditionally they have been applied to trade between one country and another, sometimes to lasting effect. The reason why port and claret are commonly drunk in the UK is a legacy of the application by France of an embargo on wine from vineyards more easily accessible than those of Portugal or Bordeaux.

Building on experience with sanctions on Iran, the focus in the case of Ukraine is on finance, or more particularly on the use of the dollar and other convertible currencies in payments and foreign exchange reserves. Moreover, unlike earlier financial sanctions, they have been applied multilaterally from the start – not just by one country that then widens their scope through secondary penalties. They have been imposed by a broad alliance of countries that, coincidentally, are responsible for issuing the major reserve currencies. Together these currencies account for about 97% of global reserves. At the same time, those who have not imposed sanctions – notably China and India – include over half the world's nations and the bulk of global population.

Sanctions are causing significant tensions in the environment in which Central Banks operate. The dollar dominates both payments and official reserve holdings because of the liquidity and efficiency of markets in dollar instruments, because of the dollar's role as numeraire in international trade and because it has been largely – if not completely - unencumbered by legal restrictions and administrative controls for decades.

The share of the dollar in total reserve holdings has declined from just over 70% to just under 60% since the launch of the Euro. Beyond the advent of the Euro, two other factors explain this decline: the search for yield since the GFC in 2008 and a desire to diversify, given the huge expansion of total reserve holdings, particularly by Asian economies.

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However, in the longer term there is the potential for momentous change, accelerated by the impact of the Ukraine war, and driven by the current constellation of technological, political and ideological forces. Despite the dominance of English law in international commercial transactions then and now, Sterling lost its position as the principal instrument for international financial transactions in the first half of the Twentieth Century because the UK restricted the free use of its currency to the Sterling area and because of the rise of a successful trans-Atlantic economic power. The US must now confront the rise of a trans-Pacific economic power. Prior to the war in Ukraine, it eschewed strict administrative controls on the use of its currency. The question is whether it will suffer the same fate as Sterling, with the world now fragmenting into politically aligned blocks with barriers to financial transactions and payments between them.

Those countries that might be best described as 'Western democracies' seem set to retain the dollar. But the various other nations could choose to make common cause with an ascendant China. Russia has little choice as it is now a financial and commercial pariah of the West. Despite its military strength, it could easily become an economic vassal of the Middle Kingdom.

The forces operating on other countries are more subtle. Nearly 150 of them are eligible for massive amounts of funding from China to develop their infrastructures under the Belt and Road Initiative. Many of them have received significant amounts. Some of them face the prospect of default. Just as the Latin American debt crisis of the 1980s led to the widespread adoption of the "Washington Consensus" in the context of debt restructuring programmes developed – some would say imposed – by the creditor countries, so too could the restructuring of debt owed to China lead to the adoption of a different economic and financial order for this group of countries. In the Nineteenth Century, trade followed the flag. In the Twentieth, democracy followed the dollar. What will international finance follow in the Twenty-First?

Unlike the trade-focussed geographically based economic groupings such as ASEAN that accept the Bretton Woods system, a new ideologically focused, China-centric grouping or groupings could adopt novel payment and settlement arrangements not ultimately based on the dollar. Whether countries or regions drawn to this block will continue to rely on the dollar depends in part on the extent of trade among emerging and developing countries relative to trade with the richer Western block. It will also depend on the availability of a viable alternative. At present, capital controls on the renminbi inhibit its use as an international reserve currency. But that could change, not least given the broad parity that now exists between the size of the US economy and that of China and the large payments surpluses that give China mercantilist clout. China could easily decide that the time has come for relaxing all exchange controls – although reserve holders will be mindful that capital and other controls can also be re-imposed at short notice too.

How central banks have responded or may respond

Payment system fragmentation

Even before the invasion of Ukraine, central banks were already contending with rapid changes in the payments landscape resulting from technological change. The fragmentation resulting from the application of sanctions could well speed the process. For example the extent of intra-Asian trade settled in dollars, using RTGS systems, requires the holding of significant dollar reserves in relevant economies such as Hong Kong. The development of net settlement systems or a move away from dollar-based pricing could reduce that need. Already some central banks are exploring options for clearing without going through the US dollar and/or reducing the need for settlement balances. This includes the central banks of Australia, Canada, France, Singapore, and Switzerland.[2]

The creation of digital currencies can also make it easier for private citizens and corporations to reduce their use of domestic currencies and, in bypassing traditional banking systems, avoid foreign exchange controls. If central banks respond with their own digital currencies, and payments systems adapt to both CBDCs and other digital currencies, then the future may look very different to the recent past.[3]

[2] See https://www.bis.org/about/bisih/publ.htm?m=3103 (assessed 18 July 2022)

[3] See https://www.bis.org/publ/arpdf/ar2022e3.pdf

Central bank reserves

Central banks have enjoyed certain privileges and immunities in their official holdings of reserve assets and monetary operations. They are usually exempt from rules on market manipulation since changing market prices is often the purpose of official operations. And central banks often have privileged access to nostro accounts at fellow central banks and/or the BIS, with a small number having windows to directly obtain dollar liquidity from the Federal Reserve via swap or repo lines. Even where special access to dollars is not granted, central banks in almost all polities have trusted that they will be able to use their reserves without let or hindrance.

Reserves are held mostly in a combination of fixed income instruments, cash accounts and gold, but occasionally in other assets such as equities. For intervention in spot foreign exchange markets, reserves need to be immediately convertible into cash. Rather than sell large quantities of assets, that cash is usually raised in the short term via repo markets. Either way, a portfolio of assets held for potential intervention purposes needs to be sufficiently liquid that it can be sold or lent for cash. The value of a reserve portfolio ultimately depends on its usability in a crisis, not its liquidity in normal market conditions.

Sanctions can severely impair the liquidity of any portfolio of assets. In the case of Russia, western counterparties – who would be the natural purchasers or repo counterparties for dollar denominated assets - cannot deal with the central bank or Russian commercial banks, substantially reducing the liquidity of all Russian reserve assets. Such sanctions and other actions taken by the US – such as the appropriation/control of Afghanistan's dollar reserves held in the US - will have opened the minds of other jurisdictions to thinking about ways to ensure the continued liquidity of their reserve assets and their ability to make payments in any and all circumstances.

The fact that asset freezes have now become part of the armoury used in clashes among states and that US courts are adjudicating private claims against reserves owned by nation states, means that other central banks may question whether even official holders of dollars can be confident about the liquidity and perhaps even the ownership status of their assets. This momentum would be strengthened should additional weaponisation take place by moving from arguably legitimate freezes, to what has hitherto been considered illegitimate sequestration, as in the case of Afghanistan.

Diversifying reserves away from the dollar

Most of the liquid alternatives to the dollar: euro, yen, sterling, are likely to be politically aligned with the dollar. These currencies offer some market diversification in normal times, but they may not if finance is weaponised. The same applies to the currencies of Canada, Australia, New Zealand, Norway or Sweden. Currencies pegged to the dollar or euro such as the Gulf States or Hong Kong offer little solace. Even gold tends to be traded in Western markets and to be denominated in US dollars. Markets in the Renminbi are illiquid and could be subject to retaliatory weaponization. The SDR is not a viable alternative given the lack of an independent settlement mechanism that could work at scale.

CBDCs and other 'crypto currencies' could become an alternative for reserve assets. But only to the extent that they are themselves liquid, convertible to conventional currencies or usable directly in large scale to settle debt obligations. The conditions for this are nowhere being met at present, but the current crisis could serve to hasten developments. Indeed, the claims from crypto enthusiasts that holders of DLT assets such as Bitcoin cannot be deprived of their assets are unlikely to be lost on jurisdictions seeking to improve the resilience of their reserves.

Gold could be used once again as a major reserve asset, but it would be a small palliative at best. In World War II gold was seized, hoarded and secreted away. It was a store of value – perhaps the ultimate one – but it did not serve as a means of payment for countries or central banks. Russia is the world's third largest gold producer and its annual production of around 360 tonnes a year (value approx. $22bn) will give it some comfort. However, that is small in comparison with its military needs, let alone its much greater economic requirements. It is relevant to note that, despite being the largest producer of gold, China is also the largest importer and could provide one ready market for Russian gold. India is also a large net gold consumer.

China's official foreign exchange holdings of over USD 3 trillion (of which one third is held in US Treasuries) are a double-edged sword – as is the case for any large creditor. Together with administrative controls, they have permitted the country to manage its exchange rate in a somewhat mercantilist manner. But they make the country vulnerable to financial sanctions of the type applied to Russia, reducing their value as a policy instrument in a conflict.

Some have claimed that China's large holdings of US dollars enable it to disrupt US markets, but its holdings of US Treasuries account for only about 3 percent of total US debt, and any operations by China that were detected could be countered with sanctions. Disruption is more likely to be a longer-term consequence of ongoing efforts by China to expand its own cross border payments system (CIPS).

Mandates and objectives

Implications for monetary policy functions

For the first time in decades, central banks must contend with a serious threat of inflation. Ensuring price stability is one of their core functions, and for some it is their primary function. The data show that the central banks of the UK, US and EU have been able to deliver average inflation rates over the past 25 years that are entirely consistent with their price stability mandates, and in Japan and Switzerland prices have on average not changed at all for more than two decades. Now that prices are rising everywhere, some observers will no doubt ask – with more justification than in the past – what is the value of independence if an independent central bank cannot deliver on its inflation mandate?

Although this is not the full picture the war in Ukraine is but one of the many factors that are causing prices to rise, The prolonged period of ultra-low interest rates, coupled with unprecedented amounts of QE, surely are important as the delayed impact of the fiscal and monetary policy expansions to counter the macroeconomic effects of the Covid-19 pandemic; continuing supply constraints resulting from the pandemic that have been made worse by the reduction in Russian energy exports and the inability to ship grain through the Black Sea; and dynamic effects as demand and prices bounce back from depressed levels and expectations of inflation become de-anchored.

Supply side shocks are the most difficult for central banks to deal with and the timing of the current rise in energy prices could hardly be worse. The combined shocks have produced the highest inflation rates in developed countries since the start of the Inflation Targeting era. The economic costs of bringing inflation down could be economically and politically significant. The fact that some of this may be attributed – arguably - to excessive monetary expansion during the pandemic, will not go unnoticed.

Country	Current CPI Inflation Rate (July 2022)	Average inflation rate since Jan 2000 unless otherwise indicated.
US CPI (Explicit numerical target of 2% only since Jan 2012)	8.5%	2.4%
UK CPIH (CPI) (Target changed from RPIX 2.5% to CPI 2% in Dec 2013)	8.8% (10.1%)	2.1% (2.1%) (Since MPC created, May 1997)
Euro area CPI (Target of below but close to 2% made symmetric in Jul 2021)	8.9%	1.8% (Since euro created, Jan 1999)
Switzerland CPI (New framework adopted in Dec 1999)	3.4%	0.44%
Japan CPI (Explicit 1% target from Feb 2012, increased to 2% in Jan 2013)	2.6%	0.13%

Implications for maintaining financial stability

So far systemic financial instability has been kept at bay, perhaps in part because of the significant strengthening of the financial regulatory framework following the GFC. However, the sharp increase in interest rates in most Western countries raises questions about the sustainability of debt contracted in an environment of ultra-low interest rates.

Managing financial stability risks is complicated by the fact that most of today's decision makers will never have had to manage such risks in the context of rampant inflation. In terms of threats, that from large and growing private and public indebtedness ranks high in conditions where interest rates are rising far faster and far more steeply than expected.

In the private space for example, it is not yet apparent to what extent the pandemic, exacerbated by Ukraine, might leave a legacy of corporate and personal credit risks. These will be exacerbated as interest rates are pushed up now that the threats to inflationary expectations are centre stage, potentially causing defaults by highly leveraged homeowners.

In the sovereign space the counterpart to that has been a serious weakening in the financial positions of many governments. Both the situation in Ukraine and the ongoing pandemic will continue to put pressure on government expenditure. Not only EME's are experiencing significant fiscal strains tending to increase debt, but so are several mature economies including Italy, France and the UK.

In addition as central banks now need to stop, and then unwind QE to tackle inflation, yield curves are rising, risking a significant increase in the cost of servicing those debts as well. Finance Ministries seem set to face a set of challenges no less daunting that those confronting Central Banks. Some degree of friction between the two would not be surprising if governments sought to monetise their deficits. The question will be whether increased levels of debt will lead at some stage to market turmoil as lenders withdraw, perhaps suddenly, and as last seen after the GFC in 2008.

The focus on Ukraine has clearly been a priority for governments, and longer-term issues such as climate change have taken a back seat. But the situation has shown it was never a good idea to rely on fossil fuel imports from non-democratic countries. Switching to domestically produced renewable or nuclear energy may now seem more attractive than relying on Russian gas and oil. For central banks however, the impact of disruption to energy supplies is likely to be a continued source of inflationary volatility, and ultimately a threat to stability.

All the above factors raise the question of the future of central bank independence: will politicians seek to take back control? If they do, history suggests that they will not do better on the inflation front.

Conclusions

If financial sanctions become an important element in the armoury of weapons used in conflict between states, it would be desirable to have a set of international rules relating to their use, much as there are conventions for traditional warfare, to protect the innocent and avoid unnecessary harm for both protagonist and antagonist. It is an open question how such rules could be written, but the need for them is apparent.

Another area where changes in laws and norms would be desirable is in settlements and offsets. Together with DLT, the appropriate design of laws and norms could reduce the need for settlement balances and increase the efficiency of payments systems, offsetting to some degree the pressures for fragmentation. It is heartening that the G20, that includes powers in both the Western and the non-aligned camps, have encouraged such work through the FSB and its constituent bodies.

The successful operation of the international monetary system requires the provision of public goods. Today this includes dealing with the existential threat of climate change which requires an efficient and functioning global financial environment capable of delivering the huge volume of finance needed for mitigation and adaptation.

The first half of the last century demonstrated what happens when important public goods are not provided. The second half demonstrated what can be achieved when they are. The configuration of economic, technological and political forces does not bode well for the foreseeable future. The formation of geopolitical blocks could well erode the enormous gains from economic integration witnessed in recent decades. Let us hope that the lessons from the carnage of the first half of the century will be heeded.