

Concerns over impact of Russian sanctions on global financial system

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Concerns are starting to be raised in financial media circles and by economic analysts about the effects on the global financial system of the sweeping sanctions imposed on Russia both immediately and in the longer term.

Combined action by the US and the EU have excluded seven major Russian banks from the Swift international financial messaging system. Banks involved in the oil market were excluded from the ban, but moves are now being considered to cut off Russian exports.

Even more significant than the Swift measure is the ban on foreign currency transactions by the Russian central bank. It has been prevented from using a large portion of its foreign currency reserves, estimated to total \$630 billion, to prop up the rouble and country's financial system.

While the central bank nominally owns its reserves, they are held in large measure as digital entries in the accounts of other banks. These accounts have now been frozen, effectively expropriated.

An article in the *Financial Times* noted: "This digitalisation separates ownership and control of FX (foreign exchange) reserves. Russia owns them but Western issuers and computerised holders of these assets control access to them. ... From a source of economic strength during peacetime, FX reserves turned into the source of a crash during war."

While the measures against Russia are not unique—the US has used them against other smaller countries in the past—they have never been deployed on such a scale. Russia, with a GDP of around \$1.7 trillion, is the world's 12th largest economy and a member of the G20.

So far, the world financial system has not been adversely affected—US Fed chair Jerome Powell said last week markets were "functioning well." But it is still early days and there are concerns about flow-on effects.

An article in the *Wall Street Journal* made the point that the sanctions could remove a direct source of short-term funding for Western banks and spread fear among them. It could make them "hesitant to lend to one another because they don't know who might have exposure to Russia."

In a recent note to clients, Credit Suisse analyst Zoltan Pozsar estimated that the Bank of Russia and private sector Russian entities together have loaned about \$200 billion in the foreign-exchange swaps. Another \$100 billion of Russian money is deposited in banks outside the country. A total of \$300 billion was a significant amount and enough to influence funding.

Pozsar said linkages in the financial "pipes" could generate unexpected shocks by jamming the flow of money, as with the collapse of the US investment bank Lehman in 2008.

The collapse of the \$3 billion US hedge fund Long-Term Capital Management in September 1998 is also being remembered. It had to be bailed out by the New York Reserve because its demise, the result of wrong bets on the rouble, threatened to provoke a crisis for the entire US financial system.

FT columnist Gillian Tett recently wrote there was "concern that some emerging market funds will dump non-Russian assets to cover losses on frozen Russian holdings," amid talk that some overleveraged hedge funds had been wrongfooted and "memories of the 1998 collapse of Long-Term Capital Management are being revived."

Economic historian Adam Tooze has commented that Russian reserve accumulation, derived from its oil and gas sales, is a source of funding in Western markets and "part of complex chains of transactions that may now be put in jeopardy by the sanctions."

Longer-term concerns about the future direction of the international monetary system and the world economy are also being raised. An editorial in the *Economist* headlined "A new age of economic conflict" said the implications of the sanctions on Russia were "huge" and marked a "new era of high-risk economic warfare that could further splinter the world economy."

One issue that has been raised is that the sanctions, which demonstrate the enormous financial power of US imperialism because the dollar functions as the world's major currency, will lead to a bipolar financial world—one

based on the dollar and the other on the Chinese renminbi.

There is no realistic prospect that the renminbi can assume anything like the dollar's global role given the fact that the Chinese financial system is controlled by the state while US markets, by contrast, are open and liquid. Furthermore, at present the renminbi is used to finance only 2 percent of world trade. While there are predictions it could rise to 7 percent in the next few years, it is dwarfed by the position of the dollar which finances 59 percent.

However, as the *Economist* noted, the sanctions will have long-term effects, the implications of which were "daunting."

"The more they are used, the more countries will seek to avoid relying on Western finance. That would make the threat of exclusion less powerful. It would also lead to a dangerous fragmentation of the world economy. In the 1930s, a fear of trade embargoes was associated with a rush to autarky and economic spheres of influence."

While the editorial did not make the point, this fracturing was one of the economic driving forces behind the eruption of World War II.

China will no doubt be carefully examining the implications of the Russian sanctions because in a war, or even a conflict over Taiwan or some other issue, the US and Western powers could freeze its \$3.3 trillion of foreign reserves. Other countries, such as India, "may worry they are more vulnerable to Western pressure," the *Economist* said.

An article by *Wall Street Journal* writer Jon Sindreu said the sanctions on Russia, which showed that reserves accumulated by central banks can simply be taken away, raised the question of "what is money?"

He noted that, in the wake of the Asian financial crisis of 1997–98, scared developing countries sought to protect themselves by accumulating foreign currency holdings, raising them from less than \$2 trillion to a record of \$14.9 trillion in 2021.

"Recent events highlight the error in this thinking: Barring gold, these assets are someone else's liability—someone who can just decide they are worth nothing," Sindreu said.

In the 19th century and into the first part of the 20th, the world financial system operated on the gold standard. This system collapsed with the eruption of World War I and attempts to restore it in the 1920s failed, leading to the breakdown of international trading and financial relations in the 1930s and a return to barter in some cases.

A new system of international finance was devised at the Bretton Woods conference of 1944 where it was determined that the US dollar would function as the global currency, with the proviso that dollar holdings could be redeemed by gold at the rate of \$35 per ounce.

The Bretton Woods system was ended in August 1971. Due to mounting balance of trade and balance of payments deficits, reflecting the start of the economic decline of the US from its absolute post-war dominance, US President Nixon unilaterally removed the gold backing from the US dollar.

Since then, the world economy has functioned entirely on the basis of the US dollar as a fiat currency, one that has no backing by gold or any other commodity embodying labour, the ultimate source of value within the capitalist system.

Money within the capitalist economy is not only a means of financing trade and financial transactions, it is also a store of value. With the dollar operating as a fiat currency this function has been sustained through a kind of fiction, or circularity. The dollar is eagerly sought after because it is regarded as a store of value, and it is a store of value because it is needed as a means of payment for international trade and financial transactions.

Now the basis of this system, which has operated for the past 50 years, is being called into question.

As Sindreu put it, "the entire artifice of 'money' as a universal store of value risks being eroded by the banning of key exports to Russia and boycotts of the kind corporations like Apple and Nike announced this week."

If currency balances become "worthless computer entries" then there will be a shift back to gold.

He noted that one of the barriers to China's push to internationalise the renminbi has been the fear that access to it was always at risk of being revoked by political considerations. "It is now apparent that, to a point, this is true of all currencies."

His conclusion was that: "For once the old trope may not be ill advised: buy gold. Many of the world's central banks will surely be doing it."

Just as the US-led NATO military war against Russia marks a new stage in geopolitical relations, directly raising the threat of world war, its weaponisation of finance has raised all the contradictions lying at the very heart of the capitalist economy, including within the entire value and monetary system.



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