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War and pieces of gold can't derail the dollar

'Eastern Powers in Goldmember' = parody

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Summary

- War/geopolitics is now crucial for markets, but this does not mean 'peaceful' market forces or central banking are irrelevant
- Epic 'War and Peace' forces-of-history market narratives which overlook that fact look like parody rather than prophecy; likewise, calls that CNY will 'link to gold' as a 'petroyuan' to dethrone the dollar are more Austin Powers than James Bond
- The reasons why 'Bretton Woods 3 Won't Work' still hold, and this report underlines why CNY ≠ gold due to underlying market forces and the likely Fed, and broader US, reactions
- In short, 'war'' and 'peace need to be analysed together: doing so means no love for 'death of the dollar' narratives

"Because of the self-confidence with which he had spoken, no one could tell whether what he said was very clever or very stupid."

War and Peace, Tolstoy

War & Peace; Love & Death

'Markets cannot ignore geopolitics' is an argument we have been making since 2016, most so since January 2022, when we flagged the risks of a Russian invasion of Ukraine and the resulting global metacrisis it would trigger.

As 2023 begins, we still feel the impact of that war, with Russia hunkering down for a long fight, and the West upping its military ante; we hear the risks of war in other locations; we see a rush for rearmament; and we experience undeclared Cold War and economic war as a necessary corollary. In short, the structure of the global economy and markets is rapidly changing, and in ways few fully grasp or address despite the lessons of history.

Understandably, this is also generating some epic, 'War and Peace', Russia-centric market narratives on the forces of history, Great Men, and The Rise and Fall and Rise of The Great Powers (and The Great Currencies), etc. Equally understandably, these focus on the outlook for the dollar.

As a particular example, there is some excitement around an emerging 'petroyuan' argued as marking the emergence of a new bloc of Eastern economies backed by commodities such as oil, and linked to China's CNY.

Collectively, this is seen as heralding the relative collapse of the US/West and global US dollar hegemony. (See: 'China looks to weaken US dollar with petroyuan as oil producers rally to Beijing, and Russia has 'become an Asian nation,' analyst says'.)

Even against the backdrop of 2022, this view implies much greater market volatility to come. As such, attention needs to be paid to this kind of 'geopolitical' projections.

Yet at the same time it is also important to realise that after having long ignored realpolitik, the analytical pendulum arguably swings too far the other way to presume *everything* is now about war/geopolitics and *nothing* is about 'peace', i.e., central banks or markets.

Crucially, this inverse approach to the pre-2022 research norm overlooks that market forces still matter hugely in some areas; so does the US Federal Reserve – which is also deeply geopolitical when it needs to be. One thus ideally needs to look at 'war' and 'peace' together.

Indeed, if we consider peaceful factors like market forces and the Fed *as well as* those of war, headline anti-dollar claims look as logical as Boris Grushenhko's father in the 'War and Peace' parody 'Love and Death': he takes the "valuable piece of land" he owns around with him in his pocket to show off to its admirers. (It's not for sale, as one day he hopes to build on it.)

"I love gold! The look of it! The smell of it! The taste of it! The texture!"

Goldmember, Austin Powers in Goldmember

Eastern Powers in Goldmember

Shifting analogies, the petroyuan has James Bond-style geopolitics, intrigue, and masterplans as a draw, yet it is also an aurophilic parody: '*Eastern Powers in Goldmember*'.

The argument is: oil is traded and priced in CNY, not dollars. The dollar gets weaker, and the West poorer, and the CNY, and gold and oil, get stronger and the East richer.

But, Dr. No, things don't work like that. CNY is not fully convertible. CNY is highly politicised rather than transparently market-driven. Chinese assets are too. China runs a trade surplus, so nobody can net earn CNY globally: there is no commodity trade in CNY for those reasons, apart from with Russia. The Gulf Cooperation Council (GCC) oil exporting countries have currencies pegged to the dollar, so don't want reserves in volatile CNY. All of this was covered in detail in 2022's 'Why Bretton Woods 3 Won't Work'.

However, apparently this now changes because of *gold*: China will allow CNY for commodities to be 'swapped for gold' to circumvent the above issues. That is seductive - like Austin Powers; retro and futuristic - like Austin Powers; has a cult following - like Austin Powers; but 'Eastern Powers' is just as silly as Austin Powers.

Let's underline why CNY ≠ gold from a market perspective:

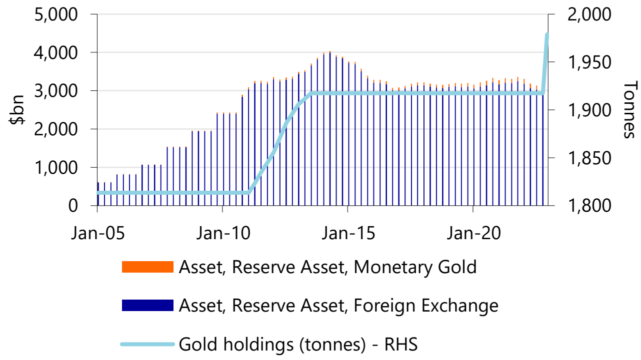
(i) Gold is deflationary. Yes, pegging CNY to gold would force it higher,… and destroy its export sector, while Beijing would lose control of fiscal and monetary policy, political anathema, and more so as it tries to avoid asset price deflation. Indeed, linking CNY to gold *and* oil would logically *deflate* oil: why would any commodity exporter want that?

(ii) China's gold holdings moved up in 2022, but its relative share in FX reserves (not held by state banks) is miniscule vs. dollars (Figure 1). What would China do with the bulk of its reserves if the dollar was dethroned – which would also destroy trade with the US/West at the same time?

(iii) CNY is *very* fiat: the increase in China's M2 base vs. its gold holdings --far lower than the US-- is hardly indicative of a country ready to go on a gold standard (Figure 2).

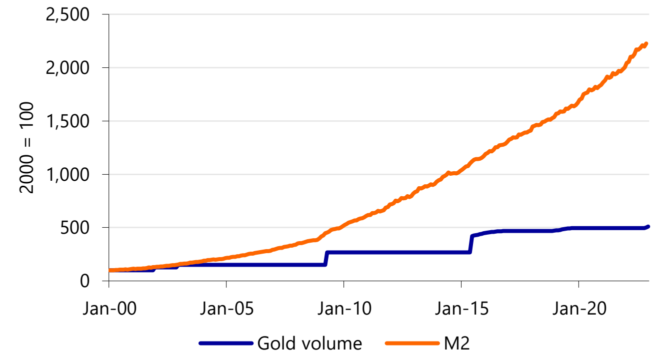
(iv) China runs large trade deficits with the Eastern commodity exporters who would want to swap CNY for gold. The Middle East's annual bilateral trade surplus alone is larger than China's total gold holdings (Figure 3).

Figure 1: Gold hardly looking Tolstoy (which means 'fat')



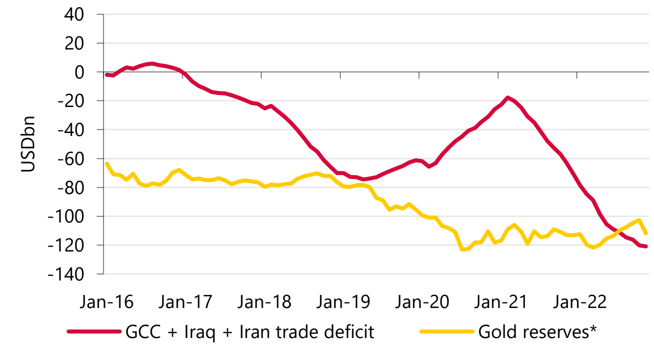
Source: Macrobond

Figure 2: And this doesn't include asset inflation/liquidity



Source: Macrobond

Figure 3: There is a limit to the number of gold toilets



Source: Macrobond, Rabobank

(v) Capital controls that now stop CNY selling for dollars would need to apply to China's gold stocks too, defeating the 'peg' for a global petroyuan. (And if, Bitcoin-like, 'gold appreciates under Eastern Powers', apparently do does oil to match - even if it actually wouldn't).

(vi) Logically, China would have to make other/Western fiat economies pay *it* in gold. The only way to make them do so against their best interests would be via Russia-style coercion - but the West resisting such moves is already a potential threat to CNY, let alone CNY 'as gold'.

"My favourite weapon is a twenty-dollar bill"

Raymond Chandler

Dollars & Sense

So, while the world is changing, *actual* market forces still trump *purely* geopolitical narratives regarding the dollar.

Moreover, the 'peace-time' Fed are deep into geopolitics, albeit under the analytical radar. Markets are already aware --if disbelieving-- of recent Fed-speech stating that Fed Funds will continue to rise in 2023, and that there will be no rate cuts this year. While there is an anti-inflation imperative to these actions, there is also an underlying geopolitical motive: *if Eastern Powers are going to push 'gold-membership' over the dollar --hugely inflationary, and damaging for the US if seen-- then the best rebuttal is sustained, higher Fed Funds to make fiat dollars more attractive than 'commodity currencies' and gold.*

Arguably, this approach is working. Admittedly including US government intervention in oil markets, broad commodity prices are well off their recent highs. Imagine what further Fed hikes might hypothetically achieve *--or be forced to achieve by commodities rising again--* even if even done while de facto easing policy *for the government* at the same time (as the ECB, Bank Indonesia, and the BOJ are all doing in various ways via new and old bond buying schemes: in short, higher rates and QE, as we argued since early 2022).

Overall, the dollar, while far off its 2022 highs on the DXY index, is *relatively* still in a strong position. Indeed, it looks capable of a further move higher again in 2023. Consider:

- EUR is rallying due to this winter being as warm as some summers, despite cyclical and structural economic problems ahead;
- CNY is rallying due to a Covid Zero reversal that will see Chinese tourists and capital flood out again, and huge cyclical and structural economic problems – and China is suddenly trying to build bridges to Europe, the US, and Australia;
- JPY is rallying due to a policy shift from the BOJ (which is raising bond yield targets *and* doing more bond buying);
- INR is close to all-time lows;
- The Egyptian pound is collapsing; and
- 'Eastern Power' RUB has slid from a post-war high of 52 back to 72.5 despite a recessionary collapse in most imports and a past surge in commodity export prices. Indeed, Russia is quietly accepting dollars and Euros for gas payments again. That's as 46% of Atlantic Council experts surveyed project it to become a failed state in the near future, while Iran is rocked with protest, and China has had to implement a series of policy U-turns.

"Once we're thrown off our habitual paths, we think all is lost, but it's only here that the new and the good begins."

War and Peace, Leo Tolstoy

Merchants & Mercantilism

Furthermore, it is time to reiterate that in this geopolitical world it is large economies with resources, technology, and military power --and *established* currency hegemony-- that stand to do best.

It's hard to keep track of the US measures being put in place across the spectrum to begin to push back against what D.C. finally perceives as allied Eastern Powers – and this process is going to accelerate. Just months ago, the US was trying to reach out to Iran: now Iran is supplying Russia with weapons to attack Ukraine with, and D.C. is appalled to find its components are used in Iranian drones. Supply chains are likely to bifurcate further, sooner than some suspected. That will be inflationary – and require a Fed response, and then a *dollar* response.

Moreover, it is by now well noted that 'The West needs to boost its industrial capacity fast' in order to maintain the flow of fast-depleting munitions stockpiles being sent to Ukraine, which in some cases use almost a year's production of key systems in weeks. After all, as foreign policy analyst @ulrichspeck notes, "*The outcome of the war in Ukraine will determine the future shape of the European security order: Either Russia's defeat will deal a decisive blow to its imperial ambitions, or any Russian achievements in the war will encourage it to continue reshaping the continent by force.*"

This means hard choices between guns and butter, if moderated by higher rates *and* QE; and against a tight labour market, will *"an expansion in the number of people in military institutions - and in the defence industry itself."* That will be inflationary – and require a Fed response, and then a *dollar* response.

In summary, the US super-tanker is beginning to turn to face East – and that process will ultimately be better for new 'mercantilists' than old ones – with a logical flow-through to financial markets.

To conclude, we need to embrace both 'war' and 'peace' arguments to understand what is really going on in geopolitics. That combined narrative is not as eye-grabbing as some others out there, but should prove more accurate over time.

Yes, it's not War and Peace: but neither is it an illogical parody like Love and Death, or 'Eastern Powers in Goldmember'.

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