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Bloc Trade: Russia, China, and the Limits of Globalization

The week of March 7: Russia's (possible) transformation into a Chinese satellite, inflation, the price of gasoline, tax, and much, much, more.

By ANDREW STUTTAFORD
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ANOTHER week, and more bloodshed in Ukraine. How the Russian invasion will play out remains anyone's guess, but one result seems increasingly likely. What began as an imperial gambit may well end up with the imperialist transformed into the junior partner, or even satellite, of a greater superpower still on the rise.

China is considering buying or increasing stakes in Russian energy and commodities companies, such as gas giant Gazprom PJSC and aluminum producer United Co. Rusal International PJSC, according to people familiar with the matter.
Beijing is in talks with its state-owned firms, including China National Petroleum Corp., China Petrochemical Corp., Aluminum Corp. of China and China Minmetals Corp., on any opportunities for potential investments in Russian companies or assets, the people said. Any deal would be to bolster China's imports as it intensifies its focus on energy and food security — not as a show of support for Russia's invasion in Ukraine — the people said.

Yes and no, I'd say. Displaying indifference to the invasion is itself a form of support. That said, this mainly looks like an attempt to exploit the isolation in which Russia now finds itself. As China's economic policy (and not just its economic policy) moves closer to the classic fascist model, self-sufficiency has become a key objective for Beijing. Where China cannot make or grow something for itself, it wants to develop secure supply lines unlikely to be disturbed by political or economic rivalry or, for that matter, disapproval of its domestic policies. Resource-rich Russia, a country with which China shares a long border and, which now, like many of the other countries with which the Beijing regime is establishing long-term trading arrangements, is going to be short of capital (in Russia's case, due, among other factors, to sanctions, a future lack of Western investment, and complications arising out of its upcoming default), fits the bill.

These investments in Russian companies are by no means done (the discussions are described as being at an early stage), but they are a pointer to the ever closer collaboration that lies ahead. In 2019, China was the largest single destination for Russian exports, of which it accounted for 13.5 percent. That's only going to increase, not least because China has no interest in supporting the sanctions being imposed on Moscow. Just three weeks before the Russian invasion of Ukraine, Russia (already China's third largest supplier of natural gas) agreed to a 30-year contract to supply up to 10 billion cubic meters per year of gas to China via a new pipeline. This deal should be worth some $37.5 billion over twenty-five years. Meanwhile, Rosneft, a Russian oil giant, agreed to sell China $80 billion worth of oil over ten years, an extension of a previous arrangement.

Moreover, in case anyone didn't get the message, China relaxed phytosanitary restrictions on imports of Russian wheat at the same time, choosing to announce that change *after* the invasion had begun.

Back in early February, Xi and Putin had also declared that the friendship between Russia and China "has no limits. There are no 'forbidden' areas of cooperation."

That same statement, the *Wall Street Journal* reported, also included:

[talk] of knitting together signature economic initiatives — Mr. Xi's Belt and Road infrastructure drive and Mr. Putin's Eurasian Economic Union — to forge stronger links across much of the Eurasian continent and with developing nations. The two sides said they would cooperate on Arctic sea passages for shipping and on international technological standards — areas where the U.S. has been wary of China's ambitions.

And then, later still (via Bloomberg, February 28) (my emphasis added):

Gazprom PJSC took a new step toward potentially its biggest-ever natural gas supply deal with China as nations around the world sever economic and political ties with Russia over the country's invasion of Ukraine.

The Russian gas giant signed a contract to design the Soyuz Vostok pipeline across Mongolia toward China, Gazprom said in a statement. If Russia reaches a new supply agreement with China, Soyuz Vostok will carry as much as 50 billion cubic meters of natural gas per year to the Asian nation.

A new supply deal with China would also enable Gazprom to build an interconnector between its west- and eastbound pipeline systems, *effectively allowing Russia to redirect gas toward China from fields that now only feed Europe. That could ease Gazprom's reliance on the European continent, currently the single-largest buyer of Russian gas.*

It would be wrong to assume that the expanded trading relationship between Russia and China will only cover raw materials. In the course of an article on the plight now facing Russia's aviation industry, Jon Sindreu noted this in the *Wall Street Journal*:

Beijing's determination to build up domestic industries in precisely the areas covered by Western export sanctions on Russia, such as aircraft and complex semiconductors, shouldn't be underestimated, even if it has so far failed. Just like weaponizing the monetary system against Moscow, shutting Russia off from high-tech components may entrench the world's partition into two economic blocs. The coincidence of wants between Russia's technology base and China's captive market may prove hard to resist.

Spoiler: It won't be resisted. Given the increasingly strong technological challenge posed by China to the U.S., that is not a reassuring prospect.

Note, too, Sindreu's reference to the weaponization of money. I'd strongly recommend reading the article to which he links (which is also by him), and which I discussed in last week's Capital Letter.

It had already been looking probable that the growing geopolitical contest between the U.S. and China would, in time, open major fissures in our globalized financial and economic system (the cracks are already there). But that process will undoubtedly be accelerated by the nature of the financial and economic sanctions now being imposed on Russia, something to which Beijing will have paid a great deal of attention. These sanctions derive much of their force from the way that Russia's participation in the arrangements underpinning what was, in many respects, a shared international financial system has now been turned against it, whether it's a matter of where Russia parks its foreign exchange reserves, Russia's participation in certain banking payment systems or its de facto acceptance of the dollar as the world's reserve currency.

The West wants the damage caused by those sanctions to persuade Putin to change course over Ukraine. That's to be hoped for. But these sanctions could well come with indirect costs on top of the obvious burden (higher energy costs and so on) they will place on the countries imposing them, for they risk undermining trust in international financial structures that are a valuable, if tacit, source of Western and, more specifically, U.S. power. If risk becomes reality and countries strong enough to do so (or countries with friends that are strong enough to do so) build alternative structures of their own, that will represent a major strategic reversal.

A related danger may well arise out of America's increasing weaponization of the dollar. The more the U.S. weaponizes the dollar, the more it undercuts the attraction of the dollar as a reserve currency. This is not going to make much of a difference for now. The euro, a frenemy currency, only accounted for around 20 percent of global foreign exchange reserves in early 2020, and the renminbi could only manage 2 percent. Nevertheless, America's rivals have now been given a strong incentive to diversify away from the greenback, and that, in time could mean trouble. The dollar's status as the world's preferred reserve currency (it accounted for 62 percent of reserves) gives the U.S. an enormous edge (not least because of the way it enables the U.S. to finance itself). That's an advantage that the U.S. should try to retain. The dollar's reserve role is a function of the strength and size of the U.S. economy, of American hard power and also of America's institutional reliability, a reliability that didn't work for Russia. That's a lesson that won't be lost on Beijing.

It was worth noting that payment for gas delivered to China through the first of the new pipelines will, Reuters reports, be made in euros, an arrangement clearly designed to help bypass American financial sanctions, now or in the future.

Meanwhile, the West is also clearly reappraising the wisdom of a globalization that has allowed certain Western countries to slip into a dangerous dependency in a number of key areas (Europe's reliance on Russian gas is only one example) of its economies on either Russia or China — although there the reappraisal has much further to go. And this is aside from concerns, whether justified or not, of the impact of globalization domestically, concerns that appeal to a significant section of the Western electorate.

Much of what happens next will, of course, be determined by the outcome in Ukraine. Nevertheless, it is easy to envisage a future in which the fissures within today's globalized order continue to widen. In the end, that may indeed leave much of the world divided into two economic blocs. And that division will be sharpened by political difference and geopolitical rivalry.

Where that will lead is anyone's guess, but it is worth noting this passage from an article by Thomas Meaney in the *New York Times*:

Of the 10 most-populous countries in the world, only one — the United States — supports major economic sanctions against Russia. Indonesia, Nigeria, India and Brazil have all condemned the Russian invasion, but they do not seem prepared to follow the West in its preferred countermeasures.

Food for thought.

The Capital Record

We released the latest of our series of podcasts, the Capital Record. Follow the link to see how to subscribe (it's free!). The Capital Record, which appears weekly, is designed to make use of another medium to deliver Capital Matters' defense of free markets. Financier and NRI trustee David L. Bahnsen hosts discussions on economics and finance in this National Review Capital Matters podcast, sponsored by National Review Institute. Episodes feature interviews with the nation's top business leaders, entrepreneurs, investment professionals, and financial commentators.

In the 57th episode David is joined by Scott Lincicome of the Cato Institute to talk about free trade, globalization, and the consequences of state intervention in trade. Scott brings his wide experience in matters of trade policy to the discussion and makes the case that not only has free trade been good for society, it has also been good for those who are most often presented as having been hurt by it.

The Return of the Regional Seminars

National Review Institute is back on the road with its biennial Regional Seminars. This year's series, titled "Creating Opportunity," will feature panel discussions and one-on-one conversations that make the moral and practical case for free enterprise.

Notable speakers include William B. Allen, David L. Bahnsen, Jack Brewer, Dale R. Brott, John Buser, Veronique De Rugy, Kevin Hassett, Pano Kanelos, Rich Lowry, Karol Markowicz, Andrew C. McCarthy, Andrew Puzder, Amity Shlaes, Kevin D. Williamson and, less notable, me.

We hope you will join us. You can learn more and purchase tickets here.

Thomas L. Rhodes Fellowship

The Rhodes Fellowship is made available to a new or recent college graduate, up to age 25 (when initially applying) who shows interest and capability in writing on, broadly speaking, current affairs, but with a focus on finance, business, taxation, fiscal policy, economics, and the workings of the free market.

Interested? More details here (scroll down).

The Capital Matters week that was . . .

Inflation

Edwin Burton:

Imagine you were driving your car and it ran out of gas. Would you call for a new set of tires or a new battery and expect that to get you back on your way?

If you don't understand why your car is no longer running, you will likely be unable to get it going again. Bizarrely, American policy-makers seem to have no idea why inflation is raging out of control and look for fixes that have nothing to do with the causes of inflation.

So, let's get back to basics. What is inflation? By definition, a positive inflation rate means that the prices of goods and services are broadly rising as measured in dollars. Flip that upside down, and what positive inflation means, by definition, is that the value of the monetary unit is declining in terms of what it can buy . . .

David Harsanyi:

Inflation hit a 40-year high in February, with the Consumer Price Index rising nearly 8 percent over last year. The White House reacted by pointing out that "Americans' budgets are being stretched by price increases and families are starting to feel the impacts of Putin's price hike." Setting aside the fact that only a fraction of February's inflation report captures the February 24 Russian invasion of Ukraine, the administration's attempt to blame a foreign dictator for its own year-long mismanagement of the American economy is both cynical and easily debunkable.

Let's start with oil . . .

Infrastructure

Dominic Pino:

In the bipartisan infrastructure law, Amtrak received $66 billion in funding, its largest influx of federal cash since Congress created it in 1971. Amtrak's statutory purpose was also changed from achieving "a performance level sufficient to justify expending public money" to "meet[ing] the intercity passenger rail needs of the United States."
In other words, we're not even going to pretend there's financial sense in running passenger-rail routes across most of the country anymore. It would be bad enough if this change in purpose were only another example of the federal government's irresponsible spending. But it's worse than that: It could do real harm to the country's freight-rail network at a time when supply chains are already facing unprecedented struggles . . .

Dominic Pino:

President Biden's affinity for Amtrak is well known, and he has appointed DOT officials who share his views. But one of the driving forces behind restoring this Gulf Coast service is Mississippi Republican senator Roger Wicker.

At first, that might seem strange. In the past, Republicans have done quite well politically by opposing wasteful rail projects. Think of Scott Walker, John Kasich, and Rick Scott all opposing federal funding for high-speed rail projects in their states during the Obama administration, for example. Some of that money went to California instead, which promptly wasted it on an over-budget and behind-schedule high-speed train that still isn't close to being operational.
Wicker, on the other hand, has been calling for restoration of the Gulf Coast Amtrak service for years . . .

Supply Chains

Dominic Pino:

"The U.S.'s industrial heartland is dotted with examples of how some links in the supply chain have been adapted to keep the wheels of commerce turning while others seized up," writes Brendan Murray at *Bloomberg Businessweek*.
Cities such as Memphis (FedEx), Louisville (UPS), and Chicago and its suburbs (railroads) have long been vital parts of American supply chains. (The North American oil industry centers on the inauspicious city of Cushing, Okla., the Pipeline Crossroads of the World.) Despite the political narrative of the heartland being hollowed out by trade, these cities actually benefit greatly from the logistics industry . . .

Ukraine

Andrew Stuttaford:

Between them, Ukraine and Russia also account for about 90 percent of Egypt's wheat imports.

Given the experience of the Arab Spring (let alone centuries of evidence showing the turbulence that sharply rising food prices can bring), it's not the boldest of predictions to think that widespread political trouble lies ahead.

Making matters even worse, there is the question of pressure in the fertilizer markets. Russia is a major exporter of potash and phosphates (a trade it may, for now, be wanting to halt) and then, of course, there are ammonia-based fertilizers.
In a report yesterday, the BBC's Emma Simpson explained that "huge" amounts of natural gas are needed to produce ammonia, the key ingredient in nitrogen fertilizer. Simpson had been talking to the CEO of Yara International, a fertilizer giant headquartered in Norway. Yara, she wrote "relies on vast quantities of Russian gas for its European plants."

Rich Lowry:

There are forgivable intellectual and policy errors, and then there's the self-delusion that has driven the West into its dependence on Vladimir Putin's oil and gas.
Russia has long been a major supplier of energy to Europe. The depletion of European natural-gas reserves has played a role in Russia's increased significance. Moscow has also benefited, though, from a deliberate choice by Europe to attempt a great leap forward into a green-energy future, especially in a Germany that turned its back on both nuclear and coal.
In taking this route, Europe made a holiday-from-history decision to forget the incredible power of oil, gas, and coal — the most reliable and efficient sources of energy the world has ever known — and ignore the inevitable centrality of energy to geopolitics . . .

Andrew Stuttaford:

Not only did Germany develop an unhealthy dependence on Russian gas, but it failed to develop a realistic plan B to develop alternative sources of supply in the event that there was a falling out with Putin. And Germany was not, of course, the only European country to fall into this trap.

To say that this cannot be sorted out "overnight" is to put it very mildly indeed. To take one example, for all the talk of a Berlin airlift-style operation to deliver liquefied natural gas (LNG) to Europe, there are not as yet enough tankers, liquification facilities (at the exporting end) or regasification terminals in Europe to fill the gap . . .

Emerging Market Debt

Desmond Lachman:

Russia is a relatively small economy, which accounts for less than 2 percent of world output. Yet it does have the ability to destabilize the global economy by triggering emerging-market debt crises.

It did so in 1998 when the default on its sovereign debt caused the Long-Term Capital Management bankruptcy that reverberated through the world financial system. It is now likely to do so again by its Ukrainian invasion. Not so much because Russia is once again poised to default on its sovereign debt. But rather because it is provoking a spike in international oil, grain, and metal prices that will accelerate the pace at which the advanced economies' central banks will be forced to engage in monetary-policy tightening as they attempt to contain inflation.

Even before the Russian invasion, the World Bank warned that the emerging-market economies had become very vulnerable to another debt crisis as a result of the Covid-19 pandemic. That pandemic plunged the emerging-market economies into their worst post-war economic recession and caused their budget deficits to balloon. As a result, on the eve of the Russian invasion, emerging-market debt had skyrocketed to an average of 65 percent of GDP or to by far its highest level on record . . .

Tax

Daniel Pilla:

And what about [President Biden's] claim about "closing loopholes for the very wealthy who don't pay"? The fact is there aren't any loopholes in the tax code that allow high-income people to escape income taxation. If there were, the top 1 percent of income earners wouldn't pay a greater share of income taxes than the bottom 90 percent *combined*.
Indeed, quite the opposite is true. The tax code is rigged decidedly *against* high-income earners in several ways, starting with the fact that we have a graduated tax system under which the rate of tax increases as one's income increases. Plus, most deductions are phased out for high-income earners, so they don't get the full benefit of otherwise legal deductions.
And, as if all that (and many more factors) were not enough, high-income taxpayers are subject to the Alternative Minimum Tax (AMT).

Gasoline Prices

Dominic Pino:

You can see that after a sharp increase in the first part of 2019, gas prices had been moving down gradually for a while before the pandemic began. The highest gas prices in 2019 were the week of May 6, when the price was $2.897. Gas prices reached that level again by the week of May 10, 2021.

Then, they kept going up. You'll see that in late 2021, gas prices declined slightly. That's not unusual in the winter months at the end of the year, when people normally drive less. You may remember Democrats trying to say that decline was a huge win for President Biden.
In January of this year, the upward trend resumed, culminating in this past week's jump of nearly 50 cents, the largest single-week jump in this data set (which goes back to 1990).

That may be "Putin's price hike." But what were the rest of the price hikes?

Nate Hochman:

No facts followed. What did follow, however, was the White House's new line on skyrocketing gas prices: "The suggestion that we are not allowing companies to drill is inaccurate," Psaki said.

"The suggestion that that is what is hindering or preventing gas prices to come down is inaccurate." That was echoed by the president himself at a press conference today: "Let me be clear," Biden said. "It's simply not true that my administration or policies are holding back domestic energy production. That's simply not true."
There's just one small problem: It is, in fact, true. "Interior has been slow-rolling oil and gas permits since Mr. Biden took office," the *Wall Street Journal* editorial board wrote last week. Citing "mounting evidence of anti-consumer behavior by oil-and-gas companies," the White House told the Federal Trade Commission to "bring all of the Commission's tools to bear if you uncover any wrongdoing" in November 2021. Biden's flurry of executive orders during his first months in office included killing the Keystone XL pipeline, which would have transported up to 830,000 barrels of crude oil per day from Canada to the U.S., and halting new oil and natural-gas drilling on public lands and waters. Last month, the administration indefinitely halted all new drilling permits altogether.

Kyle Smith:

The Biden administration is telling itself a comforting story that Americans suddenly want to pay higher gasoline prices. I hear America responding in Bugs Bunny's voice: *He don't know me very well, do he?*
Yes, there is a poll suggesting that Americans are in line with Stephen Colbert, who wants to pay $15 a gallon for gasoline to punish Vladimir Putin. But the same poll also says America wants to start World War III. As always, polling continues to be of limited utility when deciding complex questions that require actual knowledge of, and proper weighing of, the implied costs and benefits.
Some 74 percent of Americans said they supported the idea of the U.S. working with NATO to establish a no-fly zone over Ukraine. Putin has said this would be an act of war, Joe Biden has said this would be an act of war, and it would be an act of war. We would be at war. With Russia.

David Harsanyi:

President Joe Biden has been praised on the left for his deft statecraft and ability to rally our allies against Russia. Yet the *Wall Street Journal* reports that the president of the United States, the most powerful man on earth, was unable to get the theocratic petrol-sheikhs of Saudi Arabia and the United Arab Emirates on the phone. Both had spoken to Vladimir Putin a week earlier. Biden was going to beg them to open the spigot and ease oil prices. But why would they? They have us over hundreds of millions of barrels . ..

Dominic Pino:

What the federal government needs to do is let the price signals in the market work to attract new capital investment to these oil companies so they can buy the equipment they need. Taxing away their "windfall profits" would keep them starved for capital and unable to increase production.

Senator Warren's idea is not only misguided, it would actually do the opposite of what she wants. Capital-poor oil-drilling firms will remain capital-poor if their profits are taken by the government — and capital-poor firms are not going to increase oil supply.

ESG

Richard Morrison:

The movement for environment, social, and governance (ESG) investing, after several years of headline-grabbing growth, is about to hit a wall of resistance. Conservatives have come to see this collection of business trends, most often encountered at corporate conferences and investing seminars, as yet another “woke” assault on mainstream society. Their growing opposition to ESG will likely chill industry enthusiasm and curtail the growth confidently predicted by many of its advocates.

The cultural and intellectual pushback has been brewing for some time — *New York Times* columnist Ross Douthat wrote about “woke capital” in 2018 — but hit critical mass last year. February 2021 saw the publication of *The Dictatorship of Woke Capital: How Political Correctness Captured Big Business* by finance analyst Stephen Soukup. In it, Soukup traces contemporary calls for “enlightened” and “responsible” investment from left-leaning writers going back over 150 years. In this history, progressive critics have always pushed for greater “social” control of corporate America, and the push for ESG currently in vogue among their ideological descendants is only the most recent threat to investors’ property rights . . .

Electric Vehicles

Andrew Stuttaford:

The notion that China may dominate at least the affordable end of the EV market is a touch difficult to reconcile with the narrative of green new jobs that the administration is also so insistent on pushing, but there we are.

There’s also that nagging question, made more nagging still by the current Russian trauma, as to whether it is wise for this country, or its allies, to be dependent on a geopolitical rival in any industry that matters now or could matter in the future.

The answer to that question ought to be obvious, but . . .

Energy Dependence

Jordan McGillis:

Glaring as Germany’s shortsightedness now appears, the U.S. is stumbling into an analogous trap with *our* primary geopolitical opponent. Menacing though Russia is, for the United States, the long-term challenge is China, a state seeking to establish hegemony in the world’s most populous and most economically dynamic region, the Asia-Pacific. This century’s global politics will be defined by Sino-American competition in that region — and the world more broadly. Amid this reality, the United States ought to reconsider an energy and environmental orientation that favors China.

Just ten months ago, the International Energy Agency (IEA) released a report warning that dependence on China is an inherent risk in the Biden administration's forced energy transition. "The rapid deployment of clean energy technologies as part of energy transitions," the IEA wrote, "implies a significant increase in demand for minerals." China, which the Biden administration deems "our most serious competitor," has a dominant presence in the production (and more) of mineral resources required for the energy system President Biden champions — one anchored by wind, solar, and battery technology. While it is a major producer of many of the minerals in question, China's processing and refining prowess is its key advantage. China processes more than half of the world's cobalt, lithium, and the class of rare-earth elements (REEs) that includes neodymium, dysprosium, praseodymium, and terbium . . .

Global Food Supplies

Andrew Stuttaford:

History weighs. China has had terrible experiences of famine (a number of them due to the policies of the Communist party, something that Xi is unlikely to be stressing), and its unease will be increasing in a world where trading relationships are shifting: The trade war with the U.S. at the end of the last decade highlighted, among other things, China's vulnerability when it comes to food.

One particular weakness that is emerging on the back of the current Russo-Ukrainian war is likely to be that a shortage of sunflower oil, a major Ukrainian export, will drive up prices for alternatives such as soybean oil. The latter is important as, the *Journal's* Jacky Wong explains, "China imports more than 80% of what it consumes. Soy is also critical as feed for pigs, the country's main source of meat protein."
A move to greater agricultural self-sufficiency is also in line with China's shift to a form of fascism: The quest for substantial economic autarky, at least in certain sectors, was a characteristic of mid-century fascism, and, as Wong observes "self-sufficiency is a key economic plank" of Xi's regime. Food will be no exception . . .

Climate

Nate Hochman:

When it comes to energy security and climate policy, it's not actually an either/or. Or at least, it *shouldn't* be. But rather than attempt to explain, rationally and coolly, how a cleaner economy would serve U.S. interests in the long run — while recognizing that an all-of-the-above approach is the only viable way to get there in the interim — the top environmentalist organizations are opting to either politicize the crisis or ignore it altogether . . .

Jakob Puckett:

It's no secret that President Biden wants to spend taxpayer money on clean energy. He said as much in his State of the Union address, and his Build Back Better plan — now repurposed for fighting inflation — has hundreds of billions of dollars of climate-related spending, including massive extensions of the subsidies that wind and solar generation have benefited from for decades.

But the time for subsidies (if there ever truly was one) has passed, as technological advances have cut the cost of generating power from wind and solar plants substantially. In fact, the Energy Information Administration estimates of wind and solar generation by 2031 *without* Build Back Better subsidies are nearly identical to the Congressional Budget Office's expectations *with* the subsidies. That these subsidies are expected to have such negligible effect should be a clue that something else is holding back clean-energy development. The biggest obstacle to getting more clean energy on the grid isn't federal spending. It's regulation.