Global Political Drivers

REGIME CHANGE IN THE AIR

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- In a week when the US has been intensifying pressure on Iran and Venezuela – and with the North Korean situation now looking more precarious – this is a good time to consider the investment implications of America's regime change projects.
- The immediate implications are mainly local and specialised, with the only obvious global impact coming through the oil price uptick ahead of yesterday's removal of US sanctions waivers on Iranian oil exports.
- That leaves the 'minor matter' of the potential for armed conflict, with ominous echoes from the twentieth anniversary of the NATO attack on Yugoslavia. But such risks seem remote, albeit slightly higher in the Iran case – with the Hormuz strait being the most obvious potential flashpoint. Clashes there would cause a record oil price spike.
- In contrast to such tail risks, the real global investment theme here stems from Trump's preference for sanctions as "war by other means".
- Since 2014, China and Russia have been building defences against the huge coercive power of the US Treasury. Such defensive financial plumbing – focused on autonomous payment and settlement systems – can also be used to counter US-backed regime change, as now seen in Venezuela.
- While generally accentuating great power tensions and the resulting trend of global economic fragmentation, US sanctions used for regime change purposes will see diminishing returns – increasing the specific risk of yet more severe escalation causing financial shocks.

Oil price impact

This week has seen the US government step up its efforts to bring about regime change in Iran and Venezuela. While differing in some respects, the case of North Korea is also worth viewing in this same 'regime change' bracket. The difference is that in return for North Korea giving up its nuclear weapons, the US is offering that country a security guarantee. Whatever form that guarantee might take, it would boil down to the US renouncing the goal of overthrowing the totalitarian monarchy of the Kim dynasty. Any such prospect depends, however, on the peace process recovering from the failure of the Trump-Kim summit in Hanoi at the end of February. In a speech to the Supreme People's Assembly in Pyongyang on 12 April, Kim Jong Un indicated that he would wait until the end of the year for the US to "change its calculation". This implies that 2020 could see a re-run of the situation in 2017, with the North Korean regime relying on nuclear deterrence to survive.

The investment relevance of all three situations is more obviously local than global. Holders of the $65 billion-worth of outstanding Venezuelan government and PDVSA bonds face a material haircut. There seems no way of avoiding this outcome, regardless of whether the US succeeds in replacing the incumbent Maduro regime. Regime change or survival will affect the orderliness of the coming debt reduction as opposed to whether it happens at all. In any case, this situation will mainly be of interest to distressed debt specialists.

As for the Korean situation, the South Korean currency and financial assets are buffeted by the ups and downs of negotiations with the DPRK. ROK markets are on the mainstream investment radar; and in the equity market notably, the prices of stocks exposed to a reunification dividend – however hypothetical that seems in reality – fluctuate in reaction to the news flow. For all that, South Korean markets remain a relatively specialized area in a global perspective.

Only the Iranian case is making an impact on the global economy. This stems from Washington's latest moves – in force since yesterday – to throttle Iranian oil exports. The oil price surged above $70/bbl on the announcement by Secretary of State Mike Pompeo on 22 April about "going to zero" – meaning the complete withdrawal of the waivers granted last November that have allowed countries which import material quantities of Iranian crude to continue to do so for six months without incurring US secondary sanctions. The US blockade on Venezuelan oil is also contributing to this oil price impact, although PDVSA's output had already collapsed anyway as a result of domestic misgovernment. A final contribution comes through the continuing after-effects (i.e. the now re-escalating civil war) of the regime change brought about by the US and its European allies in Libya back in 2011.

To sum up, the present effect of US regime change policies on the global economy seems limited to supporting the oil price at higher levels than would be expected given global supply potential and the slowing world economy. However undesirable against the present economic backdrop, the deflationary effect should be containable. The buoyancy of US oil output itself will help. A Trump tweet last week showed him counting on Saudi Arabia playing the grateful ally role by boosting output to replace the gap left by embargoed Iran. While he may well be disappointed by the Saudi response, it is likely that OPEC+ meetings planned for this month will at least partially reverse the output cuts agreed last December.

War risk

Regime change brought about by the US since the end of the Cold War has often involved armed conflict. We have already recalled the case of Libya in 2011. The central case remains the invasion of Iraq in 2003. As regards the foreign policy and security interests of the US and its allies – not to mention US prestige – the decision of the Bush-Cheney administration to overthrow Saddam Hussein has proved counter-productive to put it mildly. As well as being a strategic gift to Iran, it spawned fresh jihadi violence culminating in the Islamic State which, with help from America's next regime change project in Syria, has exported terrorism and refugees to Western countries. Such blowback from the Iraq fiasco did not extend to the investment sphere – where the effects were limited, in hindsight, to big speculative opportunities in stocks (with the S&P Index plunging in Q1 2003 to a trough almost as low as it would later reach in Q1 2009) and the oil price.

Lessons from Yugoslavia

Yet another example of minimal economic impact from US-sponsored regime changes is the NATO attack on Yugoslavia, the twentieth anniversary of which fell last month. That 12-week air campaign achieved its immediate military goal of detaching Kosovo from the rest of Yugoslavia and led the following year to the desired political outcome of the ousting of Slobodan Milosevic.

There are some suggestive parallels and contrasts between that episode and present-day regime change projects. Yeltsin's Russia railed against that attack on a sovereign state as illegal under international law, since it had not been approved by the UN Security Council. In response, the US and its allies invoked the principle derived from the UN Charter of the 'Right to Protect' (R2P) – in this case, protecting the Albanian Kosovars from feared "ethnic cleansing". In any case, the US by-passed the UNSC to avoid a Russian veto, safe in the knowledge that Russia was then too weak in practice to interfere with the NATO intervention in Yugoslavia.

Twenty years later in Venezuela, the Trump administration does not refer explicitly to R2P, though its rhetoric matches that spirit. The difference is that a recovered Russia now has the ability to help a target of US regime change like Venezuela defend itself against an armed attack from abroad. No amount of Russian (and Cuban) military aid may suffice in the end to save the Chavez-Maduro regime from the social and economic meltdown of its own making. In hindsight, the effect of the Russian spoke in the wheels of US-supported regime change in Venezuela may prove to have amounted to little more than prolonging economic distress (in turn amplifying the likely scale of future debt write-offs) and the undersupply of heavy crude oil to the global market.

If the economic and financial market impact of regime change seems marginal, that just leaves the indirect – but always potentially drastic – effects of war. The focus here must be on Iran, given its involvement in various conflicts raging in the Middle East. Perhaps the single most important factor is Iran's enmity with Israel, since the Trump administration has taken traditional US support for Israel to a new level by, in effect, out-sourcing much of its regional foreign policy to the Israeli government led by Benjamin Netanyahu, who once again prevailed in last month's election. The US sanctions re-imposed since Trump's unilateral withdrawal from the Iran 'nuclear deal' a year ago are billed by Pompeo as set to be "the strongest in history once we have finished". They have already tipped the Iranian economy into a deep recession.

In a speech in May 2018, Pompeo framed the US campaign against Iran with a set of twelve demands. These boil down to requiring Iran to give up pursuing any independent policy in the region in line with its own view of its national interests. There is another echo here of the Yugoslav situation in early 1999, when the US and its allies served an ultimatum on Belgrade described by the Cambridge historian Christopher Clark as harsher even than the Austrian ultimatum to Serbia that triggered the outbreak of the First World War.

That echo serves to pull into focus today's contrasting reality that Trump lacks his predecessors' appetite for military adventures – even just the air campaigns favoured by Clinton, let alone following Bush's example of putting an army group into the Middle East. Instead, Trump is falteringly keeping his election campaign promise to end America's "endless and useless wars" in the region by winding down the Syrian and Afghan deployments. It follows that Trump must be counting on "strongest ever" sanctions to bring about regime changes – or at least, policy changes in the targeted countries so radical as to change the character of their existing regimes – without resorting to military force.

Iran and Hormuz

Trump's preference for sanctions over armed force does not, unfortunately, rule out war risk – especially in the Iran case. Speaking to the New York Asia Society last week, the Iranian Foreign Minister Mohammad Javad Zarif said that Iran would ride out the sanctions storm but he feared false flag attacks or other provocations on the part of the US or its regional proxies that could spark conflict. Some such spark may figure in the calculations of Washington hawks led by Trump's National Security Adviser, John Bolton. It could also come from Iranian regime hardliners deciding to retaliate against the US for imposing economic harm (and increasing the political threat to their power and wealth from the associated public discontent).

Hormuz flashpoint

A widely discussed possible flashpoint is the Strait of Hormuz (see map above), through which nearly a third of the world's seaborne oil trade passes. The obvious Iranian motive would be to make others, especially regional rival (and US ally) Saudi Arabia, feel the same pain of oil exports being impeded. Conflict could break out on far less than an attempted Iranian blockade of the strait. The oil price would likely surge on the back of just one or two incidents affecting shipping, especially as the 'fog of war' would quickly descend, with the parties denying responsibility or denouncing false flag provocations or just blaming each other. In the event of any such threat to the daily flow of 18.5 million barrels of crude, a US-led military intervention would seem inevitable.

The geopolitics of financial plumbing

To sum up the story so far, there is a tail risk of recent oil price increases caused by US actions against Iran and Venezuela being turbo-charged by armed conflict. But US regime change efforts are also having a more systemic effect which deserves greater attention than mere tail risks. This effect stems from the Trump administration's use of sanctions – that is, the unprecedented scope and intensity with which US dominance of the global financial system is being used for the purpose of political coercion.

Belying his own rhetoric, Trump is building here on a foundation laid down by Obama. The negotiation of the 'nuclear deal' with Iran was leveraged by stringent sanctions with a decisive financial element: Iranian banks, including the Iranian central bank itself, were excluded from the international payments system – meaning, above all, SWIFT. Back then, however, the sanctions were (largely) UN mandated – i.e. making all countries legally obliged to enforce them. When it came to sanctioning Russia in response to the Ukraine crisis in 2014, a UN mandate was impossible: but the Obama administration took care to coordinate all sanctions measures with the EU.

Under Trump, the approach has been unilateral, involving also the general use of extra-territorial – or "secondary" sanctions on third parties in any other countries who fail to comply with US sanctions. In the financial sphere, extra-territoriality is not even required since all banks servicing clients across borders need access to the dollar system, giving them US 'personality' and making non-compliance with any US sanctions an unaffordable risk.

Those initial sanctions against Russia in 2014 included cutting off two small Russian banks owned by Putin cronies. The Visas and Master cards issued by those banks stopped working overnight. Russia responded immediately by replicating China's Union Pay national payment card system that insulates almost all domestic transactions from foreign interference. The Russian response did not stop there. Anticipating the 'nuclear' financial sanctions option of cutting off a country from SWIFT, the Russian central bank (CBR) established a domestic counterpart to SWIFT (Russian acronym: SPFS). China acted likewise the following year by setting up CIPS. These initiatives are summarized in the table on the next page.

The main purpose of CIPS is to facilitate the use of the renminbi globally by cutting costs and process times; and it has reported transaction volumes doubling every year since 2017. But it also clearly acts as a fall-back in case China should ever find itself on the receiving end of the kind of sanctions that the US has imposed on Russia. Important for this purpose is the participation of foreign banks. CIPS reported 12 direct foreign participants by mid-2018 while the CBR announced last month that it had fully signed up two non-resident banks to its SPFS settlements system with another five in the pipeline.

China and Russia autonomous payment systems

China	Russia	Sitrep/Outlook
Cross border Interbank Payment System (CIPS)	Financial Messaging Transfer System ('SPFS')	Founded in 2014-15 SWIFT-style capabilities Fall-back if US were to cut off SWIFT
Union Pay	Mir (operated by National Payments Card System)	UP has 98% domestic market share 2018: Mir cards took 10% market share from Visa/Mastercard Next step: plugging sanctions vulnerability in interbank processing of card payments

These moves by China and Russia to de-link their financial plumbing from the global dollar system relate to our theme of US-sponsored regime change in two ways.

- **Direct defence.** Putin's Russia in particular perceives US policy as aiming to undermine Russian sovereignty, amounting to regime change. For the purposes of this analysis, it does not matter how far this kind of perception is justified, paranoid or plain cynical - for the policy response is there in any case.
- **Resistance to regime change in general.** While countries like Iran – let alone Venezuela – could not themselves create defences against US financial sanctions of the kind that China and Russia now have, they could tap into the defences of those big powers that are resisting US global hegemony.

This second effect is already visible in the Venezuelan case. CBR data indicate that $300 million-worth of Venezuelan deposits had been piled up pin Russian banks by the end of 2018, and that total has presumably increased substantially since last January, when the present regime change push began. One Russian bank – Eurofinance Mosnarbank – is closely involved in Venezuela, in fact a Venezuelan state entity has a 49% stake in that bank. Mosnarbank was accordingly sanctioned by the US in February for its dealings with PDVSA.

This caused an interesting incident. Mosnarbank's credit cards stopped working not because of a failure of the National Payments Cards System but instead as a result of fears of its payments processing operator, a domestic market leader call Kartstandart, which was probably worried about losing other banking clients fearing US secondary sanctions. So Mosnarbank must find a replacement card processing provider; and one such candidate is owned by Promsvyazbank, now a state-owned lender specifically designed to serve US-sanctioned clients (mainly in the Russian defence sector) in a fully insulated environment.

Such cut-out or expendable financial institutions likewise seem to be Beijing's preferred strategy for getting round US sanctions. The best such Chinese example is the Bank of Kunlun, a CNPC-controlled entity used almost entirely to process Iranian oil transactions. Beijing may be reluctant to use Kunlun to maintain oil imports from Iran in the near future when finishing touches are being put on the deal to end Trump's 'trade war'. Looking further ahead, however, China and Russia are now increasingly well equipped to help Iran foil the stated US aim of reducing Iranian oil imports to zero. This prospect supports our relatively relaxed view of the specific risks arising from the present US regime change projects – even the Iranian one that right now seems the most hazardous – and the relatively greater importance for the global economy and markets of this 'geopolitical financial plumbing'.

Summing up

Whether it uses its military or its financial (sanctions) muscle to try and force changes in countries around the world, the US can no longer exercise the untrammelled global hegemony that it enjoyed for the first two decades after the collapse of the USSR. Instead, it faces pushback from China and Russia. Investment risks arising from the specific regime change projects are limited – or, in the case of war risks, will be ignored by financial markets as impossible to discount (as clearly demonstrated by the financial market non-reaction to the "fire and fury" phase of the North Korea nuclear crisis in 2017). US regime change projects qualify as a Global Political Driver mainly in the way that they accentuate the costly struggle for mastery with rival big powers (i.e. China first for foremost, followed by Russia).

Leaving aside, once again, the ultimate geopolitical tail risk of great power conflict, this global rivalry has practical consequences for the world economy. It fosters fragmentation into global trading and economic blocs that will over time reduce CAPE and thus equity valuations. In the shorter run, there is a risk of financial shocks from America's increasingly intensive use of sanctions and the resistance to those sanctions by US target countries with help from China and Russia. This means that US sanctions will suffer from diminishing returns and would therefore have to be escalated ever more to obtain the same desired effects. The logical end point would be for the US to cut off the CBR or the PBOC – that is, an act of total economic war.

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