**DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST**

**"Post-G7 summit, a time of great uncertainty in the global economy"**

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*Guest:*

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*Episode Summary:*

Douglas Rediker, founding partner of International Capital Strategies and a nonresident senior fellow at Brookings, discusses a range of global economic challenges that G7 leaders tackled in their recent summit in Germany. These include a U.S. proposal to cap the price of Russian energy exports (and why Rediker is skeptical about it); Russia's default on sovereign debt and the risk of debt default in developing countries; the role of Chinese lending in developing economies; and the enormous cost of rebuilding Ukraine and who might bear it.

**DOLLAR:** Hi, I'm David Dollar, host of the Brookings trade podcast Dollar and Sense. Recently, the G7 leaders met in Germany at a time of great uncertainty in the world economy. With rising energy prices, inflation more generally, our Fed raising interest rates, and slowing global world growth. So, it's really a pretty difficult situation out there. And my guest to discuss these developments and what came out of the G7 summit is Doug Rediker. Doug is a nonresident senior fellow at Brookings and also a founding partner of International Capital Strategies, a political economy consultancy. So, welcome to the show, Doug.

**REDIKER:** Thanks, David.

**DOLLAR:** So let's start with the energy side of this, because it's very much on people's minds. Secretary Yellen has proposed capping the price of Russian energy exports. This is interesting idea. How would that work? Can we actually do that? And what would be the objective here?

**REDIKER:** All right. So, the objective is easier to answer the "Will it work and how would it work?" Because just to start off for your listeners, I'm a real skeptic about this idea. I think it works really well in the halls of an academic discussion about what a precise market that is efficient might suggest would be an outcome. That's not the world in which we live. It's certainly not the world in which Russia, when it comes to energy, occupies. This is not an efficient market, this is Putin's world, and we only live in it. And that's, I think, the starting point for this discussion.

But I think the the motivation behind it is fairly straightforward. Earlier this year, under political and public pressure, the U.S. said we were going to impose an embargo on the import of Russian oil into the U.S. Now, the U.S. really doesn't depend on Russian oil very much. It's around seven or eight percent. It's a very low grade kind of oil. It really isn't something that was going to directly impact the price at the pump or other broader energy dynamics.

On the back of the U.S. doing so, Europe was under an enormous amount of pressure to do something similar. And this is all understandable because, of course, there is an argument—it's a very credible argument backed by Europe and the rest of the world—providing income to Russia by buying its oil and gas, in this case oil, they are funding his war, and that is considered to be something we would rather not be doing. And that is all very well and good.

The problem is that once Europe took the step that it did, it was a hard fought internal battle to come up with an agreement that six months from last month, basically—it was for December of this year—that Europe would reduce its imports of Russian oil largely to a point where they were not importing either 67 or 90 percent, depending on how they decide to implement it, of Russian oil. And that was a real signal that Europe was not going to fund Russia's war effort.

The problem is, if you cut off that much supply, the prices are going to go in one direction, and that is up. And that is something that the U.S. administration is desperately afraid of, because prices at the pump are political. Inflation is obviously both economic and political, and a means by which to stop those dynamics from percolating into the U.S. political and economic sphere became a very high priority for the Biden administration.

So, at a certain point in time, the U.S. administration tried to pressure Europe to not put on this embargo, this complete cessation of importing most oil from Russia. And rather said, why not do this clever idea? Let's say we'll import the oil, but only if we pay a capped price. And that was supposed to be the best of both worlds. We in the U.S. and the rest of the world get lower oil prices. Putin gets lower oil revenues. Europe and others continue to get Russian oil. It sounds great on paper. I'm skeptical that it's going to work.

**DOLLAR:** Yeah, I guess to actually implement it, we're counting on using the fact that international insurance companies are involved in all of these transactions and international shipping companies. Is that the basic idea that we would target the sanctions very specifically to tankers that are carrying Russian oil? And so I guess you're skeptical, I mean, is that really feasible?

**REDIKER:** Well, that's one of the many reasons I'm skeptical. I mean, first of all, what you're alluding to is the mechanism or one of the mechanisms by which to enforce this would be to say, if you are agreeing to abide by the price cap, then we collectively will allow U.S. and UK insurance to continue to be offered for the shipments of that oil. And then if you offer the oil at above the price cap that we are setting, then you will not be allowed to be insured. And there are a lot of waterways in the world that require insurance in order to be able to pass through. So, this would be a disqualifier if you didn't abide by it.

But my real main skepticism is borne of two things. Number one, that you're going to get enough countries to create what is effectively a buyers cartel to be able to enforce this. It's one thing for the U.S. and the EU to say that they go along or even other G7 countries. But it is hard for me to understand why it is that oil will not simply be rerouted to other markets that are simply going to say, well, we aren't necessarily going to go along. And that could be for a variety of different reasons. I think the U.S. idea is to try and get as many countries onside as they can, but I'm still skeptical this is going to be enforceable.

But the real reason that I'm skeptical is because Vladimir Putin can say no. So, what you've already seen Vladimir Putin do in the case of gas to Germany and to others on continental Europe is to shut down the flow of gas to Europe. That means Russia does not get the benefit of the revenues, but Europe does not get the benefit of the gas. And it's hard for me to understand why Putin wouldn't do the same exact thing on oil and say, for those of you who are seeking to impose a cap on me, I say the hell with you. I'm going to sell my oil elsewhere. And by the way, we and China and others have other insurance alternatives. They're not the UK, they're not the U.S. But you know, the world is not what the U.S. and the UK and Europe used to think. They dominated entirely. There are alternatives and for countries that are operating in their national interest, they may say, Well, we'd kind of like Lloyd's of London, but if we have to get a Russian equivalent, we'll accept it if the alternative is we've got to pay more or they shut off the oil flows entirely.

**DOLLAR:** Have you heard any mention of a specific price, the kind of price or differential at which we would try to cap the oil? The reason I ask is India's reportedly buying oil, Russian oil, at about a $30 discount. So, I think the the world price has dropped to about $100, a little bit under 100, I think, and India is paying $30 less. So, that's already a pretty big discount. But clearly, it's it's profitable for Russia to do that. They're selling a lot at those prices. So, do you have any sense of what kind of differential we're trying to achieve?

**REDIKER:** Well, what's been reported is that that the discussions are around 40 to 60 dollars a barrel. And as you rightly point out, with oil trading now on the global markets at around 97, let's call it between 95 and 105—so 100, whatever—you see in India basically buying, as you say, oil at about a $30 discount. So, at the end of last week, we saw oil from Russia Urals blend, which is the Russian benchmark, at around $67. That is exactly what you described. It is higher than what we're describing here in the 40 to 60 dollar range that's been reported, but it's not that far off. And yes, Russia is continuing to price that.

But this isn't about economics. This is about politics. And so, sure, Russia is going to sell oil to India at a discount, as they are to China at a discount, because they are actually either overtly or tacitly supporting the Russian regime in its adventurism and its attacks in Ukraine.

But if you get a concerted U.S., EU, G7 style price cap, then Putin is likely to say, Okay, this is not just me accepting less than a global market price, this is me acquiescing to pressure from the West. And if I shut off that supply—there was a report out last week by JP Morgan, that speculated that if Russia were to respond as I suggest they are likely to do, which is to cut off some or all of those exports, if they were to cut off 3 million barrels a day, that the oil price would spike up to around 185 or 190 dollars a barrel if they were to try to shut off 5 million. JP Morgan's estimate was this would force oil prices to go up to $325 a barrel. So, if I'm Vladimir Putin, I might say, You know what, for me, it's worth it for a couple of months to forgo some revenues if I can actually create havoc in the U.S. and the EU and elsewhere when they try and do something to me and my reaction function is exactly the opposite of what their intentions are.

**DOLLAR:** Yeah. So, those kind of prices on the world market would clearly, would almost certainly throw the world economy into recession.

**REDIKER:** Well, and it would cause political fragmentation both within the transatlantic alliance and internally within Europe. And also, it probably wouldn't help the Biden administration's chances in the midterms if it were seeing that they tried something and it ended up being absolutely counterproductive to the point where inflation and fuel prices were to escalate on the back of whatever effort they were trying to engineer. That doesn't mean that's a necessary outcome. It's just the JP Morgan Price if Putin were to respond in the extreme case. So, I'm not suggesting that is the base case, but boy if I were making this assessment, I would certainly be looking at those risks and taking them very seriously. I think the U.S. and EU and particularly the U.S. are at risk of under appreciating the the Russian reaction function here.

**DOLLAR:** So, Doug, you make a convincing cases that this is more about politics than economics. And I think we could say the same thing about another recent development, which is Russia's default on its sovereign debt. Russia's actually earning quite a bit of money. That's what we've just been discussing. They're still exporting a lot and they're earning a lot. They're capable of paying or servicing their foreign debt, but we're essentially not allowing them to. Have I got that right?

**REDIKER:** Yeah, that's right. But again, I think you have to realize that Russia's, quote, default—and it is a default, they did not pay. They tried to pay, but they were not allowed to pay by virtue of the sanctions that the U.S. and the EU and others had imposed. But that's that's not your traditional default. So, most defaults are when countries simply don't have the wherewithal to actually make payments. In this case, Russia tried to, but because of their aggressive actions and our response, we didn't allow those payments to be processed.

But, Russia is not only making money on the basis of selling oil and gas into a very high priced market right now, but Russia was never a prolific borrower on the international capital markets. Their debt-to-GDP ratio—if you put it in context, you know, the U.S. is roughly around 100. Italy is around 150. You know, Germany is struggling to down back to its target of 60. And Russia's was around 20. So, their need to borrow internationally to finance their budget is fairly small relative to other countries that really need access to the capital markets. Reputationally, it's terrible. But in terms of their ability to fund their day-to-day budget, an inability to go to the capital markets now because they've been forced into default is probably not Vladimir Putin's first priority when he wakes up in the morning.

**DOLLAR:** So, are we likely to see much contagion from the Russian default to other emerging markets in developing countries? In the past we have quite a few cases where there's major default and then that just sets off a wave of defaults. And I think it's often hard to distinguish is this really contagion, meaning the disease is just spreading, or is it common factors. We have a lot of developing countries now that have excessive debt. Interest rates are going up. Are we going to see a wave of defaults coming or is this Russia case really unique and we're not going to see a wave of defaults?

**REDIKER:** Well, the two are completely unrelated in my mind. So, the Russian default is a Russian specific dynamic, and I don't see any contagion risk into other emerging markets on the basis of what's happened to Russia.

Second part of your question is an entirely different one, which is are there other factors in the world right now which suggest that there are emerging market default risks that are out there. I think the answer is clearly yes. So, you've got a rising interest rate environment. You've got a very strong U.S. dollar relative to other currencies. That combination is a bad combination. And that's before you get into the supply chain shocks, the commodity shocks, and other war related issues.

So, this is not a good environment for emerging markets which on the back of COVID were encouraged to borrow more for their crisis response. And now they are in many cases being forced to refinance some of those indebted positions and they're being asked to refinance them at much higher rates. And with a market that suddenly has other alternatives, not only because of the rising interest rates in the U.S., but because there are simply more attractive opportunities out there. A lot of emerging markets benefited from the hunt for yield trade, where investors were simply presented with no options to get any returns on their money. So, they went into a riskier set of assets, including emerging markets. They weren't particularly enamored of emerging markets or even very well educated about emerging markets. They were just looking for something that would pay them something. Now there are other things that will pay them something. And so now they say, Well, we have a choice. Should we do this or not?

And then to finish on this question, I made reference to it before. A stronger dollar means that if you are a country whose economy is denominated in your local currency, but you borrowed in U.S. dollars and the dollar has strengthened relative to your U.S. currency, that means your costs to repay that debt have just gone up significantly. And that is a burden that in the past we have seen has led to a series of emerging market defaults and restructurings over decades earlier.

**DOLLAR:** Right. So, we would normally expect the IMF and the Paris Club to take the lead in helping developing countries resolve some of these financial issues. Do you feel like our institutions are well placed to play their traditional role, or does the whole conflict with Russia and China's somewhat ambiguous stand in all this, does that just create a very complicated world to get the usual result from those institutions?

**REDIKER:** Well, it's a very complicated world even before you get into the Russia-Ukraine conflict. But you raised China and that's the big elephant in the room on the question that you're asking. Traditionally, you had the Paris Club representing the majority, if not the entirety, of the official creditor universe. You had the IMF that played sort of a camp counselor organizing role and was allowed to use the Paris Club and its own lending as leverage on private sector lenders. It used to be that there would be commercial creditors through the banks. Then it has become commercial creditor committees through a collection of bondholders.

But now you have a new entity, which is China. And China is not a member of the Paris Club. They have shown themselves very reluctant to provide the debt relief that other traditional Paris Club lenders had grudgingly but have generally been willing to provide in order to maintain the institutional integrity that you were suggesting of the IMF, the London Club, and commercial creditors.

Now you've got China that does not like to offer principle-based haircuts. They are willing to offer net present value hits. So, in other words, you would extend a repayment period for a longer period of time, and you might even reduce the debt servicing requirement over that period. But if they lent you a billion dollars, they expect to get paid back a billion dollars. And that is very difficult to negotiate when in fact, that creates an asymmetric set of interests vis-à-vis other official creditors and commercial creditors.

So, the example everybody is looking at right now is Zambia, which has a government which has been very constructively engaged with both commercial creditors and with the IMF and with other non-China Paris Club official creditors. But China has been very slow and very hesitant to actually play a constructive, engaged role. And so, while the government and the IMF and others have been engaged with one another for oh, six, nine, 12 months now, it is only last month that China sat down and agreed to even have a conversation. And those conversations are ongoing without any resolution to date. And that means Zambia cannot actually borrow from the IMF and restructure its debt with others. I would use that as a warning sign for other countries. It is not that China is going to affirmatively say no. It's just they're going to drag their heels so long that it is very difficult to work around them.

**DOLLAR:** So, a lot of that Chinese lending has been associated with their Belt and Road Initiative, which is their big program funding infrastructure, mostly power and transport, in developing countries. And my own sense is that some countries have made those projects work fairly well, but others have clearly gotten in the debt problems. You mentioned Zambia. Sri Lanka is another case. There are quite a few African countries that that are heading toward debt distress.

So, one of the other outcomes from this G7 summit was a new Western initiative, $600 billion over five years to fund infrastructure in developing countries. So, I'd like to get your reaction to that. Is that an effective counter to what the Chinese are doing? Is it complementary? Is it going to help solve some of these problems?

**REDIKER:** So, I would love to be able to say, this is great, I'm so glad they finally did this. And to some degree it is great and I'm glad they finally did this. But I say that with a head shaking sadness because, number one, when the G7 gets together and makes a commitment like that, it's not a commitment the way it is if you go to the bank and they sign, you know, a mortgage for your house. That doesn't mean the money is sitting there waiting to be drawn upon. In fact, the U.S. Congress has not appropriated a dime for this actual project, so it will take some time before we see just how real that $600 billion figure is.

But the other reason I'm a little bit sad about it is this is a case of if not too little, certainly too late. So, we are in a world now where, as per earlier discussion, debt to the developing world and emerging markets is a problem because of the level of that debt and the need to now refinance that debt in some cases. The idea that we're now going to finally come up with a pool to provide more debt is probably not the right thing to do at this point.

If I were sitting in that room with the G7, I probably would have been working more on how to come up with a means by which to address the earlier issue, which is these countries are overly indebted, they are not necessarily going to be able to restructure their debt under the existing architecture, both because of market conditions, their own economies, and the China factor that we discussed earlier.

So, how do we deal with that? Not by providing them more debt, but by providing them with a means by which they can maybe refinance their Chinese debt, not just new infrastructure spending. I think it's great that we're providing an alternative potentially for new infrastructure spending, but I would like to see them get their financial houses in order and get out from under the yoke of Chinese debt before we start lending them more on our own terms.

**DOLLAR:** So, while we're talking about reconstruction, clearly Ukraine is going to have very large financing needs. A lot of its infrastructure has been destroyed, a lot of the housing stock. At this kind of early stage of reconstruction you see a lot of wild estimates. I saw an estimate of a trillion dollars need to rebuild Ukraine. You know, that's a very big number, I'm not sure how serious that is. But clearly the financing needs are quite large. So, where are the likely sources to pay for that? And is that going to, in some sense, pull attention and resources away from the rest of the developing world?

**REDIKER:** Well, Ukraine reconstruction is a great unknown, I think President Zelensky addressed the Davos event earlier this year and used that trillion dollar figure. Last week in Lugano there was a conference in which the Ukrainians suggested that the total sum might be about $750 billion. To put it in perspective, the entirety of the Marshall Plan for which the U.S. takes great credit—and that credit is entirely well placed—in helping to rebuild Germany and the rest of Europe after World War II, the entirety of that in today's dollars would be around 200 billion. So we're talking about multiples, three, four times the amount of the entirety of the Marshall Plan just for Ukraine.

I'm not sure those figures are plausible. I think some of that presumes that Ukraine will recapture the 20 plus percent of the country which is currently occupied by Russia. That is where most of the damage has actually been incurred. If you talk about the remaining part of Ukraine, which remains under the Zelensky government's control, I think the figures for rebuilding would be far less than the 750 billion.

But that leads to that big question—is how do you actually decide when to spend money on reconstructing a country that is still at war? And at least my speculation is that the outcome in which fighting is halted will probably be filled with fits and starts and unsatisfying outcomes. It will not be an agreement by which the war is over and new borders or old borders are restored, and that makes reconstruction very hard.

So, that gets to your point of where does the money come from. I think the most obvious place the money would come from would be from the EU as part of the EU accession process. But again, it's very hard for me to see where the money actually trickles from the EU into Ukraine without Vladimir Putin occasionally dropping in a bomb or two on Lviv or Kyiv or wherever it is, just to make sure that that economic reconstruction effort fails because it is in his interest to see an unstable Ukraine and an unstable Ukraine government. And all he has to do is just occasionally lob in a missile or a bomb and it really undermines the financial investment climate under which any of that 750 or less billion will flow in. I'm sad when I say that, but I think reconstruction is going to be a lot harder than people think it's going to be.

**DOLLAR:** So, Doug, we've talked about mostly fairly negative, risky aspects of the global economy, and that's what the G7 leaders should be focused on. But I like to end on a positive note. So, my last question for you is, speculate a little bit about an upside scenario for the world, for developing countries. You know what what would a good landing look like given this economic situation we find ourselves in?

**REDIKER:** Well, I think one could make a case that we use the word recession or hard landing, we use that without really defining it. Yes, I think a recession obviously has negative connotations, but we're working from a very, very hot global economy on the back of COVID reopening, and that inflationary pressure that really was born of people wanting to spend and wanting to get out. And that was not just in the U.S. and Europe, it's basically everywhere.

So, I could make a case that we will see a recession, but that recession would mean a slowdown from very, very strong economic performance, which brings you back to a relatively strong, though less strong that is right now, baseline. And you're still going to have highly accommodative monetary policy relative to history when you're talking about recessions. So, usually you would see the Fed having to tighten far more than getting to something in the three or four percent range. That's still a fairly normalized monetary policy.

And so I think you could say that even if we had a slowdown and even if we have a technical recession, that the world is in better standing to actually endure that and that you could have seen many of the hardest moments of at least the stock market and the bond market already baked into the prices. And so you could see less downside risk from here and more upside risk from here.

**DOLLAR:** I'm David Dollar, and I've been talking to my colleague Doug Rediker. Doug, I think you do a great job explaining complicated international financial issues, so thanks for helping us understand some of these things that were kicked around and discussed at the G7 and that are on the front page of the business section every day. So thanks a lot, Doug.

**REDIKER:** Thanks, David.

**DOLLAR:** Thank you all for listening. We release new episodes of Dollar and Sense every other week. So if you haven't already, follow us wherever you get your podcasts and stay tuned. It's made possible by support from producer Fred Dews, audio engineer Colin Cruickshank and other Brookings colleagues. If you have questions about the show or episode suggestions, you can email us at podcasts@Brookings.edu.

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Until next time, I'm David Dollar and this has been Dollar and Sense.