

Central Banks In A Fragmenting World

Speech by Christine Lagarde, President of the ECB, at the Council on Foreign Relations' C. Peter McColough Series on International Economics - April, 2023

It is a pleasure to be here in New York.

The global economy has been undergoing a period of transformative change. Following the pandemic, Russia's unjustified war against Ukraine, the weaponisation of energy, the sudden acceleration of inflation, as well as a growing rivalry between the United States and China, the tectonic plates of geopolitics are shifting faster.

We are witnessing a fragmentation of the global economy into competing blocs, with each bloc trying to pull as much of the rest of the world closer to its respective strategic interests and shared values. And this fragmentation may well coalesce around two blocs led respectively by the two largest economies in the world.

*All this could have far-reaching implications across many domains of policymaking. And today in my remarks, I would like to **explore what the implications might be for central banks.***

In short, we could see two profound effects on the policy environment for central banks: first, we may see more instability as global supply elasticity wanes; and second, we could see more multipolarity as geopolitical tensions continue to mount.

A changing global economy

*In the time after the Cold War, the world benefited from a remarkably favourable geopolitical environment. **Under the hegemonic leadership of the United States, rules-based international institutions flourished and global trade expanded.** This led to a deepening of global value chains and, as China joined the world economy, a massive increase in the global labour supply.*

As a result, global supply became more elastic to changes in domestic demand, leading to a long period of relatively low and stable inflation.^[1] That in turn underpinned a policy framework in which independent central banks could focus on stabilising inflation by steering demand without having to pay too much attention to supply-side disruptions.^[2]

But that period of relative stability may now be giving way to one of lasting instability resulting in lower growth, higher costs and more uncertain trade

partnerships. **Instead of more elastic global supply, we could face the risk of repeated supply shocks. Recent events have laid bare the extent to which critical supplies depend on stable global conditions.**

That has been most visible in the European energy crisis, but it extends to other critical supplies as well.

Today the United States is completely dependent on imports for at least 14 critical minerals.^[3] And Europe depends on China for 98% of its rare earth supply.^[4] Supply disruptions on these fronts could affect critical sectors in the economy, such as the automobile industry and its transition to electric vehicle production.

In response, governments are legislating to increase supply security, notably through the Inflation Reduction Act in the United States and the strategic autonomy agenda in Europe. But that could, in turn, accelerate fragmentation as firms also adjust in anticipation. Indeed, in the wake of the Russian invasion of Ukraine, the share of global firms planning to regionalise their supply chain almost doubled – to around 45% – compared with a year earlier.^[5]

This “new global map” – as I have called these changes elsewhere^[6] – is likely to have first-order implications for central banks.

One recent study based on data since 1900 finds that geopolitical risks led to high inflation, lower economic activity and a fall in international trade.^[7] And ECB analysis suggests similar outcomes may be expected for the future. If global value chains fragment along geopolitical lines, the increase in the global level of consumer prices could range between around 5% in the short run and roughly 1% in the long run.^[8]

These changes also suggest that a second shift in the central bank landscape is taking place: we may see the world becoming more multipolar.

During the Pax Americana after 1945, the US dollar became firmly ensconced as the global reserve and transaction currency, and more recently, the euro has risen to second place.^[9] This had a range of – mostly beneficial – implications for central banks. For example, the ability of central banks to act as the “conductor of the international orchestra” as noted by Keynes, or even firms being able to invoice in their domestic currencies, which made import prices more stable.^[10]

In parallel, Western payments infrastructures assumed an increasingly global role. For instance, in the decade after the Berlin Wall fell, the number of countries using the payments messaging network SWIFT more than doubled.^[11] And by 2020, over 90% of cross-border transmissions were being signalled through SWIFT.^[12]

But new trade patterns may have ramifications for payments and international currency reserves.

In recent decades China has already increased over 130-fold its bilateral trade in goods with emerging markets and developing economies, with the country also becoming the world's top exporter.^[13] And recent research indicates there is a significant correlation between a country's trade with China and its holdings of renminbi as reserves.^[14] New trade patterns may also lead to new alliances. One study finds that alliances can increase the share of a currency in the partner's reserve holdings by roughly 30 percentage points.^[15]

All this could create an opportunity for certain countries seeking to reduce their dependency on Western payment systems and currency frameworks – be that for reasons of political preference, financial dependencies, or because of the use of financial sanctions in the past decade.^[16]

Anecdotal evidence, including official statements, suggests that some countries intend to increase their use of alternatives to major traditional currencies for invoicing international trade, such as the Chinese renminbi or the Indian rupee.^[17] We are also seeing increased accumulation of gold as an alternative reserve asset, possibly driven by countries with closer geopolitical ties to China and Russia.^[18]

There are also attempts to create alternatives to SWIFT. Since 2014, Russia has developed such a system for domestic and cross-border use, with over 50 banks across a dozen countries using it last year.^[19] And since 2015 China has established its own system to clear payments in renminbi.

*These developments do not point to any imminent loss of dominance for the US dollar or the euro. So far, the data do not show substantial changes in the use of international currencies. **But they do suggest that international currency status should no longer be taken for granted.***

Policy frameworks for a fragmenting world

How should central banks respond to these twin challenges?

We have clear examples of what not to do when faced with a sudden increase in volatility. In the 1970s, central banks faced upheaval in the geopolitical environment as OPEC became more assertive and energy prices that had been stable for decades ballooned. They failed to provide an anchor of monetary stability and inflation expectations de-anchored – a mistake that should never be repeated for as long as central banks are independent and have clear price stability mandates.

So, if faced with persistent supply shocks, independent central banks can and will go ahead with ensuring price stability. But this can be achieved at a lower cost if other policies are cooperative and help replenish supply capacity.

For example, if fiscal and structural policies focus on removing supply constraints created by the new geopolitics – such as securing resilient supply

chains or diversifying energy production – we could then see a virtuous circle of lower volatility, lower inflation, higher investment, and higher growth. But if fiscal policy instead focuses mainly on supporting incomes to offset cost pressures (in excess of temporary and targeted responses to sudden large shocks), that will tend to raise inflation, increase borrowing costs and lower investment in new supply.

In this sense, insofar as geopolitics leads to a fragmentation of the global economy into competing blocs, this calls for greater policy cohesion. Not compromising independence, but recognising interdependence between policies, and how each can best achieve their objective if aligned behind a strategic goal.

We could see the benefits of this in Europe especially, where the multiplier effect of common action in areas such as industrial policy, defence and investing in green and digital technologies is much higher than Member States acting alone.

There is another benefit, too: achieving the right policy framework will not only determine how our economies fare at home, but also how they are viewed globally in a context of greater “system competition”. And while the international institutions established in the wake of Bretton Woods remain instrumental for fostering a rules-based multilateral order, the prospect of multipolarity raises the stakes for such internal policy cohesion.

For a start, an economic policy mix that produces less volatile growth and inflation will be key in continuing to attract international investment. Although 50-60% of foreign-held US short-term assets are in the hands of governments with strong ties to the United States – meaning they are unlikely to be divested for geopolitical reasons^[20] – the single most important factor influencing international currency usage remains strength of fundamentals.^[21]

By the same token, for Europe, long-delayed projects such as deepening and integrating our capital markets can no longer be viewed solely through the lens of domestic financial policy. ***To put it bluntly, we need to complete the European capital markets union. This will be pivotal in determining whether the euro remains among the leading global currencies or others take its place.***

Central banks also have an important role to play here – even as protagonists.

For example, ***the manner in which swap lines are used could influence the dynamics of major international currencies.***^[22] ***Both the Federal Reserve and the ECB, within their respective mandates, have been proactive in providing offshore liquidity when recent crises have hit. But others are moving too, which is consistent with a rising role of their currencies. We have already seen the People’s Bank of China set up over 30 bilateral swap lines with other central banks to compensate for the lack of liquid financial markets in renminbi.***^[23]

How central banks navigate the digital era – such as innovating their payment systems and issuing digital currencies – will also be critical for which currencies ultimately rise and fall. This is an important reason why the ECB is exploring in depth how a digital euro could best work if launched.

So, we need to be ready for the new reality that may well lie ahead. The time to think about how to respond to changing geopolitics is not when fragmentation is upon us, but before. Because, if I may paraphrase Ernest Hemingway, fragmentation can happen in two ways: gradually, and then suddenly.^[24]

Central banks must provide for stability in an age that is anything but stable. And I have no doubt that central banks will measure up to the challenge.

Thank you.

1. While globalisation increased the propagation of global shocks to the domestic economy and made inflation developments more global, it might also have helped to smooth the impact of shocks for each economy because it made supply more elastic to changes in domestic demand in each country. See ECB (2017), "[Domestic and global drivers of inflation in the euro area](#)", Economic Bulletin, Issue 4.
2. The shift by central banks in advanced economies towards inflation-targeting regimes from the 1980s onwards also facilitated low and stable inflation.
3. The most recent data from the United States Department of the Interior are for 2021. See United States Department of the Interior (2022), "[United States Geological Survey: Mineral Commodity Summaries 2022](#)", p. 5.
4. European Parliamentary Research Service (2022), "[Securing the EU's supply of critical raw materials](#)", July.
5. McKinsey (2022), "[Taking the pulse of shifting supply chains](#)", 26 August.
6. Lagarde, C. (2022), "[A new global map: European resilience in a changing world](#)", keynote speech at the Peterson Institute for International Economics, 22 April.
7. Caldara, D. et al. (2023), "[Do Geopolitical Risks Raise or Lower Inflation?](#)", 15 February.
8. Attinasi, M.-G., Boeckelmann, L. and Meunier, B. (2023), "[Friend-shoring global value chains: a model-based assessment](#)", Economic Bulletin, ECB, Issue 2.
9. ECB (2022), "[The international role of the euro](#)", June.
10. The benefits of international currency use include seigniorage, lower transaction and hedging costs, and lower external financing costs ("exorbitant privilege"). The costs include blurred monetary aggregate signals and capital flow volatility. See Gräßl, J. and Mehl, A. (2019), "[The benefits and costs of the international role of the euro](#)", in "The international role of the euro", ECB, June.
11. In 1989, SWIFT had users in 79 countries. By 1999, this number increased to 189 countries. See "[Swift history](#)".

12. Nölke, A. (2022), "[The weaponization of global payment infrastructures: A strategic dilemma](#)", SAFE White Paper, No. 89, June.
13. Change in value of trade between 1990 and 2021. See Figure 5 in Aiyar, S. et al. (2023), "[Geoeconomic Fragmentation and the Future of Multilateralism](#)", Staff Discussion Notes, International Monetary Fund, 15 January. See also International Monetary Fund (2023), "[World Economic Outlook: A rocky recovery](#)", April, p. 107.
14. Naef, A., Monnet, E., Macaire, C., Mehl, A., and Eichengreen, B. (2022), "[The renminbi's unconventional route to reserve currency status](#)", VoxEU, 31 October.
15. Eichengreen, B., Mehl, A. and Chițu, L. (2019), "[Mars or Mercury? The geopolitics of international currency choice](#)", Economic Policy, Vol. 34, Issue 98, July.
16. The number of countries under financial sanctions has more than doubled between 2010 and 2022. See Figure 3.2 in International Monetary Fund (2023), "[Global Financial Stability Report: Safeguarding Financial Stability Amid High Inflation and Geopolitical Risks](#)", April.
17. As noted in ECB (2023), "The international role of the euro", forthcoming.
18. Such as Belarus, India, Pakistan, and certain Central Asian economies.
19. Nölke, A. (2022), "[The weaponization of global payment infrastructures: A strategic dilemma](#)", SAFE White Paper, No. 89, June.
20. Weiss, C. (2022), "[Geopolitics and the U.S. Dollar's Future as a Reserve Currency](#)," International Finance Discussion Papers, No. 1359, Board of Governors of the Federal Reserve System, October.
21. For example, with respect to the US dollar. See Georgiadis, G., Le Mezo, H., Mehl, A., and Tille, C. (2021), "[Fundamentals vs. policies: can the US dollar's dominance in global trade be dented?](#)", Working Paper Series, No 2574, ECB, Frankfurt am Main, July.
22. Tucker, P. (2022), *Global Discord: Values and Power in a Fractured World Order*, Princeton University Press.
23. Naef, A., Monnet, E., Macaire, C., Mehl, A., and Eichengreen, B. (2022), "[The renminbi's unconventional route to reserve currency status](#)", VoxEU, 31 October.
24. See Hemingway, E. (1926), *The Sun Also Rises*. The original passage in the book related to bankruptcy: "How did you go bankrupt?" Bill asked. "Two ways", Mike said. "Gradually and then suddenly."

Commentary By Equedia Investment Research

Key Take Aways

Summary

China's economy has grown so powerful, it now has what it will take to overthrow the dollar:

"In recent decades China has already increased over 130-fold its bilateral trade in goods with emerging markets and developing economies, with the

country also becoming the world's top exporter. And recent research indicates there is a significant correlation between a country's trade with China and its holdings of renminbi as reserves. New trade patterns may also lead to new alliances. One study finds that alliances can increase the share of a currency in the partner's reserve holdings by roughly 30 percentage points.

All this could create an opportunity for certain countries seeking to reduce their dependency on Western payment systems and currency frameworks.”

Moving away from a unipolar trade system. And that free trade will soon fragment around two trade blocs: the West and China's led BRICS.

“We are witnessing a fragmentation of the global economy into competing blocs, with each bloc trying to pull as much of the rest of the world closer to its respective strategic interests and shared values. And this fragmentation may well coalesce around two blocs led respectively by the two largest economies in the world.”

End of Summary

Equedia Investment Research continues:

The ECB just confirmed our worst fears.

In its last address ... Christine Lagarde gave a carefully crafted guidance speech and warned about EVERYTHING we've recently predicted.

This means only one thing: the tipping point is near.

Deglobalizing the World

In previous letters, we predicted two game-changing shifts that would rock the global economy to its core.

First and foremost, the dollar that has ruled global trade for the past 70 years will lose its reserve currency *hegemony*.

I'm not saying the dollar will cease to exist, but it will no longer be the sole currency used for settlements, as it is today.

China is now in the final stages of [launching a new reserve currency](#) for the BRICS. And in preparation for that, the BRICS has invited new members to its block.

As [we wrote last month](#), the BRICS nations announced they would entertain allowing other countries to be included in their coalition. And immediately, a dozen oil nations lined up—including oil producers Argentina, Egypt, and

Algeria, and even bigger players, such as the UAE, Iran, and even Saudi Arabia.

In other words, we are entering Bretton Woods III—a monetary era where no reserve currency will have exclusive settlement rights.

And that will have vast implications for the U.S.

Key among them is that the U.S. will lose the “exorbitant privilege” of printing as much of its currency without international recourse, and lose the ability to borrow in perpetuity with the same foreign demand it’s had for decades.

What happens to the dollar if the U.S. loses these privileges?

Such a reputational shock will certainly devalue the dollar, as Nixon did after he ended the dollar’s convertibility to gold.

But this shift in global trade goes beyond just settlement.

Our second big prediction was that global trade would fragment along geopolitical fault lines. And that we would witness the biggest on-shoring of supply chains since the World Wars.

That fragmentation is already underway.

Exports of food, fertilizers, and energy have been heavily sanctioned since the beginning of Russia’s invasion of Ukraine, and now, as [we just predicted would happen](#), **China is now threatening to ban the exports of critical rare earths.**

Via [Nikkei Asia](#):

“China is considering prohibiting exports of certain rare-earth magnet technology in a move that would counter the U.S.’s advantage in the high-tech arena. Officials are planning amendments to a technology export restriction list, which was last updated in 2020.”

But this new era of mercantilism isn’t limited to commodities. It extends to IP and technology, too.

In our recent letter, “[A Battlefield for the New World Order](#),” we exposed how Washington convinced its Western allies to ban chip technology transfer to China. And they have officially followed through.

Via [Politico](#):

“The Dutch government [confirmed for the first time](#) Wednesday it will impose new export controls on microchips manufacturing equipment, bowing to U.S. pressure to block the sale of some of its prized chips printing machines to China.”

Over the past two decades, the world has built the most interconnected trade network ever seen: a “trade block” that transcended geopolitics in pursuit of commerce. And this globalization has been one of the most deflationary forces of the past decades.

But now this trend has been forced into reverse.

As global trade crumbles, many goods will be hoarded, levied, and otherwise protected at all costs. And their supply chains will become “domesticated” along political borders.

Everything will get more expensive.

ECB Drops Truth Bomb

Last week, ECB president Lagarde flew to New York and warned policymakers of this changing global order. And her talk encompassed so much of what we predicted over the past years.

Here are some key takeaways.

For starters, Lagarde acknowledged that—as I wrote in [“A New Reserve Currency Is Live,”](#) China’s economy has grown so powerful it now has what it will take to overthrow the dollar:

“In recent decades China has already increased over 130-fold its bilateral trade in goods with emerging markets and developing economies, with the country also becoming the world’s top exporter.^[13] And recent research indicates there is a significant correlation between a country’s trade with China and its holdings of renminbi as reserves.^[14] New trade patterns may also lead to new alliances. One study finds that alliances can increase the share of a currency in the partner’s reserve holdings by roughly 30 percentage points.^[15]

All this could create an opportunity for certain countries seeking to reduce their dependency on Western payment systems and currency frameworks.”

She also affirmed that the world is moving away from a unipolar trade system. And that free trade will soon fragment around two trade blocs: the West and China’s led BRICS.

“We are witnessing a fragmentation of the global economy into competing blocs, with each bloc trying to pull as much of the rest of the world closer to its respective strategic interests and shared values. And this fragmentation may well coalesce around two blocs led respectively by the two largest economies in the world.”

She even brought up the niche minerals industry that we exposed in [“The Next Bellwether Commodity,”](#) as one of the West’s Achilles heels:

“Today the United States is completely dependent on imports for at least 14 critical minerals.[3] And Europe depends on China for 98% of its rare earth supply.[4] Supply disruptions on these fronts could affect critical sectors in the economy.”

And just as we have warned, Lagarde expects a series of destructive supply shocks as the world transitions to this two-sided trade, which, by the ECB’s calculations, can raise inflation by 5% in the short term:

“One recent study based on data since 1900 finds that geopolitical risks led to high inflation, lower economic activity and a fall in international trade.[7] And ECB analysis suggests similar outcomes may be expected for the future. If global value chains fragment along geopolitical lines, the increase in the global level of consumer prices could range between around 5% in the short term...”

And last but not least, she confirmed what we’ve been saying for years: central banks are imminently switching from fiat to CBDCs:

“How central banks navigate the digital era – such as innovating their payment systems and issuing digital currencies – will also be critical for which currencies ultimately rise and fall. This is an important reason why the ECB is exploring in depth how a digital euro could best work if launched.”

It’s one thing to hear these conspiracy-like warnings from us, but when the chief of one of the world’s most important central banks echoes our predictions, it really is time to take notice.

Back to 1970

This “new global map,” as Lagarde calls it, is one of the biggest macro stories in modern history. And while we can’t be certain as to how this will play out, there are historical precedents we can draw from to predict what might come next.

Just look back to the 1970s.

High inflation isn’t the only thing that we have in common today with the 1970s. The root causes of it and the policy responses that followed are also alarmingly identical.

For example, much like today, **the inflation of the 1970s was a result of both monetary policy and supply-side shocks.**

In 1971, President Nixon breached the Bretton Woods agreement and prohibited the dollar’s mandatory convertibility to gold, resulting in an instant dollar devaluation against other currencies.

On top of that, **OPEC’s oil embargo and following tensions in the Arab world brought two oil supply shocks. That resulted in oil prices soaring 6X when adjusted for inflation.**

Today, increased energy costs have trickled up, exploding consumer prices.

And what has been the policy response to these inflationary forces?

You guessed it: **mercantilism**.

Major powers began to adopt protectionist policies to protect domestic industries at the expense of foreign competitors. This included the use of tariffs, import quotas, and other trade barriers.

Via [Wall Street Journal](#):

“In the 1970s, oil-price hikes and other shocks triggered inward-looking, mercantilist policies, including in Europe and the United States. Immediate policy responses were not overly protectionist: There was no equivalent of America’s 1930 Smoot-Hawley tariff. But escalating domestic interventions on both sides of the Atlantic exacerbated economic stress and prolonged stagnation. **Not least, they spawned protectionist pressures. Industry after industry, coddled by government subsidies at home, sought protection from foreign competition. The result was the ‘new protectionism’ of the 1970s and 1980s.**”

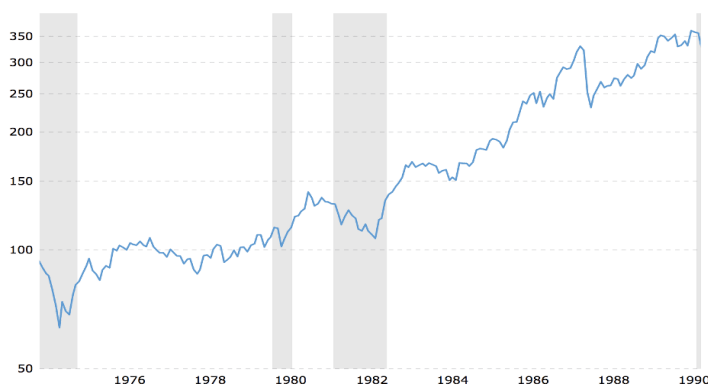
The result was that this protectionism didn’t just make stagflation worse; it made investing a real headache.

Portfolios in the Dump

If you pay close attention to historical asset comparisons, you’ll notice that most use nominal numbers. This can lead to a distorted view because they obscure the actual value of those assets.

This is particularly misleading when dealing with extended periods of inflation, such as those experienced in the 1970s.

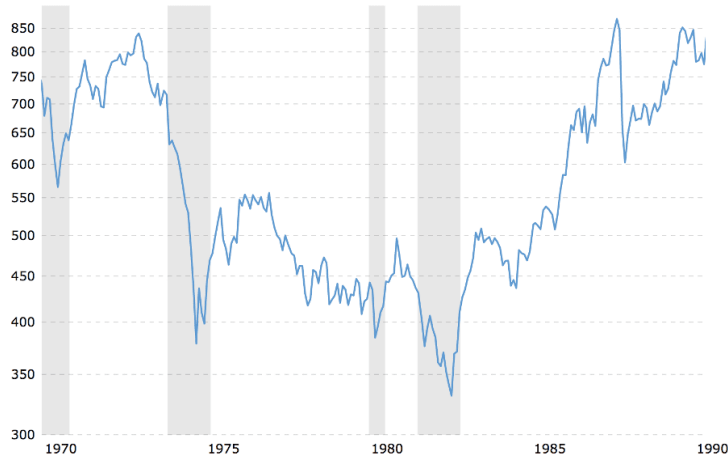
To illustrate this, take a look at the S&P 500’s *nominal* performance over a period of two decades beginning in 1970:



Source: Macrotrends

Based on this chart, it seems that stocks were a safe bet. Not only did they hold out during the '70s inflation breakout, but by 1990, the S&P 500 even experienced a fourfold increase.

BUT what happens when you adjust these numbers for inflation?



Source: Macrotrends

See that chasm in the middle of the chart? That's the real value of stocks being eaten away by the inflation of the 1970s. It took the stock market 20+ years to break even on those losses.

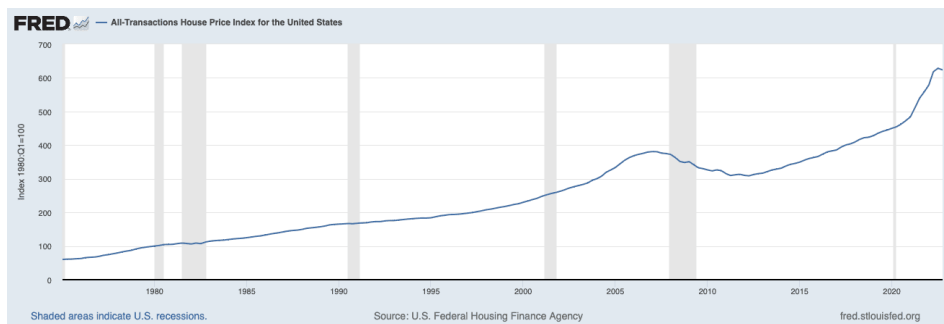
In other words, in inflation-adjusted terms, the stock market had lost two decades because of the 1970s.

What about real estate—the mainstream inflation hedge?

While some regions did really well during the 1970s, most real estate assets didn't hold up.

For example, while housing in California tripled in value during that timeframe, housing prices nationally dipped when adjusted for inflation.

Take a look:



The only two asset classes that performed well? Commodities and gold.

[Commodity prices](#)* experienced a staggering 8-fold increase during the 1970s, which further skyrocketed to a cumulative gain of 12 times over the subsequent decade. Even when adjusted for inflation, this asset class handed investors a multi-fold gain.

(*[As measured by S&P GSCI Commodity Index](#), which includes unleveraged, long-only investment in commodity future contracts diversified across a broad range of commodities.)

The same happened with gold. From 1970 to 1990, gold appreciated 4x in value—in real terms.

These kinds of returns have beaten some of the most iconic tech plays over the same timeframe.

Placing Hedges

Considering the proximity of these parallels, we can't realistically think of a more logical investment playbook moving forward.

In other words, there are two asset classes that should outperform from a historical perspective: commodities and precious metals.

Some would argue that commodities have already had their 15 minutes of fame, and that the easy gains have already been made. And while we don't think the run for commodities is over, the other asset class, precious metals, is just warming up.

With the new global order coming our way that Lagarde just confirmed, precious metals' REAL run-up likely hasn't even begun.

Seek the truth,

Carlisle Kane