Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Napoleon famously said that armies march on their stomachs. Now, it's clear that armies also march on their wallets.

The dollar's blitzkrieg triumph isn't due to any love of the greenback -- even America's closest allies have long hoped to counterbalance US. economic dominance with rival payment systems able to operate unscathed regardless of U.S. sanctions. However, the EU, U.K., and Japan have never gotten much past dreaming about payment-system challenges because the embedded dollar-based system has become essentially friction- and risk-free. That's hard to beat.

China might still have a shot at a yuan-based substitute, but it would have to ensure liquidity (essentially impossible when a currency isn't freely convertible) as well as political neutrality. China's decision suddenly to mount de facto nationalization of what was once a thriving, privately-owned digital-commerce sector will at the least give pause to those whose funds would move through a Chinese-dominated system.

Any nation that wants to replace the dollar also has to have sovereign obligations readily understood to be a safe haven under acute stress that are issued in amounts sufficient to absorb extreme shock. China and the EU has no single issuer of sovereign bonds in quantity and quality sufficient to substitute for Treasury obligations. Most market participants think China is more likely to be the cause of a shock than ever to serve as a shock absorber, ruling out its sovereign debt even if it grows large enough to mount a challenge to the U.S. Treasury.

And, finally, there's the necessity of clearing dollars given the fact that most nations and counterparties still can't do without them. This means either being domiciled in the U.S. or doing business with a U.S. bank. Once, there were loopholes around sanctions and AML law that permitted foreign banks to use non-U.S. operations to engage in activities abhorred by the U.S. without likely loss of a U.S. presence. Now, as we noted last year, there aren't. As reiterated a couple of days ago, even foreign banks without any form of U.S. presence can lose access to U.S. correspondent accounts if they fail to answer U.S. law enforcement inquiries to U.S. law enforcement's satisfaction.

Will the USD center hold forever? Of course not -- digitalization has considerable potential to upend U.S. fiat-currency supremacy even if the Fed decides on a CBDC. However, it will take a great deal of time for any challenger system to come to scale even if all of the efforts by global regulators to increase cross-border payment systems truly take hold toward the end of this decade. Cryptography knows no bounds and is a safe haven for at least some sanctions evasion, but the cops are on this beat and I doubt this payment-system bypass will stand up as is under post-Ukraine scrutiny.

During the last European conflagration, U.S. GIS said something was "dollars to doughnuts" to express a sense of certainty. Ukraine is a shocking reminder of the exigencies sovereign risk can wreak across global economies and financial systems. Thus, it's dollars to doughnuts that the lone, proven safe haven currency and the cross-border systems that still depend on it will show their strength in this crisis and retain it for a long time in its wake.