Interview with Petya Koeva Brooks, Deputy Director of the Research Department, Jorge Alvarez, Economist in the World Economic Studies Division of the Research Department, Philip Barret, Economist of the Research Department & Rui Xu, Economist at the Asia-Pacific Department, International Monetary Fund

How Does the IMF Take Account of the Ukraine Crisis in Its World Economic Outlook in April 2022?

By *Japan SPOTLIGHT*

Before the Covid-19 pandemic's lingering impact on the economy has started to fade, another global economic crisis has occurred – the war in Ukraine. Two months after the outbreak of the crisis, the International Monetary Fund (IMF) published its world economic outlook on April 19, 2022. In examining the war's impact on the global economy in its initial stages, we held an interview with IMF economists who worked on the outlook.

(Interviewed on May 14, 2022 by email in response to our questionnaire)


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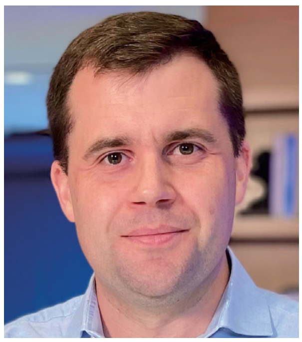
Philip Barret


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Impact of the War & Sanctions on Global Economic Growth

JS: How do you estimate the overall impact of Russia's invasion of Ukraine on the global economy so far? How do you estimate the impact of the economic sanctions against Russia on the global economy? In a globalized world, could economic sanctions against any country invite a negative impact on the rest of the world as well?

IMF: The war in Ukraine has severely set back the global recovery. Global growth is now projected to decline from an estimated 6.1% in 2021 to 3.6% in 2022-2023 – 0.8 and 0.2 percentage points lower for 2022 and 2023 than we expected in January before the war. The war and associated sanctions have both a direct impact on the two countries involved, as well as significant global spillovers through multiple channels, including higher food and fuel prices, direct trade and remittance linkages, and supply-chain disruptions. Of course, the ultimate impact is highly uncertain and will depend, among many factors, on the evolution of the war and the policy responses from authorities around the world.

JS: Please tell us about the regional diversification of the impact of Russia's invasion. Is its impact on the European economy greater than on the Asian economy? If the Asian economy suffers less from the crisis, could this be due to the relatively robust supply side of the Asian economy?

IMF: The war impacts different countries differently, depending on their direct exposure to the Russian and Ukrainian economies as well as their own individual characteristics. Emerging and Developing Europe, including Russia and Ukraine, will see GDP contract by around 2.9% in 2022. The main drivers of the contraction are higher energy prices and trade disruptions, especially for Baltic States whose external demand will decline along with the contraction in Russia's economy. In Advanced Europe, the main channel is rising energy prices and energy security measures. For them, as for other commodity importers, higher energy prices imply a negative terms-of-trade shock which translates to lower output and higher inflation. Supply-chain disruptions have also hurt downstream producers in this region.

In Central Asia, disruption to Russian-produced imports and lower remittances from citizens working in Russia will be more important channels. In contrast, the wider Asia-Pacific region seems less directly exposed. There, direct trade links to Russia and Ukraine mean that spillover effects are limited to the commodity price channel and indirect impacts of weaker demand from key trading partners, including Europe.

Inflationary Impact

JS: With energy and food prices increasing due to the Ukraine crisis as well as the lingering effects of stimulatory fiscal and monetary policies in response to the pandemic's impact on the economy, inflationary pressure would be enormous. However, would actual price rises be diverse among countries? If so, how different will these be?

IMF: Inflationary effects will differ based on individual economies' characteristics, especially differences in consumption baskets. For instance, low-income countries are likely to be most directly affected by food and fuel price rises as they have a larger share of expenditure on essential items. Moreover, there can be further compositional effects depending on the types of foods consumed. Low-income countries where wheat, corn, and sorghum are a large part of the diet have seen inflation almost wholly driven by rising food prices, while Asian countries where these crops are less prominent have faced lesser pressures. Importantly, the evolution of inflation will also depend on the policy response from the authorities in each country, which will face the now more difficult tradeoff between controlling inflation and safeguarding growth.

JS: The current oil price rise may have been largely caused by the global consensus achieved at COP26 that towards 2050 a carbon zero economy should be realized. The consensus has made cost-profit analysis of the oil business uncertain. On this assumption, even if the Ukraine crisis is contained, will oil prices continue to rise?

IMF: Recent oil price increases have been driven by many factors mostly independent of energy transition targets, including a strong recovery in oil demand and the impact of geopolitical tensions. That being said, non-OPEC+ producers had been focused on cash generation rather than investment, partly because of the energy transition, and oil and gas investment has declined since 2014. However, the net impact of the carbon reduction policy is uncertain and will depend on what measures are ultimately implemented to achieve the stated targets. While supply-side policies can exert upward price pressures, demand-side policies (such as electric car subsidies, for example), would have the opposite effect.

Risk of Global Stagflation

JS: To contain inflation, the United States and other leading economies would have no option but to raise interest rates and reduce money supply, and this would possibly drag on the weak recovery of the global economy from the recession caused by the pandemic. Would that end up in global stagflation? If so, would this be of a structural nature and continue in the long run? Could continuing stagflation destabilize the global monetary system? Would economic sanctions against Russia including banks further intensify this monetary crisis? What do you think would be the best mix of fiscal and monetary policies to avoid continuing stagflation?

IMF: The war and associated sanctions have exacerbated the difficult tradeoff authorities face between fighting inflation while safeguarding growth. This tradeoff will vary from country to country, and so will the appropriate fiscal and monetary policy response. In all cases, central banks should remain vigilant to the impact of price pressures on wages and inflation expectations. A well-telegraphed data-dependent approach to adjusting forward guidance on the monetary stance is key to maintaining the credibility of the policy framework and keeping inflation expectations well-anchored.

Regarding stagflation risks, the sharp increases in commodity prices are indeed reminiscent of those in the 1970s, when a regional conflict also prompted a spike in fuel prices and several years of inflation and low growth. However, several important factors distinguish now from then. First, the size of the oil price shock is smaller so far. Second, the economy is less reliant on oil (as measured, for instance, by barrels of oil per unit of output) than it was back then, limiting the direct impact from the shock. Third, wage-setting mechanisms have changed with indexation becoming less prevalent. And fourth, central bank independence and credibility has much improved, which has helped to maintain medium-term inflation expectations broadly well-anchored. This should limit adverse growth effects, as reflected in our still positive global growth projections. That being said, risks of higher inflation and lower growth remain.

Restoring a Rules-Based International Order

JS: International policy coordination must be inevitable to stop the global economy from falling into the worst stagflation. How do you think this would be possible against the background of intensified conflicts between democratic and authoritarian nations? Do you think a rules-based order in international trade and investment can be restored such as through the WTO or regional FTAs? Could restoration of a rules-based order strengthen the supply side of the economy?

IMF: A rules-based, pro-trade consensus has been essential for deepening global economic integration in the last several decades. By offering consumers more choice and enabling the spread of more efficient production techniques, this strategy has helped boost living standards worldwide. These benefits have been largest in previously economically isolated regions such as China and Sub-Saharan Africa, where millions of people have been pulled out of dire poverty. Current tensions put this model and its gains at risk. Indeed, such frictions are not entirely new, with trade tensions – most notably between the US and China – having been elevated for some years. To reverse these trends, governments have to choose to work cooperatively, setting aside the temptation to seek short-term gains at the expense of other countries and instead look for long-term, mutually beneficial arrangements. From forthcoming refugee and climate crises to the proper resolution of debt distress across nations, multilateral problems will require multilateral solutions and earnest cooperation.

Impact on Japanese Economy

JS: With a weaker yen, is Japan increasingly facing the risk of inflation or stagflation, and if so, how can Japan modify this risk?

IMF: Currently we project the Japanese economy to expand by 2.4% in 2022, given that inflation remains below the Bank of Japan's (BOJ) 2% inflation target. The recent inflation increase mainly reflects external cost-push factors. The yen movement so far is in line with fundamental changes, mainly reflecting a shift toward a tighter monetary policy stance by other key central banks and a sharp rise in commodity import bills given high energy prices. BOJ Governor Haruhiko Kuroda has stressed that a weak yen is a net positive for the Japanese economy. We consider it appropriate for the BOJ to maintain monetary accommodation until inflation reaches the 2% target in a sustainable manner. JS

Questions by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT*. Answers by the IMF's Petya Koeva Brooks, deputy director of the Research Department, Jorge Alvarez, economist in the World Economic Studies Division of the Research Department, Philip Barret, economist of the Research Department, and Rui Xu, economist at the Asia Pacific Department.