The Economic Consequences of Russian Aggression Against Ukraine

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The beginning of Russia's aggression against Ukraine on Feb. 24, 2022 triggered great turmoil in the financial markets and drastically increased uncertainty about the recovery of the global economy, already experiencing serious supply chain disruptions, high inflation and other negative effects since two years earlier due to the Covid-19 pandemic.

In this article I argue, firstly, that China and India are unlikely to support the Russian economy in the long-term, and also that China will not dare to use the shock from Russian aggression to attack Taiwan. Secondly, I share my expectations that higher commodity and energy prices will increase the threat of long-lasting high global inflation that could lead to food insecurity, stagflation and even social unrest in some countries most negatively affected. Certain sectors such as automotive, transport or chemicals would be the worst to suffer. European countries will be mostly badly affected, GDP growth could fall by 1 percentage point, and if they completely cut Russian natural gas supplies it could cost 4 points of GDP, thereby leading EU GDP growth close to zero in 2022. Thirdly, my analysis of the Russian economy specifically suggests that it would be massively affected into the negative, possibly even turning Russia long-term into an underdeveloped country, where a few multibillionaires exploit all the natural resources and the population is driven into misery. The numbers – even at this early stage in 2022 – are indeed staggering. The decline in GDP may reach 9% and even higher in 2023. The Russian risk assessment by various ranking agencies will continue to be downgraded. Interestingly, despite the massive censure and restrictions on freedom of expression in Russia, senior Russian bankers and analysts also suggest that Russia will need up to a decade to return to 2021 levels, and this only in case that the sanctions are lifted.

The current numbers might not look excessively bad yet, but this is entirely because of two factors: (a) many countries continue to import large amounts of Russian oil, gas, metals, foods and other resources and commodities; and (b) the prices of these have moved higher and higher. However, as soon as these countries find alternatives – and there are many – to such imports, and prices in the markets stabilize (due to balancing the high demand with more supplies), the Russian economy may be heading for collapse. At the time of writing there are no signs that the war in Ukraine will end soon, and even if it does, the economic sanctions against Russia would most probably continue mid-term and even long-term, as a tool to restrict the further militarization of the Russian Federation and to mitigate the threats to its neighbors in Eastern Europe.

In the first days of the war the Russian currency (ruble) lost almost half of its value, causing the cost of various essentials to soar and creating panic amongst Russian citizens, who had to stand in long ATM queues to pull their money out. Some of the banks had to stop operations, and the whole banking system experienced a dramatic shock. As the value of the ruble falls, the external value of all Russian debt rises and so does the value of all interest payments. The unstable purchasing power of the ruble, the freezing of credit, and the higher cost of accessing money with a high central bank interest rate makes business in and with Russia even more difficult. All this could dry up private investment which could lead to the World Bank's estimated 8.9% drop in Russia's GDP, causing a deep and long recession. Financing a war, no matter how strong a nation-state is militarily, stretches significantly its fiscal limits. It also causes all government debt obligations to the rest of the world to skyrocket – from loans to government bonds.

Will China and India Support Russia?

This question is central and will have a significant impact on the world economy. It will be interesting to see whether China and India – the world's most populous nations – choose to support Russia in terms of market access, technical assistance and technological support. Or will they prefer not to rely on Russia anymore, not least because doing business with Russia will carry very high uncertainty risks. Will these countries shift their foreign exchange reserves away from US Treasury bonds? Will they reduce their reliance on the dollar and US banks? Will they curtail their commercial and technological dependence on the United States, cutting supply chains and reshoring production? Will the global economy be reconfigured into rival blocs?

My short answer to all these questions is no. Although we have seen some movement in these directions, this has not been a primary result of the Western sanctions on the Russian economy. Prior to the attack on Ukraine, the US and China, along with other countries in their orbits, had moved some way in the direction of decoupling from the previous stable trade relations. Both sides slapped tariffs on one another's exports, and both Beijing and the administration of US President Joe Biden have shown no sign of these being reversed. The US has also prohibited sales to China of high-tech gear potentially useful for surveillance. In addition to that, Biden issued an Executive Order denying 59 Chinese defense and surveillance firms access to US investment finance. All these are occurring against the backdrop of declining US dollar dominance. The share of the US dollar in foreign exchange reserves has fallen from around 70% of the global total at the turn of the century to less than 60% today. Most of this movement has been toward the currencies of small, open economies with strong policies, such as the Canadian and Australian dollars, the South Korean won and the Swedish krone.

There is no particular reason to think that the economic sanctions against Russia will accelerate these trends. Russia has been sanctioned not just by the US, but by a large coalition of Western and other countries, including Japan, South Korea, Australia, and New Zealand. Collectively, these countries are the source of 95% of identified global foreign exchange reserves. This means that Russia and other countries contemplating a scenario in which they find themselves in the same position cannot hedge against the sanctions risk by simply shifting from the US dollar into euros or other Western currencies.

Russia may attempt to shift to gold, as it has done in the past, but gold is in limited supply. Or it may decide to shift towards the Chinese renminbi, but this currency comprises less than 3% of allocated foreign exchange reserves and is not a form in which China can hold foreign assets. While isolated Russia can shift its reserves and monetary relations in these directions, these options are not available on a large scale to other countries in the rest of the world.

It is not just US banks and clearing houses that have been prohibited from doing business with various Russian institutions. Governments, worried about Western countries weaponizing their currencies, may seek to make more payments via renminbi. They will clear those payments using the Cross-Border Interbank Payment System (CIPS), China's equivalent of the US Clearing House Interbank Payment System (CHIPS) or the United Kingdom's Clearing House Automated Payments System (CHAPS). But CIPS is still a small fish in a sea of whales. CHIPS processes 40 times as many transactions for 10 times as many participating banks worldwide – including several Chinese banks. CIPS also depends on SWIFT (the Belgium-based Society for Worldwide Interbank Financial Telecommunications) for most cross-border messaging. The continuation of the war in Ukraine and the sanctions on Russia may encourage additional banks across the world to make cross-border payments through CIPS. It is revealing that although China has been building CIPS for seven years, its transactions and membership remain far behind those of the Western clearing houses.

Will China Invade Taiwan?

My short answer is no. A Chinese incursion into Taiwan most certainly would subject China to a similar range of comprehensive sanctions such as Russia is currently experiencing. Its foreign exchange reserves will be frozen and it will be barred from SWIFT. China could eventually insist that foreign counterparties make payments exclusively in renminbi and route their payments through CIPS. Still, its business with Western countries – major importers of Chinese goods – would be decimated. This would effectively lead to an economic catastrophe for China with very serious negative effects on the world economy. Chinese officials know this very well. Regarding Taiwan at least some comfort can be derived from the fact that President Xi Jinping evidently cares more about the health of his economy than does Russian President Vladimir Putin. For China the best scenario is to maintain global peace and security and to see that international trade is not affected by restrictions, as it economically benefits enormously from world peace, international order, and uninterrupted trade relations.

Two signals to look for regarding Chinese intentions are, first, how much does China use the US dollar, and second, how much reliance does China put on SWIFT. If China trims its US dollar reserves, this might be an indication that it is preparing to take on Taiwan and face various economic, trade and other sanctions. If China insists that foreign banks with which it does business install digital translators to convert CIPS's Chinese language messages into their local language, this may be another indication that it anticipates being barred from SWIFT as a result of its potential invasion of Taiwan. So far, no such signals are have been noticed. On the other hand, China's moves could be innocent. Its reserve managers may simply be seeking to reap the benefits of diversification – a better combination of risk and return. Or they may only try to further develop the capacity of a homegrown payments system. Either way, it is important to keep a watchful eye on all such developments.

Most Vulnerable Sectors Affected by Russian Aggression

Russia is the world's third-biggest oil producer, second-biggest natural gas producer and among the top five producers of steel, nickel and aluminum. It is also the largest wheat exporter in the world (almost 20% of global trade). On its side, Ukraine is a key producer of corn (sixth largest), wheat (seventh), sunflowers (first), and is amongst the top 10 producers of sugar beet, barley, soya and rapeseed.

This explains why the financial markets fell sharply, and the prices of oil, natural gas, metals and food commodities surged. While high commodity prices were one of the risks already identified as potentially disruptive to the global economic recovery, the escalation of the conflict increases the likelihood that commodity prices will remain higher for much longer. This in turn intensifies the threat of long-lasting high inflation, thereby increasing the risks of stagflation and social unrest in both advanced and emerging countries.

The war in Ukraine is strongly impacting an already strained automotive sector due to various shortages and high commodity and raw material prices: metals, semiconductors, cobalt, lithium, magnesium. Ukrainian automotive factories supply major carmakers in Western Europe: some announced the stoppage of factories in Europe, while other plants around the world are already planning outages due to chip shortages.

Airlines and maritime freight companies will also suffer from higher fuel prices, airlines being the most at risk. First, fuel is estimated to account for about a third of their total costs. Second, European countries, the US and Canada have forbidden access to their territories to Russian airlines and in turn Russia has banned European and Canadian aircraft from its airspace. This has resulted in higher costs since airlines will have to take longer routes. Eventually, airlines have little room for raising costs, as they continue to face lower revenues due to the impact of the pandemic.

Rail freight will also be impacted: European companies are forbidden to do business with Russian Railways which will likely disrupt freight activity between Asia and Europe, transiting though Russia.

Another sector expected to suffer is the feedstock for petrochemicals. This will become much more expensive as the soaring prices of natural gas begin to impact the fertilizer markets, hence the whole agricultural and food industry.

European Economies at Higher Risk

Because of its dependence on Russian oil and natural gas, Europe appears to be the region most exposed to the consequences of this conflict. Replacing all Russian natural gas supplies to Europe is impossible in the short to medium run and current price levels will have a significant effect on inflation. At the time of writing, the estimation is for at least 1.5 percentage points of additional inflation in 2022 which would erode household consumption and, together with the expected fall in business investment and exports, lower GDP growth by approximately one percentage point.

While Germany, Italy or some countries in the Central and Eastern European region are more dependent on Russian natural gas, the trade interdependence of Eurozone countries suggests a general slowdown. A complete cut of Russian natural gas flows to Europe would raise the cost to 4 percentage points in 2022, which would bring annual GDP growth close to zero, and quite possibly into negative territory.

Effects on Asia & Rest of the World

In Asia the economic consequences will be felt mainly through the rise in commodity prices, which will fuel already existing inflationary pressures. As always when commodity prices soar, net importers of energy and food products will be particularly affected, with the specter of major supply disruptions in the event of an even greater escalation of the conflict. The drop in demand from Europe will also hamper global trade to a large extent.

In the Asia-Pacific region, the impact will be felt almost immediately through higher import prices, particularly in energy prices, with many economies being net energy importers, led by China, Japan, India, South Korea, Taiwan and Thailand.

As North American trade and financial links with Russia and Ukraine are fairly limited, the impact of the conflict will mainly be felt through the price channel and through the slowdown of European growth. Despite the prospect of slower economic growth and higher inflation, the recent geopolitical events are not expected to derail monetary policy in North America at this stage.

According to the World Bank, the US economy will likely expand 2.5% in 2022, 1.2 percentage points below the prior projection due to higher energy prices, tighter financial conditions, and additional supply disruptions caused by the invasion of Ukraine. The outlook for China's economic expansion is 4.3% in 2022 due to larger-than-expected damage from Covid-19 and related lockdowns. Eurozone growth is projected to slow to 2.5%, 1.7 percentage points less than in January. Ukraine's economy is set to shrink 45.1%.

The Russian Economy in 2022 & 2023

The Russian economy will be in great difficulty in 2022, falling into deep recession. The decline in GDP forecast for 2022 by the World Bank is 8.9%. Sanctions notably target major Russian banks, the Russian central bank, Russian sovereign debt, selected Russian public officials and oligarchs, and the export control of high-tech components to Russia. These measures put considerable downward pressure on the Russian ruble, which has already plummeted, and will drive a surge in consumer price inflation.

Russia has built up relatively strong financials: a low level of public external debt, a recurrent current account surplus, and substantial foreign reserves (about US$640 billion). However, the freeze imposed by Western depositary countries on the latter prevents the Russian central bank from deploying them and reduces the effectiveness of the Russian response.

The Russian economy could benefit from higher prices for commodities, especially for its energy exports. However, EU countries announced their intention to limit their imports from Russia. In the industrial sector, restricted access to Western-produced semiconductors, computers, telecommunications, automation, and information security equipment will be harmful, given the importance of these inputs in the Russian mining and manufacturing sectors.

Russian government consumption will increase in 2022 as the state tries to prevent a steeper decline in growth. Government consumption will be the only component of GDP to make a positive contribution to headline growth in 2022. Since the invasion, the Russian state has announced plans to spend up to $67.8 billion in social relief, compared to $42 billion spent on coronavirus support in 2020 and 2021. The other component of GDP that will add support to headline growth is net exports in 2022. In fact, I expect imports to collapse at a faster pace than exports in 2022 owing to the G7 nations' goods and technology embargos on Russia and deteriorating domestic demand.

There may be some recovery in Russian import growth in 2023 as parallel import strategies become more effective. This will turn Russia's net export balance negative. As Russian companies run out of current stockpiles of Western-derived component parts, Russia's exports will decline in 2023 as industrial production and manufacturing decelerates. Another factor limiting exports in 2023 will be the reorientation of the industrial sector toward the domestic market to meet goods shortages. Russian Central Bank Governor Elvira Nabiullina has urged manufacturers to reduce the goods they export in favor of trying to create goods needed at home, stressing that this will be very important to the economy's recovery and its adaption to sanctions.

As a result of a more bearish trade outlook for 2023, Russia's economy will possibly suffer another year of contraction at least by another 1.0% in 2023. The EU's sixth sanctions package which cuts 90.0% of Russian crude imports from 2023 onward will have serious negative effects, as Russian crude exports to India or China will not be sufficient to replace these lost volumes. Crude exports to Europe have accounted for around 50% of Russia's total oil exports. At the same time faster-than-expected disinflation points to very weak domestic demand. Savings rate data indicate that Russian households are running down their reserves to compensate for stagnating real wages. Depleted savings will limit spending in 2023, driving further difficulties for the Russian economy in the mid-to-long term.

To return to the levels of 2021 may take over 10 years, unless Russia takes reform measures, according to the head of the largest bank, Sberbank Herman Gref, at the St. Petersburg International Economic Forum (SPIEF). Under a so-called "inertia" scenario, Sberbank forecasts Russia's GDP to fall by 7% in 2022 and 10.3% in 2023 compared with 2021, when it grew by 4.7% to $1.77 trillion. The decline would slide back into single digits in the following years and reach -0.1% by 2030.

In sum, the continuing war will have serious negative effects on the world economy. There are, and cannot be, any winners in this situation. One may expect that a global recession, and the economic collapse in Russia specifically, caused by its aggression in Ukraine, will be a case study in one of the biggest ever political and economic mismanagements of the 21st century. If this is what Putin would like to be remembered for in the 22nd century, he will certainly have it.

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