The Global Economic Impact of the Russia-Ukraine War:

A Survey

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Introduction

This survey is being prepared on Wednesday March 16 -- 20 days after Russia launched its invasion of Ukraine, on Feb. 24.

The 'fog of war' [see Lexworth & Maital [1]] is thick and heavy, as with all wars. But understandably, much expert attention has been focused on the war and its anticipated impact and after math.

This survey reviews what we regard as credible, knowledgeable insights by those who have deep, wide perspectives. The sources on which we draw are almost all web-based. The situation is fluid and of course subject to instant change. Hence this is solely a midstream attempt to dispel some of the thick fog of uncertainty.

A. Stagflation?

Any effort to understand current events necessarily begins with the search for historical parallels. The 1973 Mideast Yom Kippur War led to two bouts of 'stagflation' (inflation joined with recession), as oil prices soared following an OPEC oil embargo in 1973, and again in 1979.

Stagflation is driven by rising costs, which shift supply curves (actually, cost curves) upward and to the left. (See Fig.). The new equilibrium is characterized by both higher prices and lower output (GDP). Stagnation or recession + inflation (rising prices).

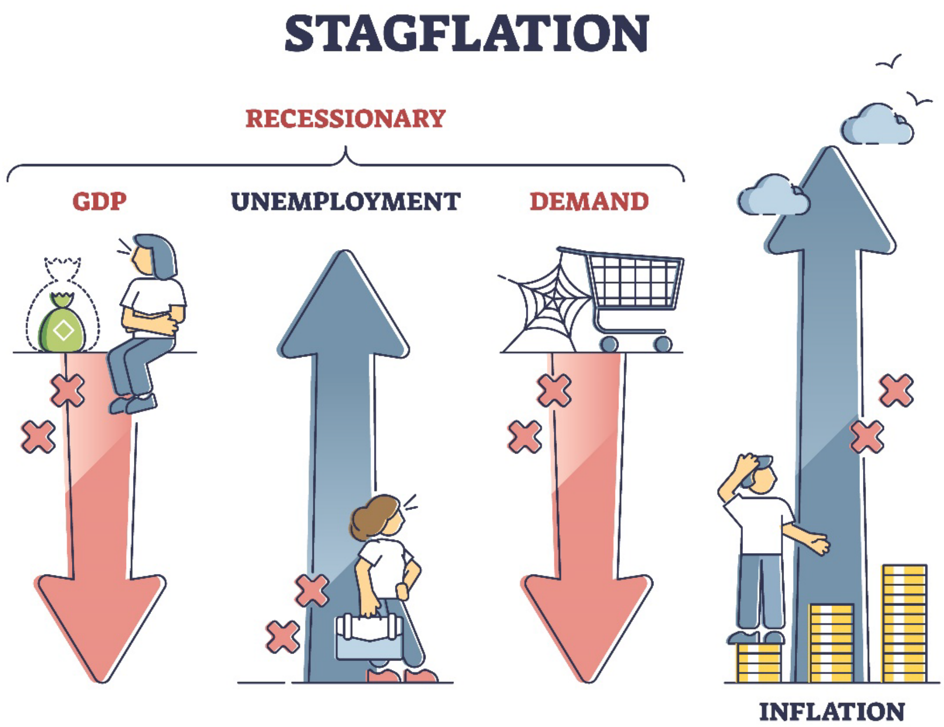

Fig. 1. Stagflation: Prices rise, GDP falls.

In the 1970's, Central Banks erred when they interpreted inflation as demand-pull and as a result acted to cut demand by raising interest rates. Using demand-side stimulus to fight cost-push inflation is folly. We economists continue to focus policies on the demand side, when the problem is on the supply side. Why? Because we still do not know, decades after the debacle of the 1970's stagflation, how to solve supply-side problems with good policies that boost supply and productivity and slash inflation, by spurring saving, investment, efficiency and productivity.

Stagflation is back. Have we forgotten the past?

Krugman[2] urges us to watch the actions of Jerome Powell, who heads the US Federal Reserve Board of Governors. Alarmed by 40-year highs in inflation (January inflation in the US was 7.5%), the US Fed may raise interest rates hastily. This is, again, a demand-side tool employed to remedy a supply-side problem.

With stagflation, an inward shift in demand curves caused by higher costs of credit will indeed diminish inflation but it will also deepend the recession by reducing output. (See the Fig. 1 illustration). Hence, Krugman asks rhetorically whether the Putin energy price hike will become a Putin recession. It will – only if Central Banks apply the wrong interest-rate 'remedy'.

Powell is known to be an admirer of former Fed head Paul Volcker. In 1979-81 the US had double digit inflation rates for three straight years. Volcker responded with massive interest rate hikes in June 1981, raising interest rates to 20%. The result was a deep recession in the US. A similar scenario today is possible but hopefully not likely.

Simulation studies have been run to forecast the war's impact. An early one was published by the UK's NIESR[3]. It predicts 20% inflation in Russia, due to higher import prices and the sharp fall in the dollar-ruble rate. Eurozone GDP may lose as much as 3 per cent of GDP in 2022, accompanied by 5.5% inflation. But given the current 'fog of war', little credence should be attached to these early estimates.

COFACE stands for Compagnie Française d'Assurance pour le Commerce Extérieur. COFACE was the export credit agency for France since its foundation in 1946. It also offers private credit insurance globally.

Coface estimates "a deep recession of 7.5% for the russian economy in 2022 and downgrade of Russia's risk assessment to D (very high)".[4] Russia's Central Bank compiled foreign exchange reserves of $650 b., in the wake of a decade-long current account surplus, but Western financial sanctions have prevented it from accessing and using at least half, owing to restrictions on dollar-ruble transactions.

B. Supply Chain Issues

In the face of mounting death tolls, in Ukraine, it is difficult to find a ray of light and hope. Here is one. Two World Wars were ignited by local acts of violence that ignited global conflict – the assassination of the Archduke in Sarajevo, WWI, and the attack on Czechoslovakia by Hitler in 1939.

When Russia invaded Ukraine on Feb. 24, the response of US President Biden, coordinating with the European Union, was to employ dollars, rather than dynamite, as weapons. Several packages of sanctions were imposed on Russia.

These sanctions came at a time when global supply chains were already in tatters owing to the pandemic, which began almost exactly two years before the Russian aggression. The war exacerated supply issues -- land-based supply routes were disrupted, air ties between Russia and Europe were suspended, and freight routes through the Black Sea (where shipments of Ukrainian grain are made) were cancelled.[5]

Will there be a resulting recession? After the global economy recovered well in 2021, with significant GDP growth, it was clear even before Feb. 24 that the Omicron wave had slowed growth. Global inflation forecasts for 2022 were already around 6% -- that number will surely rise, while GDP growth forecasts are revised downward almost daily.

Bloomberg Economics[6] reports ominously that "Russia's invasion of Ukraine carries huge risks for a world economy that's yet to fully recover from the pandemic shock".

Stagflation is inevitable. Will it involve an actual recession (decline in GDP)? Much depends on how Central Banks navigate the crisis. What is clear is the Russian economy will face a very deep and lasting recession, possibly qualifying for the term 'depression'.

Supply side effects will focus on energy (natural gas, oil), and on food and commodities (grains, maize, nickel, aluminum, palladium, titanium). Europe currently gets 40% of its natural gas from Russia. And Russia is the world's largest supplier of wheat, with disproportionate amounts flowing to the Mideast (Turkey and Egypt get 70% of their wheat from Russia).[7] Gasoline prices at the pump already top $4.00 in the US.

BOX: Basic Data

» Russia exports 6.5 million bbls. of oil daily. World output is about 100 m. bbls.

» Russia and Ukraine together account for about 29% of total world wheat exports and 19% of corn exports.

» Russia and Ukraine account for 75% of sunflower oil exports.

» Russia accounts for 17% of natural gas production

» Russia accounts for 15% of global trade in nitrogenous fertilizers and 17% of global potash fertilizer exports.

C. Ukraine: When the Guns Fall Silent

Let us put the Ukraine economy in current and historical context.

Ukraine is a nation of 41 million people. GDP is about $600 b., measured in Purchasing Power Parity (PPP) terms, or 40th in the world. Its economy shrank in 2020 and grew again in 2021 owing to the pandemic and ensuing recovery. GDP per capita is about $14,000 (PPP).

In the wake of World War I, enormous chaos enveloped Ukraine. In a bitter war from 1917 to 1921, Ukraine became the Free Territory of Ukraine; Ukrainian Soviet Socialist Republic emerged in 1919 when the Ukrainian People's Republic and West Ukrainian People's Republic merged. The Ukraine SSR was quickly subsumed into the Soviet Union.

In 1932-33 there was a Soviet famine, part of the global Depression. It is known as the Holodomor and it left 3.9 million Ukrainians dead – a number very hard to even imagine – who simply starved to death, as Stalin expropriated food produced in Ukraine.

Ukraine became an independent country again on August 24, 1991, with the collapse of the Soviet Union. Almost a decade of chaos and decline followed. GDP fell by half; there was hyperinflation. Then there came recovery. Growth became rapid from 2000-2008, ending in a huge financial crisis. Growth recovered in 2010-13, followed by another severe downturn in 2014, when Russia invaded Crimea. By 2018 the economy had recovered to pre-Crimea levels.

Ukraine has rich farmlands and major rivers (Dnieper, Dniester) that traverse Ukraine and enable shipment of wheat by water freight. For much of the 18th and 19th C., continuing in the 20th C., Ukraine was the breadbasket of Europe, and with Russia, remains so today. One-eighth of the economy is derived from agriculture.

Prewar exports from Ukraine totaled $68 b. The top five customers were: Russia 9.5%, China 8%, Poland 7%, Turkey 5.0% and Germany 4.2%.

Prewar Ukraine debt was modest, about 60% of GDP; Foreign exchange reserves were $26 billion.

In addition to tragic loss of life, the war is causing massive destruction to Ukraine's factories, infrastructure, roads, housing, and commercial buildings. It is expected that a Marshall Plan-type of recovery initiative, funded by democratic nations, will ensue. The International Monetary Fund is already supplying substantial emergency loans to Ukraine.[8]

Prior to the war, the World Bank was very active in Ukraine, investing some $8 b. since 2014.[9] Ukraine has in the midst of war requested membership in the European Union. An advisor to Ukraine President Zelesny, Alexander Rodnyansky, noted the influx of foreign investment after the so-called Maidan Revolution in 2014 and resulting drive against widespread endemic corruption and widespread modernization and 'digitization' of the Ukraine economy – perhaps, Rodnyansky observes, a major cause of Russian despot Putin's intense hatred of Ukraine, which contrasts sharply with Russia's kleptocracy (economy of thieves).[9]

D. China: Monkey in the Middle

China so far has strived to shield itself from the negative impact of the war. World Bank President David Malpass estimates China's crucial GDP growth could fall by as much as 3 per cent, from 8.1% in 2021 to only 5.1 % in 2022.[10]

Former senior Singapore diplomat Bilahari Kausikan[11] has succinctly defined China's dilemmas. First, it wants to preserve respect for sovereignty and non-interference, because of Tibet, the Uighur issue in Xinjiang, and Taiwan. Russia's invasion of Ukraine "is a direct challenge to these norms".

Second, China wants to maintain its partnership with Russia because the latter is China's heavyweight strategic partner, with a shared dislike of a Western-led global order. At the same time China has vastly benefited from the global economy, far more than Russia.

Third, China seeks to stabilize its relations with Europe and the US, to avoid collateral damage from sanctions on Russia. "China is now walking a fine and precarious line," Kausikan notes. China is Russia's largest trading partner. However, "Western markets are far more important to China than Russia and will remain so…".

China's goods trade with Russia has expanded enormously, from virtually zero in 2000 to $150 b. in 2021.[12] China consumed a third of Russian oil exports in 2020 and 17% of its gas exports. Some Chinese multinationals (Volvo, Tik-Tok) have suspended operations in Russia, fearing Western sanctions.

E. Geopolitics and Policy: Recalculation

For those who use WAZE, a wrong turn can often cause Waze to engage in "recalculate". This is what is currently occurring in the world, in the wake of the Russia-Ukraine war.

An immediate result is the increase in EU government spending, of between 1.1 and 4% of GDP.[13] The most startling 'recalculate' is that of Germany, which has rapidly moved to boost its defense spending. The North Atlantic Treaty Organization (NATO) has been brought back from the dead and has found new vigor and new life, as NATO moves to bolster especially defenses along the Polish and Baltic borders with Russia.

As Jean Monnet, father of European union, wrote once, "Europe will be forged in crisis and will be the sum of the solutions adopted for those crises." This is proving starkly true, again.[13] The Economist urges the EU to again issue joint debt to fund crisis-related spending, as it did during the Greek and Italian debt crises, beginning in 2009.[14]

Massive financial sanctions have been imposed on Russia, the world's 11th largest economy.[15] The Economist[15] observes that world Central Banks hold $20 trillion in foreign exchange reserves (roughly equal to the annual US GDP, and roughly a quarter of the world's total GDP). In the event of an attempt by China to invade and occupy Taiwan, the West could freeze China's own $3.3 trillion reserves. China and Russia have been developing digital banking systems independent of the dollar – but they are very small and not widely used, to date.

By some accounts, Russia's per capita GDP, at $10,000, is equal to or even slightly below that of China, in 2021. BBC Reporter Jonathan Josephs explains: "[This is] because they really have maintained such a centralized decision making under Putin…ever since [the year] 2000." [16]. Centralized, of course, so is China – but kleptocratic, corrupt, riddled with rent-seeking Putin-favored oligarchs.

Rich countries hold 1.5 billion barrels of oil in their strategic stockpiles. The soaring price of oil could be restrained by releasing oil from these stocks. Releasing 3 million barrels daily would not empty the reserve entirely for 18 months. The US has already made limited use of this tool.

There is a key short-term long-term force at play in energy markets. In the short term, with a year or two horizon, demand for oil and gas is overall price-insensitive, as substitutes are largely not accessible. In the longer term, there are substitutes for fossil fuels – wind, solar, geothermal, even nuclear.

There may be a major bright spot in this dark brutal war. In the past, relatively small-scale aggression led to immediate widespread world war, with massive loss of live, civilian and military. Today the West has responded to Russia's aggression with economic warfare. As David Lynch notes in the Washington Post[17], "In just a week Western allies have imposed one of the most rapidly moving sanction campaigns in modern history".

F. Conclusion

The Russia-Ukraine war will inflict considerable pain on the world. As usually happens, the poor will pay a heavier price, hurt by soaring food prices.[18]

Perhaps, though, the crisis will accelerate the painfully-slow transition away from fossil fuels. It may also cement somewhat fractious ties between the world's democracies. It may make the rise of autocratic (kleptocratic) regimes far less attractive. It may speed the political demise of Putin and his like. And the failure of Putin's war may hopefully deter other despots from similar adventures in the future.

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