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Geographical and Economic Effect due to War of Russia and Ukraine

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Abstract

As quick-fire, the Russian economy has been pummelled by Western unprecedented sanctions, unwilling to face a nuclear opponent on the battlefield. Sanctions imposed include freezing of Russian central bank assets, targeting of wealthy Russian individuals and some state-owned banks, partial access restriction to the international payments system SWIFT and a stop from Germany to its Russian gas pipeline project.Sanctions' costs to Russia are partly cushioned by higher prices for gas and oil exports and the avoidance of restrictions through trade conducted with third countries, but the net economic impact on the Russian economy will be negative. We have estimated these spillover effects using our Global Econometric Model (NiGEM). We expect the war to contribute to a fall in GDP in Russia (relative to base) of 1.5 per cent in 2022 and 2.6 per cent by the end of 2023. Russian inflation is likely to soar above 20 per cent this year due to higher import prices following the fall in the rouble and due to higher inflation expectations, resulting in lower confidence, weaker real incomes, and disrupted trade.Overall, we expect actions against Russia could reduce foreign direct investment, leading to outflows of capital, and reducing its long-term potential growth rate.

Introduction

The war in Ukraine represents a challenge for the global economy harming growth and putting upward pressure on inflation when inflation is already at high levels. Ukraine is not a significant trading partner for any major economy, but countries such as China, US, Germany, France, and Italy represent some of the major import partners for Russia.There are several channels through which the conflict impacts on the world economy. The Ukrainian and Russian economies are key suppliers of commodities, including titanium, palladium, wheat, and corn. Disruptions to the supply chain of these commodities would keep prices high, intensifying for users of such commodities (including car, smartphone, and aircraft makers).Secondly, significant escalation on energy prices due to Russia being one of the world's largest oil producers and energy exporters, will lead into higher inflation.[1,2]

Another channel is the large-scale emigration from Ukraine; the UNHCR says there could be 4 million refugees as the crisis unfolds, and it will depend on border controls, length of the conflict, and how the economy settles down after the war. We have assumed a net outflow of two million a year in 2022 and 2023.[3,4]

Finally, political risk and uncertainty may drive up savings ratios and make firms more reluctant to invest.In our simulation, we estimate that the conflict in Ukraine implies that the level of global GDP declines by 0.5 per cent in 2022, and close to 1 per cent by 2023 (which is about $1 trillion off global GDP). It adds up to 3 per cent to global inflation in 2022 and about 2 percentage points in 2023, which would also increase the cost of living and could further put pressure on household consumption. We see the issue of Ukrainian refugees mostly as a European issue; this will present substantial demographic challenges, mainly for western Europe and we expect higher public spending to solve them. In addition, the conflict is expected to increase military spending in NATO.[5,6] Both defence and refugees' assistance expenditures are likely to add pressure on resources and therefore inflation. Using our Global Econometric Model (NiGEM), we estimate Eurozone GDP growth to fall by 0.9 percentage points in 2022 and by 1.5 percentage points in 2023, compared to our February forecast. We also expect inflation rising to 5.5 per cent in 2022 and 2.1 per cent in 2023, as against the forecasts we had of 3.1 per cent in 2022 and 1.3 per cent in 2023 in the February forecast. Russia has a great exposure to the UK, and as the result of the conflict, we expect

the impact on the UK could be to reduce GDP growth by around 0.8 per cent to 4.0 per cent in 2022 and to 0.5 per cent in 2023.[7,8]

Discussion

Russia is a vitally important supplier of oil, natural gas and metals, and higher prices for those commodities are sure to inflict economic damage around the world. Europe relies on Russia for nearly 40 per cent of its natural gas and 25 per cent of its oil. For the European continent, Russia's war has significantly heightened the likelihood of runaway inflation, another economic setback or both.Infuriated by Putin's aggression, the United States and other Western nations have targeted Russia with sanctions of unprecedented breadth and severity for a major economy.They have thrown major Russian banks off the SWIFT international payment system, limited high tech exports to Russia and severely restricted Moscow's use of its foreign currency reserves.The rapid and unified international retaliation against Russia appeared to catch Putin's regime by surprise.[9,10] Natural gas prices shot up 20 per cent after the war started, on top of earlier increases, and now are roughly six times what they were at the start of 2021. The gas price shock is feeding higher inflation and swelling utility bills.The result is that households have less money to spend, and hopes for a surge in consumer spending resulting from fewer pandemic restrictions and COVID-19 cases have diminished.Escalating gas prices have caused what economists call demand destruction among industrial enterprises, like fertilizer makers, that use a lot of gas and have now slashed production.Farmers are paying more to run machinery and buy fertilizer. Germany's economy, which sagged by 0.7 per cent in the fourth quarter of 2021, would face a technical recession if it shrank again in the first three months of 2022.The economic downdraft could be offset by an increase in German defense spending.[11,12] In response to the Russian invasion, Chancellor Olaf Scholz has said the government would commit 100 billion euros (USD 111 billion) to a special fund for its armed forces and raise defense spending above 2 per cent of GDP.[13,14]

The drag from higher prices and the negative confidence affect may lower real GDP growth in the eurozone from 4.3 per cent to 3.7 per cent for 2022, said Holger Schmieding, chief economist at Berenberg bank.The world's unexpectedly robust recovery from the pandemic recession left companies scrambling to find enough raw materials and components to produce goods to meet surging customer demand. Overwhelmed factories, ports and freight yards

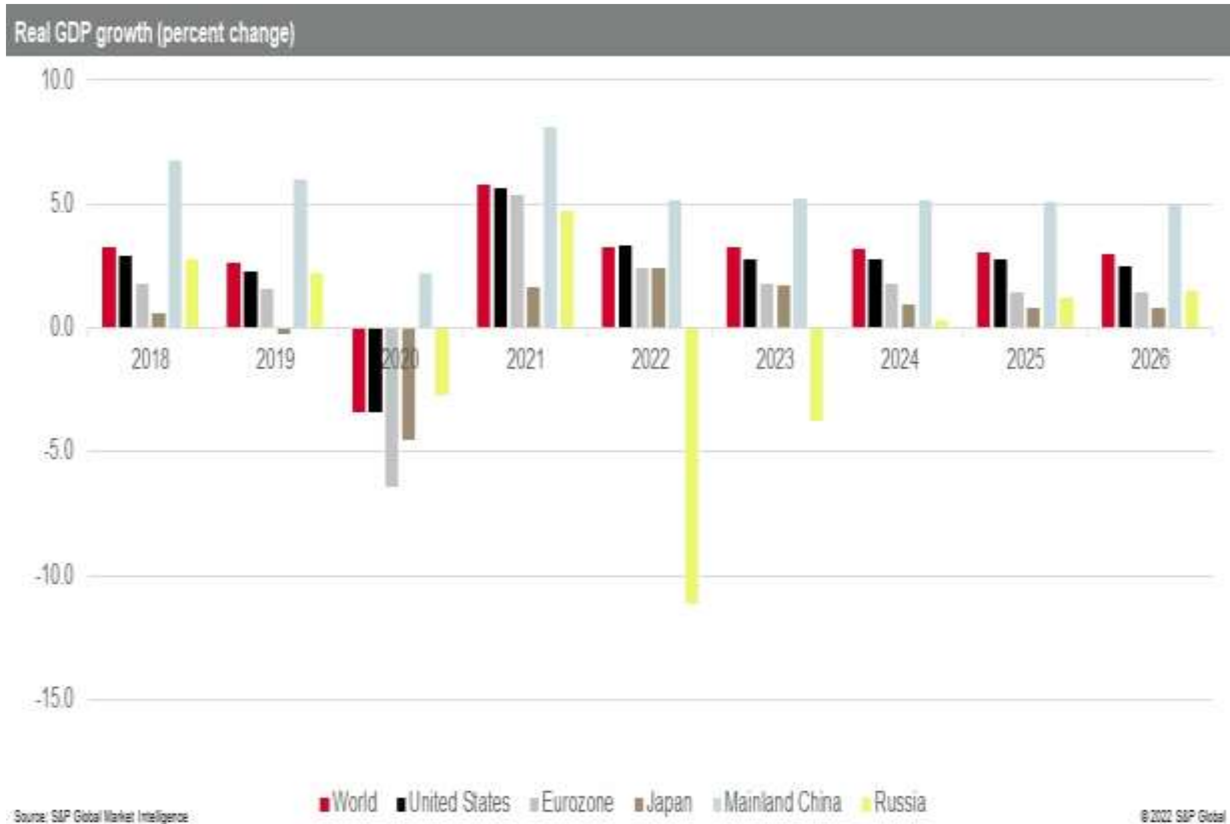
have meant shortages, shipping delays and higher prices. Disruptions to Russian and Ukrainian industries could delay any return to normal conditions.Mark Zandi, chief economist at Moody's Analytics, noted that Russia and Ukraine together produce 70 per cent of the world's neon, critical in the making of semiconductors.[15]That is especially worrisome because the world, and automakers in particular, are already enduring a shortage of computer chips.When Russia seized Crimea from Ukraine eight years ago, neon prices shot up 600 per cent, though Zandi notes that chipmakers have since stockpiled neon and sought alternatives to Russian supplies.Russia and Ukraine together supply 13 per cent of the world's titanium, which is used to make passenger jets and 30 per cent of the palladium, which goes into cars, cellphones and dental fillings, Zandi said. Russia also is a major producer of nickel, used to produce electric car batteries and steel.It's impossible for supply chains to catch up," said Vanessa Miller, a partner at Foley & Lardner LLP who specializes in supply chains.The conflict and sanctions will also do damage to Russia's neighbours in Central Asia.As its own workforce has aged, Russia has turned to younger migrant workers from such countries such as Uzbekistan and Tajikistan. Those workers' families have come to rely on the money they send home remittances.[16,17]

Even at the height of COVID-19 in 2020, remittances from Russia to Uzbekistan topped USD 3.9 billion and to Kyrgyzstan USD 2 billion, according to the Russian central bank.The pressure on the ruble, banking restrictions on foreigners and in the long run the collapse of the labor market in Russia will have an immediate and profound economic impact on Central Asia," Gavin Helf, an expert on Central Asia for the US Institute of Peace, wrote that Ukraine and Russia account for 30 per cent of the world's exports of wheat, 19 per cent of corn and 80 per cent of sunflower oil, which is used in food processing. Much of the Russian and Ukrainian bounty goes to poor, unstable countries like Yemen and Libya.The threat to farms in eastern Ukraine and a cutoff of exports through Black Sea ports could reduce food supplies just when prices are at their highest levels since 2011 and some countries are suffering from food shortages.Anna Nagurney, a management professor at the University of Massachusetts Amherst, described the consequences as extremely troubling."[18,19]

Results

Russia's invasion of Ukraine on 24 February has fundamentally changed the geopolitical landscape—with economic consequences. Four weeks into the war, Russia continues its

bombardment of cities, encountering determined Ukrainian resistance. While the outcome is highly uncertain, a lengthy political impasse appears likely. Economic damage to both countries will be substantial. Through sanctions, trade policies, and private investment decisions, Russia will be isolated for years to come. Ukraine must endure the massive displacement of people and destruction of property.[20]



The S&P Global Market Intelligence forecast of global real GDP growth in 2022 has been marked down to 3.3% from 4.1% in February.While the 2022 global growth rate represents a slowdown from 5.8% in 2021, the world economy has sufficient resilience to avert a recession. About 0.3 percentage point of the downward revision in 2022 growth is traced to sharp contractions in Russia and Ukraine, while another 0.3 percentage point reflects slower growth in Western Europe, a region hit particularly hard by the surge in prices of natural gas, oil, and electricity. Nearly every region is hurt by war-related supply disruptions and commodity price increases. A notable exception is the Middle East and North Africa, where oil and gas exporters will benefit from substantially higher energy prices.

In response to severe sanctions by western governments and a mass exodus of businesses, real GDP is projected to plummet 22% over the four quarters of 2022, reaching its lowest level since 2006. On an annual basis, output will fall 11.1% in 2022 and 3.7% in 2023, with

sharp declines in fixed investment, private consumption, and exports. The downward spiral began in late February when the United States, European Union, United Kingdom, and Canada imposed new sanctions to block the Russian central bank's access to its external assets and to block major Russian banks from using the financial messaging services of SWIFT. These actions triggered a collapse in the rouble's exchange value, prompting the Bank of Russia to raise its policy rate from 9.5% to 20.0%, its highest level in two decades. S&P Global Market Intelligence analysts expect the rouble will come under further pressure, forcing the central bank to raise its policy rate to 30% in May. Currency depreciation and supply chain disruptions will lift Russian consumer price inflation from 6.7% in 2021 to 23.6% in 2022. A difficult investment environment will impede economic recovery—real GDP is not expected to regain its 2021peak until the 2030s. S&P Global Market Intelligence analysts tentatively estimate a real GDP contraction of about 40% in 2022, along with a 30% surge in consumer prices. The pace of recovery will depend on the course of the war, governance, international aid for reconstruction, and a return of population. The United Nations estimates that 3.17 million refugees (7% of the population) have left Ukraine, while nearly 2 million have been internally displaced.[21,22]

Conclusions

While Russia and Ukraine accounted for just 1.8% and 0.1%, respectively, of world GDP in 2021, the two countries play an outsized role in production of oil, natural gas, wheat, corn, sunflower oil, fertilizer, lumber, neon gas, aluminum, nickel, titanium, palladium, iron, and steel. Through mid-March the IHS Markit Materials Price Index advanced 33% year to date, reaching a new high. Prices will peak in the second quarter of 2022 and retreat about 20% during the final two quarters of 2022 in response to rising interest rates; softening demand growth; and the slowdown in mainland China's property market.

Energy prices are the main transmission channel through which the Russia-Ukraine war will affect inflation and economic growth. The forecast assumes losses in Russian oil production and exports of about 1-3 million barrels per day through 2023. The price of Dated Brent crude oil is expected to retreat from USD118/barrel in 2022 to USD96/barrel in 2023 and USD87/barrel in 2024. Reflecting regional supply dependencies, natural gas prices will be substantially higher in Europe and moderately higher in Asia as a result of the war. The 2022 forecast is revised upward by 1.8 percentage points. While all regions will experience a

significant pick-up in inflation in 2022, the sharpest accelerations are in Europe, where energy prices are soaring. The European Union imports 90% of its natural gas consumption, with Russia accounting for 45% of that total. Russia also accounts for 25% of the EU's oil imports and 45% of its coal imports.[23]

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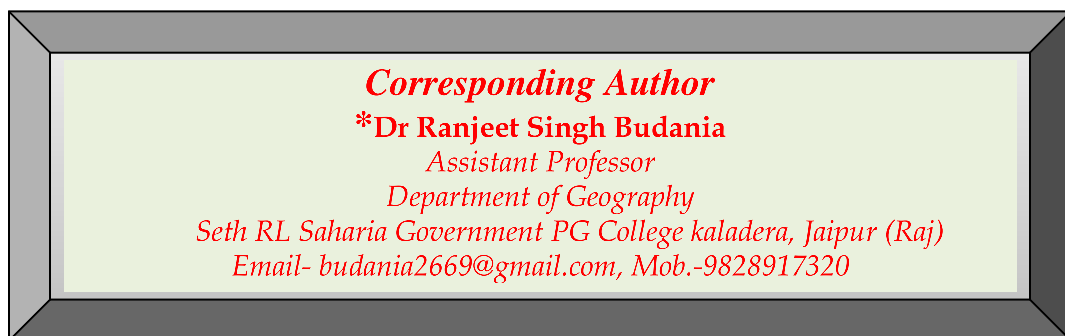
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