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Long-term Consequences of Russia-Ukraine War – a Tipping Point?

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Executive Summary

This paper assesses the possible long-term consequences for the New Zealand economy of the Russia-Ukraine War.

The Russian invasion of Ukraine has resulted in huge humanitarian costs and severely impacted current and future wellbeing. It is having significant short-term economic costs, most acutely in Ukraine and Russia themselves, but also throughout Europe and around the world, particularly for countries dependant on energy and food imports from these two countries. The extent and duration of these costs depends on how the conflict evolves, but already the war has contributed to a marked deterioration in global growth prospects alongside higher inflation.

The war will also impact on longer-term global geo-political and structural economic settings that New Zealand will be subject to and have to deal with. We expect the invasion will reinforce a number of transitions in the global economy already underway from existing pressures on globalisation including China/US dynamics and the COVID-19 pandemic, alongside long-standing but increasingly time dependent challenges such as climate change and the need for a "green transition". It is these long-term implications that this note is largely focussed on.

As with the war itself, a range of futures are possible. These futures are heavily dependent on the choices of decision-makers, particularly in the largest economies and key regional groupings of the European Union and North Atlantic Treaty Organisation (NATO), and are not pre-ordained.

Our central view is that the war will exacerbate the retreat from globalisation that has been in train in recent years. Moreover, many of the underlying economic (and political) forces operating over the past few decades are likely to go into reverse, resulting in the global economy being driven by a different set of macro conditions and priorities, with the period ahead likely to be marked by a number of transitions. These include a further shift from globalisation to regionalisation, which could increase production costs and drive-up global inflation and interest rates. Global supplies of labour and energy could become scarcer and less accessible to New Zealand. Capital investment could suffer and pressure to spend on national security and prop up flagging living standards could further stretch government balance sheets already under pressure from ageing populations. As an exporter of primary products, higher food prices will be beneficial for New Zealand exporters, but lower global growth forecasts and other countries' measures to secure their food supply such as export bans may pose risks in the longer term.

Around this central view, both more and less benign outcomes are possible. The war could represent more of a "tipping point" or "rupture" for geo-politics and the global economy. Tensions between political and economic blocks would be much increased in this scenario, heightening the chance of negative shocks. Countries could come under pressure to "choose a side" and face an increased prospect of economic coercion to influence a government's decisions.

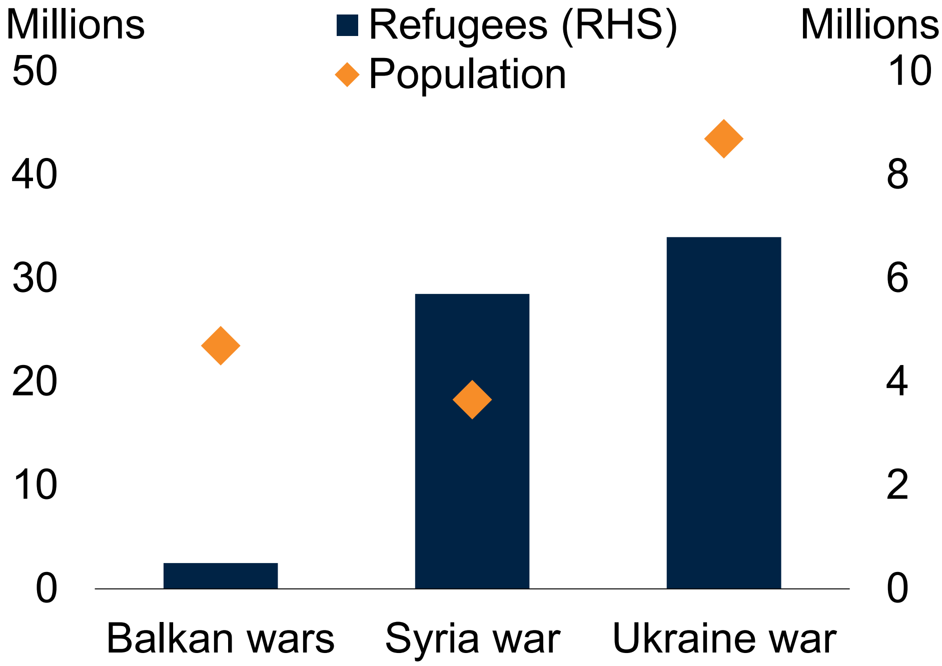
Conversely, if the Ukraine conflict can be quarantined enough (and Russia sufficiently isolated) to avoid broader geo-political and economic ruptures an outcome similar to the current status quo may be possible, albeit still with some reversal of the economic drivers of the past 30 years. In this scenario countries would work together in areas like climate change where international cooperation is necessary to achieve the desired outcomes.

On balance we believe we will be faced with a more fractured world, both geo-politically and in terms of economic systems and governance. Such a world is likely to be riskier for policymakers and businesses alike. Globally, trend growth (absent a future productivity boost from new technologies and/or a green transition) is likely to be lower, and inflation and interest rates higher. Financing and/or trade-offs involved in climate change adaptation and mitigation could be more acute, at least as the current shock is dealt with. Future wellbeing outcomes are likely to be similarly negatively impacted.

Russian invasion of Ukraine and its impacts

The war in Ukraine is first and foremost an ongoing humanitarian tragedy. The United Nations Refugee Agency (UNHCR) estimates that nearly one-third of Ukrainians have been forced from their homes and that as of 29 May 2022, 6.8 million Ukrainians had left for Poland and other countries. An even larger number of persons have been displaced internally. The war has displaced the most refugees in Europe since World War II and is the second-biggest conflict-driven displacement of people since the 1960s (see Figure 1).

Figure 1: Refugees from wars



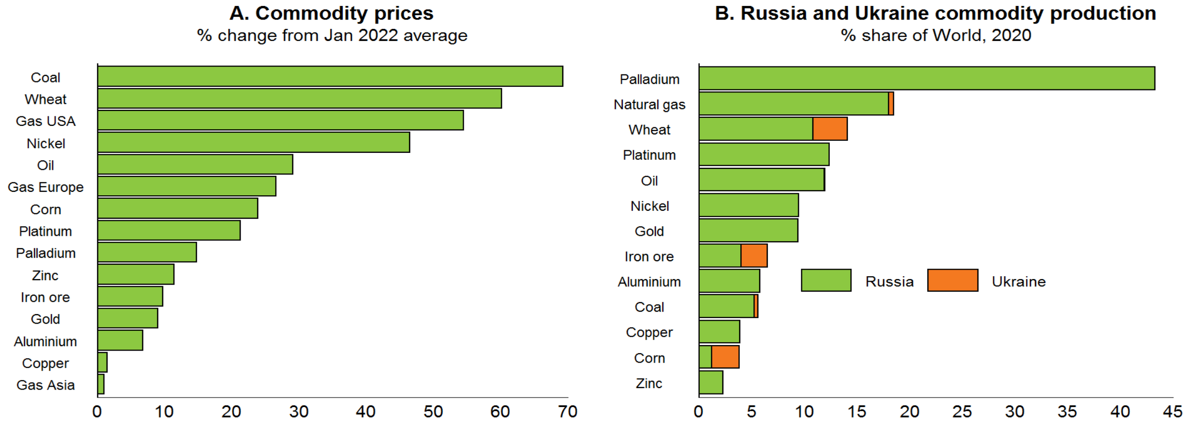
Source: World Bank

How and when the conflict comes to an end is uncertain, as is the consequent scale and duration of disruption to lives and livelihoods. Increasingly, the prospects are shifting towards an extended disruption (whereby the conflict continues throughout 2022) or further escalation of the conflict.

For the global economy, the war has generated a second large negative supply-side shock, exacerbating that caused by the COVID-19 pandemic. The impacts have been significant and unevenly felt across countries. This uneven impact reflects states' proximity to the conflict and their direct and indirect exposure to Russia and Ukraine, and to particular commodities.

The short-term impacts of the war (including the subsequent sanctions and restrictions on trade and firm behaviour) are primarily operating through commodity prices, especially for food and energy (see Figure 2). Food and energy prices have further increased global inflation. The war has disrupted production and supply chains and caused additional geo-political and economic uncertainty.

Figure 2: Commodity prices have risen sharply since the invasion of Ukraine



Note: Data in Panel A are based on an average of daily prices between 24 February 2022 and 1 June 2022 for all commodities apart from wheat and corn, which are based on average prices over March-May 2022.

Source: OECD Economic Outlook, Volume 2022 Issue 1, https://stat.link/u4ox26

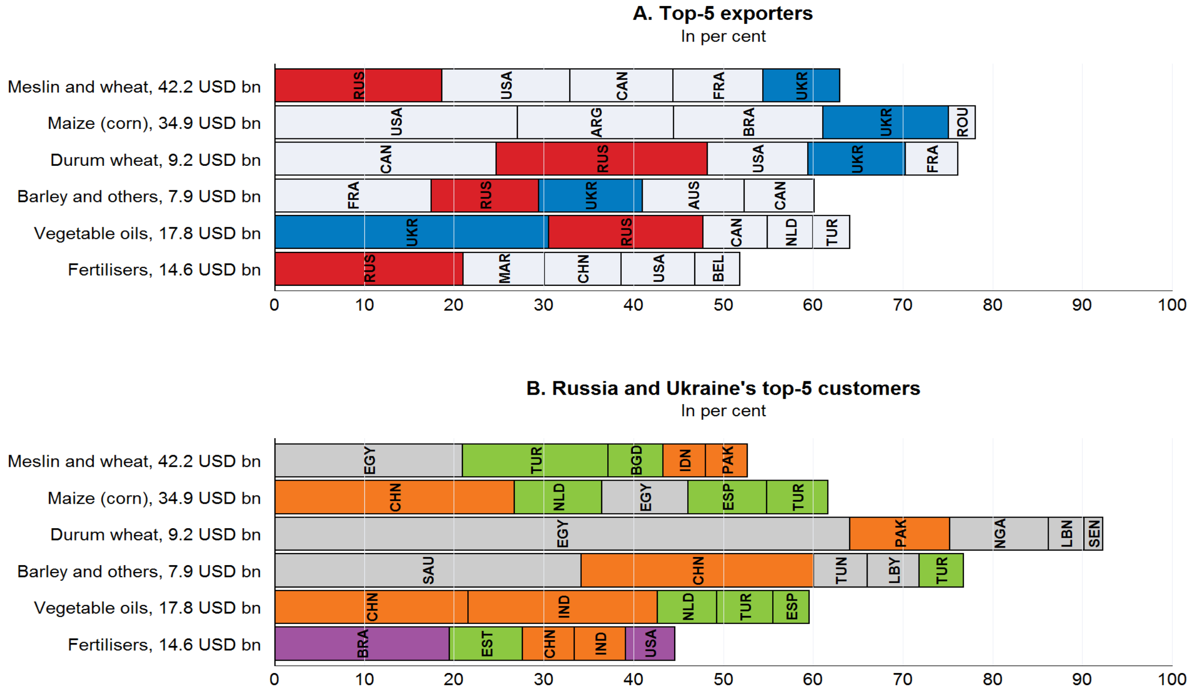
Prices for commodities produced by Russia or Ukraine, such as oil, natural gas, wheat, maize, some fertilisers and some metals spiked sharply following the invasion. Although some prices have subsequently moderated, particularly metals, at the time of writing prices for most food and energy commodities remain well above pre-war levels. In response to rising prices for food and fertiliser some countries have restricted food exports as they attempt to stabilise domestic prices. These actions have added to supply concerns in other countries.

The economic and social impacts of the disruptions in commodity markets will likely be felt most strongly in emerging-market economies. Current accounts, and through them the income of the private and public sectors, are being affected by soaring commodity prices, to the benefit of net commodity exporters and the detriment of net importers. But, for the world as a whole, the outcome is unambiguously negative. Commodities are key production inputs and an increase in their price constrains output.

In addition, the available quantities of certain commodities are also under strain. Agricultural commodities are of particular concern on this count as Russia and Ukraine are both major global suppliers of cereals and fertilisers (see Figure 3). Their production and exports for the year ahead will likely be curtailed. Countries in Africa, the Middle East and Central Asia are particularly exposed, but high prices are having a global impact. There is a heightened risk that rising food prices could spark civil unrest as occurred during the Arab Spring that began in 2010.

Figure 3: Russia and Ukraine are important suppliers of many agricultural products

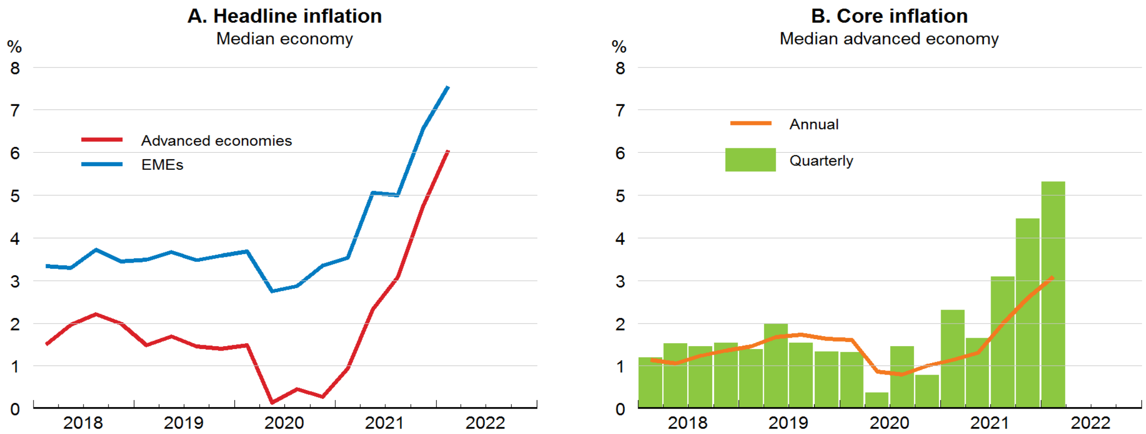
Market shares as percentage of total trade flows recorded in 2020 for each commodity



Source: OECD Economic Outlook, Volume 2022, Issue 1, StatLink https://stat.link/t7wyjv

The surge in commodity prices is adding to inflation, which was already rising materially coming out of the pandemic (see Figure 4). The conflict is exacerbating the supply-demand imbalance at the heart of the global inflation surge, accelerating the moves by central banks to start normalising monetary conditions through increasing policy interest rates.

Figure 4: Headline and core inflation have risen sharply over the past year



In Panel B, the quarterly numbers are quarter-on-quarter percentage changes at an annualised rate.

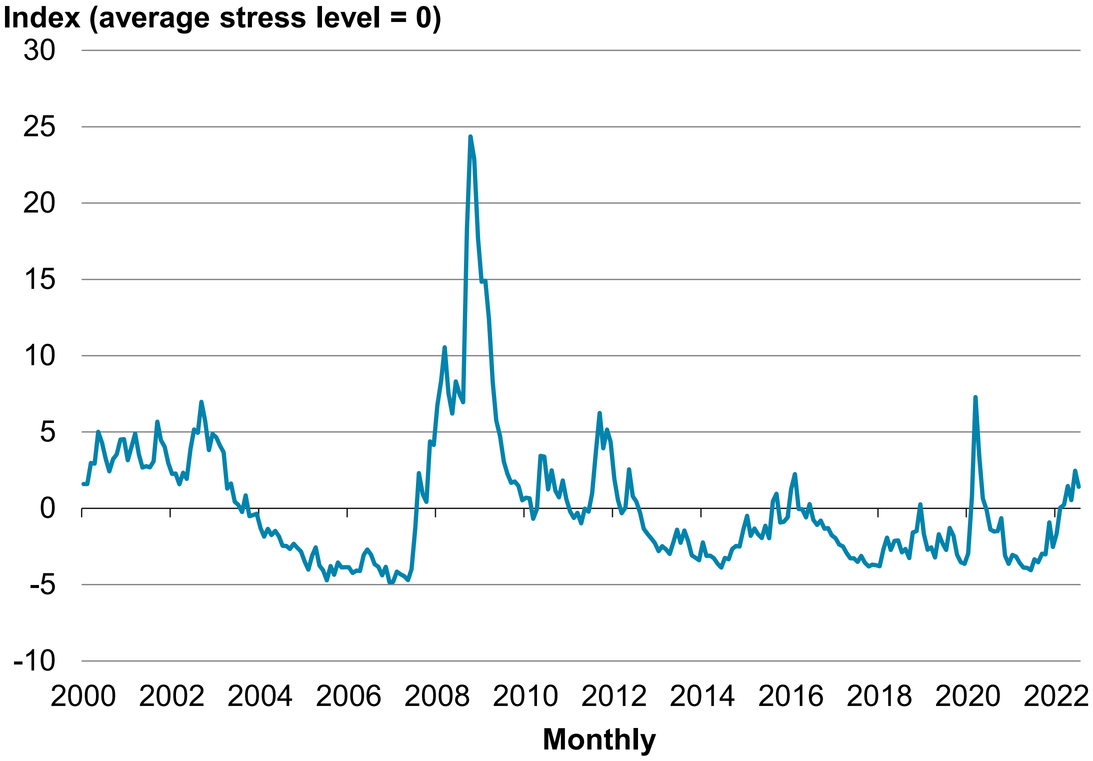
Source: OECD Economic Outlook, Volume 2022, Issue 1, StatLink https://stat.link/qh2byv

Financial system stress

Some impacts are evident in global financial markets but so far they are coping relatively well with disruption from the war and subsequent sanctions. Sanctions have made it difficult for Russia to make payments on some foreign debt obligations, although the IMF regards the impact of a default as manageable for the global financial system. Macroeconomic prospects are a major source of risk to the financial system. An economic downturn against the backdrop of high debt would test banks' resilience, particularly in emerging market economies.

One measure of financial market stress comes from the US Treasury's Office of Financial Research and summarises global market conditions. This index equals zero during periods of "average stress" and rises as financial stresses build. This measure rose sharply in early March and has remained above zero subsequently (see Figure 5). While a notable rise from an average around -2.5 throughout much of the past decade – a reflection of extremely easy monetary conditions – it pales in comparison to the spike during the European debt crisis in 2011-12, let alone the spike that coincided with the start of the global pandemic in 2020 or the Global Financial Crisis during 2008-09.

Figure 5: Global financial conditions have tightened



Source: Haver

Growth

The Russia-Ukraine conflict has led to global growth forecasts being pared back materially, with the largest hits concentrated in the region itself, the euro area, and in other commodity importing countries (see Figure 6). However, even countries distant from the conflict, like New Zealand, are seeing growth forecasts pared back as the war dents consumers' wallets via higher oil and food prices. This drag on growth will be an offset to the expected recovery from the pandemic, keeping economic activity below the pre-pandemic trend in many countries.

Figure 6: Weaker global growth

Source: War Dims Global Economic Outlook as Inflation Accelerates – IMF Blog

For New Zealand, we expect the lift in global food prices will largely offset the increase in oil and fertiliser prices in the near term, meaning that the war itself is likely to be a positive for New Zealand's terms of trade. However, there is also a broad-based increase in import prices occurring, meaning that the overall outlook for the terms of trade is broadly balanced at present. While some exporters may benefit, consumers will be bearing the cost of higher food prices, particularly those on lower incomes for whom food makes up a larger proportion of the household budget. In addition, the recent fall in the exchange rate makes imports more expensive for producers and consumers.

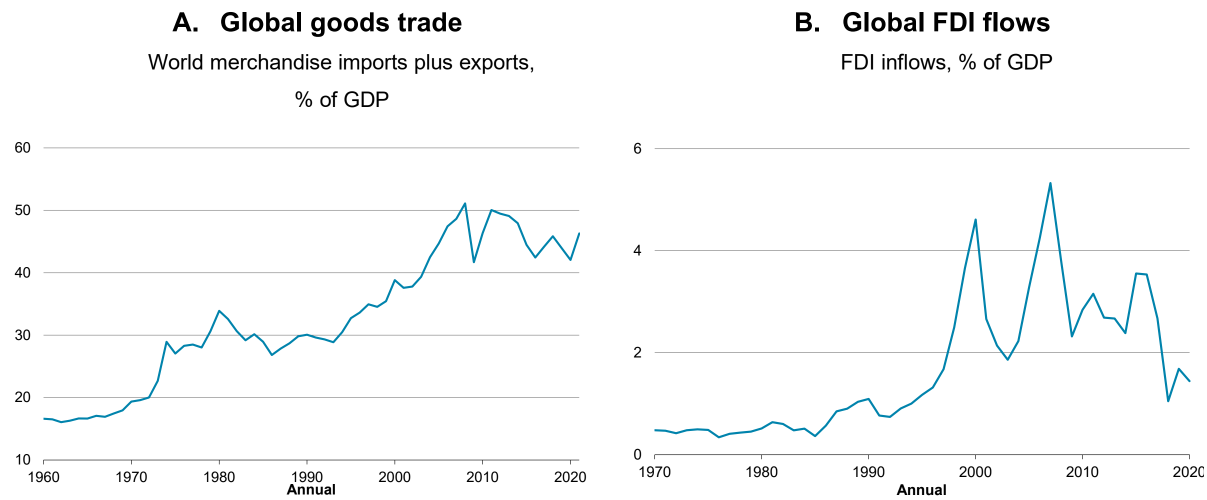
Long term implications – from “peace dividend” to “geo-political tax”?

Fracturing of global trade and finance

Looking further over the horizon, the war will also impact on longer-term global geo-political and structural economic settings that New Zealand will be subject to and have to deal with. Our central scenario is that the war will exacerbate the retreat from globalisation that has been underway in recent years, with a range of consequences.

The period from the end of the Cold War until the middle of last decade was an era of increasing globalisation (see Figures 7). The former Soviet States, Eastern Europe, parts of Southeast Asia and eventually China all entered the global system of trade and finance.

Figure 7: Globalisation has peaked with some signs of retreat



Source: World Bank

However, elements of globalisation such as goods trade and cross-border capital flows have been in retreat as the structure of China’s economy has changed (and it sold more goods to itself), and more recently as protectionism has increased and the relationship between the US and China has worsened. The pandemic and now the Russia/Ukraine war exacerbated this trend further, by closing borders, increasing concerns about economic security and emphasising the importance of having secure supply-chains.

A wide coalition of countries have imposed sanctions on Russia and many of these may remain in place for some time. Moreover, a precedent has been set. In addition to sanctions on Russia lasting a long time, sanctions could be used more forcefully on others in the future. New Zealand may face renewed asks from like-minded states to put in place a more general regime.

Commentators have been surprised by the resoluteness, speed and depth at which sanctions have been applied. Actions such as the removal of Russia from SWIFT and MFN status, and freezing access to its foreign reserves are all “new”. New Zealand’s bespoke actions are an example in this regard.

Private sector businesses have responded to government, shareholder and consumer demands and sentiment cutting investment, stopping sales and even withdrawing from Russia entirely.

While Russia is actively seeking out partners to mitigate the effect of the sanctions imposed on it, including developing alternative or standalone payment systems, it is only likely to be partially successful for both substantive and geo-political reasons. The US for example, has said that it will take action against third countries who undermine the measures imposed on Russia. China is much more integrated into the global economy than Russia and the economic costs of similar sanctions being imposed on them would be much larger.

We do not expect attempts to advance alternative payment systems to make much progress at a global level. This is not to say bilateral or small group arrangements will not emerge. But the US dollar dominated, advanced economies financial and trade system is unlikely to be materially threatened for some time.

Nevertheless, the end result is still likely to be a more fragmented, less efficient global financial system (even if digitalisation and the advent of new technologies such as digital currencies open up alternatives and reduces some costs). Movement between “fragments” will be costly and actors (governments and the private sector) may be forced to choose which they wish to belong to. The IMF Managing Director recently called for the development of a new public payment system to connect various payment systems and counter fragmentation in order to minimise these costs[1].

Financial fragmentation will accentuate pre- and post-pandemic trends in goods and services trade, which has seen a fallback in global trade, a pullback from global trade rules albeit with some regional successes (CPTPP, RCEP etc), an increase in protectionist measures, additional rules around investment flows, and most recently supply chain disruptions as a result of the pandemic and now the Ukraine war. Such fragmentation is also likely to be mirrored in the digital world as some countries such as Russia seek to advance their own version of the internet and others look to control the flow of information, further impeding the cross-border flow of digital services.

While some COVID-19 related disruptions, such as shipping and transport delays, will reduce over time, other aspects of the pandemic experience could be reinforced. Wariness about future conflicts and/or sanctions could see countries and businesses seek to bring global supply chains, including for food, closer to home. It could also see greater redundancy built into supplies and supply chains.

Changes to reserves management

One of the sanctions imposed on Russia has been freezing the foreign assets of the central bank, meaning it is unable to access most of its large foreign reserves. This has reduced Russia’s ability to use these resources to prop up its economy and finance the war, as well as service foreign debt obligations from this source. It has also impacted liquidity in the banking system and increased the likelihood of a Russian debt default.

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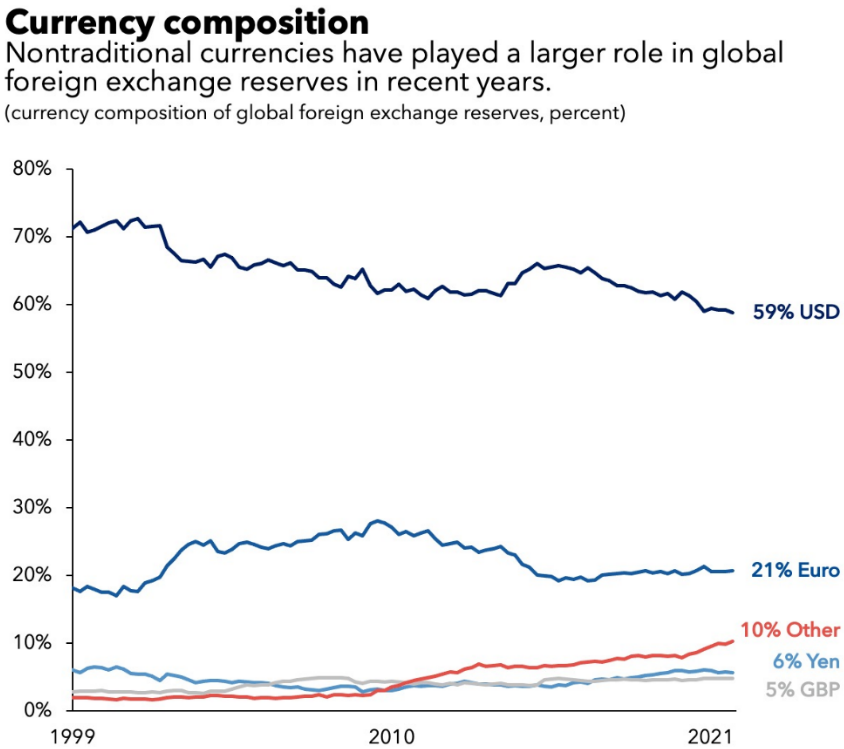
1 https://www.imf.org/en/News/Articles/2022/05/10/sp051022-md-concluding-remarks-at-the-snb-high-level-conference?utm_medium=email&utm_source=govdelivery

This may cause other countries to reassess their policies towards holding foreign reserves. China, in particular, operates its capital controls and managed exchange rate regime through the management of foreign reserves, and has accumulated a huge stock of US debt. China and others may seek to diversify their reserve holdings or rethink their macroeconomic strategy in a direction that involves fewer reserves.

Governments that fear future exclusion from the global financial system make seek alternative means to make payments, such as Russia advancing its own version of the SWIFT payments system for the purposes of trading with nearby countries. One possibility is that the development of digital currencies – be they sovereign or not – could be spurred on. Alternative payments systems could require new forms of regulation.

However, the options for widespread movement away from US Dollars (and other Western country alternatives) for both transactions and reserves is quite limited in the short- to medium-term. The US Dollar dominance has been on a downtrend but it still comprises ~59% of global reserves today (see Figure 8). In contrast the Chinese Yuan comprises only 3% of global reserves currently, and Russia holds around one third of these reserves[2].

Figure 8: The US Dollar's role has declined but it is still dominant



Sources: IMF Currency Composition of Official Foreign Exchange Reserves (COFER).

Note: The "other" category contains the Australian dollar, the Canadian dollar, the Chinese renminbi, the Swiss franc and other currencies not separately identified in the COFER survey. China became a COFER reporter between 2015 and 2018.

2 See https://blogs.imf.org/2022/06/01/dollar-dominance-and-the-rise-of-nontraditional-reserve-currencies/

Multilateral cooperation could falter

We have seen Russia's access to, and operations within multilateral organisations curtailed or cut. While this may help in the short-term by imposing costs on Russia, the long-term consequence could be to weaken the influence these multilateral institutions have on the global economy. One consequence could be a reduced ability to cooperate on matters of importance that require global cooperation, such as climate change, the pandemic response and addressing food shortages. The WTO experience over recent years with its appellate body is salutary. The actions of China (and other large countries like India) in these institutions will have an important influence on future effectiveness.

Higher interest rates and inflation

One consequence of this retreat from globalisation will be an extended period of higher inflation and/or higher interest rates. Globalisation has been a key factor in global macroeconomics over the past decade. Increasing access to China's cheaply produced goods contributed to low global inflation, allowing central banks around the world to keep interest rates low. China's abundance of savings also contributed to a secular decline in interest rates. If the world retreats from globalisation, operates "just in case" rather than "just in time" supply chains, and fragments into smaller trading blocks, then the cost of producing goods will be higher than otherwise.

This could prompt a long period of higher inflationary pressure, requiring central banks to keep interest rates higher than we became used to over the past decade. There could also be upwards pressure on neutral interest rates from increased global risk aversion, a more fragmented global financial system, and increased fiscal deficits, coming on top of secular trends like ageing populations and climate change.

If central banks are slow to respond to structurally higher inflation and/or higher neutral interest rates, then inflation could remain at elevated levels for an extended period.

Higher interest rates could stress government balance sheets. They could also cause a painful and possibly disruptive decline in asset prices, which have been pumped up in recent decades by steadily falling interest rates. However, structurally higher interest rates would leave more room for monetary policy to manoeuvre through economic cycles without hitting zero interest rates.

Fiscal pressures

As governments turn inwards and households come under increasing cost-of-living pressure, pressure for fiscal spending will intensify. Structurally, government spending is probably past its "golden period", with most forces operating to see spending increase over time. National security spending is likely to increase as governments respond to security concerns, adding to fiscal challenges from climate change, ageing populations and increased focus on reducing inequality. Cumulatively, this will add to the upward pressure on interest rates via increased economic demand and government borrowing. At the same time as pressure to spend increases, higher interest rates could reduce the sustainability of already high(er) government debt loads.

Fiscal-monetary coordination was the hallmark of the pandemic response. So far, central banks have stuck with a hawkish stance, but fiscal authorities have enacted easing policies (such as tax credits and reduction in fuel taxes) to soften the blow from surging energy prices. Thus, coordination seems to have given way to a division of labour, with central banks addressing inflation and legislatures tackling growth and supply issues. Central banks with less independence could come under political pressure to keep interest rates low, resulting in even-higher inflation.

Security ahead of trade?

War will further advance thinking about economic security in the minds of governments, with national security increasingly intertwined with economic policy. The use of economic tools to achieve geo-political objectives could make it harder to grow and maintain ties between countries that have divergent security interests, further reducing the globalisation dividend from trade. The increasing use of trade sanctions and counter-sanctions also creates risks from 'economic coercion' whereby foreign states threaten economic harm on another country in an attempt to influence decision making. This can be overt (such as via tariffs) or more covert through the use of informal barriers such as customs measures. As a highly trade reliant country, such issues pose risks to New Zealand and underline the importance of assessing the resilience and diversity of our trading markets and supply chain connections.

Food shortages and rising prices

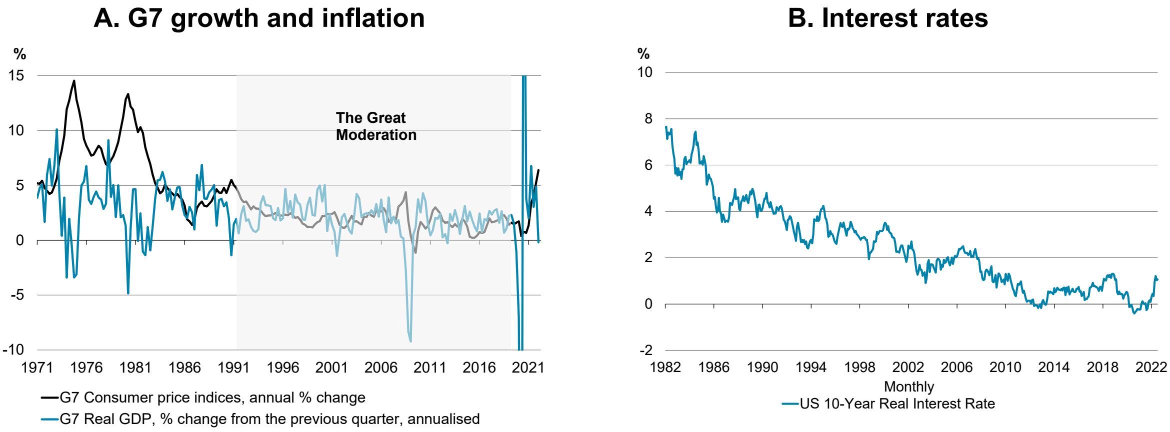
Food prices were high prior to the war in Ukraine, as demand outstripped supply. The war in Ukraine has added to supply concerns and pushed prices up further. Food shortages and rising prices will have humanitarian implications and may cause civil unrest, particularly in developing countries. It will also increase incentives for countries to take steps to secure food supplies, or accelerate measures that are already in place such as export bans or efforts to improve self-sufficiency. In developing countries, food shortages will reduce focus on other investments important to development, increasing the need for economic assistance.

While food price increases will be positive for New Zealand's exports, food security measures and any broader retreat from globalisation may pose risks in the longer term. Domestically, higher food prices will have distributional impacts as the impacts of inflation are felt by low-income households in particular.

Alternative scenarios

Our central view is that the war will exacerbate the retreat from globalisation that has been in train in recent years. This marks a real shift from the era of increasing globalisation that prevailed from the mid-1980s until the mid-2010s. That period was characterised by more macroeconomic stability and predictability (see Figure 9). It benefited from sustained falls in inflation, interest rates and risk premia. Easing geo-political tensions, supply side reforms, deregulation, and the end of capital controls led to greater integration of global capital markets and greater trade. One notable consequence was a general reduction in global interest rates as risk premia fell, cheap globalised production kept inflation quiescent, and abundant Chinese savings entered global capital markets.

Figure 9: Growing globalisation contributed to the "Great Moderation" of macro variables



Sources: OECD, Federal Reserve Bank of St. Louis, the Treasury

A reversal of these underlying forces, combined with heightened national and economic security concerns, will show up in a range of different outcomes relative to what we've come to observe over recent decades. The "central view" column of Table 1 below presents a stylised view of what such a scenario might look like across a number of different dimensions. This list is non-exhaustive and there are other key aspects of well-being that would be impacted by a more "fractured" global economy. For instance, social capital is likely to be lower in such a world, and distributional outcomes across and within countries more variable.

In the central scenario we would likely see lower trend growth as a result of increased cost structures and less innovation, more inflation pressures and higher nominal interest rates. Governments are likely to face greater spending pressures to support national security and energy transitions. In this scenario we would expect countries to continue work together in areas like climate change where international cooperation is necessary to achieve the desired outcomes, although progress could be slower. Higher energy prices and efforts to increase independence (or reduce dependence on Russia) could presage a faster transition to cleaner energy, at least in some regions.

Table 1 – A more or less fractured world?

	Less fractured ⟷		**More fractured**
	“Adjusted status quo”	**“Central view”**	**“Rupture”**
Growth and productivity	Limited last impact on trend growth, recovery from pandemic continues.	Move from “peace dividend” to “geo-political tax” sees lower trend growth due to higher costs and less innovation. Slower real income growth with more uneven distribution.	World becomes increasingly bifurcated into two economic blocs aligned around the US and China. Growth becomes more volatile in the face of more frequent economic or geo-political “shocks”. Widening of gap between less and more developed countries.
Inflation and interest rates	Somewhat higher inflation and thus higher nominal interest rates than before the pandemic.	Less disinflationary forces operating on prices. Higher inflation pressures on average. Central banks must “work harder” to stabilise inflation expectations.	
Exports, foreign direct investment (FDI), and financial linkages	Future trends in trade and global capital flows translate into an evolution of, rather than an end to, globalisation. Increased focus on the contribution of “globalisation” to promoting domestic economic and social goals. Companies choose to overstock inventories as their preferred method for improving the resiliency of their supply chains.	Restructuring of trade and FDI linkages. Increased “friend-shoring” leads to slowdown in global trade growth and higher cost structures. Use of sanctions becomes more common. Payments systems become more piecemeal increasing costs and risks of losses and contagion.	Technology decoupling between the US and China significantly accelerates in severity and scope. Greater efforts to develop competing global payments systems.

	Less fractured	⟷	More fractured
	"Adjusted status quo"	**"Central view"**	**"Rupture"**
Government spending, taxes and debt	Fiscal cost of financing war and reconstructing Ukraine. Higher debt servicing.	Fiscal cost of reconstructing Ukraine. Increased national security and energy transition spending. Higher nominal interest rates increase the cost of debt servicing.	
Energy	Higher prices, supply disruptions, additional cost of alternative sourcing.	Additional investment in energy infrastructure is necessary, whether to accelerate the transition to renewables or facilitate re-routed fossil fuels trade (eg, new LNG terminals in Europe to receive North American gas).	
Food	Higher prices until supply responds. Shorter term food shortages in developing countries, leading to limited social and political unrest. Globally there are few, and only temporary, measures to secure food supply, due to effective multilateral cooperation.	Higher prices. Severe food shortages in 2022 and 2023 in developing countries, resulting in social and political unrest. Some countries take permanent measures to secure food supply domestically.	Higher prices. Severe food shortages in 2022 and 2023 in developing countries resulting in social and political unrest, and increased global instability. Countries take widespread and permanent measures to secure food supply domestically, reducing global trade in food.
Multilateral cooperation	Continues albeit with some frictions between "economic and political blocs". Potential drive toward closer policy integration within the EU.	"Economic/political blocs" see less progress on some global economic challenges, but cooperation continues where mutually beneficial, eg, climate change or global public health.	Very limited. Key global multilateral institutions largely dysfunctional.

Around this central view, both more and less benign outcomes are possible. The war could represent more of a "tipping point" or "rupture" for geo-politics and the global economy. The world becomes increasingly bifurcated into two economic blocs aligned around the US and China. One implication of such a scenario is that countries could come under increased pressure to "choose a side" and face an increased prospect of economic coercion to influence a government's decisions. Risk of geo-political miscalculations and hence conflicts would be higher. The economic and broader wellbeing costs of such a fracturing are likely to be much more marked, including a reversal of the poverty reduction gains of the past few decades.

Conversely, if the Ukraine conflict can be quarantined enough (and Russia sufficiently isolated) to avoid broader geo-political and economic ruptures an outcome similar to the current status quo may be possible, albeit still with some reversal of the economic drivers of the past 30 years. Moreover, this scenario might see increased cooperation between Western democracies continue, resulting in faster progress on global policy challenges.

A key influence on which of these scenarios eventuates is likely to be the actions of China given it substantially greater global importance across both economic and geo-political dimensions. Actions to explicitly support Russia, either militarily or to mitigate the impact of sanctions, could push the world more towards the "rupture" scenario depending on how Western countries reacted. Conversely a broad continuation of the current situation would likely see the "adjusted status quo" or "central" scenarios playout.

Each of these scenarios imply different trade-offs, where they exist, between national security, economic security and economic efficiency as governments and the private sector assess the nature of challenges, risks and opportunities in front of them.