



Long Reads

Russia's War and the Global Economy

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NEW YORK – In late December, I warned that 2022 would prove to be much more difficult than 2021 – a year when markets and economies around the world fared well overall, with growth rising above its potential after the massive recession in 2020. By the eve of the new year, it had become apparent that the surge of inflation would not be merely temporary, that the ever-mutating coronavirus would continue to sow uncertainty around the world, and that looming geopolitical risks were becoming more acute. First among the three geopolitical threats that I mentioned was Russian President Vladimir Putin’s massing of troops near its border with Ukraine.

After two months of stop-start diplomacy and bad-faith negotiations on the part of the Kremlin, Russia has now launched a full-scale invasion of Ukraine, in what American officials say is an operation to “decapitate” the current democratically elected government. Despite repeated warnings from the Biden administration that Russia was serious about going to war, the images of Russian tanks and helicopter squadrons blitzing through Ukraine have shocked the world.

We now must consider the economic and financial consequences of this historic development. Start with a key geopolitical observation: This is a major escalation of Cold War II, in which four revisionist powers – China, Russia, Iran, and North Korea – are challenging the long global dominance of the United States and the Western-led international order that it created after World War II. In that context, we have entered a geopolitical depression that will have massive economic and financial consequences well beyond Ukraine.

In particular, a hot war between major powers is now more likely within the next decade. As the new cold war rivalry between the US and China continues to escalate, Taiwan, too, will increasingly become a potential flashpoint, pitting the West against the emerging alliance of revisionist powers.

A Stagflationary Recession

A major risk now is that markets and political analysts will underestimate the implications of this geopolitical regime shift. By the close of the market on February 24 – the day of the invasion – US stock markets had risen in the hope that this conflict will slow down the willingness of the US Federal Reserve and other central banks to raise policy rates. But the Ukraine war is not just another minor, economically and financially inconsequential conflict of the kind seen elsewhere in recent decades. Analysts and investors must not make the same mistake they did on the eve of World War I, when almost no one saw a major global conflict coming. Today's crisis represents a geopolitical quantum leap. Its long-term implications and significance can hardly be overstated.

In terms of the economy, a global stagflationary recession is now highly likely. Analysts are already asking themselves if the Fed and other major central banks can achieve a soft landing from this crisis and its fallout. Don't count on it. The war in Ukraine will trigger a massive negative supply shock in a global economy that is still reeling from COVID-19 and a year-long build-up of inflationary pressures. The shock will reduce growth and further increase inflation at a time when inflation expectations are already becoming unanchored.

The short-term financial market impact of the war is already clear. In the face of a massive risk-off stagflationary shock, global equities will likely move from the current correction range (-10%) into bear market territory (-20% or more). Safe government bond yields will fall for a while and then rise after inflation becomes unmoored. Oil and natural gas prices will spike further – to well above \$100 per barrel – as will many other commodity prices as both Russia and Ukraine are major exporters of raw materials and food. Safe haven currencies such as the Swiss franc will strengthen, and gold prices will rise further.

The economic and financial fallout from the war and the resulting stagflationary shock will of course be largest in Russia and Ukraine, followed by the European Union, owing to its heavy dependence on Russian gas. But even the US will suffer. Because world energy markets are so deeply integrated, a spike in global oil prices – represented by the Brent benchmark – will strongly affect US crude oil (West Texas Intermediate) prices. Yes, the US is now a minor net energy exporter; but the macro-distribution of the shock will be negative. While a small cohort of energy firms will reap higher profits, households and businesses will experience a massive price shock, leading them to reduce spending.

Given these dynamics, even an otherwise strong US economy will suffer a sharp slowdown, tilting toward a growth recession. Tighter financial conditions and the resulting effects on business, consumer, and investor confidence will exacerbate the negative macro consequences of Russia's invasion, both in the US and globally.

The coming sanctions against Russia – however large or limited they turn out to be, and however necessary they are for future deterrence – inevitably will hurt not only Russia but also the US, the West, and emerging markets. As US President Joe Biden has repeatedly made clear in his public statements to the American people, “defending freedom will have costs for us as well, here at home. We need to be honest about that.”

Moreover, one cannot rule out the possibility that Russia will respond to new Western sanctions with its own countermeasure: namely, sharply reducing oil production in order to drive up global oil prices even more. Such a move would yield a net benefit for Russia so long as the additional increase in oil prices is larger than the loss of oil exports. Putin knows that he can inflict asymmetrical damage on Western economies and markets, because he has spent the better part of the last decade building up a war chest and creating a financial shield against additional economic sanctions.

Damage Control Is Limited

A deep stagflationary shock is also a nightmare scenario for central banks, which will be damned if they react, and damned if they don't. On one hand, if they care primarily about growth, they should delay interest-rate hikes or implement them more slowly. But in today's environment – where inflation is rising and central banks are already behind the curve – slower policy tightening could accelerate the de-anchoring of inflation expectations, further exacerbating stagflation.

On the other hand, if central banks bite the bullet and remain hawkish (or become more hawkish), the looming recession will become more severe. Inflation will be fought with higher nominal and real policy rates, increasing the price of money, and thereby dampening the overall economy. We have seen this movie twice before, with the oil-price shocks of 1973 and 1979. Today's re-run will be almost as ugly.

Although central banks should confront the return of inflation aggressively, they most likely will try to fudge it, as they did in the 1970s. They will argue that the problem is temporary, and that monetary policy cannot affect or undo an exogenous negative supply shock. When the moment of truth comes, they will probably blink, opting for a slower pace of monetary tightening to avoid triggering an even more severe recession. But this will de-anchor further inflation expectations.

Politicians, meanwhile, will try to dampen the negative supply shock. The US will try to mitigate the increase in gasoline prices by drawing down its Strategic Petroleum Reserves, and by nudging Saudi Arabia to use its spare capacity to increase its own oil production. But these measures will have only a limited effect, because widespread fears of further price spikes will result in global hoarding of energy supplies.

Under these new circumstances, the US will feel even more pressure to reach a *modus vivendi* with Iran – another potential source of oil – on reviving the 2015

nuclear deal. But Iran is effectively allied with China and Russia, and its leaders know that any deal they do today could be tossed aside in 2025 if Donald Trump or a Trump wannabe comes to power in the US. A new nuclear deal with Iran is thus unlikely. Worse, in the absence of one, Iran will continue to advance its nuclear program, heightening the risk that Israel will launch a strike against its facilities. That would deliver a double-whammy negative supply shock to the global economy. The upshot is that various geopolitical constraints will severely limit the West's ability to counter the stagflationary shock inflicted by the war in Ukraine.

A New-Old Problem

Nor can Western leaders rely on fiscal policy to counter the growth-dampening effects of the Ukraine shock. For one thing, the US and many other advanced economies are running out of fiscal ammunition, having pulled out all the stops in response to the COVID-19 pandemic. Governments have amassed increasingly unsustainable deficits, and servicing these debts will become much more expensive in an environment of higher interest rates.

More to the point, a fiscal stimulus is the wrong policy response to a stagflationary supply shock. Though it may reduce the negative growth impact of the shock, it will add to inflationary pressure. And if policymakers rely on *both* monetary and fiscal policy in responding to the shock, the stagflationary consequences will become even more severe, owing to the heightened effect on inflation expectations.

The massive monetary and fiscal stimulus policies that governments rolled out after the 2008 global financial crisis were not inflationary because the source of that shock was on the demand side, driven by a credit crunch at a time when inflation was low and below target. The situation today is entirely different. We are facing a negative supply shock in a world where inflation is already rising and well above target.

It is tempting to think that the Russia-Ukraine conflict will have only a minor and temporary economic and financial impact. After all, Russia represents merely 3% of the global economy (and Ukraine much less). But the Arab states that imposed an oil embargo in 1973, and revolutionary Iran in 1979, represented an even smaller share of global GDP than Russia does today.

The global impact of Putin's war will be channeled through oil and natural gas, but it will not stop there. The knock-on effects will strike a massive blow to global confidence at a time when the fragile recovery from the pandemic was already entering a period of deeper uncertainty and rising inflationary pressures. The knock-on effects of the Ukraine crisis – and from the broader geopolitical depression it augurs – will be anything but transitory.

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