Ukraine conflict could change the energy landscape

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Executive Summary

The Ukraine conflict could dramatically increase near-term downside risks to the global economy by sparking energy inflation and, in turn, prompting the Fed to sharply tighten US monetary policy. Additionally, contraction in Russia's energy supplies due to sanctions could keep energy prices elevated to the long-term detriment of the global economy.

Ukraine conflict poses big risk to global economy

Russia's invasion of Ukraine could dramatically increase near-term downside risks to the global economy through, e.g., energy inflation. The IMF cut its 2022 and 2023 global real GDP growth forecasts in its April World Economic Outlook to +3.6% apiece from +4.4% and +3.8%, respectively, as of January. The biggest factor behind the downward revisions was the economic impact of G7 sanctions against Russia.

For Ukraine and Russia, the IMF is forecasting 2022 growth rates of -35.0% and -8.5%, respectively.

However, with Russia accounting for 1.7% global GDP in 2021 (per IMF estimate), even its economy were to shrink 10% in 2022, the resultant drag on global GDP would be a mere -0.17%. The Ukraine conflict's direct negative impact on the Russian and Ukrainian economies is far outweighed by global spillover effects, most notably higher energy prices due to the sanctions and accelerated monetary tightening in response thereto by the Fed and other major central banks.

From such a standpoint, the near-term global economic outlook hinges largely upon whether additional sanctions are imposed on Russia. The IMF has warned that if Russian energy exports are further restricted by escalation of sanctions against Russia, spillovers such as energy inflation, deterioration in corporate and household sentiment and financial market volatility may ensue, potentially leading to further downward revision of the global economy's forecasted growth rate by as much as two percentage points.

Russian economy hard hit by sanctions

Whether the coordinated sanctions against Russia in response to its invasion of Ukraine directly precipitate a Russian ceasefire remains to be seen, but they have dealt a heavy blow to the Russian economy over at least the short term and likely longer.

The expulsion of major Russian banks from SWIFT, the world's largest interbank payments system, and G7 governments' freeze of the Central Bank of Russia's FX reserves on deposit at their central banks have undeniably had a major impact on Russian trade and economic activity.

That said, Russia has partially recovered from the sanctions' initial impacts, including a surge in import price inflation stemming from a roughly 50% depreciation in the ruble in response to the first round of sanctions, particularly the freeze on FX reserves. For the first three weeks following the invasion, Russian consumer prices shot up at an annualized rate of around 100%. This spike in inflation presumably weighed heavily on domestic consumer spending.

From mid-March, however, the ruble started to rebound from its collapse and was soon back above its pre-invasion level. Its recovery was chiefly attributable to a regulation requiring Russian exporters to convert into rubles at least 80% of the foreign currency received in exchange for their exports. With energy, Russia's biggest export, exempted from direct sanctions, mainly in Europe, total exports have held up fairly well, decreasing only mildly. Meanwhile, the sanctions have reduced imports more than exports, expanding Russia's trade surplus. Additionally, with exporters mandatorily exchanging 80% of their foreign currency revenues for rubles, demand for rubles increased in the FX market. The extra demand has helped drive the ruble's surprising recovery. As a result, inflation has recently eased and domestic economic distress has attenuated relative to the invasion's immediate aftermath.

EU and Japan may crack down harder on energy imports from Russia

To inflict additional economic pain on Russia through a further decrease in Russian exports or renewed ruble depreciation, Europe and/or Japan would have to further

curtail or completely halt their energy imports from Russia. The US and Canada have already stopped importing energy from Russia.

In early April, the EU and Japan decided to ban imports of Russian coal. On May 8, G7 heads of state committed to phasing out or banning imports of Russian crude oil. On May 31, EU-member countries agreed to ban seaborne imports of Russian oil.

If Russian war crimes against Ukrainians come to light or Russia escalates hostilities through such means as resorting to biological or chemical weapons, the EU could conceivably ban imports of Russian natural gas in deference to international opinion. A ban on Russian gas imports would hurt European economies even more than banning coal or crude oil imports. If the EU were to ban gas imports, Japan would likely follow suit.

Russia may not be a resource superpower for much longer

Russia's 2021 crude oil production of 10.52mn bpd accounted for some 12% of global production. Sanctions imposed to date, however, have reduced the supply of Russian oil as of May by nearly 3mn bpd or ~30% of Russia's pre-invasion crude oil production. This decrease is equivalent to 3-4% of global crude oil supplies, per an IEA estimate.

Previously sanctioned oil-producing countries like Iran and Venezuela have experienced severe losses of oil production capacity and have yet to restore pre-sanction production levels. Russia may suffer a similar fate. Russian energy supplies could roll over into a medium- or even long-term downtrend as a result of major Western companies deciding to exit Russian energy businesses. Big development projects throughout Russia are already being disrupted because Russia is heavily dependent on foreign companies' leading-edge exploration and oilfield maintenance technologies.

Russia's crude oil production has long been projected to peak in the 2020s as its active oilfields age. To develop new fields, Russian oil companies had been seeking to access shale-drilling technologies from the US oil industry, but they now can no longer do so.

Russia looks likely to rapidly fall out of the ranks of energy superpowers. Such an outcome would severely strain global crude oil and natural gas supply-demand balances for a long time and keep energy prices elevated to the detriment of the global economy.

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