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News Analysis

Energy, Economic and Political Repercussions from Russia's War in Ukraine

Introduction

European leaders ramped up their push to secure alternative energy supplies as fears escalate of a complete natural gas cutoff by Russia, with the leaders of Italy, France and the European Union looking to seal gas supply deals with their counterparts in Algeria, Azerbaijan and the United Arab Emirates.

With his government's fate in limbo back home, now acting Italian premier Mario Draghi visited recently Algeria's capital of Algiers, seeking to cement the North African country's role as a preeminent regional partner. "Algeria is a very important partner for Italy, in the energy sector, in the industry and business fields, in the fight against criminality, and in the search for peace and stability in the Mediterranean," Draghi said.

Also, France and the United Arab Emirates recently signed an agreement on energy cooperation to ensure oil and natural gas supplies from the Gulf country. In addition, EU Commission president Ursula von der Leyen was recently in Azerbaijan to clinch a deal with President Ilham Aliyev on increased gas supplies from the former Soviet Republic. The EU wants to double the gas imports from Azerbaijan through the Southern Gas Corridor within half-a-decade. The bloc said the agreement also had guarantees for green energy supplies. Europe has been scrambling to secure alternative energy sources as Russia's war in Ukraine and Moscow's drawdown or cutoff of natural gas flows to a dozen EU countries have triggered soaring energy prices, inflation and growing expectations of a recession.

The 27-nation EU is now bracing for the possibility of a complete Russian cutoff of natural gas that powers industry, generates electricity and heats homes in winter. Leaders have been pushing to fill underground gas storage to try to avert a worsening energy crisis when the cold months arrive. In an effort to increase EU security of energy supply, member states reached on July 26 a political agreement on a voluntary reduction of natural gas demand by 15% this winter. **(1)**

Political Repercussions of Russia's War on Ukraine

The resignation of Britain's and Italy's prime ministers, the internal problems of France's president Emmanuel Macron and the weakness of German Chancellor Olaf Scholz are only a sample of the political destabilization that has been recently emerged as a result of the policies applied against Russia due to its invasion in Ukraine.

More specifically, UK Prime Minister Johnson resigned on July 7, 2022, bringing an acrimonious end to a nearly three-year premiership that has been beset by controversy and scandal. Johnson's resignation came after a 48-hour period of immense pressure to step down. A growing wave of resignations from within Johnson's own ruling party since July 5 evening approached 60 by July 7 morning, with one Conservative Party member after another publicly voicing their lack of confidence in the prime minister. **(2)**

On July 13, 2022, minutes after the former president of the European Central Bank (ECB) Mario Draghi presented his resignation to the head of state, Sergio Mattarella, a disturbing signal came from Moscow. Former President and former Prime Minister Dimitri Medvedev published a post on Telegram where you could see a photo of the still British Prime Minister, Boris Johnson, another of Draghi and a black box with a question mark. The message was clear: Who will be next?

Russia is watching with interest the Italian crisis, about which its Foreign Ministry also weighed in on July 15. The resignation of Draghi, an apostle of the euro and a moral leader in a weakened Europe, is seen as another political victory since the war began. Especially at a time when Johnson has announced his resignation; French President Emmanuel Macron is experiencing internal problems with a Parliament in which he does not have a majority and German Chancellor Olaf Scholz is showing signs of weakness.

Igor Pellicciari, professor of International Relations at the University of Urbino and an expert on Russia, believes that “one of Europe’s problems since the 1990s has been the fall of charismatic leadership”. “The only ones, in a way, were now Johnson and Draghi, although for different reasons. And from a symbolic point of view, their resignations have a very strong psychological impact on Russian public opinion”, he notes. “Losing those two leaders is important. We don’t know exactly who Scholz is yet, they keep voting for Macron because they think that Le Pen is worse; Von Der Leyen is a weak leader, Borrell is not up to the task of predecessors like Javier Solana… Having said that, I don’t think that Draghi’s resignation will change the political line of the EU”, he points out. **(3)**

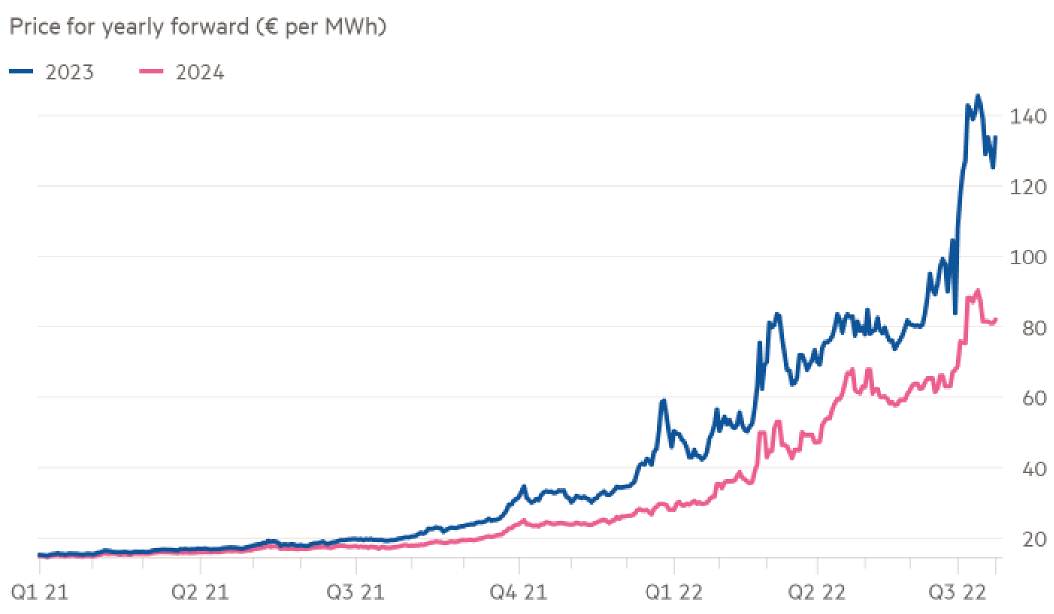
Italy was for years the country with the most important Communist Party on the other side of the Iron Curtain. The influence endured. And the governments that preceded Draghi - from the two populist executives of Giuseppe Conte to the three of Silvio Berlusconi - always maintained more ambiguous positions in the relationship with Russia than the rest of the EU. The spokeswoman for the Russian Foreign Ministry, Maria Zakharova, perhaps because of this inertia, assured on July 14 that she expected the Italian people to have a government that does not serve the interests of the Americans. She did so, precisely, shortly before the White House contacted Draghi and his spokeswoman remarked that President Joe Biden has great esteem for the Italian and follows the development of the crisis with interest. A call also came to Rome from the Elysee to learn first-hand about the Prime Minister’s plans, while Borrell warned of Russian interference in the political turmoil in some EU countries. Italian instability, in short, is of concern far beyond the Alps.

The international scope of this crisis, in any case, would be comparable to the one that ousted Silvio Berlusconi from power in 2011 after the famous knowing smile between Nicolas Sarkozy and Angela Merkel, then President of France and Chancellor of Germany, respectively. But the situation was the opposite. In that period, the country reduced its per capita income by 3.1%, according to the International Monetary Fund (IMF), the worst figure in the EU in that decade. Consumption fell by 8% and food spending by 36%. The fiscal pressure increased 1.6 points but spending on education decreased by 10.7% or that of culture by 30%. The risk premium finally brought down Berlusconi in the fall of 2011, when he hit his all-time high: 574 points. Today the additional cost that Italy pays for its debt is much lower: 223 points.

Draghi represents for the markets the opposite of what Berlusconi radiated. But the situation could get worse. And that also worries in Brussels. If he decides to uphold his decision and elections are called for the end of September, the reform plan required by the EU for access to the European Recovery Fund will have to be interrupted. The scheme of the budget law would also be delayed, a particularly important rule this year to shield Italy from the crisis derived from the war in Ukraine.

On July 14, 2022, French President Emmanuel Macron said France must quickly learn how to do without Russian gas, as Moscow is using gas cuts to Europe as a weapon in its war with Ukraine, urging everyone to rein in their energy consumption. Speaking in a televised interview to mark France’s national day, Macron said he would soon submit an “energy restraint plan” which would ask all citizens to commit to a general “hunt for waste”, such as turning off the light when leaving the office. **(4)**

Figure 1: European Gas Prices Expected to Remain Elevated for Years



Sources: Refinitiv, Financial Times

Energy prices, which were already increasing before Russia launched its war against Ukraine at the end of February, have sharply risen since then, leading to the highest inflation in most major global economies in decades. With about 17% of its supply coming from Russia, France is less dependent on Russian gas than some of its neighbours. But concerns about supply from Russia come as France grapples with already limited electricity generation due to unexpected maintenance at its aging nuclear reactors, prompting concern over winter shortages. To shield consumers from sky-rocketing energy bills, the government put in place last year a cap on electricity and gas prices, a measure that has been extended until the end of the year.

Economic Repercussions of Russia's War on Ukraine

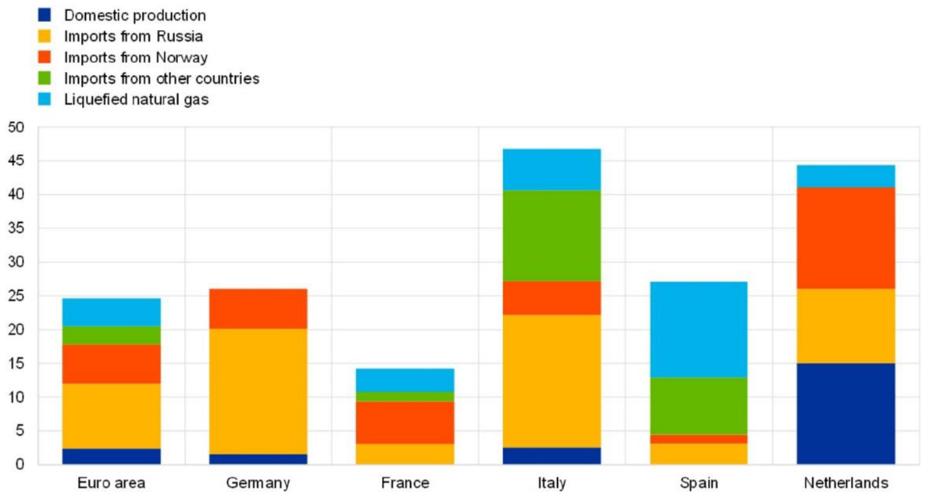
The ECB Economic Bulletin, Issue 4/2022, published on June 23, 2022 **(5)**, includes a special section on the impact of the war in Ukraine on euro area energy markets, which generated a sharp increase in energy prices broad about high volatility in the energy markets. According to ECB, strains on energy supplies from Russia may affect the euro area via both world market prices and direct supplies.

In 2019, Russia's energy production accounted for 12% of the global supply of oil, 5% of coal and 16% of gas. In 2021, the country was the largest supplier of energy commodities to the euro area, corresponding to 23% of total energy imports. Russia accounted for 23% and 43% of euro area crude oil and coal imports respectively in 2020, which represented 9% and 2% of the euro area's primary energy consumption. However, the euro area is particularly dependent on natural gas imports from Russia, which in 2020 amounted to 35% of euro area gas imports and represented 11% of the euro area's primary energy consumption.

Germany and Italy have the highest dependence on Russian gas among the large euro area countries. The degree of substitutability of these energy sources is relevant to any analysis of the economic implications of the war for energy prices and euro area supplies. The sanctions therefore also play a particular role: the EU prohibited the import of Russian coal as of August 2022, and the European Council decided at the end of May to stop most Russian oil imports.

However, to some extent, Russia can make up for the drop in shipments to Europe by redirecting oil exports to other destinations such as India. Still, the ECB observes that signs of significant, persistent reductions in Russian oil production are emerging, and that the Russian oil supply is projected to fall by 25% in the second half of 2022 (compared to the beginning of the year). That reduction would in turn lead to tighter global oil markets, unless other main producers can speed up their production. Still, the ECB reckons - referring to data from IEA - that such scenario would overall result in a downward revision to the global oil supply forecast of just 3%, for the period since the start of the invasion until the end of the year.

Figure 2: Russia Reported A Record Current Account Surplus



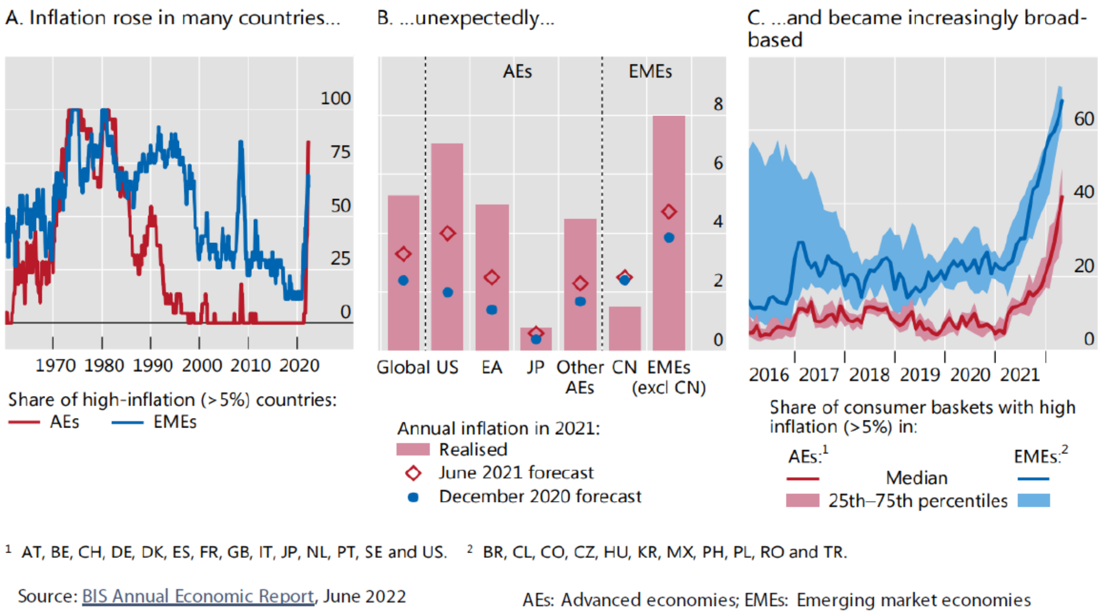
Sources: Eurostat and ECB calculations.
Notes: Imports from other countries include imports from Algeria, Libya and Azerbaijan. EU8 refers to the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia. Liquefied natural gas excludes imports from Russia, Norway and other countries. *adjusted for re-exports. The latest observations are for 2021 for panel a) and 2020 for panel b).

Sources: Eurostat, ECB

Furthermore, on June 26, 2022, the Bank for International Settlements (BIS) published its latest Annual Economic Report **(6)**, warning that the global economy risks entering a new era of high inflation. Stagflation dangers loom large, as a combination of lingering disruptions from the coronavirus pandemic, the war in Ukraine, soaring commodity prices and financial vulnerabilities cloud the economic outlook.

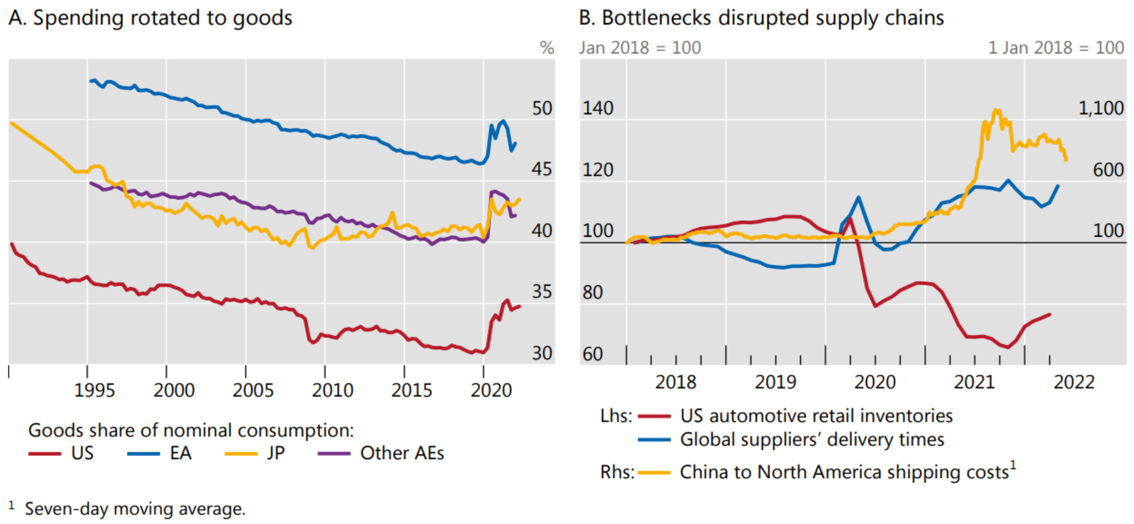
Higher inflation reflected a confluence of factors. First, the recovery from the Covid-19 recession has been unusually rapid, particularly in advanced economies. Massive fiscal and monetary policy support early in the pandemic bolstered household incomes despite large falls in GDP. This income boost – much of which was initially saved – paved the way for spending to bounce back as activity restrictions eased in 2021. Second, the pandemic-induced rotation of aggregate demand to goods from services, especially contact-intensive ones, proved surprisingly persistent. Third, supply failed to keep up with surging demand. In particular, global value chains came under pressure. Bottlenecks emerged in a number of areas, including container shipping and semiconductors, leading to sharp price increases with these supply constraints resulting in large spillovers across industries and countries.

Figure 3: An Unanticipated Rise (%) in Global Inflation



Source: BIS Annual Economic Report, June 2022

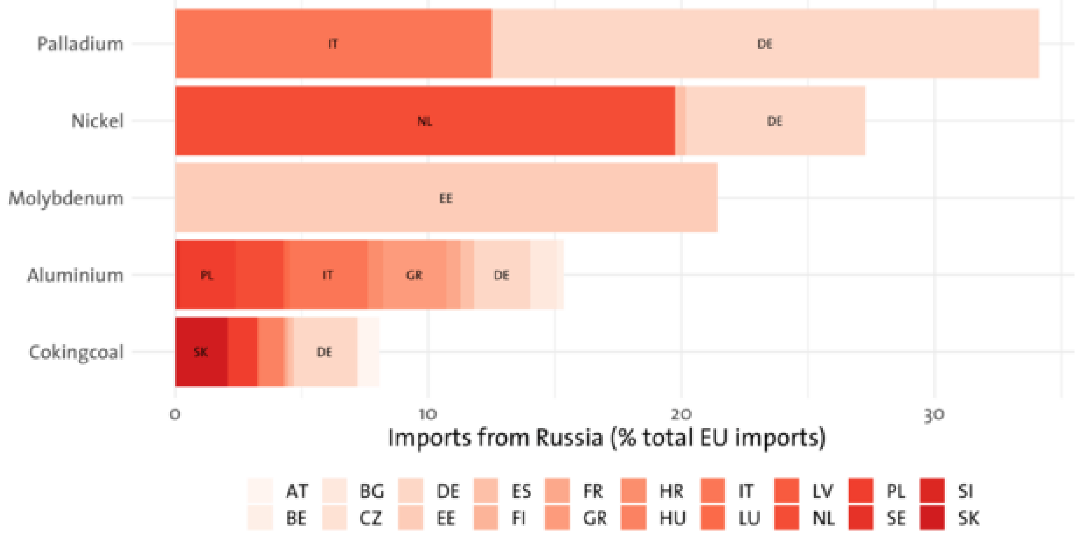
Figure 4: Causes of Higher Inflation: Demand Composition and Supply Constraints



Source: BIS Annual Economic Report, June 2022

Supply was especially tight in energy and other commodity markets, triggering major price increases and higher volatility. In this case, a legacy of low investment by resource producers further restricted supply. Partly as a result, the supply response of marginal producers, such as those of shale oil, fell short of previous ones, which had helped to moderate commodity price shifts in the 2010s. The war in Ukraine further disrupted the global supply of products such as wheat, oil, gas, nickel, palladium and fertilisers.

Figure 5: Imports of Selected Critical Raw Materials from Russia in 2020



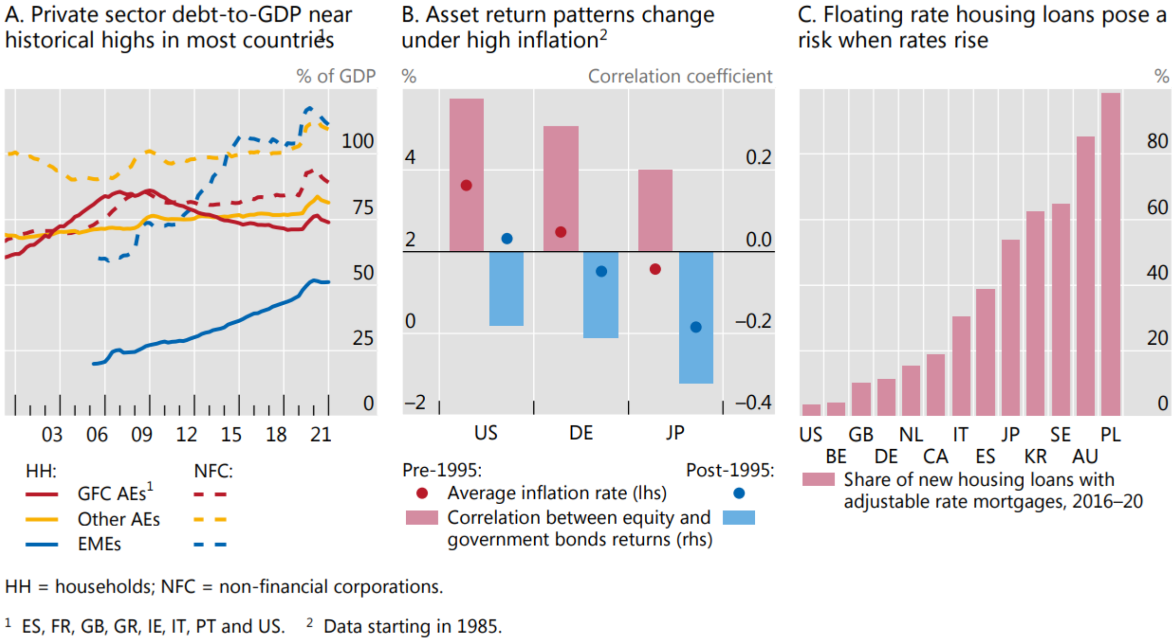
Source: Eurostat

The coexistence of elevated financial vulnerabilities and high inflation globally makes the current conjuncture unique for the post-World War II era. The tighter monetary conditions needed to bring down inflation could cast doubt on assets – including housing – priced for perfection on the assumption of persistently low real interest rates and ample central bank liquidity. The largest strains are likely to be seen in countries where floating rate loans – sensitive to higher policy rates – are more common. In this regard, several small open economies look particularly exposed, at least in their household sectors. In principle, the aggregate savings built up early in the pandemic could provide buffers for households and firms to cope with higher rates, at least initially. However, the incidence of higher savings may not match that of debt burdens.

An economic downturn against the backdrop of high debt levels would test banks' resilience. Credit losses are most likely to accrue in the medium term, after rising policy rates have passed through into market rates and households and firms have exhausted accumulated buffers. The size of credit losses will depend on the degree of required policy tightening. Developments in Non-Bank Financial Intermediaries (NBFIs) could pose greater challenges. Financialised commodity markets are a key pressure point. These markets came under strain when the war in Ukraine broke out, as sharp rises in commodity price volatility triggered large margin calls in derivatives markets.

A broader concern is that the extent of exposures among NBFIs, which could transform stresses at individual institutions into more systemic disturbances, are not well known. The collapse of Archegos Capital Management in April 2021, and the attendant stock market disruptions, is a leading example. In that instance, not only was the capital of Archegos largely wiped out, but several banks that provided it with prime brokerage services also took significant hits to their own capital buffers. While the fallout was ultimately contained, it nonetheless highlights the risks posed by hidden leverage in loosely regulated corners of the financial system.

Figure 6: Financial Vulnerabilities and High Inflation: Where are the Risks?



Source: BIS Annual Economic Report, June 2022

Discussion

The economic knock-on effects of the Russian invasion of Ukraine are already being felt throughout Europe. While the overall economic fallout is still difficult to predict, the impact will be different for different member states. It shows that the EU's member states' economic vulnerability to the Russian invasion of Ukraine is very unevenly distributed. To cushion the economic blow and ensure political unit, the EU will need to share some of the economic burden of this crisis.

Direct costs from sanctions and trade disruptions, rising inflation due to higher energy and commodity prices and mounting uncertainty will become a drag on Europe's economy. After the pandemic, the Russian invasion of Ukraine is yet another external economic shock with asymmetric consequences across Europe.

This unequal distribution of the economic hardship across EU member states is not only an economic problem: it matters politically. Making sure that Europe sticks together in the coming months and possibly years in the face of Russia's aggression will require burden-sharing to avoid some member states being affected much more than others.

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This analysis was contributed by IENE's Research Team

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