

Ukraine Crisis

Putin's war will hurt Russia above all

Dr. Michael Heise on Global Economics
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The Russian attack on Ukraine will have far-reaching global political and economic implications. It has already fundamentally changed the security architecture in Europe. Further developments depend on the outcome of the current crisis. If negotiations begin soon and a ceasefire is reached, the worst could still be averted. If, on the other hand, Russia escalates the war and refuses to negotiate, the security situation in the world and Russia itself will be permanently damaged, and its president will be further removed from the civilian world community.



The current crisis shows in great sharpness that the West has not succeeded in the past 30 years, since the collapse of the Soviet Union, to bind Russia to the Western alliance and to secure a cooperative partnership. The Ostpolitik of the U.S., the EU and also Germany must acknowledge this failure. The Western alliance has not succeeded in turning an enemy into an ally. On the contrary, for many years Russian President Putin has been formulating imperialist goals and implementing them by military means that violate international law. What a contrast to the years of liberalization and the disintegration of the Soviet Union in the early nineties, when a close cooperation of the Western alliance with Russia was discussed and even a NATO accession of the country was not excluded. It is to be hoped that the right lessons will be learned from this development. Certainly, tough sanctions must now be imposed on Russia, and there is no way around rearming military defense capacities. At the same time, however, the path back to the negotiating table must be kept open and the door to the West must not be closed completely.

The economic impact of the crisis

Developments in the coming months will be dominated by great uncertainty about Russian oil and gas supplies and the sanctions in the financial sector. In addition, the loss of inputs from Russia and Ukraine and the blocking of transport routes will cause further production disruptions. For the global economy as a whole, the Ukraine crisis has significantly increased inflation and economic risks.

The sanctions imposed by the West will mean that Russia will no longer have access to needed technologies from the West and will be cut off from the international financial market. This will further weaken the Russian economy, but will not lead to a collapse. The Russian economy is currently in better shape than it was at the time of the Crimean annexation in 2014 due to high energy prices. Russia's public debt is very low relative to GDP (circa 19%), the budget is largely balanced due to high oil and gas prices, and the country has run current account surpluses for many years, resulting in a stock of foreign exchange reserves of circa \$630 billion.

However, the use of foreign exchange reserves held in dollars, euros, pounds, francs or yen is severely restricted by the sanctions. It is not known what share these currencies currently account for in total foreign exchange reserves. Last year, for example, it was observed that dollar holdings tended to be reduced, while the shares of gold reserves and the Chinese yuan increased.

The exclusion of Russian banks from the communication system for international payments (Swift) is likely to have serious consequences for Russia, but also for the Western world. It is questionable to what extent mutually existing claims will still be settled. It is also conceivable that Russia will cut off energy supplies to the West as a counter-sanction, although energy trading may continue to be conducted via Swift. Mr. Putin's nuclear threats show that he knows no red lines.

All these developments will set back the Russian economy in its development and modernization in the long term. Western countries will now strive with even greater vigor for independence from Russian energy sources, and Russia will hardly be able to rely on partnership with Western countries for its technological development. Increased cooperation between Russia and the powerful China can compensate for some deficits, but Russia will find itself in a weak negotiating position.

For China, on the other hand, there is the possibility to get additional energy and raw materials from Russia and to achieve favorable prices due to the East-West conflict. China will be able to increase its influence on Russia and increase the importance of the yuan as a reserve currency. It is among the winners of this crisis.

For the Western world, the crisis means an increase in inflation and greater risks for economic development. Many European countries in particular, which are highly dependent on Russian energy supplies, will have to fear negative repercussions.

For net energy exporters, such as the United States, the rise in energy prices has no negative impact as long as general inflation remains under control.

As an export market for the West, Russia has lost importance in recent decades. Russia has focused unilaterally on oil and gas and neglected to modernize its economy, which would have opened up a wide range of opportunities for cooperation with Western countries. In view of the already low level of goods exports, further setbacks in the wake of the Ukraine crisis should be bearable. Russia is expected to intensify its trade and capital flows with China.

In the short term, the Ukraine crisis will also have an impact on the monetary policy of Western central banks. The heightened economic risks will prompt them to proceed cautiously in exiting from their expansionary policy and tend to delay the planned rise in interest rates. They will not respond to energy price-induced inflationary impulses in the same way as they would to demand-induced inflation. Drastic increases in energy prices always pose a particular risk to the economy and have frequently led to recessions in the past. Central banks will take this risk into account.

Conclusion: Although it is difficult at present to predict the outcome of the fighting and possible political negotiations in Ukraine, at least four trends are foreseeable. First, in the long term, Western countries will become less dependent on energy imports from Russia. Russia will have to look for new markets in Asia, for example. Second, President Putin will not enjoy any trust in the Western world for some time to come and cannot expect any concessions. Third, in view of the military and even nuclear threats, Western countries will again invest more in military defense capabilities. The peace dividend is finally history. Fourth, higher arms investment by the West will also require Russia to continue to invest a very large share of national income in military uses rather than in social and economic development. This is a deeply regrettable prospect.

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