Box 2

The economic impact of the invasion of Ukraine

The Russian army invaded Ukraine on 24 February. The ensuing war has brought devastation to the Ukrainian people, and the economic sanctions imposed on Russia by Western countries will cause significant hardship to the Russians. Uncertainty about the global economic outlook has mounted, and the war could spread to other countries. Asset prices have slid in many markets, and a number of commodities have soared in price. It is therefore clear that the global economic outlook has deteriorated and that inflation will be both higher and more persistent than previously assumed.

This Box discusses the main channels through which the war will affect the global economy and the war's potential impact on economic activity and inflation.

The economic impact of the war will be greatest in Ukraine and Russia

After the Russian army's ceaseless attacks on Ukrainian cities and infrastructure, it is clear that the Ukrainian nation will be faced with a monumental task in rebuilding their country once the war is over. Large numbers of people have been killed, and millions have fled their homes or left the country entirely. Cities, manufacturing equipment, and infrastructure have been destroyed. Reconstruction will therefore take time and cannot be accomplished without the involvement of the international community, including direct financial contributions and debt restructuring.

The economic impact on Russia will also be substantial, albeit of a different type. In the wake of widespread sanctions and ostracism from the global community, Russia is now isolated. Asset prices in Russia plummeted, and financial conditions deteriorated severely as a result of pressure on the domestic banking system and closure of access to foreign financing. The Russian central bank imposed capital controls and raised interest rates significantly to protect the rouble, although the freeze imposed on a large share of its foreign exchange reserves has greatly limited its room for manoeuvre. Furthermore, a number of Russian banks have been refused access to the SWIFT payment messaging system, which makes it far more difficult for Russian companies and the banks themselves to carry out and settle cross-border transactions. A host of international firms have discontinued business activities in Russia, and companies the world over have stopped doing business with Russians and have severed their ties with companies in the country. The US has prohibited the importation of fossil fuels from Russia, and the UK is planning to cease all imports of Russian oil by the end of 2022. The EU has also announced a ban on coal imports from Russia and is planning to reduce its imports of Russian natural gas by two-thirds within a year.

It is difficult to estimate the impact this will have on economic activity in Ukraine and Russia, but it will clearly be substantial. According to the International Monetary Fund's (IMF) (2022), GDP in Russia could contract by some 8.5% this year, and inflation could rise above 20%. In Ukraine, the contraction in output will be even more severe, or around 35%.

The impact of the conflict through the trade channel

One channel for the impact of the war on the global economy lies through trade relationships with Russia and Ukraine. Important export markets could be lost because of the war and the associated sanctions. By the same token, the war could cause world trade to snarl up, owing to shortages of important inputs from Russia and Ukraine that companies in other countries need for their own production.

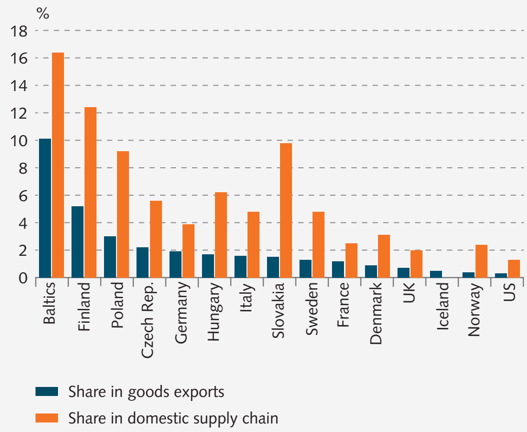
Although the effects on individual firms and sectors could be measurable, the direct damage due to lost trade with Russia will probably be relatively limited. The Russian economy accounts for less than 2% of the global economy, about the same as Australia and only 7% of the US economy. The weight of advanced economies' exports to Russia is similarly low. Russia accounts for only 0.3% of US goods exports, for instance, and 0.7% of UK goods exports (Chart 1). Among advanced economies, EU countries are probably the most exposed, Germany in particular, yet only 1.9% of German goods exports are sold to Russia. The economic impact on countries in Eastern Europe will probably be greater, as they conduct more business with Russia. This is particularly true of the three Baltic countries, which sell an average of 10% of their goods exports to Russia.

The weight of exports to Russia does not tell the whole tale about the potential economic repercussions of the war, however. Inputs from Russia can be important in individual countries' supply chains, even though they may be routed through third countries and therefore not be included in measurements of direct trade with Russia. As Chart 1 indicates, Russia's weight in other countries' domestic supply chains generally exceeds its direct weight in international trade, particularly in Finland and various Eastern European countries.[1] On the whole, though, the economic impact

1. Corresponding data on the weight of individual countries in domestic value added are not available for Iceland, but it can be assumed that Iceland is similar to, for example, Norway in this regard.

Chart 1

Weight of exports to Russia and importance in supply chains in selected OECD countries[1]



1. Goods exports to Russia as a share of total exports in 2020 and imports from Russia as a share of total imported inputs in 2018 (data for Iceland not available). "Baltics" is the average for Estonia, Latvia, and Lithuania.

Sources: OECD TiVA database, UN UNCTAD database.

through cross-border trade is probably not very strong, particularly because firms can often find inputs in other countries, although doing so can take time and effort.

The impact of the conflict through the financial channel

Despite the severe strain on the Russian financial system, the impact on other countries via the global financial system will probably be limited. Financial linkages with Russian banks and companies are relatively modest, and international banks' claims against Russian counterparties are generally small in scale (Chart 2) and have diminished in recent years, particularly following Russia's invasion of Crimea in 2014. Financial conditions in advanced economies have deteriorated in the wake of this year's invasion of Ukraine, however, and some countries' risk premia and interest rate spreads have inched upwards. In addition, financial institutions' risk premia have risen, and the hardships faced by Russian banks with cross-border operations could have a negative impact on the markets in which those financial institutions operate. The overall risk vis-à-vis Russian financial institutions appears to be limited, however. Even so, increased uncertainty as a result of the war, coupled with capital flight to safe assets, could amplify instability in some countries' financial systems.

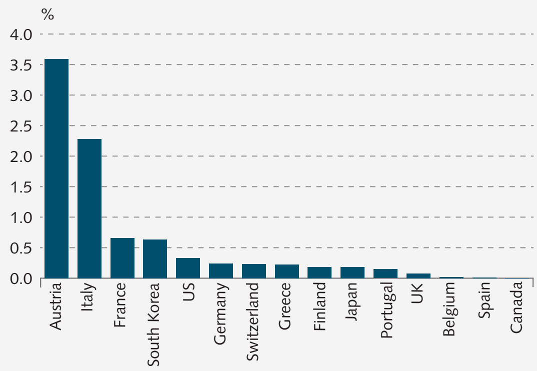
The impact of the conflict through the commodity channel

Russia's relative lack of importance in world trade and the global financial system only sheds light on part of the impact of the war and the sanctions on the global economy. Russia is one of the world's most important producers of a number of commodities, and Ukraine is also an important producer of food products. It is therefore clear that the war and the sanctions will have a colossal impact on the global commodity market and, by extension, the global economy.

As Chart 3 indicates, Russia produces about 12% of the global supply of oil, and it is the world's second-largest oil-exporting country, after Saudi Arabia. Its importance in the production of natural gas is even greater: Russia produces some 17% of the world's natural gas and is the largest single exporter of it. Russia is also very important in other commodities and metals. The country supplies the world with nearly half of its supply of palladium, an important input in the production of catalytic converters for automobiles, among other things. Russia and Ukraine are also important in the production of gases such as neon. Neon is used together with palladium to produce semiconductors, which are indispensable for the manufacture of all types of electrical equipment and computerised goods. Moreover, Russia is an important producer of nickel, which is used for the manufacture of steel and batteries. Russia and Ukraine are both leading food

Chart 2

Financial institutions' claims on Russia in selected OECD countries[1]

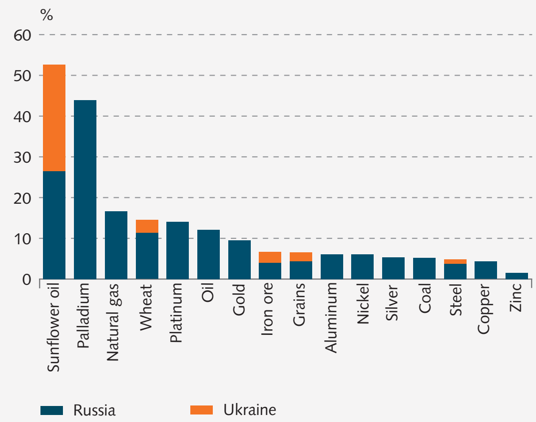


1. Outstanding bank claims against Russian entities in Q3/2021 as a share of their total claims against foreign entities.

Sources: Bank for International Settlements (consolidated banking statistics), OECD.

Chart 3

Russia and Ukraine's share in global commodity production 2020



Sources: J. P. Morgan Commodity Research, UN Food and Agriculture Organization (FAO), US Geological Survey.

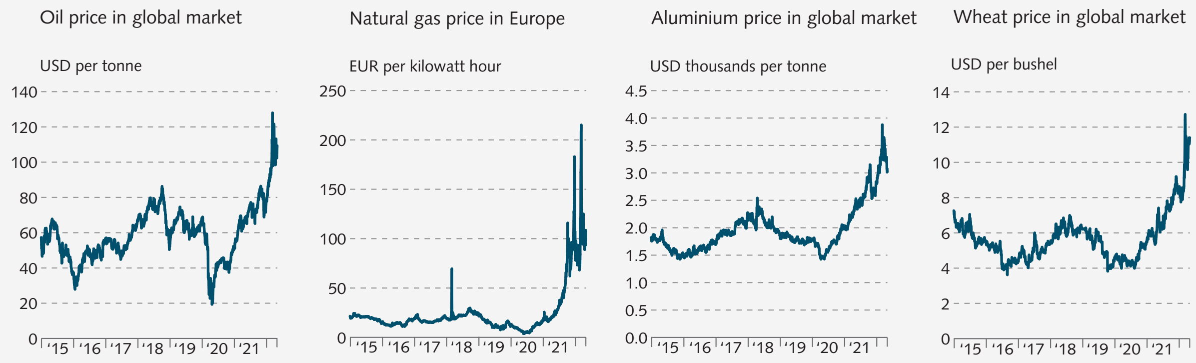
producers, ranking in the world's top five exporters of a number of foodstuffs. Almost 15% of global wheat production comes from Russia and Ukraine, and about one-fourth of global wheat exports. The two countries are also important manufacturers of fertilisers used for the production of a large number of food products, as well as producing over half of the world's sunflower oil.

Because of all this, the main channel through which the war will affect the global economy will be the commodity market, where steep price hikes will push imported inflation higher and increase households' and businesses' expenses. This deterioration in terms of trade has a negative impact on economic activity, although commodity exporters will benefit from higher prices on their own exported commodities. Some countries may therefore see their terms of trade improve, although it will be offset by the negative impact of weaker global demand and elevated global economic uncertainty.

As Chart 4 indicates, commodity prices surged in the wake of the invasion, although some of the increase has reversed since then. Oil prices, for instance, are 13% higher than just before the invasion, and European natural gas prices are up more than 18%, after having peaked at a full 150% above the pre-invasion level just over a week after the invasion. The price of wheat has also risen steeply and has only reversed to a minimal degree.

If wheat prices remain this high, it could have severe repercussions for poorer countries, and poor harvests due to persistent fertiliser shortages could compound the problem. Furthermore, soaring natural gas prices will affect large numbers of European households that depend on natural gas imports from Russia. While Eastern Europe is particularly exposed to this risk, others are affected as well:

Chart 4
Global commodity prices[1]
1 January 2015 - 29 April 2022



1. Brent crude for oil prices and London Metal Exchange (LME) for aluminium prices.
Source: Refinitiv Datastream.

Russian natural gas accounts for nearly a fifth of total energy consumption in countries such as Italy and Germany. For the EU as a whole, some 40% of natural gas, one-fourth of oil, and half of coal imports to the region originate in Russia. As a result, the impact would be severe if further sanctions were imposed and energy importation from Russia were cut back or halted entirely. The implications for Russia would be no less profound, as Europe buys more than 70% of the country's gas exports, half of its oil exports, and a third of its coal exports. Presumably, the price of these energy sources would rise still further, and it could prove necessary to impose restrictions or rationing of energy on certain sectors. Offsetting this somewhat, the inventory situation is more favourable than previously anticipated, owing to relatively mild winter weather in Europe. Increased supply of oil and gas from other countries, such as the US and Iran, could mitigate the problem as well.

Global economic impact

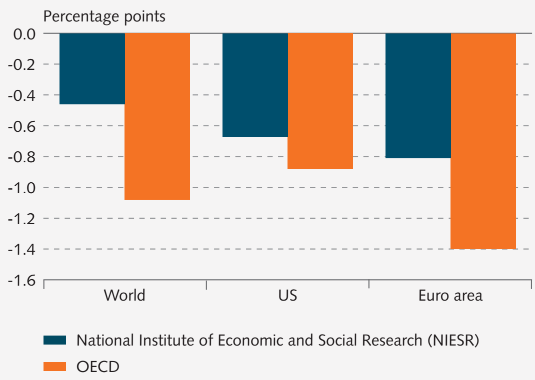
The magnitude of the war's impact on the global economic outlook is highly uncertain but will probably be considerable, and not least in mainland Europe. Recent analysis suggests, for instance, that global GDP growth could be lowered by ½-1 percentage point in 2022 as a result (see, for example, Liadze *et al*., 2022, and OECD, 2022). The impact on output growth in the eurozone would be even greater, at 1-1½ percentage points (Chart 5). Inflation would also be strongly affected: global inflation could be pushed as much as 3 percentage points higher this year, and inflation in the eurozone could be 2-2½ percentage points higher (Chart 6). The effects could be exacerbated even further if the situation deteriorates and Russia's energy exports are further reduced. If this happens, commodity prices – and inflation – will probably climb even higher, amplifying the adverse effects on household purchasing power and demand.[2]

The war could also have a long-term impact on the global economy if it results in a permanent shift in global energy trade and causes a lasting change in the structure of important supply chains. Further partitioning of international payment intermediation could make international trade more costly, and an increase in cross-border disputes could further dampen world trade and impede the sharing of knowledge, thereby permanently reducing long-term potential output at the global level.

2 According to an analysis by the IMF (2022), global output could contract by an additional 2% through 2023 if broader sanctions than are currently envisioned are imposed on Russia. This would lead to even more commodity price hikes and would contribute to more severe and protracted supply-chain disruptions. Global inflation would increase by an additional 1 percentage point in 2022 and 2023.

Chart 5

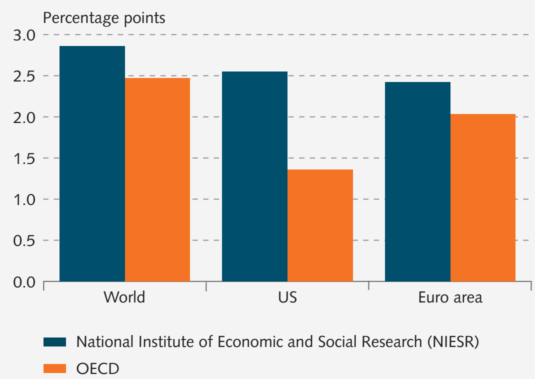
Impact of the war in Ukraine on global GDP growth[1]



1. Estimated impact of the war on 2022 GDP growth (National Institute of Economic and Social Research, NIESR), or for a full year from the initial invasion (OECD).
Sources: Liadze et al. (2022), OECD (2022).

Chart 6

Impact of the war in Ukraine on global inflation[1]



1. Estimated impact of the war on 2022 inflation (National Institute of Economic and Social Research, NIESR), or for a full year from the initial invasion (OECD).
Sources: Liadze et al. (2022), OECD (2022).

Economic impact in Iceland

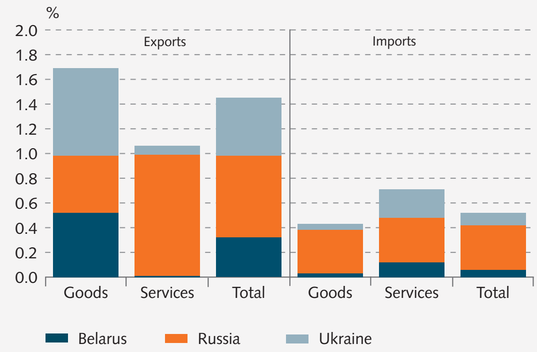
Like other advanced economies, Iceland conducts relatively little trade with Russia; as Chart 1 shows, about 0.5% of Iceland's goods exports are sold to Russia (as of 2020). Iceland's trade with Russia diminished significantly after Russia invaded Crimea and reciprocal sanctions were imposed, and it declined even further with the onset of the pandemic. A similar share of Iceland's exports are sold to Belarus and Ukraine, although exports to these countries have increased in recent years, following the Russian import ban in 2015. In particular, marine products previously sold to Russia have been exported increasingly to Belarus and Ukraine. In all, about 1.7% of Iceland's goods exports are sold to these three countries (Chart 7). Around 1.1% of Iceland's services exports and 1.5% of combined goods and services exports (totalling 14.5 b.kr.) go to these three countries. Some 0.5% of Iceland's goods and services imports (5.5 b.kr.) come from the same three countries. Used ships, miscellaneous industrial products, and food manufacturing equipment have been the mainstay of exports to Russia, while marine products – particularly pelagics and farmed fish – weigh heaviest in exports to Ukraine and Belarus. Tourists from Russia accounted for the largest share of services exports to the three countries, although their numbers fell markedly after the pandemic struck. Other services exports increased, however, especially tech services and other business services.

If all of Iceland's trade with Russia, Belarus, and Ukraine were halted, the direct loss of export revenues could come to 15-20 b.kr. The actual loss could exceed this amount, however, as marine products and aquaculture products valued at around 5 b.kr. have been exported annually from Iceland to Ukraine via Lithuania in recent years. In addition, domestic sellers hoped to sell a portion of this year's sizeable capelin quota to the Ukrainian market. It will probably be possible, however, to sell these products in other markets, although it might take longer and bring lower prices. In addition, the outlook is for other marine products, particularly demersals, to rise in price because of stronger demand for Icelandic fish and fish products in reponse to proposed higher import tariffs and Russia's reduced access to international markets for its own marine products. Moreover, Russia has been temporarily expelled from the International Council for the Exploration of the Sea (ICES). The Russians could respond by closing their fishing waters to other countries. This would affect Iceland, which has had a bilateral agreement with Russia on fishing in the Barents Sea, although it does not account for a large share of Iceland's total catch.

In addition, it will presumably be possible to obtain

Chart 7

Iceland's trade with Belarus, Russia, and Ukraine[1]



1. Imports and exports to Belarus, Russia, and Ukraine as a share of the respective totals for 2020.

Source: Statistics Iceland.

inputs previously bought from these countries – such as reinforcing steel, timber, and plywood – from other markets, although the price may be higher. In some instances, however, it could prove difficult to find comparable goods elsewhere, prolonging supply-chain disruptions and pushing prices even further upwards.

It is difficult to project what effect the war will have on Iceland's tourism sector. It is unlikely to have a strong direct impact this year, however, as the vast majority of tourists who visit Iceland are expected to come from the US and Western Europe. That said, the war could dampen appetite for travel in some cases. Elevated inflation, declining purchasing power, and higher airfares due to rising oil prices could reduce tourist numbers, even though appetite for travel has been strong since pandemic-related travel restrictions have been lifted. Nor is it likely that disruptions to air travel due to the closure of Russia's airspace will have much effect in Iceland, as large numbers of tourists from Asia are not expected this year.

All things considered, it does not appear likely that the war will have a profound negative impact on Iceland's external trade, although individual companies and sectors could be markedly affected. Indirect effects in the form of steeply rising energy and other commodity prices will be felt widely in Iceland, though, as they will be elsewhere. Firms' costs will increase, import prices will rise, and households' living costs will rise accordingly, adversely affecting demand for goods and services. Furthermore, increased uncertainty about the economic outlook may well weaken domestic households' and businesses' proclivity to spend and invest, although Icelandic households have strong net worth and significant accumulated savings that they can tap in response to rising prices. The effects on households' cost of living will also be less pronounced here than in mainland Europe, as hydroelectric energy and geothermal power are used far more widely for home heating and electricity production in Iceland than oil and natural gas are. Higher prices for important export products such as aluminium and marine products will also offset the negative impact of steeply rising oil and commodity prices on Iceland's terms of trade (see Chapter I).

Furthermore, the war will probably have a limited effect on the domestic financial system, as Iceland's financial ties to Russia and the conflict zone are negligible (see also Box 1 in *Financial Stability* 2022/1). The domestic banks have ample liquidity, the Central Bank has abundant international reserves, and Iceland's external position is strong. As a result, the domestic financial system should be well prepared to face the potential negative side effects of the war. Even though the CDS spread on Iceland has held broadly unchanged since the war broke out, credit spreads on the Treasury's foreign obligations and those of the domestic commercial banks have risen. This should not greatly affect the sovereign in the short run, however, as it does not have an urgent need for refinancing. Icelandic firms and commercial banks that need to refinance foreign bond issues in the coming term may feel the effects more keenly, however. Furthermore, risk premia on the Icelandic króna could rise because of increased global economic uncertainty, and the króna could therefore be weaker in coming months than otherwise.

On the whole, the war will cause inflation to be higher and more persistent than it would have been otherwise, and private consumption growth will be accordingly slower. GDP growth among Iceland's main trading partners will be weaker as well, and exports from Iceland therefore more sluggish, although this will be offset by improved terms of trade. Because of this, GDP growth in Iceland will be weaker than was anticipated before the war broke out. The economic outlook is highly uncertain, however, and the magnitude of the impact will be determined by global developments.

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