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Ukraine, Energy & Inflation

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It is a truism that the Russian economy is dependent upon energy exports, principally oil, for its balance of payments.

According to the International Energy Agency (IEA) Russia accounts for 5 million barrels a day on world export markets some 12% of total demand. That export success is not matched by an equal desire for Western goods and services. For example, McDonalds derives 9% of its turnover from Russian consumers with Britain's ASOS some 4%, the latter being more typical of companies trading in Russia. Consequently, Russia runs a large current account surplus

Russia is still a relatively poor country ranking with Chile, China, Greece, and Latvia on a per capita GDP basis and entirely lacking the growth rate achieved by China, which at the time of the fall of the Iron Curtain was a smaller economy than that of the USSR, but is now on some measures the world's largest.

Whilst Apple, H&M, Dell, BMW, Ford, and many other firms ceasing trade in Russia are motivated by disgust with Putin and support for Ukraine, the brutal truth is that the collapse in the Rouble has both destroyed consumer purchasing power and eviscerated margins, making Russian trade uneconomic.

As a trading economy, Russia is insufficiently large to inflict significant damage on Western businesses but Western dependence on Russian energy exports is a rather different story.

Higher energy costs, along with damage to supply-chains from the pandemic, have been pushing global inflation rates higher. Consequently, central banks have been mulling the necessity to tighten policy and reverse "Quantitative Easing," ending the "easy-money" years of the last decade.

Today, embargoed Russian supply will place further upward pressure on energy prices, and therefore inflation, putting additional strain on central banks to address rising inflation. However, raising interest rates can only act to dampen demand they cannot stimulate oil and gas production.

Europe is particularly exposed, taking 60% of Russia's oil with 20% going to China. So, how can the West contain an inflationary spiral exacerbated by higher energy costs?

The International Energy Agency (IEA) identifies a number of responses:

1. Opening the "Strategic Reserve:" the members of the IEA has announced the release of 60m barrels of oil from the "Strategic Reserve" from a stockpile of 1.5 billion barrels. Those 1.5 billion barrels are equivalent to 2 years of Russian export production.
2. Western authorities have also approached Saudi Arabia and Venezuela along with others, including US shale, to increase production.
3. Russian natural gas, accounting for 40% of EU gas consumption in 2021, is more problematic.

Proposals to reduce EU dependence on gas include:

1. Not renewing long-term contracts with GazProm
2. Increasing Liquid Natural Gas (LNG) imports from Norway and Azerbaijan
3. Accelerating investment in Wind, Solar, and Nuclear

4. Temporary return to coal-fired electricity generation

In total these proposals would reduce EU energy dependence on Russia by more than half.

Nonetheless, the conflict will raise the immediate cost of energy which is unquestionably demand suppressing. Consumers will be forced to direct a larger proportion of their budget to non-discretionary expenditure: food, heating, transport and away from discretionary expenditures.

There are several further issues that investors will need to think about.

Short of a regime change, it is very hard to see Russia being welcomed back into the Western “family of nations” in the foreseeable future. The damage done to business confidence by Putin’s revanchism will not be easily reversed, and it is likely that investors will review their exposure to “Emerging markets” generally.

Issues surrounding governance, property rights, and enforceability of contract will come to the fore, and international investment flows will look for “safety” rather than “opportunity.” This will tend to favour the dollar and USD assets, but UK and core European markets will also seem more attractive.

Conflict tends to accelerate innovation; it also accelerates defence spending and the two are surprisingly inter-linked. The iPhone has its roots in military spending back in the 1970s.

Domestic spending on infrastructure, not just defence, is likely to rise as the requirement to modernise somewhat flabby Western institutions takes on a more urgent dimension. Joe Biden’s “Build Back Better” programmes are aimed at just these areas. Putin may have, albeit inadvertently, provided the spark that was missing to spur improvements in Western productivity. Higher productivity will tend to lower inflation.

Finally, the scientific consensus is overwhelmingly in agreement that industrial scale carbon emissions are slowly suffocating the planet. From flooding in New South Wales to wildfire across America the evidence of the costs of global warming is accumulating. From that perspective the cost of hydrocarbons has been too low to incentivise the large-scale energy transition required to cool the planet.

In attacking his neighbour and raising those costs, Putin has incentivised the West both to ostracise Russia in the short-term and to eliminate the market for Russian oil and gas in the long-term.

As Talleyrand observed, “It was worse than a crime, it was a mistake.”