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# CURRENT CRISIS IN UKRAINE AND ITS CONSEQUENCES

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***Abstract:*** *The last decades, but also the centuries, have been full of financial crises of various characteristics, intensities, and areas of occurrence. Experiences of financial crises have shown that countries reach a financial crisis when the economy as a whole continuously has a current account deficit when it spends more than it creates, which leads to an increase in external indebtedness. The subject of the research is the current crisis, caused by Russia's intervention in Ukraine, as a result of which comprehensive and very drastic sanctions followed, which resulted in serious market outcomes. This paper aims to see in which segments the consequences of the crisis will be seen first, and whether and to what extent the crisis will affect the global economy. Despite Russia's small economic size, intervention and related sanctions are already causing global disruptions through financial and business ties.*

***Key words:*** *financial crisis, sanctions, the global economy*

***JEL classification:*** E44

## 1. INTRODUCTION

The economic theory defines a financial crisis as a sharp, short, and ultra-cyclical deterioration of all or most financial parameters, interest rates, and stock and real estate prices resulting in commercial insolvency and bankruptcies of financial institutions (Goldsmith, 1982).

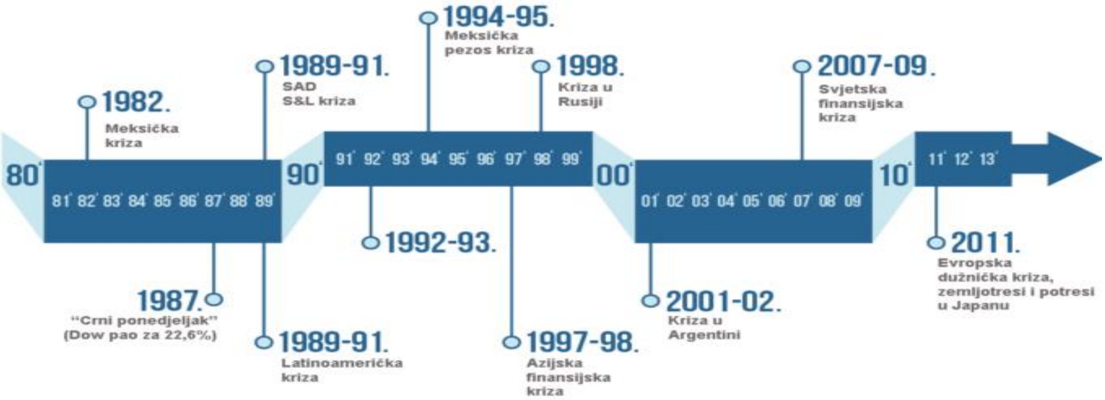
Financial crises are not uncommon, and in the last 300 years alone there has been an average of one every eight and a half years. Their frequent occurrence led to the conclusion that the financial sector is unusually sensitive to shocks. A shock initially affects only a certain region or only a few institutions, but it can turn into a systemic risk and infect the economy. The last decades, as well as centuries, are full of financial crises of different characteristics, intensities, and areas of occurrence. In the period from 1800 to 1850, there were a total of 14 economic and financial crises, and in the period from 1950 to 2000. year 13 crises. In conclusion, a negative cyclical movement of the economy could be expected every 3.85 years. A financial crisis is a broader concept than a banking crisis, which means the bankruptcy of several banks or the collapse of the entire system. It is characterized by the rush of depositors to banks, bank failures, and poor collection of bank claims. They are extremely dangerous for the economy, both because of the strong financial effect and high costs of rehabilitation and because of the loss of trust of citizens and savers in the banking and financial system. Although a financial crisis does not necessarily cause a banking crisis, there is a strong interaction between the two. The history of banking crises is as old as the history of banking. In the last thirty years, there was almost no country that did not go through stages of the banking crisis.

A bank's crisis represents its insolvency, or the inability to settle its entire obligation. A banking crisis is a state of insolvency that takes the form of an epidemic and tends to the regression of the financial and banking system. Occasional financial crises of some banks or groups of banks also occur when it comes to the developed banking system, so the causes of the crisis, as well as bank control and supervision, are examined. It is evident that in the last 30 years, financial crises have regularly erupted in fast-growing markets. The consequences of the crisis in all affected countries were severe and long-lasting.

A currency crisis is a subtype of a financial crisis. It represents a situation in which speculative attacks on the currency lead to a strong depreciation, a significant reduction in foreign exchange reserves, or a combination of both. Currency crises are most often associated with devaluation or a change in the exchange rate regime. The currency crisis index is used to define the currency crisis. This measure reflects both the strength of the loss of reserves and the strength of currency oscillations, thus enabling the ranking of crises according to their strength. Experiences of financial crises have shown that states reach a financial crisis when the economy as a whole continuously has a current account deficit, that is when it spends more than it creates, which leads to an increase in external indebtedness. It does not matter whether the public or private sector leads in borrowing and whether the level of the deficit is high or low, especially if it has been present for years. The risks multiply enormously when the state, economy, and citizens borrow foreign currency. Due to the growth of foreign debt, the economy of a country is increasingly surrendering to the will of foreign creditors, and the domestic financial market is exposed to the risk of speculative attacks.

These attacks, if well coordinated, can threaten the financial stability of the country even when its macroeconomic fundamentals are sound. For this reason, a balanced current account is the strongest factor in the stability of any economy, especially a small economy. States are also at great risk when they pursue a policy of overvalued domestic currency. Finally, it is very risky when states ignore their own and other people's experiences and follow imposed ideological patterns without any empirical foundation.

**Table 1.** Presentation of crises since the end of the last century




***Source***: www.investitor.me/2018/08/27/pouke-finansijskih-kriza-da-li-smo-naucili-lekcije/

The banking sector can be characterized as one of the few economic areas in which a very cautious approach is represented (Trenca, T., Petria, M., Corovei, C., 2012). It is interesting that despite such a cautious and conservative approach, the banking sector faced with a global crisis and greatly contributed to its emergence. The world economic crisis of 2008 soon took on global proportions and very quickly some of its negative impacts began to affect the business activities of companies, banks, and the lives of individuals (Elahi M., 2017)

## 2. OBJECTIVE AND RESEARCH METHODS

The subject of the research is the current crisis, caused by Russia's intervention in Ukraine. The goal of the work is to see how many interventions affect global economic processes, as well as in which segments the consequences of the crisis will be seen first. One thing is certain, the problems that have been identified now will strategically influence the redefinition of the global economy, and not only it. The paper used the methodology of content analysis of current research and expert analysis, related to the intervention in Ukraine.

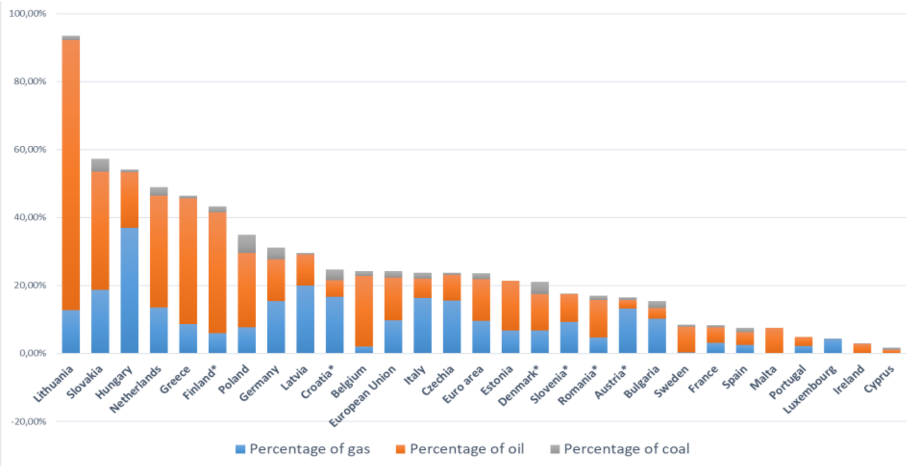
## 3. CRISIS AS A RESULT OF RUSSIAN INTERVENTION AND IMPOSED SANCTIONS

Escalation of the conflict between Russia and Ukraine, according to Allianz research, (www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economicresearch/publications/specials/en/2022/february/2022_02_24_RussiaUkraineCrisisWatch.pdf) has important economic and financial consequences through three main channels – the energy, trade, and financial sectors, depending on how successful current and future sanctions are. The research indicates that Russia is now in a much stronger position than it was in 2014, economically speaking. As the world began to recover and reopen from Covid-19 with higher inflation, disrupted energy and supply chains, and highly sensitive financial markets, the "Escalating Conflict" research highlights the impacts on European inflation growth as well as equity markets. The severity of the imposed sanctions speaks of the impact on economic and financial market outcomes.

### 3.1. Energy channel

Graph 1 shows the dependence of certain countries on the Russian energy channel, as stated in the aforementioned research.

**Graph 1.** Percentage of total gross available energy coming from Russian imports for member states, 2020



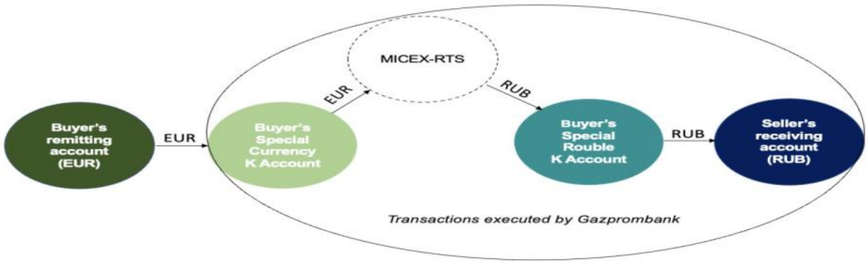

***Source:***https://www.europarl.europa.eu/thinktank/en/document/IPOL_IDA(2022)699522

Europe's dependence on Russian energy sources is so great that their substitution in a shorter period is not feasible, which would lead to systemic disruptions in the European economy, and numerous chain reactions, from the devastation of the economy, even entire economic branches, the loss of many jobs, and which would again lead to dangerous social turmoil.

Looking at energy dependence, according to Allianza's research, since February 23, Gazprom has dramatically reduced the fulfillment of its contractual obligations through the volume of transit through Ukraine. The authors of the study see limited risk of that change. Furthermore, Europe has about a month's supply in reserves, which should allow it to get through a mild winter relatively easily. On February 22nd, the entire EU reserves amounted to about 31% of the total capacity - that is, about 1.2 million terajoules of energy. In a typical winter month, the EU consumes around 1.4-1.5 million terajoules of energy from natural gas. Adding some options for crisis management, such as mobilizing "cushion gas" from storage, reserves should be sufficient until the end of March. Accordingly, prices are expected to remain in the range of 75-90 EUR/MWh until the summer. In a scenario where Russia shuts off Europe's gas supply - although this did not happen even at the height of the Cold War - the price of natural gas could rise to an average of 140 EUR/MWh. Unfortunately for Europe, alternative suppliers are limited. Russia, on the other hand, in response to the seizure of its gold reserves by the USA, the UK, and Switzerland, introduced a new rule for the payment of energy supplies for enemy countries - payment in rubles!

This is an extremely dangerous blow to the petrodollar, whose comprehensive consequences cannot yet be seen in full. Developments have shown that Russia is determined to cut off gas to anyone who does not comply with the given scheme, Poland and Bulgaria are among the first countries to do so.

**Graph 2.** Order of the foreseen payment mechanism in rubles for gas deliveries




***Source:*** Oxford Institute for Energy Studies “Rouble gas payment mechanism: implications for gas supply contracts”

We should not lose sight of the fact that natural gas is part of China's long-term plan to change its energy mix and Russia has played and will continue to play a very important role in this. Before 2019, by volume, China's natural gas imports from Russia represented an insignificant share of the total.

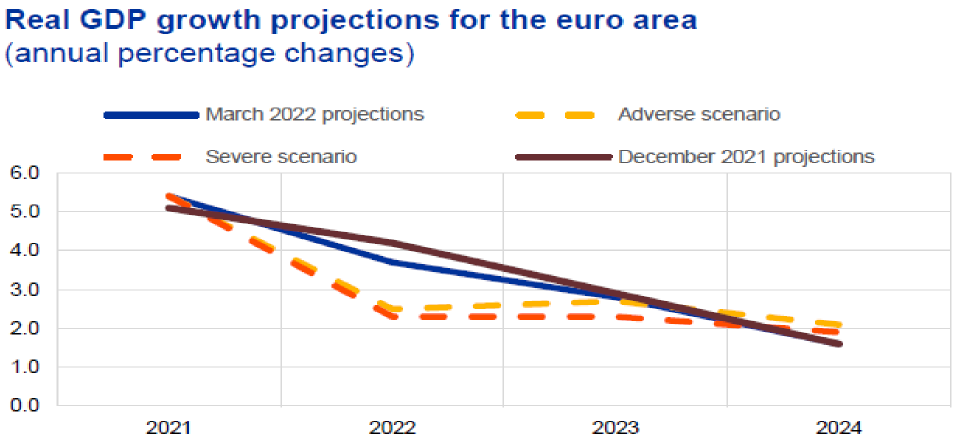
The share moved to 4% in 2019, to 9% in 2020, and 10% in 2021, mainly due to the Power of Siberia gas pipeline between the two countries, which started operating in 2019. The annual capacity of the Power of Siberia is 38 billion cubic meters, which means that it is used at only 20% of its full capacity in 2021. However, 80% of idle capacity represents only 15% of Russian natural gas exports to the EU in 2021. More importantly, to date, Power of Siberia is not connected to natural gas sources that feed European pipelines, which means that rerouting to China is operationally extremely difficult, according to researchers (www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economicresearch/publications/specials/en/2022/february/2022_02_24_RussiaUkraineCrisisWatch.pdf). The current developments regarding Russian gas, as well as the signing of contracts with other countries in the East by Russia, call into question the assessments of Western analysts.

### 3.2. Trade channel

Obstacles to the growth of the Eurozone have intensified, Morgan Stanley European believes in its March 2022 research, and real GDP growth has been revised downwards for the period 2022-23.

The reasons should be sought in the fact that the prospects for the activity of the Eurozone have become more uncertain, primarily because the rising prices of energy and goods, as well as the negative effects related to confidence, introduce negative risks for the growth of the domestic GDP, as shown in Graph 3.

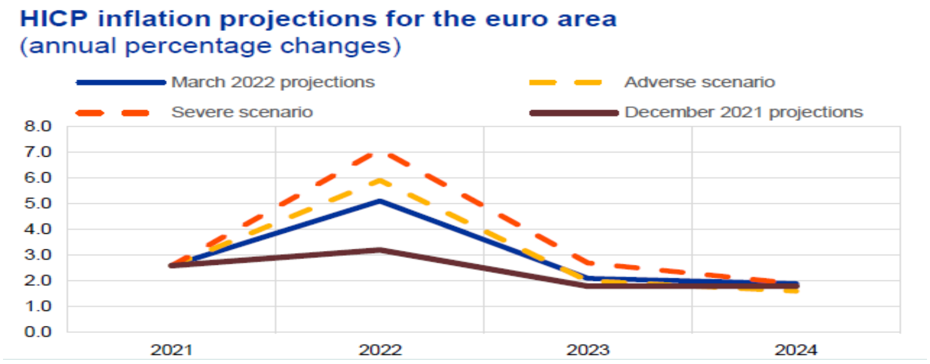
**Graph 3**. Projection of real GDP growth for the eurozone




***Source:*** Invasion of Ukraine: euro area banks so far resilient to a second exogenous shock, *Morgan Stanley European*, Mart 2022. www.bankingsupervision.europa.eu/press/speeches/date/2022/html/ssm.sp220315~e641a6f3e4.en.pdf

Rising energy prices have resulted in a significant revision of HICP inflation for 2022, adding further upside risks to the near-term inflation outlook. Short-term price pressures have increased significantly, driven mainly by the recent increase in commodity prices and current supply. Graph 4 presents 3 possible scenarios of inflation in 2022, as well as predictions for the next two years.

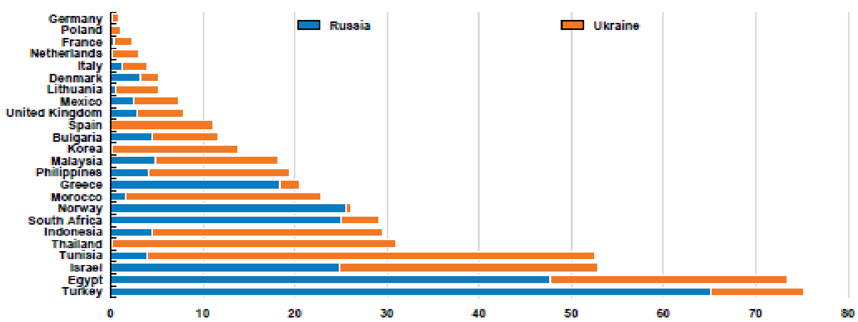
**Graph 4**. Inflation projection for the eurozone




***Source:*** Invasion of Ukraine: euro area banks so far resilient to a second exogenous shock, *Morgan Stanley European*, Mart 2022 www.bankingsupervision.europa.eu/press/ speeches/date/2022/html/ssm.sp220315~e641a6f3e4.e

Russia has recorded continuous annual current account surpluses since 1998 even during the 2008-2009 GFC, 2014-2016 Ukraine crisis, plus the oil price crisis and the 2020 Covid-19 crisis. A closer look at trade and services balances shows that countries that would most likely be dealt with serious sanctions against Russia in the current context (USA, EU, UK, Japan, Switzerland, Norway, Ukraine) account for about 60% of Russia's a trade and service surplus in 2016-2020. This means that even in the extreme case of zero trade, Russia would almost certainly still run current account surpluses and not have to draw down its foreign exchange reserves to finance imports from other countries. However, in the short to medium term, a complete reorientation of Russian exports away from Europe to China seems unlikely due to scale and operational reasons, according to Allianz Research. However, current events speak of Russia's turning to the east, and the earthing of the east, and production from the east. Substitutes are relatively easy to find, and Western sanctions, as well as the withdrawal of companies from the Russian market, are now starting to act like a boomerang. Also, the quick departure from Russia by companies that dealt with consumer goods now seems premature and even unnecessary to them, so many of them express their desire to return. According to the statements of Russian officials, the return is possible, when the conditions are met and in the areas where it is necessary. Russia is the world's largest producer of wheat, while Ukraine is in fourth place. Graph 5 shows the high dependence of certain countries on wheat imports from Russia and Ukraine. The first estimates by GB indicate that the production of wheat, at this moment, will be lower in Ukraine by 20%. It is already certain that the current events will affect the price of wheat in the world, which opens the global problem of hunger in the world.

**Graph 5**. Share of wheat imports from Russia and Ukraine in total wheat imports in 2019, in percentage




***Source:*** OECD Economic Outlook, Interim Report, Mart 2022. https://www.oecd.org/economy/Interim-economic-outlook-report-march-2022.pdf

### 3.3. Financial channel

Looking at the financial sector, European banks have reduced their exposure to Russia, and it is at a very low level. For Germany, assets declined from 0.45% of the consolidated balance sheet in 2008 to less than 0.1%. The share of French banks is slightly higher.
As for Austria, whose exposure is the highest among the larger European countries, they believe that these numbers can also be managed successfully.

**Graph 6.** Banks' exposure to Russia (selected countries/2nd quarter 2021)


Despite Russia's small economic size, the war and associated sanctions are already causing disruptions of a global nature through financial and business ties. Financial sanctions imposed on Russia have targeted selected individuals and banks, reduced access to foreign capital, and frozen access to foreign reserves held by the Central Bank of Russia (CBR) in Western economies. As a result, the ruble depreciated sharply, the CBR interest rate rose by 10.5 percentage points to 20%, and risk premiums on Russian sovereign debt rose. Delays and difficulties in international payments disrupt trade and can lead to debt defaults in Russia. Conditions have also tightened in financial markets around the world, reflecting greater risk aversion and uncertainty, with greater risk premiums and currency depreciation also occurring in many emerging market economies and Central and Eastern European economies with relatively strong business ties to Russia. The situation with energy products led to an increase in inflation in Germany in March by 7.8%, which has not been recorded in the last 40 years. Also, the inflationary pressure in America is constantly increasing, which is also a great precedent and shock for American society. The West decided to use financial sanctions as part of its initial actions against Russia. In this regard, exclusion from SWIFT is no longer just a threat, it has become a reality. After all, cutting Russia off from SWIFT does not mean banning cross-border transactions. Above all, it raises operational issues that can be solved/circumvented by using alternative messaging systems. There are also cryptocurrencies, which also provide the ability to bypass financial transactions. Since 2014 and the crisis in Crimea, Russia has built its financial transfer system ("Sistema Peredachi Finansovikh Soobshchenii" or SPFS), which, despite its flaws, can count on the membership of 400 banks, of which 23 are foreign banks (based primarily in Switzerland and Germany). Now SPFS processes about 20% of domestic payments. Although it remains less capable and more limited in scope than SWIFT, it could provide a safety net for Russian trade and act as a potential solution for continued cross-border transactions. (Subran, L., 2022). The European Banking Authority's (EBA) risk dashboard points to a limited direct impact of the Russian invasion of Ukraine on EU banks, but also points to clear medium-term risks:(https://www.eba.europa.eu/eba-risk-dashboard- indicates-limited-direct-impact-eu-banks-russian-invasion-ukraine-also-points)

- The first-round risks arising from the Russian invasion of Ukraine are not a fundamental threat to the stability of the EU banking system, but the second-round effects may be more material;
- Capital and liquidity ratios of banks in the EU remained strong;
- Profitability stabilized at a higher level than in the pre-pandemic period;
- Non-performing loan (NPL) ratios declined as asset quality continued to improve;
- Cyber and information and communication technology (ICT) risks remain high.

## CONCLUSION

The escalation of the conflict between Russia and Ukraine has important economic and financial consequences through three main channels - the energy, trade, and financial sectors, and Russia is now in a much stronger position than it was in 2014, economically speaking. Europe's dependence on Russian energy sources is so great that their substitution in a shorter period is not feasible, which would lead to systemic disruptions in the European economy. Obstacles to the growth of the Eurozone have increased, and the reasons should be sought in the fact that the prospects for the activity of the Eurozone have become more uncertain, primarily due to the increase in the price of energy and goods, as well as negative effects related to confidence, introducing negative risks for the growth of domestic GDP. Inflationary pressures on prices in the EU have increased significantly, mainly driven by recent increases in commodity prices and current supply. Despite Russia's small economic size, the war and associated sanctions are already causing disruptions of a global nature through financial and business ties. Financial sanctions imposed on Russia have targeted selected individuals and banks, reduced access to foreign capital, and frozen access to foreign reserves held by the Central Bank of Russia (CBR) in Western economies. The reality on the ground shows that Russia is successfully fighting the sanctions and that they have not achieved their original goal.

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## SUMMARY


*The weakening of the ruble since the end of February has increased the pro-inflationary pressure. In December-February, the nominal exchange rate of the ruble fell by 5-7% among the three main currencies of Russia's trading partners (the US dollar, the euro, and the Chinese yuan). Since the end of February, the depreciation of the ruble has accelerated due to new sanctions imposed by Western countries. By mid-March, the ruble had weakened almost 1.5 times compared to the February average. The pro-inflationary pressure caused by this weakening of the exchange rate will be reflected in the prices of imported consumer goods and goods with a significant share of imported components in costs, but with different time delays. The growth of global prices has had a limited impact on the domestic (Russian) market. Global prices for cereals and sunflower oil continued to rise in February. At the end of February-March, this trend intensified due to the reduction of exports from Russia and Ukraine. The impact of external trends on the Russian market is significantly limited thanks to customs mechanisms that reduce the sensitivity of domestic prices of wheat and sunflower oil to world price movements. (UN Food and Agriculture Organization, Blumberg, Bank of Russia calculations). Commercial air transport and cargo are also being diverted or completely suspended, increasing operating costs, and many multinational companies have suspended operations in Russia. There are also some possible long-term consequences of the war, including pressures for higher defense spending, the structure of energy markets, potential fragmentation of payment systems, and changes in the currency composition of foreign exchange reserves. Dividing the world into blocs would sacrifice some of the benefits of specialization, economies of scale, and the dissemination of information and knowledge. Excluding Russia from the SWIFT messaging system could accelerate efforts to develop alternatives, potentially reducing the dominant role of the U.S. dollar in financial markets and cross-border payments.*