INVASION OF UKRAINE: A GLOBAL IMPACT

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Invasion of Ukraine

On February 24, 2022, Russia invaded Ukraine from northern, eastern, and southern borders, as Russian President Vladimir Putin planned to topple the current Ukrainian government and replace it with a pro-Russia government. While there are some similarities to the 2014 Russian annexation of Crimea, this unprovoked attack may have been a miscalculation on Putin's part.

Putin's strategy was based on Russia's military outpowering Ukraine's defenses, his belief that NATO would not send troops, and that European countries would hesitate to impose harsh sanctions due to its dependence on Russian oil and gas. Uncomfortable with NATO's expansion into the Eastern European region, Putin planned to quickly overthrow Ukraine's government and endure the sanctions through Russia's stockpile of foreign exchange reserves that it had accumulated during the past several years.

The Crimea annexation taught Putin that there may be little resistance to a Russian invasion, and he probably thought this time would yield similar results. However, Ukrainians are resisting Putin's takeover and gaining strong sympathy from rest of the world, including Russian citizens. Although Russia could still conquer Ukraine, maintaining control seems unlikely.

Putin claims that Russia was compelled to take actions against Ukraine's aggression to protect its own security. The Kremlin may try hard to spin Putin's narrative, but it will unlikely convince the West and others who are sympathetic to Ukraine's democracy and its desperate yet unified efforts to defend its sovereignty.

Sanctions

The U.S. and the West responded to Russia's invasion by imposing sanctions to thwart Putin's aggression. Earlier sanctions targeted Russian politicians and business leaders by freezing assets and banning travel. Major Russian banks also were cut off from the global banking system, and exports of sensitive materials (for example, semiconductors) to Russia also have been suspended.

Soon thereafter, the U.S. and several of its partners took measures to block Russia's access to the SWIFT international banking payment system. SWIFT (the Society for Worldwide Interbank Financial Telecommunication) is the main secure messaging system that banks use to make rapid and secure cross-border payments. It is considered the Gmail of global banking.

Removing Russian banks from SWIFT disconnects them from the international financial system, which hinders their ability to operate globally, and effectively blocks Russian exports and imports. The sanctions will deny the Russian central bank from accessing its foreign-exchange reserves, preventing it from defending the Russian ruble from free-fall. This will cause an economic shock to Russia's economy.

In terms of military support, the European Union (EU) will finance the purchase and delivery of weapons. Even Germany shifted its stance to provide military aid, despite being heavily dependent on energy from Russia.

Global Impact

Ukraine remains a significant exporter of metals and grains, while Russia also exports oil and gas. Outside Ukraine and Russia, Europe is the most exposed to the disruption, as Russia supplies Europe with 40% of its gas and about a quarter of its oil. The rest of the world will feel the economic impact through higher commodity prices, which would further boost inflation and hurt growth.

The decision to block Russian banks from SWIFT may lead to missed payments and overdrafts within the international banking system. This scenario will spur major central banks to supply the market with dollars, which means the U.S. Federal Reserve (Fed) may have to expand its balance sheet again right before it had planned to end its bond purchases. Furthermore, the Fed and other major central banks may become less hawkish on interest-rate hikes. At this point, a 50 basis-point hike in March is highly unlikely as a result of this conflict.

The uncertainty remains whether this situation draws NATO forces into a military conflict with Russia, which could prolong this war. So far, Russia and Ukraine have agreed to continue talks aimed at ending the war. A delegation led by Ukraine's defense minister began cease-fire talks with Russian officials. Negotiators made some progress but failed to agree on a cease-fire during the initial talks as Russia intensified its assault, killing some Ukrainian civilians in a shelling attack. After the initial talks, negotiators agreed to meet again in coming days, which may be a narrow window for Putin to prevent a long-lasting conflict.

Market volatility is expected to remain high and continue in the near-term. When the U.S. stock market opened after the invasion, it initially plunged about 3%, which was reminiscent of September 11, 2001, or the 2003 Iraq invasion. On average, the market impact of these geopolitical events is a one-day loss of around 1%. Total drawdown from such geopolitical events averages nearly -5%, taking almost 20 days to bottom and more than 40 days to recover. However, when the U.S. entered into WWII after the bombing of Pearl Harbor, it took just over 140 days to bottom and more than 300 days to fully recover.

The lesson is not to panic sell amid such geopolitical events and stay diversified to navigate through the short-term volatility. Moreover, the risk of stagflation supports the case for portfolio diversification to address the heightened volatility and uncertainty.

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