The Implications of the War in Ukraine for the International Economic System[1]

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Introduction

Russia's invasion of Ukraine on 24 February was an unparalleled attack by a permanent member of the UN Security Council not only on an independent sovereign state, but on the entire post World War II system for international security and rules-based multilateral governance.

The West responded in three main ways: by launching a package of economic and financial sanctions targeting Russia's ability to sustain the war; by expanding and strengthening the NATO military alliance; and through the development of a large-scale package of economic/humanitarian, military and political support for Ukraine.

These actions were unprecedented in many respects, going beyond anything implemented or even seriously contemplated before. This reflected the high threshold crossed by President Putin's actions and the realisation that to accept Russian aggression against Ukraine as a *fait accompli* would have completely unacceptable consequences for international security and the rules-based system of global governance going well beyond the political sphere.

The West's actions have in turn triggered retaliation from Russia, most importantly, restrictions on gas supplies to the European countries supporting Ukraine.

The shock to the global economy resulting from Russia's invasion of Ukraine has come on top of two previous extraordinary economic shocks – the global financial crisis, or GFC, (from 2008-9) and the Covid-19 pandemic (2020-21). Both these events leave legacies for the global economy (ranging from the tightening in financial regulation that followed the GFC to the impact of long-covid on advanced country health budgets following the pandemic). In addition, the global economy is being influenced by powerful external forces, notably the accelerating physical and policy impact of climate change, rapid technological progress, and the rising geopolitical tensions between China and the West which is contributing to moves on both sides towards less economic interdependence.

The legacies from previous shocks and the independent forces on the global economy are having a substantial influence on the way the Ukraine war is likely to impact on the global economy.

For example, the backdrop of the urgent need to transition the global economy to net zero means that once individuals and companies give up oil and gas in favour of renewables, there is little chance of them moving back to their previous energy consumption patterns even if the conflict ends, relations between Russia and the West improve, and the required energy infrastructure is still available. This is because new renewable energy infrastructure will have been constructed, the running costs of which will likely be lower than for historic oil and gas infrastructure. Meanwhile regulation will likely have been tightened to take account of lower GHG levels. Similarly, while Russia may plan to develop China and India as alternative gas customers over the long term, investors will be reluctant to finance expensive additional infrastructure which will take several years before it makes a return given the knowledge that even China and India will have limited scope to use gas given the overarching demands of net zero.

It is also likely that those economies which are forced - by the war in Ukraine - to accelerate the introduction of net zero policies, will benefit from a substantial boost to growth over the long-term reflecting the reduction in capital costs resulting from the early elimination of policy uncertainty and the economic benefits (through e.g. economies of scale) of forcing all economic actors to move on to net zero technologies and policies at the same time.

The interaction between multiple shocks is also illustrated by the way in which new ways of working - and new financial instruments - developed to respond to the pandemic are now being applied to address the consequences of the Ukraine crisis. Both the EU's Euro 750bn Next Gen EU fund and the IMF's US$ 42bn Resilience and Sustainability Trust (RST)[2], funded through the general allocation of US$ 650 bn in SDRs in 2021, are now being deployed in response to the Ukraine shock.

Taken together, it is highly likely that Russia's invasion of Ukraine and the response it triggered from the West will have significant consequences for geopolitics and the international economic system. But, as was the case with the pandemic, it is difficult to assess *ex ante* which of the many consequences so far will be lasting and which will not.

This is partly due to the fast-changing picture on the ground in Ukraine and the continuing uncertainty over what an eventual settlement will look like. Recent advances by Ukrainian forces in the east and south of Ukraine hold out some prospect of a much earlier conclusion to the conflict than had previously been expected (i.e. within a number of months rather than years). But Russia's mobilisation of 200,000 additional troops could eventually slow the Ukrainian advance. Russia's recent widespread attacks on Ukraine's energy infrastructure may weaken Ukraine's economy, but appear likely to make the Ukrainian public even more determined to resist Russia and eventually obtain full control of their territory. There is also an unlikely, but not impossible, scenario in which Russia deploys so called battlefield nuclear weapons. This would completely transform the conflict, with a strong likelihood of NATO becoming directly involved.

[2] International Monetary Fund (2022), 'Resilience and Sustainability Trust Frequently Asked Questions', Resilience and Sustainability Trust FAQs (imf.org)

For the purposes of this paper we define the **international economic system** as the set of institutions, laws, norms and economic relationships which determine how the global economy functions and how it is governed.

We will assume that Russia does not in the event deploy nuclear weapons, that the Russian regime does not fundamentally change, and that Ukraine never formally accepts the loss of its territories to Russian occupation. We will also assume that the West does not give way as a result of economic pressure or military threats from Russia (even with electoral shifts – e.g. the Republicans taking control of the US House of Representatives).

Under these assumptions, the outcome might either involve a complete expulsion of Russian forces from Ukrainian territories, or a freeze in the conflict with the establishment of de facto boundaries between an independent Ukraine and Russian occupied territories. In the latter case, a key consideration, will be the extent to which Russia continues to try and disrupt economic recovery in Ukraine though sporadic military attacks as well other forms of "grey" warfare, and how far Ukraine is able to withstand this. Currently Russia occupies some 18% of Ukrainian territory[3].

We will describe the four key **economic and political drivers** triggered or accelerated by the war which are likely to lead to a fundamental change in the international economic system. We will then describe four **main impacts** of these drivers on the international economic system and how it may evolve in future. Finally, the paper will set out recommendations to the forthcoming 2023 Japanese G7 Presidency on priorities for the coming year.

Drivers of change arising from Russia's invasion of Ukraine

Russia's attack on Ukraine resulted in four main drivers of change in the global economy which will have long-term consequences for the international economic system.

These are:

- The **economic and financial sanctions** already imposed on Russia by the G7 (or being contemplated) combined with the impact these measures are likely to have on the **long-term role of Russia in the global economy**.

- The **steps taken by Russia against the West** in retaliation for sanctions and the West's continuing financial and military support to Ukraine. These include restrictions on supplies of gas to the EU.

[3] *The New York Times (2022)* 'Ukraine has reclaimed more than half the territory Russia has taken this year', 14 November 2022, [Ukraine Maps: Tracking the Russian Invasion - The New York Times (nytimes.com)]

- The **increased demands on Western development budgets** arising form the financial support being provided direct to Ukraine, and other indirect effects of the conflict.

- The long-term impact of the war on **Ukraine's economy** and the role that Ukraine may, as a result, play in the global economy in the future.

Economic and financial sanctions imposed by the West and their consequences for Russia

Comparisons with the previous use of sanctions

Until Russia's attack on Ukraine, the US and its allies held back from deploying some of the most powerful economic and financial measures at their disposal - such as restrictions on bank access to the dollar clearing system - on the grounds that they were better deployed as a threat, but rarely, or never, used. This reflected the view that actual deployment could be counter-productive, both in forcing countries that saw themselves as potential targets to take extraordinary steps to avoid such measures in future (thereby limiting their usefulness) and in the unintended consequences that might follow for the global economy - such as fragmentation in global financial markets, or a weakening in the reserve currency system.

Other factors influencing - and limiting - the West's deployment of sanctions included the desire to avoid punishing the entire population of the offending country (lest it increase support for the illegal actions), the desire to limit the impact on western economic interests, and concern to ensure that the proposed sanctions had broad support among allies (to ensure both their effectiveness and equal burden sharing). This led policy makers to focus on so called "smart" financial sanctions which targeted those around the leader leading the illegal policy actions, if not the leader themselves.

However, President Putin's action in invading Ukraine posed such a threat to the system of collective security established after WW2, as well as to the broader principles of a rules based international order that all these considerations were fairly quickly put to one side.[4] Western policy makers faced the question, "if not now when" should such a measure be deployed. Moreover, Ukraine's success in withstanding the initial Russian attack and the Western public's reaction to Russia's invasion quickly re-enforced policy makers' early instincts to deploy measures that had never been deployed against such a major economy before.

As a result, the package of sanction measures adopted to date, principally by the G7, has been unprecedented in both type and extent. It has four main components:

[4] See US Department of the Treasury (2022), 'Economic Statecraft in International Affairs: Speech, Wally Adeyemo, Deputy Secretary of the US Treasury', 29 March 2022, Remarks by Deputy Secretary of the Treasury Wally Adeyemo on Economic Statecraft in International Affairs at the Chatham House in London, England | U.S. Department of the Treasury

- measures to restrict Russia's access to international financial markets, including unprecedented steps (for an economy of Russia's size) such as: freezing the Russian Central Bank's assets, banning sales of gold, blocking Russia's ability to service its foreign currency international debt and suspending major Russian commercial banks from the SWIFT payment messaging system;

- much stronger - and better coordinated - measures against over 1000 very wealthy Russian individuals who support President Putin. The goal has been to freeze their international assets, and where there is evidence that these have been obtained illegally, to confiscate them.

- measures to restrict Russia's access to international markets for goods and services. This is particularly focussed on restrictions on Russia's ability to buy advanced technology equipment critical to its transportation, energy and defence sectors. Boeing and Airbus, which account for 70% of Russia's civil airline fleet, have suspended sales of new planes and parts.

- measures designed to restrict Russia's ability to raise revenues from hydrocarbon sales, including bans on purchases of Russian coal and oil by companies in the EU, US and UK (these have been partly implemented and are due to be implemented in full by early 2023).

The fourth category of measures are different from the other sanctions in that they were not designed to prevent from the outset Russian sales of oil and gas to European or global markets. It was recognised that this would push up world prices, causing widespread economic distress, not just in the countries imposing sanctions, but in the wider world too. It could also enable Russia to maintain its overall hydrocarbon revenues, even if its volume of sales dropped. On the other hand, the optics of Western energy firms continuing to pay billions of dollars to the Russian government which it would then use to sustain its attack on Ukraine was very hard to defend.

The West's goal has therefore been to limit the revenues Russia can raise from its hydrocarbon exports, particularly through sales to Western companies, while not necessarily limiting the volume. The EU ban on purchases of coal and oil is being phased in, allowing time for alternative supplies and sources of energy to be put in place. And there has been no ban on sales of Russian gas to Europe. Meanwhile the G7 has agreed in principle to establish what essentially will be a buyers' cartel, beginning in December, which would impose a cap on the price that Russia can charge for oil (the most important energy commodity in sustaining government revenues). This would be implemented alongside, and be sustained by, a ban on the supply - from Western financial centres - of shipping and insurance services for cargoes that exceed a given price. At the same time the EU is exploring imposing a price cap on organised exchange transactions in gas, based on the Dutch Transfer Facility Index. It is not clear however, how this will work if demand pressures increase.

The West has also looked for support from OPEC, and in particular Saudi Arabia, in maintaining plentiful international oil supplies. This would have paralleled the contribution that the Gulf States made to maintaining economic stability during the 1991 Gulf war. However, this has not been forthcoming. Indeed, OPEC agreed in September to a 100,000 bpd production cut starting in October. OPEC has defended this decision by saying that it is trying to avoid a collapse in the international oil price as the global economy slows. However, it is also possible that at least some OPEC members are concerned about the precedent that could be set through a buyers' cartel for action against OPEC - and are therefore determined it should not succeed.

The urgency of the situation has meant that sanctions measures were devised and implemented at great speed, and often without time to think through the full ramifications. They also, arguably, went a lot further than some countries in the coalition initially expected, carried along by the public reaction to Russia's attack, and certainly further than the Russian government had expected.

The core purpose of the sanctions is to weaken Russia's ability to continue its attack on Ukraine. This was confirmed as soon as it became clear that Ukraine's current government would survive Russia's initial attack. Moreover, the sanctions are not expected to address the situation *on their own*. In contrast to some other situations in which sanctions have been deployed, the current measures are part of an *integrated strategy,* including direct military and budget support for Ukraine as well as diplomatic support, which is designed to ensure Ukraine's survival and ability to win back as much as possible of the territory occupied illegally by Russia.

The West no doubt also hopes that the response to Russia's unprovoked attack will deter other countries, or ruling elites, from contemplating similar steps in future. But deterrence does not appear to be as high a priority in the design of the sanctions as securing a satisfactory outcome to the current war. Initially, there was also much debate over what the terms for lifting the sanctions might eventually be. However, as the war has continued, with growing evidence of war crimes by Russian forces, and the success of the Ukrainian armed forces in reclaiming territory, there appears to be a growing consensus among policy makers and analysts that the sanctions will remain in place indefinitely, or until Russian forces leave Ukrainian territory.

Breadth of support

The officially-mandated sanctions have been substantially amplified by voluntary steps taken by many hundreds of western multinationals which have suspended activities, or withdrawn completely from the Russian economy. This has sometimes come at considerable financial cost, as seem with BP's $24 bn pre-tax charge linked to its disinvestment from Rosneft.

This in part reflects the desire to avoid legal risks and in particular the fear of inadvertently conflicting with US and EU sanctions. But it also reflects pressure from staff, customers and investors underpinned by the Environment Social and Governance (ESG) investor movement, and the recognition by some company CEOs of the threat President Putin's action poses to the rules that govern not just global security, but also trade and investment. The response of Ukraine's creditors to its need for long-term debt restructuring will be a further test of the international financial community's approach to the moral and humanitarian issues raised by Russia's invasion.

The official sanction measures have been adopted by a broad range of countries (some 40-50) going beyond the G7 and NATO members. For example, both Switzerland and Singapore have dropped their traditional neutrality and adopted sanctions of different kinds against Russia.

But the number of countries actively supporting the sanctions regime still falls well short of the number who have publicly condemned Russia's actions. 141 out of 193 UN member states voted for a resolution on 2 March demanding that Russia "immediately, completely and unconditionally withdraw all of its military forces from the territory of Ukraine within its internationally recognized borders" and 93 member states voted on April 7 to suspend Russia from the UN Human Rights Council. On 12 October, 143 countries backed a resolution reaffirming Ukraine's independence and territorial integrity. Thirty-five countries abstained from voting, while Russia and four other countries with close ties to Moscow voted against it.

The most important country which has declined to take part in the sanctions campaign against Russia is China. On 4 February, shortly before Russia's invasion of Ukraine, Presidents Xi and Putin met and agreed that "Friendship between the two states has no limits, there are no 'forbidden' areas of cooperation… ".

Since Russia's attack on Ukraine, China has called for a diplomatic solution to the crisis, while providing relatively strong political support to Russia. It has also taken advantage of Russia's need to find new markets for its hydrocarbons to become one of Russia's largest oil importers.

China does not want to see the West "win" in its conflict with Russia, or to see President Putin replaced by a pro-western regime. But nor does it want to rule out future cooperation with Ukraine once the conflict is over, see the war escalate to the point where Russia deploys so called "battlefield" nuclear weapons, or become associated too closely with a failing regime. At the Summit of the Shanghai Cooperation Organisation (SCO) on 16 September, President Putin referred to Chinese "concerns" about the situation in Ukraine.

The Chinese government has therefore been cautious about going beyond verbal support and the purchase of commodities to providing military equipment. Similarly, Chinese-owned public and private companies - have been cautious about taking steps that might trigger Western secondary sanctions or expose Chinese companies to legal action in US and EU courts.

India has also abstained in the UN General Assembly votes on Russia and has sharply increased its purchases of Russian oil, but it has come increasingly critical of Russia's actions. At the September SCO Summit, Prime Minister Modi told President Putin that 'now is not a time for war'.

The growing concerns of *both* China and India, as well as several other emerging economies, with Russia's behaviour in Ukraine are illustrated by their endorsement of a final declaration at the 15-16 November G20 Summit which states that "The use or threat of use of nuclear weapons is inadmissible." and "Today's era must not be of war."[5]

Some low-income countries have condemned Russia's action, while others abstained in the UN General Assembly vote. But there is a widespread concern across the developing world at the costs of a continuing war (in high energy prices, high US interest rates and a strong dollar, supply chain disruption and possible food shortages) and a fear that the sheer scale of Western economic assistance to Ukraine, combined with the need to address the sharp pandemic-related rise in public debt, will lead to a de-prioritisation of their needs. The UK government's decision over the summer temporarily to block "non-essential" new aid payments re-enforced this concern.

It is also important to note that the Western sanctions were specifically not designed to restrict Russian exports of food or fertiliser, although the impact of the war more generally (including the disruption to Ukrainian wheat exports from Black Sea ports) contributed to a surge in food prices. These have, however returned to pre-invasion levels, in part reflecting the UN-brokered deal that has allowed export of Ukrainian grain from Odessa.

Meanwhile, several other major emerging economies have tried to avoid explicitly taking sides and, in some cases (notably Turkey), have sought to maintain good relations with Russia while supporting Ukraine and the G7 on some issues.

Overall effectiveness

The Western sanctions package initially caused dramatic falls in the Russian currency and equity markets, but through a mixture of conventional macroeconomic policies (raising domestic interest rates to 20%) and imposing capital controls, the authorities were able **to stabilise the short-term outlook**. This was helped by a sharp increase in the price of oil and gas exports, and fall in the volume of general imports, which helped sustain the current

[5] European Council (2020), 'G20 Bali Leaders' Declaration', 16 November 2021, [G20 Bali Leaders' Declaration - Consilium (europa.eu)]

account. Government revenues from the energy sector were as high after sanctions were imposed as before. The success of the authorities' short-term measures can be seen in economic forecasts for Russian GDP in 2022. While initial market forecasts were for Russian GDP to fall by 15% in 2022, the latest IMF estimate is for a fall of 3.4% in 2022 and 2.3% in 2023.

However, although the short-term picture (2-3 years) looks much less serious than initially thought, the medium-long term outlook for **Russia's economy, assuming sanctions are maintained, is very poor.**

There are four reasons for this.

First is the loss of access to **western technology which** will have an increasing effect across the board in reducing Russia's productivity growth. For example, while Russia, has announced plans to replace Western civil aircraft with its own designs and manufacturing, these will be more expensive and potentially less reliable. Experience from the cold war showed that while it was possible to maintain technical parity, or even a lead, in a few areas (e.g. electricity generation and defence equipment) while operating an autarkic economic model, it was impossible to do so for the bulk of the economy.

Second, is Russia's loss of **access to western financial capital**, both as a result of official sanction measures and private decisions by western companies to with draw from existing FDI investments.

Third is the **very substantial brain drain** and loss of human capital that has result from the increase in political restrictions that followed the invasion and the imposition of a selective draft (leading some 200,000 Russians to leave over a few weeks). Those choosing to leave were typically young and better educated. Moreover it seems likely that the outflow will continue if the war continues. While the Russian authorities may try and check the flow by imposing exit visas, preparations to do this would trigger a further sharp outflow, and once imposed would only serve to increase the Russian economy's isolation.

Fourth is the prospect that Russian hydrocarbon revenues will eventually fall to the point where it imposes **serious constraints on government revenues**, as well as triggering a **balance of payments crisis**. The global oil and European gas price have already fallen substantially from their peaks, with the crude oil price at the end of October at 70% of its June peak and the benchmark European gas future at less than 30% of its June peak. At the same time Russia has cut supplies of gas to Europe to 20% of pre-war levels. While these adjustments may prove temporary, and market analysts remain very concerned about a peak in energy prices in 2023/24 given the current European winter storage levels (currently over 90%) will be much lower then, Russia now faces the medium-term prospect of losing its entire market for gas in Europe. Germany has, for example, set a target of completely eliminating gas imports from Russia by 2024.

It is unclear how the Russian authorities will respond to this increasing pressure. They may, for example, hope to rely on expanding trade and investment ties with China. But China's own growth is slowing sharply, and the Chinese are likely to drive a hard bargain. Russia may be forced to pay itself for the infrastructure necessary to increase gas exports to China in circumstances where the long-term demand for gas is highly uncertain due to climate change. China is also likely to demand a discounted price.

At the same time, if Russia were to face a financial market crisis, it is very unlikely that it would have access to the normal system of balance of payments support overseen by the IMF. The West would likely veto any Fund programme in circumstances where Russia was continuing its attack on Ukraine.

In the worst-case scenario - with growing isolation, reduced domestic economic potential and being ruled by an unelected clique - Russia may find itself in a situation approaching that of Iran, or even North Korea. The political consequences of this are hard to judge, with some analysts arguing that even in these circumstances, President Putin would not be removed from office.

Future sanctions

Western sanctions have been repeatedly extended and re-enforced since 24th February. The EU, for example, announced its 8th package of sanctions on 12 October, while on 14 November the US announced a new set of measures targeting firms and individuals who have acted as financial facilitators or enablers of Russia's arms industry.[6]

Typically each package of sanctions has extended and strengthened previous measures following an existing dimension – e.g. deepening Russia's exclusion from international financial markets, targeting a broader range of supporters of President Putin, further restricting Russia's access to advanced technology, or restricting sales of hydrocarbon products. However, there are two ways in which the sanctions measures could take a radically different route.

First is to introduce the **oil price cap** which has been agreed in principle by the G7, but not yet implemented. This would be fiercely resisted by Russia, and the Russian authorities have said that they would not sell oil to any country which sought to impose the cap. However, given the lower price of oil, the West may find it is in a stronger position to impose the cap.

Second, is a measures to **confiscate Russian state and private assets** with a view to compensating Ukraine for the infrastructure it has lost during the war and providing it with the public funds needed for reconstruction. The total volume of frozen Russian foreign exchange reserves alone (in excess of $300bn) is of the same order as current estimates of

[6] DefenseNews (2022), 'US announces sanctions targeting Russian military suppliers', 14 November 2022, US announces sanctions targeting Russian military suppliers (defensenews.com)

the reconstruction costs (of some $349bn[7]). Having a credible mechanism to confiscate Russian assets to meet reconstruction needs might also have a deterrent effect since Russia would be aware that there was a strong likelihood it would end up paying for damage caused to civilian infrastructure.

However, this is not straight forward as the legal base for confiscating assets is not the same as for freezing them. It would also raise many complex issues regarding sovereign immunity and human rights (in the case of private assets). However, various western authorities are currently looking at ways these issues might be addressed. For example, new EU legislation will make it a criminal offence to try and evade sanctions[8]. This could in turn provide a basis for the confiscation of certain assets.

Russian retaliation against the West

Given that the goal of western economic and financial sanctions is to weaken Russia's ability to continue the war by restricting its access to financial markets, advanced technology and markets for its hydrocarbon products, the main way Russia can respond is through restricting sales of goods that the West still wants to buy.

This is why Russia's main, and most visible, form of retaliation has been to cut its supplies of gas to Europe to 20% of pre-war levels (so that Russian gas now only accounts for some 9% of European demand).

This was initially very effective in pushing up European gas prices four-fold, although they have subsequently eased. European governments reacted by pursuing a wide range of measures with four objectives:

- to find **alternative sources of energy** (including renewables, LNG from the US and Qatar, extended use of coal and nuclear);

- to **reduce energy demand** through public and private conservation measures;

- to try and **cushion consumers** (business and retail) from the very sharp increase in prices with expensive subsidy packages in some cases funded through windfall taxes on energy companies;

- to take **direct control of energy infrastructure** and supply, through nationalisation, so that short-term emergency measures could be implemented more effectively, while long-term strategic shifts could be put in place more rapidly.

[7] World Bank (2022), 'Ukraine Recovery and Reconstruction Needs Estimated $349bn', press release, 9 September 2022, Ukraine Recovery and Reconstruction Needs Estimated $349 Billion (worldbank.org)
[8] Strupczeski, J., (2022), 'EU to make breaking sanctions against Russia a crime, seizing assets easier', Reuters, 25 May 2022, EU to make breaking sanctions against Russia a crime, seizing assets easier | Reuters

Countries have differed in how they have mixed these approaches, and some initial decisions (such as an untargeted and highly expensive two-year UK energy price cap for all domestic consumers) have been rolled back. But the principle of large-scale government intervention in energy markets is well established.

It is also notable that Russia targeted the EU, as one of Ukraine's strongest supporters and potentially one of the most vulnerable to such pressure given its high degree of dependence on Russia. It has not to date targeted Japan which has highly diversified gas sources and takes only 8% of its total supplies from Russia.

The second area of retaliation has been in "grey" activities, such as the attack on Baltic gas pipelines (which, although unclaimed, some analysts have attributed to Russia). It is likely that there has also been an increase in cyberattacks on the West. According to one report[9], the average weekly level of cyber-attacks per organization a month after the war started stood 18% higher in Europe compared to before the beginning of the war and 14% higher in the US. It is hard to judge the full economic cost of this form of retaliation. However, it illustrates the vulnerabilities western economies live with.

Increased demands on western development budgets

Despite the energy price shock this year, the IMF's October 2022 forecast for debt/GDP in 2025 in the US, EU and Japan is broadly similar to its October 2021 forecast (See Annex A). So the overall burden of debt is not expected to change significantly as a result of the war in Ukraine.

However, Western assistance to Ukraine is on an extremely large scale when compared with normal external assistance budgets. Between 24 January and 3 October 2022, total G7 support (delivered and committed) for Ukraine amounted to euros 83.8 bn and was broken down as follows: military support, euros 36.2; budgetary support, euros 34.7; and humanitarian assistance, euros 12.7bn.[10] Moreover, the *on-going* requirement for budget support in Ukraine is around euros 5bn a month.

This compares with total official development assistance (ODA) from official donor members of the OECD's Development Assistance Committee (DAC) of US$ 178.9 billion in 2021, a figure which had increased 4.4% in real terms from 2020 as developed countries stepped up

[9] *El Pais* (2022), 'Cyberattacks on the rise since the start if the Russian invasion', 9 April 2022, Russia war: Cyberattacks on the rise since the start of the Ukraine invasion | Science & Tech | EL PAÍS English Edition (elpais.com)

[10] Keil Institute for the World Economy (2022), 'Ukraine Support Tracker', Ukraine Support Tracker | Kiel Institute (ifw-kiel.de). This includes the contribution of the European Institutions and EU member states that are part of the G7, but not e.g. direct contributions by Poland, whose support has amounted to a further euros 3bn.

to help developing countries grappling with the COVID-19 crisis. This was equivalent to 0.33% of DAC donors' combined gross national income (GNI).[11]

The relative size of the West's current spending and future commitments in support of Ukraine has raised deep concerns among developing countries that it will divert planned aid from poorer countries to Ukraine (an ODA-eligible country).

Moreover, even before the Ukraine war, there were already enormous challenges for international development finance, as seen in the delay in reaching the $100bn pa target for public climate finance under the Paris Agreement, and the difficulties encountered in funding the relatively modest (when compared with the risks) needs for pandemic preparedness and response (estimated by the Global Commons Report[12] at $15bn pa over five years).

The scale of on-going commitments to Ukraine, combined with need to fund higher defence spending and (in Europe) provide support for energy consumers facing sharply higher natural gas prices, means there is bound to be pressure on Western development funding (outside Ukraine) going forward. And if the war continues, this could last for a number of years.

Economic transformation of Ukraine

Ukraine's economy is under enormous strain in the short term. Russia's invasion has triggered an outflow of some 7mn refugees, disrupted economic activity, increased defence and social spending, caused the government to default on its debt, and destroyed vast swathes of infrastructure. Russia's recent attacks on Ukraine's energy system alone have taken out 40% of generation capacity and it remains to be seen if Ukrainian air defences can be strengthened sufficiently to limit further damage. Meanwhile, Russia's widespread mining of the Kherson region (recently reclaimed by Ukraine) could leave Ukraine with costs lasting many years. Against this background, the IMF is projecting a fall of 33% in GDP in 2022 with inflation of 20%. Moreover, as mentioned above, Ukraine needs continuing large budgetary support to cover the government's current fiscal deficit.

However, the **medium-long term prospects for Ukraine,** once the hot war stops, are much brighter. This reflects four factors:

First is Ukraine's **strong underlying economic capabilities,** particularly in agriculture, high tech and defence industries. It also has thriving SMEs and an enormous diaspora (of same 20 mn people) to call on.

[11] OECD Development Assistance Committee (2022), 'ODA Levels in 2021 – Preliminary Data', Detailed Summary Note, 12 April 2022, [Title] (oecd.org)

[12] Italian Presidency of the G20 (2021), 'A Global Deal for or Pandemic Age', Report | Pandemic Financing (pandemic-financing.org)

Second, the war and the struggle for survival against Russia has built a much stronger **sense of national identity**, national purpose and commitment to reform.

In the past Ukraine's economic development was held back by widespread corruption and the political dominance of oligarchs in politics. However, over the period from 2014 to 2022, following Russia's occupation and illegal annexation of Crimea, a western orientated, technocratic, liberal, group in Ukrainian society led a series of successful reforms (in agriculture, the military, the national health system, and financial system) which demonstrated Ukraine's ability to reform and also played a substantial role in enabling it to withstand Russia's invasion earlier this year.

Russia's invasion has carried that process further forward, galvanising a sense of national identity and sense of purpose and uniting Ukrainian and Russian speakers in the pursuit of independence and reform. Ukrainians are determined that the society that emerges from the war will not revert to the pre-war practices of corruption and oligarchy.

Third is Ukraine's acceptance as a candidate for EU membership which creates a **strong external framework and incentive for future reforms** and the maintenance of democracy. If Ukraine is eventually successful and accepted as an EU member, it will initially need substantial financial support from the EU, over and above what will in any case be required to enable it to survive Russia's attack. However, the economy could be a strong long-term contributor to EU growth - in the manner of Spain and Poland following their accessions - and will also strengthen EU food security.

Ukraine's relationship with NATO will also contribute to the external framework for Ukraine's post war development. While formal membership of NATO does not seem likely for the foreseeable future, the close relationship established as a result of the war will yield a number of benefits for Ukraine's future development, including the "NATO-isation" of the Ukrainian armed forces, access to Western weapons and training and NATO support for the development of key defence industries.

Fourth, is the **enormous global soft power** that Ukraine has acquired as a result of its resistance to Russia's invasion. This may eventually translate into substantial FDI, particularly when combined with the factors above (including the ability to access trained labour from the diaspora).

Given these factors, Ukraine has the potential to achieve a high and sustained growth rate (of perhaps 5-10% pa over 10 years – comparable to Ireland's performance in the 1990s, or South Korea in the 1960s).

But to achieve this it will need to repel Russia's attack and achieve a cessation of hostilities in which Russia is no longer able to disrupt its development, either politically or militarily. This has parallels with the situation faced by South Korea through much of the post-war period. North Korea has continued to threaten the South, which is highly vulnerable militarily, but, with support from the US, the latter has achieved enough stability in the conflict to prosper.

Ukraine will also need to devise a plan to finance reconstruction which does not depend on reparations from Russia (given the uncertainties) and is protected from corruption threats. Several experts have argued that DEFI ('decentralised finance') which draws on crowd funding and virtual currencies can play a valuable role in the latter, as it would help ensure transparency in funding flows and draw on Ukraine's established strengths in fintech.

Impacts on the international economic system

The four drivers of change described above are impacting the international economic system in four main ways:

- by changing our system of **global economic governance**;
- through their impact on our **response to climate change**;
- by contributing to the **fragmentation of global markets** for goods, services and capital; and
- through the different roles that the transformed (for better or worse) **Ukrainian and Russian economies** may play in the global economy in the future.

Consider each of these in turn.

Global economic governance

Implications for the G7 and EU

Russia's attack on Ukraine has, somewhat perversely, helped unify and **strengthen the Western alliance** which only a few months earlier had seemed to be in a serious trouble following the chaotic withdrawal from Afghanistan and the recriminations that followed.

US leadership has underpinned the unprecedented economic and financial sanctions, the enormous package of economic, humanitarian and military assistance for Ukraine, the strengthening of NATO forces along the Russian border and the positive and speedy response by most NATO Alliance members to the request by Sweden and Finland to join organisation.

Moreover, the integrated nature of the required response - across political, economic and military spheres - has meant that collective action in one area has re-enforced cooperation in another.

Within this framework, and urged on by Poland and other member states bordering Russia, the **EU has taken substantial action** despite the disparate views and interests of its 27 members and the position of Hungary's Prime Minister, Victor Orban, who has remained sympathetic to President Putin. It has largely resisted Russian efforts to divide EU members, backed the exceptional sanctions package against Russia, provided and promised extensive economic, military and humanitarian support for Ukraine (including accepting an estimated 4.18 mn refugees as of the end of October 2022[13]), and reached a consensus on difficult issues such as offering Ukraine and Moldova EU candidate status and a plan to phase out Russian hydrocarbon imports. Some individual member states have also taken tough decisions to increase defence spending, notwithstanding the very difficult budgetary situation created by multiple international economic crises.

To some extent the EU's actions - for example in developing a collective response to Russia's cuts in gas supplies and reaching rapid agreement on Ukraine's application for EU candidate status - have built on its successes in response to the pandemic, such as the creation of a pan-EU funding mechanism to support the Next Generation EU package and the (ultimately) successful roll out of collective vaccine purchases.

It is also likely that the impetus of the Ukraine crisis will lead to a **further deepening in the EU's technical capabilities.** It is clear, for example, that the EU (as well as potentially other G7 countries) needs new instruments to deliver short-term budgetary support to Ukraine (as opposed to conventional medium-long term macro-financial assistance).[14]

The intense economic pressure on EU member states resulting from Russian retaliation has led many commentators to question whether the EU will retain its unity of purpose in supporting Ukraine through a difficult winter. This has been re-enforced by the election of a new Italian government in September which includes Silvio Berlusconi's Forza Italia as a junior partner. Berlusconi has made no secret of his friendship with President Putin and his sympathies for Russia's position on Ukraine. However, the realties of what compromising with Russia would mean for Europe's long-term security, the strength of opinion among most EU member states, the bureaucratic momentum in the European Institutions, and Italy's need for EU solidarity in the context of its very high public debt and low growth, suggest that the EU will be able to maintain its current stance.

Consequences for broad based multilateralism

But while Russia's action has strengthened cohesion within the G7 and EU, it has put broader multilateralism under enormous strain.

[13] European Council (2022), 'Infographic - Refugees from Ukraine in the EU', 31 October 2022, [Refugees from Ukraine in the EU - Consilium (europa.eu)]

[14] The lack of such instruments may in part explain the significant delays in disbursement of EU financial commitments to Ukraine.

The UN Secretary General condemned Russia's attack on Ukraine, but the UN's ability to compel Russia to comply with the UN charter is effectively paralysed by the Russian Security Council veto and Chinese political support. This paralysis also affects, to a greater or lesser extent, the work of many UN bodies with economic functions.

The specialised international economic organisations, such as the IMF and World Bank, have continued to act within their existing mandates to try and address the economic and humanitarian consequences of the war, without addressing the question of ultimate responsibility for its origins. This has been helped by the legal basis for the IFIs operations, but has still been difficult, and future issues affecting these institutions' governance (such as proposals to enhance the IMF's legitimacy through a further revision of IMF voting weights) may be stalled. Meanwhile, international economic organisations whose governance and direction is more heavily influenced by the West - such as the IEA, EBRD, FATF and OECD - have been able to use the space created to take more active measures against Russia while also providing direct support for Ukraine[15].

The pressure on multilateralism can also be seen in the walkouts by Western countries from the IMFC[16] and the G20 at the IMF/World Bank spring meetings. Western countries have balked at being required to work collaboratively within a group that includes a major country which is undermining the entire international governance system. At the same time, other major (emerging market) economies have declined to expel or suspend Russia from the G20. The informal nature of the G20 means that there are no well-defined rules, procedures or legal texts governing its operation to fall back on.

One option is for the West is to rely more on the G7 and "G7 plus" groupings, and to some extent this has happened, with the creation of new political/economic groupings. The *European Political Community* [17] met for the first time on 6 October and links the EU with 17 other European countries (including the UK and Ukraine). Issues such as energy security and migration are included within its scope. Similarly, in March the G7 plus Australia launched a new multilateral task force to coordinate efforts to freeze and seize assets of kleptocrats, focussing initially on allies of President Putin.[18]

However, there are limits to how far this approach can go given the G7's limited band width (particularly as it focusses on support for Ukraine), its wider lack of legitimacy (e.g. in the

[15] For example, a Financial Action Task Force (FATF) statement on 17 June 2022 said "The Russian actions run counter to the FATF core principles aiming to promote security, safety and the integrity of the global financial system. They also represent a gross violation of the commitment to international cooperation and mutual respect upon which FATF Members have agreed to implement and support the FATF Standards." Financial Action Task Force (2022), 'FATF Statement on the Russian Federation', 17 June 2022, **https://www.fatf-gafi.org/publications/?hf=10&b=0&q=ukraine&s=desc(fatf_releasedate)**

[16] International Monetary and Financial Committee

[17] Council of the European Union (2022), 'Meeting of the European Political Community, 6 October 2022', Meeting of the European Political Community - Consilium (europa.eu)

[18] US Department of the Treasury (2022), 'US Departments of Treasury and Justice Launch Multilateral Russian Oligarch Task Force', Press release, 16 March 2022 U.S. Departments of Treasury and Justice Launch Multilateral Russian Oligarch Task Force | U.S. Department of the Treasury

eyes of many developing countries) and the need on many key global issues to extend cooperation beyond like-minded Western countries. In particular, there is a limit to the willingness of G7 members to carry the financial burden of addressing massive global challenges without buy in and contributions from other major emerging economies.

Lack of legitimacy, financial resources, and policy capabilities, are also a key constraint on the extent to which private sector initiatives can substitute for government led action through groups like the G20.

The 2022 Indonesian G20 Presidency persevered in trying to progress its agenda on global challenges in the run up to the G20 Leaders' summit on 15-16 November. And the resulting agreed Leaders' statement, following a series of ministerial meetings in which no concluding statement had been agreed, suggests that the West concluded (rightly) that it was important to preserve the G20 as a functioning body, even while Russia continued as a member. This is because the G20 remains the most important framework through which to develop cooperation on critical economic challenges with major emerging economies, notably China, India and Brazil. It is also likely that Russian officials will continue to keep a low profile (President Putin did not attend the G20 Summit) since their top priority will be to preserve the membership of the organisation.[19]

But, while the G20 may survive, it will require a major repair effort if it is to restore the role it identified for itself in 2009 as the 'the premier forum for international economic cooperation'. Moreover, the overall weakening in global governance that has resulted from the on-going war in Ukraine is an enormous concern, particularly as the need for global coordination and political leadership on such issues as the management of the global economy in the face of inflation shocks, climate change, food shortages, cyber-security, preventing future pandemics and tackling the escalating developing country sovereign debt crisis is growing by the day.

Impetus for climate action

Many governments responded to the sharp increase in oil and gas prices during 2022 by cutting taxes on hydrocarbon energy products and/or increasing subsidies linked to their use, arguing that this is a social and political necessity. There have also been short-term moves to expand the use of coal as an alternative to Russian gas exports. This has led to the fear that supposedly temporary emergency measures damaging for the climate will one way or another become "locked in". The energy price shock has also emboldened political groups which oppose climate action in the US to push back against moves by institutional investors to follow ESG investment principles. The Texas legislature passed a law in 2021 to

[19] Butler, C., (2022), 'The G20 will survive but needs major repair', Chatham House Expert Comment, 15 November 2022, [The G20 will survive but needs major repair | Chatham House – International Affairs Think Tank]

boycott investment firms that follow ESG principles, and this has resulted in a number of fund management firms weakening their commitment to ESG investing in 2022.

But, while there is a risk that the energy price shock triggered by Russia's invasion of Ukraine will delay climate action in some parts of the world, in Europe at least there is strong likelihood is that it will accelerate rather than delay implementation of climate action measures[20].

This is because in the context of increasing incidence of extreme weather, growing evidence that we are approaching climate tipping points, and recognition that the GHG budget agreed at Paris in 2015 to stay on track for 1.5 degrees of warming is rapidly running out (less than nine years left), most political and business leaders see climate action measures as inevitable. In addition, Russia's attack on Ukraine and the experience of cuts in Russian gas supplies means that energy security and climate objectives are viewed as closely aligned.

The implications of accelerated climate action for the European economy are still being assessed. But while the concerns over adjustment costs and the size of the financial investment required for transition remain, there is also an increasing body of economic research that suggests that faster and more comprehensive implementation of carbon reduction measures will accelerate growth. This would happen through two channels. First is the reduction in policy uncertainty, which reduces the required return on private investment in carbon reduction measures and boosts the overall levels of investment. Second is the likelihood that implementing carbon reduction measures quickly and comprehensively so that everyone moves together will reduce costs through economies of scale and faster technical development. In circumstances where Europe followed this course, while other countries did not, one would expect to see a substantial out performance in European growth performance over the coming decade[21].

Looking beyond Europe, the same rationale - on the potential for higher growth - would also apply to developing economies, where a much higher proportion of investment would need to be focussed on adaptation, rather than mitigation.

However, a key requirement - for both advanced and developing countries – in circumstances where a very large amount of money (estimated at US$ 5 tn a year) has to be spent in a very short space of time is to ensure the required financial flows are protected against corruption risks.[22] The experience from Afghanistan and the response to the

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[20] See, for example, the analysis in the International Energy Agency's latest World Energy Outlook. International Energy Agency (2022), 'World Energy Outlook', October 2022, World Energy Outlook 2022 – Analysis - IEA

[21] While the US Inflation Reduction Act is expected to have a major positive impact on the speed of US transition to net zero, the divisions between political parties in the US on climate action mean that it is less certain that the US effort will be sustained compared with Europe.

[22] See Butler, C., Hagen, S. and Martin, D., 'Corruption Risks Loom Large over Financing of Green Investment' Peterson Institute for International Economics Briefing Paper, September 2022,

pandemic illustrates the threat. Meanwhile, Russia's efforts to evade Western sanctions may well lead to a substantial stepping up of state-led efforts by Russia, and possibly other authoritarian governments, to undermine international mechanisms to control illicit financial flows. This will be highly damaging in its own right, but could also open the way for organised crime to further undermine the system. And if corruption risks are not controlled a substantial part of essential climate funding may be wasted either because funds are siphoned off, or because they do not do what was intended on climate mitigation or adaptation. There is also a risk that much necessary investment may not happen at all because the private sector is scared off, or political support in the West for international public climate finance is eroded.

A further possible consequence of Russia's attack on Ukraine is that it will lead to changes in the wider international economic system that could have implications for climate action. For example, the move to develop a mechanism to cap the price of Russian oil and gas exports could also have long-term implications for the viability of the OPEC cartel. A breakdown in the cartel could push Saudi Arabia sooner into what is likely to be its optimal long-term strategy, keeping oil prices low to drive out high cost competing producers, so it secures its position as the lowest cost and last remaining supplier of hydrocarbon products. In the short term, lower oil prices could increase consumption of hydrocarbons, but it will also reduce returns on future investment and accelerate the shift of international finance away from hydrocarbon extraction to alternative energy sources.

Acceleration in market fragmentation

Russia's invasion of Ukraine has further undermined belief in, and support for, the model of unbridled globalisation under which trade, investment, information and ideas move unrestricted across international borders.

In recent years Western countries (particularly the US, UK and EU) have tightened restrictions on the use of Chinese technology and limited Chinese investment in sectors where it is judged to create national security risks. This has been re-enforced by concerns over unfair trading practices and strategic competition from Chinese firms.

The experience of supply chain vulnerabilities (both political and technical) during the pandemic and growing concern over extreme weather events and resulting radical policy shifts linked to climate change have added to the focus on resilience[23]. While this does not *necessarily* mean greater reliance on domestic production, it has caused governments and

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https://www.piie.com/publications/policy-briefs/corruption-risks-loom-large-over-financing-green-infrastructure

[23] For example, the EU is planning to introduce a Border Carbon Adjustment Mechanism (BCAM) designed to enable high carbon intensity industries (steel, aluminium et) to undertake the high-cost investment, including R&D, necessary to achieve net zero without the fear of being undermined by external competition from countries without similarly advanced climate regulation. While probably necessary to enable the EU to move faster than other countries are willing to, the measure will inevitably contribute to fragmentation in the global markets for the commodities targeted.

companies to be far more focused on how supply chains work rather than allowing them to be driven entirely by competitive forces.

Both the Ukrainian and Russian economies are relatively small in relation to global GDP, but the war has given these trends a *further* substantial impetus.

First has been the immediate direct impact of the conflict, due e.g. to the initial closure of Black Sea ports, on supplies of critical commodities such as wheat, where the central role of Russia and Ukraine as a leading surplus producers has become all too evident. Before the war the two countries together accounted for 53 per cent of the share of global trade in sunflower oil and seeds, and 27 per cent of the share of global trade in wheat.[24]

Second is the shattering of the belief of many European politicians that it would never be in Russia's interest to restrict the supply of gas to EU markets. This has not only transformed the European view of economic security, but has also had ramifications elsewhere, as, for example, Japanese companies and the Japanese government are looking even more closely at mitigating Japan's reliance on China as both a major source of production and a major market.

Thirdly, the unprecedented nature of the West's financial sanctions has very likely heightened concern among non-democratic governments with large hard currency reserves, such as China ($3.2tn) and Saudi Arabia ($0.5tn), as to whether such reserves can really be relied on as a buffer against political as well as economic shocks.

The West's action against the Russian central bank means that Russia has been unable to deploy more than 50% of its liquid foreign exchange reserves. Meanwhile the US veto means Russia is very unlikely to get access, while the war continues, to IMF facilities designed to support countries facing foreign exchange difficulties.

Other authoritarian regimes could take the view that they would never contemplate actions as damaging to the international system - and therefore as likely to trigger a united response from the West - as Russia's attack on Ukraine, but they will nonetheless be looking for a response.

And yet an effective response is not at all easy to envisage given that the only genuinely convertible currencies are provided by Western liberal democracies. In these circumstances, conventional diversification does not help address the threat of united Western sanctions. Use of cryptocurrencies and international payments systems for non-convertible currencies may help mitigate the impact of potential restrictions on use of convertible currencies to some degree. But the ability to make payments in non-convertible currencies does not address the need for a readily accepted international store of value. And the relatively small size of crypto currency markets compared with those for foreign

[24] UNCTAD (2022), 'The Impact on Trade and Development of the War in Ukraine', UNCTAD Rapid Assessment, 16 March 2022, [The impact on trade and development of the war in Ukraine (unctad.org)]

exchange, as well as the operational and regulatory uncertainties associated with these markets, means their ability to substitute for traditional foreign exchange reserves is likely to be limited, at least in the short-medium term.

Against this background, it is possible that some countries may seek to reduce their overall reliance on both foreign exchange reserves and IMF facilities by reducing current account imbalances. If this is the case it could have profound implications for trade and investment and overall growth in the world economy.

Of course, the economic arguments for an open trade and investment regime remain very strong and it is not inevitable that world markets will become substantially more fragmented over the long-term. There is some evidence that the pace of globalisation has slowed in the last decade, but the change is not yet dramatic. China and the West are already closely integrated in economic terms and the economic costs of de-linking, except where national security concerns make it essential, are high. In addition, a global market with multiple suppliers can typically add to, rather than detract from, resilience. The agency of private companies and the choices they make within the constraints set by national governments will also be critical.

However, Russia's attack on Ukraine and everything that has followed from that has clearly increased the chances of the world reaching a tipping point in which there are accelerating moves towards fragmented markets for goods, services and capital.

Future roles of Russia and Ukraine in the international economic system

The earlier analysis in this paper sets out the very different scenarios facing the Russian and Ukrainian economies if the conflict and related sanctions continue.

On the one hand, the Russian economy is likely to become increasingly isolated with loss of key factors of production (financial and human capital, technology, external markets) and hence substantially lower growth, and possibly secular contraction. Support from China and India will be of limited use, even assuming it continues, and some critical markets for Russia's commodity exports (notably oil, gas and coal) will disappear altogether as the world economy accelerates its move to net zero. In a worst-case scenario Russia will become similar to Iran or North Korea, with a much reduced global economic footprint, but playing an increasingly disruptive role through its use of illicit finance and markets for illegal technology.

By contrast, the outlook for the Ukrainian economy is strikingly different, *provided* it can get through the immediate and very acute economic challenge of fighting the war and sustaining public services. But once the "hot" war has ended and the conflict stabilised, and provided, critically, that it continues with the reform process started in 2014, re-enforced, by the social transformation brought by the war and the requirements of accession to the EU, the influence of Ukraine on the global economy and global economic system is likely to increase substantially. Its role in agriculture is already clear, but it is also likely to have a significant impact on global technology markets (fintech, defence, software), through demonstrating new policy innovations, and eventually via the EU, on key global economic decisions. Parallels may be drawn with the role that some other medium-sized economies that have emerged from severe crisis and/or conflict play globally - notably South Korea, Israel and Poland.

Recommendations to G7

The G7 has a critical role to play, both in coordinating defensive action among like-minded partners, and in developing proposals that can help address global challenges in the interests of the entire international community.

As Japan prepares to take on the presidency of the G7 from 1st January 2023, the analysis in this paper suggests four key areas which it should consider prioritising.

Future use of sanctions

The eventual contribution of economic and financial sanctions to ending the war on terms which do not reward Russia's aggression remains to be seen. But overall, it is clear that the leverage of a united and determined West on the global economy is substantially higher than many had previously assumed. However, given the speed with which the sanctions package had to be put together, and the sequential manner in which new measures were introduced, it is vital for the G7 to take stock of what worked and what didn't in the light of experience, and what any unintended consequences of particular measures may have been.

A key part of this analysis will be to take account of how far the circumstances in which economic and financial sanctions were applied in Ukraine were special – e.g. because of the nature of the trigger, the clarity of the goal, and the interaction with climate change. This will then help inform future judgements on how far it would be appropriate to apply the measures taken in different circumstances. And whether there is a case for the G7 to intervene publicly now to condition financial market expectations on, for example, the circumstances under which the freezing of a country's foreign exchange reserves would be contemplated.

Global economic governance

The war in Ukraine has put enormous strain on the multilateral system of global economic governance, while significantly strengthening the G7. At the same time, there are numerous proposals being made to reform the international financial institutions and other parts of the global economic architecture in response to the pandemic, the climate crisis and the increasingly serious prospect of a sovereign debt crisis. Many of these proposals would be attractive in an ideal world, or even in the circumstances that existed some 15 years ago. But they do not typically take account of the damage to international trust caused by the Ukraine war and other recent geopolitical trends.

There is therefore a strong case for the G7 to take stock of the system as it stands today and consider practical proposals for improvement. This should take account of such questions as how to balance increasing legitimacy through broader representation in the governance of the IFIs vs maintaining effectiveness; how to ensure equitable burden sharing between advanced and emerging economies; and identifying where the precise priorities are for West-China cooperation on each of the key global issues (including sovereign debt distress, global health financing and climate action) given the possibility that the bandwidth for effective cooperation could prove to be limited.

Climate action

The war in Ukraine is forcing a wide range of countries - particularly in the EU - to take very radical economic policy measures - beneficial in the fight against climate change - that might not have been considered in the absence of Russia's attack. This is likely to create opportunities to accelerate climate action along traditional lines but may also open up entirely new policy avenues which could not be considered before. The G7 should examine what has happened and why, and what lessons should be drawn from this experience.

The war in Ukraine is another example, following on from the pandemic, where policy makers have been willing to take truly extraordinary policy measures, with wide ramifications (many of them not well understood) in response to a global economic shock. And yet, on the issue of climate change, which poses an even greater existential threat to mankind, the policy response is still falling far short of what is required.

Economic security

The G7 began looking seriously at economic security and resilience under the UK and German Presidencies in 2021 and 2022 and it is likely that this work will continue under the Japanese Presidency in 2023. As mentioned earlier, Russia's attack on Ukraine has both given greater urgency to the issues, and expanded the range of scenarios that need to be considered. However, as well as following through on the existing agenda set by earlier presidencies - including addressing systematically supply chain vulnerabilities and developing a response to economic coercion - the G7 should also take the opportunity to think through more precisely where it wants the current trend towards economic fragmentation to end. This entails looking closely at what is really required under e.g. national security, competition and climate change considerations, and what is not. The cost to global prosperity of going further than is needed would be considerable.

Conclusions

The eventual implications of the war in Ukraine for the international economic system will depend critically on how long the war continues, and what the eventual settlement looks like. The strength and determination of Ukrainian resistance has if anything deepened as the war has continued. Moreover, the Western consensus on providing strong support for

Ukraine has so far held up firmly despite a barrage of economic and implicit nuclear threats by Russia.

Several commentators have questioned whether this consensus will be sustained through winter 2022-23 (when EU countries will be most vulnerable to reduction or suspension of gas exports from Russia), or after 2024 (if President Trump, or a Republican politician with a similar outlook, is elected). Nonetheless, the most probable scenario is that the Western commitment will be very largely sustained, essentially because of the enormous national security issues at stake. In these circumstances, the war could go on for months and possibly even years until the situation is stabilised (potentially through a complete, or near complete, withdrawal of Russian forces from Ukrainian territory).

Ukraine has enormous natural resources and human capabilities, combined with a strong civil society, free media and pluralistic government. The period from 2014 to 2022 has demonstrated its ability to reform and progress economically and militarily despite continuing influence of oligarchs on Ukrainian politics. The post-war reform process is likely to be even more effective. There are, of course, other much less positive scenarios, particularly if Ukraine finds it hard to maintain the unity and sense of purpose it has achieved in response to Russia's attack in the face of continuing Russian disinformation campaigns and/or a revival in the influence of oligarchs.

But the more successful Ukraine is over the long-term, even if it fails in the short-term to recover all the territory occupied by Russia, the more the West's actions will be perceived as a success, and the more likely it will be that the underlying principles of the post-WW2 rules-based multilateral system - economic and political - will be preserved.

Another key aspect of how these geopolitical forces will play out is what lessons China and the US take from Russia's invasion of Ukraine for their handling of the dispute over Taiwan and whether it proves possible for the West and China to establish a working relationship which enables them to tackle global challenges where they have a strong common interest in cooperation.

Some foreign policy experts have advocated a system of "managed strategic competition"[25] which would enable cooperation between the West and China on areas of vital common interest while managing competition and conflicts in other areas. Achieving this will be difficult, but the alternatives are very unpalatable. It is also possible that rapid deterioration on one of the current global policy challenges, such as the emergence of a full-scale sovereign debt crisis in the developing world or a macroeconomic crisis triggered by accelerating impacts pf climate change, could force the key parties to put in place the necessary working relationship. If an understanding between the West and China is achieved, other key elements for global cooperation are much more likely to fall into place.

[25] See "The Avoidable War" by Kevin Rudd

Against this background, it is recommended that Japan use its forthcoming G7 Presidency, at least in part, to enable G7 members to think through the implications of what has happened in Ukraine for the future role and effectiveness of the group, as well as the tools it deploys, given that it is likely to play a substantially more important role in global economic governance than has for some years been envisaged.

Annex A **Projections for gross debt/GDP ratios (%)**

	October 2022 WEO			October 2021 WEO
	2019	2021	2025	2025
Average of all countries	103.9	117.9	112.7	*118.9*
US	108.8	128.1	129.4	*132.5*
Japan	236.3	262.5	260.7	*251.3*
Japan (net debt/GDP ratio)	151.1	168.1	172.4	*168.7*
Euro Area	83.8	95.3	88.8	*93.4*
UK	83.9	95.3	76.7	*111.2*
China	57.2	71.5	94.8	*78.5*
Sub-Saharan Africa	43.5	51.4	46.1	*47.8*

Source, IMF Fiscal Monitor, October 2022 and October 2021