Nervous market response to sanctions on Russia

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Global stock markets have fallen in the wake of the decision by Russia to order troops into the Eastern Ukrainian separatist republics of Donetsk and Lugansk after recognising their independence and the initiation of the first round of economic sanctions by the US and other major powers. Markets have not dropped sharply, at least, not yet.

In the US, following falls in Asia and, after an initial decline, flat markets in Europe, the major market indexes all recorded a decline of more than 1 percent. The S&P 500 index dropped by 1 percent taking it into correction territory—recording a 10 percent fall from its high on January 3. The Dow was down 1.4 percent and the NASDAQ dropped 1.2 percent, taking its decline for the year to 14 percent.

The US market has been showing increased volatility since the start of the year because of the surge in inflation, now running at more than 7 percent, which has prompted moves by the Fed to tighten its monetary policy, starting with an interest rate increase when it meets in the middle of next month.

But in a perverse way—an expression of the short-term time horizon on which financial speculation operates—the Ukraine crisis may have worked to soften the initial market fall. This is because it is seen to make a first interest-rate hike of 0.5 percentage points less likely due to the worsening geo-political situation. An interest rate rise of 0.25 percentage points has already been priced in as 100 percent certain.

Further market falls are expected in the next days and weeks with the *Wall Street Journal* reporting that investors are “scooping up at a record pace options contracts that would pay out if the recent declines in stock and bond markets worsen.”

The most immediate effect of the US-Russia conflict is the impact on energy prices. The price of oil is approaching $100 a barrel, a level it last reached in 2014, with predictions that it could go to $120 or even $150.

According to Mark Zandi, chief economist at Moody’s Analytics, the price of oil is probably up by $10 to $15 per barrel because of the conflict and, if the increases are sustained, this could add at least half a percentage point to the inflation rate.

“My sense is it really complicates the Fed’s efforts to rein inflation and get back to full employment,” he told the business channel CNBC.

The complications arise from the fact that in previous periods of geo-political turbulence, such as that which occurred in 2014 when Russia took back Crimea, inflation was low, the Fed acted as the backstop for the financial system through the provision of ultra-cheap money.

Now the Fed is moving to tighten monetary policy because of rising prices and is starting to remove some of the financial support it provided previously. But such has been the dependence of the financial markets on the flow of virtually free money that even a relatively small adjustment, as compared to what took place in the past, can have significant consequences. The fear is that it could set off major financial turbulence and a global recession.

“The Ukraine situation has become more tense when the markets are already in a potentially unstable condition because of rapid global inflation and rate-increase expectations in the US,” Takahide Kiuchi, executive economist at Nomura Research Institute, told the WSJ.

JPMorgan’s chief economist Bruce Kasman told CNBC that the rise in the oil price made things more complicated for the Fed and there was a scenario where “the growth hit starts to get more substantial.”

He said the fact that the Fed was tightening under conditions of rising oil prices magnified the “negative supply shock,” a situation which has not been seen since the days of Fed chair Paul Volcker in the 1980s.

It is a measure of the dependence of the financial markets on cheap money that Volcker lifted interest rates to as high as 20 percent in 1981, inducing the deepest recession to that point since the 1930s. Now his actions are being recalled under conditions where the rate rises being contemplated are only a tiny fraction of those carried out 40 years ago.

It remains to be seen how the effect of sanctions will play out and their impact on the global financial system and the world economy more broadly. But there are warnings of a major downturn.

According to a report in the WSJ, the UK National Institute for Economic and Social Research had made calculations based on a cut in Russian oil and gas exports, either because of sanctions imposed by the West or retaliation by Moscow.

It said major interruptions to supplies would lower global growth this year by just under 1 percentage point and would lead to a 1.7 percentage point cut in eurozone growth.

“The broad implications ... are somewhat reminiscent of the 1970s energy crisis,” it said. “Higher prices and supply limitations severely disrupted economic activity in the global economy and led to higher inflation.”

Even if oil and gas exports are not directly hit—Biden has said the measures will target Russia’s financial sector and President Vladimir Putin’s inner circle—they could still have an effect on major global firms.

According to a report in the *Financial Times*, “some of the world’s biggest oil companies and commodity traders are at risk of disruption to their business operations in Russia,” if the threat of imposing “unprecedented” sanctions is carried out.

Major oil companies, including BP, Shell and ExxonMobil, have deep ties with Russian oil companies and are involved in joint projects. Commodity traders, the FT report noted, such as Glencore, Vitol and Trafigura “all have important business relationships in the country.”

The possibility of a blowback from the imposition of sanctions was reflected in their announcement. Among the measures announced by Biden were sanctions on the raising of Russian foreign debt. Following Biden’s statement, there was a hasty clarification from the White House that they would only be applied to new debt and not on trading in the secondary market.

No doubt the experience of 1998 was recalled when the hedge fund Long Term Capital Management collapsed because of its heavy involvement in bets in the Russian financial monetary and financial system. Its demise threatened to spark a crisis in the US financial system and it had to be bailed out by the New York Federal Reserve.