

Ep 181 - A long war in Ukraine

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ATTENDEES

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Kristen Hallam

Roughly 18 months ago, Russia invaded Ukraine, sending shock waves through financial and commodities markets. Since then, we've seen rounds of sanctions from the U.S. and EU, an expansion of NATO and an attempted mutiny in Russia, and still the war grinds on. How long is the conflict likely to last? And what factors could influence its trajectory?

I'm Kristen Hallam, Content Strategist at S&P Global Market Intelligence and your host for this episode of the Economics & Country Risk podcast. Alex Kokcharov, Associate Director for Country Risk for Europe and CIS, is here with me to discuss his recent analysis of the conflict. Welcome back to the podcast, Alex.

Alex Kokcharov

Hello. Thank you for having me.

Kristen Hallam

Alex, what would make this conflict qualify as a long war? What are the criteria for that?

Alex Kokcharov

There's no official definition of what the long war is, but this war, in its current phase, has been going on for nearly 1.5 years, and there is no realistic prospects of it finishing anytime soon. For as long as the current political leadership in Moscow, especially President Vladimir Putin, is still in power in the Kremlin. But the prospects of a negotiated settlement of the war will be low.

Putin's current term ends in March 2024. All the indicators suggest that he will run for reelection. And following the constitutional changes in 2020, he has the right to do so for 2 more terms. So potentially, if he chooses to do so and his health permitting, he can stay in power for 2 more times until 2036.

At the same time, Ukrainian leadership refuses to agree to a settlement in which Russia would keep control over significant parts of Ukrainian territory. And this sentiment is widely shared by the Ukrainian general public with the opinion pulse saying that more than 85% of Ukrainian respondents would not agree to territorial concessions as a condition for a peace settlement.

So as a result, the prospects of a negotiated settlement are quite low and all the indicators suggest that this military conflict, this war, is going to be quite protracted. Sadly, I don't have a crystal ball to tell you for how long it will last, but I do not see a realistic prospect of a quick resolution to the war.

Kristen Hallam

85%, that's a pretty high level of support there. Pretty likely then that we will see this conflict continue to go on for some time. Is that currently our most likely scenario for the conflict?

Alex Kokcharov

It is. And again, we don't have a specific time frame but it will be quite challenging to see this conflict resolved within the next, say, year if the current political leadership of Russia is still in place. So our expectation is that we're going to still see this war well into 2024.

And various indicators from Russia suggest that Russia actually realized this as well, and they are preparing for a much longer protracted military conflict. They're actively preparing for it because, in our view, the Russian leadership believes that over time, it will be advantageous to them as this -- the longer this war will continue, it will strengthen their position and weaken the Ukrainians.

Kristen Hallam

In your recent report on the conflict, you discussed the likely Russian assumptions that you just alluded to about the conflict. And one of those assumptions was Ukraine fatigue, that we will see Ukraine fatigue in the West. What does that mean?

Alex Kokcharov

It means that currently, Ukraine is reliant on continued military, financial and humanitarian support from Western nations, particularly on the military front. Ukraine would not be able to resist as effectively as it has against the Russian forces if not for the supply of weapons and ammunition from Western countries.

Russian political leadership probably calculates that the ongoing economic challenges such as higher inflation than historic averages for the past couple of decades and low growth rates would shift focus of electorates in Western countries to domestic matters, specifically economic matters, and thus would reduce appetite for supporting foreign policy causes such as supporting Ukraine. So this is probably the calculation in the Kremlin that over time, the Western countries would reduce military, political and economic support to Ukraine and it would help Russia as a result.

Kristen Hallam

Now how likely do you think that is to happen? How likely is it that we will see Ukraine fatigue?

Alex Kokcharov

We do not think that this is something that is going to be happening anytime soon, most probably not in the next 12-month outlook. We still see that opinion polls in both North America and Europe suggest significant support to Ukraine. Most respondents still believe that their countries, their respective countries, should continue supporting Ukraine and provide it with means to withstand the Russian invasion. But of course, this has potential to change due to the change in economic circumstances and political developments in specific countries. So we obviously don't know whether such Ukraine fatigue will eventually develop. But the level of support over time would probably be reduced.

And of course, what Russia would be interested in exploiting would be major elections, presidential, parliamentary in the Western countries, hoping that these elections would produce different governments, which would be less keen on supporting Ukraine at current levels.

And I still would add that Europe would be less likely to significantly reduce support to Ukraine, various countries in the European Union. This is largely due to the geographic factor. Proximity is very important here from the European perspective. They must support Ukraine because if Ukraine is defeated on the battlefield and is occupied by Russian forces, that would probably lead to a much larger wave of refugees into Europe compared to what we've witnessed in 2022.

And this is one of the factors why we have seen that some of the countries are developing longer-term plans to continue to support Ukraine for years to come, not just 1 year ahead, but for 4 years ahead. All these governments, of course,

understand the risk. They understand that there is a risk of Ukraine fatigue developing, but they are working with it and they understand that Ukraine's defeat would be even more problematic to them than the cost of continued support, which is, of course, having an impact on their finances, but the cost of not supporting Ukraine would probably be even higher.

Kristen Hallam

As you note, several elections on the horizon, including, of course, the U.S. election next year. So it will be interesting to see as the war continues, how public opinion shifts or not as we get closer to some of those key election dates that you mentioned there. What implications would a long war have for defense spending, both regionally and globally?

Alex Kokcharov

There will be continued increase in defense spending, including in Europe and in Russia and in the Ukraine, of course, and this will probably be narrowed in the United States. We've seen that a number of countries on the Eastern flank of NATO have dramatically increased their defense and military spending in the past year. Some of these countries, such as Estonia, have set quite remarkable targets for defense spending, which are to reach 3% of their GDP. Poland, which is a very close ally and partner of Ukraine has also expanded its military and defense spending.

But we also have seen that Russia, which is hoping for a longer-term success in this war against Ukraine, is also significantly increasing its defense spending. And since this report was published in July, we've seen evidence that Russia is expanding its military spending even further than it was the case in the first half of the year. So basically, what happened is that by the end of July, Russia used up all of its allocated defense spending for 2023. So now they are reallocating funds from other areas, including health care and construction, to support their military efforts. We also have seen that Russia is expanding military manufacturing.

And we also see that countries in Europe, and particularly in the European Union, are reviving their defense manufacturing sectors due to the high demand from this war in Ukraine. The stocks across Europe of many types of weapons and ammunition have been significantly depleted as this war is very much an attritional warfare. There are significant losses in weapons and significant usage of ammunition by both Russian and Ukrainian armed forces. We see that there is a resurgence in military and defense manufacturing, which means that there will be of higher spending on these sectors.

And with this war continuing and the risk of this war spilling over, especially if Russia is successful in Ukraine and could potentially threaten further countries in the region in the coming years, there will be more spending on defense and on the military. And there will be increases to the size of the armed forces, which are reversing the trend of the previous several decades when after the end of Cold War, there has been the peace dividend as defense spending, especially in Europe, was falling very sharply and some of those industries have been quite neglected.

Kristen Hallam

Speaking of industries, there are certainly -- certainly will be an impact on businesses. We've already seen an impact on businesses from, as I mentioned earlier, the fluctuations in the financial and commodities markets and economic impact, the migratory impact as well. What kind of questions are you getting from clients about the war, about the outlook? What do businesses seem to be most concerned about? And what should they be concerned about?

Alex Kokcharov

There are lots of topics, of course. One of the issues is continued operations in Russia as many of the multinational firms still have some presence, commercial presence in Russia. While many have opted to leave the country, it became very difficult from the regulatory point of view to divest from Russia, and there are multiple regulatory hurdles and tax hurdles, which Russia established. So there are lots of questions about that, about divestment from Russia about how to deal with these regulatory obstructions or how to exit the Russian market, how to avoid outright expropriations, which there have been several of in the past year by the Russian government.

Another type of question relates, obviously, to Ukraine, about safety and security in Ukraine. Again, Ukraine is a very large country. It stretches for more than 1,000 kilometers from east to west. So the security risk varies quite significantly. And yes, there are some areas in the country which are exposed to very high risk of shelling and missile strikes from Russia. These are areas which are close to the front lines or to the Russian border. But further west you travel, the risk and incidence of such strikes would be lower.

So there are lots of questions around that, about the safety in Ukraine. A lot of multinational firms still have supply chains connecting them to Ukraine. This is especially pronounced in the agricultural sector. Grain, sunflower oil and other agrifood products and fertilizers where Ukraine plays a big role are now obviously experiencing problems with being exported from Ukraine after Russia opted to end the Black Sea grain initiative.

But there are companies across multiple sectors, which still have presence in Ukraine or they have the subcontractors in Ukraine who supply them with certain components. And they need to understand how safe these supply lines are, how safe their people are or their assets in those areas of Ukraine are. So there are lots of questions around that as well and it very much depends on the specific business and their needs and whether they have presence in Ukraine or in Russia.

A lot of businesses have questions about the spillover risks. Is the war going to spill in Moldova, for instance, which is outside EU and NATO. Would Belarus become involved in the war? And again, there are even questions about physical security and safety in Russia, where you hear reports of UAV strikes on Moscow area. And again, some firms still have presence in Russia because they were not able to leave the Russian market because of regulatory hurdles. And they have people or assets in Moscow and they're concerned about their safety.

Kristen Hallam

Lots to be concerned about there for sure and lots that will come to you in the form of questions over the next -- well, over the foreseeable future because we don't see an end to the conflict at this stage.

Alex Kokcharov

Yes, probably it will not be resolved in the 1-year outlook, but potentially even 3-year outlook. We've seen some long wars even in fairly recent history. Iran-Iraq war was a protracted conflict. Wars in Afghanistan, one which involved the Soviet Union and then another which involved the United States and its allies. They were very protracted military conflicts. So some of the wars can last for protracted periods of time.

And this is our expectation, is that this conflict would be unlikely to resolve as neither Russia nor Ukraine are currently willing to agree to territorial concessions due to the fact that they have conflicting territorial claims. Rationale claims that a significant part of Ukraine, about 1/4 of the Ukrainian territory is now Russia, which is obviously not something that Ukraine would agree to, especially as some of those areas have never been under Russian control.

Kristen Hallam

Interesting. So you've mentioned a few signposts that you're watching, Alex, including elections. What else are you keeping an eye on over the next year or so as you follow the trajectory of this war?

Alex Kokcharov

There will be multiple indicators we'll be looking at, particularly would Russia conduct another wave of mobilization and try to build a bigger and stronger army? How would Ukraine responds to such development? Is there going to be another wave of mobilization in Ukraine, which is a smaller country than Russia? So its pool of eligible reservists or conscripts would be much smaller than that of Russia.

Then we will be looking at what happens to military budgets and defense spending in Russia on the one hand and in Ukraine and its Western partner countries, which are supporting Ukraine on the other. And we're going to be watching what happens with the military assistance pledged and committed to Ukraine and when and how it's going to be delivered and in what volumes.

We have seen that Ukraine has received a lot of weapons. It had requested, but not all. But there has been some progress on the F-16 fighter jets in recent weeks. There have been reports that training of Ukrainian pilots is going to start soon. But this will probably still mean that they are not going to be delivered before the end of 2023, early 2024. And it will obviously have an impact on how this war goes.

The other elements we'll be watching is the ability of both Russia and Ukraine to conduct longer-range strikes. How many -- what would be the missile stocks of Russia? Would it be able to conduct the strikes deep into Ukrainian territory, including Western Ukraine? And what about Ukraine? Would it be able to continue conducting these long-range UAV strikes on areas such as Moscow or USV, unmanned surface vessels, basically drone boats on Russian ports in the Black Sea, which is a very important commercial area for Russia as the biggest commercial ports of Russia are located on the Black Sea?

So all of this will have an impact, but they can, of course, be game changers such as the outcomes of U.S. elections in November 2024, then the domestic developments in Russia. Because based on everything we see, Putin is a very strong proponent of this war. But if he were replaced for whatever reasons, there could be scenarios where he will be succeeded by people who would prefer to focus on trade and on restoration of economic links with the West, which were beneficial to Russia due to its ability to export commodities for all these decades to the West and to be linked with the West by trading and investment relations.

And also what happens to the Russian Army, is the Ukrainian current offensive going to be successful in reducing the capabilities of the Russian armed forces? And not just the capabilities, but also will to fight. We need to remember that in military conflicts, in wars, it's not always about numbers. It's not always about how many weapons you have. It's also about the will to fight and about the morale. Soldiers who do not want to fight are not very effective.

So if we're going to see changes when the Russian forces becoming increasingly demoralized, that could be obviously another indicator of change. Some of the wars in the past 100 years or so have ended because of demoralized troops and the governments deciding to end the war because they could see that the war is not going anywhere and the troops are not really willing to fight. And there are domestic opposition forces who no longer support the war. There will be lots of things to monitor both in Russia, in Ukraine, in the West, including Europe and United States, of course. So I anticipate an eventful and busy year ahead.

Kristen Hallam

All right. On that note, we will wrap it up. Thank you, Alex, for sharing your insights with us today. And thanks to our listeners for joining us. Let us know what topics you want us to cover on the podcast by interacting with us on the S&P Global Market Intelligence social media channel and join us next week as we delve deeper into the economic and geopolitical forces at work in 2023.

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