THE BIG QUESTION

Economist Lars Christensen Assesses the War in Ukraine and the Potential for a Remarkable Recovery

From nearby Copenhagen, the Danish economist deconstructs Europe's worst conflict since World War II and the implications for economies and markets now and in the future.

Eric Uhlfelder
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Lars Christensen, courtesy photo.

Lars Christensen was not surprised by Russia's invasion of Ukraine. He thought President Vladimir V. Putin's actions over the past two decades foreshadowed the war. However, the Danish economist is dumbfounded by Russia's inept military and economic planning that has resulted in the opposite of what Putin intended. The war has unified Ukraine, NATO and the West, and if Ukraine prevails, Christensen believes its rebuilding presents an opportunity to recast governance, institutions, and prosperity beyond what the country ever dreamed.

Christensen has often made shrewd observations.

In May 2020, as the U.S. started to brush itself off from the initial shock of the Covid-19 pandemic, Christensen told *The Economist*: "By the time Americans vote in November, unemployment will be below 6%." He argued that, unlike financial crises induced by economic policy missteps, natural disasters are usually followed by more rapid recovery.

Lockdowns had sent the April 2020 unemployment rate soaring to 14.7 percent. In June, according to the magazine, "at least 14 of the Federal Reserve's 17 interest-rate-setters forecast that quarterly unemployment at the end of the year would still be above 9%." The Bureau of Labor Statistics reported US unemployment in November at 6.7 percent.

Christensen is unabashed challenging leadership. In 2015, the independent Danish Central Bank turned rates negative to help keep its currency in line with the euro. But Danish banks continued to pay positive returns until they stopped subsidizing savers in 2019. This infuriated the country's business minister Simon Kollerup: "It's too greedy when banks deliver large profits, but still continue to impose negative interest rates on more and more Danes."

Responding to the business minister's comments, Christensen told Reuters, "at best, it is an expression of a minister who does not understand quite simple financial and economic contexts; at worst, it is an expression of extreme populism."

Christensen specializes in international economies, emerging markets and monetary policy, and is a widely respected economist. After serving as an economic policy analyst at the Danish Ministry of Economic Affairs, he became head of emerging markets research at the leading Scandinavian bank, Danske Bank. In that role, he reported on Central and Eastern Europe issues, having anticipated a number of economic crises.

He is now the owner of the economic consultancy Markets and Money Advisory, and currently advising large Scandinavian pension funds and European blue-chip manufacturers about ongoing geo-political and economic risks related to the war, inflation, and interest rates.

In this April 20th interview with *RIA Intel*, Christensen provides a close-up analysis of the war.

Good afternoon, Lars, what's your 30,000-foot view of present economic conditions?

We're seeing the collision of events which each on their own would be a major matter. All together, we haven't been challenged like this since the Second World War. The pandemic is still with us. Inflation is spiraling toward double-digits across most of the world, led by essential commodity prices. Central banks are way behind the curve, something we haven't seen in 40 years, portending aggressive interest rate hikes that may no longer be carefully phased in. We have China locking down critical regions of its economy that will significantly curtail growth both domestically and globally. And then the unprovoked Russian invasion of Ukraine has caused devastation and soaring geopolitical tensions we haven't seen since Hitler was Chancellor of Germany.

As an international advisory, what are you telling your clients?

In advising major Scandinavian pension funds and European manufacturers, I'm assessing investments that are directly and indirectly exposed to the war. We're facing uncertainty that's now at a different kind of level than we've been used to after two years of Covid. The cocktail of events is making it extraordinarily difficult to accurately assess and respond to.

Broadly speaking, I'm advising to reduce exposure to turbulent regions, planning for alternative work arounds. Manufacturers continue to be plagued by supply chain problems and rising manufacturing costs, aggravated by China's zero-Covid policy that's further impacting supply chains and manufacturing. Then we have rising commodity prices, inflation, and central banks being way behind the curve. So, clients need to prepare for increasing market volatility and uncertainty that come with rising interest rates.

Did the Russian invasion surprise you?

No. Two weeks before the war began, I was talking with a good friend, a senior Nordic corporate manager who lives in Russia. He asked me if I thought war was likely. I said I see no good reason Russia should invade. But I have a feeling Putin will do it nonetheless.

I've been covering Russian activity and behavior for more than 20 years. One of the first papers I wrote was on the Yukos Oil scandal. Putin threw the head of the company, Mikhail Khodorkovsky, in jail for 10 years for having challenged him politically. The Kremlin confiscated his company. Then you have the terrorist attacks at a Moscow theater and a Beslan school, which both ended with government forces having killed hundreds of innocent civilians. Putin intervened in the leadership of Georgia and Ukraine and was furious when their respective Rose and Orange revolutions ended up ousting the Kremlin's men. Throughout, Putin poisoned opposition leaders. In 2008 he went to war with Georgia. But when he annexed Crimea in 2014, Putin fundamentally changed tactics, which was a precursor to the current invasion of Ukraine. We shouldn't forget Russia's horrific bombing in Syria in 2015 and 2016.

Those who were surprised by the invasion didn't appreciate the cumulative picture all these activities were painting over the past 20 years. Many characterized these actions as a nuisance, much the way the U.S. misjudged the threat posed by Al Qaeda before 9/11.

Why do you think Russia-focused advisors were generally wrong in their thinking that war wasn't likely?

That's a really good question. I've been talking with people over the years, since 2014, and I think a lot of observers put too much emphasis on what they saw to be the average Russian perspective: that invasion would be insane. Analysis wasn't based on Putin's own rational, which in part may have been badly informed about the adequacy and capability of Russian military capability, and how ready the Russian economy was for this.

When he first took power 2000, Putin surrounded himself with military and security specialists, economists and finance experts, oligarchs and opinion leaders that collectively provided him with diverse views of the world. That disappeared starting in 2008. This means Putin has not been receiving a full presentation of reality. I speculate that no one is now fundamentally close with Vladimir Putin. And that's the problem, which also makes it difficult to forecast what he might do next.

Bottom line: He either didn't think or care how bad such a war would be, not only for Ukraine and the rest of the world, but for Russia and himself. With his future in doubt, this makes him more unsafe than ever.

What is your perception of Putin?

The commonly accepted perception of Putin as an astute five-dimensional chess player is wrong. He thinks instinctively. And when you talk with military analysts, the entire invasion went against how such military actions should be planned. And if you look at the economic planning, it's clear that Putin didn't anticipate the degree of Western sanctions. Putin might've thought war would've divided Europe. Putin has united Ukraine and Europe like we haven't seen before.

Ignorant or incompetent, Putin still worries you greatly.

Yes. I am personally terrified by many things I'm seeing. What distresses me so much is the whole Putin narrative, which sounds like racial war with echoes of Hitler's concept of *Lebensraum*. This makes it impossible to understand the motives of the man. Ukrainians and Russians are very much the same people, and Russia doesn't need land to grow. It's the largest country on earth. It comes down to Putin wanting something and he uses bullying tactics to get it. And no one has ever stopped him in the past. His behavior over the past two decades is a street thug. He's not clever or artful enough to build a productive society. He would rather steal one.

How do you assess the West's response so far?

I'm extremely positive about the West's united and robust response to the Russian invasion — from well-calibrated sanctions to refugee resettlement, especially after nearly two decades in which Europe struggled with how to effectively and humanely deal with the influx refugees from war-torn Syria and Northern Africa.

Do you believe the West's response will hold through 2022?

Yes. The economic sanctions put in place have been very well conceived, minimizing the effects on both the European and global economy. Opinions across Europe are remarkably unified against Russia: Danes, Poles, Latvians, Portuguese, French, Italians share a common point of view. That means the politicians can more easily remain united. Exacerbated by significant brain-drain, sanctions have seriously weakened Russian growth prospects over the next 5-10 years.

I'm don't normally believe in sanctions to topple a regime or significantly alter its trajectory. They won't make Russians nor the country's elite rise up against Putin. But I see sanctions are having a tremendous cost on the Russian economy and the funding of the Russian war machine. They make it harder to wage war without an end. And sanctions make it virtually impossible to start new military ventures.

I believe the next step we should consider is a global import tax on Russian energy exports. (Remember the current ban is voluntary and Europe is still buying lots of Russian gas.) A worldwide 30 percent tax on oil and coal, and a 10 percent tax on gas, would shift part of the war costs. It would have a negative impact on the world economy. But it would be far less harmful than an all-out embargo. Foreign buyers would pay this tax to their respective governments, and proceeds could ideally be sent back to aid Ukraine.

But isn't Russia struggling to sell its oil and gas?

Yes. And where it's doing so, it's probably selling significantly below market. Further, international shipping companies have been self-sanctioning. The world's largest container-shipping line based here in Denmark, Maersk, has abandoned Russia. Oil pipelines don't cross Europe. So, it's a bit of an untold story that the price Russia is receiving for its oil has collapsed.

If the war drags into 2023, do we have to reassess the West's collective unity?

Even if we drift into a stalemate like we saw 70 years ago in Korea, where there's no peace and no hot war, and if Russia holds on to stolen lands, then I believe sanctions will largely stay in place.

After having collapsed 40 percent, the Russian rubble is almost back to pre-war levels. Please explain.

This may seem counterintuitive at first, but the rubble has rebounded because sanctions are working. Russians cannot spend the money they get on foreign products. The economy has become suddenly internalized. Typically, when Russia sells oil and gas, the wealthy go out and buy Mercedes-Benz or Prada. They are no longer buying these products. So, you're not seeing rubbles being spent on foreign goods and services. With no outflow, only inflow of capital, you see a significant improvement in trade balances. Further, with limited trade and little hedging, there's no active trading between the rubble and other major currencies — which would have also influenced exchange rates. The rubble is largely in a vacuum, performing on its own.

From an economic perspective, do you think the West should be more involved militarily to help end this war, to minimize destruction and reduce the ultimate cost of the war?

I can't answer that because I'm not a military expert. I've been surprised by Europe's aggressive arms response to Ukraine. The amount of hardware flowing is very significant. Nobody could've imagined this a year ago. Even neutral countries like Sweden, Finland, Ireland and Austria are providing aid to Ukraine — even arms.

But I can offer one military observation. I believe the West's response would've been very different had Putin never attempted to move on Kyiv and had kept its invasion focused on the East. If Russia had done so, the West's response would not have resembled anything like what has materialized, and there's a reasonable chance that Putin would've gotten what he wanted: destabilizing the Zelensky government without having seriously awakened NATO.

Russia's massive encirclement of the country and its attempt to decapitate Ukrainian leadership completely altered NATO's and the West's response. From a tactical perspective, this decision was a major blunder. He united Europe and the U.S., and now Sweden and Finland are applying for NATO membership.

Why do you think the Russian invasion has seemingly gone so poorly for Putin?

I'll be blunt. We're seeing a really stupid guy making really stupid decisions. Digging deeper, the weakness of the Russian military is in large part due to the country being one of the most corrupt places in the world. As a result, the bureaucracy doesn't work well. There's a lot of inefficiency. And this is showing up in a corrupt and poorly operating military.

Do you think NATO is seeking an efficient Ukrainian victory or to bleed the Russian military and economy?

I don't want to speculate on the motives of NATO. But if one is cynical, it's possible to see the West's response has been to bleed Russia, not to seek a quick Ukrainian victory or an end to the war. A war of attrition is terrible for Ukraine. NATO officials are struggling with whether its actions are designed to save Ukraine or to defend NATO. It's probably both.

On a personal level, as someone who has spent a great deal of time in Central and Eastern Europe, in the Baltics, Ukraine, and in Russia, I'm furious about the war. I have many friends and colleagues who are caught up in the war. Ten minutes before this phone call, I was talking with a Ukrainian refugee boy who's playing basketball in the club where I'm on the board. But if I let my personal feelings color my analysis, I wouldn't be a good economist or advisor.

What are your thoughts about the West extending sanctions to Russia's trading partners that are not honoring sanctions, like China and India?

I think that's a step too far. Before we consider going there, there are loopholes we can still close, including trade with Belarus and adding taxes on Russian exports. Remember, if the decision to sanction countries like India and China is questioned by any in the coalition, then it could weaken our unified front.

The IMF recently reduced its 2022 global growth estimates by nearly one full percentage point in response to the war. Please share your estimates for this year.

I am much less negative than the IMF on the impact of the war on the global economy. So far, I don't think the war has had a major impact on global growth. Domestic demand remains very strong both in the U.S. and Europe.

My fear is the war will provide central banks the perfect excuse for not moving aggressively on inflation and keep on missing their inflation targets. Remember, in the ‘70s central banks saw oil prices, the Middle East conflict, labor unions, and public spending as reasons for having kept rates too low. As a disciple of Milton Friedman, I fear we’re repeating some of the mistakes of the ‘70s.

Inflation will remain elevated, may continue to rise for a rather long period and this will force both the Fed and the ECB to act aggressively to restrain inflation no matter the geopolitics.

You don’t believe the pandemic and the havoc it has had on supply chains, transportation, and imbalances on demand and supply, explain much of inflation?

Economies have reopened for more than a year. And yes, there are issues of delivery of goods and services. But it is demand that has been growing so fast that’s at the heart of the imbalance that’s driving inflation. I don’t believe inflation is now a supply-chain problem. You have to stop printing money, you have to suck up liquidity, and you need to hike interest rates.

I think conditions are similar to what the U.S. experienced after the hardships of the Second World War, where there was rationing and people were not spending money, and then all of a sudden they could. Money the government was printing to fight the war and partially ending up in the hands of civilians couldn’t be used because everything was rationed. Then once the war was over, remarkable demand and inflation were unleashed. That’s what we’re seeing now.

If the IMF is too pessimistic, what are your concerns about global growth?

Let me be more precise. I’m most concerned about slowing Chinese growth. The country’s pursuit of zero-Covid policies is having an extremely negative effect on the world’s second largest economy. Economically, I’m much more concerned about that than the effects of the war. And again, because central banks may have to aggressively play catch up with inflation, that could end up spiking rates, causing recession, and reversing growth.

I’m not a perma-rate hawk. But the Fed failed to act as the economy rebounded very well during the summer and autumn of 2020. From that point onward is when monetary policy should’ve gradually tightened. Instead, fiscal and monetary easing was actually stepped up. That was a major mistake. And I fear there’s tremendous pressure from the Biden administration not to excessively tighten monetary policy.

How would you assess the ECB’s response?

Because the European economy was not doing as well as the U.S. economy going into the pandemic and the ECB didn’t ease as much — about half of what we saw in the U.S. — there is less severe monetary overshooting in the eurozone. I’m therefore less concerned about ECB policy being too loose because it will require less action from the ECB to correct.

But the ECB is confronted by a different reality than the Fed. The war is happening in its own backyard. It's on T.V. in Europe 24/7. When you sit in Frankfurt and make monetary policy decisions, it's very hard not to be influenced by the constant reporting of the war. I believe the war, so far, is not having that much of a negative impact on the economy and inflation. It's not dampening demand. It's causing some impact on supply. But the central bank should ignore the supply side of the economy because it can't do anything about it. It can only impact demand, so it should target nominal demand to grow at a steady, sustainable rate without causing excessive inflation.

Where do you think U.S. and eurozone interest rates will end the year?

I think they will move in sync so as not to impact trade between the two economies with the Fed Fund target rate likely ending the year above 2 percent and ECB overnight rate reaching 1.5 percent. The ECB takes its lead from the Fed, but it doesn't have the same kind of hawkish voices that you now hear in the Fed.

Where and when do you think rates will peak?

U.S. rates will possibly top out above 4 percent and eurozone above 3 percent toward the end of 2023 or early 2024.

How do you expect equity markets to respond in 2022?

When there's inflation and volatility, investors go to property and equity markets because they are good hedges against rising prices. So, right now, I'm not too negative about U.S. and European equity markets. I think the S&P 500 is about 10-15 percent overvalued — the market is expensive but not massively overvalued. European stocks are not very expensive given the outlook for inflation, which has essentially discounted valuations.

Here's another way to look at valuations. If you look at the S&P 500 in terms of price-earnings ratio, it looks massively overvalued. If you replace earnings with money supply — a proxy for future inflation and future nominal earnings — the U.S. stock market is about where it's supposed to be. And this has been my contention for the past year since inflation has started to rise.

Do you think the huge stock market rally in the U.S. after the initial Covid selloff was an indicator of inflation that was to come?

Absolutely. The U.S. market was essentially the first indicator — coupled with money supply growth — that we're going to have high inflation. And this became extremely clear going into 2021. So, while I'm not overly concerned about equity market behavior this year, preferring stocks to bonds in 2022, next year may be a different story. If the Fed aggressively boosts interest rates, then we're likely to see more bearish markets.

Getting back to Ukraine, the refugee crisis is growing more acute as the war drags on, along with the likelihood of the pandemic spreading. Are you worried if this outflow of Ukrainians across Europe continues, it will have negative effects both on regional economies and the will of neighboring countries to help?

About the risk of massive spreading of Covid, Omicron is certainly highly contagious. But it's causing less serious health issues so I don't think this will be an issue, especially as infected portions of the region are gaining immunity without significant health costs to individuals and health systems.

So far, with unemployment at its lowest point in the eurozone since its creation, economies have been able to absorb refugees in an extremely smooth manner. Here in Denmark, the willingness of citizens to open their homes to refugees and the country's overall reception have been particularly heartening. This is more remarkable to see across Europe because the continent has been struggling for the last two decades with a strong anti-immigrant sentiment. Now, it's absent. The question is how long will that good will last?

That's why it's critical that we don't embark on foolish sanctions where we harm European economies and sentiment so much that there's a sudden resentment for accepting Ukrainian refugees.

With a handful of frontline countries hit with the highest costs of managing refugees, is the EU making necessary financial transfers to assist these governments?

No, and I don't expect any discretionary funds to be transferred either because the EU doesn't have the automatic mechanisms to respond like that. The EU suffers from not having a common immigration policy. We have open borders, but we don't allocate refugees across Europe in any formal way to distribute liability. That means some countries are inevitably more burdened by this crisis than others. Moldova, which is not an EU country, is under massive pressure and it was a very poor country to begin with. The silver lining is that European unemployment is very low and a sharp increase in the number of workers can be absorbed.

We've seen multiple systemic events that have challenged globalization. First Covid, then the war, and at the same time China unexpectedly locking down. What does this mean for globalization and corporate commitments for relying on external support in manufacturing and trade?

Institutional investors over the past 20 years have been increasingly focused on ESG. If you look at how investment strategies are now being parsed, in terms of their ethical standards, governance will now get far greater attention than it once did, especially pertaining to international investments. "Do I invest in countries that invade their neighbors, that don't respect property, contract and human rights, and that don't support democratic values?"

Russia has been a major wake-up call. Could China be next? Could China pursue some aggressive policy that could lead to sanctions? Should we start considering other countries for manufacturing and support? That said, I'm deeply concerned about moves toward de-globalization.

In a way, the war is a strong argument for globalization. Had the world not been so integrated, then our ability to meaningfully respond to such crises would have been limited and lacking in an ability to punish Russia without reliance on arms.
By having taken Russia out of the global economy, trade networks, and out of the global financial system, the West has the ability to hurt Putin a great deal without having to launch a single missile. This point shows how incredibly risky it would be to decouple from global trade because it would give up leverage in dealing with a crisis.

Let me drill down a bit deeper. Do you think businesses will reduce outsourcing parts and instead have more made closer to home with minimal geopolitical and supply chain risks?

I've had such meetings with business leaders over the past couple of months where I've been making the argument that deciding where to outsource production should be guided by countries' respect for contracts, economic freedom and reforms and human rights of both their citizens and their neighbors. If they don't have that, sooner or later something will happen where a company may be forced to bear a great cost. I think many international companies have lost sight of that.

But today's events are opening eyes. I think governance issues have become an even more immediate issue than climate change. Making this a priority could put pressure on countries to behave better, especially after seeing what has happened to Russia.

As for countries that have remained neutral or sided with Russia, they are clearly running the risk that they may enjoy less foreign trade and growth. This may be a wake-up call to behave better. And their citizens will also notice the link between whom their leaders have sided with and how it's impacting their earnings prospects. I believe this may be happening in Thailand, Malaysia and even India, Pakistan, and South Africa.

So, it's not clear whether current events will actually be a net negative for globalization. It could be. But I see an argument for why it could promote more sound globalization going forward.

And let me offer an even more positive scenario: Putin's horrendous mistake could lead to regime change in Russia over the next six months and possibly new leadership that may behave less aggressively towards its neighbors. We also might see a relatively swift integration of the Ukrainian economy into Europe — much faster than had there been no war. Further, it may make the communist party in China rethink the direction President Xi has been pushing the country in a more totalitarian direction.

Let’s address the eventual rebuilding of Ukraine. If the war stopped today, some estimate costs of $500 billion or more to rebuild the country. Regardless of the exact amount, how is this going to be done?
Yes, this is going to be as massive an undertaking as winning the war. My first concern would be that the West just pours money into Ukraine without clear planning and oversight to ensure proceeds are used efficiently. The country requires vastly improved, well-functioning democratic institutions to help deliver improvements. I’m optimistic the Ukrainian government will move in this direction after the war and to learn from Poland, the Czech Republic, and other former Communists countries in Central and Eastern Europe, which undertook massive reforms in the 1990s after having gained their independence.

One key in this process is for the country’s businesses to become more integrated with the West. If that happens, don’t be surprised if rebuilding moves at an exceedingly quick pace.

Yes, the country’s East and Southeast is in very poor condition and it will be littered with countless numbers of unexploded ordinances and landmines, which will take decades to clean up. Here in Denmark, we suffered from this same problem for decades since the end of World War II. I’m not overly concerned about the actual cost of replacing the infrastructure. That’s never a problem once a society rebuilds economic and political institutions, and business life restarts. Money then will flow.

Who will be the key players rebuilding Ukraine?
The key partners will be Poland, the Baltic States, Romania, along with the Nordic countries and potentially the U.K. The leading international institutions will be the IMF, the World Bank, and the European Bank of Reconstruction and Development. They all bring a great deal of experience from rebuilding the former Soviet bloc nations after 1989, which was a tremendous achievement that spans the breadth of Europe.

Do you think European Union and NATO membership for Ukraine will follow?
No. I don’t think there will be any kind of military alliance that will soon envelop Ukraine. EU membership...maybe in 15-20 years. Paradoxically, when Ukraine is again free and independent and NATO membership is no longer needed, NATO membership will follow.

Thank you Lars.

Eric Uhlfelder is an award-winning journalist who has covered capital markets for three decades. He wrote one of the first books about Europe after the adoption of the euro (Investing in The New Europe, Bloomberg Press). He's also the author of the annual Global Hedge Fund Survey, which includes statistical analysis of each of the top 50 funds along with manager profiles and interviews. Contact Eric at Uhlfelder@hotmail.com