

New Ukraine Situation after Russia's Recognition of Pro-Russian Regions

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On February 21, Russian President Vladimir Putin announced that Russia would recognize the independence of two regions controlled by pro-Russian rebels in eastern Ukraine. The pro-Russian rebels earlier declared the independence of the Donetsk People's Republic and Luhansk People's Republic, seeking Moscow's recognition of the regions as independent countries. In response, President Putin convened an emergency meeting of the Security Council, discussed the recognition of their independence and eventually signed decrees for the recognition.

President Putin also ordered the Defense Ministry to send Russian troops to the regions for peacekeeping missions. Furthermore, he signed mutual assistance treaties with the two republics that allow Russia to construct and use military bases there and provide for mutual defense obligations.

So far, tensions have remained extremely high between Russia, which has amassed 100,000 to 200,000 troops near its border with Ukraine to increase military pressure, and Ukraine and its Western supporters such as Europe and the United States. Meanwhile, major Western countries and Russia held meetings of their top leaders and foreign ministers to explore diplomatic solutions. Russia, though supporting the pro-Russian rebels in eastern Ukraine secretly and openly, has positioned conflicts in eastern Ukraine as a civil war and refrained from intervening directly in the conflicts. Through the unilateral recognition of the two pro-Russian regions as independent countries, however, Russia has made a major step forward from the traditional stance, creating a new situation. The step would also nullify the 2015 Minsk agreement that set out a ceasefire and peace process in eastern Ukraine.

In response to the recognition of the two pro-Russian regions, Russian troops are expected to be deployed into the regions. Some analysts say that Russian troops could launch an all-out invasion into Ukraine. Depending on future developments, the Ukraine situation could transition to a new phase, heightening Russia's tensions with Western countries and the international community rapidly.

U.S. President Joe Biden harshly criticized Russia's recognition of the pro-Russian regions as representing the launch of Russia's invasion into Ukraine. British Prime Minister Boris Johnson and other European leaders also condemned the Russian action as a grave infringement of Ukraine's sovereignty and territorial integrity running counter to international law. They are concerned that the Russian action would unleash an all-out invasion into eastern Ukraine.

Responding to the Russian action, Western countries have taken their first step to toughen economic sanctions, considering a ban on trade with and investment in the two pro-Russian republics, sanctions on major Russian banks and individuals engaged with their independence, restrictions on the Russian government's debt issuance for blocking Russia's new fundraising deals and other sanctions. U.S. Secretary of State Antony Blinken called off his planned meeting with his

Russian counterpart Sergey Lavrov on February 24. Depending on future developments, economic sanctions on Russia could be enhanced further.

In reaction to the rapid situational change and destabilization, energy markets became unstable. Crude oil futures prices scored substantial gains on February 22. The front-month Brent contract rose by a steep \$1.45 per barrel to close at the year-to-date high of \$96.84/bbl. It briefly rose to \$99.50/bbl, close to \$100/bbl. The key West Texas intermediate futures contract soared by \$1.28/bbl to \$92.35/bbl. As market players became strongly conscious of geopolitical risks emerging from intensified tensions over Ukraine, crude oil futures tested a rise above \$100/bbl.

As a matter of course, a low oil inventory level has remained as a fundamental factor behind crude oil price hikes. Given the hikes since late last year, the fundamental factor's influence is seen as great. Furthermore, the OPEC-plus group of oil-producing countries has failed to implement its planned monthly production increase of 0.4 million barrels per day, leading to insecurity about the OPEC-plus supply increase and contributing to boosting crude oil prices. However, the biggest factor that currently pushes up crude oil prices is the combination of Ukraine developments and concern over their impacts on Russian oil and natural gas exports.

Russia is an extremely important oil exporter to the European Union, providing some 2.4 million bpd to the region. Russian crude oil accounts for about 30% of total EU oil supply. Whether Russian oil supply would be disrupted depending on future developments or how much and long such disruption would be are uncertain. Given the importance of oil exports for Russia and the significance of Russian oil supply for Europe and the rest of the world, it is difficult to predict any easy disruption to Russian oil supply. As far as the situation is uncertain, however, market players may have various potential events including the worst one in their mind. If a Russian invasion into Ukraine comes, crude oil prices may rise above \$100/bbl in response to geopolitical risks. However, later crude oil price fluctuations may depend on the scale of and period for the invasion, the details and effects of Western economic sanctions, and whether and how Russian oil supply would be disrupted. If a large-scale oil supply disruption comes, crude oil prices may shoot up far beyond \$100/bbl. In the absence of any oil supply disruption, however, crude oil prices may fall back below \$90/bbl after topping \$100/bbl.

If oil supply is disrupted, we will have to watch potential oil production expansion by such producers as Saudi Arabia to stabilize the market, Iran's oil supply increase through its successful nuclear deal negotiations with the United States, a possible U.S. shale oil production rise reacting to high oil prices and oil consuming countries' release of oil reserves. Depending on a future Russian military invasion, however, the international oil market could be rapidly destabilized, fueling uncertainties.

International natural gas and LNG markets could become more destabilized and uncertain than the oil market. Particularly, Europe that depends on Russian imports for about 40% of its gas supply has great insecurity about future gas supply from Russia. Already, Europe has tried to cooperate with the United States, Qatar and Asian LNG importers such as Japan to substantially increase LNG procurement. If Russian gas supply is disrupted on a large scale, however, the supply-demand balance may tighten to push up gas prices and even LNG prices substantially. Given the significance of gas exports for Russia and the importance of Russian gas supply for Europe, however, any large-scale disruption to Russian gas supply to Europe among various conceivable developments is difficult to expect, as is the case with oil. However, no one can deny a potential unpredictable development. Concern on such development may move market players. The future

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Ukraine situation is the most important factor to exert decisive influence on international energy markets.

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