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The rising toll of the war in Ukraine

Lives lost and upended. Soaring food and energy prices. Supply chains at risk. Much is at stake as the war continues.

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In this episode of *The McKinsey Podcast*, Sven Smit, senior partner and chair of the McKinsey Global Institute, talks with Lucia Rahilly, global editorial director, about some of the potential effects of ongoing war and uncertainty in Ukraine. This conversation was recorded on March 21, 2022. An edited transcript follows.

The McKinsey Podcast is cohosted by Roberta Fusaro and Lucia Rahilly.

A human—and humanitarian—crisis

Lucia Rahilly: I recognize this is a chaotic time for you, given the brutal effects of the war in Ukraine and ongoing shock and uncertainty, both in the European region and worldwide. We're very grateful you were able to make the time to talk with us today.

Sven Smit: It's indeed a complex time. I live in Europe, and this is so close that you can't get it out of your heart. My mother is 80. She lived in Eastern Germany and fled from government oppression in the '60s. She didn't think she would live to see this again. And now it's happening on our territory while we're watching. This is a true atrocity and a humanitarian pain that's unimaginable.

Lucia Rahilly: The war clearly affects all of us, but it must be particularly acutely felt in Europe, even outside the conflict zone. It's the largest war in Europe in nearly eight decades. So I would imagine you're hearing similar things from the leaders you talk to day-to-day.

Sven Smit: Yes. The pandemic is a virus. We can fight it with masks and vaccines. But in Ukraine, we're fighting human against human—and that's just so different.

Lives and livelihoods, lost and disrupted

Lucia Rahilly: This war is obviously causing massive disruption on a range of fronts. We can't talk today about all of them, but let's touch on at least a few. The foremost disruption, as you alluded to, is the horrific and rising toll on lives. What have we learned so far about the scale of this humanitarian tragedy—and about who is likely to bear the brunt of much of this suffering?

Sven Smit: At the moment, north of a few million people are moving out of Ukraine as refugees. That number could grow much bigger if the hostilities protract for the remainder of the year. Some people estimate it might then go north of ten million, 15 million. But there are different segments—the lives lost in the direct war, the displacement of refugees, and the displacement within Ukraine.

The energy and food crises are also pinching at the lives and livelihoods of people across the world. Among some less-well-off populations in Western Europe or the United States, energy and food make up 10–30 percent of what they spend. The price doubles, triples—all of a sudden, these people can't do anything else but pay for food and energy. So you see some people already adjusting their behavior, eating less. And some of them just can't pay.

Then you multiply that in a low-income country—one that maybe had an aspiring population, ready to go up the next step. Now these people get pinched by this increased price of food, increased price of energy, maybe even decreased access to food and energy. And you can easily imagine that more lives and livelihoods will be lost and disrupted outside the immediate conflict. We should not miss that. In the pandemic, there was a little bit of an under-told story: richer countries were really not paying enough attention to the pain of this economic disruption in lower-income countries.

Rising prices, rising risk

Lucia Rahilly: Food prices spiked even prior to the war, given supply chain issues and rising energy prices during the pandemic. In the US, we saw grocery prices shoot up at the highest rate in something like 40 years. Do you see increased food insecurity in Europe—and potentially also an increase in world hunger—as a big risk as a result of this war?

Sven Smit: We haven't yet seen shipments of oil, gas, and food stopping at a massive scale. There hasn't been a major harvest disrupted in the northern territory, which could happen if this goes through the summer. We also haven't yet seen some form of sanction or countersanction or hostility saying, "Let's not ship the oil." But if that changes, either by physical disruption or by intent, we may see problems with access.

At the moment, prices are rising in anticipation of potential shortages. And what will happen is high-income countries will buy—they'll be able to pay. And lower-income countries will have access problems—or at minimum, even greater affordability problems.

Lucia Rahilly: In some lower-income countries, there is also a history of food shortages and rising food costs contributing to social unrest and uprising.

Sven Smit: That's not just a risk in low-income countries. The yellow-vest movement reacted to an increase in diesel prices. Only a small increase in these items—which you need to buy to stay warm, to drive to your job, to earn an income—is very disruptive. It means you have to stop buying other stuff. And that's where the pain comes. Of course, for some, that means not going on holiday—not the worst thing in life. But for others, it means cutting back on essentials because their spend gets crowded out by these enormous price rises.

We're all experiencing just how sensitive a doubling of the price in oil or doubling in the price of food is to the spending patterns of the lower-income parts of the population. It's very easy for higher-income people to say, "You know, this is part of the fight," but it really pinches other segments of the population.

What about net zero?

Lucia Rahilly: Energy is obviously a huge disruption, given the role of Russian oil and gas not just in Europe but worldwide. I saw a quote a couple of days ago from the International Energy Agency warning that we could be headed into what they called the biggest supply crisis in decades. Sven, you've been so heavily involved in our energy research, including our recent report on the net-zero transition. Anything more to say about energy access, at least in the near to medium term?

Sven Smit: The first point is the energy is still flowing. But it could stop flowing. So we need to do much more radical things.

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Currently, the energy policy of major countries is rotating: "Let's build more wind. Let's build more solar. Let's build more nuclear." It's almost like saying, "Let's try everything and find out what protects us the fastest." What that does to net zero, what that does to the net-zero equation, I think we will only learn over time. Because the reality is that some countries might start reoperating coal plants as the fastest way to become somewhat less dependent. And other countries might actually finalize the wind farms that are already there.

For now, people are going to go all out. And then, at some point, we will resettle into a new equilibrium, which could go either way. For physical supply chains of energy that are now at stake, oil travels a little bit more on boats and can therefore be flexibly reallocated, while gas needs to be liquefied and then re-gassed. And the capacity for liquefication (SIC) and re-gassing is actually short. As a result, if we were to have a gas shortage, rebuilding might take a lot of time—much more time than we ever want.

Supply chains under strain—again

Lucia Rahilly: Supply chain resiliency had already come to the fore as an urgent priority during COVID-19 lockdowns. And obviously, COVID-19 continues to be a dynamic issue, as we're seeing right now in China and some parts of Europe. How much worse could this get?

Sven Smit: First, we need to reframe a bit what happened last year. The narrative was a broken supply chain—but the reality was an unbelievably strong supply chain. We had unprecedented levels of demand for consumer-goods purchases in the back half of 2021. And the supply chain actually delivered. The shelves were empty because everybody bought so much. A jittery supply chain could not have fulfilled this exceptionally high level of demand.

And why was there this demand? People were not buying services. They were not yet going on holiday, not going to the restaurants—which caused an enormous demand shift toward goods. Now, at least in the West, you can see a rotation back to travel and to restaurants and other activities that may ease the demand on products a little and also relieve some pressure on the supply chain.

But of course, if basic materials from Russia and Ukraine—food, metals, fertilizer—are not shipped, then that's a problem. And some industries have important factories or important IT talent in Ukraine. If they can't access them, their supply chains could be impeded again.

Every single company I work with is now asking, "What were we actually producing in Ukraine? Where did we get our nickel? Where did we get our cobalt?" And then trying to figure out what to do.

Economic implications in the eurozone and beyond

Lucia Rahilly: Acknowledging that the context is incredibly dynamic, let's turn now to some of the ways this war might play out in the eurozone specifically, which is a very sizable macroeconomy and also very highly exposed. If hostilities were to be resolved diplomatically in the coming weeks, and we were to assume a modest policy response, what might the economic implications of this war be?

Sven Smit: We might hope for this to happen. If it did, for example, we at least would be unlikely to see a stop to the supply of energy and certain critical materials, which would help. And if a resolution were to happen quickly, the refugee situation might not be quite as big, and it would be a bit faster to rebuild some of Ukraine. In that case, maybe the first or second quarter of this year might look wobbly, and then we might emerge back to some form of normal trajectory. But of course, it could get worse if the hostilities are more protracted, the sanctions stay longer at much higher levels, and so on. Then we could easily be two, three years under.

We don't, at this moment, expect the dip to be larger than the dip during the pandemic. The simple way to think about this is that COVID-19 created an enormous demand shock. That applied across all

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countries because we had lockdowns everywhere. Basically, because of this demand shock, aggregate demand fell.

Energy and food and the supply chain—these are very important. But even twice the price of energy is not a 10 percent GDP drop. That’s just how this translates. I’m not saying there’s no scenario imaginable where hostilities expand and you actually get a shutdown of the energy supply, in which case it could get much worse. But that’s not the scenario we’re talking about right now.

Lucia Rahilly: Say a bit more about what might happen if the war drags on.

Sven Smit: In that case, we would be a few years under with a few percent, and the question is, “How do we restore together?” Once a form of normality returns, you get a return to past growth. That depends a little bit on the energy mix. In a severe case, some stimulus to help the weakest get through will be important.

Lucia Rahilly: Many economists expected 2022 to be the year the global economy bounced back after the shock of COVID-19. At the start of the year, we heard a lot of optimism about returning to prepandemic growth trajectories. All that very quickly changed following the invasion of Ukraine, and the economic outlook began to feel much more precarious. What can leaders expect globally, beyond the eurozone?

Sven Smit: The eurozone is far more directly affected. It has the highest dependency on Russian energy and some of the other supply chains. We expect the US to do better and China, probably even better, although China is still dealing with another wave of COVID-19, which could be a factor. But if you just look at the war in Ukraine, Europe will feel it the most, then the US, and then China.

Leading with lessons from COVID-19

Lucia Rahilly: Acknowledging variation among the leaders and organizations you work with, is there anything you think leaders can do right now to navigate the current uncertainty?

Sven Smit: I’ve spoken to maybe 100 leaders by now. Basically, they’re going back to the playbook of dealing with COVID-19, by setting up some form of a crisis team. And they all are, first, caring for their people, which they did during the pandemic, too. But in this situation, they’re asking, “Where are my people? Where are they in Russia? What can we do? Where are they in Ukraine? What can we do about that? Who else is affected more indirectly?” And then, in their crisis teams, they're looking into, "Can we continue our operations given our dependency on Ukraine's supplies and on Russian supplies?"

The next level is, "OK, how is this energy disruption going to hit me? These prices mean my products will be more expensive. What do I do? Does this mean people will have to spend more on energy—and therefore that they're likely to spend less on my products?"

Leaders are translating the information coming in to model supply disruption for their companies. And they're asking what it will do to demand, as well. As they start adjusting their strategies, I think they are also likely to start scenario planning. They're asking, "What kind of storm are we weathering here and in what range?"

Lucia Rahilly: Sven, I've heard you say that the COVID-19 crisis actually helped revitalize the social contract by massively reinforcing the social safety net in places like Europe and the US, at least temporarily. How do you see the social contract evolving in the face of the war in Ukraine?

Sven Smit: During COVID-19, the level of support to those affected by the pandemic has been enormous. Of course, you can always debate specific points – for example, "Did it exactly land in the right place?" But we did help restaurant owners. We did help factory workers. We did help people who couldn't work inside other people's houses.

One way or the other, a significant amount of money landed in many places. This was the largest support action in a long, long time. We have increased debt-to-GDP ratios now, but in hindsight, people thought this was worth it. The alternative would have been much worse—mass unemployment, no support. So I think we have a lesson here.

And even at the beginning of this year, when we were cutting the supply of oil and gas for other reasons, prices went up. Italy and Spain talk about billions in energy support—or they decouple VAT [value-added] taxes for energy to slightly compensate for the blow of the energy price—hoping that it won't sustain that long.

I also think we need to be careful not to be too light on how much these price increases can affect people. Some people say, "This is the energy crisis; we anyway wanted people to shift to alternatives. And this is exactly the right thing to help fight the battle." That might be very easy to say if you have the money. But with the old prices, if food was 30 percent of your costs, that's now 90 percent. And that means there's nothing left.

That's the pain that people feel. But as the pinch gets felt more directly, we're already creating the kind of situation we've had during the pandemic. And clearly, we're taking action because we recognize that this level of energy crisis and of food insecurity—it's not a good way for people to live.

Lucia Rahilly: That's very helpful, Sven. Thanks so much for joining us today.

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The invasion of Ukraine in February 2022 is having deep human, as well as social and economic impact, across countries and sectors. The implications of the invasion are rapidly evolving and are inherently uncertain.

As a result, this document, and the data and analysis it sets out, should be treated as a best-efforts perspective at a specific point of time, which seeks to help inform discussion and decisions taken by leaders of relevant organizations. The document does not set out economic or geopolitical forecasts and should not be treated as doing so. It also does not provide legal analysis, including but not limited to legal advice on sanctions or export control issues.

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