Macro Research

Eurozone

The EU’s Response to Russian Aggression and Its Costs

War has broken out in Europe, bringing with it devastating humanitarian consequences. Our focus on the economic effects of these point to a delicate attempt by Western powers to target Russia’s economy without harming European sourcing of Russian energy. However, sanctions could lead to banks avoiding Russian counterparties altogether, potentially jeopardising the energy trade. Moreover, even if Russian energy to Europe keeps flowing, higher commodity prices pose significant risks to both European inflation and the growth outlook. Separately, significant residual risks such as conflict spillover effects and refugee flows leaves our forecasts fraught with uncertainty once again.

War in Europe

Russian troops have invaded Ukraine. Diplomatic overtures have failed. At the time of writing, Russia has made significant inroads from the North, East, and South, but has so far met stiff resistance from Ukrainian forces. Earlier clashes suggested only a fraction of Russian troops had been deployed and more recent speeches by Russian officials have indicated that additional forces will be entering Ukraine in the coming days. Casualties in the conflict rise by the hour and millions of Ukrainians are expected to be displaced as a result of it.

On Sunday, President Putin ordered that Russia’s strategic deterrence forces, including the units in charge of its nuclear capabilities, be put on high alert in response to what he labelled “illegitimate western sanctions”. Even though experts were quick to point out that this did not suggest Russia was preparing to use its nuclear arsenal to strike first, it still points to the gravity of the situation.

Sanctions

The severity of the sanctions implemented by Western nations has increased rapidly in lockstep with Russian transgressions of Ukrainian sovereignty. Whereas sanctions before the recognition of the separatist republics in the Donbass region may have been more focused on deterrence, the sanctions implemented lately seem aimed at punishing Russia’s actions to a much larger degree.

Sanctions from Western countries, in particular the US, EU, and the UK have come in waves. After Russia recognised the separatist republics Donetsk and Luhansk on Tuesday:

- Sanctions were implemented on Russia’s sovereign debt, Russian lawmakers, trade and investment with the separatist republics, and two (three) banks were sanctioned by the US (EU).
- In addition, the German government announced it would postpone indefinitely the certification of the Nord Stream 2 pipeline project, which puts the entire project on ice.

Once Russian troops invaded Ukraine-controlled territory on Thursday:

- The US added five banks (including the two largest, SberBank and VTB) and 90 financial institutions to the sanctioned list together with new prohibitions related to new debt and equity issuance of major Russian state-owned enterprises and large privately owned financial institutions.
- The EU sanctioned two additional banks: Alfa Bank and Bank Otkritie). It would further prohibit the listing of new shares of Russian state-owned enterprises on EU exchanges and blacklist several state-owned companies in the shipbuilding and shipping industries.
- These financial sanctions nonetheless included significant carve-outs for the energy sector, largely as a result of European pressure to continue sourcing Russian oil and natural gas.
- Export controls: I) The EU and the US also imposed further restrictions on exports of dual-use goods and technology, as well as restrictions on exports of certain goods and technology, which might contribute to Russia’s technological enhancement of its defence and security sector. This will include products such as semiconductors or cutting-edge technologies. II) The export ban also included the aviation and space industry, particularly a ban on the sale of all aircrafts, spare parts and equipment to Russian airlines, as well as a prohibition on the provision of insurance and reinsurance and maintenance services related to those goods and technology.

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III) The EU will also prohibit the sale, supply, transfer or export to Russia of specific goods and technologies in oil refining and will introduce restrictions on the provision of related services.

- The EU will also impose limits on bank deposits and restrict Russian citizens from making any new deposits of more than EUR 100,000 in EU banks.
- Meanwhile, throughout the week, the number of individuals sanctioned and thus subject to asset freezes and travel banks were expanded continuously, including President Putin, the foreign minister Lavrov and a number of other senior government officials.

Late on Saturday night, the sanctions were further expanded to remove "selected" Russian banks from SWIFT as well as sanctions against the Russian central bank, the first time this has occurred for a G-20 country. Whereas the former measure makes it substantially more costly for sanctioned parties to conduct international transactions, they are not impossible, as banks could in principle still use alternative messaging systems. The idea behind the central bank sanctions seems to be to prevent it from selling its foreign assets for local currency to prop up Russian banks and firms hit by sanctions. This would be accomplished by effectively freezing a large part of Russia's reserves abroad. Without access to these reserves, Russia's ability to halt the rouble's depreciation, and thus preventing an inflationary shock, would be severely curtailed.

Energy carve-outs appear to remain in place even after the most recent sanctions expansion. Whereas the central bank may find its hands increasingly tied in defending the currency, it remains unclear whether this could be to some extent alleviated by non-sanctioned private and state-owned banks selling dollars in its place. This method became important in 2020 in Turkey and could in theory be replicated in Russia. After all, whereas the central bank may have USD 300bn in non-gold, non-Chinese FX reserves, the private sector reportedly has roughly USD 500bn in liquid assets.

Moreover, as analysts from Credit Suisse have argued, the USD 300bn of Russian liquid assets held by the central bank "can either be potentially trapped by sanctions, or moved somehow from West to East to avoid being trapped by sanctions".

Even if Russia somehow manages to save its liquid assets from being trapped in Western sanctions, energy revenues continue to flow, and even if the list of sanctioned banks is not expanded, Western financial institutions could still choose self-censorship in their dealings with Russian counterparts, which would exacerbate the isolation of the Russian financial system. Thus, even without specific sanctions, Russian intermediaries could find themselves isolated nonetheless. Regardless, in our view, the risk of bank runs in Russia in the coming days has increased substantially, as well as that of a broader financial crisis in the country.

The other side of this is that if banks opt to avoid dealing with Russian banks, energy supplies to Europe could still be threatened even without explicit Western sanctions.

Economic and financial effects

The effects on the global economy could come via a number of channels including trade, financial linkages, sentiment, as well as commodity prices.

Trade (non-energy):

Trade so far looks like a modest channel through which the war in Ukraine effects the world economy, unless either the West targets the Russian energy sector or Russia retaliates by cutting supplies. As we have shown previously, trade exposure is relatively limited and any impact of reduced exports to Russia on GDP in the EU and the US ought to be marginal.

Commodities

As for energy imports, the Eurozone has significant exposure and a disruption of this trade would likely result in substantial supply shortages in Europe, especially in countries that are particularly dependent on gas from Russia, such as Austria, Germany, and Italy. As indicated by Western powers' deliberations on Russian sanctions, some leaders of EU member states have been adamant about doing whatever is necessary to ensure energy supplies from Russia keep flowing. The EU and the US are thus unlikely to agree on sanctions against the energy sectors, and as long as Russia can receive and manage payments from this source, it is unlikely to cut off supplies unilaterally.

Another type of commodity that could be affected is agricultural products, such as wheat and other grains. The disruption of grain exports from Ukraine and Russia through the Black Sea could very well result in shortages of food globally, but especially for countries dependent on those supplies. A prolonged conflict could end up affecting millions of people living in places ranging from the Middle East to Asia and Africa. This also raises the risk of political con-

sequences, especially given the role of grain shortages as contributing factors to the 2011 Arab Spring uprisings, as well as the Syrian civil war.

Commodity prices

With Russia being such a large natural resource exporter, ranging from energy and metals to agricultural products, commodity prices will likely rise further. Thus, even if supply is not disrupted, higher prices will feed into global energy inflation, which in Europe and the US will compound existing concerns over higher-than-normal inflation.

Financial linkages

Sanctions could also affect the European banking sector. In its December 2021 risk assessment report for the European banking system, the EBA reported that EU banks had an exposure to Russian residents of around EUR 60bn in July last year. The most recent locational banking statistics from BIS places BIS-reporting banks' claims on Russian residents at EUR 89bn, two-thirds of which is made up of the Russian non-financial sector and the rest Russian banks. Meanwhile, BIS banks' liabilities to Russian residents amounted to EUR 127.7bn. These magnitudes are too small to have a large effect on aggregate level, but some individual banks could be more vulnerable than others.

Uncertainty, sentiment, and residual risks

We are likely to see a significant risk premium in several mainstream financial assets, owing to the uncertainty around the intensity and duration of the conflict. This stems from some of the above-mentioned events and sources of further escalation, but an additional concern is the degree to which the conflict could escalate overall, and also in respect of EU and NATO countries. This could manifest through a number of different channels:

- Refugees: Should the conflict result in large civilian casualties and dislocation of local population, we are likely to see refugees moving westwards toward the EU border, but also likely into EU countries. This could result in refugee camps on the border with a risk of overt or hybrid attacks on these camps if the Russian government were to claim that they were harbouring Ukrainian forces. In addition, large refugee flows in central European countries could be destabilising, both economically and potentially politically.
- Direct spillover effects: In the event that Ukrainian forces retreat towards the EU border, there is a risk that fighting could spill over onto the EU side of the border. This could occur e.g. through misfire resulting in projectile landing on EU territory, or Ukrainian forces retreating into EU countries, potentially followed by Russian troops. Depending on how NATO decides its rules of engagement in these examples, and other contexts, we cannot rule out the risk of NATO troops being drawn into the conflict.
- Should the Russians make significant headway with the Ukrainian defence turning into a prolonged insurgency and NATO countries continuing to supply weapons, there could be Russian retaliation in different ways (hybrid or conventional).
- The ECB has recently warned against cyberattacks. Whereas the financial system could be one target, broader types of infrastructure such as energy, transportation and health are also potentially at risk.

Policy reactions

Increased pressure on commodity prices come at a delicate time for central banks. Already high headline inflation, pushed upward by energy prices, has resulted in a policy shift towards increased tightening by both the Fed and the ECB. In terms of the latter, the upcoming March monetary policy meeting is likely to see the banks' inflation forecast revised upwards, and recent weeks have seen a growing number of Governing Council members indicate that an end to QE and rate hikes could be moved forward in time.

Whereas central banks would normally look through energy price hikes, inflationary pressure appears to be continuing also in services and goods, partly because of ongoing supply disruptions and also due to the relative resilience during the omicron wave of the pandemic. The ECB further expects wage growth to increase substantially this year and remain high in both 2023 and 2024, which ought to suggest internally consistent reasoning for a gradual return to more normal monetary policy. Yet, stacked against this is the concern that energy prices will affect firms' and households' recovery prospects, and thus economic activity going forward. Already seeing negative real wage growth while costs rise, households could prove unwilling to increase consumption as previously expected. Meanwhile, firms may choose to delay investment until the current level of uncertainty has abated somewhat. Moreover, if lower future demand pulls down company revenues, this could even result in lower-than-expected wages going forward. These concerns have not been lost on the ECB, as evident by Isabel Schnabel's comment

that risks to growth and confidence implies it is unlikely that the ECB would choose to "accelerate policy normalisation in such circumstances." Our view is that the ECB will end QE in Q4 this year and hike twice by 25bp in March and June respectively next year, before keeping rates on hold for the rest of our forecast horizon.

Outside of the Eurozone, however, economies may absorb higher oil prices better and as the Russia-Ukraine conflict would be less likely to stave off tightening plans. For example, US net imports of oil-related products are much more modest in comparison and Canada is a major oil exporter. Meanwhile, with wage growth and labour shortages more pronounced in the US and the UK than in the Eurozone, inflationary pressure is arguably higher as well. That said, political considerations in the US over upcoming midterms could mean authorities want to limit how oil prices affect households, particularly through gasoline prices.

Another noteworthy policy response so far has been Germany's push to increase spending on defence expenditure. The government has reportedly decided to spend an additional EUR 100bn this year, while also increasing defence expenditure as a percentage of GDP to above 2 percent going forward. While this ought to imply some fiscal expansion on the part of Germany, and may to some extent also be replicated by some other Eurozone countries, such as the Netherlands and Austria, it seems less likely that countries with less fiscal space will be as fast to adjust.

Risks to our forecasts

The primary channel through which our forecasts come under risk commodity prices, particularly oil. A scenario whereby the oil price goes to anywhere between USD 120-140 per barrel, and with food prices also seeing a substantial increase, could result in European inflation being 1.5-2.5 percentage points higher this year. The pass-through from market prices to households, however, is somewhat muddled as European governments could scale up their fiscal measures to shield some of firms' and households' exposure to higher prices. This also makes assessing the likely impact on GDP especially challenging. Absent a broader disruption of energy supplies from Russia and a non-linear spike in corresponding prices, we expect GDP growth could now grow by 0.4pp less this year, although escalation of the conflict could cause a much larger impact. Uncertainty surrounding our forecasts has once again increased dramatically.

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