Market Focus

A CLOSER LOOK AT
KEY MARKET THEMES

1 March 2022

Russia's invasion of Ukraine:
What are the potential effects on the Eurozone economy?

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What are the potential effects on the Eurozone economy?

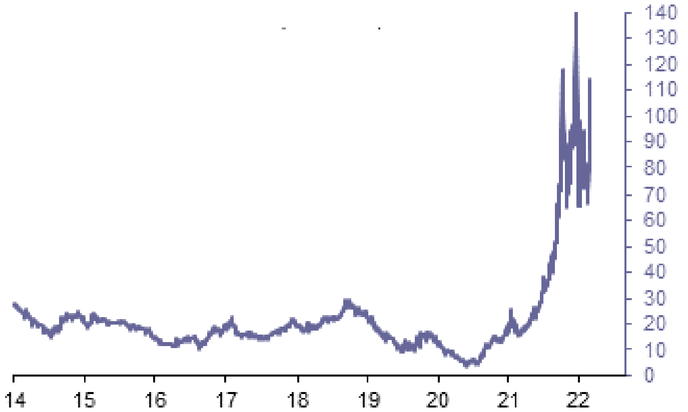
The tensions at play since 2014 in the Donbass region have come to head with the large-scale military invasion of Ukraine by Russia, that began on 24 February 2022.
The United States, the European Union, and Great Britain have responded with increasingly tough sanctions against Russia. Specifically, several Russian banks and major state-owned companies will be excluded from the SWIFT international payment system (a detailed list should be published shortly). Furthermore, around 50% of the international reserves of the Russian central bank held in G7 countries, have been frozen, limiting their potential use to mitigate the impact of the sanctions.

The war will reap a clearly negative impact on global growth, to the detriment of the mix of growth and inflation.
The Eurozone risks being one of the hardest hit regions, given its strong commercial and financial ties with Russia, and most importantly in light of its strong dependence on Russian gas supplies. The United States, on the other hand, will only be marginally affected by the conflict.

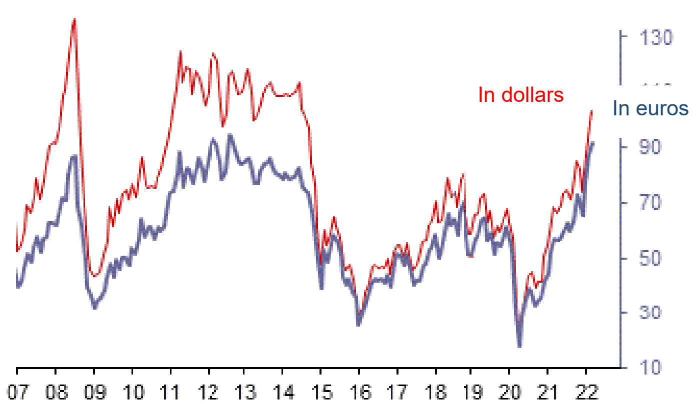
It is hard to accurately quantify the effects of the war on the Eurozone economy. Much will depend on the duration of the conflict and on which sanctions (and countersanctions) will be imposed, that change from day to day. **Inflation will obviously be higher, by an estimated one per cent or so,** than under the pre-war scenario, due to the upward pressures exerted by energy prices. For what concerns the impact on growth, on the other hand, **the Chief Economist of the ECB, Philip Lane, has said that the war and the sanctions could curb GDP growth from -0.3% assuming an intermediate scenario, to -1% in the worst-case scenario.**
This means that instead of growing by 4% this year, as currently forecast by the main international institutions and by the central banks, Eurozone GDP could increase by 3%. The growth rate would in any case be very solid, thanks to the effects of post-pandemic re-openings, that will support demand and mitigate the negative effects generated by the war on Ukraine. However, this scenario applies in the assumption of the conflict not escalating further, and leading for instance to a full interruption of gas supplies to Europe.

For the time being, the energy sector has been shielded from the sanctions.
But there has been an impact in any case: both oil and gas prices have risen significantly in the past week. The rise added to the existing uptrend of energy prices over the past few months, due to the post-lockdown mismatch between demand and supply, and to the effects of the green transition.
This will drive inflation even higher, but will also slow growth, complicating the mandate of the ECB, that will have to strike a difficult balance between the need to respond to rising inflation, and the need to avoid damaging growth. Ultimately, risk-management considerations will probably lead the ECB to remove stimulus at a slower pace than it had intended to until only a few days ago and, in particular, to delay the initial rate hike.
And if the crisis spirals further, it may even launch un new emergency asset purchase programme.

Price of natural gas in Europe (EUR/MWh)



Price of oil (Brent, price per barrel)



Source: Eurizon Capital elaborations on Refinitiv Eikon data – Data as at 1 March 2022

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Repercussions on the economy

The repercussions on the Eurozone of the Russian invasion of Ukraine, and of the increasingly strict sanctions being put in place by the West against Russia, will be felt through three channels: trade, with gas supplies at the fore, the financial channel, and sentiment.

1) The most important channel is trade, with energy supplies in the spotlight

Although Russia, as an individual country, is one of the Eurozone's main trade partners, **it accounts for only 3% of the Euro Area's total exports,** a share that has in fact dropped from 5% in 2013, before the war in Crimea. A much larger share of exports is addressed to the United States (15% around), Great Britain (10%), China (8.3%) and Switzerland (6%). **Therefore, the fallout on European growth of weaker exports to Russia should prove relatively modest.**

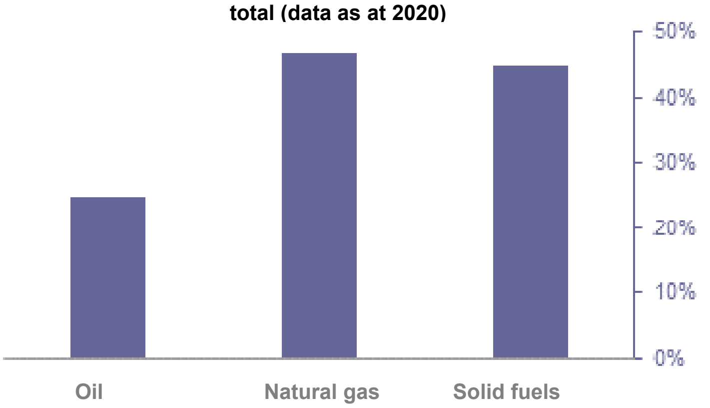
Eurozone: exports of goods by destination market (2021 avg., % of total)	
Other EU countries	22.7
USA	14.7
UK	9.9
Asia – of which:	23.9
China	8.3
Japan	2.3
Switzerland	6.0
Russia	2.9
Turkey	2.7
Africa	5.4
Latin America	4.3
Rest of the world	7.5

Source: Eurizon Capital elaborations on Refinitiv Eikon data – Data as at 1 March 2022

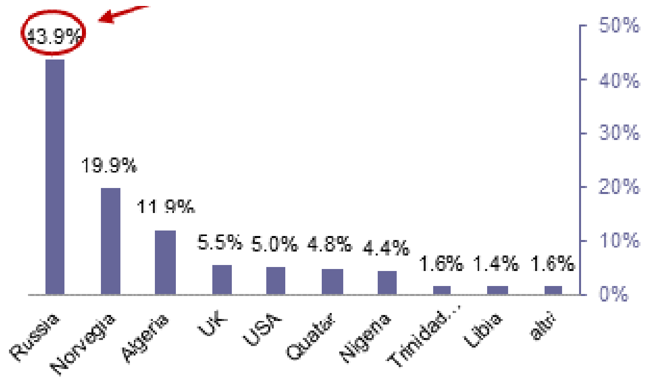
A much greater potential impact on the Eurozone's economic growth could be felt through the channel of imports from Russia, on which Europe is heavily dependent for its energy supplies. Indeed, Europe imports around 25% of its oil and 45% of its gas from Russia, with peaks of close to 100% for Bulgaria, 80% for Poland, and around 60% for Austria, Hungary, Slovakia, and Slovenia. However, gas imports from Russia are also a major factor for Germany (around 50% of the total) and Italy (40%).

What's more, dependence on Russian gas supplies has increased significantly compared to 2014, the year of Russia's annexation of Crimea: at the time, gas imports from Russia accounted for 25% of the total. **To date, the West's sanctions have avoided targeting the energy sector (the ban from the SWIFT system will not include energy payments), and Russia has sent no signals of wanting to limit or interrupt energy supplies in retort for the sanctions. However, Putin could change his position in the future, if the war drags on.**

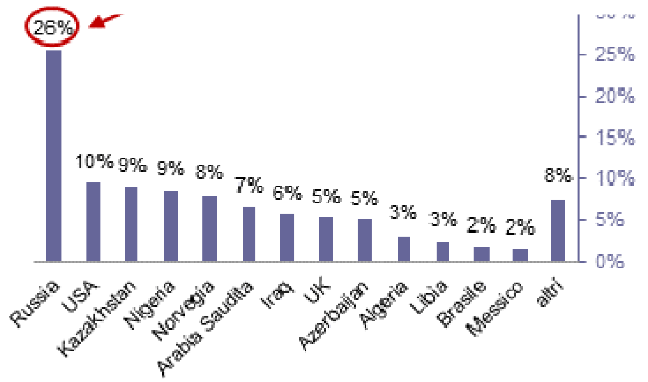
EU: share of energy imports from Russia on total (data as at 2020)



EU: natural gas imports from non-EU countries (% of total in 2020)



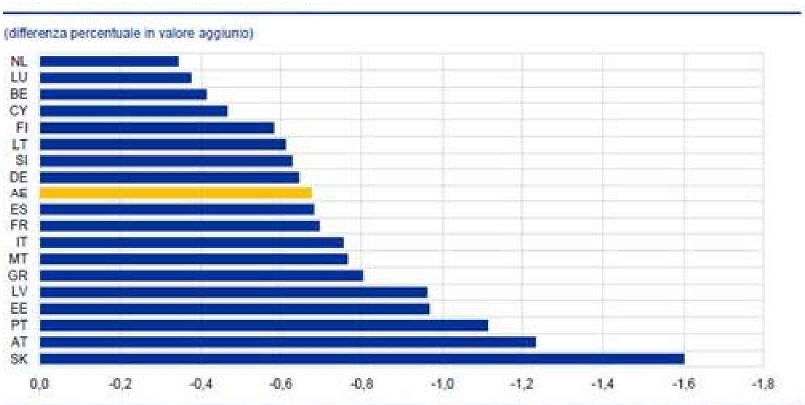
EU: oil imports from non-EU countries (% of total in 2020)



Source: Eurizon Capital elaborations on Refinitiv Eikon data – Data as at 1 March 2022

The ECB has estimated that the impact on growth of a 10% reduction of energy supplies could subtract an average of 0.7 percentage points from output growth in the Eurozone. The most affected sectors would be the energy-intensive ones, such as the extraction industry, the metal and mineral processing sectors, the chemicals industry, and the paper and print sector.
On top of this, the energy bills of households would also play a role, holding back consumption.
The effect would offset in part by the savings accumulated during the pandemic, and by the measures put in place by national governments to limit price increases, but would be relevant, nonetheless.

Impact of a 10 per cent reduction of gas supplies on gross value added, based on input-output simulations



Source: OECD 2021 data bank on trade in value added (TiVA), Eurostat, and ECB staff elaborations

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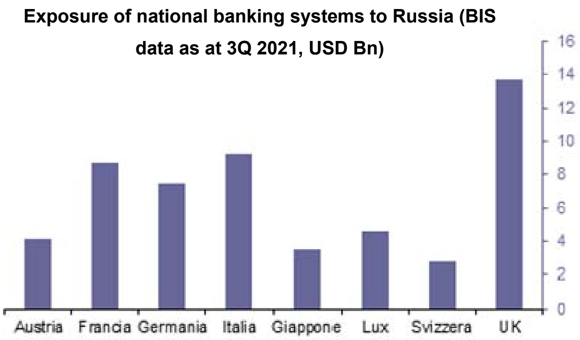
2) The financial channel

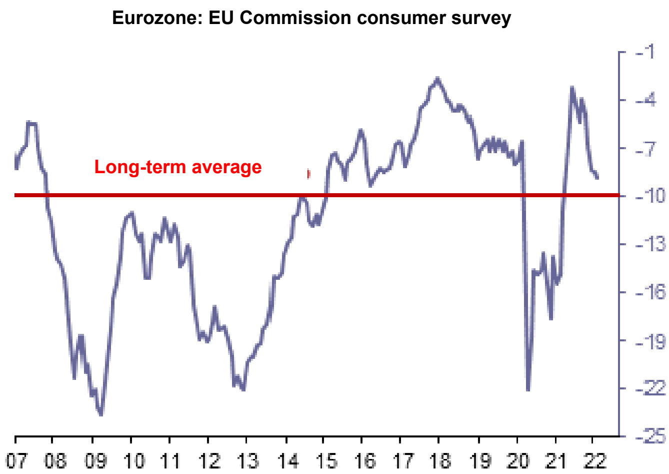
The financial channel should also be considered, with particular reference to the exposure of Eurozone banks to Russian assets. British, French, and Italian banks are the most exposed.

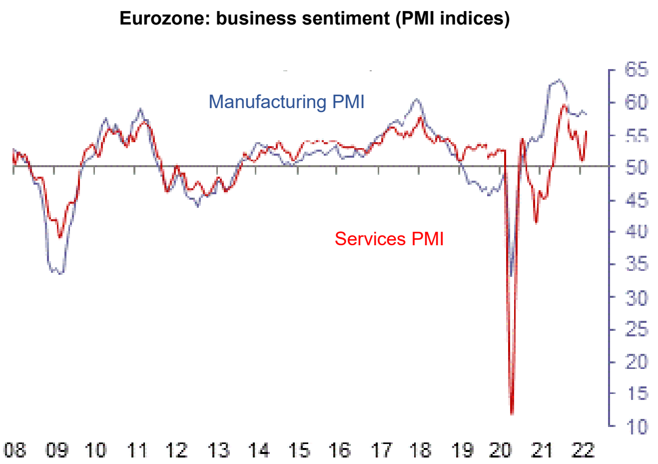


Source: Eurizon Capital elaborations on Refinitiv Eikon data – Data as at 1 March 2022

3) Sentiment

Another channel, not least important, through which the war in Ukraine could affect the Eurozone economy is sentiment. Consumer confidence had already worsened between December and February, due to surging energy bills. By contrast, business confidence improved significantly in February, in the services sector especially, thanks to the drop in Covid infections. However, survey data were not yet able to detect the impact of the war.
Therefore, the next set of confidence data should be carefully monitored, as they represent the most timely indicator with which to assess the impact of the war on economic activity.





Source: Eurizon Capital elaborations on Refinitiv Eikon data – Data as at 1 March 2022

A quantification of the potential impacts on growth

Quantifying the impact on Eurozone growth of the war in Ukraine, and the of sanctions imposed on Russia, is a complex exercise, as numerous transmission channels need to be considered, as also the indirect negative effects stemming from the adverse impact of the crisis on third countries, for instance in East Europe. Therefore, multi-country structural macro models, such as those used by the ECB, need to be run.
As reported by Reuters, **the Chief Economist of the ECB, Philip Lane, has said that the war and the sanctions could curb GDP growth from -0.3%, assuming an intermediate scenario, to -1% in the worst-case scenario.** This is a very similar estimate to the one drawn up in 2014 by the EU Commission, on occasion of the invasion of Crimea.

Based on the study conducted at the time, under a worst-case scenario Eurozone GDP would have proven lower by around -0.9 per cent in 2014, and by -0.3 per cent the following year. An "intermediate" scenario, on the other hand, would have had a modest impact on Eurozone growth, according to the EU Commission's study, by around -0.3 p.p.
This means that instead of growing by 4% this year, as currently forecast by the main international institutions and by the central banks, Eurozone GDP could increase by 3%. The growth rate would in any case be very solid, thanks to the effects of post-pandemic re-openings, that will support demand and mitigate the negative effects generated by the war on Ukraine

While these estimates may seem reassuring, it should be said that they do not consider the potential effect of a further escalation of the crisis, that could bring, for instance, new EU sanctions or a retorsion by Russia, with the result of blocking gas supplies to Europe in full or in part: **this would clearly have much more serious impacts.**