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EUROPE: EXPOSURE TO RUSSIA/UKRAINE CONFLICT

EURO AREA FACES THREAT OF STAGFLATION

Author

NADIA GHARBI, CFA
ngharbi@pictet.com

SUMMARY

- The conflict between Russia and Ukraine represents a significant shock for Europe. Its full impact is difficult to gauge and will depend on how long the conflict lasts, the nature of sanctions and the risk that violence spreads to other countries.
- There are several channels through which the conflict could impact the economy. Commodities are the most important due to the EU's high dependence on Russian gas and oil, followed by sentiment, finance and trade.
- Higher energy prices will act as a drag on consumer spending, but we expect this to be compensated for to a certain extent by government policy measures and the mobilisation of part of the excess savings that were accumulated during the pandemic. We have cut our 2022 GDP growth forecast for the euro area from 4.5% to 4.1%. Risks remain tilted to the downside. Much will depend on the severity of supply disruptions. A full shutdown of Russian gas supplies would have a significant effect on the economy and would likely push the euro area into recession.
- Given higher energy prices, we have also revised our euro area inflation forecasts upwards. We now expect headline inflation to average 4.9% in 2022 (previously we expected 4.5%) and core inflation to average 2.6% (up from 2.3%). We believe it is likelier to be above these levels than below them.
- The ECB is faced with a dilemma. Additional price pressures will reinforce concerns about high inflation and possible second-round effects on wages. At the same time, risks to economic activity and the potential implications for the fiscal outlook suggest ECB could be more patient with respect to policy normalisation.
- Beyond the direct economic implications, the conflict will have significant long-term consequences for EU policy, particularly with respect to security and energy. The EU will probably run a more expansionary fiscal policy than it has over the past decade.

Russia's invasion of Ukraine represents a significant downside risk to our growth outlook. There are multiple channels through which the conflict could impact the EU's economic outlook: commodities; consumer and business sentiment; banks and trade.

Commodities: if only Europe was not so dependent on Russian gas

Commodities are likely to have the biggest impact on the outlook for Europe. Europe is highly dependent on Russian gas. Indeed, **more than 40% of Europe's gas imports come from Russia**. The region is less dependent on Russia for oil than it is for gas, with Russia accounting for 25% of the Europe's oil imports (see *chart 1*)

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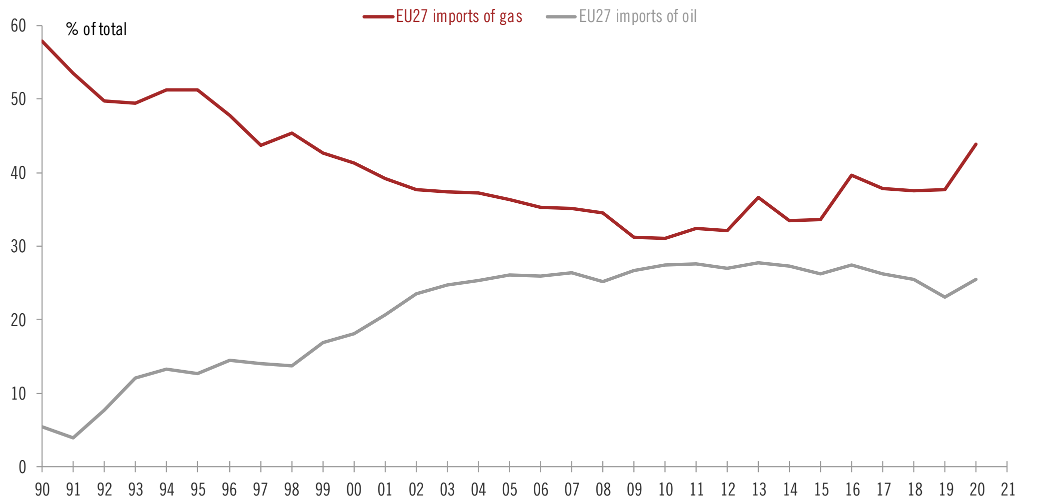
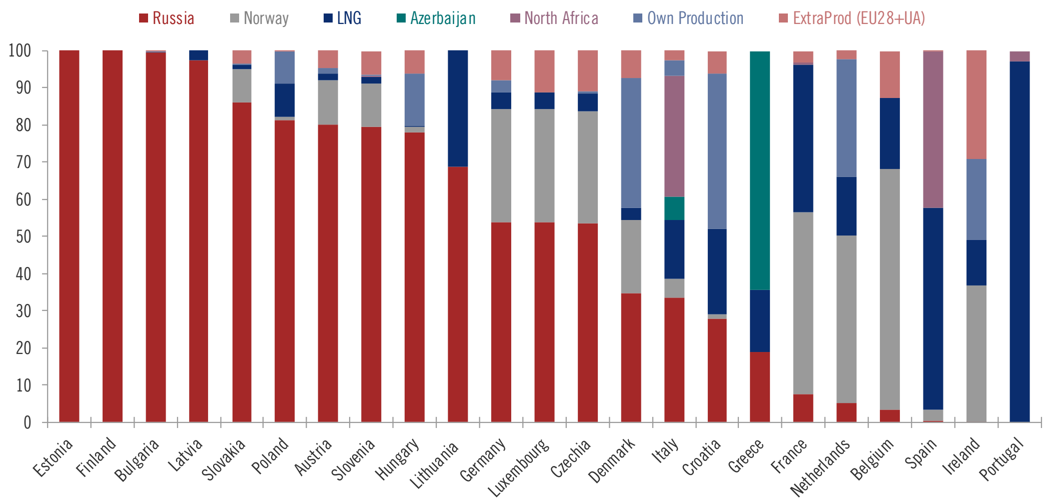
CHART 1: EU 27 – IMPORTS OF GAS AND OIL FROM RUSSIA



Source: PWM - AA&MR, Eurostat

Given the complexity of the European gas market and the fact that trade statistics do not capture well the internal EU countries' reliance on foreign gas, we look at the data published by European think tank Bruegel in a recent paper[1]. Estonia, Finland and Bulgaria import 100% of their gas from Russia (see *chart* 2). **Germany obtains more than half of its gas from Russia while countries on the Iberian Peninsula, which is a hub for liquefied natural gas import terminals, have little direct exposure to Russian gas**.

CHART 2: EU - ATTRIBUTION OF GAS IMPORTS TO INDIVIDUAL SOURCES IN 2021



Source: Bruegel calculations

The dependence on gas as a source of energy varies by country (see *chart* 3). While Finland and Estonia import all of their gas from Russia, they are less dependent on gas as

[1] McWilliams, B., Sgaravatti, G., Tagliapietra, S. and G. Zachmann (2022) 'Preparing for the first winter without Russian gas', Bruegel Blog, 28 February

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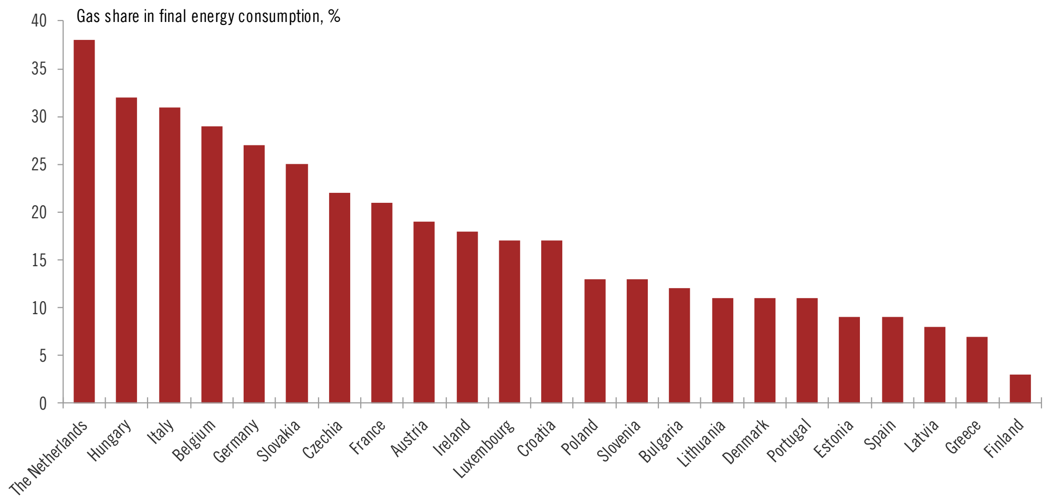
a source of energy than some other countries. In contrast, Italy is much more dependent on gas and will suffer more from increases in gas prices or disruptions to supply.

CHART 3: EU - GAS DEPENDENCY



Source: Bruegel, Eurostat

The key question is whether Europe can survive without Russian gas. Over the short term, alternative sources of supply are limited. According to a recent study published by Bruegel[2], "Until the summer, the EU would likely be able to survive large-scale disruption to Russian gas supplies, based on a combination of increased liquefied natural gas imports (to the limited extent this is technically possible) and demand-side measures such as industrial gas curtailments. However, this would come at a cost for the EU economy and might even result in some countries (those more exposed to Russian gas and less interconnected with other EU countries) having to take emergency measures. But, should a halt of Russian gas be prolonged into the next winters, it would be more difficult for the EU to cope".

Beyond the increase in oil and gas prices, **severe disruptions to gas flows would likely have a sizable impact on production, especially in sectors that make intensive use of gas and electricity** (especially basic metals, mining and quarrying, paper and printing, and chemical sectors). According to a recent study published by the ECB[3], "the direct and indirect impact of a hypothetical 10% gas rationing shock on the corporate sector is estimated to reduce euro area gross value added by about 0.7%, with losses being particularly significant for countries where production relies more heavily on gas". Among the four biggest euro area economies, Italy would be the most impacted by a gas rationing shock.

The conflict could also worsen input shortages and bottlenecks, impacting euro area manufacturing activity as Russia is also a major global exporter of metals including palladium, platinum, nickel and aluminium.

[2] McWilliams, B., Sgaravatti, G., Tagliapietra, S. and G. Zachmann (2022) 'Can Europe survive painlessly without Russian gas?', Bruegel Blog, 27 January
[3] Gunnella, V., Jarvis,V. Morris, R and Máté, T (2022) 'Natural gas dependence and risks to euro area activity gas', ECB Economic Bulleting, January

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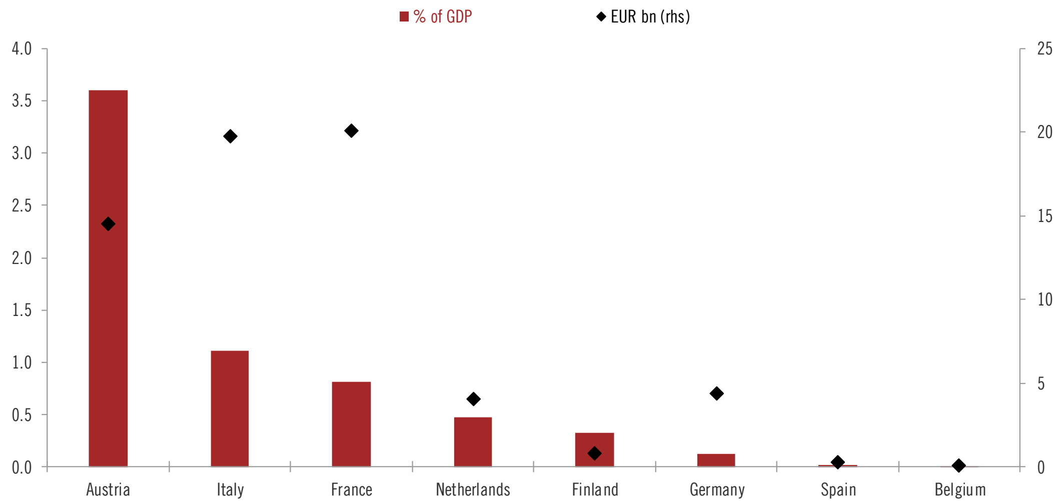
The impact on sentiment: difficult to quantify

The war could also have an effect on euro area consumer confidence and business sentiment, leading to delays in spending. The full impact is difficult to quantify, however. Most of the data that have been published so far do not cover the short period since the Russian invasion on 24 February.

The financial channel: Austrian bank are the most exposed to Russia

Banks could be directly impacted due to their exposure to Russia, in addition to the impact on investor sentiment and on the prices of global and Russian assets. European banks' exposure to Russia has fallen overall since 2014, but it's a mixed picture at the individual country level, with banks in Austria, Italy and France (see *chart 4*) having the highest exposure.

CHART 4: EU BANKS' EXPOSURE TO RUSSIA – INTERNATIONAL BANKS' CLAIMS ON RUSSIA (Q3 2021)



Source: PWM - AA&MR, BIS

Trade: risks largely contained to Baltic

Russia is a small export market for Europe overall. **Exports to Russia fell markedly after its annexation of Crimea in 2014 such that it now only represents less than 1.6% of total exports (or 0.6% of EU GDP).**

This means that even if exports to Russia fall sharply, the impact should be limited. Lithuanian, Latvian and Estonian exports to Russia are higher than for any other European country (see *chart 5*).

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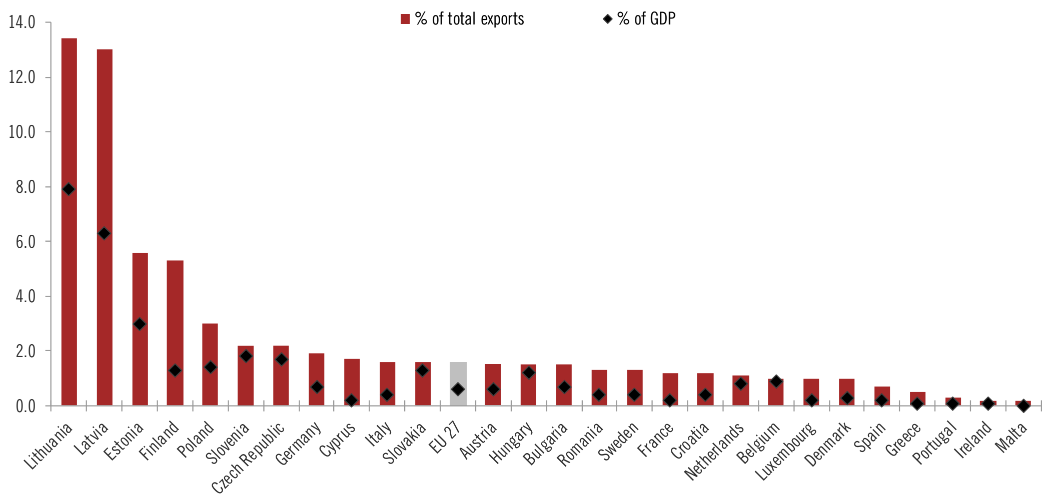
CHART 5: EU27 EXPORTS TO RUSSIA (2020)



Source: PWM - AA&MR, Eurostat

Lower growth, higher inflation

The full impact of the invasion is difficult to gauge and will depend on how long the conflict lasts, the nature of sanctions and the risk that the conflict spreads to other countries. The situation remains highly uncertain.

While reduced trade with Russia would have a limited impact on the euro area economy as a whole, we expect higher energy prices to act as a drag on consumer spending even if part of the hit is compensated for by government support policies. As such, **we have cut our 2022 GDP growth forecast for the euro area to 4.1% from 4.5% previously**. We believe it is likelier to be below this level than above it. Much will depend on the severity of supply disruptions. **A full shutdown of Russian gas supplies would have a significant effect on the economy and would likely push the euro area into recession**.

Given higher energy prices, we have also revised our inflation forecast for the euro area upwards. **We now expect headline consumer inflation to average 4.9% in 2022** (previously we expected 4.5%) and **core inflation to average 2.6%** (up from 2.3%). We believe it is likelier to be above these levels than below them.

The ECB's policy dilemma

The ECB faces a policy dilemma. Additional price pressure will reinforce concerns about high inflation and possible second-round effects on wages. At the same time, the threat **to economic activity and the fiscal outlook might lead the ECB to be patient before normalising policy.**

The ECB is likely to adopt a cautious tone at its next Governing Council on March 10. In a recent speech[4], member of the ECB's Executive Board Fabio Panetta stated that "the dramatic conflict in Ukraine" created an environment in which it would be "unwise to pre-commit on future policy steps". He added that the ECB "stands ready to act to avoid

[4] Panetta, P (2022), "Small steps in a dark room: guiding policy on the path out of the pandemic", 28 February

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any dislocation in financial markets … and to protect the transmission of monetary policy".

As such, **the ECB is unlikely to provide a firm commitment about when it will end its Asset Purchase Programme (APP)**. It could signal its intention to wrap up its asset purchase programme in Q3 if all goes well, while keeping the door open to continue or even accelerate its purchases if the conflict worsens. ECB President Christine Lagarde will probably sound more cautious with regards to raising rates later this year, emphasising the risks and the need to consider new policy instruments if needed.

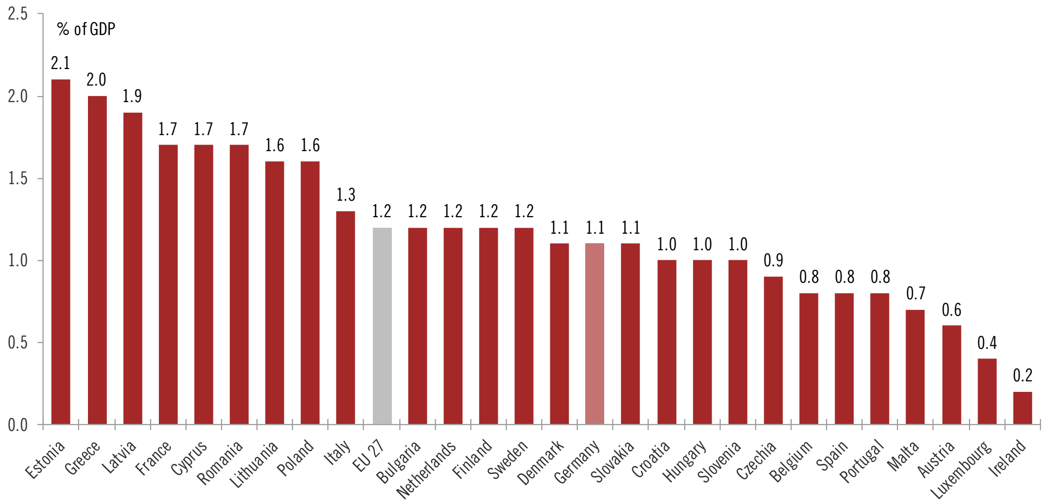
Longer-term implications for Europe

The crisis represents a significant challenge for Europe and has led its leaders to take unprecedented measures. Beyond the direct economic implications, the conflict will have significant long-term consequences for EU policy. In particular, it has highlighted the needs for a bigger and better defence capabilities and for energy independence.

By way of illustration, Germany has made a historic policy shift. It is allowing weapons to be delivered to Ukraine and will open the fiscal taps to finance a special EUR 100bn fund to strengthen and modernise its army. The government plans to spend at least 2% of GDP each year on defence, in line with a NATO target that Germany has previously consistently failed to meet. It also plans to reduce its dependence on Russian gas, with the government announcing the construction of two liquefied natural gas terminals.

We expect **the EU to run a more expansionary fiscal policy than it has over the past decade**. Spending on security will probably increase, as will spending on achieving a more sustainable energy mix.

CHART 6: EU GOVERNMENT EXPENDITURE ON DEFENCE (% OF GDP) (2019)



Source: PWM - AA&MR, Eurostat

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