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Research Briefing | Eurozone

How the clash with Russia will affect Europe's economy

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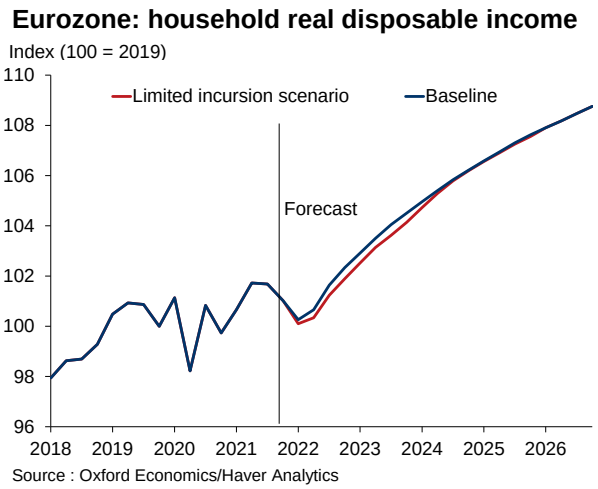
- **The escalation in the Russia-Ukraine conflict will hit the eurozone economy mainly via higher energy prices giving another spur to inflation, which will affect real incomes. The impact on each European economy will depend on their degree of energy dependence, direct trade, and financial links with Russia.**
- **We outlined a number of scenarios for an escalation in the conflict in January. The latest developments are closer to our "limited" incursion scenario.**
- **For most European countries trade links are relatively minor, so with a few exceptions present only a low threat to the outlook. Similarly, financial links are also limited, with only three European banks having a noteworthy presence in Russia and will not represent a systemic risk to the banking system.**
- **Energy dependence is the biggest risk given Europe's reliance on Russian gas, which in some countries represents their entire supply. But with the risk of actual supply cuts relatively low, the main transmission channel continues to be via higher prices, which will affect all countries similarly.**

Russia's recognition of Ukraine's separatist regions and decision to send troops into the Eastern part of the country moves closer to our "limited" incursion scenario. The escalation raises the risks of energy prices rising higher in the short term and staying elevated for a longer period than we had previously considered. This will lead to higher inflation and a drag on growth, mainly via lower real incomes for households and a drop in confidence. Alongside reliance on Russian energy exports, other transmission channels for Europe include direct trade and financial links. Although on aggregate we do not see these as large enough to cause substantial damage to the eurozone economy, the picture varies widely across European countries. The Baltic states and some Eastern European countries will feel the negative effects of the crisis more acutely.

Figure 1: Escalation of the Russia-Ukraine conflict will impact eurozone growth via higher inflation and a knock to real incomes



The recent developments between Russia and Ukraine means we are now closer to our "limited" incursion scenario, which envisages higher energy prices and a larger impact on household real incomes owing to higher inflation.

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Links with Russia vary widely across Europe

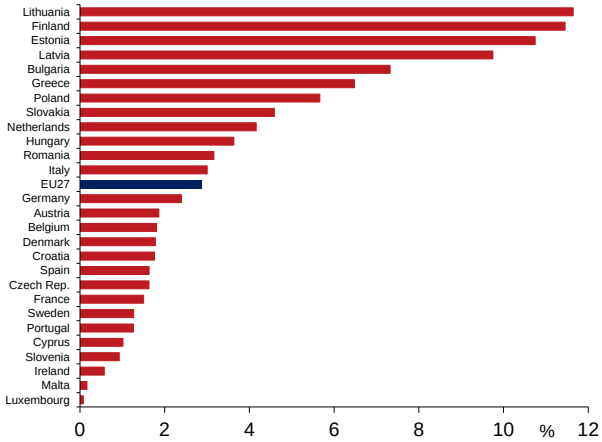
The trade channel represents a small risk to the European growth outlook given the low prominence of Russia as an export market. Less than 3% of EU exports go to Russia (**Figure 2**), so the impact of either a collapse in Russian imports or trade barriers imposed by the Putin administration would be very modest for the European economy. The main exceptions are the Baltic states and Finland, which due to their proximity and historical connections export a much larger proportion of goods to Russia.

Similarly, financial links between Europe and Russia are limited. Foreign banks, including their Russian subsidiaries, are owed $121bn by Russian entities, with European lenders accounting for over half of that amount. But the debt is mainly concentrated at three banks: UniCredit in Italy, Société Générale in France, and Raiffeisen Bank in Austria (**Figure 3**). The ECB recently warned that financial institutions operating in Russia should prepare for the imposition of sanctions if Russia invades Ukraine. Although sanctions could have a sizable impact on those banks' results in Russia, their operations in the country represent a small fraction of their total business (less than 3% of total risk-weighted assets in the case of SocGen and UniCredit, but close to 10% for Raiffeisen). Consequently, the systemic risk for the wider European banking system is limited. Equity markets are likely to see increased volatility, focused particularly on firms with larger exposures, but we do not expect European equities will suffer large, sustained losses unless the conflict intensifies severely.

Europe's reliance on Russian energy also varies widely across countries, with some economies importing all of their gas from Russia (**Figure 4**). This would put them in a very vulnerable position in an extreme scenario where gas flows to Europe are cut. But we still consider this as a tail risk, therefore limiting the significance. The main transmission channel currently continues to be higher energy prices, which given the interconnections in commodity markets, are impacting all countries similarly regardless of where they buy their gas from. There is also an additional impact on food prices via higher energy costs, but also given Russia's role as a big exporter of agricultural products and fertilisers. The response of the West to Russia's actions, including Germany's suspension of the certification of the Nord Stream 2 pipeline, will add stress to gas prices. But we don't think this presents a substantial risk to the supply of gas to Europe at the moment.

Figure 2: Russia represent a small share of European exports in most countries

Exports to Russia, share of total

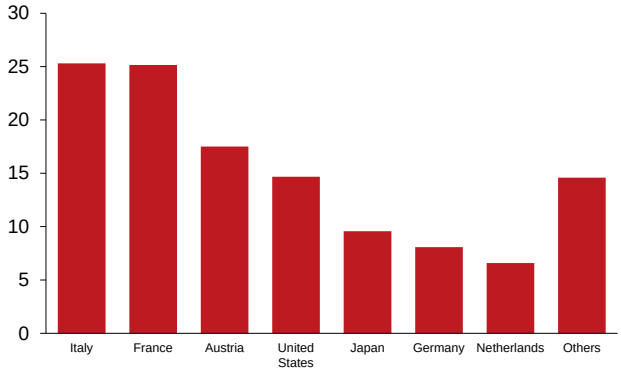


Source: Oxford Economics/Haver Analytics

Figure 3: European banking exposure to Russia is mainly limited to three banks

Banking sector: consolidated positions of residents on Russia

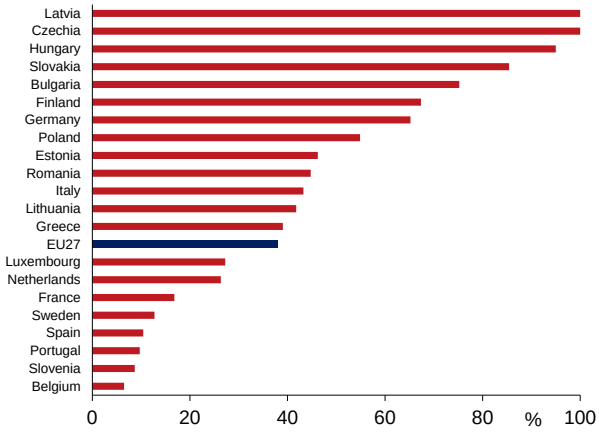
Amounts standing, $US billion, end-September 2021



Source: Oxford Economics/BIS

Figure 4: Russia dominates Europe's supply of gas, reaching 100% of total in some countries

Imports of gas from Russia (% of total)



Source: Oxford Economics/Eurostat