17 February 2023

Research Russia-Ukraine

One year since Russia's invasion – Europe faces three changes as it settles into new reality

- **One week from now, exactly one year has passed since Russia started its unprovoked attack against Ukraine.**
- **In our view, the war has brought along three important changes. First, it has fundamentally changed the way we perceive security and peace in Europe. Second, it has forced changes in our economic model, and third, it has changed the priorities of businesses and policymakers who prepare for the future.**

A reality check for Europe

When Russia started its invasion of Ukraine in the early hours of Feb 24th last year, the European security order changed overnight. Media outlets showed dark images of burning buildings in Kyiv, providing a very unpleasant reminder for Europeans that a military conflict is not only a thing of the past.

Wars, as distant as they have been to an average European for long, cause massive losses on human capital. Since the start of the war, more than 7,000 Ukrainian civilians have lost their lives and more than 11,000 have been injured. The war has displaced more than 14 million people. The people who are now deceased, injured, displaced or mobilised could have been productive, both for the private sector and for their country. Some of them will of course build a new life and start to work elsewhere but it will take time.

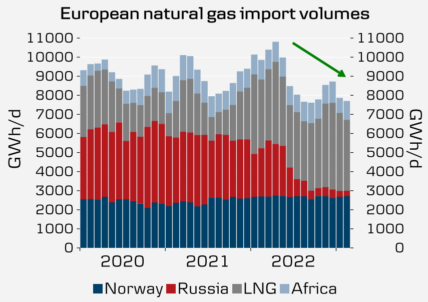
Despite the discomfort a war brings, it is also a healthy reminder. All conflicts cause massive human suffering and economic losses, but the ramifications from conflicts do not respect country borders. According to the IMF, Ukraine is estimated to have lost at least one-third of its GDP last year, while the OECD has estimated total costs from the war at USD 2.8 trillion in lost output for the global economy. That is more than ten times the size of the Ukrainian economy.

Rethinking our economic model

The losses for the global economy mostly come from higher energy and food prices, as well as disrupted supply chains. Europe now grapples with an acute energy crisis that could last for years. Before the war, 25% of the EU's imported petroleum and 39% of the natural gas originated from Russia. By the third quarter of 2022, these shares had fallen to 14% and 15% respectively. After the EU imports ban on Russian oil entered into force in December 2022, this share has shrunk even further.

For decades, many European countries fostered close economic ties with Russia, and industries in many large European countries relied on cheap, fossil energy from Russia. The war has forced Europe to rethink; it has triggered a race to build more emission-free energy production capacity, not only in Europe but globally. The European Commission now plans an additional investment of EUR 210 billion on energy independence and security by 2027. Cutting Russian fossil fuel imports should save an additional EUR 100bn.

Russia now comprises only a marginal share of Europe's gas imports



Source: Refinitiv

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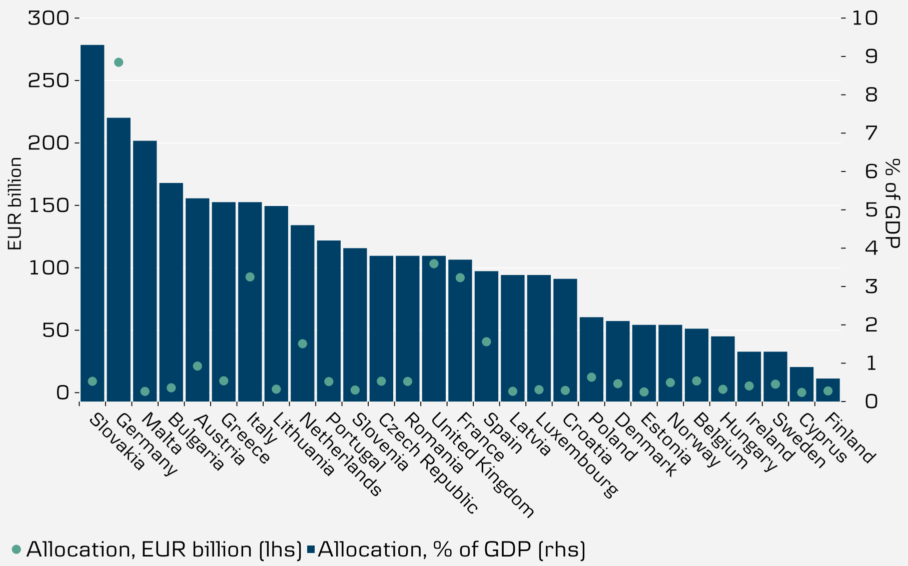
As Europe has managed to avoid an acute gas crunch, energy prices have stabilised. The 1-month natural gas price in Europe has fallen below 60 EUR / MWh and is already at a lower level than before Russia's invasion in February 2022. Yet, Europe is not out of the woods. In short term, saving energy and improving energy efficiency are the only viable options, since building new infrastructure capacity is a slow process and typically takes years. Controlling for the weather impact shows that actual consumption has adjusted to energy price variations; the higher the price has been, the more demand adjustment has taken place. Recently though, lower prices seem to have again led to higher consumption.

Europe's energy transition could still be painful and prices could stay elevated and volatile for some time, but eventually, the outcome should be positive. The good news is that costs of building renewable energy capacity have fallen drastically. The cost of newly installed solar photovoltaic capacity is now only 10% compared to what it was in 2010. Costs for onshore and offshore wind are down 70 and 60% respectively. In five years' time, Europe is likely to have established an energy system that is more robust to external shocks but also ecologically more sustainable. Climate will be the big winner but also businesses should benefit since renewable energy is very affordable.

While in long term this crisis could make Europe more resilient, in short term, economies are being challenged. Apart from energy investments, governments are pushing for increased spending on defence. Handouts to citizens and businesses to compensate for rising costs have been generous, particularly in Germany, where earmarked and allocated support exceeding EUR 260 billion makes up approximately half of the euro area total. Ballooning government deficits and rising government debt in euro area could become an issue as real interest rates rise. Same time, the ongoing fiscal easing threatens to undermine central bank efforts to tame price pressures. Rising tensions between fiscal and monetary policy could be one of the key financial market themes for 2023.

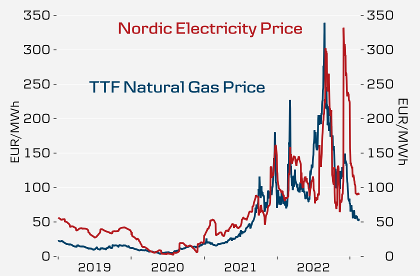
German government has been particularly generous in compensating citizens for the rising costs of living

Governments earmarked and allocated funding to shield households and businesses from the energy crisis



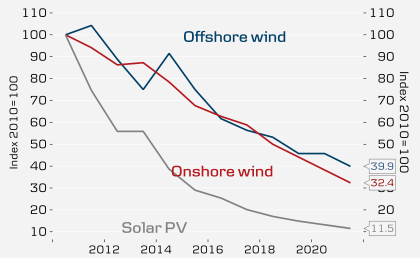
Source: Bruegel

Electricity and gas prices are sharply lower thanks to mild weather



Source: ICE, Macrobond Financial

Cost of installed wind and solar power has fallen substantially since 2010



Source: IRENA

New priorities going forward

The war has served as a reminder that the inter-connectedness of our global economy also makes the system vulnerable. The reaped benefits from decades of globalisation, the increased efficiency and cost gains, are now increasingly weighed against the risks the process entails. Investment decisions for future production locations, or the choice for new markets, have become more complicated and parameters could be weighed differently than before. Geopolitical, security and energy risks, factors that may entail significant economic costs long term, are likely to weigh more on decision-making even if the short-term cost impact from this risk management exercise is negative.

Most notably, businesses are likely to reconsider their exposure to China who is already at odds particularly with the US. Last year, for example, the US stepped up sanctions related to technology exports to China. If the reshuffling of global production and supply chains really happens, it will have substantial implications. Those emerging economies that face a high risk of sanctions will find it hard to attract investments from Western companies going forward. Then again, it is unlikely that countries like China would ever face similar sanctions as Russia. It is simply too important for the West.

Changing priorities of businesses and policymakers will benefit some economies but there is a risk that low income economies are left behind. The UN has assessed that the annual sustainable development goal financing gap in developing economies has increased from USD 2.5 trillion, estimated in 2015, to USD 4 trillion. All progress achieved since 2015, has effectively been rolled back. Many emerging economies will be reluctant to choose side in the ongoing geopolitical battle, which makes them unattractive to investors. Then again, the rising investment gap is likely to exacerbate economic deprivation, which creates a fertile ground for foreign influence by the 'enemy block'. A vicious circle?

The endgame – will Russia run out of resources?

Over the last 12 months, Russia has become an international pariah state similar to Iran. It faces a range of sanctions by the US, the EU and many other nations. In addition, many businesses and people have voluntarily left the country. Yet, thanks to high commodity prices, contraction in the local economy last year was less than expected. The Russian government was well prepared before they started the war, and although Western countries froze a part of Russia's foreign reserves, Russia has continued to receive foreign currency by selling its energy products to China, India and Turkey. The central bank has managed to keep the local exchange rate stable with a number of controls in place.

In the longer term, sanctions, boycotts by foreign companies and brain leakage altogether will hamper Russia's economic development, and drain its military resources. Particularly the sanctions against Russian financial industry and limitations to technology exports will reduce Russia's economic potential while also hampering military production. Still, Russia will not run out of resources completely. The government can prioritise, and they have already. They have focused social spending on the most vulnerable parts of the population. Last year, the Russian government hiked pensions and minimum wages, and recently, President Putin again instructed his government to raise minimum wage in 2023 ahead of inflation, which stood at 12% in December 2022.

Life will become harder for many and the middle class will lose the most, but in a totalitarian state, options are limited. It's 'fight, flight or freeze' and many have opted for the third. Unfortunately, it also means this war is likely to drag on. In the eve of the first year anniversary, Russia has launched a new offensive. The endgame is as uncertain as ever but as long as Putin is in in charge and Ukraine continues to successfully fight back, it is hard to see how the two sides could even enter the same table.

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Expected updates

None

Date of first publication

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Report completed: 16/02/2023, 16:30 CET

Report first disseminated: 17/02/2023, 06:00 CET