14 January 2022

Research Russia

Expect serious market disruptions if a war breaks out

- **Crucial talks to de-escalate the tensions between Russia and Ukraine have kicked off. But early optimism from bilateral talks between Russia and the US is quickly fading as it is ever more apparent that the parties remain far apart on key issues.**
- **In the event of a contained military re-escalation in Eastern Ukraine, we think the US and the EU would likely impose sanctions related to exports and targeting Russian individuals and businesses. In this case, we expect the negative market reactions to be relatively short-lived, as long as the West abstains from the most extreme measures, such as removing Russia from SWIFT.**
- **In the unlikely event of a full-blown war where Russia attempts to seize control of the whole of Ukraine, we would likely see substantial flight-to-safety flows, RUB depreciation and disruptions in the gas market. In this case, Russian exclusion from SWIFT is possible, with devastating economic repercussions.**

Political background: What is happening?

Since early November, Russia has been enforcing its military presence at the border of Ukraine and is pressing the West with a list of demands, published on December 17. Russia has deployed more than 100,000 troops at the Ukraine border, and the estimated time it needs to prepare a military response, should the talks fail, *has been estimated at 1-2 weeks*. Hence, the ongoing dialogue between Russia and the West is crucial. We are not confident that a deal can be reached but we also do not expect a full-blown war.

The first round of bilateral talks between Russia and the US ended on a cautiously positive note but this optimism is already fading. After Russia's consultations with NATO on Wednesday and their meeting with the members of the Organisation for Security and Cooperation in Europe (OSCE), it is ever more apparent that the two sides stand far apart from each other on key issues. The US has refused to discuss the issue of NATO expansion, while Russia insists that the possibility of Ukraine joining NATO would be 'crossing the red line'[1]. *Russia does not seem content* with the offer by the US to discuss weapons positioning and military exercises in Europe, which it calls 'secondary' matters.

As of now, the date to continue talks has not been set. Earlier this week, Russian Deputy Foreign Minister Ryabkov said that Russia was not prepared to wait for weeks or month, but on Thursday, another Russian representative for the talks, Alexandre Grushko said Russia has made no decision yet on whether to continue negotiations, as they await written proposals from the alliance. NATO's Secretary General Jens Stoltenberg has confirmed that Russia was not ready to commit to a schedule. As uncertainty mounts, time is not on Russia's side if you consider their negotiation power: 1) Europe's reliance on Russian gas will become less of a factor after the cold winter period, 2) conditions for any military operations in Eastern Ukraine will become more challenging as the weather gets warmer and the soil turns muddy.

Russian ultimatum

- By laying out its demands on Dec 17, Russia communicated its desire to restore the pre-1997 security order in Europe.
- Russia wants a commitment from NATO that they would not accept membership applications from Ukraine or from any of the other former-Soviet states. It also demands NATO to scale back military deployments in Central and Eastern Europe.
- Russia has threatened the West with a 'military-technical' response if they fail to meet its demands.

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[1] See *here* for a status update of Ukraine's request to join NATO.

Why now, Putin?

The ongoing tensions between Russia and Ukraine date back to 27 October last year, when Ukraine destroyed the artillery of pro-Russian separatists in the Donetsk People's Republic (the self-proclaimed state in Eastern Ukraine) using a Turkish-produced drone Bayraktar[2].

However, on top of this incident, several factors are likely to have contributed to a re-escalation in tensions. Nationalist and pro-European sentiment has strengthened in Ukraine over the last few years, while the Ukrainian government has made significant investments in its military since 2014. For Putin, this may imply that Ukraine, leaning towards West and a potential NATO member eventually, is a rising security threat. Considering Putin's view of Russians and Ukrainians being 'one people' (*as outlined in his July 2021 speech*), one could also conclude that Putin eventually sees Ukraine as non-sovereign, and as the Ukraine military is becoming stronger by year, the time to act could be sooner rather than later, if it wants to secure and expand its dominance over Eastern Ukraine.

Putin's motives have also been linked to domestic politics and geopolitical balances of power. Over the recent years, Putin's legitimacy has been built upon the narrative that the West is hostile and aims to weaken Russia. In the context of slowing economic growth and weaker productivity, Putin needs to convince the domestic audience that it remains a global military superpower. Also, the shift in focus for US foreign policy towards China (and away from Russia), as well as the change of government in Germany, have been presented as reasons for why Putin sees the time is right to strengthen its sphere of interest in Europe.

Exclusion from SWIFT would be costly ...

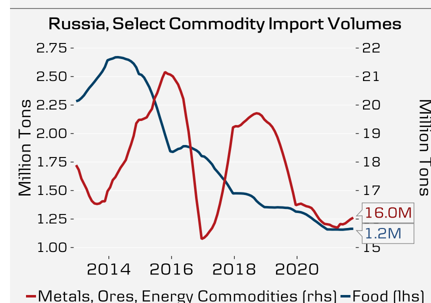
As a starting point, we do think both parties want to avoid conflict, since a military escalation would entail significant economic and financial market implications for both sides. Economic impacts would hurt especially Russia and Europe given their closer economic ties than the US. The direct impacts for Russia are clear, as a full-blown war would be very costly. *Military experts estimate* that Russia has the capabilities to invade Ukraine in a relatively short timeframe, possibly a matter of days or weeks. However, as Anti-Russian sentiment particularly in Western and Central parts of Ukraine is strong, a large-scale attack would probably result in significant resistance resulting in substantial economic and manpower losses for both sides. Even if Russia succeeded in seizing control of most of Ukraine, they would likely be stuck in a years-long guerrilla war, a scenario to avoid. A gradual step-up in influence across Eastern Ukraine and further dominance over the Donbas region would instead be a more cost-efficient solution for Putin, particularly if the West is willing to make some concessions.

The impacts from economic sanctions that are likely from the West if Putin decides to invade Ukraine, would have wide-ranging consequences. One of the options that has been laid on the table is the exclusion of Russian counterparties from the international payments system, SWIFT. The decision would be unprecedented at this scale, as only countries like Iran and North Korea have been previously excluded from the system. While it is likely that Russia would be able to relatively quickly adjust its domestic financial transactions (e.g. paying salaries and pensions) using alternative internal payment systems, the move would entail that all cross-border payment traffic between Russian and foreign counterparties would suddenly stop, providing a significant shock to the Russian economy.

Ukraine has increased military expenditure since 2014

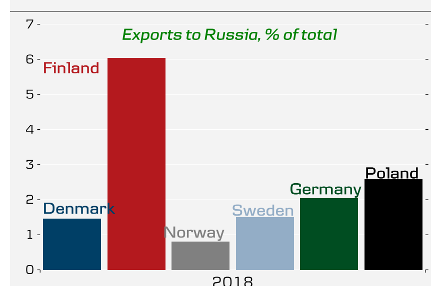
Source: World Bank, Macrobond Financials

Russian import volumes have decreased broadly



Source: Macrobond Financial, Federal Customs Service of Russia

Finland has the largest exports exposure to Russia amongst the Nordics



Source: OECD, Macrobond Financial

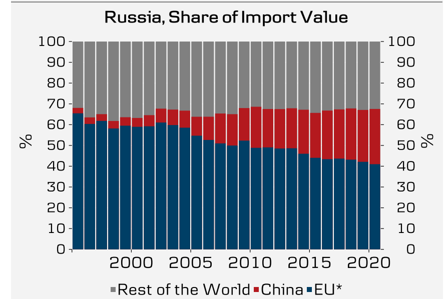
[2] Drones play a game-changing role in conflicts nowadays. Last November, similar Turkish *drones helped Azerbaijan defeat Armenia* in their 44-day. *Drones also helped Ethiopian government* to tip the balance in the ongoing civil war in December 2021.

On the other hand, from the West's viewpoint, removing Russia from SWIFT could also have undesired second-round effects in the broader geopolitical landscape; it could lead to Russia (and China) stepping up their efforts to develop their own payment systems.

In any case, the impacts would be devastating for Russia and for any businesses doing trade with Russian counterparties. Russian imports remains stable at around 20% of GDP, but a more detailed look shows that Russia has been able to somewhat reduce its dependence on foreign imports, particularly from Europe, since 2014. While total import values have risen near earlier levels since the drop in 2014, the broad push for import substitution has led to a decrease in import volumes across a broad range of categories, including food but also services. Aside from increased local production, some of the products are now increasingly imported from non-European countries.

In reality, some of the products sold to Russia from non-European countries have originally been produced in Europe, but have simply been re-routed via a third country. This illustrates how Russia and the overall situation adapt to the sanctions over time, and as such, one could argue that sanctions hold the most negotiation power before they are put in place, when they are still a future threat.

EU's relative importance in terms of Russian imports has declined

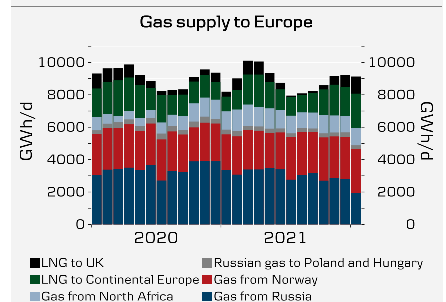


*Source: Macrobond Financial, Rosstat, *) Data for EU includes 18 most important trading partners*

...but not only for Russia

The impacts from sanctions would also be heavy on Europe that relies on Russia, particularly for gas imports. *The main destinations* of Russia's crude oil and condensate exports are Germany (11%), Netherlands (11%), Poland (7%) and Finland (4%). The share of Russia is around 30% of EU's total energy imports but e.g. for Finland, Russia accounts for app. 60-65% of its energy imports. Over the past years, Russia has accounted for around 40% of EU's total gas supply, but inflow has declined and even reversed in two of the three main gas pipes running through Poland and Ukraine since December. While the already tight supply situation creates upside risks in energy prices, increased LNG shipments have compensated for the drop in Russian supply so far.

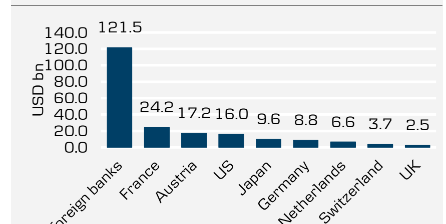
Drop in Russian gas imports has not had a major impact in total European supply



Source: Macrobond Financial, Refinitiv

While the European energy crisis has shown some signs of calming lately (see also *Euro inflation notes - Energy crisis not over yet, but light at the end of the tunnel*, 7 January), an escalation of Russia-Ukraine tensions remains one of the biggest upside risks to energy prices in the near-term in our view. While the euro area HICP weights of gas (1.9%) and electricity (2.9%) are relatively small, recent months already showed an increasing contribution from gas and electricity prices to euro area inflation, although the pass-through remains very heterogeneous across countries. In the scenario where a military conflict is avoided, we still expect a slowdown in euro area energy inflation during 2022, although elevated gas and electricity prices could continue to exert upward pressure in Q1 22. In case of a military conflict, including Nord Stream 2 sanctions and reduced Russian gas supplies, a gas price spike as outlined below could add another 0.7-1.5pp to our baseline forecast for euro inflation of 3.2% in 2022.

European banks' exposure to Russia is limited



Source: BIS database

Based on the BIS database, the exposure of European banks to counterparties resident in Russia is fairly limited, although there are some gaps in the data (e.g. no comparable data for Nordics). The largest exposures are in France (USD 24.2bn) and Austria (USD 17.2bn). The US exposure is USD 16bn. At 1.6%, the share of total banking sector assets in Russia is the highest for Austria, while for banks in other major European economies, exposures are in the range of 0.1-0.2% of total assets.

Russia's strong external position buffers it from some of the negative impacts

Looking at external vulnerabilities, Russia's strong commodity exports and prudent macroeconomic management have led to a constant current account surplus and positive net international investment position. Russia's external debt-to-GDP has remained stable near a moderate level of 30% for the past years and the amount of foreign direct investments has also been low.

Russia's international reserves have increased steadily since 2014, and now exceed the amount of total foreign debt. All together, we do not consider Russia particularly exposed to external shocks (except for maybe the removal of Russia from the SWIFT system) or rising interest rates, especially relative to other emerging markets, as we outlined in *Emerging Markets Monthly - Updated EM vulnerability heat map raises Turkey and Poland to spotlight*, 18 November.

Russia does not stand out as vulnerable to external shocks

Source: Macrobond Financial, CBR

Three scenarios imply potential turbulence for broader markets, gas prices and the ruble

The key question is whether the two sides will be able to reach some sort of agreement or not and what the two sides' reaction will be in the event of failure to find a solution to the tensions. Below, we sketch out three scenarios that we see most likely to play out over the next 4-6 weeks. In general, we think it is a close call between scenario 1 (of a deal) and 2 (no deal but limited Russian military intervention), while we think scenario 3 (of full-blown Russian invasion in the event of no deal) is more unlikely.

Scenario 1: De-escalation resulting from a deal between Russia and the West (40% probability): This scenario implies that the two parties reach an agreement leading to a de-escalation in the form of Russian troops returning to their barracks from the Ukraine border. We think in order to achieve this, some concessions by the West are necessary, since for Putin, backing down threatened by sanctions only would be a face-losing scenario. The problem is that for the West many of the Russian demands are unacceptable. A commitment by NATO not to expand more to the East would effectively compromise the sovereignty of not just Ukraine, but all of Russia's neighbouring states, such as Belarus, Finland and Sweden. Even an agreement to scale back troops deployment or weaponry would weaken the security position of all of Russia's neighbours, including the Baltics that are NATO members. Concessions regarding weapons positioning (*e.g. the revival of the INF treaty*), or around military exercises in Europe are possible but they also entail the risk that Russia could soon be posing new demands that undermine peace in Europe. Hence, we are not fully confident a deal can be achieved, unless it is so skilfully orchestrated that it is de-facto without tangible concessions but somehow manages to display Putin as the winner. Of course, that is sometimes the art of foreign diplomacy.

Scenario 2: No deal, contained re-escalation of conflict in Eastern Ukraine (50% probability): The scenario we consider most likely is the eventual escalation of a conflict in Eastern Ukraine – a conflict that nevertheless remains contained in scope and does not lead to a full-blown war. We think the two sides are simply too far from each other on their key priorities to reach a compromise. Russia wants to convince its domestic audience and the West that it remains a military superpower. It craves for international respect in the form of being feared by others, and military intervention is an easy way to achieve this. Under this scenario, Russia strengthens its dominance over Eastern Ukraine but does not aim to capture the whole of Ukraine. For example, they could aim to establish a land bridge between Crimea and Donetsk by attempting to seize the southern port city of Mariupol.

While capturing Mariupol could be plausible for Russia, we also think it would prove costly to hold since there is significant resistance to separatists along the 300km-wide strip.

The possible Russian actions would prompt a diplomatic crisis between the West and Russia, and force new sanctions by the EU and the US against Russia. Exports controls are possible. However, we do not think the West would go all the way to introduce extreme measures such as removing Russia from SWIFT. As a counter-measure, Russia would likely keep limiting gas supplies to Europe.

Scenario 3 – No deal, full-blown military conflict (10%): In this scenario, Russia undertakes a full-blown invasion of Ukraine. The West will undoubtedly do everything it can to avoid a full-blown war with a nuclear weapon equipped Russia. At the same time, the West could probably better serve Putin's interests through a peaceful solution that nevertheless leaves it with perceived respect. The main reasons we think Putin wants to avoid a war are the direct and indirect costs, as we have outlined above (see section *Exclusion from SWIFT would be costly…*).

Should Russia decide on a large-scale attack on Ukraine, we think the West's response would be significant. Exports controls and targeted sanctions against businesses and individuals would be very likely but we could even see Russian exclusion from SWIFT. In terms of the direct costs for Russia, we have a very recent example of a protracted intervention requiring massive military expenditure and leading to significant manpower losses, in the US presence in Afghanistan. We think Putin is smart enough to want to avoid repeating the mistakes of its arch-enemy. While we see the likelihood of a full-blown war very limited at the moment, it is a tail risk that cannot be ignored, particularly considering that conflicts often result from a series of seemingly small, unexpected events as well as from failures in diplomacy. History serves us a lesson here.

Implications for equity markets

From an equity market perspective, scenarios 1 & 2 will have very limited effect. Both Russia and Ukraine makes up a marginal share of global equity market cap and investors will only focus on the region if it threatens the global geopolitical situation. The supply of oil and gas is one of the crucial things to focus, but in scenarios 1 & 2 this will again only have limited effect. The current level of oil price and not least the current level of real oil price is low in a historical context and it would take a massive increase before it turns into a significant issue.

In scenario 3, it becomes much more challenging for equity markets. The biggest effect will come immediately as uncertainty will increase. We expect a bit of the similar reactions as we saw back in 2014 went Russia invaded Crimea. However, we also see a great likelihood that things will calm down again if the conflict stays in Ukraine. That would also mean despite an initial sell-off we could see a relatively fast reversal. For Russian equities, it will be a very different story, as new sanction will hit Russian companies severely. Hence both initially and with lasting effects it would mean massive underperformance of Russian equities, with negative spillover effects on the rest of Eastern Europe as well.

Implications for fixed income markets

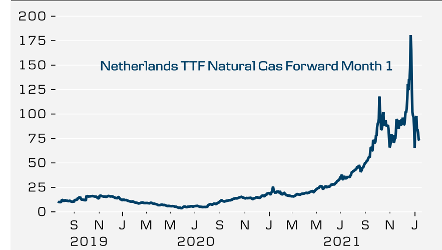
Rates markets have not paid much attention to the ongoing geopolitical tensions as other drivers have dominated. Under our baseline scenario 2, we would likely see a short-lived flight to safety with Bunds initially some 3-4bp lower. Historically, markets have not cared much about sanctions either. However, in case of a closure of the gas pipelines we should see a larger reaction, also on inflation pricing. In the tail risk scenario of a full-blown war, we would likely see strong bund rally and significant spread widening.

Implications for gas markets

The gas market in Europe is very sensitive to any news on the tensions between Russia and Ukraine. Russia provides approximately 40% of the gas to EU and a significant part of it goes through Ukraine. Hence, any cut-off of gas supplies either due to outright conflict, sanctions or Gazprom reducing gas flows could have a devastating impact on the market.

EU gas storages are at critical lows here in the middle of the heating season on the Northern Hemisphere. Hence, a cut-off in supplies over the next two months could have severe impact on prices on not just gas, but also electricity. The risk of "rolling" electricity black-outs throughout Europe due to lack of gas for power generation has been mentioned by *industry experts* as a possible consequence.

Gas prices are record high



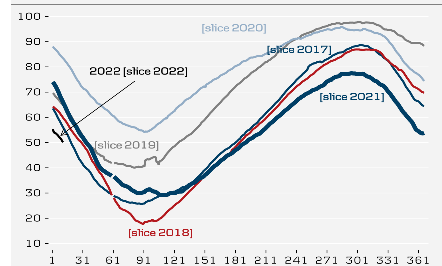
Source: Macrobond Financial

However, the closer we get to the spring and summer where demand is low, the lesser the imminent price impact of any cut-off of gas would be. However, the market might soon start to fear a repeat during the winter 2022/23 if storages are not refilled fully throughout the summer. The chart to the right shows that the current size of gas storages in Europe relative to capacity is significantly below normal. The head of the International Energy Agency, IEA, Fatih Birol said this week in a *FT interview* that Russia and Gazprom was to blame for the low EU inventories. He said that Russian gas export had been down 25% in Q4 compared to 2020. He also said that especially inventories at Gazprom run storages in the EU were at a critical low level.

Gas prices have already reacted to the low gas storage and the fear of a cut-off of supplies. Prices peaked at EUR 180 MWh just before Christmas. We use the Dutch TFF 1 month forward price for reference. Europe experienced a gas crisis in the beginning of 2009 as Russian gas through Ukraine was cut off. However, the situation was relatively quickly resolved and it came at the height of the financial crisis and with a better storage situation making the price impact less severe.

If we have an escalation of the situation as we assume in our Scenario 2, we should expect a significant and imminent price impact. Depending on the season, a temporary spike above EUR 200 MWh is likely. However, prices will most likely move lower relatively quickly as LNG shipments arrive and as the market realize that Russian gas flows will continue. However, we should expect gas flows to be volatile and it is likely that we could go into the next heating season with very tight supplies. Hence, average prices during the heating season 2022/23 could be 10- 25% higher than during the current heating season. LNG supplies might help to ease the situation.

Gas storage at a critical level in Europe, EU gas storage in percent of capacity



Source: Macrobond Financial

In a scenario with fewer tensions, we should expect a normalisation on the storage situation during the summer and an EU approval of the Nordstream 2 pipeline (assuming there is no delay). Hence, we should expect a more normal market during the next heating season though the gas market will most likely operate with a higher risk premium. But prices will be significantly lower over the summer and during the next heating season. The forward curve today is probably too high.

If we end of up in the last scenario with a full-blown war and new sanctions including an exclusion of Russia from SWIFT the price impact could be very severe given the current storage situation. If it happens during the heating season, LNG supplies and supply from other countries would probably not be able to make up for the supply shortfall. Hence, prices could potentially go to EUR 300 MWh and we should expect a severe impact on demand. We should expect that outright lack of gas would be seen. The risk of rolling power black-outs would be high in several European countries.

Implications for RUB

Ruble has weakened moderately over the past weeks as tensions have risen, but in the baseline scenario 2, we would expect USD/RUB to remain relatively stable around 73-74 near recent levels. RUB weakened moderately also when Russia relocated troops near Ukraine back in spring 2021, but was able to recover on the back of rising oil prices and monetary tightening, even when the political situation remained unresolved.

We think fast expected and realized inflation is going to lead to further rate hikes by the Central Bank of Russia, which should support RUB against EUR even in scenario 2. In contrast, de-escalation outlined in scenario 1 would be a positive surprise for the RUB markets, likely pushing USD/RUB towards 70-72 range. The market reaction in the tail risk scenario 3 would depend largely on the scale of the invasion, but we would expect to see USD/RUB rising above 82.

Deal or no deal – the topic will not go away

We think even if a deal is reached, Russia is likely to maintain its aggressive stance against Ukraine (and the West) in the medium- to long-term. That is because, going forward, Russia's only way of getting international recognition and respect is by maintaining a climate of fear. Instead of military actions, Russia could step up other ways of warfare, such as hybrid and cyber-attacks, disinformation campaigns, and other attempts that aim to destabilise Ukraine and dismantle a coherent approach by the US, the EU and the NATO. We also highlight that, regardless of what is agreed, Russia could slowly enforce its dominance over Eastern Ukraine. Their advance could be so gradual it could even go largely unnoticed by the West.

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Expected updates

None

Date of first publication

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