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Research Global

What would a dirty deal in Ukraine mean for markets?

- **Ukraine peace talks will kick off between the US and Russia in Saudi Arabia this week. Ukraine's representatives apparently will not attend. We think now is the time to prepare for an outcome that many have feared: a dirty deal that clearly favors Russia, and where Ukraine is left with insufficient security guarantees.**
- **In this paper, we discuss two alternative scenarios, leaving the door still open for a more positive scenario – an acceptable deal – as well. Economic impacts would be different under these two scenarios. Under a *dirty deal*, we should be prepared for some European countries rapidly restoring energy trade ties with Russia. Migration back to Ukraine would be limited and appetite for reconstruction investments would be low. Under an acceptable deal, energy sanctions would remain in the short term, and we would see more migration and reconstruction. Europe would continue to invest in defence, regardless of the type of the deal.**
- **Energy market is the key variable for the European economy. Under a dirty-deal-induced rapid sanctions relief, we expect particularly gas prices to fall, which would push inflation expectations lower. EUR/USD could see a short-lived lift in a knee-jerk reaction. In the rates space, a peace deal would be no gamechanger for the ECB but issuance by EU institutions would increase under both scenarios, lifting term premium and widening supra-ASW spreads.**

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Summary table: +/– indicates direction & scale, red = negative for EA short-term growth, yellow = neutral, green = positive

Variables	Dirty deal (Kremlin dictates the terms, rapid US sanctions relief)	Acceptable deal (Ukraine gets sufficient security guarantees, gradual sanctions relief)
EU states restore trade ties with Russia	++	+
Reconstruction efforts in Ukraine	+	++
Defence investments in Europe	++	+
Migration back to Ukraine	+	++
Confidence/reduced uncertainty	+/-	+
Market impacts		
Energy prices	--	-
Raw material prices	+	++
EUR/USD	+	++
Rates/ ECB monetary policy	-	+
Economic impacts		
Inflation	-	+/-
Growth	+	+

Peace, please – but not any kind

In light of the recent remarks by the US officials, including the ones we heard over the weekend in Munich, we think the likelihood of a bad outcome for Ukraine has increased and we adjust the scenarios we previously communicated in our *Geopolitical Radar – Better get used to the uncertainty*, 7 February. We continue to see a high chance of a ceasefire in Ukraine this year. That said, we think the likelihood of Ukraine getting a deal they were originally after (entailing no land losses and a NATO membership) has further diminished (5%, pr. 10%). The new US administration clearly prefers a deal sooner rather than later. Hence, we lower the likelihood for the war continuing into next year from 30% to only 15%. **This leaves us with a high likelihood (80%) of a deal this year,** with a good chance of an initial ceasefire deal during the first half of 2025.

We think for the economy it makes a difference whether the compromise deal is a *dirty* one, clearly favouring Russia, or an *acceptable* one, that is more likely to bring sustainable peace. There are some alarming signals that should keep us on alert for a bad outcome: 1) talks are kicking off bilaterally between teams from the US and Russia, while Ukraine's role in the process remains unclear, 2) the US officials have said it would be unrealistic for Ukraine to demand restoration of pre-2014 borders or hope for a NATO membership, making *de facto* concessions to Russia before talks have even started, and 3) Keith Kellogg, Trump's special envoy to Ukraine who has made some critical comments in the past, seems to have been sidelined as he will not be part of the US negotiating team.

The faster the talks proceed, the higher the likelihood of a dirty deal, as we see it. That is because Russia is in no hurry to stop fighting. Its man losses towards the end of last year exceeded its pace of new recruits. The current level of intensity is not sustainable without a new round of mobilisation but Russia could well continue the war at a lower intensity for a long time still. Since Russia is under no imminent pressure to end the war, an immediate ceasefire would signal that it has been promised sweeteners, such as sanctions relief.

Currently, we tilt towards a dirty deal (50%) because, as we see it, Russia has already been made concessions. An acceptable deal is still possible (30%) but it requires a rapid, strong and coordinated response by European states to the US-led initiative.

Dirty deal (50%)

In a *dirty deal*, Kremlin would be allowed to largely dictate the terms. Hence, under a *dirty deal*, we expect the US would move rapidly in lifting most sanctions against Russia. Taking cues from the US behaviour in the past e.g. with Iran, we think they would prefer removing energy-related sanctions, over ending the asset freeze. This would leave it up to the EU to decide whether they want to restore energy trade with Russia, and we think some countries would (see below). This would constitute a positive supply shock for (pipeline) gas particularly, and potentially for oil as well if oil sanctions were removed.

Also, under a *dirty deal*, Ukraine reconstruction would not begin at full force. Particularly private investors would remain wary as security risks in the medium term would remain. For the same reason, migration back to Ukraine would be limited. The EU would urgently seek to step up defence investments in order to prepare for possibly another attack by Russia in medium term.

In their *updated threat assessment* in February 2025, the Danish Intelligence Service stated that if the war ended and Russia was allowed to regroup, within six months it would be able to fight a local war against a neighbour, and within two years it could pose a credible threat to one or more NATO countries (in the absence of US intervention). For obvious reasons, we think any confidence boost for markets from a *dirty deal* would be short-lived.

Acceptable deal (30%)

Under an *acceptable deal*, Ukraine would still have to accept some territorial concessions, but it would also get sufficient security guarantees. The US support would likely be transactional; it would continue to provide military support, but in exchange for access to Ukraine's mineral sources (note: *Zelensky rejected* the first US offer in Munich). The EU countries would over time take an ever larger role both in securing Ukraine and the bloc as a whole, as they build more military capacity but they would not send troops.

Under this scenario, we would expect any sanction relief to be gradual. As long as the US sanctions would remain, European countries would struggle to restore trade ties with Russia even if they wanted to (because of the risk of secondary sanctions). Hence, we expect only moderate downward pressure on energy prices in this scenario. Also**, we think the reconstruction boost would be stronger and migration flows back to Ukraine would be larger than under the *dirty deal*.** The EU would continue to prioritise investing in defence but the sense of urgency would be less than under a *dirty deal*.

It is difficult to estimate the psychological impacts from the war. Markets tend to quickly shrug off geopolitical events. Hence, we expect any confidence boost for markets to be short-lived even under an *acceptable deal*. Any easing in financial conditions driven by improved risk appetite alone is unlikely to last. However, as both consumer and business confidence indicators plummeted following the war, a sustainable peace could give a boost to consumption and investments, especially if it co-incided with lower energy prices.

Key variables

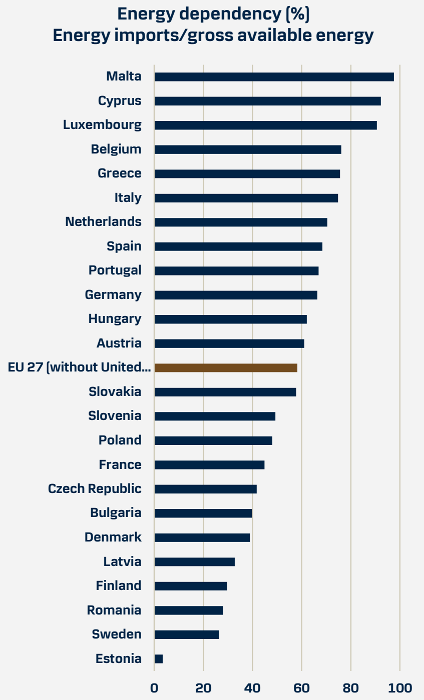
Energy trade: Some EU states can't wait to restore trade ties with Russia

The EU remains highly reliant on energy imports as they only produce around 40% of energy consumption themselves. Hence, in case of a peace deal, any resumption of energy imports from Russia would mark the biggest gamechanger for European growth prospects in near term. Following the Russian invasion of Ukraine, the EU has significantly lowered its energy imports from Russia, but dependencies remain. In 2021, 45% of the EU's gas imports came from Russia, and by 2024, that share had declined to 18%. On the other hand, EU imports of Russian LNG reached record levels in 2024 (see *FT*). Approximately one fifth of that was trans-shipments that will be banned in March, but still, it highlights that many EU counterparties continue to engage in energy trade with Russia.

It is likely that energy imports from Russia would increase again if a deal was reached, particularly in the *dirty deal scenario*. The EU sanction response could be best characterized as surprisingly strong (considering the historical dependence on Russian energy), yet uneven. The most hawkish (pro-sanctions) EU member states have been the Northern European countries, while South-Eastern European countries such as Hungary and Slovakia have been reluctant to impose sanctions against Russia. France and Germany, the EU's two largest countries, have sent mixed signals regarding their support for Ukraine. If a peace deal is reached, we would expect similar attitudes among these groups concerning the resumption of trade and energy imports. Considering the variety of views, we think the EU's overall hawkish bias would come under a serious test in a *dirty deal* scenario.

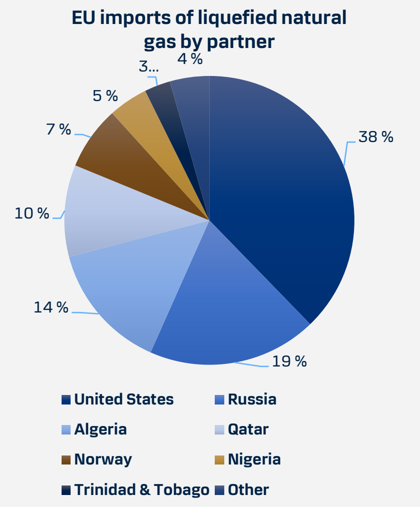
The German election is expected to give in a more pro-Ukrainian government. Friedrich Merz, who is likely to become the next chancellor, has criticised former chancellor Scholz for his reluctance to fully support Ukraine. Of particular importance is whether the far-right AfD, currently polling at 21%, and the far-left BSW, at 5%, can collectively secure 33% of the votes, potentially forming a blocking minority against some defence support for Ukraine.

Energy imports dependency remains high in the EU



Source: Eurostat, 2023 data

Russia remains the EU's second largest supplier of LNG



Source: Eurostat

The EU remains divided in their stance regarding the support for Ukraine

Note: Classification made by Think Tank EUROPA based on three factors 1) Material Support, 2) Popular Support, and 3) Political Goodwill
Source: Think Tank EUROPA

Reconstruction: acceptable deal is a prerequisite for reconstruction rush

Ukraine's estimated recovery and reconstruction needs over the coming decade are estimated at USD 486 billion (EUR 462 billion), equivalent to 2.7 times Ukraine's annual GDP or 3% of euro area annual GDP. How much investments will ultimately materialise depends on two factors mainly: 1) the perceived long-term peace and stability in Ukraine (terms and conditions of the deal), and 2) availability of funding. The latter also will be linked to the terms the deal. The better the deal for Ukraine, the more funding is likely to be available, and the more front-loaded the process will be.

Development banks have launched initiatives to fund Ukraine's reconstruction. The World Bank's private sector arm, the IFC, *had committed* USD 1.4bn (EUR 1.3bn) into Ukraine's reconstruction as of June 2024. The EIB's *total* contributions to Ukraine thus far total EUR 2.2 billion. The EBRD, in turn, *has invested* and mobilised a total of nearly EUR 6.2 billion in projects in Ukraine since 2022. The EBRD leads a joint investment initiative with development finance institutions, and both the IFC's and the EBRD's figures include money from other financiers. Hence, there is likely some overlap in these numbers. In addition, the World Bank and bilateral donors will also be financing Ukraine, but these investments will mostly focus on public sector investments and initiatives.

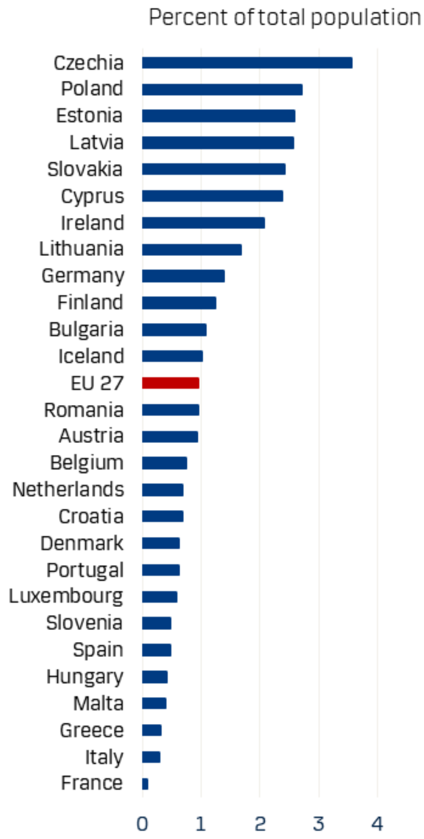
Looking at the different initiatives by development financiers and considering the massive reconstruction needs, it is safe to argue that a significant financing gap remains. This gap could be filled by private investors but those will be particularly wary of investing in Ukraine under a *dirty deal* scenario. Hence, we conclude that reconstruction efforts alone will not contribute meaningfully to euro area GDP growth even if they can offer real business opportunities for European and Nordic companies in specific industries such as construction and manufacturing. Also, the projects will be less risky for a supplier than for an investor.

Migration back to Ukraine would constitute a negative labour supply shock for Europe but a modest one

Migration back to Ukraine could have a negative impact on the EU labour market, as there are currently 4.3 million Ukrainian refugees in the EU, with 2.6 million of them being of working age (18 to 65 years old). Yet, Ukrainian refugees account for just 0.9% of both the total EU population and the working-age population, and the employment rates for these individuals are low. The rates differ across member states, from approximately 50% in Lithuania, Denmark, and Estonia to 15% in Spain, and about 30% in Germany and France. Many Ukrainians are employed for only a few hours a week, often on short-term fixed contracts and below their qualification levels. Consequently, their influence on the labour market is relatively minor, likely contributing to around 0.15% of total EU hours worked.

While the overall effect on the EU labour market would be limited, the countries that have taken the most refugees in percent of total population would see a larger effect. This is especially the neighbouring countries such as Czechia, Poland, Estonia and Latvia where Ukrainian refugees represent between 2.5% and 4% of total population. Surveys show that around 66% of Ukrainians want to return to the Ukraine after the war, but numbers are uncertain and depend on the availability of work, housing, and security following a peace deal. We expect more would return under the *acceptable deal* due to improved long-term security perception, and more opportunities thanks to reconstruction.

Neighbour countries to see largest effect of migration back to Ukraine



Source: Eurostat

Box: Legal status of Ukrainian refugees in case of an end to the war is uncertain

The EU has implemented temporary protection measures for Ukrainian refugees, which allow them to stay and work in the EU without having to go through the standard asylum process. If the war ends, the legal situation for these refugees is currently uncertain and will depend on decisions made by individual EU countries and any changes to EU-wide policies. If no changes are made, the refugees who want to stay would most likely have to apply for standard asylum, which would be overwhelming for the EU Asylum offices, making integration into EU labour force slow.

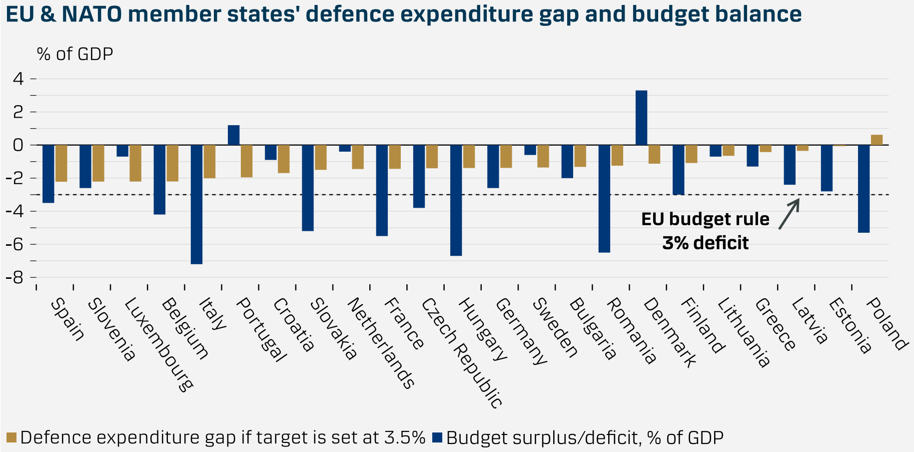
Source: EPRS, Danske Bank

Defence investments: time to put the money where the mouth is

The EU has identified the need to invest EUR 500 billion in the bloc's defence over the next decade. In case of a dirty deal, we think these investments would be front-loaded. The estimated investment need is in the same ballpark with the estimated need for Ukraine's reconstruction (EUR 462 billion), but we expect more funding to be available for defence. Between 2021 and 2024, EU member states' total defence expenditure already *rose* by more than 30%. In 2024, it reached an estimated EUR 326 billion, equivalent to 1.9% of EU GDP. Expenditure is further expected to rise by more than another EUR 100 billion in real terms by 2027.

US President Trump has suggested that its European NATO allies should step up their defence investments to reach 5% of GDP from the current EU average of 1.9%. NATO is expected to lift the official target from 2% to above 3% this year when the allied countries meet in the Hague in June. On the chart below, we sort those EU countries that are also members of NATO based on their defence expenditure gap assuming that the new target would be set at 3.5%. Out of the TOP10 countries with largest expenditure needs, five (Spain, Belgium, Italy, Slovakia and France) run a budget deficit exceeding 3%.

Few European NATO member states spend more than 3% of GDP on defence



Sources: NATO, Eurostat

Until now, EU member states have mostly financed their growing expenditure from their own pockets, and the EU contribution has been modest. Under its multiannual financial framework (MFF) for 2021-2027, the EU *has allocated* just EUR 16.4 billion to security and defence-related activities. This is likely to change. Commissioner Andrius Kubilius has proposed allocating at least EUR 100bn for defence in the next MFF (2028-2034), and indeed, there is growing momentum across the union to significantly step up EU-level spending on defence. Even financing it with joint debt issuance is clearly gaining traction, but thus far it is still more talk than action.

Government expenditure aside, nineteen EU states *have also called* for the **EIB**, that currently is not allowed to finance the production of ammunition, weapons of military equipment, to remove the prohibition. The bank can already invest in dual-use goods, but its overall defence investments remain small in scale. This year, the EIB is expected make total investments of EUR 95 billion, out of which just EUR 2bn will be in defence.

Market impacts

EUR/USD – Tactical upside potential if a deal is reached

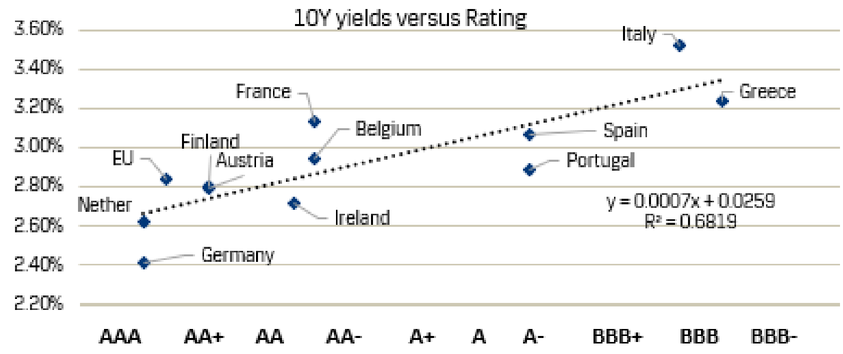
Given the recent FX price action, it appears that a war risk premium has weighed on EUR/USD since Russia's invasion in February 2022. While multiple factors continue to drive EUR/USD volatility – particularly tariff discussions and uncertainty around the Fed's policy trajectory – markets have clearly taken the rising likelihood of an imminent peace deal as good news, lifting EUR/USD into the 1.04–1.05 range. We expect a relief rally to modestly lift EUR/USD in the near term, though much of this optimism has likely already been priced in. As the overall economic impact, irrespectively of the type of the deal, should be modest, we think any deal could provide some tactical upside at best. We maintain our view that US economic resilience, the Fed's still uncertain policy stance, and the Trump administration's economic policies will ultimately weigh on EUR/USD, driving it towards parity over a 12M horizon as the US economy outperforms euro area.

Fixed income – no gamechanger for ECB, but issuance would be affected

The impact on ECB monetary policy is likely to be modest in the two scenarios. A decline in energy prices is likely to produce only a short-term decline in inflation, which should not alter the ECB's reaction function, and thus the impact on rates should be modestly positive.

However, we do see more impact from the funding of the reconstruction of Ukraine under an *acceptable deal*. The EU has already given substantial financial aid to Ukraine, which is funded through issuance of EU bonds. This has added pressure on the pricing of the EU bonds relative to AAA-rated peers. Hence, looking at the rating of the EU and the pricing of the 10Y EU bond, it looks too cheap (see below). There has clearly been an impact on the pricing of the EU due to the substantial issuance of EU bonds.

Chart 1. EU is too cheap relative to the rating



Past performance is not a reliable indicator of current or future results.
Source: Danske Bank

Furthermore, if the EU is to scale up financing to Ukraine or if the additional aid comes from the other E's such as the EIB and the EBRD, then this will add pressure on the supra ASW-spread, which will have an impact on the agency ASW-spreads. **Hence, we could see euro area covered bonds become more expensive relative to supras and agencies.**

In the *dirty deal* scenario where Europe could no longer rely on US military support, we expect it to speed up the process of increasing military spending either through a joint EU funding programme or through the sovereigns. This will also lead to additional issuance of either EU bonds or sovereign bonds. In either case, then **bond risk/term premia should rise, the curves should steepen and ASW-spreads widen (SSA bonds underperform swaps).**

Hence, the biggest impact from any peace deal on the rates market is probably more from increased fiscal spending rather than the disinflationary impact of falling gas prices. Finally, more fiscal spending could lead to more inflation in the long run, thus adding pressure on the long end of the yield curve.

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