

Russia's Invasion: Eurozone Recovery Delayed but not Derailed

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Last month, we described how the European Central Bank (ECB) pivoted to a more hawkish stance at its February meeting. At the time, we outlined how the bank would update its economic projections and reassess its outlook in March. Now, instead, a single development is likely to dominate discussions when the ECB's Governing Council meets on 10 March: Russia's invasion of Ukraine.

The Conflict in Ukraine Will Weigh on Activity and Raise Inflation – a Dilemma for the ECB

The economic impact of Russia's invasion constitutes a clear negative supply shock for the euro area that creates a dilemma for policymakers. On the one hand, higher energy prices will hit economic activity, reduce confidence and damage trade and financial links. On the other hand, the conflict will raise inflation for firms and households.

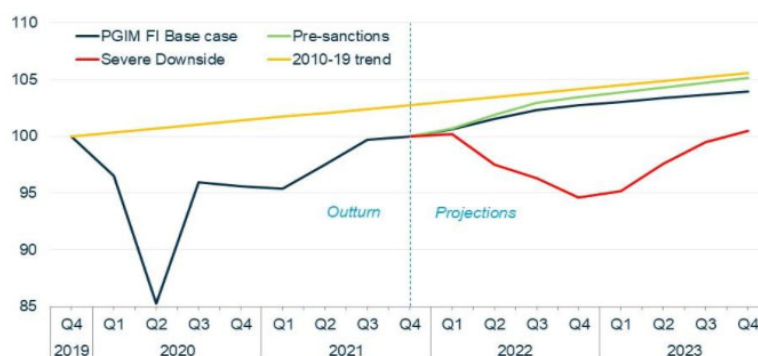
ECB President Lagarde's statement last Friday, 25 February, that "the ECB is closely monitoring the evolving situation" makes clear that the bank is keeping its options open. We expect it to maintain its dovish stance on 10 March, with a gradual tapering in asset purchases as announced last December.

Recent events also offer the ECB an opportunity to regain control of the inflation narrative: higher-than-expected inflation outturns are clearly due to an external shock outside of its control. All else equal, sustained higher energy prices will slow the pace of monetary policy normalisation in the eurozone, with a 2022 rate hike now unlikely.

Our Base Case Scenario Foresees a Delayed, but not a Derailed, Euro Area Recovery

Our base case scenario assumes that gas from long term contracts with Russia continues to flow, as it did throughout the Cold War. Additional supply from the U.S. and Norway can cap further price rises, possibly helped by mild weather and the end of winter in western Europe. This scenario, the blue line in Figure 1, sees euro area GDP (gross domestic product) grow by 3.7% in 2022, 0.5 percentage points below our 4.2% projection before Russia invaded.

FIGURE 1: Euro Area GDP Projections (Index, Q4 2019 = 100)



Source: PGIM Fixed Income.

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Despite higher energy prices, however, momentum in the eurozone economy remains strong. Deeper budget deficits can therefore lead support to households and firms, with accommodative monetary policy as a facilitator. The corresponding increase in national budget deficits could plausibly lie in a range of 1 to 3 percentage points (pp) of GDP. Centrally-issued European Union (EU) debt, first conceived during the pandemic, would probably support member states' deficits. And appetite for a more radical overhaul of the bloc's Stability and Growth Pact, away from austerity, is likely to grow among its members.

Beyond the immediate support to households and firms, additional outlays could encompass investments first tabled to address climate change. These would include spending on alternative gas supplies, accelerating the conversion to renewable energy and slowing down the phase-out of nuclear power. As demonstrated by German chancellor Olaf Scholz's €100 billion initiative unveiled on Monday, defence spending is expected to rise as well.

Politically, the conflict in Ukraine has reinforced the eurozone's recent direction of travel: accelerating the transition to a green economy, further integrating member states' economies, and reinforcing its so-called "open strategic autonomy" - the ability to rely on the euro bloc's own resources while working with external partners, such as the U.S., when needed.

Recent elections in Germany and Italy have demonstrated a shift away from the nationalist, anti-EU sentiment that was popular only a few years ago. In France, Russia's invasion has strengthened President Macron's position ahead of presidential elections in April, at the expense of candidates seen to be friendly towards President Putin. As a result, the European Union has a much stronger centre of gravity now, compared to its situation before the pandemic.

A Worst-Case Scenario: Long-Term Disruption to Gas Supplies

Further escalation of the war and long-term disruption to gas supplies are plausible risks to our base case scenario. They could materialise due to a further tightening of sanctions, physical damage to pipelines, payment system problems or the wilful interruption of supply by Russia. Russia supplies around one-third of Europe's energy imports, a gap that would be difficult to plug in short order.¹ Such a shortfall could meaningfully affect energy-dependent, industry-heavy economies that rely on Russian gas, like Germany and Italy.

Provisional calculations based on ECB research suggest that a 10% reduction in gas supplies to the euro area would reduce gross value² added by 0.7%, not including amplification effects on economic confidence and supply chains. Back-of-the-envelope calculations suggest that a total shutdown of Russian gas supplies to Europe might reduce euro area GDP by as much as 5 percentage points (the red line in Figure 1) - an effect 10 times larger than our base case.

Even these conservative estimates of the effect of long-term disruption on European growth are large, in line with the Global Financial Crisis (2008). Should our worst-case scenario materialise, we expect that GDP growth would fall to -1% in 2022, similar to what happened during the euro sovereign debt crisis (2012).

Asymmetric Risks to the Euro Area

Disrupted Russian gas supplies would have an asymmetric impact across the eurozone. Austria, Slovakia and Italy would feel the effects of a stoppage first, because they rely on Ukraine as their main transit corridor for Russian gas. Later on, Germany and Italy's industry-oriented, energy-intensive economies would be hardest hit, due to their greater reliance on Russian energy than, for example, France. The Netherlands and Germany export significant volumes of high-tech manufacturing equipment to Russia, which export bans would reduce.

An asymmetric shock may disproportionately weigh on growth in economies such as Italy and make their debt unsustainable. That danger may make the ECB more cautious in normalising monetary policy, to prevent peripheral sovereign bond spreads from widening. But traditional monetary hawks such as Austria, the Netherlands and Germany are relatively susceptible to the supply shock we described as well. Their acquiescence could remove a further obstacle for the ECB to adopt a dovish stance for longer.

If the situation were to deteriorate, we could see the continuation of open-ended asset purchases, a so-called "lower for ever" scenario for interest rates and active interventions by the ECB to stop a widening in the bond spreads of peripheral eurozone members. Even the creation of a permanent central fiscal authority for the Euro area could conceivably be an option.

Conclusion

In our base case scenario, the crisis in Ukraine will reduce euro area growth from 4.2% to 3.7% in 2022, delaying but not definitively derailing the recovery. Euro area budget deficits will widen further, possibly by 1 to 3 percentage points as a share of GDP, and monetary policy is expected to remain lower for longer, with no rate hike in 2022.

In our worst-case scenario, long-term disruption of Russian gas supplies could reduce the euro area's GDP growth by as much as 5 pp in 2022, to -1% for 2022. The conflict in Ukraine will affect some euro members, such as Italy, more than others. Such fragmentation could lead to an even more dovish stance by the ECB and greater fiscal integration across the euro area.

¹ See McWilliams, Sgaravatti, Tagliapietra, Zachmann (2022), "Preparing for the first winter without Russian gas", Bruegel blog post 28 February 2022.

² Gross Value Added is a close proxy for GDP, which removes product subsidies and product taxes from GDP.

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