Research & Strategy Insights

Zeitenwende

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Key points

- The stepped-up sanctions will trigger a very significant macro-financial crisis in Russia.
- The European Union (EU) – and particularly Germany – have made a time-defining strategic choice on defence. The natural and necessary complement to this new assertiveness on foreign policy and defence is more fiscal mutualization.
- The partnership between Russia and China will be asymmetric. Moscow is in a position of weakness.

The EU has very significantly stepped up its reaction to the war in Ukraine. The restriction on the Russian central bank access to its own assets combined with a selected ban on SWIFT has the potential to trigger a far-reaching macro-financial crisis in Russia. In the economic realm, beyond the immediate market reaction which may force Western central banks to stand ready to extend liquidity, the next crucial issue is to see how Moscow responds on gas and oil supply. The wholesale energy market is unlikely to wait anyway and we need to brace ourselves for another steep rise in energy prices, which would visibly affect the EU's growth trajectory.

Sanctions were only one aspect of the EU's tougher stance. Germany has jettisoned its traditional attitude towards Russia, defence, and military implication in Europe, and accepted the financial cost of such a shift, which Christian Lindner, a fiscal hawk, explicitly said would be covered by debt. This is likely to be a signal for a general move towards more military spending in the EU. Together with the cost of the energy transition – made even more urgent by the new geopolitical configuration – the fiscal burden continues to rise from the already elevated level left by the pandemic crisis. For now, we think the European Central Bank (ECB) will choose prudence and is likely to be flexible on the fate of the Asset Purchase Programme (APP), which would help keep sovereign funding cost low. However, in the medium run, this can't be a sustainable set-up. The solution probably lies in another step ahead on fiscal mutualization, extending the scope and size of the Next Generation framework. Now that the EU is taking the first steps towards "federalizing" its defence, pooling its resources to fund a share of military aid to Ukraine, the logical next move is in the fiscal realm to mutualize the transitory macroeconomic cost of this new strategic assertiveness.

An even tighter partnership between Russia and China is likely to be a consequence of the current crisis. Financial and trade links have already intensified these last few years. It is likely to be a very asymmetric partnership though. Russia is running out of alternatives, and its economic prospects are poor. China can diversify its energy supply with Russian gas and oil without providing unambiguous support to Moscow.

Compelling financial action

After an initially weak response, **the West has dramatically stepped up its sanctions against Russia**, restricting the Russian central bank (CBR) access to its own reserves and unplugging some Russian banks from the SWIFT international payments system. **While this dual approach is not perfect, it has the potential to significantly cripple the Russian economy.**

Let's start with the restrictions on the CBR. Russia's very favourable external position, with reserves to the tune of USD650bn (nearly 40% of its nominal GDP and exceeding external debt) has been a key factor behind the Ruble's surprising resilience given the circumstances (see Exhibit 1), with a decline of only 6% over one month and 12% relative to the 2021 average. It's highly likely CBR intervened. If that possibility vanishes, a sudden steep depreciation is unavoidable. What would be the consequences?

This will create the usual currency mis-match problems for Russian entities receiving their income in Rubles but indebted in hard currency, with thus a raised probability of default. **Inflation in Russia will also rise quickly** (it already stood at 8.7%yoy in January 2022), eroding the population's purchasing power – and Putin's domestic standing. **The only Russian entities which would be unaffected would be those which receive their income in hard currency, i.e. the oil and gas sector**. Moscow then has an incentive NOT to retaliate by reducing its crucial shipments of gas to Europe as it is their lifeline: the collapse in the Ruble and disappearance of at least a part of their reserves would make access to hard currency even more vital.

Still, **why would Moscow choose to maintain shipments of gas and oil to the West if there is nothing Russia could do with those currencies? This is in our understanding the reason why the West has chosen to avoid – at least for now – a blanket unplugging of the Russian banking system from SWIFT**. We need to wait for the technical details, but it seems it will still be possible for the Europeans to pay for their Russian gas, and in turn allow the Russians some capacity to purchase foreign goods with the hard currency they would still earn.

How stringent would these sanctions be ultimately for Russia? The drawback of the selective approach on the SWIFT ban is that nothing prevents Moscow from building an indirect exchange system allowing banned banks to transact via those which will retain SWIFT access. Since 2014 Russia has been working on a substitute to SWIFT, the System for Transfer of Financial Messages (SPFS), which according to CBR handled 20% of Russian domestic transfers in 2020. Creating "informal bridges" between SWIFT and SPFS through the non-banned banks is an option. Another would be to plug Russian banks on the Chinese payment system (at the December high-level meeting between the Chinese and Russian governments "developing shared financial structures" was discussed). Implementing any of these two solutions should however take some time. While those bridges are created and transaction routes are "re-mapped", the entire Russian financial system is going to be severely crippled.

There were indications over the weekend of queues forming at Russian Automated Teller Machines (ATMs) to withdraw cash as individuals want to protect themselves against the risk of banks collapsing. **A full-on bank run is a possibility.** Russians with bank accounts abroad may want to beat the SWIFT ban and transfer their deposits. Pending transfers to Russia are likely to be stopped for fear they could not be repatriated down the line. Russia could actually respond with capital controls. The end-game with this sort of mechanisms could be massive money printing by the central bank to respond to domestic demand for cash, coupled with an informal dollarization or euroization as individuals will seek to hold as much hard currency as possible while a "Potemkin formal economy" would be hastily built on a forced Ruble exchange rate completely disconnected from its market value. Individuals would have a strong incentive to use their Rubles for consumption as fast as possible while keeping their hard currency for saving, feeding even more inflation.

There are also limits to what the restrictions to CRB transactions can achieve, but the impact would however be significant. The precise location of Russia's FX reserves is unknown, but it is highly likely that a significant portion of them are held outside Russia. The general approach for reserve management is that except for gold (21.7% of Russia's reserves) which stays home, reserves are held in foreign banks and – quite often – in other central banks. As of Q2 2021 (latest data released by the CBR, see Figure 2), 55% of Russia's reserves are denominated in 3 "NATO-controlled" currencies: the US dollar (16.4%), the euro (32.3%) and the British Pound (6.5%). Indeed, while the focus at the time of the decision in 2018 to significantly reduce the exposure to the dollar was on Russia's build-up of a significant yuan buffer (more on this in the last section of this note), a lot of the space was actually filled by euro-denominated assets. It's likely that some of the "NATO-assets" have been moved to constituencies outside the reach of the West. Yet, beyond the fact that its overall capacity would be smaller, the CBR would have to use these protected assets indirectly, with an intermediary to hide behind when buying Rubles against hard currency from a Western entity, which would dent the efficiency of its interventions to shore up the exchange rate (FX intervention is as much about signalling as its about actual purchases).

Exhibit 1 – Surprisingly resilient so far (last point 25 Feb)

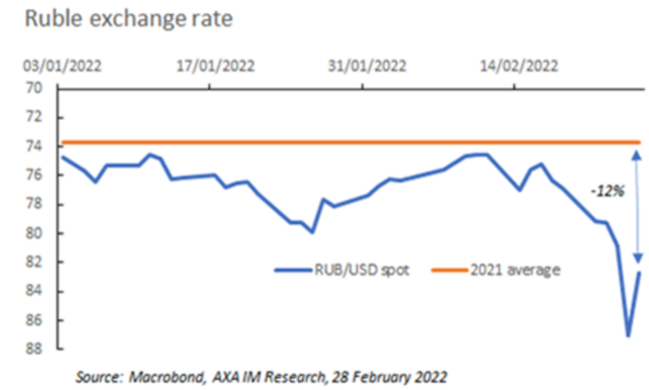
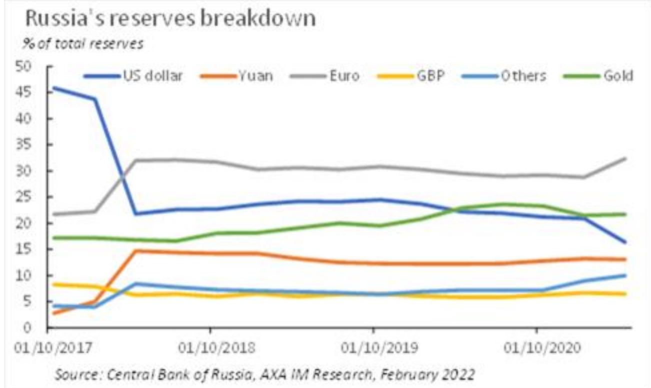


Exhibit 2 – Still a lot of "NATO currencies" in Russian reserves



The cost for Europe

The benign market reaction on Friday to the war in Ukraine was probably predicated on the West's weak initial response, combined with expectations of a quick military resolution which would make additional sanctions less likely, thus triggering a decline in energy prices (see Exhibits 3 and 4). Both expectations have been proved wrong, with strong resistance in Ukraine against the Russian offensive and, ultimately, a significant step-up in the West response. Coupled with the negative impact on confidence of Putin's decision on Sunday to put Russia's nuclear deterrence under alert, **the market's reassessment of the situation is likely to be painful. Western central banks may have to stand ready to extend liquidity** to deal with counterparties affected by a failure to pay from a Russian entity. Beyond the immediate market reaction, we want to present here a more granular version of the broad stroke estimates of the impact of the crisis on inflation and GDP growth we gave in last week's Macrocast (see here for the full paper).

Exhibit 3 – Friday's relief energy trade

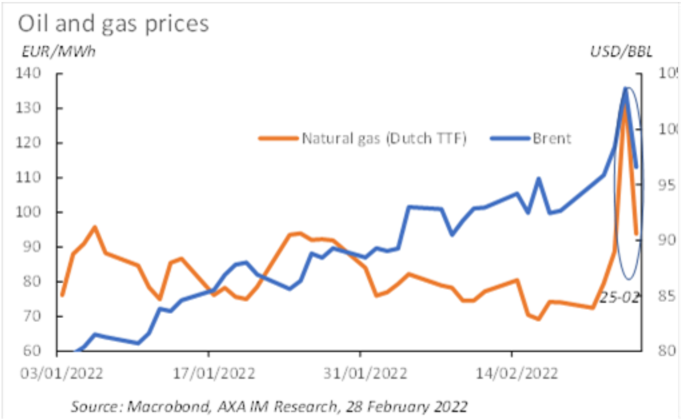


Exhibit 4 – The same on equity

Rising European natural gas prices would be the key risk to household real income growth in the Euro area and the UK, which in turn would likely hit consumption. Business sentiment may also weaken, and rising energy costs are likely to reduce profits and investment for Europe-based companies. By contrast, US exposure to natural gas price increases is smaller, but the indirect, upward pressure on wholesale oil prices would have a more direct impact on the US consumer given the lower tax content of retail oil products. The assumptions we retained for gas and oil prices are by construction fragile and imply a significant upward move from where we were last Friday, but spot prices hit EUR135/MWh last Thursday. Note as well that as usual, the persistence of the shock matters a lot. Here, we have posited a slow decay back to USD 100/bbl for oil and EUR 80/MWh for gas by the end of next year. In any case, these scenarios are linear. Our readers can easily substitute their own assumptions for energy prices and compute the additional shock from the baseline.

Finally, while direct trade exposure to Russia/Ukraine is not considered a large threat to activity (with possibly the exception of Germany, where exports to the two countries stand at 2.2% of GDP, against 1% at best in the other big Euro area countries), the synchronized softening in global demand likely to follow the indirect effects would have a knock-on effect in other regions. Developing markets would face a softening in key export markets, on top of rising inflation pressures, and the prospect of more domestic monetary policy tightening. China would see a drop in overseas export demand as an additional headwind for domestic authorities to navigate.

Exhibit 5 shows our key assumptions with regards to energy price developments and a summary of our projected impact on GDP, inflation, and central bank policy rates. In summary, we consider the conflict could lift inflation even further and more persistently over the coming two years. Euro area inflation would be 1.1 percentage point (pp) higher in 2022 (US 0.8pp) and 0.4pp higher in 2023 (0.2pp). We estimate that this would reduce global GDP to 3.6% from 4.0% in 2022, and to 3.3% from 3.5% in 2023. In the Euro area, GDP could be 0.9pp lower this year and next cumulatively.

Exhibit 5 – A macro scenario based on the energy shock

Summary of Russia-Ukraine conflict assumptions and projections

Assumptions		2022		2023	
Oil price (WTI)		$125 (peak)		$100 (end)	
European gas price		€125/MWh (peak)		€80/MWh (end)	
Projections (%)		Projected new forecast		Current forecast	
		2022	2023	2022	2023
Global	GDP (avg)	3.6	3.2	4.0	3.5
Euro area	GDP (avg)	3.0	1.6	3.4	2.1
	CPI (avg)	5.1	2.2	4.0	1.7
	Policy rate (end yr)	-0.25	0.00	-0.25	0.0
US	GDP (avg)	2.9	2.2	3.2	2.0
	CPI (avg)	5.8	3.1	5.0	2.9
	Policy rate (end yr)	1.25	2.25	1.25	2.75
China	GDP (avg)	5.0	5.0	5.0	5.3
	CPI (avg)	2.5	2.8	2.0	2.3
	Policy rate (end yr)	2.65	2.65	2.75	2.75
UK	GDP (avg)	4.0	1.7	4.3	2.1
	CPI (avg)	6.3	2.4	5.5	2.1
	Policy rate (end yr)	1.00	1.00	1.00	1.00
EM	GDP (avg)	4	3.9	4.4	4.3

Source: AXA IM Macro Research, 25 February 2022

Beyond the extreme uncertainty surrounding the energy price assumptions, there are two main risks around this scenario. **On the downside, we assumed that actual or expected Russian retaliations on gas would trigger a rise in prices, but without any actual supply disruption. This may not be the case.** True, while gas inventories are low, they are not drained out, so there is no immediate threat, but if tension with Russia lasts several months – which is unfortunately quite likely – and Moscow chooses to "switch off" its exports, more alternative sources to Russian gas will be needed. We already discussed last week the fact that Liquefied Natural Gas (LNG) cannot fully offset Russian gas, in particular because LNG producers themselves have little spare capacity. Norway and Algeria may be able to step up their shipments of natural gas (for the latter via the pipeline to Italy, which has become very dependent on Russian gas) but meeting demand is likely to be "touch and go". Gas consumption can be typically sliced in three broadly equal parts: home and offices heating, industrial use, electricity production. Depending on weather conditions (which affect energy supply via the contribution from wind and solar and demand via heating needs) when the disruption occurs, while coal may temporarily replace gas in electricity generation, **it may be that** industrial use would have to be rationed to prioritize heating. This could have a significant impact on industrial production (and would again hit Germany disproportionately given the share of manufacturing in its economy and its industrial specialization) and add to the downward effect on GDP.

On the upside, it is likely that a significant share of the energy shock will be accommodated by fiscal policy, so that much of the GDP loss we estimated would be absorbed at the cost of a higher government deficit. As we discussed last week, several Euro area countries have already put in place transfers to households, or intervened "upstream" to alter the transmission of wholesale to retail prices. As the European fiscal rules are still suspended for this year, some additional room for manoeuvre exists, and the probability of an extension to 2023 has increased with the Ukraine war. However, beyond the flexibility of fiscal rules, it may well be that the realization by European governments of the severity, and time defining nature of this crisis, will accelerate the deepening of the current mechanisms of fiscal solidarity across the Euro area.

Europe's strategic epiphany

We discussed two weeks ago in Macrocast how the EU, without an herculean effort given its economic size, could outpace Russia on re-building a conventional military capacity adapted to a European theatre (instead of focusing on overseas intervention capability), forfeiting some of the "peace dividends" which it had been accumulating since the end of the cold war. We were not expecting swift progress on this issue, but Germany's sudden turnaround this weekend is comforting. Moving abruptly from its initially cautious stance on SWIFT, Berlin relented over the weekend. But Germany went much further than merely breaking with its growing isolation on the sanction issue to announce a historic shift on defence policy, pledging EUR100bn in a special fund to modernize its military as well as reaching North Atlantic Treaty Organization (NATO)'s target of spending 2% of GDP on defence (1.4% in 2020 according to the World Bank). Also breaking with the past, Chancellor Scholz announced the delivery of lethal military equipment to Ukraine. Interestingly, the normally fiscally hawkish Finance Minister Lindner publicly endorsed the ensuing rise in debt.

On top of public opinion pressure, the German strategic shift might have been influenced by Russia's public threat against Finland and Sweden joining NATO. By raising massively their support to a non-EU country, Germany – and the other member states – are sending a strong message to Moscow on how far they would be ready to go *if* an EU member was under direct Russian pressure. A less immediate factor has also probably gradually worked its way through the traditionally uber-atlanticist German policy circles: the uncertainty around US military support in Europe. While Joe Biden has been more alert than most of his European counterparts to the seriousness of the Ukraine issue, the memory of Donald Trump's presidency is probably fresh enough – and the probability of his comeback in 2 years high enough – to convince Berlin that the EU is in need of a stronger, autonomous military capacity, following the approach defended by France.

If "even Germany" agrees to take on more debt to upgrade its military spending, there is probably a signal for all member states to loosen the constraints and step up. What we also found properly revolutionary in this weekend's announcements was the decision to fund EUR 0.5bn of military assistance to Ukraine directly through an EU off-budget vehicle, the European Peace Facility, which usually channels funds to partner countries for peace-keeping operations. This is a clear step towards a "federalization" of EU defence. There could be more steps. Luis Garicano, a Spanish economist, and member of the European Parliament proposes to extend the Next Generation EU framework to cushion the shock of Russian retaliation and fund the transition away from gas. This would complement the paper produced by the economic advisors to Mario Draghi and Emmanuel Macron we presented three weeks ago. The special EU summit on 10-11 March on economic governance should be the occasion for the French presidency to start laying out the groundwork for such approach.

ECB: relatively clear path in the short run, challenging in the medium run

In the alternative scenario we presented in exhibit 5, although the US economy would be hardly affected in 2022, we still have the Federal Reserve (Fed) proceeding more cautiously with its normalization, the Fed Funds rate reaching 2.25% in 2023 instead of 2.75% as the added layer uncertainty may change the debate between hawks and doves (in turn, this softer monetary stance would get US GDP above our baseline next year). The calculation is different for the ECB since – as we repeated ad nauseam in Macrocast – even before the current geopolitical crisis there was no blatant overheating in the Euro area which call for an urgent tightening.

From the point of view of a central bank, the economic and financial shock triggered by the Ukraine war is ambiguous. Inflation is likely to rise further, but the output gap is likely to take more time to plug as the real economy struggles. **If a lot of the blow to economic activity is absorbed by fiscal policy, the central bank may want to concentrate on the inflation risk and proceed with its normalization. This is however more complicated in the context of the Euro area because of the "fragmentation risk",** i.e. the possibility to see the fiscal push from the most fragile countries drowned in an elevation in market interest rates. All in all, this would probably call for retaining maximum optionality at the Governing Council next week.

While putting an end to Pandemic Emergency Purchase Programme (PEPP) at the end of March remains very likely, the ECB could finally decide to leave the forward guidance on the end of APP unchanged, i.e. keeping the door open to a trickle after October 2022. Market reaction this week – and particularly the behaviour of the BTP-Bund spread – will probably be a key input for the ECB as the council meeting is nearing. If spreads widen fast into Q2, recreating another facility similar to PEPP to deal with the shock of the Ukraine war could be envisaged, but we would be surprised to hear about this at the March press conference already – beyond the usual words about the ECB always "standing ready to react". On the rate lift-off, we were already below consensus, but while a December hike remains our baseline, there is now a decent chance (again) this would have to wait until 2023.

While we think the ECB's immediate response to the intensification of the Ukraine war and the accumulation of risks for the Euro area economy will be on the dovish side, **the ECB will face tough questions in the medium-run on how it deals with a public debt which would rise even faster on trend.** Indeed, if we need more spending on defence, while dealing with the cost of the energy transition combined with the additional pressure on welfare expenditure which ageing is in any case going to exert, the central bank will likely be asked to maintain a "perma dovish" approach which at times will collide with its price stability mandate. We think the resolution of this equation firmly lies in the institutional realm. The risk of fragmentation is what can, at some point, force a monetary policy stance which will prove overly loose from an inflation point of view. Addressing fragmentation by extending, in time and in scope, the Next Generation framework, is what will eventually "free" monetary policy from fiscal dominance.

Russian-Chinese rapprochement: an asymmetric partnership

Sanctions operate by altering the opponent's cost/benefit assessment. Russia's war with Ukraine is about re-asserting control over a close neighbour and stop NATO's enlargement to protect Russia's strategic depth. It's also about re-affirming Russia's superpower status. Moscow would normally need to measure these strategic potential gains against the risk of prolonged economic hardship which would ultimately dent its capacity to maintain its status. After each of the crises Russia has gone through since the start of the century, its trend growth has taken a hit (see Exhibit 6). Now faced with probably the most serious macro-financial crisis since the end of communism, an even larger permanent deceleration could be in store, compounding the impact of population decline we described two weeks ago.

Russia has been pivoting towards China for some time now. The shift of a part of its reserves towards the Yuan was a clear reflection of this trend, and so was exploring the possibility to share a payment system. The same has been occurring on the trade front, with more Russian gas sent to China after a deal in 2019 between the two countries (see Exhibit 7). **In early February 2022 a new agreement on the construction of another gas pipeline in Siberia to distribute gas to Northern China was signed**. This would not offset losing the Western European market at this stage, but the move is significant. Still, the pivot to China is imposed by circumstances, by a lack of alternative solutions for Moscow, which puts Russia in a position of weakness relative to Beijing, which can access Russia's energy resources and diversify its supply, hence improving its strategic autonomy, for ultimately quite little in terms of actual political capital: while Beijing abstained in the vote at the UN Security Council condemning Russia for its aggression on Ukraine, it support so far has been measured, with repeated calls for negotiations.

For now, Russia has managed to push two countries (Finland and Sweden) towards NATO, trigger the beginning of a re-armament of the EU, including by Germany which has jettisoned 30 years of “Ostpolitik“, and impose onto itself a very likely recession which will further impair its military capacity and possibly jeopardize its political stability. If a partnership is formed with China, it will be asymmetric.

Exhibit 6 – Each time it’s worse

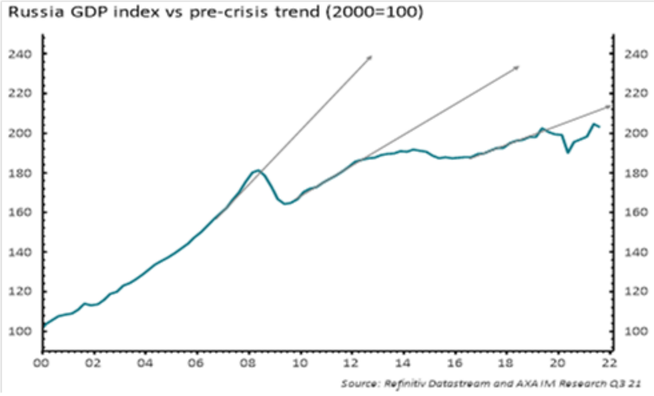
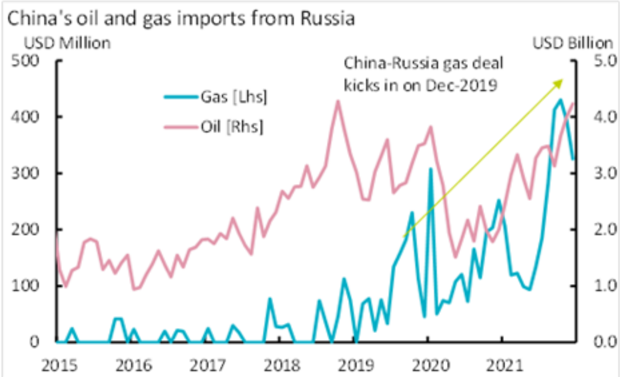
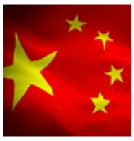


Exhibit 7 – The Russian trade pivot to China



Country/Region	What we focused on last week	What we will focus on in next weeks
	• Russian invasion of Ukraine • US enacts "severe" sanctions on Russian banks, individuals and dual-use tech exports. • President Biden says will tap US Strategic Petroleum Reserve to address oil price spikes. • GDP revised modestly higher to 7.0% (saar) • PCE inflation (Jan) rises to 6.1% (from 5.8%), core to 5.2% (from 4.9%) • Personal spending (Jan) rises by 2.1%mom, but income was flat on the month.	• Developments in Ukraine including impact on energy prices • President Biden to deliver State of the Union address • Labour report (Feb) – easing in Omicron wave to drive rebound in jobs and participation? • Mfg and non-mfg ISM indices (Feb) to gauge pace of rebound in economy • Vehicle sales (Jan) –jumped in Dec to 15.0mn, await figures to see if supply constraints easing
	• Business surveys suggest improved momentum in Feb (ahead of escalated conflict in Ukraine). • German Q4 21 GDP growth revised higher (+0.4pp) to -0.3%qoq. • France flash HICP for February showed improved momentum in core inflation	• Minutes of ECB Feb GC meeting (Thur) • Flash Feb inflation: country releases ahead of euro area's on Wed Euro area and Germany labour market (Jan, Feb)
	• UK imposed sanctions on Russian banks, oligarchs, exports and banning Aeroflot flights. • Serv PMI (Feb,p) rebounded to 60.8 from 54.1. • GfK cons conf fell to -26, the lowest since first lockdown on cost-of-living squeeze worries. • BoE's Ramsden: 'modest' tightening is needed.	• Developments in Ukraine, further sanctions response and energy price impact. • BoE housing lending data (Jan) expected up. • Nationwide House prices (Feb) pick up expected in rush before rates rises. • MPC members Saunders and Cunliffe to speak.
	• Svcs PMIs Flash (Feb) went down to 42.7 (-4.9pp), Mfg sector is more resilient (52.9). Composite fell to 44.6, consistent with weak production in Q1 • CPI Tokyo (Feb) doubled to 1% from 0.5%	• January IP and retail sales should confirm expected weakness at the beginning of Q1. • Omicron + rising prices should derail consumer confidence in (Feb) • Employment data should remain robust
	• House prices tick up slightly in January but on very thin transaction volumes	• PMI may stay around 50, indicating close to flat growth in manufacturing activity
	• Russia/Ukraine conflict stepped up • CB: Hungary hiked +30 bps to 4.60%. Korea (1.25%) & Israel (0.10%) kept rates on hold • Jan CPI (%yoy) picked up in Malaysia (2.3%) & Singapore (4.1%) • Q4 GDP %yoy lost steam in Taiwan (4.86%) & Peru (3.2%). Russia +4.7%yoy in 2021 • Korea's 1st 20 day exports trend softened	• Focus on Ukraine/Russia/global developments • CB: Malaysia expected on hold at 1.75% • Q4 GDP in Brazil, Mexico, India, Korea & Turkey • Feb CPI (%yoy) to accelerate in Peru, Philippines, Thailand & Turkey, ease slightly in Indonesia & Korea • PMI figures (Feb) across EM countries

Upcoming events		
	US:	Mon: Goods trade balance (Jan), Chicago PMI (Feb); Tue: Mfg PMI (Feb), ISM Mfg indx (Feb); Wed: ADP employment change (Feb), Fed's Beige Book; Thu: Weekly jobless claims (26 Feb), Non-farm productivity (Q4), ULC (Q4), Services PMI (Feb), ISM non-mfg indx (Feb); Fri: Non-farm payrolls (Feb), Unemployment (Feb), Average earnings & weekly hours (Feb)
	Euro Area:	Mon: Sp HICP (Feb,p); Tue: EU19, Ge, Fr, & It Mfg PMI (Feb), Ge & It HICP (Feb,p), Ge CPI (Feb,p); Wed: EU19 CPI (Feb,p); Thu: EU19 PMIs (Feb), EU19 Unemployment (Jan), EU19 PPI (Jan), ECB account; Ge, Fr, & It services PMI (Feb); Fri: EU19 Retail sales (Jan), Fr Ind prod (Jan), It GDP (Q4)
	UK:	Tue: Lending data (Jan), M4 (Jan), Mfg PMI (Feb), MPC's Saunders; Wed: BoE's Cuncliffe; Thu: Composite & services PMI (Feb); Fri: SMMT new car registrations (Feb), Construction PMI (Feb)
	Japan:	Sun: Ind prod (Jan,p)
	China	Tue: Official PMIs (Feb), Caixin mfg PMI (Feb); Thu: Caixin services PMI (Feb)

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