ALLIANZ RESEARCH

RUSSIA-UKRAINE CRISIS: CONFLICT ESCALATION

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EXECUTIVE SUMMARY

- *The escalation of the conflict between Russia and Ukraine is bound to have important economic and financial consequences through three main transmission channels – energy, trade, and the financial sector, depending on how current and future sanctions will play out. Note that Russia is in a stronger position than it was in 2014 economically speaking.*
- *As the world reopens from Covid-19 with higher inflation, disrupted energy and supply chains, and sensitive financial markets, our scenario "Conflict escalation" highlight impacts on Europe's inflation (+100bps), growth (-0.5pp), equity markets (-10%), sovereign and corporate spreads (+20-60bps), and policy outlook (dovish pivot, fiscal support reloaded to offset impact). Severity of sanctions is a clear gradient for economic and financial markets outcomes.*
- *In an extreme "Black-out" scenario in which Russia turns off Europe's gas supply, the natural gas price would rise to an average of 140 EUR/MW, because alternative suppliers are limited; this would add up to +2.5pp to our current Eurozone inflation forecast of 3.8% this year. As for the headwinds to economic growth, a recession will be all but certain.*

On 21 February 2022, Russian President Putin formally recognized the separatist republics Donetsk and Luhansk in east Ukraine as independent states. On 22 February 22, the US, Europe, the UK, Canada, Japan and Australia announced a first tranche of sanctions to serve as deterrent to a further escalation of the conflict. Sanctions remained on the moderate side. On 24 February 2022, Russia decided to invade the Ukraine, beyond the Donbas region. It is expected that the West will enact further sanctions, such as more extensive sanctions on Russian sovereign and corporate debt; cutting Russia's banks off from access to SWIFT; sanctioning the Central Bank of Russia; and a partial or full-blown trade embargo, including Russia's oil and gas exports. This conflict escalation will have important economic and financial markets consequences which we outline in this paper.

EULER HERMES

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Figure 1 – Sanctions overview (as of February 25, 2022)

	US	EU	UK	CAN	JPN
Pre-existing measures	Export controls (arms, dual use goods, firm-specific measures; financial sanctions on major banks and energy companies; blacklisting of individuals, entities, aircrafts and vessels; restriction on financial services and financing on primary and secondary markets of Russian entities; ban on trade with Crimea. US banks not allowed to provide financing to Russian government (since 2019), and US financial entities banned from buying Russian national debt primary markets (since 2021).				
Finance	Severing access to the US financial system Russia's two largest banks (Sberbank, VTB Bank), three additional major financial institutions (Otkritie, Novikom, and Sovcom) cut off from US payment system Debt and equity prohibitions against major state-owned and private entities Sanctioning 24 Belarusian individuals and entities	Financial sanctions on 70% of the Russian banking sector and key SOEs Bar several state-owned companies from launching new listings on stock exchanges Prohibition of lending and the purchase of securities for several state-owned Russian enterprises	Freeze of Russian banks assets in the UK and shutting off their access to the banking system Ban on Russian state-owned and key strategic private companies from raising finance in the UK	Restrictions on Russian banks and prohibition of any person in Canada and Canadians abroad from dealing in new debt originated by Russian entities	Prohibition on the issuance and trading of corporate and sovereign Russian bond (but largely symbolic since there is not of outstanding Russian debt in Japan)
Trade and Investment (incl. Energy)	Regional prohibition for Donetsk and Luhansk regions by US persons (imports, exports) Russia-wide restrictions on imports of technological goods Prohibition of exports using US inputs with sensitivities technologies to Russia	Export ban on technologies critical to upgrading oil refineries Ban on the sale of aircraft and equipment to Russian airlines Limits on Russia's access to semiconductors and selected software	Suspension of dual-use export licenses and restrictions on trade and export controls against Russia's high-tech and strategic industries (e.g., natural resources and defense companies)	Sanctions on exports of aerospace and technology, including tech companies in the minerals sector	General ban of exports and imports of the regions of Donetsk and Luhansk. Export controls on high-tech products (e.g., semiconductors)
Other	Individual sanctions on political elite (executive and legislative) as well as industry representatives	Blacklist and asset freezing of all politicians in Russian parliament who voted in favor of recognition of Ukraine's breakaway regions	Individual sanctions on more than 100 companies and oligarchs at the heart of Putin's regime	Asset freeze and dealings prohibition on designated persons ("Russian elite"), which are also barred from entering Canada	Asset freeze in certain individuals

Sources: National authorities, Allianz Research

RUSSIA: READY TO WITHSTAND HARDER SANCTIONS

Note that compared to 2014, Russia is in a different position, ready to withstand harder sanctions (see Figure 2). In 2014, the total economic cost of sanctions – which also included counter-sanctions imposed by Russia on imports of foodstuffs – tallied up to -1pp. This time, global oil and gas prices today are significantly higher, and we do not forecast a sharp decline as seen in H2 2014 and 2015. Strong increases in oil and gas revenues helped Russia post a record current account surplus of USD120bn in 2021, equivalent to about 7.5% of GDP. In addition, Russia's gross FX reserves (excluding gold) currently stand at just below USD500bn, compared to USD339bn at end-2014. Moreover, the level of maturing debt in the next 12 months (short-term debt plus principal repayments due) currently stands at USD114bn vs. USD146bn at-end 2014. Coverage of maturing short-term debt was already good in 2014 (232%) but is even better now (439%).

Figure 2 - Indicators for Russia's initial conditions in 2014 and 2022

	2014*	2021*/2022
Oil price (Brent; USD per bbl)**	57	97
Gas price (TTF; EUR per MWh)**	22	73
Fiscal balance (% of GDP)	-1.1	-0.5
Public debt (% of GDP)	15.1	19.0
Current account balance (% of GDP)	2.8	7.5
External debt (% of GDP)	29.3	30.4
Maturing short-term debt in next 12 months (USD bn)	146	114
FX reserves (USD bn)***	339	498
Import cover (months)	9.5	15.5
Coverage of maturing short-term debt in next 12 months (%)	232	439

* End-year 2014 and 2021, respectively, unlees otherwise indicated

** As of 22 Feb 2022

*** As of 31 Jan 2022

Sources: Refinitiv, Central Bank of Russia, Euler Hermes and Allianz Research

Russia has posted continued annual current account surpluses since 1998, even during the GFC 2008-2009, the 2014-2016 Ukraine plus oil price crises and the 2020 Covid-19 crisis. A closer look at the trade and services balances shows that the countries that would most likely engage in serious sanctions against Russia in the current context (the US, EU, UK, Japan, Switzerland, Norway, Ukraine) accounted for approximately 60% of Russia's trade and services surpluses in 2016-2020. This means that even in the extreme case of trade being reduced to zero, Russia would almost certainly continue to post current account surpluses and would not have to draw down its FX reserves to finance imports from other countries not applying sanctions.

However, in the short to medium run, a full diversion of Russian exports away from Europe to China seems highly unlikely for scale and operational reasons. However, natural gas is part of China's long-term plan to change its energy mix and Russia has played and will continue to play an important role in this. Before 2019, in volume terms, Chinese imports of natural gas from Russia represented an insignificant share of the total. The share moved up to 4% in 2019, 9% in 2020 and 10% in 2021, largely driven by the Power of Siberia pipeline between the two countries that became operational in 2019. Its annual capacity is 38bn cubic meters, which means that it was used at just 20% of full capacity in 2021. However, the 80% of idle capacity represents just 15% of Russian exports of natural gas to the EU in 2021. More importantly, as of today, Power of Siberia is not connected to the natural gas sources feeding European pipelines, meaning a diversion to China is operationally extremely difficult. China and Russia have agreed on a new deal and new pipeline (Power of Siberia 2) that would be connected, but the planned additional capacity of 50bn cubic meters would be operational only in 2030 and would represent just c.28% of 2021 exports to the EU.

THREE CHANNELS OF IMPACT: ENERGY, TRADE, AND THE FINANCIAL SECTOR

As the world recovers from Covid-19, the economic and financial markets consequences of the conflict escalation hinges on three main transmission channels, namely energy, trade and the financial sector.

First, Russia's economy could then face significant adverse effects (multi-year recession). The financing situation of Russian corporates and banks would also suffer, increasing non-payment risks significantly. However, we believe that a large-scale trade embargo against Russia is very unlikely – in contrast to the above-mentioned financial sanctions – given the EU's higher vulnerability, at least in the short term. We also do not expect Russia to cut off gas supply to the EU as this would mean a sharp reduction in the country's export and fiscal revenues, though this cannot be excluded for a few months, given the increased room to maneuver over the past year (including more than 15 months of import cover, frontloading debt financing).

Looking at **energy dependency**, as of 23 February, Gazprom has been fulfilling its contractual obligations though transit volumes via Ukraine have been dramatically reduced. We see limited risk for that to change. Furthermore, Europe has about one month of supply in reserves, which should take it through the relatively mild winter. Indeed, overall EU reserves stood at about 31% of total capacities as of 22 February – this is roughly about 1.2mn terajoules of energy. In one typical month of winter, the EU consumes about 1.4-1.5mn terajoules of energy from natural gas. Adding in some crisis-management options such as mobilizing "cushion gas" from storage facilities, reserves should be sufficient until end-March. Consequently, we expect prices to remain in the 75-90 EUR/MWh range until summer. In a scenario where Russia turns off Europe's gas supply – though this did not happen even during the height of the cold war – the natural gas price could climb up to an average of 140 EUR/MWh.

Unfortunately for Europe, alternative suppliers are limited. Diplomatic efforts from the US and the EU to have some contingency plans (the US reached out to Qatar, the EU had discussion with Algeria and Morocco – who have been having tensions disrupting supply to Spain etc.) appear mostly intended to send a signal to Russia and to reassure markets so that prices do not shoot up further. Practically, Norway does not have much leeway to increase supply, but Algeria could probably do so. Qatar, whose liquefaction capacities are already stretched, said through its energy minister that up to 15% of LNG exports tied to long-term contracts could be diverted to the EU. Other countries such as the US, Azerbaijan, Australia, Libya or Egypt could also increase deliveries to the EU. But adding up these hypothetical extra volumes would give the EU the equivalent of just three days of winter consumption (see Figure 3, next page).

Figure 3 - Potential alternative suppliers of natural gas for the EU

Country	Potential volume (monthly mn m³)	Via
US	850	LNG
Australia	965	LNG
Qatar	1,350	LNG
Norway	*Marginal*	Pipeline
Algeria	580	Pipeline
Libya	40	Pipeline
Egypt	80	Pipeline
Azerbaijan	165	Pipeline
Turkmenistan	*Unlikely*	Pipeline
TOTAL	**2,680**	

Note: We use monthly volumes to account to transportation time
Sources: Euler Hermes, Allianz Research calculations

Some countries (including Japan) have pledged to cover some of the potential supply shortfall by digging into their reserves or agreeing to divert their contracts. However, this would be at their own "expense" and it is difficult at this stage to count on as no country came out with a strong announcement or commitment. Moreover, as most of the world's gas transits through pipelines, the LNG carrier fleet is limited. Should all LNG carriers around the world head to Europe for a delivery in the coming month, that would give only up to an additional week of consumption to the region. Overall, our view is that it will be very hard, if not almost impossible, to make up for the volumes the EU needs. In this context, if Russia cuts the energy supply to Western Europe, it will be painful. The only hope would then be an early end to winter, renewables electricity generation picking up, maintenance speeding in nuclear facilities and a quick resolution in Ukraine.

Beyond spring, the EU will need to replenish stocks ahead of the next winter. More than 80% of storage capacity has been designed to keep natural gas in gaseous form, meaning that the continent will need to rely on suppliers connected to the current EU network. The capacity to receive (port terminals) and store LNG are limited and cannot be built overnight as it requires special infrastructure with cooling capacities etc. Therefore, should the situation remain tense and supply from Russia limited, prices could shoot up again in Q3 and Q4. We cannot exclude a situation in which governments may be forced to ration power, given the high dependency on imports of Russian gas. This is bound to take a toll on economic activity: A 10% reduction in energy supply might cut Eurozone quarterly GDP in Spring 2022 by around -0.5%, based in part on Japan's experience with power cuts in 2012. Meanwhile, Eurozone inflation would likely be at least 2.5pp higher compared to our baseline forecast of 3.8% in 2022.

From the Russian perspective, not counting any penalties and based on the average gas price in Q4 2021, a complete cut-off of piped gas to Europe would cost Gazprom up to USD228mn a day in lost revenues. A three-month embargo would hence tally up to USD20bn in lost sales. However, in the context of the Central Bank of Russia's gross FX reserves of USD500bn (excluding gold), the loss is small.

Even if a volumes crisis can be averted, i.e. energy needs can be covered to avoid rationing, a price shock is still to be expected. The European economy will feel the heat, given an expected sharp rise in global energy prices at a time when inflation is already registering around 5% y/y. A further notable increase in energy prices would add at least 1pp to our 2022 inflation forecast for the Eurozone. With the post-Covid-19 economic recovery far from complete, national governments would have to implement policies to limit the pain for the private sector.

In such a scenario, the ECB would be stuck between a rock (surging inflation) and a hard place (weakening growth momentum). As long as domestic inflation pressures – i.e. core inflation, wage growth and inflation expectations – remain in check, the ECB would likely prefer to err on the dovish side and opt for a slower tightening plan in the face of softening economic growth. A meaningful disruption of the economic recovery or signs of growing financial stability concerns could even derail altogether the ECB's normalization plans for 2022. ECB hikes for this year have been priced out (20bps lower over the last two weeks), while supply-side increases in oil prices, a likely weakening of the EUR relative to the USD (with monetary policy expectations being affected more (vs. the Fed)), and broader risk-off sentiment to the spatial proximity of the export-oriented economies of European powerhouses are likely to push up inflation. On fiscal policy, we expect more European countries to adopt and/or scale-up their transfers to households and industry to cushion the impact of higher energy prices, especially in those with a high share of gas in the energy mix and a high pass-through of higher energy cost to consumers.

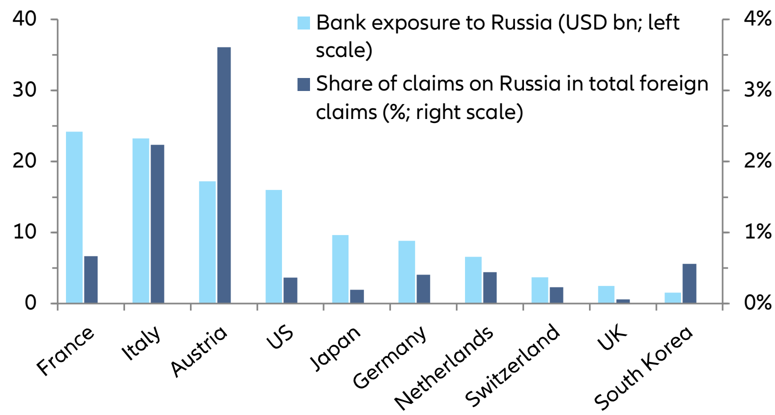
Looking at **trade dependency,** unless EU trade sanctions and Russian counter sanctions are notably stepped up compared to 2014 – in particular by including EU energy imports from Russia – any impact should be modest on the EU economy, though more significant for the Russian economy. Russia is the EU's fifth-largest trade partner (down from rank three in 2012), representing around 5% of the EU's total trade in goods and around 2% of Eurozone heavyweights' exports. Meanwhile the EU accounts for almost 40% of Russia's total trade in goods. The main EU exports to Russia are machinery, transport equipment, medicines, chemicals and other manufactured products. The main EU imports from Russia are raw materials, especially oil (crude and refined) and gas, as well as metals (notably iron/steel, aluminum and nickel).

Given the deterioration in EU-Russia economic relations over the past decade, the total economic loss, including negative spillover effects on firms that are part of the supply chain for companies/sectors exporting to Russia, is likely to be more muted compared to 2014, when it was estimated at up to -0.4pp.

In the adverse scenario in which Russia is cut off from the SWIFT (Society for Worldwide Interbank Financial Telecommunication) payments system, trade flows could dry up more significantly as Russia would be left unable to pay for imports and to receive payment for exports.

Looking at the **financial sector**, European banks have also reduced their exposure to Russia to very low levels. For Germany, assets have fallen from a peak of 0.45% of the consolidated balance sheet in 2008 to less than 0.1% and French banks have only a little more at stake. Even for Austria, whose exposure is greatest among the larger European countries, the numbers are manageable.

Figure 4 - Bank exposure to Russia (selected countries; Q2 2021)



Sources: BIS, Euler Hermes, Allianz Research

The West has decided to use financial sanctions as part of their initial actions against Russia. In that regard, an exclusion from SWIFT – when undertaken in 2014, Russia's finance minister at the time warned that Russian GDP could contract by up to -5% as a result – is not off the table anymore. Yet, the cooperative in charge of SWIFT is based in Belgium, ruled by Belgian and EU laws and owned by member banks. It is governed by a 25-member board of directors (including one Russian national) and is overseen by the G10 central banks as well as the ECB. It will take a strong consensus to enact such a decision. Moreover, it is not the most effective measure. After all, cutting Russia off from SWIFT does not mean a ban on cross-border transactions. Above all, it poses operational issues that can be solved/circumvented by using alternative messaging systems. Since 2014 and the Crimea crisis, Russia has built its own financial transfer system ("Sisteme Peredachi Finansovykh Soobshchenii" or SPFS), which despite its flaws can count on the membership of 400 banks, of which 23 are foreign banks (based notably in Switzerland and Germany). It now handles about 20% of domestic payments. Though it remains less capable and more limited in scope than SWIFT, it could provide a safety net for Russian trade and act as a potential solution to continue cross-border transactions.

An alternative would be targeted financial sanctions, including the blacklisting of the three largest state-owned Russian banks and, in turn, their ability to convert the ruble into hard currency. This is likely to be more effective in cutting them out of the global financial system while at the same time not further disrupting energy exports to Europe. Including third countries in the discussion such as Switzerland can ensure that transactions are not diverted elsewhere. However, financial sanctions would also cause Europe self-inflicted pain by disrupting energy imports. After all, without payment, the flow of gas and oil exports to Europe would also quickly stop.

FINANCIAL MARKETS: TAKEN BY SURPRISE?

Russian equities have had a tough beginning of the year, with a -19%YTD aggregate performance (excluding the currency depreciation). However, through the week, the energy stocks recovered part of the losses while financials did not, likely due to the different bargaining power of both sectors against Western sanctions. The losses in the main global financial markets were between the 1% and 2% on the same day, although stocks with higher Russian exposure have been more affected. US equity market volatility persists at elevated levels between 25 and 30 (as measured by the VIX). At the time of writing and with the first military actions already taking place in Ukrainian soil, Russian equities are losing -29% since market opening and -42%YTD in local currency terms. At the same time European and US future markets are showing an intraday equity market correction of up to 5%, with a clear rotation to safe assets (sovereign bonds and gold) (see Figure 5).

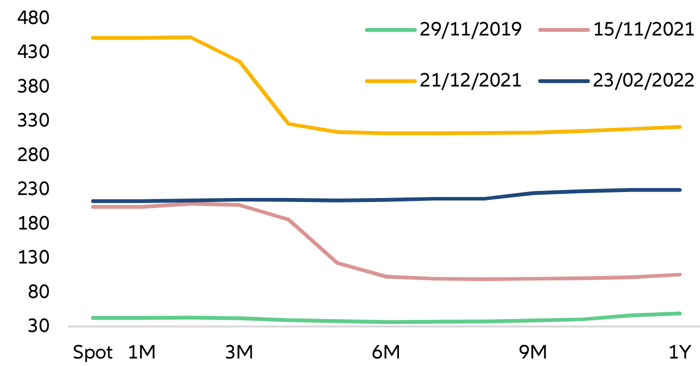
Figure 5 - Key capital markets indicators

			Value				Change since		
	Indicator	Currency / Unit	Latest	Last Friday	31.12.2021	Median 2015-2019	Week to date	Since 31/12/2021	Since 31/12/2019
							% (but points for VIX)		
Equities	S&P 500	USD	4,226	4,349	4,766	2433	-2.84%	-11.34%	30.79%
	S&P Energy	USD	512	515	423	500	-0.53%	21.14%	12.19%
	S&P Aerodefense	USD	1,282	1,306	1,246	987	-1.85%	2.83%	-5.56%
	Nasdaq	USD	13,037	13,548	15,645	6221	-3.77%	-16.67%	45.30%
	VIX	points	31	28	17	14	3	14	17
	Eurostoxx	EUR	441	452	479	368	-2.43%	-7.96%	9.11%
	MOEX Russia	RUB	3,085	3,393	3,787	2070	-9.09%	-18.55%	1.28%
	Energy sector - Russia	RUB	6,727	7,444	8,223	4229	-9.62%	-18.19%	-6.53%
	Financial sector - Russia	RUB	7,275	8,498	9,877	7436	-14.40%	-26.34%	-23.67%
							bps		
Sovereign	US 10Y yield	%	1.98	1.93	1.50	2.26	4.7	48	7
	BD10Y yield	%	0.22	0.21	-0.18	0.33	1.8	40	41
	IT 10Y spread	bps	172	164	136	153	7.2	35	10
	RUS Sov USD Spread	bps	430	267	170	192	163.0	260	293
	UKR Sov USD Spread	bps	1,745	1,085	793	643	660.0	952	1347
	RUS main interest rate	%	9.5	9.5	8.5	9.0		100	325
	RUS 3Y CDS	bps	401	257	98	104	145	303	377
	UKR 3Y CDS	bps	1,344	981	625	602	362	719	894
							% for exchange rates, point for volatility and swaps		
Currencies	Rubel	RUB per 1 USD	81	77	75	64	-4.82%	-7.23%	-23.18%
	Hrywnja	UAH per 1 USD	30	28	27	26	-4.97%	-8.75%	-20.37%
	Rubel 1M impl vol	points	34	26	14	13	8.3	20	26
	Rubel Curr. Swaps Basis	bps	-44	-70	-104	-102	26	60	-2
							%		
Commodities	Brent oil	USD/barrel	97	93	78	58	3.92%	23.70%	46.25%
	Nat. Gas (ICE)	BPN per therm	213	176	171	42	20.87%	25.02%	586.61%

Sources: Refinitiv, Allianz Research

Gas prices in Europe have increased although they remain below the record peak prices recorded during the winter. The futures market depicts a conversion to lower prices for the Oil Brent, but not for gas prices (Figure 6) – it showed this conversion in October 2021. At the time of writing European 1-month Gas futures indicate an intra-day increase of +20 to 30% over the day.

Figure 6 - Forward gas prices for Europe (ICE, BPN/Th)



Sources: Refinitiv, Allianz Research

The Russian Ruble, which back in 2014 was the one of the main financial victims (losing 44% in that year), is showing signs of weakness. This year, the Ruble and the Ukrainian Hryvnia have depreciated 15% and 10%, respectively. For the time being, the different financial approaches from the US and EMU (sanctions to Russia vs. financial aid to Ukraine) are being felt in FX.

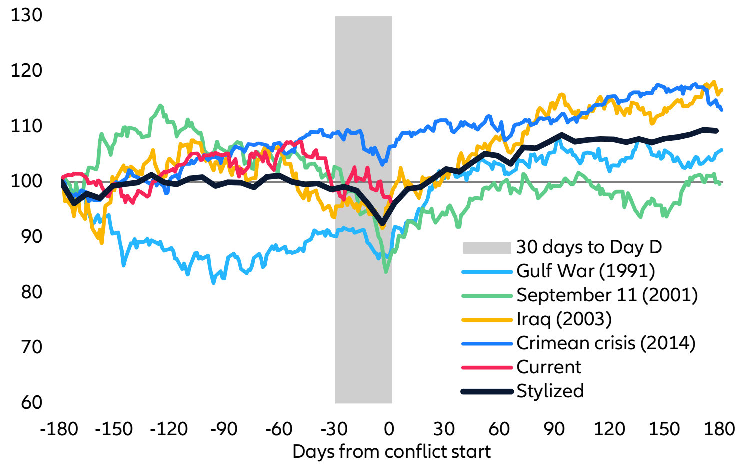
Similarly, tensions were being felt in the sovereign bond market. As of the writing of this memo, the Ukrainian Sovereign USD bonds had a spread close to 1800 bps, almost tripling the numbers at the beginning of the year. In the case of the Russian bonds it was 430 bps, also tripling beginning of the year numbers. Nevertheless, the sovereign debt structure of Russia and Ukraine is quite different. Russia has a much lower debt/GDP ratio (below 20%) and a relatively low share of debt denominated in FX (~84% in RUB), while in Ukraine fundamentals are weaker and the share of FX denominated debt is close to 50%. One has to recall that Ukraine already went through a restructuring process after the 2014 conflict and several international organizations have stated their willingness to provide financial aid to the country once again if needed. It is important to consider that both countries hiked significantly since early 2021 to fight inflation (currently reference interest rate in Russia is at 9.5%) which have brought the yields in local currency to around the 19% in Ukraine (which has very short maturity) and to 11% in Russia (currently displaying an inverted curve).

Uncertainty has spilled over to other Emerging markets translating into a generalized spread widening shock. A shock that comes in times of already high bond volatility due to the upcoming US policy normalization. Along these lines, countries that were already suffering from a rapid sovereign risk deterioration such as Turkey (international turmoil could change Erdogan's plan to stabilize the TRY) could be impacted the most.

Looking ahead, the impact on financial markets depends on two major developments: the scale of US (and NATO) military engagement and whether it leads to a long-lasting shock on energy commodities (similarly to the oil embargo after the Yom Kippur war in

1973). In Figure 7, we have tried to stylize the S&P 500 performance in the year surrounding an invasion or military tension since the Gulf War in 1991. Although they all have a different context (the US intervention in the Gulf War was preceded by the annexation of Kuwait; September 11 preceded by the Afghanistan War), they share common features: the shock in the weeks surrounding the invasion/impact can be significant (~10%) but is usually temporary. As mentioned, the real danger of such a situation that cannot be ruled out as of today is a long-lasting shock on energy commodities (both in prices and availability), which would lead to more severe scenario such the one following the oil embargo.

Figure 7 - S&P 500 stylized performance around key military events



Sources: Refinitiv, Allianz Research

CONFLICT ESCALATION: OUR CENTRAL SCENARIO

As if the post-Covid19 world was not challenging enough amid elevated economic uncertainty, prolonged supply-chain bottle necks and heightened inflation concerns, the Russian-Ukraine crisis increased stagflationary winds.

We have revised our mid-January Don't look up scenario (currently labeled "Ceasefire") to take into account latest development. In our new base case, called "Conflict escalation", to which we attach a 65% probability, we see the open conflict triggering a marked step up in sanctions and counter-sanctions including measures against Russia's three largest state-owned banks, Russia's exclusion from SWIFT, bilateral partial export embargoes excluding the energy sector. The impact would be felt above all in Russia but would also slow the post-Covid recovery in Europe (shaving off 0.5ppt from 2022 GDP growth and adding 1ppt in inflation compared to our previous baseline) with some very limited negative spillover expected for the US economy.

While the direct impact of sanctions on economic activity would still be moderate, the expected further leg up in energy prices (oil and gas averaging at USD90 (EUR/MWh) and USD90 bbl. respectively) will weigh on confidence, notably among households by further adding to already marked inflation pressures. In such a scenario we expect fiscal policy to step in and to shield the private sector by keeping a lid on the pass-through from elevated wholesale energy prices to consumer prices. Meanwhile the ECB would slow its policy normalization plans with QE continuing throughout 2022 to backstop expansive fiscal policy. Only in 2023 do we expect a first-rate hike.

A downside scenario "Black-out" could materialize should Russia opt for a full occupation of Ukraine to which the responding harsh sanctions and counter-sanctions include a full bilateral trade embargo covering also the energy sector. As a result, Europe will be cut off from Russian energy supply over the forecast horizon sending the region into a marked recession at the turn of 2022/23 while inflation will remain high over the forecast horizon. Policy makers will need to further step-up their game as broader effects on financial markets, including periphery bond spreads, as well as business and consumer confidence become a concern.

Figure 8 - Macroeconomic impact under different scenarios

Ceasefire (Probability 10%)
Ceasefire & search for a diplomatic solution amid persistent sanctions

Russia:
- GDP growth: +2.5% in both 2022 and 2023.
- Inflation (aop): +7.5% in 2022, +4.5% in 2023
- FX controls (forced RUB buying by companies) remains in place.
- Capital controls on specific FDI flows possible (retaliation for new sanctions).
- No sovereign default in 2022-2023.

Ukraine:
- GDP growth: -1% in 2022, +3% in 2023.
- Macroeconomic fundamentals remain weak and continued IMF support needed.

EU:
- GDP growth: +3.8% in 2022,+2.3% in 2023
- Inflation: +3.8% in 2022, +1.8% in 2023.
- Policy: ECB sticks to hawkish pivot – QE ends in Q3, first rate hike in Dec, +50pts in 2022.
- Insolvencies: +17% in 2022; +11% in 2023.

Energy prices normalization
- **Natural gas price** (TTF: €/MWh): average 75 in 2022, 45 in 2023.
- **Oil price** (Brent: $/bbl): average 79 in 2022, 72 in 2023.

Conflict Escalation (Probability 65%)
Escalation triggers more extensive sanctions, (financial & trade excluding energy)

Russia:
- GDP growth: +1% in 2022; -2.5% in 2023.
- Inflation (aop): 13% in 2022; 11% in 2023
- Capital flight leading to intensified FX and capital controls.
- No sovereign default in 2022-2023.

Ukraine:
- Deep recession in 2022-23 (-6% to -10%) Another BOP and sovereign debt crisis possible, with the IMF is likely to step in.

EU:
- GDP growth: +3.3% in 2022, +2.0% in 2023
- Inflation: +4.8% in 2022, +2.3% in 2023
- Policy: ECB scales down policy normalization plans with QE continuing throughout 2022 to backstop expansive fiscal policy, +50bp hike in 2023
- Insolvencies (additional increase): +2.8/3.8 pp in 2022; +1.1/1.5 pp in 2023.

Energy prices elevated
- **Natural gas price** (TTF: €/MWh): average 90 in 2022, 70 in 2023.
- **Oil price** (Brent: $/bbl): average 90 in 2022, 85 in 2023.

Black-out (Probability 20%) *
Harsh sanctions put economic & financial relations between Russia & the West on ice

Russia:
- GDP growth: -5% in 2022, -6% in 2023.
- Inflation (aop): 20% in 2022, 25% in 2023
- Full-fledged FX and capital controls
- No sovereign default in 2022-2023.

Ukraine:
- GDP growth: -15% in 2022, -10% in 2023.
- BOP crisis and sovereign default.

EU:
- GDP growth: +2.5% in 2022, -1% in 2023
- Inflation: +6.3% in 2022, +4% in 2023
- Policy: ECB remains in crisis-mode throughout the forecast horizon, PEPP revived to "close spread", no rate hikes
- Insolvencies (additional increase): +7.2/9.8 pp in 2022; +18.0/24.8 pp in 2023.

Energy crisis
- **Natural gas price** (TTF: €/MWh): average 140 in 2022, 110 in 2023.
- **Oil price** (Brent: $/bbl): average 120 in 2022, 100 in 2023.

*Note: We reserve a 5% probability for tail risk scenarios

Sources: Euler Hermes, Allianz Research
**Note: We reserve a 5% probability for tail risk scenarios.*

Risky assets will continue to be vulnerable over the short term despite some increase in risk premia having been priced in already. We expect a further near-term correction in equity markets of 15 percent in our central scenario before markets consolidate during the course of the year (since equities are oversold from a short-term perspective). For corporates bonds, investment grade names are likely to see a moderate widening (+20bps) whereas the high-yield segment will continue to be under pressure (+60bps). Similarly, emerging markets will be adversely affected by a retrenchment of capital flows to safe haven assets, which will give near-term support to the USD, which tends to rise during episodes of deteriorating sentiment (see Figure 9). However, central banks and local governments could once again act as a perma-put limiting the downside risk potential.

Figure 9 - Capital market outlook under different scenarios

	31/12/2021	Last value (23.02.2022)	Ceasefire		Conflict Escalation		Black Out	
			Market impact*	eoy 2022	Market impact*	eoy 2022	Market impact*	eoy 2022
Policy rates								
Policy rate (ECB deposit rate) (%)	-0.5	-0.5		-0.25		-0.25		-0.5
Sovereign Debt								
Germany 10y yield sovereign (%)	-0.18	0.22	+10bps	0.35	-20bps	0.0	-50bps	-1.0
Italian 10y sovereign spread (bps)	136	172	-25bps	140	+20bps	150	+150bps	175
Corporate Debt								
Investment grade spreads (bps)	98	133	-25bps	110	+20bps	120	+130bps	180
High yield spreads (bps)	331	410	-60bps	370	+60bps	400	+250bps	650
Equity								%
Eurostoxx (%)	22.9(y/y)	-7.5	10	7	-10	2	-20	-15
Emerging Markets								
Hard currency spreads (bps)	386	458	-60bps	400	+80bps	440	+130bps	560
Local currency yields (%)	4.9	5.0	-30bps	5.1	+100bps	5.4	+170bps	6.7

*Immediate change from last available value

Sources: Euler Hermes, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

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