Global Counsel

The Russia-Ukraine war

Scenarios and the economic impact

3 March 2022

Our scenarios for the Russia-Ukraine war

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Scenario 1
A new modus vivendi

Ukraine agrees to new Russian terms at gunpoint. Ukraine and Belarus become part of Russia's sphere of influence, perhaps with further annexations. Warfare ceases. Russia is likely to keep some troops in Ukraine and Belarus, keeping them in Crimea and with DPR/LPRs' fate for Putin to decide. Europe still sees Russia as an existential security threat but, with Ukraine formally accepting terms, the EU, US and allies permit some sanctions to be lifted in the medium term. Russia continues gas transit via Ukraine while Europe seeks ways to reduce energy dependence on Russia. For as long as Putin remains in power there is no return to the *status quo ante*.

Scenario 2
Protracted hybrid war

Ukraine's resistance to Russian aggression continues, with Moscow likely achieving conventional military victory, despite massive western financial and arms support for Ukraine. Russian forces seize key Ukrainian infrastructure and the cities but guerrilla warfare begins. Some kind of government in exile exists and the domestic opposition to war is supressed, despite heavy losses. Full-scale sanctions are tightened, significantly cutting economic ties between Russia and the West, which hopes for Putin's fall from power. Some continued western support in arms for Ukrainian resistance risks escalation. Some cyberwarfare and covert operations a possibility.

Scenario 3
Wider escalation

Ukraine's resistance moves to a guerrilla mode as Russia overtakes Ukraine and possibly Moldova. Sweden and Finland decide to join NATO. A military build-up in Europe and increased threats (including nuclear) from Russia intensifies confrontation between NATO and Russia. Russia's trade with Europe comes to a halt with energy supplies fully stopped. China takes advantage of the conflict and attempts to capture Taiwan while Iran feels emboldened in the Middle East. Russia eventually faces an increased economic decline and social unrest over the war fatigue. A direct conflict between Russia and NATO seems a real possibility.

Nine emerging issues

Time horizon →

Economic and commercial	Implications for monetary policy by major central banks, including the pace and scale of interest rate rises	Implications for commodity supplies (energy, food, metals) and bilateral relations between countries (US policy towards Iran might soften)	Implications for global energy security and related strategies/policies (including low carbon transitions)	Implications for SWIFT, the international payments system and for global FX reserves strategies by major EM central banks, most notably China
Geopolitical	Implications for internal Russian stability and for policies towards Russia either in anticipation or as a consequence of instability	Implications for Chinese foreign policy and strategy towards the west, including Taiwan policy (ditto some other EMs, like Turkey)	Implications for other frozen conflicts or diplomatic tensions in the region, such as Georgia, Moldova, or Armenia-Azerbaijan	
European politics and policy	Implications for EU policies towards defence and security, including spending, strategy and co-operation at EU level	Implications for central European attitudes to EU and for internal politics (Poland and Hungary, but not only)		

The economic impact on Russia and the world

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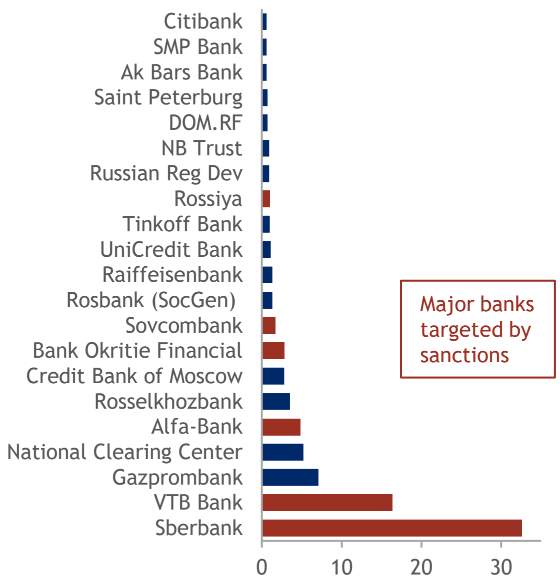
Channels of exposure	

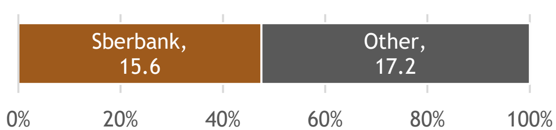
Banking ties

Russia's banking system is concentrated
Banks' market share by assets, %



*The smaller banks Novikombank and Promsvyazbank have also been targeted

Sberbank dominates personal deposits
Russian personal deposits, RUB trillion and share in %



Sources: JPMorgan, Federal State Statistics Service

Russia's banking system has been a key target of western sanctions designed to impose heavy economic costs on Russia. Market concentration means sanctions on a few Russian banks likely have an outsized impact.

- The US and UK have frozen the assets of Russian banks and limited access to their financial system. The US has cut off Sberbank from the US financial system, blocking it from converting roubles to USD through its control of the dollar clearing system. This will hamper even the most straightforward international transactions for the lender. Washington also froze assets at four other Russian banks including VTB. The UK has frozen the assets of all major Russian banks and will ban them from accessing sterling and clearing payments through London.
- The EU has refrained from the more drastic US and UK measures but imposed capital market restrictions on banks that hadn't been targeted yet in the aftermath of the annexation of Crimea.
- The EU, US, UK and Canada have also announced that they will use the often called "nuclear option" by cutting off seven Russian banks, including VTB and Bank Otrkitie, from the messaging service SWIFT.
- Despite their broad scope, western sanctions have not targeted the entire Russian banking system. For instance, state-controlled Gazprombank, the main conduit for foreign payments for oil and gas, is only facing capital market restrictions so far. In a more extreme scenario, western powers could extend existing restrictions or impose sanctions against the entire banking system as was done in the case of Iran.

Banking ties

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Impact on the world

Western sanctions against Russia's financial system will force foreign banks to restrict their Russia business and will leave them exposed to compliance risks and the risk of Russian retaliation.

- Foreign banks with exposure to Russia will need to comply swiftly with new sanctions regimes and cut out clients and counterparts with whom they are banned from doing business. This will severely affect their investment banking operations, which deal with multi-national companies and oligarchs. The impact will be most severe for euro zone banks which have more than $115bn in exposure to Russia both through cross-border lending and subsidiaries' operations.

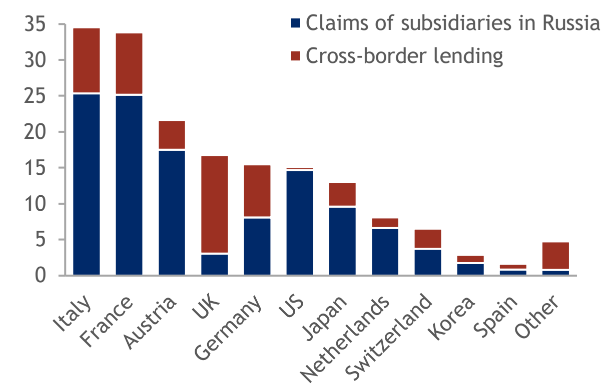
- A sharp economic slowdown will mean Russian borrowers have increasing difficulty to repay their loans, a reason why banks with Russia exposure have increased their loan-loss provisions. Payment restrictions could also make it difficult for them to collect interest.

- The largest western banks in Russia, notably UniCredit, Société Générale, Raiffeisenbank International and Citibank could be the target of retaliation for complying with western sanctions. Raiffeisen generates more than a third of its profits from Russia. Retaliation could range from asset freezes to the jailing of bank executives.

- Russian banks will look to raise funds and perhaps serve customers in other markets, such as China.

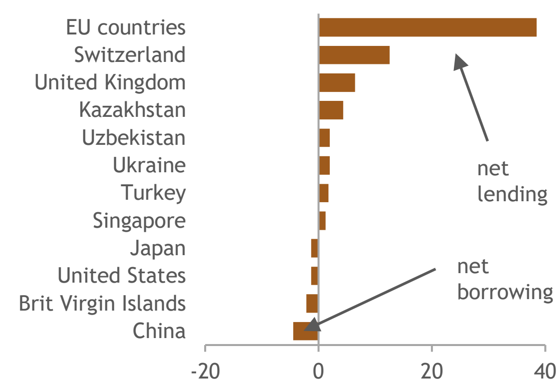
European banks are most exposed

Foreign bank claims on Russian residents, USD bn



Russian banks are net lenders in Europe

Russian banks' net foreign assets, selected countries in USD bn



Sources: BIS, CBR

Payments

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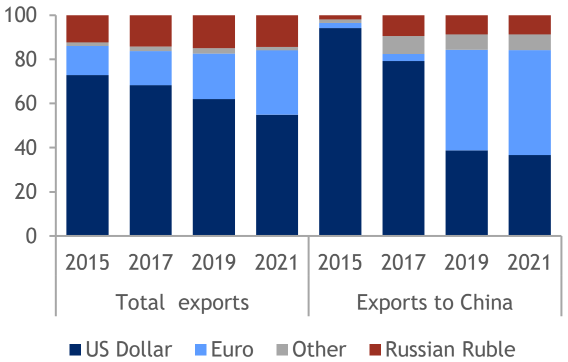
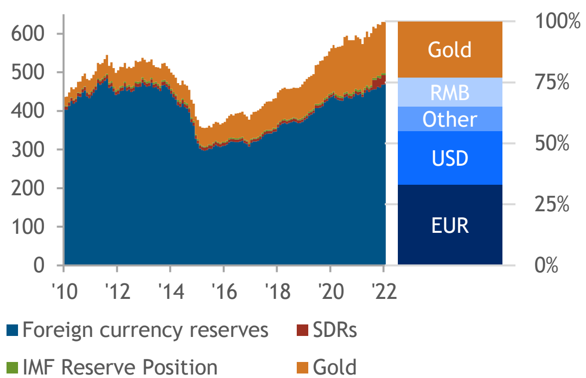
Russian exports are billed in USD and EUR
Share of Russian export invoicing by currency, %



$630bn in FX reserves, mostly in EUR & USD
Russian int'l reserves, USD bn; and % by currency (rhs)



Sources: CBR

Sanctions targeting Russia's access to international payments infrastructure will increase the burden of cross-border transactions and partially cut the country off from the international financial system.

- SWIFT restrictions will have an immediate impact on Russia's ability to receive payments for its exports and access traditional hard currencies. Payments in USD will be further complicated by the Sberbank sanctions. Russia has in recent years sought to switch the dollar for the euro, especially in trade with China. Brussels wants a greater international role for the euro and has refrained so far from cutting off Russian banks' access to the single currency.

- Russia's own payment system SPFS, developed after the invasion of Crimea, could be used for domestic settlements as more Russian banks are now connected to it than to SWIFT. The system is currently used for about 20% of all transactions in Russia. But SPFS could only be an alternative for international transactions in the medium term. It will likely take 3-4 years to provide the necessary capacities that currently SWIFT provides. 21 foreign organisations have so far expressed interest in using the system, 12 of which are already connected to the system. The Bank of China is the only Chinese bank connected to the system.

- Western sanctions against Russia's central bank are meant to prevent it from deploying its USD, EUR and other western currency assets which account for more than half of Russia's $630bn foreign reserves. This will make it hard for the CBR to intervene in the FX market to stabilise the rouble and provide liquidity should importers run out of hard currency.

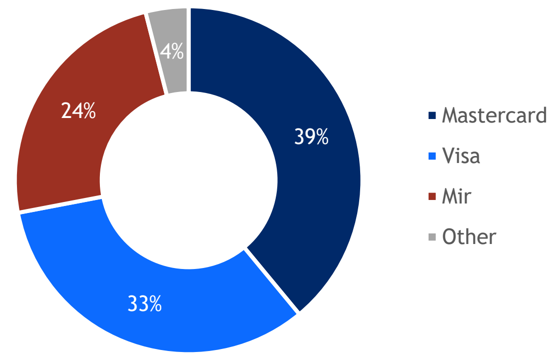
Payments

Impact on the world

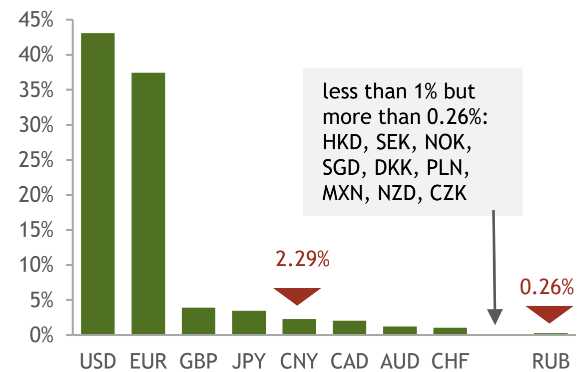
Sanctions on international payments will hamper business with Russia and likely lead to harsh counter-measures and a move away from the USD.

- Western SWIFT sanctions will have severe implications for Russia's ability to trade, which is why Moscow has called them a declaration of war in the past. But they will also hurt western banks that use SWIFT for Russia business and the companies they serve.
- Western actions against Russia's financial system could lead to Russian counter-actions against western payments providers in Russia where Mastercard and Visa account for more than two-thirds of card spending. Domestic payment processing is done locally by the National System of Payment Cards (NSPK), so should not be affected by sanctions. Apple Pay and Google Pay stopped working on the cards of sanctioned banks and may be targeted by Russia further in counter-sanctions.
- In the longer term, cutting Russia off SWIFT could hurt the role of SWIFT and of the USD in the global financial system. It could also complicate the EU's attempt to internationalise the euro. Russia's own payments system could become more widely used. Or even more likely perhaps, China's CIPS payments infrastructure could be the ultimate winner as Beijing encourages the international use of the RMB.
- SWIFT sanctions might also steer Russia and other emerging markets toward crypto currencies that would reduce global reliance on the US-centric international monetary system. Altogether, SWIFT sanctions could incite the de-dollarization of the world economy.

Mastercard and Visa still dominant in Russia
Russian card spending by provider, %



USD and EUR dominate int'l payments
Share of currencies in SWIFT transactions, based on value



Sources: Statista, SWIFT

Energy

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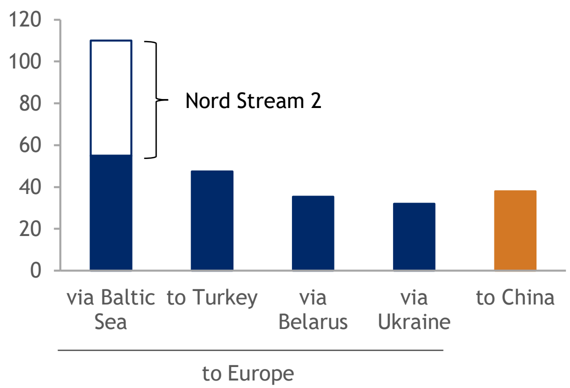
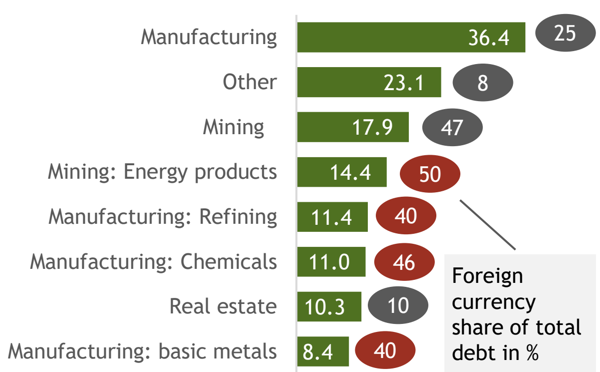
Russia relies on European gas market
Annual pipeline export capacity in in bn m^3



Its wider energy sector uses foreign funds
Outstanding corporate loans in foreign currency, USD bn



Sources: Statista CBR

Russia‘s economy relies heavily on oil and gas exports. These could be curtailed by western sanctions while restrictions on capital markets and technology could impede its future production capacity.

- Financial sector sanctions could hurt Russia’s ability to receive payments for its oil and gas exports. Annual revenue from the export of crude oil, oil products and gas reached about $240bn in 2021, only a quarter of which is from gas. Western nations have so far avoided causing a wider disruption of Russian energy exports. This could change through more extensive sanctions against certain Russian banks and companies, or should Russia itself halt exports to the west.

- Russia’s grip on the European gas market could suffer. The military conflict could disrupt the pipeline via Ukraine while Germany’s suspension of Nord Stream 2 could be made permanent, limiting future Russian gas exports to Europe. Berlin has already announced investments in new LNG terminals to increase energy security. Russia would struggle to replace the European market in the short term. China is an increasingly important customer, but pipeline volumes are still low. Russia’s LNG export capacity has risen significantly in recent years to 40 bcm, but this is still less than it can send to Turkey alone.

- Russia’s wider energy sector has relied heavily on foreign currency funding. Restrictions for companies like Gazprom to raise capital in the west will increase costs or lead to lower investment in future.

Impact on Russia

Energy

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Impact on the world

With more than 10% of global oil and gas production, Russia is one of the world's largest exporters of energy. A disruption in Russian supply will have implications for global energy prices and inflation.

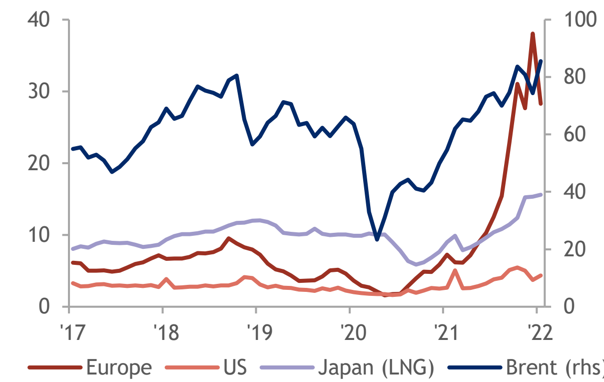
- European nations are heavily dependent on Russian gas (Annex 1). Sanctions will likely keep prices high and more extensive disruptions could lead to a price shock. Smaller supply disruptions could be offset by LNG imports. However, Europe's import capacity is low – in part because significant regasification plants in Spain cannot be connected to the central European gas network. There is also limited scope for households, industry and the power sector to switch to alternative fuels. Coal could be a short term solution, though it is politically controversial and often sourced from Russia too. European industry could suffer from shortages in a more severe scenario.

- Oil can be shipped to new customers more easily. Russia could sell oil denominated in RMB on the Shanghai International Energy Exchange - China is already Russia's largest oil importer. Saudi-led OPEC could increase production should Russian supply fall, though spare capacity is limited and Riyadh is keen to maintain its oil alliance with Moscow.

- Higher energy prices globally will drive inflation. Because of its gas dependence, Europe is most exposed and its competitiveness could suffer, putting pressure on policymakers to alleviate the burden on consumers and industry, which could be costly.

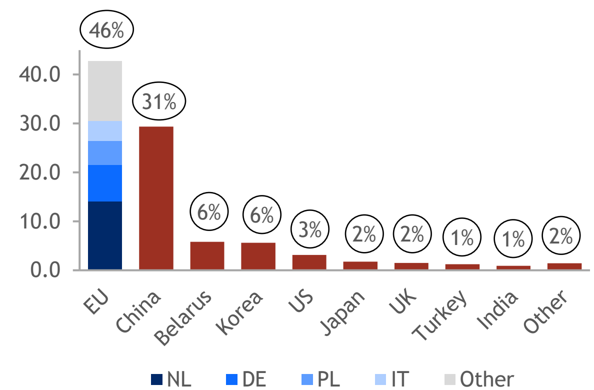
Europe is in the midst of a gas crisis

Gas prices in $/BTUm; and Brent crude oil $/b (rhs)



Russian oil exports are concentrated

Russian exports of oil, $ billion in year ending Sep '21



Sources: World Bank, Federal Customs Service

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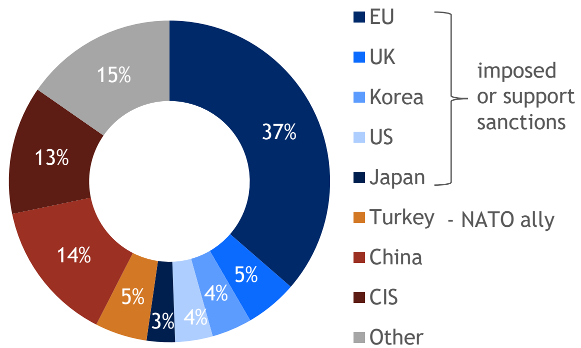
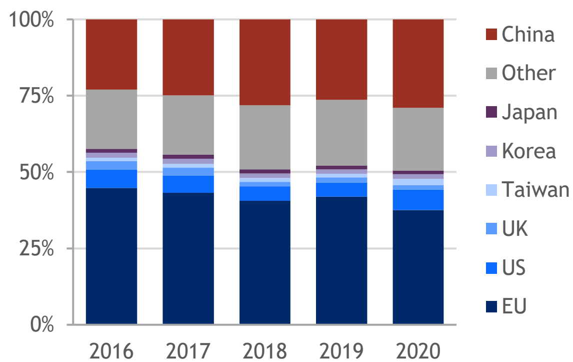
Sanctions could hit and shift Russian exports
Russian exports by market, %



West + Asian allies are big tech suppliers
Russian imports of high-tech products by source, %



Sources: IMF, UNCTAD

Western sanctions have directly targeted only small parts of trade with Russia, but financial sanctions will make Russia's entire trade increasingly complicated.

- The US has barred US-owned companies from exporting advanced hardware and software to Russia, and also blocked foreign firms from exporting to Russia products that incorporate American high-tech components. The White House estimates this could affect half of Russian high-tech imports. Taiwan has also banned semiconductor exports to Russia.
- Besides targeting some Russian high-tech sectors such as aerospace, dual-use goods and semiconductors, the EU has also banned exports of products and technology that can be used to build and upgrade Russian refineries. This could impact Russian capacity over the medium term.
- Chinese suppliers could fill some gaps left by western producers. But the impact of the rouble's fall will increase import prices. Coupled with hurdles to international trade, import substitution is set to become a cornerstone of Russian industrial and trade policy for the years to come. In certain industries, such as aerospace, machinery and software, import substitution will mean that defence and dual-use products could be prioritised at the expense of consumer goods.

Impact on Russia

Trade

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Impact on the world

Russia is a large importer of industrial products and also a significant supplier of minerals and agricultural products. Trade ties and global supply chains will be affected by sanctions and counter-measures.

- Sanctions and Russian retaliatory actions could restrict the supply of certain metals and minerals. Russia is the world's largest producer of palladium, a crucial ingredient for many electronic products. As a significant supplier of titanium, Russia can also restrict exports of this key input used in the aerospace, marine and auto industries. Airbus and Boeing are major users of Russian titanium.

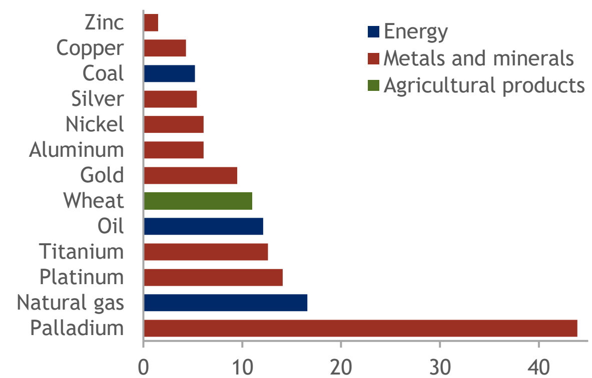
- Russia could restrict its wheat supplies. Prices are already rising because Ukraine is another major wheat producer. China has said it has relaxed restrictions on imports of Russian wheat as food security concerns rise. Price effects could be particularly sensitive in poorer regions, such as the Middle East and North Africa.

- Sanctions and the economic slowdown in Russia will depress and shift trade flows to Russia. This could be even more so should Moscow apply further restrictions in sectors where China can increase supply and replace western products, eg in consumer electronics.

- Moscow has threatened to stop honouring IP rights in high-tech sectors like machinery and medicines.

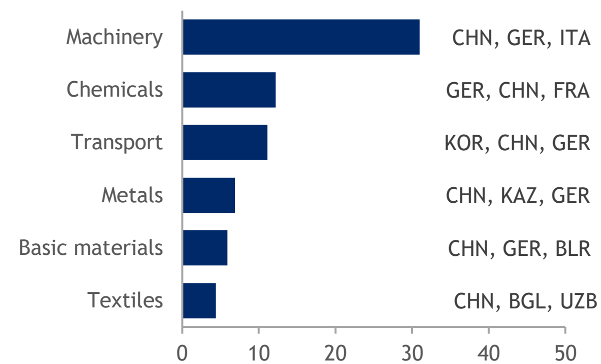
Russia is a key supplier of some commodities

Russia's share in global commodity production in 2020, %



Russia needs machinery imports

% in Russian total imports in 2021, top-three partners



Sources: JPMorgan, Federal Customs Service

Annex: European exposure to Russia

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	Merchandise trade with Russia (% of GDP)		Energy import dependency (%)*…			…from Russia (% of total)		Banking ties (USD mn)	
	Imports	Exports	Total	Oil	Gas	Oil	Gas	Cross-border	Foreign banks
Austria	0.5	0.6	71.6	95.7	122.8	5.8	0.0	4122.0	17511.0
Belgium	1.4	0.4	77.6	101.5	101.8	22.2	6.5	522.0	45.0
Bulgaria	2.6	0.8	38.1	102.6	100.4	8.0	75.2		
Croatia	45.9	0.4	56.2	76.3	66.4	8.9	0.0		
Cyprus	1.2	0.5	92.8	99.7	0.0	1.2	0.0		
Czech Republic	1.6	1.5	40.8	97.5	109.8	29.1	100.0		
Denmark	0.8	0.4	38.7	44.8	-7.2	14.9	0.0	34.0	
Estonia	11.1	1.3	4.8	129.6	100.0	32.0	46.2		
Finland	2.6	1.2	42.1	95.1	100.6	66.8	67.4	742.0	
France	0.2	0.4	47.6	98.4	104.5	13.3	16.8	8689.0	25156.0
Germany	0.6	0.6	67.1	97.3	100.1	29.7	65.2	7390.0	8076.0
Greece	1.7	0.1	74.1	95.7	99.0	26.3	39.0	25.0	187.0
Hungary	2.1	1.4	69.7	86.6	115.2	44.6	95.0		
Ireland	0.1	0.4	68.7	98.8	53.0	4.7	0.0	1425.0	2.0
Italy	0.7	0.6	77.5	92.5	95.1	12.5	43.3	9244.0	25310.0
Latvia	10.1	1.4	43.9	100.2	100.0	20.3	100.0		
Lithuania	7.9	1.0	75.2	100.8	100.0	68.8	41.8		
Luxembourg	0.0	0.2	95.0	100.4	100.0	0.0	27.2	4585.0	
Malta	16.2	0.2	97.3	97.8	103.6	8.2	0.0		
Netherlands	4.0	0.4	64.3	101.1	25.9	21.0	26.3	1472.0	6588.0
Poland	2.2	0.9	45.2	97.3	82.4	67.5	54.9		
Portugal	0.2	0.2	73.9	98.1	99.9	4.0	9.7		149.0
Romania	1.0	0.5	30.3	65.4	23.2	32.8	44.8		
Slovakia	3.5	1.8	69.8	101.3	136.6	78.4	85.4		
Slovenia	0.6	1.6	52.1	101.4	99.2	12.9	8.7		
Spain	0.2	0.2	75.0	101.8	101.5	5.6	10.4	818.0	812.0
Sweden	0.2	0.4	30.0	106.8	100.0	12.9	12.7		
Norway	0.3	0.2	-567.3	-776.6	-1905.0	10.6	30.0		
Switzerland	0.4	0.4						2778.0	3725.0
United Kingdom	0.8	0.1	34.8	27.8	49.8	12.2	6.4	13686.0	3042.0

*A dependency rate above 100% includes re-exports. Negative rates mean the country is a net exporter of energy.

Sources: BIS, IMF, Eurostat, CEIC Data

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