Holger Schmieding, Chief economist | holger.schmieding@berenberg.com | +44 7771 920377

PUTIN'S AGGRESSION: SUMMARY OF THE POTENTIAL IMPACT

Berenberg Macro View

Vladimir Putin has escalated his aggression against Ukraine. In a clear breach of international law and the Minsk ceasefire accords, he has recognised the separatists entities in Ukraine‘s Donetsk and Luhansk regions as “independent” and is sending Russian forces into these regions. The US has reacted with first sanctions, European and further US sanctions look sets to follow today. The big uncertainty remains: Only Putin may know whether he will stop here – or whether moving Russian troops openly into Donbas is another step towards an invasion of free Ukraine. If he stops here, sanctions would weaken the Russian economy over time with very limited impact on the advanced world. Markets would return to normal after a while. But as Putin continues to escalate the situation, the text below summarises our assessment of the potential consequences if Putin launches an invasion of free Ukraine.

A Russian war against Ukraine would be a human tragedy and arguably the worst global security threat since the Cuban missile crisis of 1962. The potential economic, financial, and political impact on Europe could come in three stages:

SHORT-TERM IMPACT (1-2 months)

- Further significant risk-off move in markets amid unusual uncertainty followed by a rebound once the outlook becomes clearer
- Temporary setback to European business and consumer confidence
- Rebound in economic growth from Omicron setback delayed by up to two months, but recession (2 quarters of GDP contraction) unlikely
- Some further rise in energy inflation (but Europe beyond peak vulnerability as winter is largely over)
- ECB/BoE to tread more cautiously at their March meetings, even stronger emphasis on keeping options upon charting the course of stimulus removal
- Political shock to Europe
- Tougher times for friends of Russia such as France’s Marine Le Pen ahead of the French elections in April

MEDIUM-TERM IMPACT (3-12 months)

- Markets return mostly to previous trends
- Economic growth in Europe back on track for strong post-Omicron rebound amid easing supply shortages
- Inflation stays slightly more elevated (by c0.3 ppt) due to somewhat higher energy prices
- Monetary policy returns to path that seemed likely beforehand
- Gradually mounting economic problems in Russia due to sanctions, self-isolation and the costs of imperial overstretch
- Significantly stronger political cohesion within EU and NATO in response to Russian threat

LONG-TERM IMPACT (beyond one year)

- No significant impact on European growth
- Faster diversification away from Russian oil and gas, more spending on renewables plus nuclear power and on hydrogen for storage of energy
- More military spending

- Right-wing populist challenge to cohesion of EU recedes as Putin's Russia loses its allure and the means to finance its fans among the European populists
- Geopolitical impact to depend partly on 2024 US election (moderates win = stronger NATO; return of Trump-style "America first" = US-European alliance severely strained)
- Progressive weakening of Russian economy which, like the Soviet Union before, falls ever more behind the advanced world, see The Russia gap: Chart of the Week from 18 February 2022

Key assumption: Russia does not go on to attack a NATO member, which even the Soviets never did.

One way or the other, coping with a heavily armed Russia mired in relative economic decline will be a key challenge for Europe and the US for the foreseeable future. Putin's ex-KGB "silovki" seem to be more afraid of democracy in Ukraine than of Chinese autocratic assertiveness. With Moscow's remaining semi-liberals ever more side-lined, an underperforming Russia may become more vulnerable to Chinese pressures to turn into a vassal of Beijing in the long run.

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