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What to watch: Two years of war in Ukraine – impacts on Russia and Europe

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Executive summary

This week marks two years since the Russian invasion of Ukraine, which sent energy prices and inflation surging, intensifying monetary tightening around the world. In this edition, we take stock of the economic consequences, for the Russian economy, energy markets, Europe and capital markets:

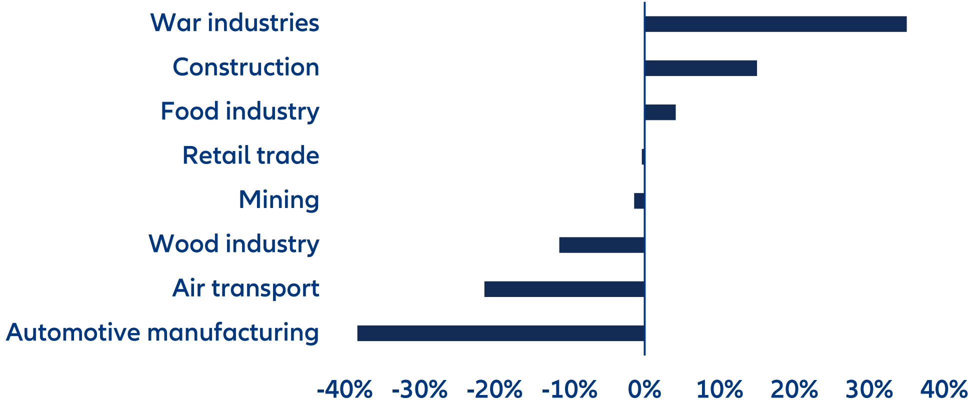
- **Russia: strong growth reflects war economy rather than resilience.** Stronger-than-expected real GDP growth in 2023 (+3.6%) reflects the redeployment of resources towards war industries and construction, disguising the underperformance of most other sectors. We forecast growth of +2.5% in 2024. Withdrawals from the National Wealth Fund will ensure that Russia's fiscal deficit will remain manageable this year but financing may become challenging thereafter. The current account surplus narrowed markedly in 2023 as exports plunged while imports rebounded, helped by sanctioned EU exports still making their way into Russia through third countries. However, foreign investment has dried up as investors shy away from Russia.
- **Energy markets: unplugging from Russia comes at a great cost.** Europe is managing successfully through a second winter without Russian gas, thanks to energy savings and increased LNG flows. But energy prices are still +35% higher, and Europe has also doubled subsidies to fossil fuels to shield households and firms. The only silver lining comes from the rising weight of renewables in the energy mix – but that effort needs to be sustained over the longer run.
- **Europe: double the inflation, double the interest rates.** We calculate that the war pushed Europe's already-high inflation up by an additional +5pps, prompting the ECB to hike rates by +200bps more than it would have in the absence of the war in Ukraine. European corporates have benefited from pricing power, keeping profitability resilient. But households' purchasing power has dropped, with energy and food bills jumping by EUR673 and EUR1,316, respectively, despite substantial government support (4% of GDP on average) that has stretched European public finances even further.
- **Capital markets: higher bond rates, higher volatility.** Although capital markets seem to be regaining some bullish traction and corporates' growth engines seem more resilient than previously anticipated, the additional ECB rate hikes have led to an extra 50-70bps being added to the long-end of European sovereign curves, an extra 5 to 10% decline in equity market performance and an around 40-50bps extra widening of corporate spreads, which has led to substantial additional losses in EUR exposed portfolios.

Russia: strong growth reflects war economy rather than resilience

The Russian economy rebounded stronger than expected in 2023, driven by firm domestic demand. Real GDP grew by +3.6% last year, according to preliminary data released by Rosstat last week, marking a recovery from the -1.2% contraction in 2022 (revised up from -2.1% previously). A partial expenditure breakdown showed that the upturn was driven by surging fixed investment (+10.5%), a recovery in consumer spending (+6.1%) on the back of strong wage growth and a tight labor market, as well as a record-high increase in government spending (+3.6%). Low base effects from 2022 – when sanctions and decoupling from Europe caused a recession – also helped. Rosstat has withheld real export and import data but we estimate from the available information that net trade subtracted about -2.5pps from overall growth in 2023.[1] This suggests that real exports performed significantly worse than real imports last year.

However, Russia's economic outperformance reflects the redeployment of resources towards war, disguising the underperformance of the rest of the economy. On the supply side, growth in 2023 was mainly boosted by strong expansion in industries linked to the war, construction and retail sales. War industries and construction in particular have surged in the past two years, with their 2023 output being +35% and +15% higher than in 2021, respectively (Figure 1). On the other hand, output in the automotive and air transport sectors was well below pre-war levels in 2023.

Figure 1: Real output growth from 2021 to 2023 in selected Russian sectors

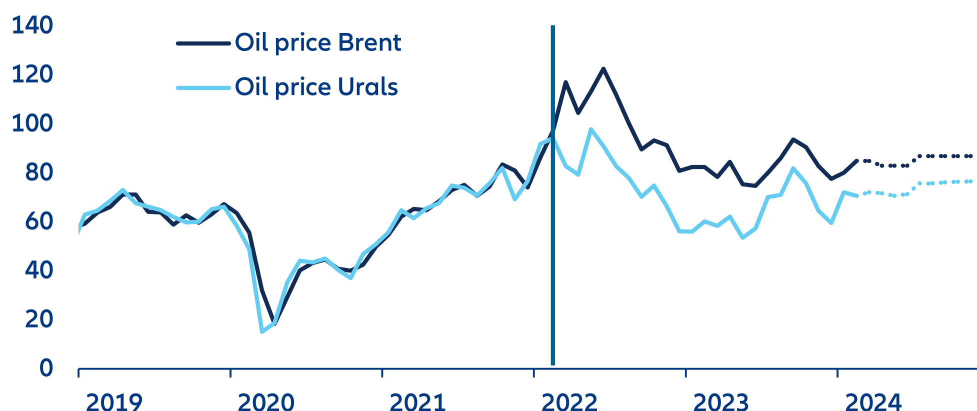


Sources: Bank of Finland Institute for Emerging Economies, Rosstat, Allianz Research. Note: War industries is a proxy measure comprising sectors linked to the war effort (for example manufacturing of fabricated metal products, electronics and other transport equipment).

We forecast Russia's economy to moderate to about +2.5% growth in 2024. Base effects have faded and monthly data for industrial production and retail sales suggest that output expansion has slowed in recent months. Going forward, inflation is projected to remain elevated, averaging 6.5% or so this year (after 7.4% y/y in December and January), in part due to labor shortages and high real wage growth (nearly +8% in 2023). As a result, the Central Bank of Russia (CBR) should keep monetary policy tight; last week it kept its key policy rate unchanged at 16% and we forecast an end-year rate of around 11%. That said, economic activity will continue to be supported by high government spending and investment, especially in sectors linked to the war. Oil flows to China, India and Turkey will also offer some respite on the external trade front. The oil-price spread between Brent and Russian Urals has in the meantime narrowed to around 10 USD/bbl from 25 USD/bbl a year ago (Figure 2). However, Russian gas exports will continue to suffer as the vast majority of Russia's gas pipelines are connected to the EU, and less than 10% of the country's gas capacity is LNG.

[1] *Following the imposition of rigorous sanctions by Western countries, Russia has been selective in publishing (quarterly) national accounts statistics and stopped releasing detailed data on public finances, balance of payments, external trade and FX reserves, making it challenging to project economic developments. Moreover, the announced annexation of four occupied Ukrainian regions in September 2022 is likely to further distort Russian statistics.*

Figure 2: Oil prices (USD/bbl)



Sources: LSEG Datastream, Allianz Research

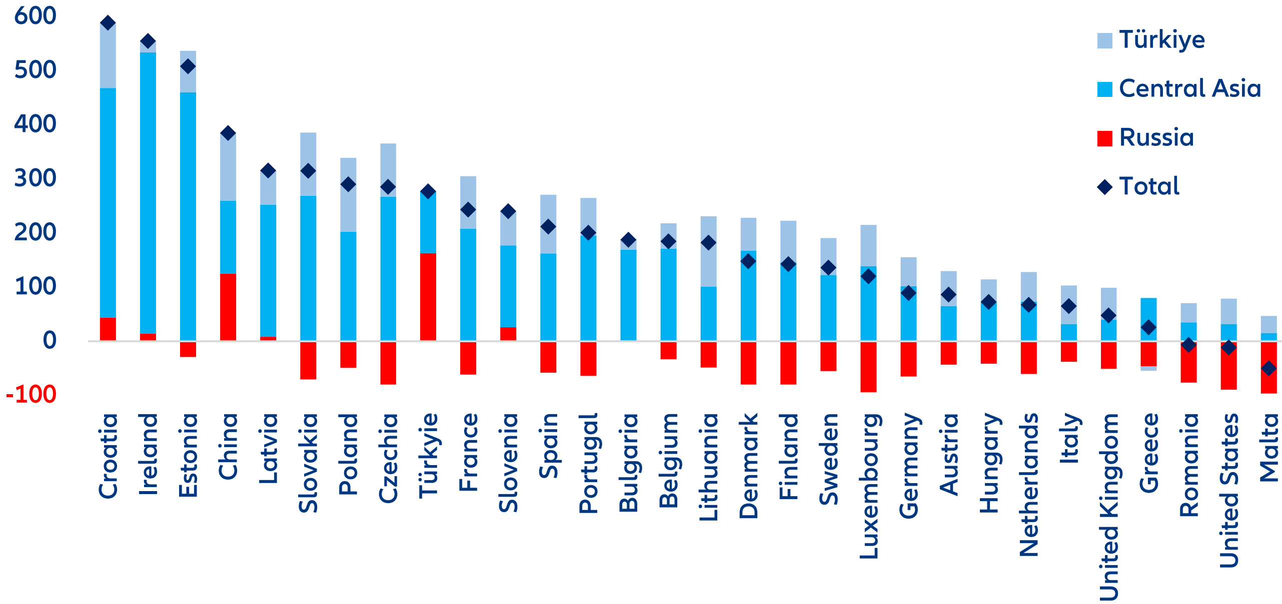
Russia's fiscal deficit will remain manageable in 2024 but financing may become challenging thereafter. In 2023, government fiscal revenues increased broadly in line with expenditures since the RUB exchange rate functioned as an automatic stabilizer. Thanks to the -18% RUB depreciation last year, the RUB value of export revenues received in foreign currency increased and thus fiscal revenues also rose in RUB terms. As a result, the fiscal deficit was contained at around -2% of GDP in 2023. For this year we forecast a similar shortfall on the back of a projected -15% depreciation of the RUB. To finance the deficits, the Ministry of Finance has increasingly shifted to withdrawals from the National Wealth Fund (NWF, a sovereign wealth fund). On 1 February 2024, liquid NWF assets were estimated at RUB5trn, or USD55bn, equivalent to 2.9% of GDP or so. This is down from approximately RUB7trn (USD100bn, 4.5% of GDP) a year ago.[2] Overall, we can conclude that a projected fiscal deficit of -2% of GDP in 2024 will be manageable for the government and allow it to fund military activities for at least another year. Beyond 2024, however, it will become increasingly difficult to finance budget shortfalls through NWF drawdowns. Moreover, the latter would have crucial medium- and long-term effects for the economy and the welfare of the Russian people.

Russia's current account surplus narrowed significantly in 2023 and should remain modest in the coming years. Russian exports of goods and services (in USD) declined markedly by -27% y/y in 2023 owing to stepped-up Western sanctions and the relative normalization of global oil and gas prices. It stood at -16% below the pre-war level in 2021. At the same time, imports recovered last year from their decrease in 2022 and came in on par with 2021. As a result, the current account balance narrowed from a record USD238bn (+10.6% of GDP) in 2022 to USD51bn (+2.5% of GDP) in 2023, which compares to a long-term average of +5.3% of GDP.

Despite sanctions-enforcement efforts, EU goods are still making their way into Russia through third countries. Trade data suggests that EU-sanctioned products are being exported from the EU to nations such as Türkiye and Central Asian countries which have close ties with Russia and have not imposed sanctions. Goods entering the Eurasian Customs Union face minimal checks, facilitating this flow. While most Western countries have significantly reduced their direct exports to Russia, EU exports to Türkiye rose by +106% on average between 2019 and 2023 and Central Asian economies saw a significant +172% increase during the same period (Figure 3). These trends coincide with increased trade between these regions and Russia, indicating a potential circumvention of sanctions.

[2] *Total NWF assets stood at USD134bn on 1 February 2024. The liquid assets of the NWF are held at the CBR and thus part of the CBR's official FX reserves. The illiquid assets of around USD79bn include an estimated USD55bn that were frozen due to Western sanctions in 2022 while the remainder has become illiquid because the government has used it since to support state-owned companies (for example deposits in state banks, investments in stocks, corporate bonds).*

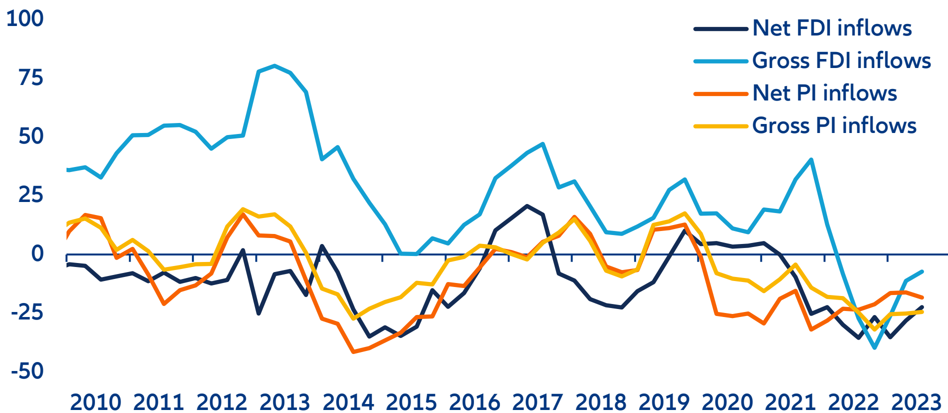
Figure 3: Growth in exports to Russia, Central Asia and Türkiye, 2019 to 2023, in %



Sources: National statistical offices, COMEXT, IMF DOTS, Allianz Research

Meanwhile, foreign investment has dried up significantly as investors shy away from Russia. The lack of new investment has been evident since the full-scale invasion of Ukraine, with greenfield investment inflows dropping by -95% compared to pre-invasion levels. The number of announced greenfield foreign direct investment (FDI) projects in Russia has plummeted, with only 13 projects recorded for 2022 and nine for 2023. Direct investments in Russia have also decreased by more than -19%, leading to a decline in the value of foreign assets in the country from USD381bn at the end of 2022 to USD308bn at the end of September 2023. The share of Western European investors, which previously accounted for half of Russia's greenfield investments, only made up 18% in 2023. In addition, many companies have scaled back or completely ceased their activities in Russia. By July 2023, 1,028 companies had left the country, including 32% from the US, 11% from the UK and 7.6% from Germany. These developments are also reflected in Russia's financial account, which shows that the country has recorded gross FDI outflows in the last two years for the first time since 1994 (Figure 4). This also shows that the countries that did not impose sanctions on Russia and have replaced some of the trade that Russia has lost with Western countries are not willing or able to invest in Russia on a large scale. More generally, plunging foreign direct and portfolio investments have pushed Russia's capital account deep into negative territory and we expect this to continue in the coming years.

Figure 4: Foreign direct investment (FDI) and portfolio investment (PI) flows (USD bn)

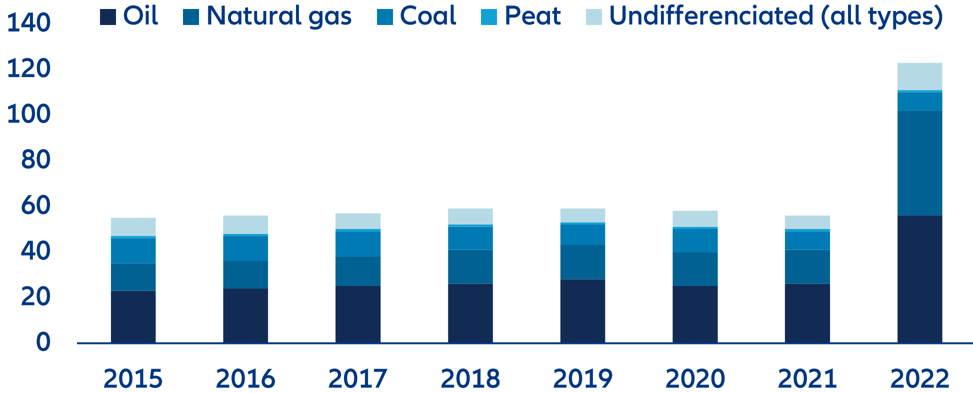


Sources: Central Bank of Russia, Allianz Research

Energy markets: unplugging from Russia comes at a great cost

Europe is successfully managing its second winter without abundant Russian gas. But it is paying the price in the form of higher subsidies for fossil fuels. Sanctions and delivery cuts sent already high energy prices even higher in 2022. But thanks to strong storage – close to 90% in September 2023 – a steady flow of pipeline gas from Norway and LNG mostly from the US, as well as significant energy savings (-10% in energy consumption), Europe has managed to navigate through the energy crisis. Expecting seaborn gas to continue to flow, a large number of LNG terminals are planned, including six in Germany, with a combined capacity of 55bn cubic meters (bcm), and another five in Greece, with a combined capacity of 27.4bcm. Such projects would increase and rebalance the regasification of the continent as the majority of existing terminals are located in France, Italy and the Iberic peninsula. Although Europe continues to manage the tight supply quite smoothly from a volume perspective, this has come with a hefty price. First of all, electricity prices remain elevated in Europe, and gas prices, despite being lower than the peaks seen in 2022, are highly volatile. In August 2023, European gas prices jumped by almost +40% because of a potential strike at LNG plants in Australia. More recently, they increased by close to +10% over fears related to the conflict in Gaza. Second, governments across Europe had to support households and corporates struggling with higher energy prices. As a result, subsidies to fossil fuels in the EU more than doubled in 2022 compared to 2021 (Figure 5). Most of the 2022 subsidies were maintained in 2023 and many governments have no concrete plan for how and when they will be phased out, given the risks of backlash from recipients.

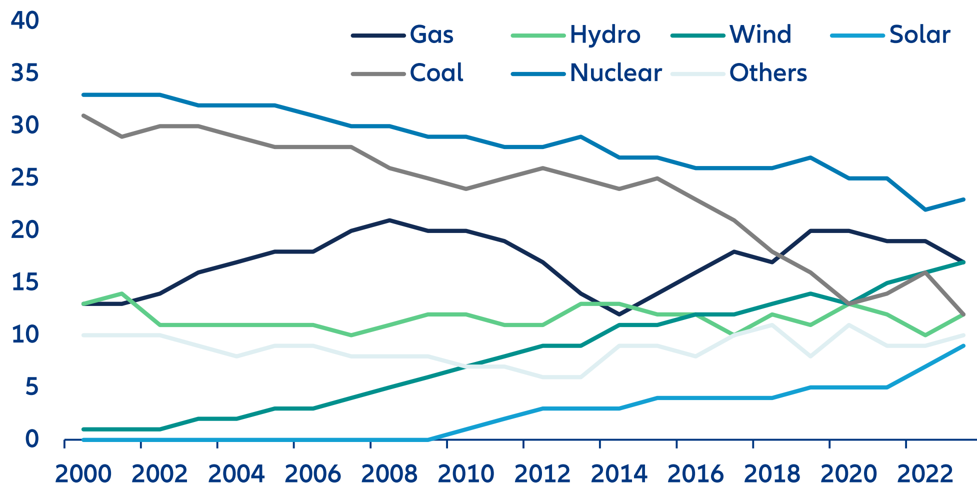
Figure 5: Fossil fuel subsidies in the EU



Sources: European Environment Agency, Allianz Research

There is one silver lining: the region's electricity mix is getting greener. Although there were initial concerns that the energy crisis could spark a strong come-back of fossil fuels, and especially coal, fossil fuel power generation is decreasing significantly in the EU. More importantly, renewables are growing strongly. In 2023, renewables accounted for 44% of the EU's electricity generation. In fact, wind generated more power than natural gas for the first time (Figure 6). This milestone was achieved thanks to both strong generation from wind but also falling electricity demand, which contributed to the drop in fossil-fuel generation. Demand for electricity fell for a second consecutive year in 2023 by -3.4% y/y after -6.4% y/y in 2022. However, with the electrification of transportation, demand will likely recover and increase in the future. In this context, the EU will need to keep up and continue to bolster renewables.

Figure 6: EU electricity generation by source (% of total)

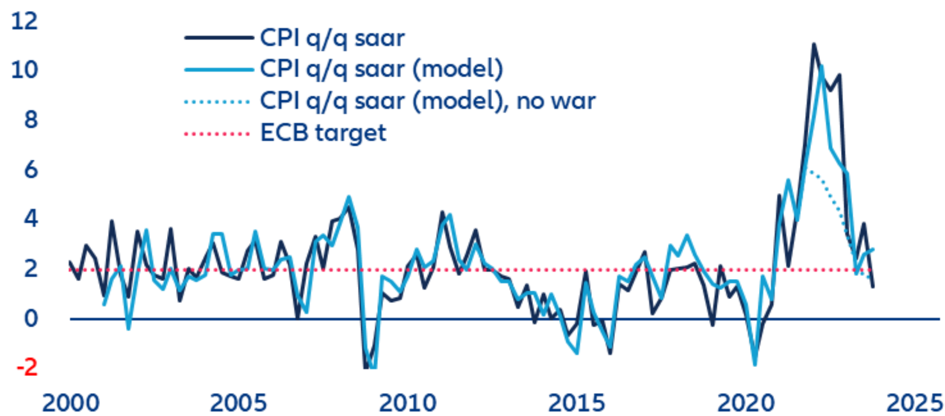


Sources: Ember, Allianz Research

Europe: double the inflation, double the interest rates

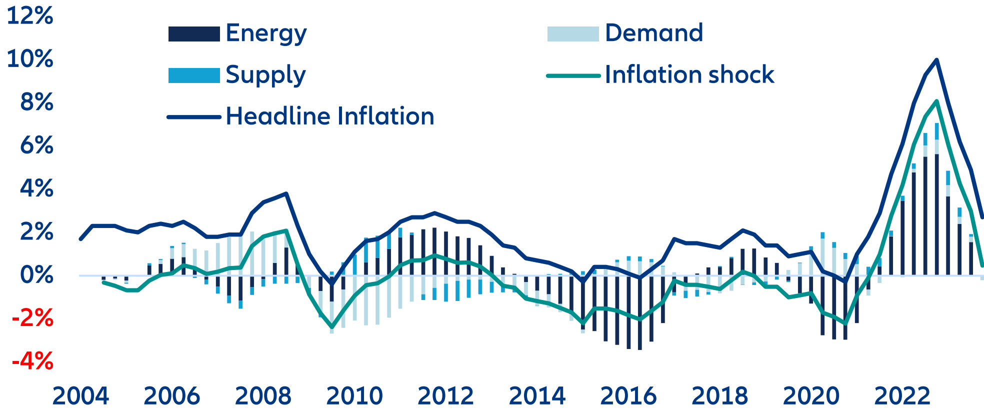
Without the war, Europe's already-high inflation would have been around -5pps lower. While the USD benefited from its safe-haven status, the US's comfortable net energy exporter position and a favorable shift in terms of trade, the euro felt the pressure of proximity to the conflict. Had oil prices and inflation expectations remained stable, and the EUR not lost value against the USD, we estimate inflation would have been 5pps lower compared to historical levels (Figure 7). An inflation decomposition model confirms that energy contributed most to the inflation shock in 2022 – not demand (Figure 8). A lower inflation path would have resulted even though the output gap would have dropped less after 2022. GDP growth would have been around +0.8pp stronger in 2022-2023 since consumers would have been able to spend more in real terms amid lower energy and food inflation (see below).

Figure 7: An alternative inflation path for the Eurozone in the no-war scenario (%)



Sources: LSEG Datastream, Allianz Research

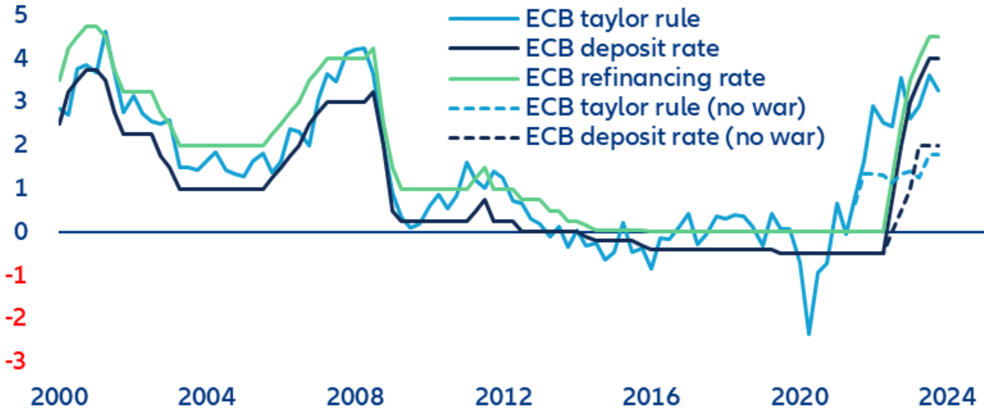
Figure 8: Eurozone inflation shock decomposition



Sources: LSEG Datastream, Allianz Research

Lower inflation would have allowed the ECB to be less hawkish, leading to rates increasing only by 250bps instead of the 450bps observed so far. A simple Taylor rule model with interest-rate smoothing indicates that the significantly lower inflation path in a no-war scenario would have led to less pressure on the ECB to tighten rates as much as we have seen so far. Instead of raising the deposit rate from -0.5% to 4.0% between July 2022 and September 2023, raising it to 2.0% would have sufficed to achieve a similar pattern (Figure 9).[3] The most significant contribution to a lower model-implied policy rate stems from the 5pps lower inflation, despite a less negative output gap amid higher GDP growth. However, the positive impact of a less hawkish ECB on economic growth would have been lower than one might expect since the real interest rate would have remained higher for multiple quarters in the no-war scenario due to the significantly lower inflation rates.

Figure 9: ECB policy rates and Taylor rule (%)



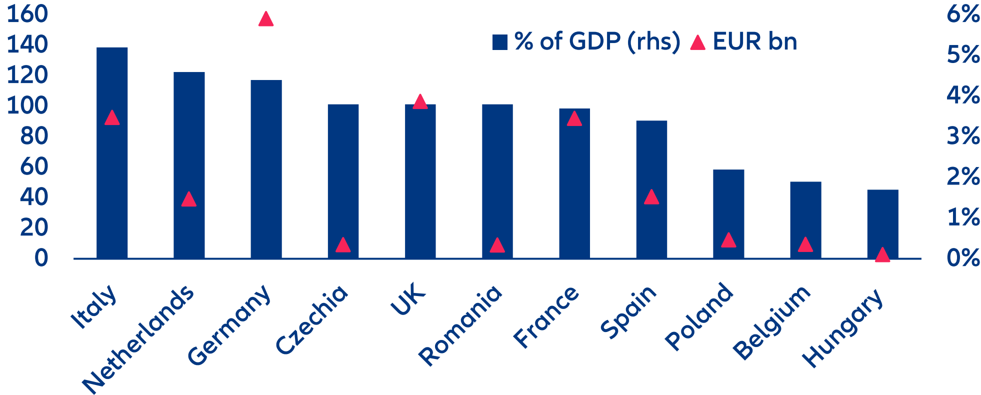
Sources: LSEG Datastream, Allianz Research

The war has also stretched Europe's public finances further, though the inflationary burst helped reduce the public-debt-to-GDP ratio. After the large financial efforts made by European governments during the pandemic, we would have expected a gradual return to at least pre-Covid-19 fiscal trends (and so narrowing fiscal deficits). However, policymakers had to step up again to counteract the negative effects of the energy crisis triggered by the war (Figure 10). Moreover, public-debt-to-GDP dynamics estimated before the Ukraine war would have encountered different paths and directions. For instance, in Germany, we would have expected a more decisive reduction of the debt ratio in a no-war scenario while in France public debt was expected to decrease at a slower pace. On top of the effect of the revised denominator, the main driver of the downward forces was the so-called snowball effect (the differential between interests paid on debt and nominal growth). On the other hand, the expansion of the countries' primary balances has counteracted the positive effect on the ratio. The comparison at

[3] In the alternative scenario we did not change the late response of the ECB to already high inflation rates during 2021 reflected by the much earlier hiking cycle implied by the Taylor rule.

the end of 2023 with a no-war scenario is negligible for Germany while France and Italy have seen their debt-to-GDP ratios turn out lower by 9pps and 13pps, respectively (compared to 120% and 154% in a no-war scenario).

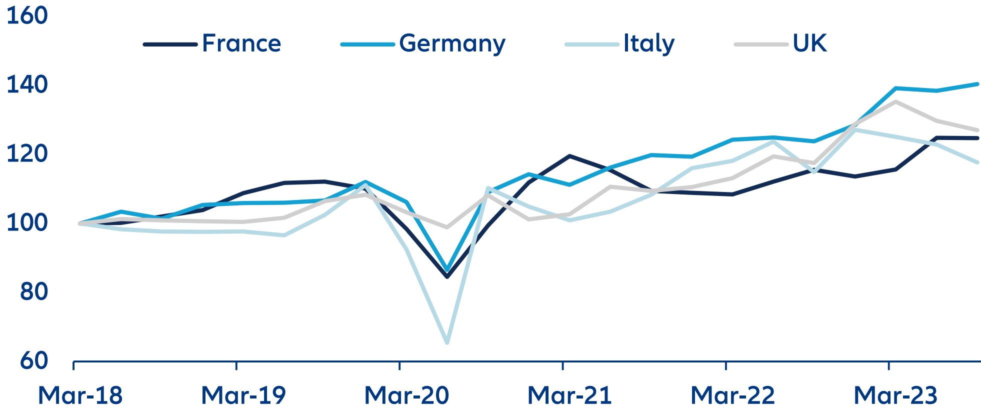
Figure 10: Government support to shield households and firms from higher energy prices (period 2021- Q1 2023)



Sources: Bruegel, Allianz Research

European corporates mostly benefited from war economics as they could pass on the rise in input prices to selling prices… Despite the initial shock (Figure 11), corporate profits recovered quite rapidly and were even above trend as of end-2023 in Germany, thanks to strong pricing power and resilient demand. Some sectors, such as transportation and oil & gas, benefited more than others but overall profitability in Europe has remained robust. However, the real challenges lie ahead as demand is weakening, higher financing costs are biting and elevated energy prices will continue to dampen European firms' competitiveness.

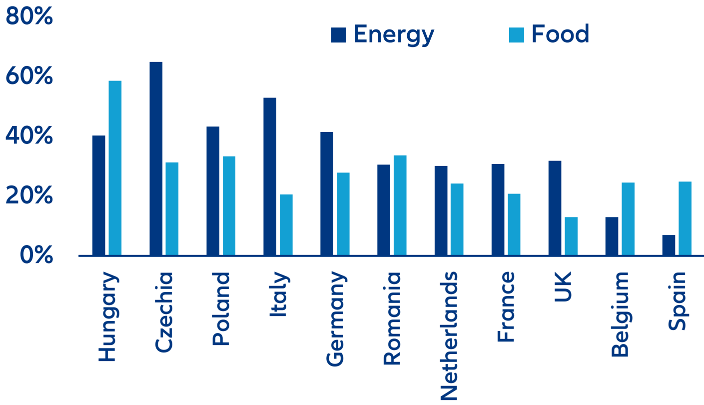
Figure 11: Corporate profits (2018=100)



Sources: LSEG Datastream, Oxford Economics, Allianz Research

…while European households have seen an immediate loss of purchasing power: On average, the energy bill increased by EUR673 and the food bill by EUR1,316. Overall, the cost to GDP growth has averaged -0.8pp over the two years, with the swift fiscal policy response preventing an additional -2pps loss. On average, European consumers still face energy prices that are +35% above pre-war levels and food prices that are +28% higher, especially in Hungary, Czechia, Poland, Italy and Germany (Figure 12). In absolute terms, overall food bills have increased more than energy bills, except for Italy and Czechia where the increase has been relatively similar and high (Figure 13). We estimate the impact on GDP growth of increased energy and food costs for households alone ranged from -0.4pp in the Netherlands to -1.6pps in Romania, with an average of -0.8pp in the main Western and Eastern European economies (Figure 14). Had governments not massively subsidized energy prices by a total of 4% of GDP in the EU and the UK, either through direct support or tax cuts, average GDP growth in 2022-23 could have been up to -2pps lower.

Figure 12: Energy and food consumer prices, increase in 2022-2023



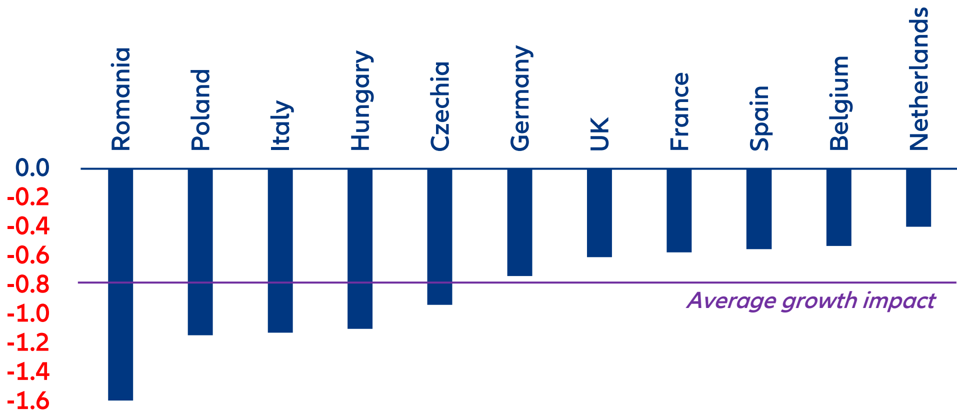
Sources: various, Allianz Research

Figure 13: Increase in energy and food bills per household by country, 2022-2023 (GBP for the UK, EUR for others)

	Energy	Food
Germany	1078	1759
Spain	106	1370
France	568	1308
Italy	1294	1224
Belgium	334	1784
Netherlands	713	1626
UK	857	876
Czechia	1004	1036
Hungary	502	1565
Poland	659	1089
Romania	410	967
Average	**673**	**1316**

Sources: various, Allianz Research

Figure 14: Impact of increased energy and food costs for households on GDP growth, 2022-2023 (pps)

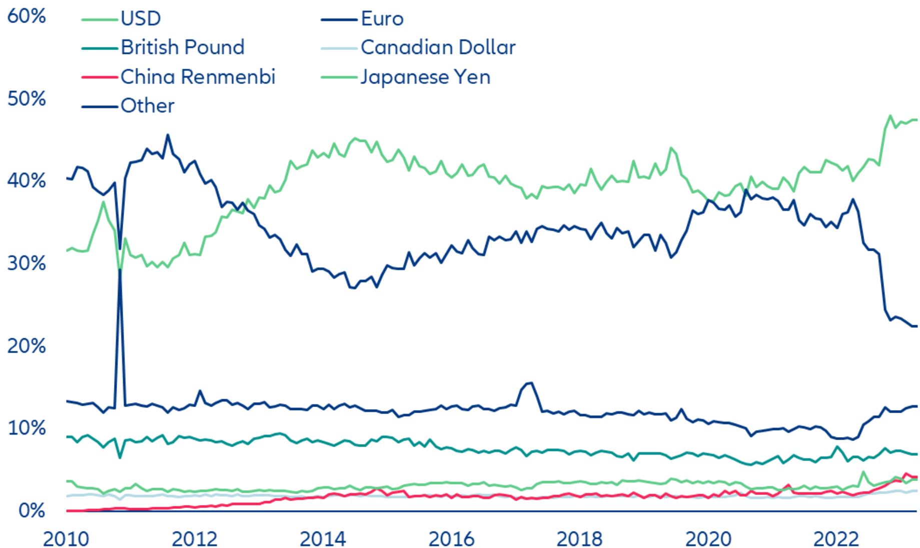


Sources: various, Allianz Research

The euro is also falling out of favor in SWIFT transactions for the first time since the sovereign debt crisis, another sign of the geopolitical uncertainty weighing on the outlook. Research suggests that there is a significant degree of inertia in the use of currency for cross-border payments, which reflects strong network effects and switching costs. Yet, since mid-2023, the use of the euro in SWIFT transactions has declined, with the USD gaining market share. The

last time this happened was during the sovereign debt crisis in 2012-2013, suggesting an increased risk perception over the region's economic outlook.

Figure 15: Evolution in share of currencies in SWIFT payments

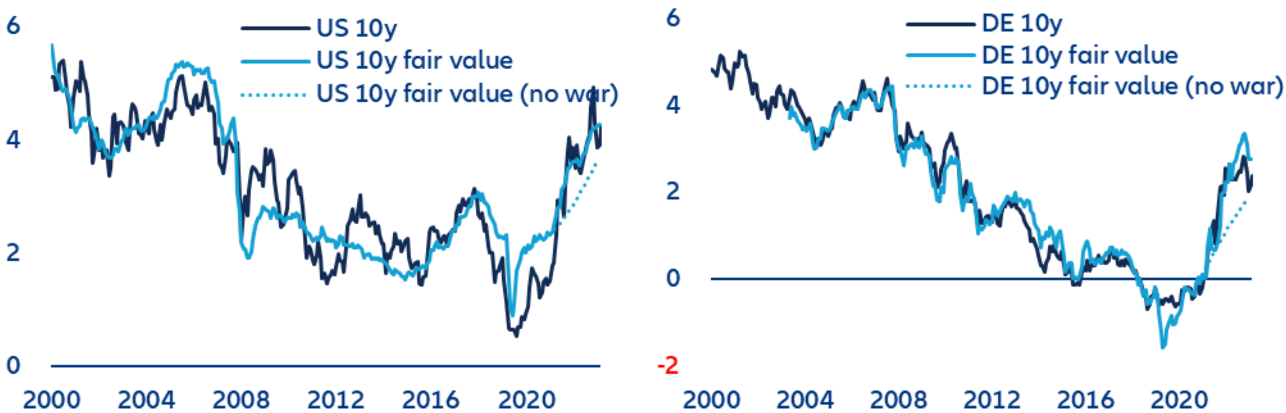


Sources: Refinitiv, BIS, Allianz Research

Capital markets: higher bond rates, higher volatility

Without the war, long-term government bond rates would have been lower. Again assuming that the ECB had only raised policy rates by 250bps instead of 450bps, and assuming less aggressive quantitative tightening as well as a lower increase in inflation expectations, 10-year rates in Germany would have increased only to around 1.9% instead of the current 2.4%. In the US, the Fed would have likely also refrained from hiking rates as much as it did, given that lower energy prices were also felt in the US; however, inflationary pressure in the US was overall less impacted by Russia than in the Eurozone. A model-based estimate would have seen US 10-year rates increasing to around 3.6% compared to the current 4.3% (Figure 16).

Figure 16: Long-term government bond yields in the US and Germany

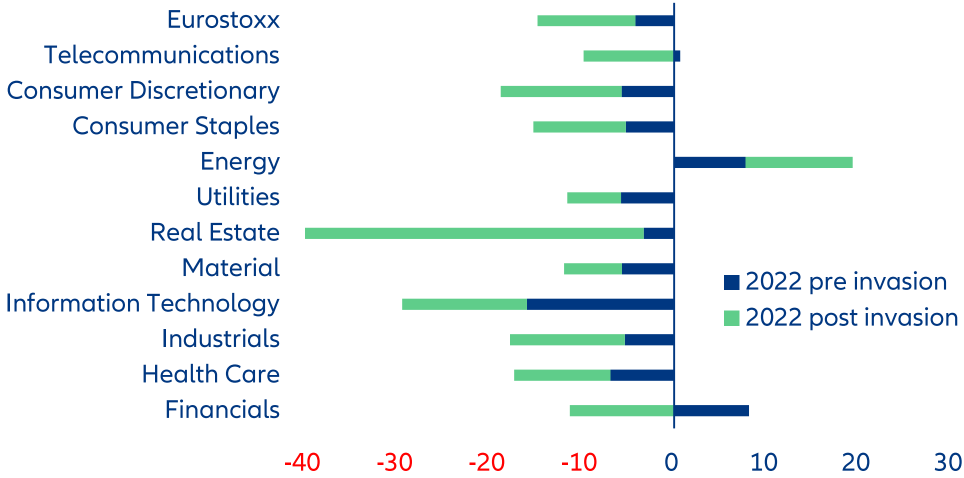


Sources: LSEG Datastream, Allianz Research

Financial markets would have also seen far less volatility, partially mitigating the observed market downturn. However, the momentum from the reflationary trends tied to the economic reopening would not have fully reversed the established bearish inclinations. Before the invasion, market participants were already adopting a cautious stance due to the surfeit of liquidity and the strategic use of accumulated savings from the Covid-19 period, which heightened the risks of tightening by central banks. Consequently, investors had already factored in the anticipated additional rate hikes stemming from the potential volatility in commodities, particularly in the energy sector. In this

environment, interest-rate-sensitive sectors suffered the most, with "overvalued and overleveraged" sectors such as real estate taking a big hit during the initial exponentially shaped inflation acceleration (Figure 17). In numbers, the Eurostoxx tanked around 4% until the invasion, already pricing in a market deceleration due to higher central bank rates and the subsequent readjustment in both valuations and relative attractiveness. It then fell by %, and a further 10% afterwards as it proceeded to price in an even steeper policy path and stagflationary winds.

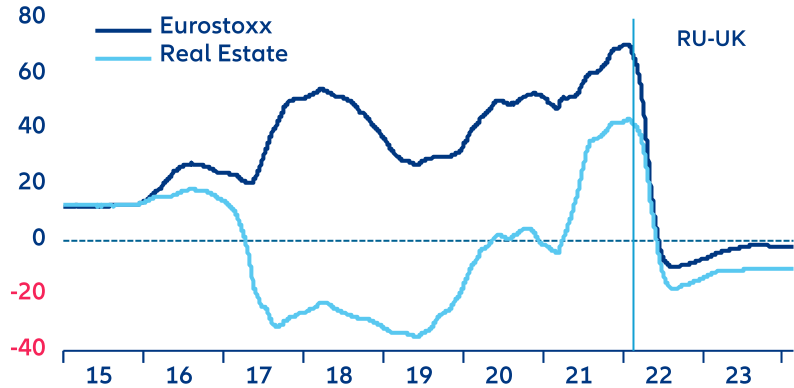
Figure 17: Eurostoxx 2022 performance breakdown by sector (in %)



Sources: LSEG Datastream, Allianz Research

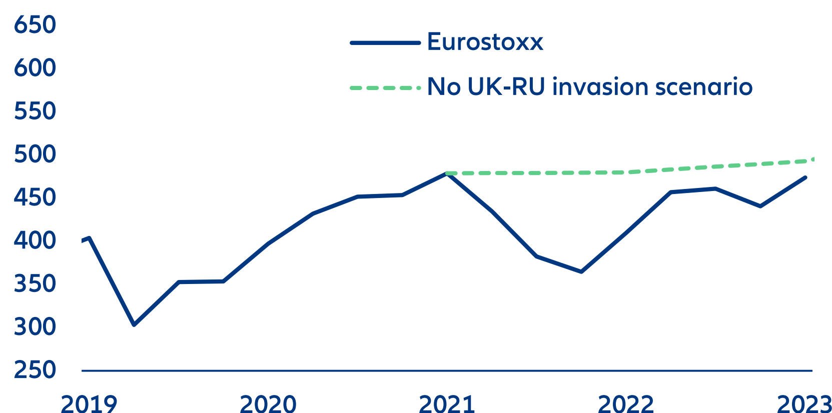
In other words, the invasion precipitated an immediate shift in market dynamics. The conflict transformed the previously mild view of inflation and the role of equities as a hedge against it into a scenario where the fear of stagflation led to a drastic reevaluation of assets. This shift resulted in a negative correlation between equity values and inflation/short-term interest rates, prompting a significant market correction. Specifically, the additional 200bps in rate hikes prompted by the invasion translated to an estimated 8% to 10% additional decline in the Eurostoxx index in 2022, and a 20% downturn in the real estate sector. Had the invasion not occurred, the transition from benign to harmful inflation would have been more gradual, causing only slight negative impacts on the overall index and a lesser effect on sectors sensitive to interest rates (Figure 18). Overall, the trajectory of stock market performance would have been relatively stable, albeit slightly negative, in 2022 (approximately 0%), and would have trended positively in 2023 (between 5 to 10%). This hypothetical scenario suggests that investors and market participants could have avoided the sharp downturn and subsequent rapid recovery, often described as a V-shaped correction and rebound, that actually transpired in 2022 and 2023 (Figure 19).

Figure 18: Rolling Beta between short-term rates and equity performance



Sources: LSEG Datastream, Allianz Research. Note: 3y rolling beta between short-term rates and equity performance

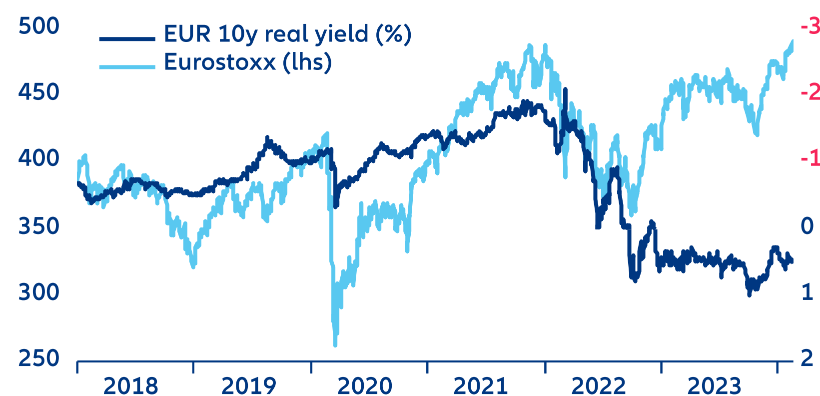
Figure 19: Eurostoxx no conflict simulation



Sources: LSEG Datastream, Allianz Research

But the rebound in 2023 was mainly driven by a select group of top-performing companies , which somewhat obscures the mid- to long-term effects of the war in Ukraine. Despite the negative pressure on stock valuations and attractiveness, the broad European equity index posted double-digit positive returns in 2023 on the back of strong earnings and margins (Figure 20). This represents a significant win for investors in broad market indices, though it somewhat obfuscates the reality that the remainder of the index has not, and does not, perform as impressively as the top 10% of companies. This underscores the disparity within the broad European indices, where a few high performers can skew the perception of overall market health.

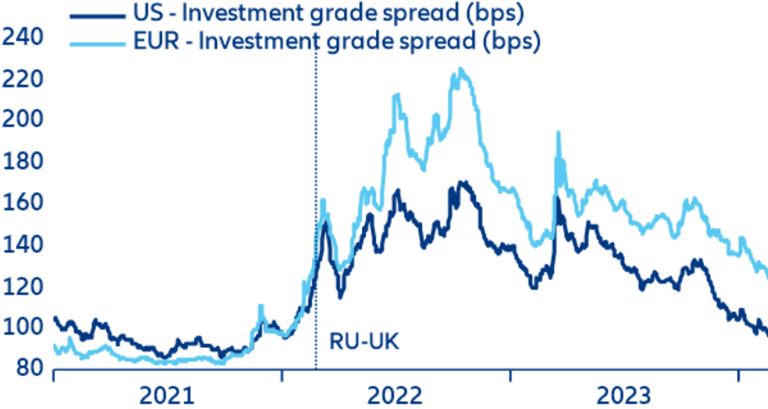
Figure 20: EUR Real yields vs Eurostoxx



Sources: LSEG Datastream, Allianz Research

The equity story also extends to corporate debt, which is often closely tied to equity market performance, particularly during periods of market declines. Using the US as a hypothetical alternative, the absence of an invasion would likely have mitigated much of the divergence observed between the two regions. Even if the two regions are comparable, European corporates have faced more challenges, remaining on the bearish side primarily due to differences in funding sources, earnings generation and proximity to the conflict. In this regard, European companies were less proactive than their US counterparts in refinancing during the Covid-19 era, which made them more vulnerable to the anticipated surge in financing costs. In the absence of the war, instead of the widening to approximately 220bps, Euro investment-grade spreads would have aligned more closely with 180bps in 2022, and narrowed further to around 120bps in 2023. This adjustment would have represented a more gradual erosion of creditworthiness than markets had initially braced for (Figure 21).

Figure 21: EUR and US investment-grade corporate spreads (bps)



Sources: LSEG Datastream, Allianz Research

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

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.

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