ODDO BHF

# MACROECONOMIC *view*

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## *Europe-Russia : who will win the economic war?*

### KEY HIGHLIGHTS

- In response to the aggression against Ukraine, Europe is looking to suffocate Russia's economy.
- Sanctions are forcing Russia to live in financial autarky, which is not sustainable.
- But sanctions have a perverse effect as they lead to soaring energy prices, inflating Russian export revenues and penalising European consumers.

*"Do we want to have peace or the air conditioning on [this summer]?"* was how the Italian Prime Minister recently summed up the dilemma facing Europeans in their response to Russia's aggression against Ukraine. Achieving peace means weakening the aggressor, either through military intervention (which was ruled out from the start) or by suffocating its economy. This is the purpose of the sanctions against Russia. They aim to freeze its foreign exchange reserves, prevent it from trading in dollars to push it into default, block its production lines and reduce its exports.

The dilemma stems from the fact that Europe largely depends on Russia for its energy needs and there is no quick way to switch to other suppliers. The consequence would not only be to turn off the air con in summer but also to go without heating in winter and bring much of the European industry to a standstill. The cost of a complete embargo would therefore be a severe recession in Europe and a further rise in inflation. The alternative is to continue buying from Russia, albeit less and less over time, but this amounts to financing Vladimir Putin's war of aggression. By definition, a dilemma forces trade-offs between the immediate and future impacts of each option.

**It should be considered that the economic war between Europe and Russia is playing out on three levels: the energy markets, the financial sector and public opinion.**

**On the energy front, Russia has the upper hand.** Admittedly, as a result of international sanctions, it is selling its oil at a significant discount ($30 per barrel compared to Brent), but as the macro uncertainty spreads to all commodity prices, its export revenues are increasing despite the fall in volumes. While the Western world is prepared to do without Russian oil, other countries, particularly in Asia, are delighted to buy it cheaper than the current spot price. According to Bloomberg estimates, Russia's external surplus over the January-April 2022 period is around $90 billion, about four times as much as over the same period in 2021. In this battle, the only way forward for Europe is to reduce its dependence on Russia as much as possible, either by finding more reliable suppliers or by reducing the share of fossil fuels.

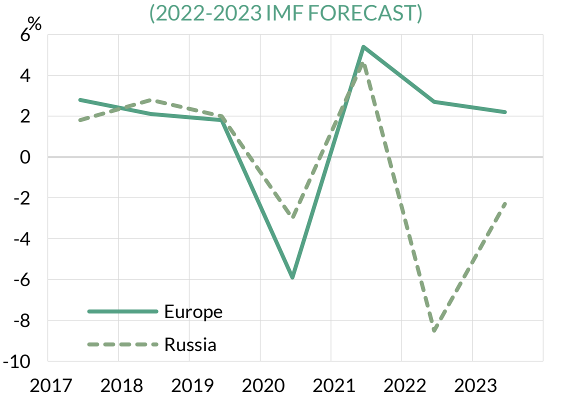
**On the financial front, Russia is now forced to operate in autarky.** After the invasion of Ukraine, capital inflows stopped and the Russian currency collapsed, threatening the country with a wave of bankruptcies.

In similar circumstances, after the invasion of Crimea in 2014, the Russian central bank sold its foreign reserves to stabilise the currency. This time, with reserves frozen, authorities introduced strict foreign exchange controls. Russian companies with foreign currency revenues must exchange them for roubles and capital outflows are prohibited. As a result, the rouble has strongly rebounded but this is an artefact as there are no longer any foreign exchange transactions. Starting from a position of external surplus, Russia can operate in autarky for some time, but this is not sustainable in the long run, especially if the war absorbs all export earnings. The financial restriction on the Russian economy will have a huge cost. Moreover, as the country can no longer receive supplies from Western companies, Russia will experience a chronic shortage of intermediate and final goods, causing a loss of efficiency in the economy and a fall in per capita income.

**In any country where people can freely voice their opinions, such an economic cost would have quickly sparked a social crisis leading either to a change of government or a change of policy. That is not the case in Russia.** We will not make much of Russian propaganda describing a society united behind its leader, but it is a fact that Vladimir Putin, unlike other European leaders, does not have to worry about his public opinion. Let's go one step further, it is likely that the Russian leader is stirring up certain fears (nuclear war) or shortages (food security) in order to divide the opposing camp and bring it to compromises, such as leaving gas outside the scope of sanctions.

The economic consequences of the war in Ukraine are incomparably higher in Russia than in Europe (graph). There is a risk of recession in Europe. In Russia, it is already a certainty. According to international bodies, the contraction of GDP could exceed 10% in two years, a sharper fall than during the pandemic and with no hope of a swift recovery. Economically, Russia may win a few battles, but it cannot win the war.

REAL GDP GROWTH
(2022-2023 IMF FORECAST)




*Sources: ODDO BHF Securities, Thomson Reuters, IMF*

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