

Research Russia-Ukraine

Several signals point to an escalation in the war in Ukraine as Victory Day looms

- **With the May 9 Victory Day approaching, we think Russia is likely to step up their offensive against Ukraine. While we keep our base case of a frozen conflict in Ukraine, in this brief note, we discuss four early signals that could point to an escalation.**
- **Signals emerging in the last two days that point to this direction include: 1) Lavrov's warning of a nuclear war, 2) a potential false flag operation in Russia-leaning Moldovan break-away region Transnistria, 3) Germany's sudden reversal of its earlier decision not to send heavy weapons to Ukraine and 4) Russia's new round of joint military drills with Belarus starting today.**

It is more than two months since Russia started its large-scale attack on Ukraine. Also, it is less than two weeks until May 9, the Victory Day when Russians celebrate their victory over Germany in the WW2. It is ever more apparent that Russia has not achieved any of the objectives in its 'special operation' in Ukraine, largely thanks to a remarkable Ukrainian resistance and heavy military support by the Western nations. Still, many believe that Victory Day remains an important deadline for Russia and that by May 9 they would prefer to have some concrete results to celebrate with the Russian public.

The looming Victory Day raises the sense of urgency on the Russian side, and same time, we now see several signals pointing to a potential escalation in the war. On Tuesday, Russian Foreign Minister Sergei Lavrov warned of the risk of nuclear war saying *"the danger is serious, the danger is real, and shouldn't be underestimated"*. We still think the threshold is high, particularly for using strategic nuclear weapons, but Lavrov's comments should not be ignored. We think Russia's clear underperformance in the conventional warfare increases the risk of them resorting to the use of tactical nuclear weapons or chemical or biological weapons. Such action could prompt a more aggressive response by the West/NATO, which could lead to an escalation.

On the evening of April 25, headquarters of the Ministry of State Security in the Moldovan separatist republic of Transnistria came under attack from a grenade launcher. Transnistria is a self-proclaimed independent state since 1992, but no country has recognized its independence. Russia has military presence (officially called peacekeepers) in the region. Also, on the evening of 25th, Russian media reported that Romania, with the support of NATO and with the participation of the Ukrainian army, plans to seize Transnistria and is carrying massive political repression against supporters of Russia in the region (see *BNE Intellinews*). On Tuesday April 26, two explosions damaged Soviet-era radio masts that broadcast Russian radio in the same region, prompting an urgent security meeting convened by Moldova's president.

Our recent research on war in Ukraine

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We think the latest developments could constitute a false flag operation by Russia, marking an escalation as Russia may be seeking a pretext to expand its military operations to Moldova in an effort to step up pressure in the southwest of Ukraine – something analysts have previously warned about (see *CNBC: Putin's next target may be Eastern Europe's Moldova, analysts warn*). While Moldova has officially applied an EU membership, neutrality is enshrined in its constitution. Transnistria shares a 405km border with Ukraine and its capital, Tiraspol, is located around 100km from Odessa, a key city on the southern coast of Ukraine that remains under Ukrainian control.

As another recent twist, on Tuesday 26, Germany reversed its earlier decision not to send heavy weapons directly to Ukraine. Previously, Chancellor Scholz has emphasized that sending heavy weapons could be interpreted by Russians as an intervention by a NATO member in the conflict, raising the risk of an escalation. In a clear switch of Berlin's cautious policy, the German government has now agreed to send used Gepard anti-aircraft tanks to Ukraine. Meanwhile, the EU leaders are in the process of discussing the 6th sanctions package against Russia and what now appears like a harder line from the German government could raise the likelihood of a step-up in sanctions. While further military support to Ukraine and tighter sanctions are needed to halt the Russian offensive, and the latest action by Germany highlights the sense of urgency, we think they also raise the risk of an escalation in the conflict.

As another potential signal of an escalation, Russia announced on Tuesday April 26 that it will again hold joint drills with Belarus from April 26 to 29. The previous joint military drills were held in the period of February 10-20. Russia attacked Ukraine on February 24.

All in all, we think tensions are again building up and Russian offensive is likely to expand and become nastier in Ukraine over the next two weeks ahead of the May 9 Victory Day. We maintain our base case of a frozen conflict in Ukraine, but the tail risk of an escalation remains and the most recent developments raise the downside risks. The main triggers for an escalation of the war outside Ukraine include: 1) NATO's involvement in the conflict in one way or another leading to a direct confrontation with Russia and 2) NATO membership processes by Finland and Sweden that are likely to proceed over the coming weeks. While Russia is unlikely to deploy military force against the Nordic countries, it is likely to step up pressure by other means of warfare, e.g. hybrid, cyber and information warfare. Same time, the risk of direct military intervention by Russia now looms larger in Eastern Europe, particularly in Moldova.

In our base case of a frozen conflict, we think financial markets will continue to focus on other topics: tightening global financial conditions, persistent inflation pressures and aggressive central bank tightening. In a tail risk scenario of a severe escalation, markets would likely enter at least a brief period of broad-based risk aversion. The duration and magnitude of such a market shock would largely depend on the sanctions response (e.g. a full EU embargo on Russian energy would drive euro area into a recession, likely triggering a re-pricing of expected ECB action) but also on the severity of the escalation. Any signs that e.g. Nordic countries would be drawn into a conflict would most likely entail much more substantial market implications than Belarus army joining Russia in the offense against Ukraine, or Moldova drawing into the war.

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