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Research Euro Area

Rising stagflationary headwinds from Ukraine conflict

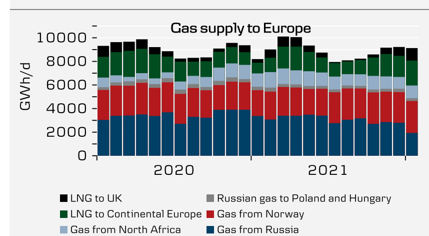
- **The Ukraine conflict is not only creating upward pressure on euro area energy prices, but also food and core inflation items. We see upside risks to our base line HICP inflation forecast of 4.7% of ca. 0.5pp in 2022 in light of the latest developments. However, should oil and gas prices stay at elevated levels throughout the rest of the year, inflation rates well in excess of 6% could be on the cards for H2 22.**
- **We see downside risks to our 2022 euro area GDP forecast of 4.0% of 0.4-0.5pp, mainly through the adverse hit to consumers from continued high inflation.**
- **We think the hit to European exports will be manageable, as trade links to Russia are of small importance for most euro area countries. However, an exclusion of Russia from the SWIFT system could create some wider adverse repercussions to global trade flows, especially for commodities. Sanctions could especially hurt Germany's car sector.**
- **Heightened uncertainty could weigh on business sentiment in the short term, but an accelerated implementation of renewable energy and energy efficiency projects as well as defence spending could end up boosting investments.**
- **Germany has performed a significant policy U-turn and stepped up defence and energy spending, which may open up for a larger political discussion on how these areas should be treated under the upcoming Stability and Growth Pact rules review.**
- **Many unknowns remain, especially what role China will play to limit the economic fallout for Russia and the scale of disruptions to gas supply. Europe would most likely survive a large-scale disruption to Russian gas imports in the short-term, but running the economy for several years without Russian gas would likely entail measures to curb demand, with clear disruptions to economic activity.**

Short-term pain...

Over the last days, wide-ranging sanctions have been announced by the West in response to Russia's invasion of Ukraine (*Research Russia: The West walks the talk with unprecedented sanctions against Russia - what's next?*, 27 February). **We see three channels how the Ukraine conflict is impacting the euro area economy**: (1) Higher oil and gas prices stoking inflation and real income erosion of consumers, (2) adverse spillovers through the trade channel and (3) a sharp rise of uncertainty weighing on business investment.

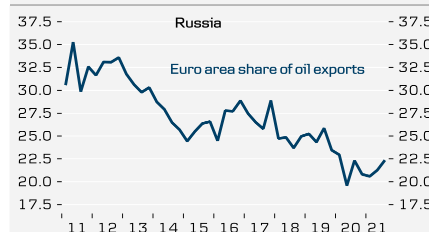
Europe's key vulnerability stems from its energy dependency from Russia, which accounts for ca. 44% of natural gas and 25% of oil imports (for Germany the dependency is even larger - 55% of gas and 35% of oil stems from Russia). Oil prices have risen above 100 USD/bbl and natural gas prices are up 20% since the escalation of the conflict. *EU Commission estimates* show that on average almost 40% of a change in Brent oil prices is passed onto consumer prices within 12 months, with 80% of the price increase occurring

Russian gas supply to Europe has declined



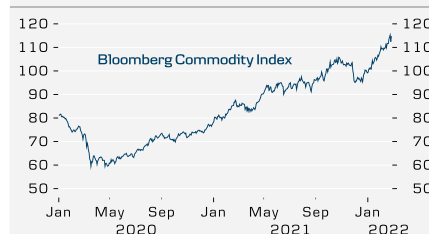
Source: Refinitiv

Russia supplies a quarter of euro area oil imports



Macrobond Financial, Danske Bank

Commodity prices continue to soar



Sources: Bloomberg, Danske Bank

Note: Past performance is not a reliable indicator of current or future results. It is not possible to directly invest in an index.

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within one month. The pass-through for natural gas and electricity prices is slower, with only about 13% and 4% of the increase in wholesale prices passed on to consumer prices 12 months later, respectively.

The Ukraine conflict is not only creating upward pressure on energy prices, but also food and core items. Russia supplies about 40% of the world's palladium, which is needed for vehicles production and about 30% of titanium, which is crucial for the aerospace industry. The country is also a leading exporter of aluminium, nickel, copper and platinum and we see a clear risk that supply disruptions in raw materials could re-inforce cost-push dynamics already visible across a range of core inflation items (see also *Euro inflation notes - Cost-push inflation: the genie is out of the bottle*, 23 February). Furthermore, Ukraine and Russia together account for a third of the world's wheat exports and a fifth of its corn trade. Wheat prices are up 20% since the start of the year, while corn prices have risen 15% and supply disruptions and rising prices for fertilizer could have *negative repercussions* on food prices not only in Europe.

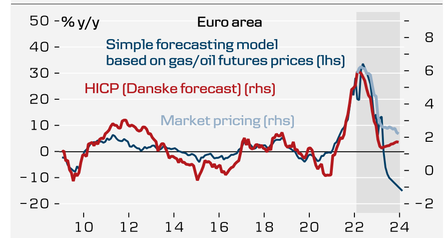
At the current stage we see upside risks to our base line HICP inflation forecast of 4.7% of ca. 0.5pp in 2022 in light of the latest developments. However, should oil and gas prices stay at elevated levels throughout the rest of the year, inflation rates well in excess of 6% could be on the cards for H2 22. This will accentuate the hit to consumers' purchasing power, especially with wage growth expected only in the range of 2.5-3% this year and consumer confidence already weakening over the last months.

Additionally, growth could be hit from sanctions disrupting trade links with Russia. That said, Russia stands much more exposed than the EU. Russia accounts for only 3% of total euro area exports and trade with Russia has declined noticeably over the years, especially after the 2014 Crimea crisis. Sanctions could especially hit Germany's car sector, which is already fighting with severe production bottlenecks due to the global semi-conductor shortage. Car manufacturers and suppliers operated 49 production facilities across Russia and Ukraine and last year Germany exported some 40.000 cars to Russia (less than 2% of total car exports). Over the weekend, *Volkswagen* already announced idling two German plants due to lack of supplies from Ukraine, in a sign than more disruptions could be in the cards. Overall, we think the hit to European exports will be manageable, as trade links to Russia are of small importance for most euro area countries (with the exception of the Baltics). However, an exclusion of Russia from the SWIFT system could create some wider adverse repercussions to global trade flows, especially for commodities.

...long-term gain?

The heightened uncertainty could also weigh on business sentiment in the short term, but unless the crisis drags out for a long time, we believe the impact will be fairly limited and short-lived. While firms with links to Russia and Ukraine might be reluctant to undertake large-scale investments until the geopolitical situation stabilizes, an accelerated implementation of renewable energy and energy efficiency projects could even end up boosting investments. A similar case could be made for defence spending, as the Ukraine conflict has again laid bare Europe's defence vulnerabilities. *German chancellor Scholz* has already announced a dramatic foreign policy U-turn, pledging to raise military spending above NATO's 2% of GDP goal and creating a EUR 100bn special fund to modernise the armed forces this year. Furthermore, Scholz also promised to speed up efforts to reduce Germany's energy dependency by constructing two new LNG terminals and to build up coal and gas reserves. Even extending the operation of Germany's three remaining nuclear power plants beyond the end of this year is now under discussion. While the details of the

We see upside risk to euro inflation of ca. 0.5pp in 2022...

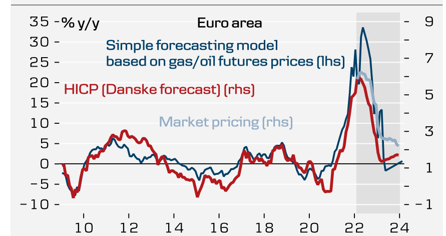


Source: Eurostat, Bloomberg, Macrobond Financial, Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

Assumptions: Brent oil at USD/bbl 150 in 1M, 100 in 12M, 80 in 24M; natural gas at EUR/Mwh 125 over next 24 months.

... But inflation rates well in excess of 6% could be on the cards if oil and gas prices stay elevated for longer



Source: Eurostat, Bloomberg, Macrobond Financial, Danske Bank

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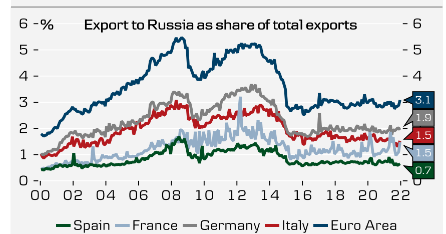
Trade links to Russia are limited for most euro area countries

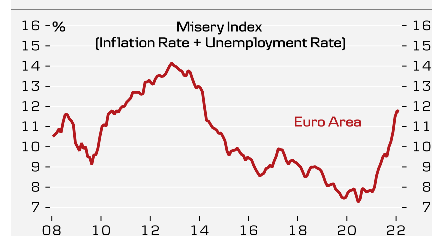


Source: Macrobond Financial, Danske Bank

financing have yet to be sketched out, the shift in stance regarding accelerated defence and energy spending may open up for a larger political discussion on how these areas should be treated under the upcoming Stability and Growth Pact rules review later this year.

In sum, at the current stage we see downside risks to our 2022 euro area GDP forecast of 4.0% of 0.4-0.5pp, mainly through the adverse hit to consumers from continued high energy price inflation. This is broadly in line with other studies on this topic. Preliminary *ECB estimates* based on the commodity price channel expect the Ukraine conflict to reduce euro area GDP by 0.3-0.4% in 2022 in a 'middle scenario' and close to 1% in a 'severe scenario'. An earlier *ECB study* found that the current surge in oil and gas prices will reduce euro area output by around 0.2pp in 2022 and an extra 10% reduction in gas supply would reduce output by an additional 0.7%. *IfW Kiel simulations* find that a gas and oil embargo would decrease Russian GDP by 2.9% and 1.2%, respectively. The hit to the German and EU economies would be significantly more contained in magnitude (-0.1%).

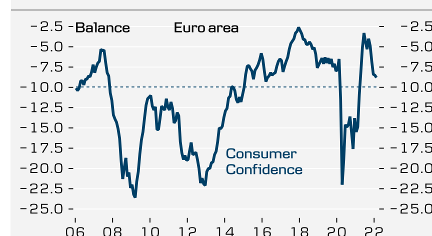
Consumers are feeling the pinch...



Sources: Bloomberg, Danske Bank

However, many unknowns remain, especially what role China will play to limit the economic fallout for Russia and the scale of disruptions to gas supply (which continues to flow at the time of writing). According to *Bruegel* calculations, Europe would most likely survive a large-scale disruption to Russian gas imports in the short-term, as long as temperatures stay mild and increased LNG imports compensate for the shortage. However, running the European economy for several years without Russian gas would be hugely challenging. In this case, Europe would likely have to take measures to curb demand as well, with the risk of disruptions to economic activity (sectors such as steel & aluminium, chemicals and fertilizer stand most exposed). Reduction of heating in commercial/office buildings and homes could also be necessary, while a massive investment offensive in energy efficiency of buildings would probably constitute the best way to reduce Europe's energy dependency in the future. An issue in that respect remains ongoing global supply chain bottlenecks that are creating difficulties in sourcing materials and labour.

... and confidence has eased



Source: EU Commission, Macrobond Financial, Danske Bank

Optionality and flexibility remain key for ECB

The stagflationary forces (i.e. weaker growth and higher inflation) from the Ukraine conflict put ECB is a tricky position how to react in terms of policy calibration. Naturally, geopolitical risks are a concern to ECB and liquidity operations and/ or swap lines could be activated in case of market turmoil to ensure price and financial stability. All else equal see a risk of a more gradual monetary policy normalisation path in light of the elevated uncertainty. Optionality and flexibility remain key in light of the high uncertainty of the inflation outlook and we believe ECB will adjust its policy measures as necessary once more information on the economic repercussion from the conflict is emerging. We still believe ECB will formally put an end to the APP programme as inflation is running high, but likely only by Q3 22, and send no signals of imminent rate hikes after the end of QE, as further tightening will depend on the extent of the negative demand shock.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

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Ad hoc.

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