PRESS RELEASE **8 February 2022**

Ukraine crisis: Sanctions would have negative impact on Russia, the EU and Ukraine

- *Russia's exclusion from SWIFT and the US dollar would be painful, but government prepared*
- *Russia's increasing isolation from the West would exacerbate already weak growth prospects*
- *EU: Rising inflation looming; Raiffeisen, Société Générale, Unicredit with Russia risk*
- *Maintaining Ukraine's macro-financial stability will require Western support*

What would be the economic impact of new sanctions against Russia? In a new study the Vienna Institute for International Economic Studies (wiiw) analyses the potential consequences for Russia, the EU and Ukraine based on two scenarios for a Russian assault on Ukraine: a limited military intervention and a full-scale invasion. *"In the first scenario, we would expect a more confined response, particularly from the EU, whereas in the unlikely event of a full invasion the EU and US would certainly impose heavy sanctions against Moscow,"* says Olga Pindyuk, economist at wiiw and one of the authors of the study.

Russia's exclusion from SWIFT and the US dollar painful, but government prepared

Russia is most vulnerable to a reduction of its energy exports. *"However, restricting oil and gas trade with the EU is a 'nuclear' option, given the huge costs this would inflict on EU members such as Germany, the Baltic states and Central European countries, that are highly dependent on Russian energy supplies,"* explains Artem Kochnev, economist at wiiw specialised in Russia and co-author of the study.

The other "nuclear" option would be cutting Russian banks off from US dollar funding and excluding them from the SWIFT system. *"That would cause significant financial disruption in Russia, a reduction of lending and investment, and require large-scale state injections of capital into the banking sector,"* says Kochnev. While this would seriously weigh on economic growth, a coordinated policy response by the Russian Central Bank and the government would maintain macro-financial stability for at least one year.

Russia is not fully sanctions-proof, but it has plenty of room to manoeuvre if sanctions are imposed by the West. The country has very low levels of external debt (29% of GDP in 2020) and a current account surplus, limiting external exposure. Excess oil and gas revenues have accumulated in the National Welfare Fund, which accounts for 12% of GDP, and conservative monetary policy has allowed the build-up of substantial foreign reserves, totalling around 640 billion US dollars. *"Putin has worked hard to build 'Fortress Russia' to make western threats less of a deterrent, though parts of the economy remain vulnerable to sanctions,"* says Olga Pindyuk.

They include industries that rely heavily on high-tech imports from the West, especially semi-conductors and machines. However, although an embargo here would be a heavy blow to certain industries, it would not be lethal for the economy as such.

A-1060 Wien, Rahlgasse 3 ZVR-Zahl
T: (+43-1) 533 66 10, F: (+43-1) 533 66 10-50, wiiw@wiiw.ac.at, www.wiiw.ac.at 329995655

Given Russia’s substantial fiscal buffers, the real threat to its economy is not in the short term, but rather the effects of significant Western sanctions long into the future. Restrictions on Russian imports of high-tech industrial inputs would further increase its isolation from the most advanced parts of the global economy. This would hinder economic modernisation, particularly a much-needed diversification and improvement in competitiveness. Russia will partially offset sanctions through stronger ties with China, especially in the energy sector, but limited access to Western capital and technology would exacerbate its already weak growth prospects.

EU: Rising inflation looms in case of energy crisis

Even limited military operations would have considerable direct and indirect economic consequences for the EU, especially in the energy sector, where dependence on gas and oil supplies from Russia is strong. The most exposed countries are Germany, Austria, and much of Central and Eastern Europe (CEE).

After Russia's annexation of Crimea in 2014, trade between the EU and Russia declined significantly. *"Almost all EU and CEE countries export and import proportionately less to and from Russia than in 2013,"* points out Richard Grieveson, Deputy Director of wiiw and co-author of the study. At the same time, the share of Russian direct investment has fallen sharply.

Although the Russian and the EU economies have partially decoupled since 2014, the repercussions of a military conflict would still be severe for the EU. Even countries that diversified their energy supplies more than Germany or Austria would feel the pain. The current tensions are contributing to very high energy prices, which has pushed up headline consumer price inflation to multi-year highs across Europe. Any cut in gas supplies to Europe would have an immediate additional impact on world markets. *"Sharp increases in energy prices would further fuel the already high inflation, with negative consequences for the economy in the entire EU,"* argues Grieveson.

Raiffeisen, Société Générale, Unicredit with Russia risk

“Financial sanctions against Russia could also hit some major European banks with large Russian holding hard,” warns Grieveson. The biggest Western lenders are Austria’s Raiffeisen Bank International (RBI) and France’s Société Générale, both owning Russian assets worth 18 billion euros as well as Italy’s Unicredit with 15 billion euros of exposure in Russia.

Ukraine’s stability in danger, Western support required

Ukraine's economy would suffer the most from a military conflict. It has already been affected by the threat of an invasion. The currency hryvnia has depreciated, while the risk premiums for government and other securities on capital markets have risen. Additionally, the domestic reform process has slowed down. If military intervention by Russia does take place, its impact on economic activity will vary between regions, with the Western parts of the country, located further away from military activity, being less affected. However, possible destruction of key parts of the country’s infrastructure would have repercussions for the whole economy. Ukraine might lose access to its main ports around Odessa, which handle almost a half of the country’s exports and imports. If part of the transit pipeline infrastructure is damaged, it will cause major interruptions of energy supplies to a large part of the country.

Though the economic linkages between Ukraine and Russia drastically reduced in the aftermath of 2014, rising energy prices due to sanctions will strongly affect the economy, as energy bills account for a substantial share of household expenditure and the country has limited fiscal space to shield households from price spikes. The conflict is also severely affecting private investment activity and interrupting foreign direct investment inflows.

Therefore in both scenarios the country will need very strong Western support to ensure macro-financial stability. The EU and the International Monetary Fund both have promised billions in new aid. *“In the long run, the conflict with Russia could establish a clear demarcation line, with the rest of Ukraine becoming more firmly entrenched in the Western camp receiving significant economic support. However, it is also possible that the current conflict will lead to a further slowdown of reforms,”* says Pindyuk.

The study is available for download here.

About the Vienna Institute for International Economic Studies (wiiw)

wiiw is an economic think tank that has been producing economic analyses and forecasts for currently 23 countries in Central, East and South-East Europe for almost 50 years. In addition, wiiw conducts research in the areas of macroeconomics, trade, competitiveness, investment, the European integration process, regional development, labour markets, migration and income distribution.

Contact:

Andreas Knapp
Communications Manager
Tel. +43 680 13 42785
knapp@wiiw.ac.at

Richard Grieveson
Deputy Direktor
grieveson@wiiw.ac.at