RADICAL GEOPOLITICAL UNCERTAINTY

The war in Ukraine influences the euro area economy through different channels: increased uncertainty, financial market volatility, reduced exports, higher prices for oil, gas and certain other commodities. Although the economic channels of transmission are clear, the size of the impact is not. Counterfactual analysis of last year's jump in oil and gas prices provides a reference point but the geopolitical nature of the economic shock reduces the reliability of model-based estimates. Moreover, the other transmission channels should also have an impact on growth. Finally, there is a genuine concern that, the longer the crisis lasts, the bigger the economic consequences because eventually, months of elevated uncertainty would end up weighing heavily on household and business confidence.

The events in Ukraine have made us enter an environment of radical uncertainty. *"It is not just that we do not know what will happen. We often do not even know the kinds of things that might happen."*[1] Although the economic channels of transmission are rather clear, the size of the impact is not because it depends on the reactions and decisions of political leaders, households, companies and financial markets.

Uncertainty complicates the task of the forecaster but it is also a channel of transmission of the geopolitical shock. Economic agents feel less convinced than before about the outlook in terms of income, employment, profits, etc. and this may lead to a wait-and-see attitude until uncertainty is resolved. The impact on the euro area economy should be small in the short-run – investment projects will not be stopped overnight – but should increase if uncertainty were to remain high and possibly cause non-linear reactions. Financial markets are another channel whereby lower equity prices would weigh on the real economy through a drop in confidence, a negative wealth effect and higher financing costs. However, research shows that the effect of a severe decline in equity prices on the real economy is limited. Moreover, the market reaction thus far has also been limited, although this does not provide insight in how things might evolve going forward.

International trade should play a bigger role as transmission channel. Depending on the nature of sanctions and their consequences for the Russian economy as well as the possibility of retaliation, exports to Russia should be impacted. In 2020, goods exports to Russia represented 4.1% of EU exports, but there are huge differences between EU members (table 1). For Poland, Lithuania, Czech Republic, Finland, Latvia, Estonia and, to a lesser degree, Hungary, Slovakia and Slovenia, exports to Russia represent a significant share of their extra-EU exports. Exports to Ukraine will suffer from a decline in import demand following the invasion. In 2020 they represented 1.2% of EU goods exports but this percentage was significantly higher for Hungary, Poland, Lithuania. Ukraine is also an important trading partner of Latvia, Slovakia, Romania, Czechia and Estonia.

A better measure to assess the potential impact is looking at exports to Russia and Ukraine as a percentage of domestic value added of the exporting countries. This takes into account the possibility that exports have a certain import content such as commodities or intermediate inputs. This implies that a reduction in exports would also cause a decline in imports. Table 1 shows that, from this perspective, Lithuania has the highest exposure to Russia (8.62%) followed by Latvia (7.13%). Exports to Ukraine represent a very low percentage of domestic value added, except in Lithuania (2.02%) and Hungary (1.97%).

Commodity prices are a crucial transmission channel, in particular oil and gas prices considering that Russia provides 27% of EU oil imports[2] and 38% of EU gas needs[3], but also wheat and certain metals (palladium, aluminium, nickel). The weights of electricity, oil, gas and food prices in the HICP (table 2) vary considerably between countries, which implies large differences in terms of exposure to higher oil, gas and wheat prices. Gas prices are particularly important because, as we have seen last year, higher prices spill over to wholesale electricity prices[4], implying an even bigger impact on households' purchasing power and company profits. Within industry, certain sectors are particularly gas-dependent. This is the case for the energy sector itself, which mostly transforms natural gas into other forms of energy, but also for chemicals, basic metals, non-metallic minerals (glass, cement, ceramics, etc.) and food and beverages[5].

What can be assumed in terms of potential impact on GDP? With respect to the impact of higher oil and gas prices, the counterfactual analyses of the European Commission and the ECB of last year's increase can be used as a reference point. The European Commission calculations show a negative impact on real GDP growth of -0.3 percentage points in 2021 and -0.5 percentage points in 2022. Counterfactual simulations by the ECB based on the surge in oil and gas prices since the start of 2021 suggest a negative impact on euro area GDP in 2022 of -0.2%.

1. Source: Radical uncertainty, John Kay, 12 February 2020, www.johnkay.com.

2. Source: Eurostat (data for 2019).

3. Source: McWilliams, B., Sgaravatti, G., Tagliapietra, S. and G. Zachmann (2022) 'Can Europe survive painlessly without Russian gas?', Bruegel Blog, 27 January (data for 2021).

4. Gas power plants have become price setters in wholesale electricity markets because the EU electricity market is based on a marginal pricing and pay-as-clear model, where the market wholesale price normally reflects the cost of the last unit of energy bought via an auction mechanism where gas is a predominant input. Source: European Commission, European Economic Forecast, Autumn 2021, Institutional paper 160, November 2021.

5. Source: ECB, Economic Bulletin, Issue 1, 2022.

There is a genuine concern that, the longer the crisis lasts, the bigger the economic consequences because eventually, months of elevated uncertainty would end up weighing heavily on household and business confidence.

However, the assessment of the economic impact for the eurozone of higher commodity prices is hugely challenging due to the geopolitical nature of the economic shock, which reduces the reliability of model-based estimates. Moreover, the other transmission channels should also have an impact on growth. Reuters recently reported that according to ECB chief economist Philip Lane, the Ukraine conflict might have a negative impact on this year's euro area GDP of -0.3% to -0.4%. Under a severe scenario, the reduction could be close to -1%[6]. The range of estimates is wide. In addition, there is a genuine concern that, the longer the crisis lasts, the bigger the economic consequences because eventually, months of elevated uncertainty would end up weighing heavily on household and business confidence.

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6. Source: ECB policymakers told Ukraine war may shave 0.3%-0.4% off GDP, Reuters, 25 February 2022.

EXPORTS TO RUSSIA AND UKRAINE IN 2020

2020	EU exports of goods to Russia			EU exports of goods to Ukraine		
	EUR million	as a % of extra EU exports	as a % of gross value added	EUR million	as a % of extra EU exports	as a % of gross value added
Germany	23 155	4.0	0.8	4 673	0.8	0.2
Poland	7 136	11.5	1.5	5 250	8.5	1.1
Italy	7 101	3.4	0.5	1 702	0.8	0.1
Netherlands	6 684	3.3	0.9	1 194	0.6	0.2
France	5 158	2.6	0.3	1 012	0.5	0.0
Belgium	3 893	3.0	0.9	612	0.5	0.1
Lithuania	3 830	30.4	8.6	897	7.1	2.0
Czechia	3 698	10.9	1.9	1 166	3.4	0.6
Finland	3 016	11.4	1.5	194	0.7	0.1
Austria	2 158	4.7	0.6	560	1.2	0.2
Spain	1 874	1.8	0.2	506	0.5	0.0
Latvia	1 831	34.3	7.1	235	4.4	0.9
Sweden	1 777	2.7	0.4	350	0.5	0.1
Hungary	1 608	7.0	1.4	2 272	10	2.0
Slovakia	1 184	7.4	1.4	668	4.2	0.8
Denmark	911	2.0	0.3	287	0.6	0.1
Slovenia	865	6.7	2.1	229	1.8	0.6
Romania	818	5.1	0.4	572	3.6	0.3
Estonia	803	16.6	3.4	156	3.2	0.7
Bulgaria	420	4.4	0.8	227	2.4	0.4
Ireland	373	0.4	0.1	71	0.1	0.0
Portugal	178	1.2	0.1	31	0.2	0.0
Croatia	176	3.6	0.4	58	1.2	0.1
Greece	161	1.2	0.1	194	1.5	0.1
Luxembourg	116	4.9	0.2	13	0.5	0.0
Cyprus	47	2.6	0.2	15	0.8	0.1
Malta	4	0.4	0.0	2	0.2	0.0
EU 27	78 951	4.1	0.7	23 062	1.2	0.2

TABLE 1

SOURCE: EUROSTAT

WEIGHT IN % IN HICP BASED ON INDIVIDUAL CONSUMPTION BY PURPOSE									
2022	**Housing related**			**Transport-related**		Total	Energy	Food	Bread & Cereals
	Electricity	Gas	Liquid Fuels	Diesel	Petrol				
EU 27	3.1	2.0	0.6	1.7	2.6	10.1	11.3	15.9	2.9
Euro Area	3.1	2.2	0.7	1.8	2.4	10.3	10.9	15.1	2.8
Belgium	3.9	2.4	1.2	1.8	1.4	10.6	10.7	15.5	3.2
Bulgaria	4.3	0.7	0.0	1.9	3.2	10.1	13.6	20.5	2.9
Czech Republic	3.7	2.0	0.0	1.3	2.5	9.5	11.7	18.6	3.4
Denmark	2.9	0.7	0.3	0.8	1.9	6.7	8.9	12.7	1.8
Germany	3.0	2.9	1.3	1.0	3.0	11.2	12.1	11.1	2.0
Estonia	4.3	1.2	0.0	2.4	3.4	11.3	15.9	19.2	3.2
Ireland	2.5	0.9	1.1	1.9	2.0	8.5	8.9	10.8	2.0
Greece	4.3	0.9	1.7	0.4	3.8	11.2	11.5	19.8	4.2
Spain	4.1	1.5	0.6	3.1	2.5	11.7	11.7	20.6	3.1
France	3.3	1.9	0.7	2.2	1.7	9.8	10.3	15.2	2.8
Croatia	5.1	1.7	0.8	2.0	2.4	12.1	13.2	18.6	3.7
Italy	2.4	2.3	0.1	2.0	2.4	9.2	9.7	17.9	3.4
Cyprus	3.1	0.3	0.5	1.1	4.5	9.5	9.7	14.1	2.9
Latvia	3.4	1.1	0.0	3.6	2.7	10.7	16.2	23.4	5.1
Lithuania	1.8	0.8	0.1	1.9	3.7	8.3	12.8	19.2	2.8
Luxembourg	1.5	1.5	0.5	6.2	2.9	12.6	12.7	10.9	2.2
Hungary	1.6	1.9	0.0	0.7	5.9	10.1	11.3	19.3	3.5
Malta	2.5	0.2	0.0	1.4	2.5	6.7	6.7	15.8	3.1
Netherlands	3.2	3.7	0.0	0.7	3.4	11.1	11.3	14.2	3.0
Austria	2.4	0.9	0.5	2.1	1.5	7.4	8.7	12.0	2.5
Poland	2.8	1.5	0.0	1.7	3.3	9.3	14.5	16.7	2.4
Portugal	2.7	1.0	0.1	2.5	1.6	8.0	8.0	20.4	4.1
Romania	2.0	2.3	0.1	1.8	3.8	10.0	12.1	28.3	6.5
Slovenia	3.2	1.0	0.9	3.1	2.9	11.1	13.2	15.8	2.5
Slovakia	4.2	3.6	0.0	0.8	2.3	10.9	15.1	21.0	4.2
Finland	3.4	0.0	0.4	1.2	2.9	7.8	9.5	14.0	2.1
Sweden	5.3	0.1	0.0	1.3	1.6	8.3	9.6	13.8	2.1

TABLE 2

SOURCE: EUROSTAT