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Will Russia Derail the Eurozone Recovery?

Geopolitical tensions from Ukraine threaten what is already a weak recovery in its neighbouring European economy. The situation is very fluid and things can change rapidly, but - as things stand - we think that the crisis will shave approximately 0.3% off eurozone GDP. This is a modest impact overall, but one that will be felt in an environment of already-very-low growth. And things could be worse: If tensions in Ukraine escalate, the eurozone could plunge back into recession.

Faced with disappointing growth and inflation data, and new headwinds hitting the eurozone economy, the European Central Bank (ECB) this week cut the policy rate to 0.05% and announced an asset-backed securities and covered bond purchases programme starting next month. But, the ECB may well have to do more to lift growth and inflation, and embark on a broader quantitative easing (QE) programme over the next few quarters. This has important implications for Western European markets.

Direct trade with Russia to shave approximately 0.2%-0.3% off eurozone GDP

The spillover of the Ukraine crisis into Europe will be felt through four main channels: direct trade linkages, energy price/supply, market confidence and direct financial linkages.

The most significant impact on eurozone growth is likely to come from the direct trade channel. Exports from the eurozone to Russia are over €80 billion, equivalent to around 6.5% of all exports headed outside the region, or 0.8% of total GDP. Although this is not a large exposure in absolute terms, it is large enough to be felt in an environment in which exports decline quickly.

Eurozone exports to Russia have fallen around 15% from their peak in early 2013, shaving 0.1% or so off eurozone GDP (see Figure 1). The ongoing weakening of the Russian economy, the recent introduction by the Kremlin of European/U.S. food import bans and the possible extension of trade sanctions

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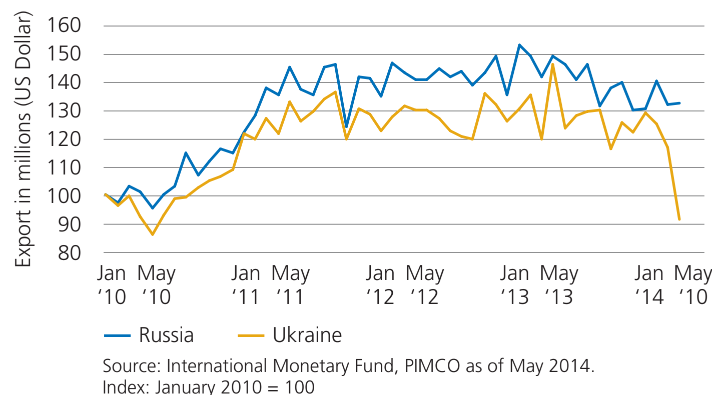
ahead suggest that exports will fall further, pointing to an overall drag on growth from direct trade linkages of 0.2%–0.3% of eurozone GDP.

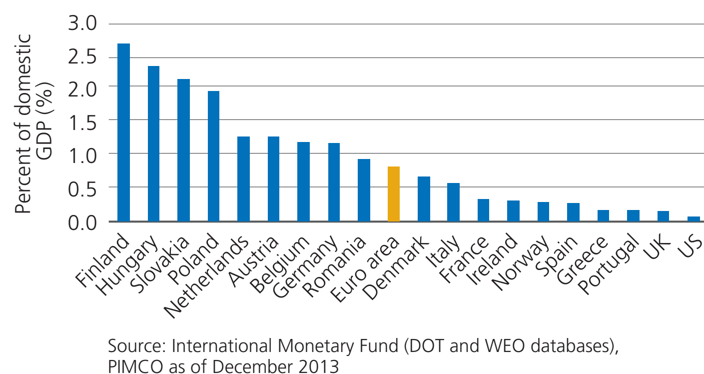
FIGURE 1: EUROZONE EXPORTS TO RUSSIA AND UKRAINE



Source: International Monetary Fund, PIMCO as of May 2014.
Index: January 2010 = 100

How will this distribute across the region? A way to scale the economic impact is to look at the size of different member countries' exports to Russia relative to domestic GDP (see Figure 2). As one would expect, Eastern Europe – and to a lesser extent Northern Europe – are the most vulnerable. Among the eurozone's major economies, Germany looks like the most sensitive, with an export exposure to Russia around 1.5 times larger than the eurozone (1.2% of GDP versus the eurozone's average of 0.8%). Peripheral economies, on the other hand, look less vulnerable.

FIGURE 2: EXPORTS TO RUSSIA (% OF DOMESTIC GDP)



Source: International Monetary Fund (DOT and WEO databases), PIMCO as of December 2013

Energy shock to take another approximately 0.1% off growth

Direct trade effects aside, the largest impact on growth is likely to come from energy. Russia is the second-largest producer of both gas and oil in the world, and Europe imports around a quarter of its gas and oil consumption from Russia. Europe's gas dependence on Russia is particularly vulnerable given the difficulties involved in finding alternative sources of energy in winter, and given that a large portion of Russian gas travels to Europe via pipelines that cross Ukraine.

Russia has already curtailed its gas supply for domestic consumption in Ukraine, which may be forced to use some of the gas going to Europe as winter sets in. We think that energy disruptions will be manageable, particularly as Europe and Ukraine will coordinate on gas supplies. We see such disruptions providing some boost to gas prices ahead, though a modest one overall (based on our analysis, we see a boost in gas prices in the order of 5%–10% over winter). The impact on oil prices, meanwhile, should be very small as supplies have not been curtailed.

On net, we think that the effect from energy disruptions on eurozone GDP should be in the order of 0.1%.

Only a modest impact from the effect on confidence and financial linkages

Eurozone growth could also suffer from the impact of geopolitical tensions on market confidence and "animal spirits" in the economy. With European equity prices down nearly 10% from their peak in mid-June 2014 to their low in early August, one could argue that some effect is already in the pipeline. However, equity markets have already retraced more than half of that drop and, provided the crisis does not deepen, we think the impact on the economy from market confidence will be small.

Similarly, we believe that the effect on GDP from direct financial exposures is negligible. With banking exposures to Russian assets amounting to less than 0.5% of the eurozone banking sector balance sheet, and the stock of foreign direct investment in Russia accounting for less than 2% of eurozone GDP, these exposures are too small to matter.

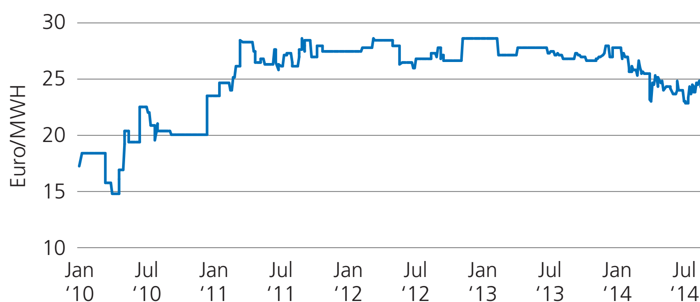
When we put it all together, our assessment is that the combined effect of the geopolitical tensions in Russia and Ukraine will shave approximately 0.3%-0.4% off eurozone growth, of which approximately 0.1% has already been realised via declines in exports to Russia (and Ukraine).

Things could actually be worse

Although our analysis assumes that the crisis will linger on, we believe that it will not get much worse. However, there is the potential risk of a "fat tail" scenario, one in which the conflict in Ukraine deepens militarily and geopolitical tensions intensify.

Under such a scenario, the consequences of the geopolitical tensions in the region are much larger. Not only would eurozone exports to Russia decline at a faster rate, but Europe would face a significant rise in costs resulting from larger disruptions in the energy supply from Russia (see Figure 3). This scenario would also be associated with a meaningful fall in market confidence and weaker animal spirits.

FIGURE 3: GERMAN GPL NATURAL GAS PRICE (FIRST WINTER CONTRACT, IN EURO/MWH)



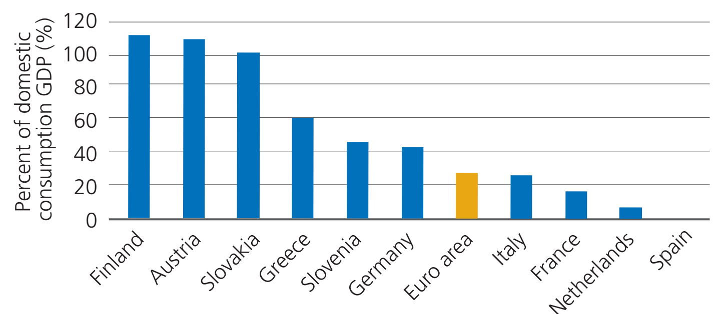
Source: Bloomberg, PIMCO as of 26 August 2014. GPL = Gaspool, one of two major sub-national German wholesale markets in the form of different virtual trading points (hubs). GPL covers Northern Germany.

Weaker exports would probably shave 0.3% off eurozone GDP, which would come on top of an estimated energy price shock worth 0.4% of GDP (driven by oil price gains in the order of 10% and gas price gains in the order of 20%). The confidence effect is hard to quantify. For example, our analysis of the impact of the 9/11 attack in New York on the economy suggests that it reduced eurozone GDP by about 0.5% over the following two quarters (an effect which was then unwound in later quarters). Under the above-described fat tail scenario, we think that the effect on market confidence would be somewhat smaller, and estimate it at 0.2%.

Putting it all together, the total drag on eurozone growth in such a fat tail scenario would amount to around 1% of GDP. This kind of shock would be enough to bring the region back into stagnation at best, and likely into recession.

It is worth noting that the energy disruption (like the above-mentioned direct trade impact) in this scenario would disproportionately affect Eastern and Northern European countries (see Figure 4). Among the eurozone's major economies, Germany once again looks more exposed than the eurozone average (importing more than 40% of its gas consumption from Russia versus the eurozone's 28%). Among peripherals, Greece looks vulnerable, although Italy's exposure is understated in the table given its high reliance on gas versus other energy sources.

FIGURE 4: IMPORTS OF GAS FROM RUSSIA (% OF DOMESTIC CONSUMPTION, 2012)



Data include re-exports of gas.
Source: Eurostat, J.P. Morgan as of December 2012

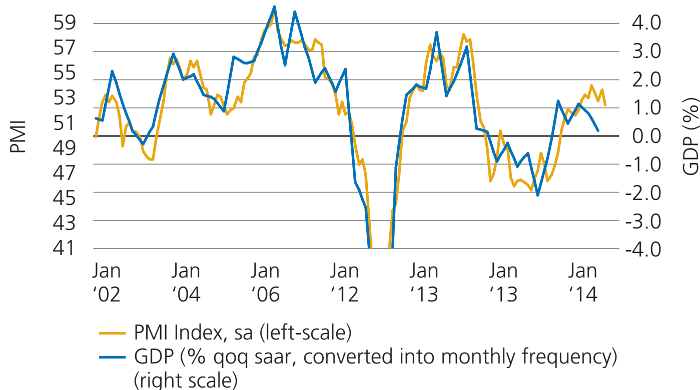
Although the fat tail scenario just described looks grim, recent developments in the region could take a turn for the worst. Hypothetically speaking, geopolitical tensions could escalate sharply, trade between the West and Russia could come to a stop and Europe could be cut off from the Russian

energy supply altogether. Such an outcome would be disastrous, but it is very unlikely as it would counter the economic interest of all parties involved.

Weak nominal growth could trigger QE

The headwind from geopolitical tensions in Ukraine is hitting the eurozone at a time when macroeconomic data are disappointing. Eurozone GDP grew at an annualised rate of only around 0.5% in the first half of 2014, well below most forecasters' expectations, and below the level indicated by high frequency indicators, such as the Purchasing Managers Index (PMI) (see Figure 5).

FIGURE 5: EUROZONE PMI AND ANNUALISED GDP GROWTH



Source: Markit, Eurostat, PIMCO as of 3 September 2014.
SA = seasonally adjusted. SAAR = seasonally adjusted annual rate.

Even allowing for some reacceleration in eurozone GDP growth towards the level indicated by business surveys and other key economic indicators, it seems likely that consensus expectations of 1.5% GDP growth over the next year will be disappointed. The weak pace of growth will hardly dent unemployment, which is still only 0.5% below the recent cyclical high of 12%. The current rate of expansion will prove insufficient to generate any meaningful acceleration in inflation, which is likely to get stuck between 0.5% and 1%.

Given the current macroeconomic backdrop, there is a good chance that the ECB will have to go beyond what it announced this week, and embark on a broad QE programme involving large scale purchases of private and public sector assets over the next few quarters. Whether it does engage in such broad QE or not, what is clear is that the ECB will keep the policy rate stable near zero for an extremely long time, even as other major developed market central banks get ready to raise interest rates.

The prospect of a very accommodative ECB stance ahead, and of a possible additional stimulus, has deep implications for markets. The belly of the European interest rate curve will be supported in anticipation of a QE launch. But, with bond markets pricing the ECB policy rate on hold until 2017 and 10-year Bund at a historic low of 0.94% (according to Bloomberg as of 4 September 2014), we believe that the best opportunities to exploit the current policy environment are peripheral bonds (in particular, Spanish and Italian government bonds). At the same time, the prospect for a widening policy rate differential in the U.S. and the UK on the one hand, and the eurozone on the other, calls for an underweight currency position in the euro.

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