S&P Global Ratings

Moving The Russia-Ukraine Scenario Needle: European Output At Risk

Why most downside scenarios look manageable

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This report does not constitute a rating action

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There are good reasons to believe that current scenarios surrounding the Russia-Ukraine conflict are manageable for the European economy, taking into consideration the usual transmission channels--trade, commodity prices, and confidence. Russia was only the fifth destination of EU exports in 2021, accounting for no more than 4% for total goods exports. Higher energy and commodity prices can be cushioned, at least temporarily, by the large excess savings that households and corporates have accumulated during the pandemic--in many countries, fiscal policy is working to mitigate their impact. And even if confidence takes a severe knock from the conflict, it will be from a high level due to the quick recovery in the labor market as well as fading, but ongoing, fiscal and monetary stimulus.

Even the most adverse scenarios so far considered by economists do not conclude that a full-year recession could be in the making. As an example, in its forecasts published last week, the European Central Bank considered a severe scenario that assumed a persistent rise in commodity prices, second-round effects on inflation, and a large degree of financial fragmentation on top of supply-side constraints in production. Even this severe scenario left GDP growth forecasts slightly above potential for 2022 to 2024.

What could move the needle

What could really move the needle on economic forecasts is not more severe scenarios on trade, commodity prices, and confidence but, rather, a spread of the conflict to other countries. Such developments would lower demand in many European countries and make assumptions on commodity prices fiercer. They would also exacerbate supply-chain issues. Let's not forget that after the fall of the Iron Curtain, European industry relocated to the Eastern part of the continent to be closer to the new European markets and to benefit from a cheaper local workforce, well before heading to Asia.

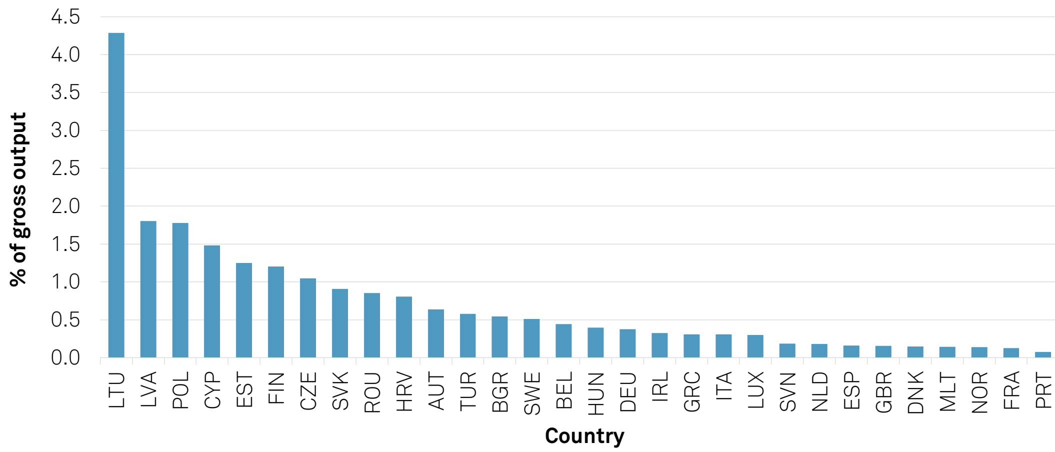
Output at risk

We've investigated the European supply chain and its share of production that is at risk in the ongoing conflict. We first looked at the share of intermediary consumption embedded in European production that comes from Russia. Then we looked at a first ring of countries that are direct neighbors of Russia and Ukraine: Estonia, Latvia, Lithuania, Romania, and Bulgaria. Finally, we looked at a second ring of countries in the sphere of influence of the former Soviet Union, or geographically close to it: Poland, Slovakia, Hungary, and Greece.

Russia only. Supply chains are affected by gravity. The closer a country is to Russia, the higher its share of Russian components in domestic output. Up to 4.3% of Lithuanian production has Russian components. On the other side of the continent, less than 0.1% of Portuguese production and less than 0.2% of U.K. production contain Russian components. Overall, the impact of Russia is limited for the large European economies (see chart 1).

Chart 1

Intermediary Components (IC) From Russia That Are Embedded In National Gross Output

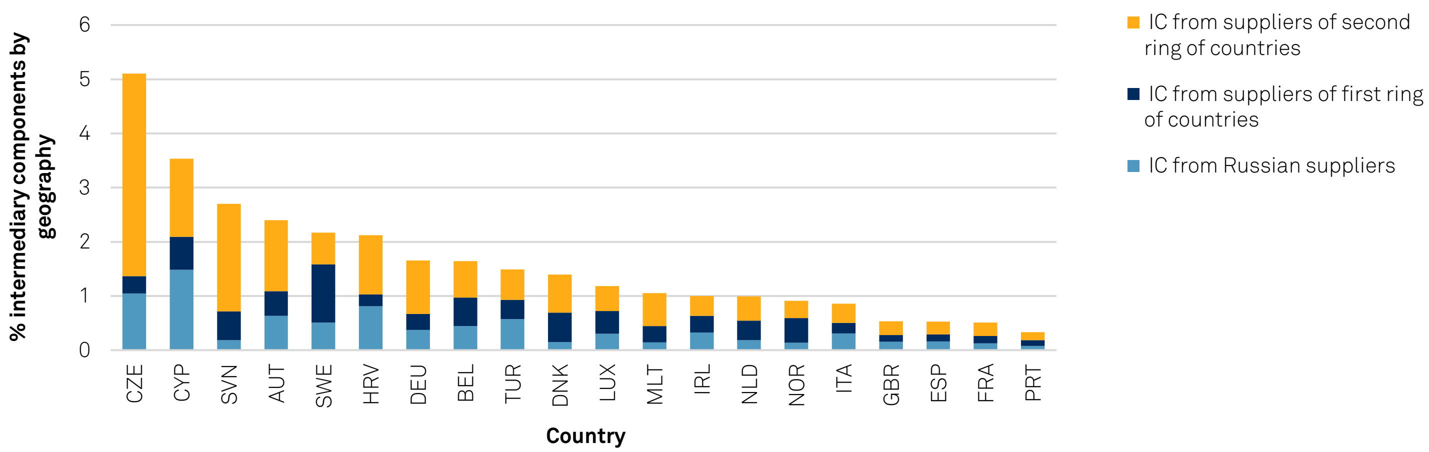


Source: S&P Global Ratings. Calculations are based on WIOD.

Russia plus the ring countries. The picture changes when we add the share of intermediary consumption in European production that comes from first-ring and second-ring countries. The impact on large European economies is now bigger and nonlinear. Specifically, it becomes more than 4x larger for the German economy and more than 3x larger for the U.K. economy (see chart 2).

Chart 2

Intermediary Components (IC) From Russia And Neighboring Countries That Are Embedded In National Gross Output



First ring of countries: Estonia, Latvia, Lithuania, Finland, Romania, Bulgaria. Second ring of countries: Poland, Slovakia, Hungary, Greece.
Source: S&P Global Ratings. Calculations are based on WIOD.

Bottom line

Current scenarios around the Russia-Ukraine conflict, even severe ones, that focus on the usual three transmission channels typically fail to generate a meaningful impact on European output. We find this encouraging, as it shows the region's macroeconomic resilience. A needle-moving scenario would require an escalation of the conflict, which, thankfully, remains a tail risk at this juncture.

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