Winter is coming in Europe

As inflation continues to surge and the energy crisis looms, an expert panel at IESE considers the hybrid fronts of the West's response to Russia's invasion of Ukraine and their economic consequences in Europe.



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In 1914 Europe became embroiled in what was meant to be a quick war, over by Christmas. In February 2022, many expected Russia's invasion of Ukraine to be over within a month. There are echoes between the two situations, says Harold James, professor of history at Princeton University. "And we now know that this war won't be over by Christmas either," he adds.

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For most people in Europe, the fallout isn't directly military but economic, and both sides are weaponizing finance against each other. The West has imposed economic sanctions on Russia, which, in turn, is cutting off Europe's gas supplies. Inflation and a looming energy crisis are the new facts of life.
In a wide-ranging discussion chaired by IESE's Xavier Vives, held for the European Finance Association (EFA) on the Barcelona campus in late August, James was joined by Nicholas Veron (of Bruegel and the Peterson Institute for International Economics), Lucrezia Reichlin (London Business School) and Elena Carletti (Bocconi University) to dissect the situation from various historical and economic perspectives — considering the financial effects so far, how the situation might develop and the difficult reconciliation of energy security and climate goals.

Early results from the financial sanctions

Veron highlighted that the act of freezing Russian Central Bank reserves marks the first time since the financial system was built that a core member of the Bank for International Settlements (BIS) has been subject to sanctions by the BIS itself. What's also striking is the remarkable coordination between countries in enacting these sanctions — not only the United States and the European Union, but countries like Switzerland, Monaco and San Marino, too. "This is remarkable and tells us something about what is possible," Veron says. Fellow panelists James and Reichlin also remarked on the unanimity of the Western response to support Ukraine, although they point out potential fragmentation and disagreement going forward.

The results of these financial measures — freezing reserves and decoupling Russia from the SWIFT payment system — are still hard to call with any certainty. Veron makes the argument that they might actually stabilize the system by presenting a united front to an invasion that was a violation of global norms. "Even China has obeyed," he says. "It sends a strong message."

And yet, on another level, these measures have been destabilizing: politicizing supposedly neutral issues, such as the relationships between banks, and revealing that neutrality to be a falsehood. "This is not just Russia's view," Veron asserts. "Many agree." (See, for example, "The war's collateral damage: the end of SWIFT as we know it.")

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How does the crisis find the EU?

Lucrezia Reichlin sees the European Union's position entering this crisis as weak. The crux of the problem is energy and geopolitics, and she finds Europe unprepared as an energy importer and as a conscientious fighter against the climate crisis. For example, as Bocconi's Elena Carletti points out, banks may need to finance coal again as an alternative to Russian gas before renewable energies can properly take over as secure sources for Europe's needs. And Green Deal commitments mean EU members aren't meant to be financing such dirty forms of fuel.

"The war will have short- and long-term economic consequences," Reichlin says. Although at the moment there is much concern with how deep and long a recession may be coming, the long-term consequences are ultimately more important, as energy and climate policies are key to long-term EU functionality.

"During decades of low energy prices, Europe forgot how important energy is. The ability of Europe to deal with energy security and not to renegotiate the commitment to the Green Deal will be very important for understanding where we are going."

For Reichlin, this presents the EU with "the sobering realization that a common energy policy is an indispensable complement to the common green agenda." And this necessitates remaining clear-eyed in terms of geopolitics globally, including maintaining good relations with China — a key supplier in the renewable supply chain.

Banks weathering the storm

Carletti's remarks center on the role of Europe's banks in the current conflict. In contrast to Reichlin's pessimistic outlook on EU preparedness, Carletti highlights that its banks, at least, have entered the current crisis with higher scores in terms of both equity and liquidity compared with the global financial crisis of 2008.

Nonetheless there are challenges. Inflation might require banks to take on even higher operating costs, especially if they implement much needed investment in digital and IT now. These areas are becoming increasingly important given the heightened risks of cyberattacks in the wake of Russia's war.

And while Carletti accepts that exceptional global cooperation went into levying sanctions against Russia, operationally, she says, this has not resulted in identical sanctions across the

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board. The same language was not used by different countries in describing what the sanctions should accomplish, leading to interpretive variations. "Before, banks were very used to dealing with sanctions coming from the U.S." Now, the water has muddied. Will we see banks being fined in the future for failing to uphold the complexities of a Canadian or Japanese sanction?

Second-quarter banking results have been broadly, and perhaps surprisingly, positive, but Carletti underlines that there is still great uncertainty: How much prudence will be needed going forward? Only time and the geopolitical situation will tell.

Who will blink first?

Global cooperation in these early days of responding to the crisis is mentioned and praised by all participants. But not everyone believes it will last.

James in particular feels the conflict has become a waiting game, with each side trying to hold on until the other implodes. For the West, the risk comes from inflation and energy shortages, which if prolonged, may erode support in governments and, ultimately, cause a disintegration of the united front against Putin. Yet it is unclear if Putin will be able to wait long enough. Economic sanctions, military setbacks, brain drain in Russia and the general hopelessness of the long-term outlook for Russia's young people may contribute to a regime change there first.

Underlying all the current worry was the nagging reality of a scorching European summer that is the context of the cold winter to come. With the climate crisis looming large, unity, creativity and focus are needed on a large scale.



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