

Box 3

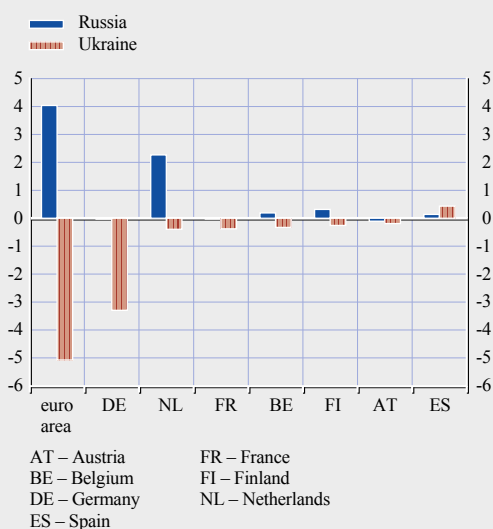
FINANCIAL STABILITY IMPLICATIONS OF THE CRISIS IN UKRAINE

Geopolitical tensions related to developments in Ukraine have been on the rise in recent months. The potential for such tensions to spill over into a larger conflict has given rise to short-lived bouts of financial market jitters against a backdrop of considerable political uncertainty. While the human and social costs of the crisis in Ukraine are clear, financial stability risks are harder to assess, given the still-evolving situation. Nonetheless, an analysis of direct euro area exposures can be illustrative in gauging the prospective economic and financial impact.

The direct *economic* impact on the euro area could be felt mainly through the trade channel, with related negative implications for euro area exports and, ultimately, economic growth. This channel seems relatively important in the case of Russia, while trade links to Ukraine appear to be much less relevant. The importance of the channels varies strongly by direction, with the euro area accounting for 40% of Russian merchandise exports and 30% of imports, while the corresponding figures for the euro area (net of intra-euro area trade) are below 10% for both exports and imports.¹ Russia therefore runs a trade surplus with the euro area as a whole, while the opposite is true for Ukraine (see Chart A). The interdependencies are concentrated in the energy area, with 18% of gas imports and 27% of oil imports by the euro area originating from Russia, which in turn constitute about half of Russia's commodity exports by value.

Chart A Merchandise trade balances for Russia and Ukraine vis-à-vis selected euro area countries

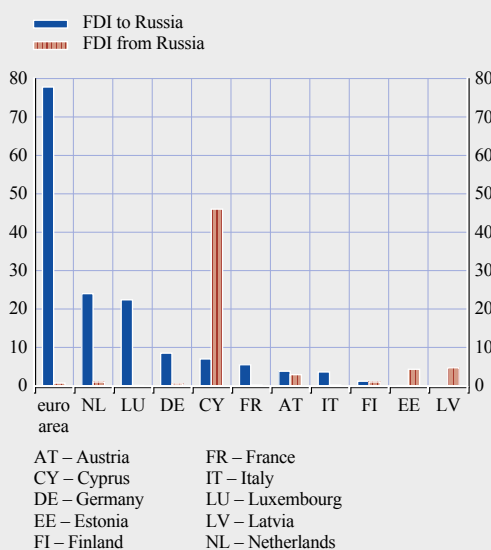
(percentage of 2013 GDP)



Source: IMF Direction of Trade Statistics.
Note: A positive balance indicates a trade surplus, i.e. the exports from Russia or Ukraine to a particular euro area country exceeding the imports from that country.

Chart B Country shares of total inward foreign direct investment in 2012

(2012; percentage of total)

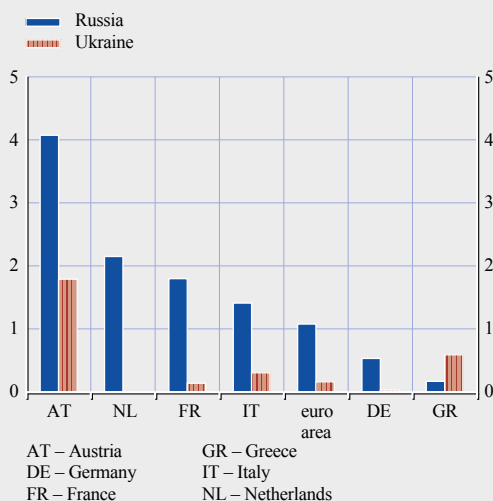


Source: IMF Coordinated Direct Investment Survey.
Note: "FDI to Russia" refers to the share of individual euro area countries in the stock of inward foreign direct investment to Russia; "FDI from Russia" refers to Russia's share in the inward foreign direct investment stock of the respective euro area countries.

1 A similar pattern holds for the euro area and Ukraine, although the importance of that channel is dwarfed by Ukraine's exposure to Russia.

Chart C Foreign claims of BIS-reporting banks from selected euro area countries vis-à-vis Ukraine and Russia

(Q4 2013; percentage of GDP, ultimate risk basis)

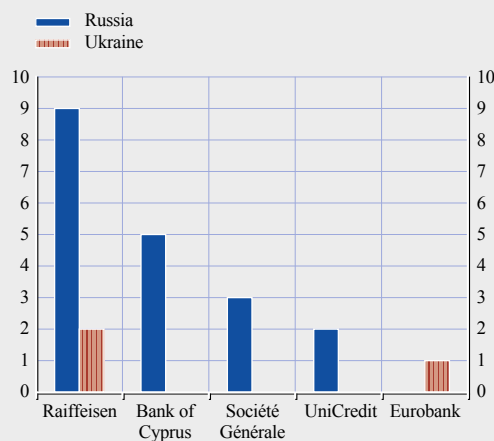


Sources: BIS Consolidated Banking Statistics and ECB calculations.

Note: Data for Austria and France on Ukraine refer to the latest publicly available data.

Chart D Selected euro area banks' exposures at default to Ukraine and Russia

(Q2 2013; percentage of total exposures at default)



Sources: EBA's 2013 transparency exercise and ECB calculations.

Notes: Exposure at default is defined as the sum of on-balance sheet exposures and the credit conversion factor of off-balance sheet exposures as per COREP definitions. See also footnote 2 for a discussion of the included sample.

The bulk of *capital flows* to Russia come from the euro area, while flows from Russia to the euro area, and those to and from Ukraine, are small in the aggregate. The euro area accounted for almost 80% of foreign direct investment (FDI) and 50% of the portfolio investment in Russia at the end of 2012, while the corresponding weights for Russia in the euro area were less than 1% in both investment categories. A notable exception is Cyprus, where almost 50% of inward FDI originates from Russia (see Chart B).

Concerning the direct *financial* channels, euro area bank exposures to Russia and Ukraine are significant for some countries and a few individual banks. Exposures exhibit considerable heterogeneity across countries, with Austria, France, Italy and the Netherlands displaying relatively large exposures (see Chart C). Four euro area banks have considerable exposures to Russia, while two banks are significantly exposed to Ukraine (see Chart D).² The largest exposures are, in general, recorded towards the non-financial private sector, while claims on banks and the public sector are relatively smaller.

The impact on the euro area has been contained so far as financial market reactions have been muted amid continuously high risk appetite, steady energy prices and largely unabated trade flows. Absent interruption of trade relations with Russia, direct economic effects can be expected to be small going forward. Financial stability risks could, however, mount over time owing to deteriorating economic developments in Russia and Ukraine, such as negative GDP growth, exchange rate depreciations and capital outflows. Such developments could have negative

2 Data collected through the EBA transparency exercise may understate banks' emerging market-related exposures as they were reported to the EBA to a minimum of (i) 90% of total exposure at default, and (ii) top ten countries in terms of exposure. Accordingly, banks which have, for example, low exposures to EMEs relative to their own total exposure, but high EME exposures in absolute terms when compared to other individual banks, are not included in the analysis. In other words, the analysis mainly captures banks' whose business model is tilted towards banking in EMEs.

effects on profit generation and credit quality for individual euro area banks with high exposures to these countries. Likewise, indirect effects – for instance, through trade and financial linkages with third countries – could lead to other propagation mechanisms. Ultimately, cumulating all such effects suggests that direct exposures represent only a fraction of the potential impact, thereby warranting continued close financial stability monitoring of these geopolitical tensions.