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GLOBAL MACRO RESEARCH

THE FUTURE OF EUROPE PART II

ADAPTING TO DEAL WITH RUSSIAN AGGRESSION

AUGUST 2022



EXECUTIVE SUMMARY

- The invasion of Ukraine by Russia has exacerbated strains between Russia and its European neighbours, and relations have deteriorated to levels not seen since the Cold War.
- Although a tragedy, the conflict has acted as a catalyst to greater cohesion amongst European Union member states, NATO and European countries more broadly. We believe there are three ways the crisis has increased integration:

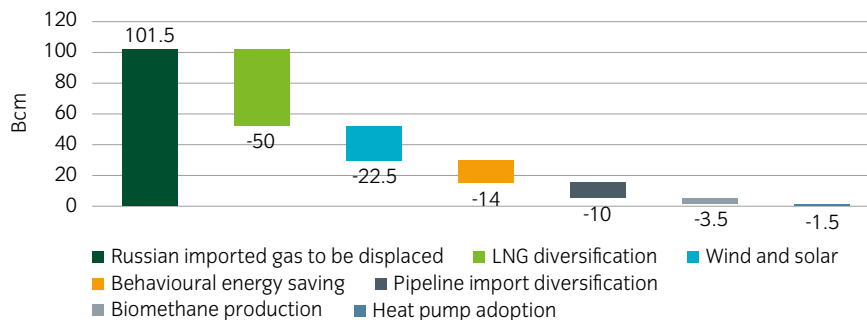
- 1 Energy:** Any perception of Russia as a strategic partner in energy have come to an end, and a shift to replace Russian oil and gas supplies is underway. Although the road is likely to be bumpy, we believe that a robust and co-ordinated EU wide energy policy will emerge that would have been unthinkable even a short time ago // 03
- 2 Defence:** NATO has united, and EU defence spending is likely to increase to meet minimum NATO spending requirements. Sweden and Finland have dropped their military neutrality, and represent significant additions to the military alliance // 06
- 3 Refugees:** EU member states bordering Ukraine have borne the brunt of the humanitarian crisis as refugees flee the conflict, but centralised funds have been made available and further action is likely to be taken to better share the fiscal burden // 07

ENERGY: HARD DECISIONS FOR LONG-TERM BENEFIT

PROPOSALS TO REDUCE RELIANCE ON RUSSIAN ENERGY ARE UNDER WAY

In May 2022, the European Commission proposed the REPowerEU Plan¹ in response to “the hardships and global energy market disruption caused by Russia’s invasion of Ukraine”. The plan aims to reduce EU imports of Russian gas by just over 100 billion cubic metres, roughly two-thirds of imports, within a year via a range of alternative sources of energy (see Figure 1). Delivering these objectives will require additional investment of €210bn to 2027 but will bring €100bn in annual savings from reduced spending on Russian fossil fuel imports once implemented.

Figure 1: The EU will aim to replace Russian gas via a six-part plan²



Investment projects undertaken as part of REPowerEU will be financed by both the private and public sector. Public sector projects can either be financed at a national level, or with additional support provided by the Recovery and Resilience Facility (RRF), which will be amended to include specific REPowerEU strategies within existing national programmes. The RRF has around €225bn in unused resources as many countries were able to directly issue debt at more attractive levels than offered by the Commission, so chose not to use the facility. The Commission has also indicated that it will add €20bn of grants to the facility from the proceeds of an auction of EU Emission Trading Scheme allowances. These changes will need to be approved by the European Council, and likely all individual EU member state parliaments, so are likely to come into operation around year-end.

¹ https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3131

² Source: European Commission.

A NUCLEAR RESURGENCE WILL ONLY LIMIT NET CAPACITY DECLINES

The need to replace Russian energy supplies has caused a reassessment of plans for nuclear power. Belgium, having previously committed to retiring all nuclear energy plants, has now extended 2GW of its 5.9GW in nuclear energy to 2035, with the remaining 3.9GW still due to be retired in 2025. In France, President Macron has announced plans to build up to 14 new reactors by 2050. The government has taken the electricity provider EDF into full state control in order to use the company to spearhead its nuclear plans. There are also proposals for new reactors in a range of other countries, both within the EU and more broadly across Europe.

Despite these plans, Europe will still lose around a net 5.5% of its nuclear capacity by 2030. The long lead times for new reactors (a reactor starting construction today will only be completed by around 2030) mean that even though new projects will be helpful, they are not a solution to the immediate problem.



With nuclear unable to provide short-term relief, renewables are likely to be the focus for the majority of new energy infrastructure investment.

THE ROLLOUT OF RENEWABLES NEEDS TO BE ACCELERATED

With nuclear unable to provide short-term relief, renewables are likely to be the focus for the majority of new energy infrastructure investment. The Commission is proposing to increase the headline target for renewable energy use by 2030 from 40% to 45% under the Fit for 55 package³. Underlying this are a range of specific proposals⁴:

- a dedicated EU Solar Strategy to double solar photovoltaic capacity by 2025 and install 600GW by 2030
- a Solar Rooftop Initiative with a phased-in legal obligation to install solar panels on new public, commercial and residential buildings
- doubling the rate of deployment of heat pumps, and measures to integrate geothermal and solar thermal energy into modernised district and communal heating systems
- a Commission Recommendation to tackle slow and complex permitting for major renewable projects, and a targeted amendment to the Renewable Energy Directive to recognise renewable energy as an overriding public interest
- setting a target of 10 million tonnes of domestic renewable hydrogen production and 10 million tonnes of imports by 2030, to replace natural gas, coal and oil in hard-to-decarbonise industries and transport sectors
- a Biomethane Action Plan sets out tools including a new biomethane industrial partnership and financial incentives to increase production to 35bcm by 2030, including through the Common Agricultural Policy

³ The Fit for 55 package is a climate law that enshrines EU climate targets of at least a 55% reduction in greenhouse gas emissions by 2030 compared to 1990 levels.

⁴ https://ec.europa.eu/commission/presscorner/detail/en/IP_22_3131

A COORDINATED REBUILDING OF EU-WIDE INFRASTRUCTURE LIES AHEAD

If the EU carries out its plans then it should be possible to replace Russian gas over the medium term, but it will require the revisions of dozens of regulations and procedures, huge sums of investment and many hard decisions. To be effective, the EU will have to co-ordinate a wholesale rebuilding of its energy system, with greater diversification of supply, stronger interconnectivity and well-defined contingency plans to respond to future supply disruptions. To help facilitate this the EU Energy Platform⁵ has been launched to help pool demand, coordinate infrastructure use and negotiate with international partners to facilitate joint gas and hydrogen purchases.

In the shorter term, ensuring that inventories are built and fairly distributed across the EU will be critical to reducing the EU's vulnerability to any escalation from Russia in the coming Winter. The challenge there will be sourcing sufficient alternative supply without being forced to overpay for it. The contractual nature of the global LNG market further increases this challenge; most LNG contracts are for 20 to 25 years to ensure that the construction costs of liquefaction plants and terminals are justified. Russia is also actively limiting the flow of gas to Europe, making it difficult to fill storage.

The Commission is, however, making considerable efforts to overcome this. This includes:

- an agreement with the US to deliver additional LNG supply (at least 15bcm in 2022 and around 50bcm annually until at least 2030)
- establishing a working group with Canada to source future LNG and hydrogen deliveries
- working towards a trilateral agreement with Egypt and Israel on LNG supply
- working with Asian partners such as Japan and Korea to redirect LNG cargoes to Europe where possible
- working with a range of countries to resource energy supplies including Algeria, Azerbaijan, Nigeria, Senegal and Angola



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⁵ https://energy.ec.europa.eu/topics/energy-security/eu-energy-platform_en

DEFENCE: A UNITED FRONT WITH DEEPER RESOURCING

A MORE COORDINATED APPROACH AHEAD, BUT STILL NATO-DRIVEN

The EU clearly sees strategic autonomy as a major priority and there is a centralised push to improve coordination. Josep Borrell, Head of EU Foreign Affairs, has stated that once the EU had refilled stockpiles of military material sent to Ukraine the medium-to-long-term goals need to focus on augmenting existing capabilities, reinforcing and modernising. Although there are numerous EU initiatives on the table to facilitate defence cohesion in the bloc, it is likely that the collective defence of the EU will continue to be largely orchestrated by NATO.

EXPANDING NATO TO THE NORTH

Both Sweden and Finland have formally announced their intention to join NATO in May 2022 and NATO's secretary general has confirmed that both applications will be fast tracked, with accession to the alliance potentially as soon as October. Polls suggest large swings in public opinion within both countries towards support of NATO membership, which is driving the political shift. This is a significant change for both countries, with Finland having become a neutral country in the years following World War II and Sweden since the early 19th century. Similar swings have not been seen in Ireland, perhaps because of its distance from Russia, so there has been no indication that Ireland will change its militarily neutral position.

The addition of Sweden and Finland will significantly bolster NATO resources; both countries have sophisticated, well-trained military capabilities and have committed to higher levels of defence spending in the years ahead.

BOLSTERING NATO'S EASTERN FLANK

NATO boosted its presence in Eastern Europe following the annexation of Crimea and has been maintaining four permanent NATO battalions in the region since 2017. In March 2022, at an emergency summit, members agreed to significantly increase the NATO presence on the Eastern flank, including battle groups in eight countries and 10,000 troops deployed as a rapid response force. In aggregate, Eastern European nations are hosting 330,000 NATO-affiliated troops (including their own standing armies) and have 130 aircraft and 140 naval vessels on high alert⁶.

GERMANY HAS COMMITTED TO A RADICAL SHIFT IN DEFENCE POLICY

Germany will play a key role in deepening EU and NATO defence resources. Shortly after the invasion of Ukraine the German government announced a new €100bn fund to modernise its armed forces. This fund will be debt-financed, taking advantage of the pandemic-induced suspension of the constitutional debt brake, and disbursed over time to boost defence spending to meet Germany's NATO commitment of 2% of GDP per annum by 2024. Initial measures include the purchase of 35 F-35 fighter jets from the US⁷, European-made Eurofighter Typhoons and 140 armed drones from Israel⁸.

⁶ Source: <https://www.ft.com/content/a1a242c3-9000-454d-bec7-c49077b2cc6c>

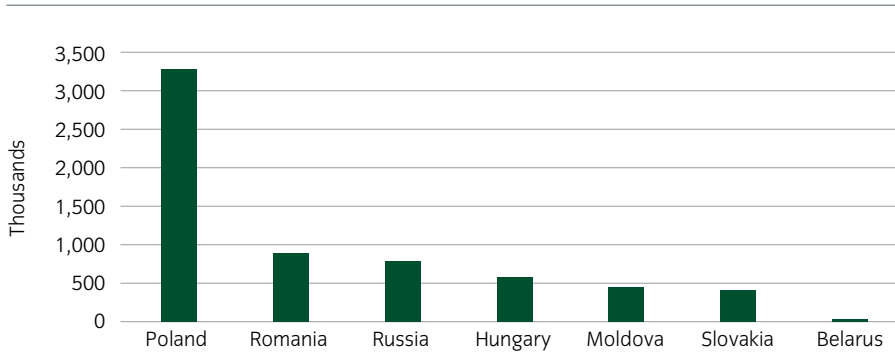
⁷ Source: <https://www.defensenews.com/air/2022/07/29/state-department-approves-84-billion-f-35-sale-to-germany/>

⁸ Source: <https://www.timesofisrael.com/turning-to-israel-germany-to-get-weaponized-drones-for-the-first-time/>

REFUGEES: SHARING THE COST OF THE HUMANITARIAN CRISIS

Russia's invasion of Ukraine has forced about 13 million people, in a country of just over 40 million, to leave their homes. By May 2022, 7.7 million Ukrainians were internally displaced, while the number of people having fled the country exceeded 5.3 million. The majority (90%) of Ukrainian refugees fled to the EU, which has welcomed them with unprecedented speed and support.

Figure 2: The refugee crisis is largely focused on neighbouring countries⁹



The extent of the humanitarian crisis is at a level not seen since the Second World War. For example, at the height of the 2015 to 2016 refugee crisis, the largest number of new asylum seekers in a single month was 161,000. In the current crisis, there were single days when the number of new refugees were in excess of 200,000. In response to the crisis, the EU activated the 2001 EU Temporary Protection Directive in March 2022 – a never-before-used policy mechanism that allows Ukrainian refugees to access social services while allowing them to live, work and study within an EU country for up to three years without having to formally apply for asylum.

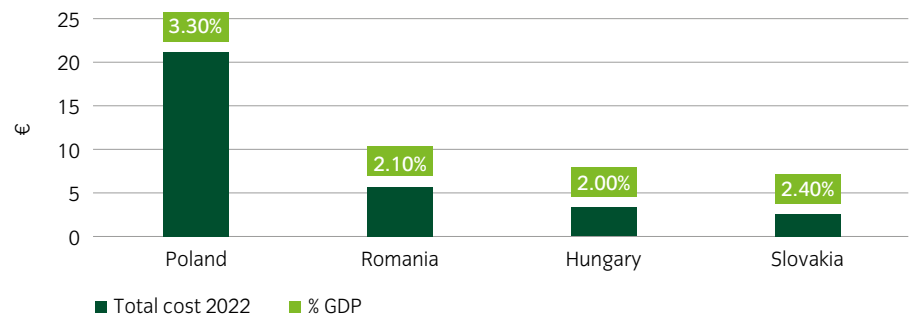


The extent of the humanitarian crisis is at a level not seen since the Second World War.

⁹ Source: UNHCR data as of 11 May 2022.

The significant fiscal cost of this falls heavily on the four EU member states neighbouring Ukraine. In a scenario in which the number of total refugees is around 5.7 million in the EU, of which only two-thirds require support from the EU, with an average cost of €15,000 per year, and for an average period of nine months in 2022, the total cost would amount to €40 billion in 2022. Although intra-EU movement and support from private donations and non-governmental organisations is likely to reduce the burden, the impact on the budgets of these front-line countries is significant (see Figure 3).

Figure 3: The estimated budget impact of the refugee crisis on frontline member states is significant¹⁰



THE COMMISSION HAS STEPPED IN TO PROVIDING EU-WIDE SUPPORT TO FRONTLINE MEMBER STATES

To provide relief for those countries on the frontline of the humanitarian crisis, the Commission is adopting the Cohesion's Action for Refugees in Europe (CARE) policy¹¹. This will provide funding of around €17bn, €10bn of which will be from unspent funds within the REACT-EU programme¹², which was part of Next Generation EU. Although welcome, some members are pushing for additional funds. Małgorzata Jarosińska-Jedynak, Poland's deputy minister for development funds and regional policy, has stated that "fresh EU funds that can deliver, that can respond to the needs of local governments and NGOs are needed". Redirecting funds from the 2022 annual EU budget would likely be difficult as the majority of it is already committed, but a new fund may be possible, financed either by national contributions or EU borrowing.



Although intra-EU movement and support from private donations and nongovernmental organisations is likely to reduce the burden, the impact on the budgets of these front-line countries is significant.

¹⁰ Source: Insight investment estimates for annual budget impact

¹¹ Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1607

¹² Source: https://ec.europa.eu/regional_policy/en/newsroom/coronavirus-response/react-eu/



CONCLUSION: SHORT-TERM PAIN FOR LONG-TERM GAIN

There is no doubt that the EU faces a difficult winter. A dramatic reduction in energy imports from Russia will be a huge task, with Russia supplying around 45% of total EU gas imports in 2019. Russia is likely to feel increasingly isolated economically, and militarily encircled by the Nordic expansion of NATO, elevating the risk of retaliation. Deliberately disruptive 'technical problems' will be designed to make it difficult to fill European reserves before Winter, increasing the pain of transition.

However, the right amount of investment and swift decision making could see the bloc emerging with a more co-ordinated and robust energy policy that would have been unthinkable just a short time ago. We believe that this would potentially represent another step along the path to deeper integration that we have witnessed in recent years. EU leaders have become adept at overcoming crises with measures that incrementally bind member states together and ultimately strengthen the EU as a whole.

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