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Russia's war on Ukraine could be a game changer for global banking. European banks are in the front row, whether they are prepared or not. Market analysts and supervisors[1] say that direct exposures to Russian counterparties are manageable, hence no need to panic. But in my view the impact of the war may end up being wider on European banks, potentially affecting market globalisation, which during the last three decades has been taken for granted.

Call it globalisation 2.0, call it de-globalisation. It is now a plausible scenario. European banks are in the front row, first, because the war is in Europe. Second, large banks throughout Europe have the lion's share of cross-border banking worldwide relative to large counterparts in other regions including the US. Such banks are in France, the UK, Spain, Switzerland, Netherlands, Italy, Germany, Austria, or Sweden. Their global presence is in retail and commercial banking carried out through local subsidiaries or branches and in wholesale segments (corporate lending, investment banking, trading), private banking, as well as asset and wealth management.

Of course, not all those banks have a material presence in the war-affected zone – Russia, Belarus, and Ukraine. But to the extent that the economic globalisation that has evolved over the last three decades is impacted, the ripple effect of the conflict can spread well beyond the affected zone.

Markets and banks may find a paradigm shift of this magnitude and impact difficult to assimilate, since globalisation of financial activities has been a given for a very long time. A degree of cognitive dissonance comes to mind. Very few decision makers in the financial services sector were professionally active before that watershed period three decades ago when the Berlin Wall was torn down and the Soviet Union was disintegrating. Thus, they have neither the institutional knowledge nor any personal memories of international activities conducted during the Cold War.

In Europe, banking deregulation started in earnest with the Second Banking Directive of 1992, enabling banks to diversify in terms of both activities and geography.

[1] ECB head supervisor Andrea Enria's introductory statement at last week's European Parliament hearing: https://bit.ly/37pnScC

Russia's disruptive impact…

Despite being the world's largest country by area, Russia's GDP is smaller than that of most of the world's major economies from both developed and emerging markets. With heavy financial and economic international sanctions tightening, Russia's economy is about to shrink massively and for some time. A sovereign default, which will be devastating for Russia's future in international markets, may also be in the offing.

Its banking system is almost 80% State-owned and controlled. The level of State ownership will undoubtedly rise further as Western banks pull out. Commentators note the recent unexpected strengthening of the ruble. In my view this is not so relevant any longer, because high restrictive barriers – internal capital controls, prohibitively high domestic rates, severe and expanding external financial sanctions – now wall off Russia's financial system from international markets. The Russian ruble's relative strength in the international currency markets is as useful an indicator as it was back in Soviet times – which means not very useful.

In fact, it has become increasingly difficult to still consider Russia a market economy. It will be less the case as the current situation progresses. And, unlike the old Soviet Union, Russia no longer benefits from the centrally planned framework of Comecon[2], which included the more developed economies in the ex-Soviet bloc and gave it a degree of stability.

Diminished economy notwithstanding, Russia remains a very relevant geopolitical power. Its tentacles are widespread, through substantial exports of fossil fuel and other raw materials, through arms sales (Russia is the world's second-largest arms dealer), and extensive military and covert adventures.

Putin's Russia is in a growing predatory and revanchist mode and has the will and capacity to massively disrupt the existing economic and political equilibrium. This is not about to go away, short of a change in political leadership or in geopolitical priorities – unlikely at this time. But it could be constrained if external financial, economic and technology sanctions are consistently applied and tightened.

So, against the "the world is our oyster" philosophy of international markets in recent decades, global banks will have to face some new realities for some years to come. The extent to which the global balance is disrupted depends on the various scenarios of Russia's war.

Under any scenario, again, short of a leadership change which is not likely in the short run, it is very probable that, against the horrors of its war of choice and under heavy sanctions, Russia will be ostracised by international investors and banks for the foreseeable future. A sovereign default would institutionalise this exclusion for a long time. The very few Western banks still present in Russia will not be there for long, as the economics of conducting activities locally no longer work and because of the heightened political and reputational risks which exist now.

For the foreseeable future, it is unlikely that international markets will see activity by Russian banks in the way it has in recent decades. That ship has sailed and is probably not coming back for a considerable time. Radical additional financial sanctions, like shutting off SWIFT to all Russian banks (including Sberbank and Gazprombank), would be another significant nail in the coffin. Equally, it is plausible that once Europe (especially Germany) shifts its energy sources away from Russia, economic links will

[2] Comecon is the byname of Council for Mutual Economic Assistance – an organisation created in 1949 to co-ordinate the economic development of the Soviet bloc (Soviet Union and satellite countries in eastern Europe). It was dissolved in 1991.

become of secondary importance, even when sanctions are removed.

… could be magnified if China closes ranks

Russia's finances could become more dependent on China's, as would its economy through energy exports and imports of finished goods. These trade flows will probably occur more on China's terms.

It is possible that Chinese banks, already large players in the banking markets, will increase their activities in Russia further. Both with providing business credits but also, potentially, through the transfer of advanced payment infrastructures for retail and business customers – which they already use domestically. China is advanced in implementing its central bank digital currency, the digital yuan (e-CNY), which in time could play a role in helping Russia avoid USD-EUR payment circuits (which under the sanctions are not available to it anyway).

Were geopolitical ties between Russia and China to deepen further, following their 4 February strategic agreement, a radicalisation of anti-Western attitudes in China could affect the activities of the numerous global banks with a presence in China. Which is far more significant than Western banks' activities in Russia.

Direct material support by China of Russia's war in Ukraine, let alone an invasion of Taiwan, would bring Western sanctions on China as well, with a new set of existential strategic challenges for those Western banks present there, which are engaged in the full range of banking and asset management activities. Compared to Russia, China is of course an economic giant, but its economy depends heavily on exports, notably to Western markets.

While this is not the most likely scenario, it is nonetheless on the radar of top global bankers.

The likely reshaping of global banking should also be on investors and analysts' minds and be part of their dialogue with the global banks they cover. Equally, it should figure in the qualitative factors included in supervisory stress-test scenarios.

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