IN THE SHADOW OF THE WAR
The economic fallout from the war on Ukraine
Regional Economic Update for the EBRD Regions

In the shadow of the war

The economic fallout from the war on Ukraine

March 2022

The economies of the EBRD regions expanded by an estimated 6.6 per cent in 2021 after contracting by 2.6 per cent in 2020 as Covid-19-related restrictions were phased out and people’s mobility (movements to places of work and recreation) returned to pre-pandemic levels.

Growth is expected to decelerate to 1.7 per cent in 2022, a downward revision of 2.5 percentage points relative to the forecast made in November 2021, as Russia’s invasion of Ukraine has been having a profound impact on the economies in the EBRD regions as well as globally. In 2023, growth in the EBRD regions is expected to pick up to 5 per cent. Projections are subject to an exceptionally high degree of uncertainty, including major downside risks should hostilities escalate or should exports of gas or other commodities from Russia become restricted.

After Russian armed forces invaded Ukraine on 24 February 2022, the world economy faced the greatest supply shock since at least the early 1970s. Russia and Ukraine supply a disproportionately high share of commodities – from energy to metals to food to fertilizer (including ammonia and potash, also exported by Belarus). Prices of food commodities, oil, gas and metals increased sharply as markets anticipated a major reduction in exports from Russia, Ukraine and Belarus.

The shortage of commodities started reverberating through supply chains. For instance, titanium is used in planes and smart phones alike, corn is a major input into meat production, while many batteries rely on nickel. This added to inflationary pressures. They were exceptionally high even before February 2022 owing to rebound in global demand as Covid-19 restrictions were being phased out.

Inflationary pressures have been greater in lower-income economies where food commodities (such as grain or corn) and energy account for a higher share of consumption. This is because poorer people spend higher proportions of their incomes on food and energy. Furthermore, where incomes are lower, wheat accounts for a higher share of the cost of a loaf of bread in a supermarket. Lower-income economies have also seen faster deterioration of current account balance as well as fiscal balances in cases where governments stepped in to subsidize food. North African economies and Lebanon have been particularly exposed to reduced global supply of wheat.
Economies in Central Europe, in addition, are closely integrated in manufacturing supply chains with Ukraine. Owing to lack of deliveries of parts from Ukraine, a number of car factories had to partially or fully suspend production and look for alternative suppliers as hostilities escalated.

In addition, Europe has been witnessing the greatest forced displacement of people since the Second World War, with major inflows of refugees into Hungary, Moldova, Poland, the Slovak Republic and other economies. If Europe’s history is a guide, relatively skilled migrants from Ukraine may provide a boost to Europe’s rapidly aging economies in the longer term, in particular where they move to less congested areas. In the short term, the recipient economies face fiscal pressures and administrative challenges as they scale up provision of schooling, housing and health care. In the wake of the invasion, a number of economies, in particular in Central Europe and the Baltic States, announced higher targets for military spending in the coming years, further adding to fiscal pressures.

Markets have also been reassessing geopolitical risks, leading to pressures on the currencies in the Caucasus, parts of Central Asia – and beyond, as well as higher bond yields (and hence borrowing costs). Yields on Egypt’s dollar-denominated government bonds increased in the aftermath of the invasion of Ukraine, reflecting the vulnerability of the Egyptian economy to steeply rising food and energy prices.

Central Asia and the Caucasus may be additionally impacted by restrictions on convertibility of the Russian rouble and reduced air links between Russia and neighbouring economies which weigh on remittances and trade. Remittances from Russia amounted to 5 to 30 per cent of GDP in Armenia, the Kyrgyz Republic, Tajikistan and Uzbekistan. In addition, Russian tourist spending in Armenia, Cyprus, Estonia, Georgia and Montenegro used to range between 1 and 2 per cent of GDP – in the short term, only part of this deficit is expected to be offset by visitors from elsewhere.
Table 1. GDP growth in real terms

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Source: National authorities and EBRD. Weights are based on the values of gross domestic product at purchasing power parity. "e" denotes unofficial estimates.
Strong growth in 2021
The economies of the EBRD regions expanded by an estimated 6.6 per cent in 2021 after contracting by 2.6 per cent in 2020 as Covid-19-related restrictions were phased out and people’s mobility (movements to places of work and recreation) returned to pre-pandemic levels (see Table 1). The recovery in the second half of the year was stronger than anticipated in the November 2021 Regional Economic Prospects.

Sharper-than-previously expected deceleration in 2022
Growth is expected to decelerate to 1.7 per cent in 2022 (see Chart 1), a downward revision of 2.5 percentage points relative to the forecast made in November 2021, as the war on Ukraine has been having a profound impact on the economies in the EBRD regions as well as globally.

Chart 1. Growth in the EBRD regions is expected to decelerate to 1.7 per cent in 2022

Sources: IMF, EBRD, national authorities via CEIC and authors’ calculations.
Notes: Weights using GDP at market exchange rates.

As a result, average income per capita in the EBRD regions is expected to be 3.9 per cent above the pre-Covid level by the end of 2022 (see Chart 2), corresponding to an average per capita income growth of only 1.3 per cent per annum over 2020-22.

In 2023, average growth in the EBRD regions is expected to pick up to 5 per cent.

High degree of uncertainty
The forecasts assume that a ceasefire is brokered within a couple of months, followed soon after by the start of a major reconstruction effort in Ukraine which will bring GDP by end-2023 back close to, but still below, pre-war levels. Sanctions on Russia are expected to remain for the foreseeable future, condemning the Russian economy to stagnation in 2023 (after a sharp GDP drop in 2022), with negative spillovers for a number of neighbouring countries in eastern Europe, the Caucasus and Central Asia.

The 2022 harvest in Ukraine is assumed to partly come in, with food prices remaining elevated in the coming months but dropping a bit towards the end of the year. Oil prices are also assumed to stabilise once peace is brokered, declining towards US$ 90 per barrel of Brent towards the end of 2022.

Significant downside risks
Projections are subject to major downside risks should hostilities escalate or should exports of gas or other commodities from Russia become restricted.
Rising prices of food, energy and metals exacerbating inflationary pressures

As the war escalated, the world economy faced the greatest supply shock since at least the early 1970s. Russia and Ukraine supply a disproportionately high share of commodities – from energy to metals to food to fertilizer (including ammonia and potash, also exported by Belarus, see Chart 3). Prices of food commodities, oil, gas and metals increased sharply as markets anticipated a major reduction in exports from Russia, Ukraine and Belarus.

Chart 3. Russia and Ukraine supply a disproportionately high share of commodities

Sources: UN Comtrade, World Bank, IMF, Bloomberg and authors’ calculations.


The shortage of commodities started reverberating through supply chains. For instance, titanium is used in planes and smart phones alike, corn is a major input into meat production, while many batteries rely on nickel. This added to inflationary pressures. They were exceptionally high even before February 2022 owing to the rebound in global demand as Covid-19 restrictions were being phased out.

Inflationary pressures have been greater in lower-income economies where food commodities (such as grain or corn) and energy account for a higher share of consumption (see Chart 4). This is because poorer people spend higher proportions of their incomes on food and energy. Furthermore, where incomes are lower, wheat accounts for a higher share of the cost of a loaf of bread in a supermarket. Lower-income economies have also seen faster deterioration of current account balances as well as fiscal balances in cases where governments stepped in to subsidize food. North African economies and Lebanon have been particularly exposed to the reduced global supply of wheat.

Chart 4. In lower-income economies food commodities (such as grain or corn) and energy account for a higher share of consumption

Sources: Eurostat and authors’ calculations.

Ruptured supply chains

Economies in Central Europe, in addition, are closely integrated in manufacturing supply chains with Ukraine. Owing to lack of deliveries of parts from Ukraine, a number of car factories had to partially or fully suspend production and look for alternative suppliers as hostilities escalated.

Greatest forced displacement of people in Europe since the Second World War

In addition, Europe has been witnessing the greatest forced displacement of people since the Second World War, with major inflows of refugees into Hungary, Moldova, Poland, the Slovak Republic and other economies (see Chart 5). If Europe’s history is a guide, relatively skilled migrants from Ukraine may provide a boost to
Europe’s rapidly aging economies in the longer term, in particular where they move to less congested areas. In the short term, the recipient economies face fiscal pressures and administrative challenges as they scale up provision of schooling, housing and health care.

Chart 5. Europe has been witnessing the greatest forced displacement of people since the Second World War

![Chart 5](chart5.png)

Sources: UNHCR, national authorities and authors’ calculations.

Notes: As of 22 March 2022. Arrival numbers do not fully account for subsequent departures.

In the wake of the invasion, a number of economies, in particular in Central Europe and the Baltic States, announced higher targets for military spending in the coming years, further adding to fiscal pressures.

Markets reassessing risks

Markets have also been reassessing geopolitical risks, leading to pressures on the currencies in the Caucasus, parts of Central Asia – and beyond, as well as higher bond yields (and hence borrowing costs). Yields on Egypt’s dollar-denominated government bonds increased in the aftermath of the invasion of Ukraine, reflecting the vulnerability of the Egyptian economy to steeply rising food and energy prices (see Chart 6).

Chart 6. Markets have been reassessing geopolitical risks

![Chart 6](chart6.png)

Sources: Bloomberg, CEIC and authors’ calculations.

Remittances at risk

Central Asia and the Caucasus may be additionally impacted by restrictions on convertibility of the Russian rouble and reduced air links between Russia and neighbouring economies, which weigh on remittances and trade. Remittances from Russia amounted from 5 to 30 per cent of GDP in Armenia, the Kyrgyz Republic, Tajikistan and Uzbekistan (see Chart 7).

Chart 7. Remittances from Russia amounted to 5-30 per cent of GDP in Armenia, the Kyrgyz Republic, Tajikistan and Uzbekistan

![Chart 7](chart7.png)

Sources: Central Bank of Russia, IMF and authors’ calculations.
These economies may also be to a greater extent impacted by the loss of corresponding bank relationships via Russian banks as many Western corresponding banks withdrew earlier in the face of higher compliance costs (see Chart 8).

**Chart 8. Economies may also be impacted by the loss of corresponding bank relationships via Russian banks**

Exposure of banks in the EBRD regions to Russia has been limited with the exception of Hungary’s OTP which derived 7 per cent of its profit in 2021 from the Russian market. However, there is a risk of second-round negative effects on foreign-owned banks (Unicredit, Societe Generale, ING, Raiffeisen) present in the region, given their existing exposure to the Russian market (see Chart 9).

**Chart 9. European banks’ claims on Russia are significant but manageable**

In addition, Russian tourist spending in Armenia, Cyprus, Estonia, Georgia and Montenegro used to range between 1 and 2 per cent of GDP (see Chart 10). In the short term, only part of this deficit is expected to be offset by visitors from elsewhere.

**Chart 10. Russian tourist spending in Armenia, Cyprus, Estonia, Georgia and Montenegro used to range between 1 and 2 per cent of GDP**

Sources: EBRD Trade Facilitation Programme Survey on Correspondent Banking Relationships 2019 and authors’ calculations.

Sources: Bank for International Settlements and authors’ calculations.

Sources: World Bank, Russia’s border service outbound tourism statistics and authors’ calculations.
Regional updates

Central Asia

Central Asian economies will likely experience significant collateral damage resulting from the war on Ukraine and international sanctions on Russia. The region will be negatively affected through five main channels.

First, remittances are a major source of income and foreign currency earnings for Central Asian economies (31 per cent of GDP in the Kyrgyz Republic, 26.7 per cent in Tajikistan and 11.4 per cent in Uzbekistan). Russia is a major source, accounting for more than 50 per cent of the total received in the first nine months of 2021 by Tajikistan and Uzbekistan, and more than 80 per cent of the total received by the Kyrgyz Republic.

Second, uncertainty is affecting investment and job creation. Domestic labour markets may be slow to create new jobs because of major uncertainty affecting investment (as already reported by EBRD clients). With Kazakhstan and the Kyrgyz Republic still reeling from recent political upheavals, labour market pressures may have implications for their continued political stability.

Third, returning migrants may put strain on labour markets. If Russia goes into a protracted crisis, many Central Asian countries will see migrant workers returning to the region, putting pressure on wages and increasing competition in the low-qualification segment of the labour market. Such pressures may be particularly acute in Uzbekistan and Tajikistan due to their migrant workers being concentrated in the Russian construction industry (Russian-speaking Kyrgyz migrants are mostly employed in the Russian services industry). On the other hand, the inflow of Russian, Belarusian and Ukrainian migrants to Central Asia may provide the region’s knowledge-intensive sectors with a strong impetus given that many of these migrants are entrepreneurs, developers and digital nomads.

Fourth, increased energy prices will negatively affect net energy importers – the Kyrgyz Republic and Tajikistan. Kazakhstan, Mongolia, Turkmenistan and Uzbekistan, on the other hand, will reap significant benefits.

Elevated prices for gold, ferrous and non-ferrous metals will be a major compensating factor for all Central Asian economies.

Last, supply chain disruptions will affect all Central Asian countries, but will be particularly acute for countries with the highest share of transit trade through Russia, such as Kazakhstan and Mongolia. Lingering Covid-19 restrictions on the Chinese border will be an aggravating factor. Turkey will likely emerge as a major regional distribution hub serving Western, South Korean and Japanese companies, resulting in additional transport and logistics costs. Russia’s share in Central Asia’s imports is very substantial, ranging from 42 per cent for Kazakhstan to 21 per cent for Turkmenistan.

Economies also faced quick pass-through from devaluation and higher global commodity prices to inflation. The first weeks of war resulted in most of Central Asia’s national currencies quickly losing value (by about 20 per cent in the Kyrgyz Republic and Kazakhstan, by 15 per cent in Tajikistan and by 7 per cent in Uzbekistan) – despite increased policy rates and market interventions by Central Banks. Some of these early losses have been erased in more recent days, in sync with the Russian rouble. A major drop in remittances is one immediate cause of this turbulence (Tajikistan officially reported a 75 per cent drop in the value of remittances received in the first 10 days of March 2022, a blow to the country’s supply of foreign currency liquidity). Another cause is dependence on Russian banks for the supply of physical hard currency cash and correspondent bank accounts (for example, 75 per cent of all correspondent accounts held by Tajikistani financial credit institutions are held with Russian banks). The pass-through from currency devaluation to inflation is likely to be very significant given that imports account for a very large share of consumption across Central Asia (for instance, 60 per cent in Tajikistan). Most Central Asian economies can ill afford a spike in food and consumer good prices. Major producers of wheat, such as Kazakhstan and Uzbekistan will
seek to constrain price increases by setting export quotas. Importers will have no choice but to subsidise basic food commodities, straining fiscal balances. To add insult to injury, increased fertilizer costs are expected to impact agricultural productivity and the prices of domestically produced foods.

The Kyrgyz Republic may be a special case, at least as far as official growth figures are concerned. In January 2022, the country introduced sweeping tax and custom administration reforms, which are likely to reduce illicit trade and informal economic activity. China’s trade statistics consistently show an excess of US$ 5-6 billion in Chinese exports to the Kyrgyz Republic (equivalent to 70-80 per cent of GDP) over the officially reported Kyrgyz data. Assuming the on-going reforms are at least partially successful in curbing smuggling activities, the Kyrgyz Republic will see very significant gains in fiscal revenues and official GDP statistics over the next few years (paradoxically, the impact on actual income may be negative due reduced trade volumes).

Another special case is Turkmenistan, which is in a position to reap the benefits of its “splendid isolation”, immense energy reserves, strict rationing of access to hard currency, and its transportation-friendly location on the Caspian Sea.

Central Europe, the Baltic states and the south-eastern European Union

The four main channels through which the war is affecting the EU countries of operations are: i) refugee crisis, ii) prices, iii) trade and industry, and iv) financial markets.

Two million Ukrainian arrivals have made Poland the host of the second biggest refugee population in the world. Almost all other countries of the region are also significantly affected. Population growth exceeding 5 per cent in monthly terms is bound to create major pressures in public services, housing, and the labour market. Tight labour market before the war does already help in securing job access to the refugees. On the macro level, the refugee population will support consumption, however, at the cost of higher budget and trade deficits and inflation.

Higher energy prices are already visible in wholesale and retail markets across Europe. The potential escalation of import sanctions would result in both price and availability issues, especially for Russian gas. The EU imports 25 per cent of oil, 47 per cent of coal and 40 per cent of its gas from Russia. The first two are more easily replaceable, as shown by the recent temporary technological switch away from Urals crude in the region. The Baltic states (Estonia, Latvia and Lithuania), the Slovak Republic and Bulgaria are most dependent on imports of Russian fuels. LNG capacities are now expected to take on a core part of the supply stack (the Czech government aims to invest in LNG infrastructure, potentially in Germany), but currently terminals have limited capacities for extra imports from countries outside the EU. A potential replacement of Russian gas supplies by LNG would take some time, as currently LNG makes up only 1 per cent of all gas consumption in the EU. Fuel rationing may be necessary if Russia blocks gas supplies to the EU. Combined with the pressure on food prices, higher energy prices are compounding earlier overheating issues, leading to further tightening of monetary policies in the region.

Apart from commodity import disruptions, direct export declines and supply chain issues will impact several industries in the EU. In particular, this applies to the EU’s automotive industry. In general, trade restrictions will have a greater effect on smaller Baltic countries (Russia is still one of the most important markets for Latvian and Lithuanian goods exports, at 14 per cent of total exports (7 per cent of GDP) in the case of Lithuania).

A drop in Russian tourism would affect some countries, notably Bulgaria, which received 450,000 Russian tourists in 2019. Other tourism-dependent countries such as Croatia and Greece which, while not reliant on Russian or Ukrainian tourists, could suffer from a general drop in tourist appetite of Western European and North American countries because of higher costs and/or perceived heightened risks of spillovers from the conflict.
The financial system’s direct exposure to Russia and Ukraine is limited in most economies in Central Europe and the Baltic states, apart from Hungary’s OTP – 7 per cent of its profit in 2021 came from the Russian market. In a heightened general risk environment, increased currency volatility and higher financing costs will likely affect the investment climate in the EU EBRD regions. Foreign direct investment may be delayed in countries closer to Ukraine, such as Bulgaria and Romania, especially in the context of a militarisation of the Black Sea.

**Eastern Europe and the Caucasus**

**Ukraine**

Ukraine’s economy is currently functioning under war conditions. On the day of invasion (24 February) the National Bank of Ukraine (NBU) fixed the exchange rate, limited cash withdrawals and introduced capital controls by almost fully preventing cross-border transactions.

Budget priorities have shifted towards security expenses and providing basic food for the people in need, while financing moved to war bonds purchased by domestic banks and the NBU, which is allowed to purchase government bonds on the primary market under Martial Law.

The IMF and EU have already provided US$ 1.4 billion of rapid financing and €0.6 billion of MFA respectively, with many other multilateral and bilateral creditors/donors pledging and delivering additional external financing.

Currently, the war is happening on territories that produce around 60 per cent of Ukrainian GDP, and the NBU estimates that 30 per cent of businesses have stopped production, while electricity consumption is estimated at about 60 per cent of the pre-war level. This is severely weakening companies’ finances, with some being even physically damaged, thus exposing the banking sector to a drastic deterioration of asset quality. However, at the moment there are moratoria on changing the risk classification of banks’ credit exposures.

On March 16, the national power grid was connected to the continental European Energy System, a year earlier than planned. Previously, Ukraine’s power grid had been disconnected from the grids of Russia and Belarus several hours before the Russian attack on February 24. Connection is currently just technical but the authorities are looking at the possibility of commercial flows, which would mean export of surplus electricity from Ukraine because of depressed domestic demand.

**Other economies**

In other EEC countries, trade disruptions are likely and high energy and grain prices will keep inflation at elevated levels. Armenia and Georgia also have high export shares to Russia (25-30 per cent), which would likely be affected by the expected downturn of the sanctioned Russian economy. Georgia may additionally suffer from a slowdown in tourism from Russia and Ukraine, strongly affecting an already battered hospitality industry. Armenia might also be hurt by a fall in remittances from Russia. Increasing arrivals of Russians who seek refuge in Armenia and Georgia might compensate this to some extent. Moldova’s fragile economy and constrained institutional capacity mean it is struggling to cope with the influx of Ukrainian refugees. It is likely that this will seriously disrupt the reform agenda of the new government. Azerbaijan’s economy could benefit from increased oil prices, and the move by European countries to alternative suppliers of oil and gas, thus boosting GDP growth in 2022. Beyond the short term, the economic implications of possible post-conflict scenarios are difficult to assess at present but could be serious for countries in this region. Even if the conflict lessens, the persistent risk of another major escalation is likely to continue to have a devastating impact on the investment climate and financing conditions.

**Southern and eastern Mediterranean**

The impact of the conflict on the southern and eastern Mediterranean is increasingly felt, especially through higher oil and food prices for consumers, and secondary effects for the budget, food security and medium-term growth drivers. In all countries, petroleum products are the biggest single import position, and several are also dependent on imported food products (notably
Egypt, Tunisia, and Jordan). Imported inflation will be a drag on growth and weigh down the post-pandemic recovery.

In Egypt and Tunisia especially, food and fuel subsidies (and/or price caps) might limit inflation for households, but create a burden for public finances: Egypt already announced an economic support package, whereas fiscal space in Tunisia is probably too constrained for extensive support measures. Besides the macroeconomic impact, the rise in prices will bring risks to food security, notably for the poorest parts of the population which were already hit hard by the pandemic. According to the dietary sourcing flexibility index (DSFI) developed by FAO, consumers in Tunisia, Morocco and Egypt are particularly vulnerable, with significant shares of the population unable to support a healthy diet if prices rise and governments do not step in with support programmes.

All economies in the southern and eastern Mediterranean are net importers of petroleum products and dependent on food imports, (notably wheat but also maize and other products) and will likely face some imported inflation. Ukraine and Russia together contribute more than 25 per cent to global wheat exports. Egypt is the world’s largest wheat importer, but other countries (including Tunisia, where wheat is the 6th largest import product absent local production, and Algeria) as well as Lebanon also import food commodities (including wheat and maize) from Ukraine and Russia. Compounding this, several countries have a long history of subsidising essential products (food and fuel), although progress was made in recent years in scaling back subsidies in some countries (for instance in Egypt and Tunisia). Governments face challenges from various sides. First, populations in the region have faced rising inflation in recent months and these are likely to increase with Ramadan (commencing in April) and increased demand for food products, so rocketing prices for large parts of the population entail serious socio-economic downside risks. At the same time, governments are already under significant budgetary and macroeconomic pressure (Tunisia and Lebanon, especially), and were committed to expenditure consolidation after the pandemic to preserve debt sustainability, meaning they will have to find a delicate balance between supporting populations and managing fiscal space.

An additional impact could arise from new opportunities for gas exporters (on the upside) but also a negative impact on tourism and supply chains in countries with sectoral concentration. On the upside, changes in global gas markets may create (longer-term) opportunities for potential gas exporters in North Africa, namely Algeria. Egypt and Libya, if Europe engaged more actively to resolve current tensions and facilitate pipeline access. A drop in tourism as well as general supply chain bottlenecks and volatility could also affect important growth drivers: Ukrainian and Russian tourists accounted for around 20 per cent of arrivals in Egypt in recent years, and Russian tourists accounted for around 7 per cent in Tunisia, for example. An extended conflict could also weigh on the general tourism industry from Europe, endangering the ongoing recovery of the sector. Lastly, supply chain disruptions and volatility in other global markets could also negatively affect the current account balance of most countries (through more expensive imports) as well as the export performance of those economies which are more strongly integrated into global manufacturing value chains, such as Morocco and Tunisia.

Overall, these developments create varying degrees of pressure on international reserves. In Egypt, authorities have allowed the exchange rate to absorb part of the impact (with 17 per cent devaluation) and tapped into international debt markets. A prolonged crisis will likely add further pressure on the exchange rate, particularly with weaker tourism income. The need to speed up talks with the International Monetary Fund is even bigger now for Tunisia and Lebanon as both lack access to international markets to finance larger import bills. Jordan appears slightly better off with 15 months of wheat reserves and comfortable foreign exchange reserves, but similar concerns will be increasingly relevant with an extended crisis. Forecasts for Lebanon are subject to a particularly high degree of uncertainty.
**Turkey**

In Turkey, the key direct impact will be higher commodity import prices – notably energy and wheat and reduced tourism, particularly at the present time when Turkey is pursuing a new economic model, which relies on balancing the current account in order to achieve macroeconomic stability. Turkey imports 93 per cent of its oil and 99 per cent of its gas needs, and Russia and Ukraine together provide over 20 per cent of Turkey’s tourists.

The higher cost of imports and loss of tourism revenues would not only make achieving current account balance difficult, but also make it harder for the central bank to rebuild its severely diminished foreign exchange reserves, limiting its ability to support the lira if needed.

The failure to balance the current account will dent investor confidence in the ability of the new economic model to maintain macroeconomic stability, putting further pressure on the lira, potentially increasing dollarisation once again, and give rise to even more inflationary pressure. These indirect effects in the form of the failure of the new economic model would potentially have a greater impact on activity than the direct impact of a fall in tourism revenues and rising oil prices.

**Western Balkans**

Economies in the Western Balkans have only a limited exposure to Russia or Ukraine in terms of direct economic links such as trade, investments, remittances and other inflows.

However, Montenegro has some exposure via tourism: Ukraine was the second largest source of tourists in 2021, though this is likely a temporary effect due to the pandemic (easier access to Montenegro than to other markets last year), while pre-pandemic Russia was an important source of tourists.

In terms of trade, Serbia has the highest exposure to Russia (around 6-10 per cent of total goods imports and 5 per cent of total goods exports in recent years). Goods imports from Russia mostly relate to mineral fuel, while exports are more diversified. All gas imports in Serbia are sourced from Russia and subject to a bilateral government contract with preferential prices to a large degree. New long-term contract on gas delivery is expected to be signed in the second quarter of 2022. Should the conditions change, it might make Serbia more exposed to future changes in market prices. Direct trade with Ukraine is negligible in the entire region.

All Western Balkan countries would be adversely affected by higher oil prices, some by rising gas prices, while North Macedonia and Albania are more exposed than others to an increase in electricity prices as they import a significantly higher amount of power than they export. Domestic weaknesses in the energy sectors across the Western Balkan economies increase vulnerability to global energy crisis.

Indirect effects on Western Balkan economies from a wider European and global recession could be significant, given the close interlinkages between the Western Balkan and eurozone economies, in particular in the automotive sector where North Macedonia, Serbia and Bosnia and Herzegovina might be the hardest hit. The national airline Air Serbia is one of the few European carriers that still can operate into Russian airspace and the number of flights between the two countries recently increased.

**Belarus**

Belarus’s economy is likely to be heavily hit by additional sanctions and by its close linkages to Russia’s plunging economy.

**Russia**

Initially it was believed that the robust situation of the Russian economy, arising thanks to the ‘Fortress Russia’ policy settings of the past few years, would mean the economy would be well placed to withstand the short-term impact of economic sanctions. The economy has endured several years of tight fiscal policy and external deleveraging in order to prepare for just such a situation. However, as the severity of the sanctions imposed increases on an almost daily basis, it is clear that the economy will be hit hard. Sanctions on energy exports and the exclusion of banks from SWIFT have gone from being
considered beyond the pale due to the associated collateral damage, to a reality. The United States recently announced that it would ban imports of Russian oil, LNG and coal, and the United Kingdom said it will phase out imports of Russian oil. The EU announced plans to reduce Russian natural gas imports by two thirds by the end of 2022. These measures come on the back of earlier sanctions on the Central Bank and the exclusion of several financial institutions from SWIFT, which interrupted non-energy exports, and rendered around half of Russia’s US$ 620 billion of foreign exchange reserves unusable.

The impact on the economy will be heavy, with a significant increase in inflation (the central bank has already doubled interest rates to 20 per cent) which will hit already weak consumer incomes and choke investment. The recent oil and gas sanctions will mean a loss of around $30 billion of export revenues, around 2 per cent of GDP. It remains to be seen whether the EU decides to go one step further and ban oil imports from Russia, or whether other countries decide to follow suit and stop importing Russian oil and gas. Oil and gas exports are worth US$ 240 billion (50 per cent of total goods exports), and provide a third of government revenues. Restrictions will also result in a loss of foreign exchange revenues for energy companies with foreign exchange debts and may lead to a more significant financial crisis in Russia. However, the actions taken by the Central Bank to support the banking sector (forbearance measures and liquidity provision, in addition to the sharp rate hike) appear to have stabilized the financial system for the time being, and sovereign default on external debt was (narrowly) avoided recently. But with the latest energy-related sanctions, GDP could contract by around 10 per cent in 2022. Furthermore, in the medium term, a hostile approach that moves Russia further along the road to autarky will result in European diversification away from Russian energy and trade, and a perpetuation in Russia’s ongoing productivity issues, with negative implications for Russia’s already tepid potential growth rates.
About this report

The Regional Economic Update complements the Regional Economic Prospects, which are published twice a year. The report is prepared by the Office of the Chief Economist and the Department for Policy Strategy and Delivery and contains a summary of regional economic developments and outlook, alongside the EBRD’s growth forecasts for the economies where it invests.

For more comprehensive coverage of economic policies and structural changes, see the EBRD’s country strategies and updates, as well as the Transition Report 2021-22, which are all available on the Bank’s website at www.ebrd.com.

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