# EXECUTIVE SUMMARY

Companies around the world are facing "business unusual" as they experience the aftershocks of a global pandemic and as a devastating war rages in Europe. Russia's invasion of Ukraine has resulted in the largest forcible displacement of people in Europe since the 1940s, while individuals and firms face unprecedented increases in the prices of energy and food. At the same time, supply chains continue to be upended by the Covid-19 pandemic, and many companies have accumulated record levels of debt, often as a result of loans issued on favourable terms. This report examines those various exceptional circumstances in turn, discussing their implications for public policy.

Wars have a profound impact on people's livelihoods and economic activity. In a typical war, government debt increases by 47 percentage points of gross domestic product (GDP) and the state assumes a more proactive role in the economy. Even if income per capita manages to recover after a few years of reconstruction, there may still be lasting scars affecting stocks of labour and capital.

While wars have become less common overall since the 1990s, the number of forcibly displaced people worldwide has grown rapidly in recent years (being forecast to exceed 100 million by the end of 2022), with low and middle-income economies hosting 75 per cent of the world's refugees. Ukrainian refugees in European Union (EU) member states have been granted access to their host countries' labour markets, and survey results suggest that they tend to be satisfied with the support provided.

Many firms have recently experienced major disruption to their supply chains. Across the EBRD regions, firms have adjusted to this disruption, primarily by increasing stocks of inputs and sourcing goods from larger numbers of suppliers (predominantly from abroad). The climate crisis is likely to bring more disruption in the future.

After a decade of rising indebtedness and the shocks caused by the Covid-19 crisis, corporate debt levels in the EBRD regions are at record highs. The "evergreening" of cheap loans to vulnerable firms represents a significant risk, as "zombie firms" create negative spillovers for healthy companies. Undercapitalised and state-owned banks have stronger incentives to support zombie firms, as do banks in countries where insolvency frameworks are weak.

The EBRD regions have seen unprecedented increases in the prices of energy and food. Countries have implemented a wide range of measures in response, with differences in policy choices reflecting variations in national priorities and in citizens' preferences.

## The economics of war and peace

This chapter provides an overview of the impact of wars and post-war recoveries over the last two centuries. While a typical war sees GDP per capita drop by 9 per cent relative to pre-war levels, with inflation increasing by 8 percentage points, the most damaging wars see GDP per capita decline by 40 to 70 per cent. As most wars are financed via domestic borrowing, government debt increases by an average of 47 percentage points of GDP.

Post-war recoveries vary widely. In 29 per cent of cases GDP per capita returns to the trend levels observed for comparator countries without wars within five years, but in almost half of all instances it remains below those levels 25 years later. Reconstruction is particularly difficult if peace is fragile, and more than half of all civil wars are followed by another conflict within six years, with only a fifth of all wars being followed by 25 years of peace.

A focus on GDP may significantly understate the lasting damage done by wars. Even 25 years on, the populations of such economies are typically considerably smaller than those of comparator countries, reflecting casualties, outflows of refugees and declining birth rates. This loss of human capital adds to the long-term cost. On average, capital stocks are also 12 per cent smaller five years after the end of a war (with the corresponding figure for the EBRD regions standing at 23 per cent, as wars in those regions have often coincided with transition recessions).

While wars do have the potential to bring about improvements in states' administrative and fiscal capacity, meaningful upgrading of economic and political institutions in the wake of an armed conflict is the exception rather than the rule.

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## War, conflict and migration

The number of people being forcibly displaced – either internally or across international borders – has increased considerably of late, with the total figure worldwide forecast to exceed 100 million by end 2022. Almost two-thirds of all refugees come from Syria, Ukraine, the West Bank and Gaza, Venezuela or Afghanistan, and nearly half are children.

Low and middle-income countries host three-quarters of the world's refugees, with EBRD economies hosting 33 per cent. Refugees tend to be younger and better educated than the average person in their home country, and effective integration policies can help them to make meaningful contributions to their host countries. On average, the policies of EBRD economies in the EU are marginally to moderately supportive in this regard.

In many economies, Ukrainian refugees have been granted access to work, healthcare, education and social services. Those refugees could increase the EU's labour force by an estimated 0.5 per cent by end-2022 – about twice the size of the increase that followed the influx via the EU's southern borders in 2015-16. This could alleviate some labour shortages in rapidly ageing European economies if mismatches between available jobs and skills are minimised.

Survey data indicate that nearly three in ten Ukrainian refugees in Europe are already employed in their current host country, while 20 per cent are working remotely in Ukraine. Overall, their living conditions and the help provided by locals are regarded as very good, although feelings of homesickness and helplessness are common.

Polish data suggest that Ukrainian refugees are more likely to head for places with higher tax revenues and areas that had larger Ukrainian communities before the war. Almost half of all school-age refugees are enrolled in Polish schools, with many others attending Ukrainian schools remotely.

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## Global supply chains in turbulence

Technological advances have incentivised firms to spread production across borders, with many choosing to specialise in a particular task rather than manufacturing an entire product. Consequently, trade in intermediate goods accounted for around half of all global trade in 2020. EBRD economies are, on average, more entwined in global supply chains than the typical middle-income country.

While trade theory suggests that specialisation on the basis of comparative advantage is optimal, policymakers are often concerned about the vulnerability that arises from the concentration of exports and imports. The last few years have seen considerable disruption to trade, with causes ranging from Covid-19 to extreme weather and the war in Ukraine.

A recent survey shows that more than three-quarters of firms participating in global supply chains have taken steps to boost the resilience of their supply chains (with the most common measure being an increase in stocks of inputs, followed by diversification of the supplier base, predominantly using new suppliers from abroad). Despite pandemic-related disruption, relatively few firms have dropped Chinese suppliers.

Given the growing frequency of extreme weather, firms may experience such disruption more often in the future, as well as having to deal with new policies seeking to mitigate the impact of climate change. For example, firms exporting aluminium, steel and other products to the EU will soon be subject to the Carbon Border Adjustment Mechanism, a price correction applied at the border which seeks to level the playing field as regards the effective carbon price faced by EU and non-EU producers. While awareness of that initiative remains limited in EBRD economies, producers with better green management practices are more likely to have assessed their carbon intensity as a result.

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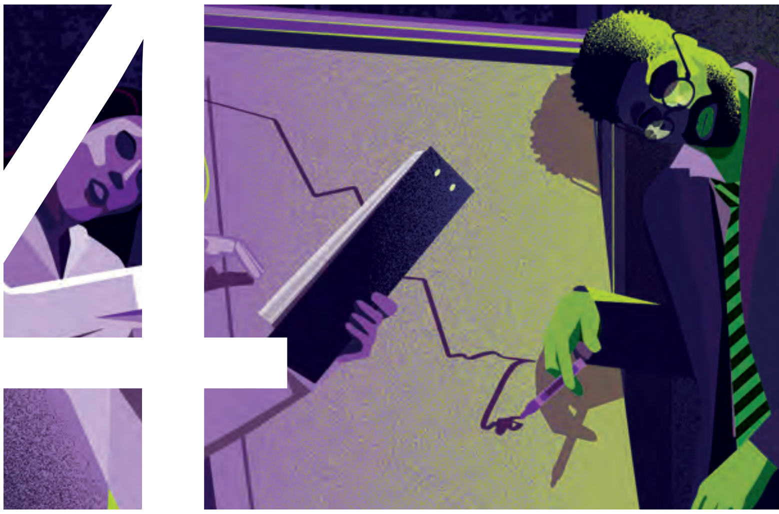


## Corporate debt and business dynamism

After a decade of rising corporate indebtedness and the events of the Covid-19 pandemic, firm-level debt is at record levels in the EBRD regions. The onset of the pandemic was a major shock to the global economy, triggering an extraordinary decline in activity and considerable uncertainty for businesses. The vast majority of firms in the EBRD regions suffered substantial negative cash-flow shocks, while day-to-day banking operations were also disrupted, making it difficult for lenders to assess firms' viability.

Policymakers responded by taking far-reaching steps to help businesses navigate the pandemic. Many firms benefited from the deferral of loan repayments, with some repayment holidays being mandated by governments and others being offered voluntarily by banks. Largely as a result of the generous support provided by governments, corporate defaults are currently at record lows in many economies, despite the severity of the Covid-19 crisis. This is uncharacteristic of recessions in general, and those exceptional support measures will need to be withdrawn as the pandemic subsides.

A significant number of firms with weak financial performance indicators have constant access to cheap (often subsidised) credit. Such evergreening of loans to vulnerable firms is a concern, as zombie firms – indebted companies that are in distress, but avoid default thanks to their continued access to cheap funding – create negative spillovers for healthy firms. Indeed, strong firms see lower investment, revenue and employment when they operate in sectors with more zombie firms. Such negative spillovers are particularly pronounced along the value chain, exacerbating the economic impact of global supply-chain disruption. Undercapitalised and state-owned banks have stronger incentives to support zombie firms, as do banks in countries where insolvency frameworks are weak.

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## Structural reform

This chapter presents the latest assessment of transition challenges in the EBRD regions, tracking progress in the area of structural reform. It focuses on six key qualities of a sustainable market economy, looking at whether economies are competitive, well governed, green, inclusive, resilient and integrated.

Since 2016, reform scores have been converging in most areas, notably with regard to competitiveness, resilience and economic integration. This contrasts sharply with developments in the area of environmental reform, with growing divergence between greener and less green economies. Almost all of that convergence was observed before the Covid-19 pandemic, with progress having slowed in the last couple of years.

To some extent, progress on reforms is aligned with citizens' preferences. Such alignment is strongest in the area of inclusion and weakest with regard to the green economy, and it tends to be greater in countries with free media. On average, survey data suggest that people in EBRD economies have a greater desire for economic integration than their peers in advanced comparator economies, whereas support for the green economy is stronger in comparator countries.

Faced with unprecedented increases in the prices of energy and food staples, policymakers across the EBRD regions have used a wide range of measures to mitigate the impact on households and firms, with most countries taking action of some kind. The varied nature of that response reflects the multitude of objectives that policy measures seek to pursue in terms of reaching out to those in need, ensuring cost-effectiveness, avoiding negative externalities (such as excessive consumption of energy) and achieving broad consensus on such measures within society. The overall effectiveness of those measures is estimated to be lower than in advanced comparator economies, partly reflecting inferior administrative capacity.

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