Wide Angle Shot: Stumbling blocks for (European) billions of EUR for Ukraine

Raiffeisen RESEARCH

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Reconstruction and preparation of Ukraine for integration into the EU economy will be a mammoth (financial) task. In addition to public funds, hundred(s) of billions of private capital will be needed. This aspect seems underexposed in the current debate. On a positive note, there is also the chance that capital from CE/SEE can participate in the transformation of Ukraine.

Mix of public and private investments the success factor in transformation journeys

History does not usually repeat itself one-to-one, but it does rhyme (unfortunately). Already **back** in **2015**, we **tried** to **estimate** the **amounts** of **investment** that would be needed for a **long-term reconstruction** of **Ukraine** plus the **pre-accession preparation** to **EU economic structures** after the first (still limited) escalation in eastern Ukraine in 2014/2015. Now there is an outright war in Ukraine that violently affects the entire country, so the **reconstruction question** and **equation** have a **completely different dimension**. The same applies to bringing Ukraine closer to the economic structures of the EU and its highly competitive internal market — a basic prerequisite for a credible EU perspective.

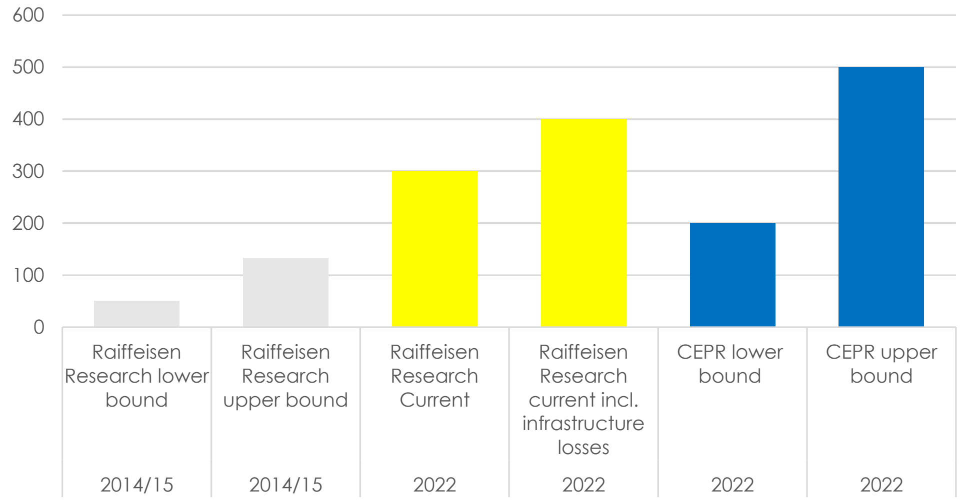
Back in 2015, we **not only** looked at the **sums** needed for **immediate reconstruction** in the conflict area (also on the basis of empirical values from support and reconstruction programmes in war economies) but also tried to **estimate** what amounts of **further medium-** and **long-term investments** (beyond macro-financial stabilisation) would be needed to enable Ukraine — in addition to humanitarian aid and the costs of (internal) refugee integration — to follow a **transformation path towards** the **EU**. We have made this estimate approximately on the basis of transformation and private capital flow experiences in Central and Southeastern Europe (CE/SEE). Already in the **2014/2015 calculus**, the **required investment sums** were **substantial** and in the range of **50** to **130 billion EUR** (see: German-language Ukraine Analysis No. 149, April 2015). And above all, we have been able to show already back then: **substantial sums** of **public** and **private money** are necessary, "just" public money will not make the trick. A mix of public funds, EU funding, substantial Foreign Direct Investments (FDI), local equity investments and also loans or other bank financing is certainly needed. And it is also important to emphasize: from 2015 until the outbreak of the Ukraine war this year, hardly any investments of the magnitude outlined above have flowed, or relevant sums have at best approached the lower end of the range mentioned. EU institutions and relevant **European financial institutions** have mobilised at least **EUR 17 billion in public funds** since 2014 (until the outbreak of the war). However, in recent years, FDI inflows have been rather subdued,

Gunter DEUBER
Analyst Editor
+43 1 71707-5707
gunter.deuber@rbinternational.com

Oleksandr PECHERYTSYN
Analyst
oleksandr.pecherytsyn@aval.ua

hovering around EUR 3-4 billion at maximum, and international banks have kept their exposures to Ukraine just constant rather than expanding them.

Estimations of cost of rebuilding Ukraine (EUR bn)*



CEPR, RBI/Raiffeisen Research

** Based on own calculations back in 2014/15 updated in 2022 (see Ukraine Analysen Nr. 149) and CEPR (2022): Rapid Response Economics, A Blueprint for the Reconstruction of Ukraine*

Reconstruction calculations from 2014/2015 revisited: Factor 5 or 10 nowadays?

Ukraine will certainly **need more investment support** in the **coming years**. It is true that in some areas of indirect economic restructuring and/or macroeconomic stabilisation, the sums to be invested today may even be somewhat lower than in 2014/2015. In the years leading up to the outbreak of war, Ukraine made **substantial progress** in its **orientation towards macroeconomic stability**. The banking sector was substantially reformed. Ukraine also has much lower economic dependencies on Russia today, which reduces short-term adjustment costs compared to the situation back then in 2014/2015. Ukraine has already **increased** the degree of **integration** with the **EU economy** in recent years on the back of institutional arrangements, like trade agreements. Today the EU is by far the largest trading partner of Ukraine. This is slightly positive news for now. However, the **overall economic losses** and **immediate costs** of the **war raging** almost nationwide are, of course, **much higher** this time compared to the more regionally contained conflict in 2014/15. The same applies to the **costs** of **(internal) refugees** plus the costs of **maintaining** and **(re-)building** adequate internal and external **security structures**.

Further course of Ukraine war and upside risks for reconstruction costs

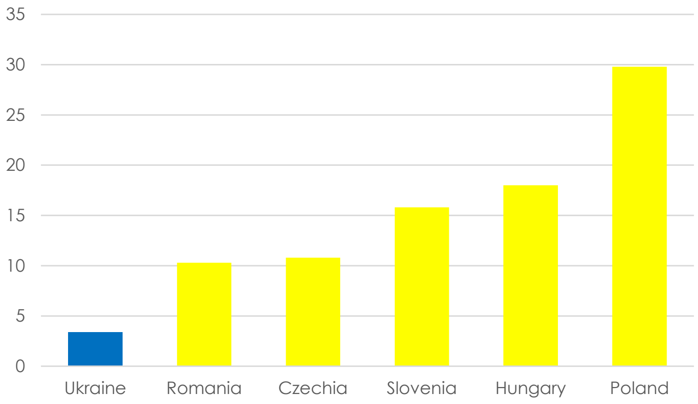
In 2015, we estimated necessary longer term investment sums for Ukraine's reconstruction at **50-130 billion euros**, with a **50/50 split** between the **public** and **private sector**. This is clearly about long-term investments that go beyond pure macro-financial stabilisation now and today. And quite a lot of money has already flowed in this policy dimension in recent months. On the basis of **today's economic structures** and **refugee dimensions**, we would **estimate necessary investment sums** in the neighbourhood of at least **EUR 300 billion** for the coming years. These estimates do not yet include the massive **costs** for the **destroyed infrastructure** in Ukraine, which could amount to hundreds of billions of euros. At present, local cost estimates here are around **EUR 100 billion** and currently this cost category is still rising. At present, it looks as if **Russia** might be deliberately **trying** to **increase** the **economic costs** of the conflict for Ukraine — apart from the naval blockade — by attacking important installations and businesses in the Western parts of the country.

Depending on the continuation of the conflict and the type of warfare, further damage in the billions can be expected. Whereas with the sums mentioned above, the absolute

lower limit of **reconstruction costs** is already **around EUR 400 billion**. Compared to the limited conflict in 2014/15, substantial costs for the reconstruction of Ukraine's military capacities would also have to be considered. In addition, the possible re-integration of regions of Ukraine currently or in the past occupied by Russia may cause substantial additional costs. Here, one can assume costs at least in the low single-digit billions at the regional level (depending on size of the relevant territories). And ultimately, Ukraine's GDP in the coming years will be about EUR 250 billion below a hypothetical path without the Ukraine war. In this respect, based on our calculations from 2014/2015 and previously outlined damage dimensions, **we consider estimates** of **EUR 500 billion needed** to **rebuild Ukraine** currently circulating in (Western) political and/or expert circles to be very valid (see a CEPR Paper as of April 2022).

Considering ongoing financing in terms of macro-financial stabilisation and humanitarian plus military aid sums of **EUR 1.000 billion** (as mentioned in part by the Ukrainian side or the World Bank) are not completely out of the question in order to support Ukraine. However, such cost estimates shall be separated from reconstruction cost estimates. Nevertheless, sums in the order of the magnitudes outlined cannot be completely dismissed. If one compares the Western reconstruction funds for Afghanistan with the economic strength and population in Ukraine, then one could easily justify sums of around EUR 1,000 billion. However, the policy **focus should be on attracting** as much **private investment** as possible in the years to come — as outlined above — and not on playing poker for maximum commitments of public support funds at present. In this respect, we see it as a positive signal that the reconstruction of Ukraine will also be an important topic at the 2022 World Economic Forum in Davos, where the forum will explicitly deal with the responsibility and contribution of (large) companies.

Market cap. listed dom. companies (% of GDP)*



World Bank, RBI/Raiffeisen Research

** 2020 data*

Reconstruction of Ukraine: largely a European task and opportunity

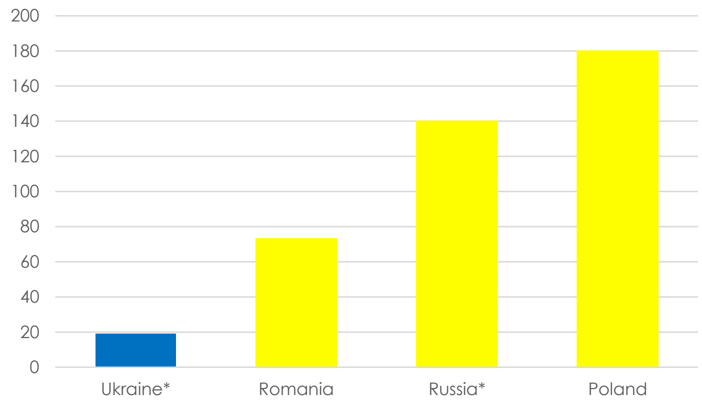
In the end, **"only"** the **sums** that the **West** and **especially Europe** and **Western corporates** have **invested** in **Russia** in recent years/decades should possibly flow into Ukraine going forward. However, the inflow of hundreds of billions of euros in private capital is not a foregone conclusion. We are almost less concerned about the necessary public funds. The much-needed **inflow** of **private capital** certainly also needs sufficient backing via **risk-sharing instruments** and/or **co-financing** by **International Financial Institutions** (IFIs). Here, **European IFIs** in particular have substantial experience and maintain close cooperative relations with Western credit institutions operating in Ukraine and/or the CE/SEE region. The same holds true for the development of local capital markets. Reconstruction of Ukraine could also be of particular interest to **investors** and **economic actors from CE/SEE**. On the one hand, they have deep transformation experience; on the other hand, they may dare to enter the country more quickly than large Western investors and corporations (that benefited strongly from the transformation in

CE/SEE). Moreover, in contrast to the transformation of the 1990s, there are now also regional champions in CE/SEE, companies for which a market entry into Ukraine could be interesting — if local conditions would allow.

In 2014 and 2015, the stabilization or **reconstruction** of **Ukraine** could be seen as a **genuine European interest** even more so than at present. This time, the **consequences** of the **Ukraine war** are substantial for the **global economy**. **Reconstruction** of **Ukraine** and its logistical and agricultural capacities is thus even more of a global issue this time, which may also justify the provision of public funds and risk protection from non-European countries and actors (e.g. on a bilateral basis or by global and non-European IFIs). After the 2014/15 conflict and against the background of other international reconstruction programmes, our assumption was that **Europe** or the **EU would probably** have to bear **70-85%** of the **reconstruction costs** of **Ukraine**. This time we might end up at the lower end of that range.

Nevertheless, we believe that this means that the EU will have to deal with the fact that **hundreds** of **billions** of **EU public money** will have to be mobilized. In the EU context, such provision of funds (in addition to bilateral national commitments) can possibly only be achieved by **joint (market) financing** and not only via IFIs (i.e. issuance of new joint debt instruments on capital markets). This holds especially true since many EU countries are currently facing substantial investment projects at the national level directly or indirectly connected to the Ukraine war as well. However, it **should not be underestimated** that a **renewed substantial joint EU debt financing** must not be a political no-brainer. Firstly, **critics** of the **mutualisation** of **public debts** could thus see even more of a risk that joint financing will become a new "EU standard crisis instrument". In this respect, it must be made clear that the Ukraine war, like the COVID 19 pandemic, is a "crisis of the century" and requires special responses. However, the outlined issue also shows that at some point one has to face the tough question at the EU level whether the NGEU instrument is really "only" a one-off instrument or not. Secondly, there are certainly enough **critical social issues** within the **EU, possibly aggravated** by the **Ukraine war**. Here, critics might note that there is just as much need for substantial investments and support inside the bloc. In this respect, it stands to reason that, if necessary, **Ukraine's reconstruction funding** could also be linked to internal EU agendas in the area of **social affairs** and **cohesion** (possibly taking into account the direct costs of the war in Ukraine for individual EU members or neighbouring countries).

European FDI (EUR bn, 2020 data)



national sources, RBI/Raiffeisen Research

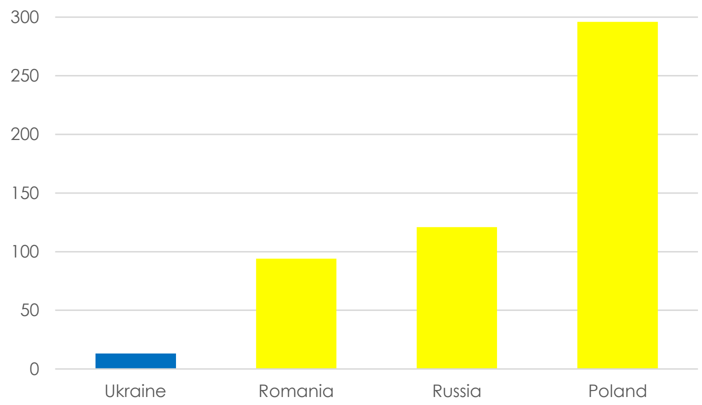
** Ukraine & Russia corrected for (potential) offshoring exposures inside the EU in order to have a "true" FDI stock estimate*

High level of responsibility on behalf of Ukraine

A **final assessment** of the **sums needed** for the **long-term stabilisation** and **reconstruction** of Ukraine will only be possible when there is more predictability in the outcome of the conflict. However, it is also clear that **Europe**, and **especially** the **EU**, must prepare for **financing volumes** in the **hundreds** of **billions** of **euros**. Especially since this time, compared to 2014/2015, we see a greater chance of Ukraine following in the footsteps of Romania or Poland. This time it seems clear that Ukraine's orientation towards the West will most likely endure. There is **no alternative** to **Ukraine's deep integration into** the **EU's economic structures**, whereas in 2014/2015 it was still possible to think that Ukraine could play a "bridging" role between the EU, Russia and the Russian-led EAEU and that such an approach could be good for Ukraine and EU.

It goes without saying that the need for substantial inflows of EU funds also places a **great deal** of **responsibility on Ukraine**. On the one hand, it is important to create structures in the public sector that will enable a substantial inflow of **EU funds**. Even more important is to create structures through deep institutional reforms that will enable inflows of EUR 50-80 billion in **FDI** in the coming years, which has been achieved in **Romania** or **Poland**. Foreign/Western banks (mainly from the EU) have also built up **multi-billion exposures** and **substantial market shares** in both countries and CE/SEE banking markets at around 60-70% of total assets. Currently, the respective EU investments in those dimensions in Ukraine are much smaller, with a market share of non-Russian banks in Ukraine at around 20%.

Cross-border banking exposures (USD bn)*



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** As of Q4 2021*

No alleged quick fixes and naïve assumptions, please

At present, a discussion is gaining momentum about using **frozen funds** or **assets** of the **Russian state** and/or **Russian oligarchs** for the reconstruction of Ukraine in public, academic and policy circles (in Europe and the US). There are demands on the part of Ukraine in this direction as well. Such demands for **de facto "reparations"** may have a certain justification from a moral and economic perspective. Certainly, Russia has engaged in excessive reserve accumulation, and its foreign exchange reserve position has clearly exceeded classical benchmarks needed for preserving macro-financial stability. Moreover, there are indications of alleged war crimes by Russia that may justify reparation claims apart from reconstruction investments. However, **confiscation** of **assets**, as opposed to mere freezing, is a **much more complex matter**. Firstly, special international law standards apply to state assets. Secondly, the complete confiscation of private assets is also not easy to implement legally and could be exploited by Russia for publicity purposes. Moreover, it should be borne in mind that such a further escalative step of "economic warfare" and de facto expropriation will certainly result in substantial countermeasures by Russia. Thus, a wind-down of still existing economic relations between Russia and the West or the EU in particular (with hundreds of billions of EUR in FDI exposures on both sides) might become much more complex. Overall, an enforced usage of Russian assets for rebuilding Ukraine would certainly be **more of a political signal**. The West will possibly not need the amounts that might be raised with such a risky policy move for the reconstruction of Ukraine given the capabilities of Western IFIs plus debt capital market financing availability. Furthermore, it should not be forgotten that there is also **substantial private money** with **origin from Ukraine** in the **West**. So far, this issue has hardly been highlighted in the current situation. These funds can and should also make a substantial contribution to the reconstruction of Ukraine.

In the context of Ukraine, the term "Marshall Plan" is often used as well. We would not consider this term to be one-to-one transferable given the conflict context in Ukraine. After Germany's total defeat, it was clear that there would be a reconstruction in Germany and Europe that will not be quickly disrupted by another war. In Ukraine, both the outcome of the conflict itself and the context are more unclear. Should the Ukraine war end in a **large-scale frozen conflict**, where there is always the risk of escalations, skirmishes and also revanchist political considerations, then the **reconstruction** of **Ukraine** and the **attraction** of **substantial private investment** will be much more difficult than with a more sustainable conflict resolution.

This assessment is intended to support our participation at the Euromoney CEE Forum 2022 in Vienna, where we are honored to be invited to present our views in the panel "The next 12 months: looking forward to peace, rebuilding and reconciliation" taking place on 25 May 2022.

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PETER BREZINSCHEK
Austria ,
peter.brezinschek@rbinternational.com

GUNTER DEUBER
Austria ,
gunter.deuber@rbinternational.com

CASPER ENGELEN
Austria ,
casper.engelen@rbinternational.com

MATTHIAS REITH
Austria ,
matthias.reith@rbinternational.com

GOTTFRIED STEINDL
Austria ,
gottfried.steindl@rbinternational.com

ANNE VALDER
Austria German,
anne.valder@rbinternational.com

FRANZ ZOBL
Austria ,
franz.zobl@rbinternational.com

PETER ÖHLINGER
Austria ,
peter.oehlinger@rbinternational.com

BRISIDA BUZI
Albania ,
Brisida.BUZI@raiffeisen.al

VALBONA GJEKA
Albania ,
valbona.gjeka@raiffeisen.al

FJORENT RRUSHI
Albania ,
Fjorent.Rrushi@raiffeisen.al

ARISTEA VLLAHU
Albania ,
Aristea.Vllahu@raiffeisen.al

OLGA ZHEGULO
Belarus ,
olga.zhegulo@priorbank.by

ASJA GRDJO
Bosnia Herzegovina ,
asja.grdjo@raiffeisengroup.ba

IVONA ZAMETICA
Bosnia Herzegovina ,
ivona.zametica@raiffeisengroup.ba

MIRZA ZORNIC
Bosnia Herzegovina ,
mirza.zornic@raiffeisengroup.ba

EMIL KALCHEV
Bulgaria ,
emil.kalchev@raiffeisen.bg

ANA LESAR
Croatia ,
ana.lesar@rba.hr

ELIZABETA SABOLEK-RESANOVIC
Croatia ,
elizabeta.sabolek-resanovic@rba.hr

ZRINKA ZIVKOVIC-MATIJEVIC
Croatia ,
zrinka.zivkovic-matijevic@rba.hr

HELENA HORSKA
Czech Republic ,
Helena.Horska@rb.cz

DAVID VAGENKNECHT
Czech Republic ,
david.vagenknecht@rb.cz

LEVENTE BLAHÓ
Hungary ,
levente.blaho@raiffeisen.hu

GERGELY PÁLFFY
Hungary ,
gergely.palffy@raiffeisen.hu

ZOLTÁN TÖRÖK
Hungary ,
torok.zoltan@raiffeisen.hu

DOROTA STRAUCH
Poland ,
dorota.strauch@raiffeisen.pl

NICOLAE COVRIG
Romania ,
Nicolae.Covrig@raiffeisen.ro

ANDREEA-ELENA DRAGHIA
Romania ,
Andreea-Elena.DRAGHIA@raiffeisen.ro

IONUT DUMITRU
Romania ,
Ionut.Dumitru@raiffeisen.ro

ANASTASIA BAYKOVA
Russia ,
ABAIKOVA@raiffeisen.ru

GREGORY CHEPKOV
Russia ,
grigory.chepkov@raiffeisen.ru

STANISLAV MURASHOV
Russia ,
stanislav.murashov@raiffeisen.ru

LJILJANA GRUBIC
Serbia ,
ljiljana.grubic@raiffeisenbank.rs

TIBOR LORINCZ
Slovakia ,
tibor_lorincz@tatrabanka.sk

OLEH KLIMOV
Ukraine ,
oleh.klimov@aval.ua

SERHII KOLODII
Ukraine ,
serhii.kolodii@aval.ua

OLEKSANDR PECHERYTSYN
Ukraine ,
oleksandr.pecherytsyn@aval.ua

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