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Risks to the Ukrainian economy caused by Russian pressure

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The growing fears of a Russian invasion of Ukraine observed in recent weeks are exacerbating the country's economic problems. On 14–19 February, Russia conducted military exercises which closed off a large part of the Sea of Azov and the Black Sea, restricting shipping routes and significantly impeding access to Ukrainian ports. In addition, on 16 February a cyber-attack took place which led to a temporary blockage of internet banking services in two of the largest Ukrainian banks and the state-owned Diia, which offers online administration services.

Concerns about the war are negatively affecting the Ukrainian financial market. In January 2022, non-residents began to withdraw *en masse* from bonds denominated in hryvnia (their share dropped from US$3.3 billion to US$2.85 billion within a month), which negatively affected the currency market and led to a decrease in the reserves of the National Bank of Ukraine (NBU) by US$1.6 billion since the start of this year. Due to the growing tension, international insurance companies (including Lloyd's) have stopped covering risks associated with military operations for planes in Ukrainian airspace; this has led to several airlines (including KLM and Ryanair) to limit or completely suspend their flights to Ukraine. Initially the situation was managed thanks to the government's decision on 13 February to allocate US$586 million as payment for potential damages, but on 20 February Lufthansa, SAS, Austrian Airlines and SWISS announced they would suspend flights to Kyiv the following week.

The Ukrainian government has estimated the losses resulting from reports about the possibility of an invasion at US$2–3 billion per month. The situation has been mitigated by the fact that in recent weeks Kyiv has received announcements of clear financial support from the West: the US has pledged to grant loan guarantees to a total of US$1 billion, the European Union is to allocate a macro-financial aid package of €1.2 billion, France has announced a €200 million loan and loan guarantees for €$1 billion, while Canada will grant a loan of nearly US$400 million, and Germany of €150 million.

Commentary

- In recent days, the biggest problem for the Ukrainian economy has been the restrictions on access to ports, as two-thirds of Ukrainian exports are shipped by sea. A possible total blockage would be catastrophic, as it would mean losses of US$180 million a day. Although Kyiv has managed to identify an access route bypassing the Russian manoeuvre zones, it is narrower (1 km) than the previously used 'recommended corridors' (nearly 40 km wide). The situation has caused bottlenecks, disrupted logistic

chains, and as a consequence, led to serious financial losses. Moreover, the use of routes other than those recommended is associated with higher costs for insuring the goods (up from US$3 to US$10/tonne). It is possible that Russia will regularly repeat naval exercises to further obstruct Ukraine's foreign trade.

- Cyber-attacks on Ukrainian institutions are being regularly carried out. In mid-January, many websites of state offices were blocked. It is most likely that the Russian special services are behind these actions, although the participation of hackers from Belarus cooperating with them cannot be ruled out either. The electronic banking system was paralysed for several hours; this was connected with the sending of false text messages stating that ATMs would cease operating, which was intended to cause panic among the population. Although it is difficult to assess the direct financial losses caused by the attack, it can be assumed that this was only a demonstration of the ability to block critical infrastructure.
- Despite the fact that the NBU still has significant reserves (US$29.2 billion at the beginning of February), the periodic turbulence on the currency market poses a great challenge to it. In mid-January, the demand for foreign currency forced it to sell nearly US$1.5 billion in order to maintain the hryvnia's exchange rate. In the first two weeks of February, the situation stabilised, which allowed the bank to boost its reserves by nearly US$600 million. However, on Monday 14 February, due to reports over the weekend about a very high probability of war breaking out in the coming days, the NBU intervened in the first hour after the market opened to the tune of US$377 million. Later, the situation returned to normal and the value of the Ukrainian currency did not decline any further, but it is very likely that there will be more turbulence associated with the gradual drainage of the country's foreign exchange reserves. If serious panic breaks out on the market, the NBU will not be able to maintain a stable exchange rate, which will lead to a serious depreciation of the hryvnia's value.
- The actions being undertaken by Belarus are an additional problem for Kyiv. At the beginning of February, Minsk introduced a blockade on the transit of fuels and fertilisers from Lithuania. According to data from the State Statistics Committee of Ukraine, for the period from January to November 2021, the country imported 927,000 tonnes of fuels from Lithuania, including 246,000 tonnes of gasoline (14.6% of its imports) and 681,000 tonnes of diesel oil (11.1% of its imports). Almost all of these goods were sent via rail through Belarus. However, the transit blockade need not immediately cause a fuel deficit on the Ukrainian market, because Orlen Lietuva, the owner of the refinery at Mazeikiai, will be able to deliver at least some of the necessary materials via Poland, and it is also possible to increase imports by sea and from Belarus and Russia – but the latter option would deepen Ukraine's dependence on these countries for its fuel supplies (Belarus accounts for 45.1% of its imports, and Russia 23.8%). Although it seems unlikely that Minsk will stop the exports, as Ukraine is their main recipient, such a step would be another potential tool to pressurise Kyiv.
- Despite the aforementioned problems, Ukraine's macroeconomic situation remains relatively stable. Following the 2020 COVID-19 pandemic recession (-4%), 2021 ended in the black (+3.2%), with GDP reaching $200 billion, the highest level since independence. The National Bank of Ukraine has forecast a rise in GDP this year of 3.4%. The country's

biggest problem remains high inflation (10% in 2021; in January 2022 it was also running at 10% y/y), which is mainly driven by significant increases in fuel prices (26.8%) and food products (14%). Even if there is no military escalation, we can expect Russia to continue to use its economic tools of pressure, which will have a negative impact on the public mood and economic development in Ukraine.

- Although the estimates that the Ukrainian economy could lose US$2–3 billion a month due to the current crisis seem to be many times overstated, the continuing tension over the next few months will undoubtedly exacerbate the country's economic development. Support from the West is of great importance as it will ensure the stability of the state's finances in conditions of limited access to credit on external markets, caused by high interest rates on bonds. In addition to funds from the EU, the US and other countries, Ukraine can also expect a sum of US$2.1 billion under the International Monetary Fund's stand-by programme. However, the earmarking of this amount is subject to conditions, mainly relating to the progress the country makes in its fight against corruption.