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Central Europe Economics

Ukraine cease fire and its consequences

OUR TAKE

A ceasefire agreement would likely result in a significant boost to near-term growth in Ukraine, but a lack of reliable security guarantees means it may be difficult to fully use the potential for recovery. CEE FX reacted enthusiastically to Ukraine headlines, with both PLN and HUF appreciating. We are less optimistic than investors about the medium term consequences. A scenario of permanently elevated defense spending would raise questions about future fiscal trajectories in CEE, especially in Poland.

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The shape of potential Ukraine-Russia cease fire is still highly uncertain but recent comments from US defense secretary Hegseth (politico.eu, 12th Feb) have defined the key points:

- No US troops in Ukraine in peacekeeping role
- No NATO membership for Ukraine
- Security guarantees for Ukraine to be provided by European states, not the US
- Troops of other NATO member states present in Ukraine would not be covered by Article 5 (article defining the principle of collective defense)
- returning to Ukraine's pre-2014 borders '*an unrealistic objective*' according to defense secretary Hegseth

Earlier in an interview for Fox News president Trump suggested also that the US would expect to get access to Ukraine's rare earth minerals worth $500B, as compensation for past military assistance (see politico.eu on 11th Feb and FT, 15th Feb).

Our take – Implications for Ukraine

The above general conditions defined by secretary Hegseth are consistent with earlier signals from the new US administration and as such they are not unexpected. What is surprising, however, is that they were articulated even before negotiations started. This means that something that could be an outcome of peace talks is actually a starting point for negotiations and therefore it is possible the future deal may be even less favourable for Ukraine.

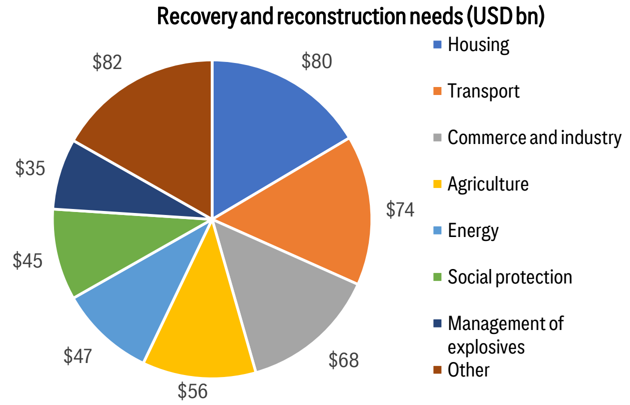
On a more positive note, we would highlight that secretary Hegseth's comments about Ukraine's territory referred to pre-2014 borders, which leaves space for negotiation regarding territories which fell under Russian occupation after February 2022.

As far as economic implications are concerned we think the first two conditions (i.e. no US boots in Ukraine, no NATO membership) seem the most consequential. Admittedly, the signing of a ceasefire agreement would likely result in a significant increase in reconstruction efforts, almost regardless of the precise conditions behind the deal. That is because reconstruction activities are happening even as hostilities continue, and with a ceasefire deal signed, these activities could accelerate further, at least temporarily. However, the lack of reliable security guarantees related to presence of US troops on the ground or NATO membership means that it would be more difficult for Ukraine to mobilize funds and thus to fully use the potential for recovery.

Based on World Bank estimates and taking into account the current map of Russian control over Ukraine's territory we assume that actual recovery and reconstruction needs might reach around USD 300bn (see Ukraine Economics - What could a peace deal mean for the region?). This could be partly financed by international assistance from European governments, Ukraine's own resources or by foreign private capital. In our view lack of security guarantees would likely limit the latter one, leading to smaller FDI inflows than in case of a more favourable deal.

As signaled in our earlier research a ceasefire without proper security guarantees could also undermine Ukraine's recovery prospects through its influence on the labour market. In such a scenario Ukraine would likely need to maintain significant troops, releasing only a portion of more than 1 million of military personnel. Simultaneously, the opening of borders would make it possible for military-aged men to travel abroad either for work or to reunify with families. The combined impact of those trends would likely weigh on potential growth, private consumption and could lead to wider trade deficit (purchases by emigrants are treated as imports).

Figure 1. Reconstruction efforts (and contracts) will be relatively evenly split across various sectors



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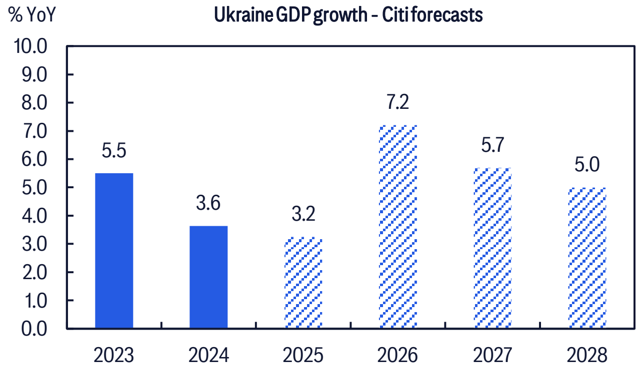
Source: World Bank, Citi Handlowy

Figure 2. Real GDP growth is likely to accelerate sharply over next two years



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Source: Citi Handlowy Forecasts, Haver Analytics

Our current growth forecast for Ukraine already assumes implementation of a ceasefire with limited security guarantees. In such a scenario real growth is expected to exceed 7% in 2026 after 3.2% growth in 2025 (Figure 2). We see risks skewed to the upside, especially for 2025, but this will depend on the timing of a potential peace agreement. Our scenario implies also double-digit growth in nominal GDP over next three years. If the European states turn out to be ready and able to provide sustainable and credible security guarantees this would imply an even stronger and more lasting recovery – we would consider adding 1-2 percentage points to our growth forecasts after 2026.

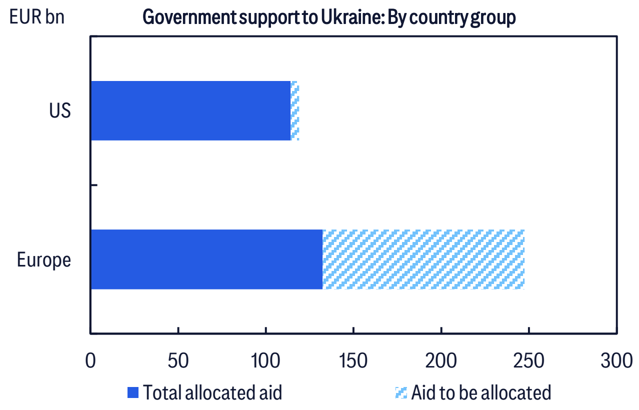
One source of risks for such a scenario is how the political landscape can change after signing of a potential peace deal. Presidential elections that were scheduled for 2024 could not take place due to ongoing hostilities, but they may be organized after signing of a ceasefire agreement. Their outcome will likely depend also on conditions of the agreement and how it is perceived by the electorate.

Our take – implications for other Central European countries

CEE FX has benefited in recent weeks from the prospect of a ceasefire agreement, as Central European economies remain highly exposed to geopolitical developments. This refers in particular to PLN and HUF (Figure 5).

We still think the region is likely to benefit from increased reconstruction activity in Ukraine, as firms in Poland or Czechia may be granted reconstruction contracts given these two countries remained among those providing most support to Ukraine (Figure 4). However, from our conversations with clients we sense investors may actually be overly optimistic about the size and macroeconomic impact of those contracts. If involvement in reconstruction projects is proportional to assistance provided by CEE countries, even in an optimistic scenario (where all contracts go to foreign firms) this would be less than 0.5% of GDP annually in case of Poland and even less in Czechia. We think in reality a significant portion of contracts would be realized by Ukrainian firms and therefore the actual impact on CEE economies would be only a fraction of these amounts. We do not expect a direct positive impact on Hungary.

Figure 3. Ukraine support from European governments exceeded EUR130bn, with additional 115bn still to be allocated



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Source: Citi Handlowy, Ifw Kiel Institite

Figure 4. US, Germany, Poland and UK among biggest suppliers of aid (including aid to refugees)

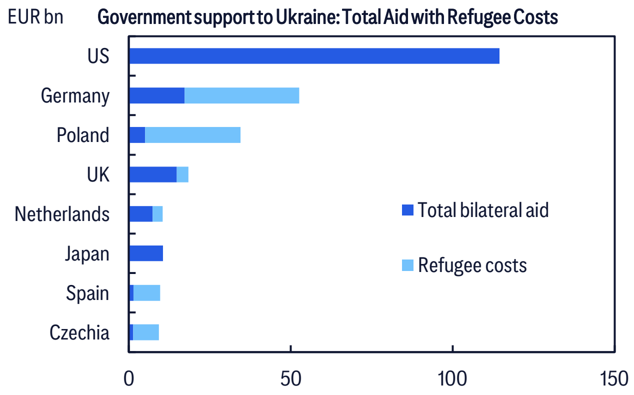

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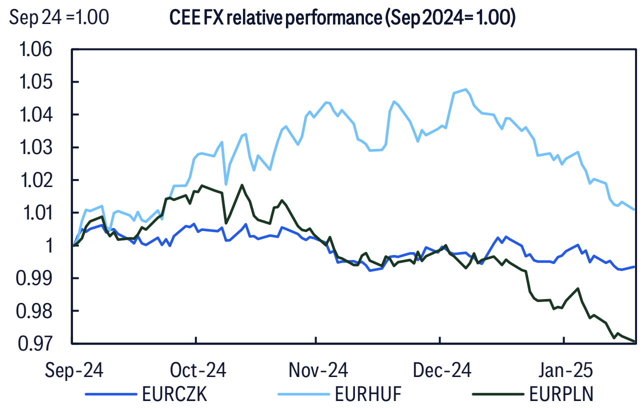
Figure 5. Zloty and forint gained in recent weeks, fueled by expectations of a cease fire deal



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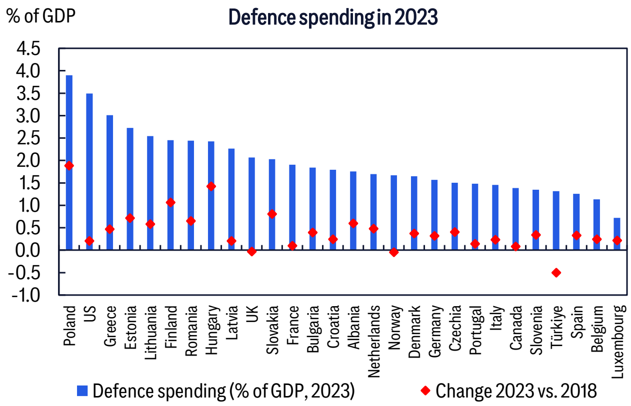
Source: Bloomberg, Citi Handlowy

Figure 6. Increased defence spending is likely to remain a permanent feature of the fiscal landscape in CEE



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Source: NATO, Citi Handlowy

In the longer term the impact could be more ambiguous. In our view it is worth noting that the general reception of proposed peace conditions was lukewarm in countries like Poland or Czechia (RMF24, 15th Feb or expats.cz on 14th Feb). With limited security guarantees for Ukraine, countries in the region may be concerned the peace deal will turn out to be unsustainable. Taking this into account, increased defense spending is likely to become a more permanent feature of the fiscal landscape. For example Poland already in 2022 adopted a law that requires the budget to allocate at least 3% of GDP to defense, but it seems actual spending will likely exceed that level (vs.~ 2% of GDP in the period up to 2022). This implies that room in the budget for education or for investment will be respectively smaller in the coming year. In other words fiscal trajectories in the region will be less favourable than previously assumed and/or CEE countries will need to raise taxes to finance new revenues. And given the sized of additional spending (additional 2% of GDP vs pre-2022 levels) the challenge appears difficult to ignore.

All in all, in the near term the ceasefire discussion is likely to be disinflationary, as stronger currencies and potentially lower energy prices will help push CPI lower, opening room for additional rate cuts. In the longer term the additional fiscal spending in the region and potentially also in other EU countries could make central banks more wary of inflation risks. While we think the near term positive reaction of markets seems understandable we are skeptical about the sustainability of that trend. After all, signing a ceasefire deal without reliable security guarantees would not change much fundamentally for CEE.

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