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Ukraine Economics View

What would a peace deal mean for the region?

OUR TAKE

US election outcome, in our view, increases the possibility of at least a temporary cease-fire between Russia and Ukraine. If this then turned into a lasting peace deal, it may have significant macroeconomic implications, paving the way to reconstruction projects and significant changes in the Ukrainian and CEE labour markets. However, actual macroeconomic implications would depend on details of the potential agreement and the extent to which it would provide sustainable security guarantees to Ukraine.

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As US election results became clear on 6th November, Donald Trump reiterated (Newsweek, 6th Nov) his plan to stop the Russia-Ukraine war (for earlier comments of Donald Trump on Ukraine, see BBC on 27th Sep). Details of any such plan are not known yet and it is unclear what any 'peace deal' would look like. However, if the new US administration pushes for a cease-fire agreement between Ukraine and Russia, this may have noticeable macroeconomic and geopolitical consequences for the region.

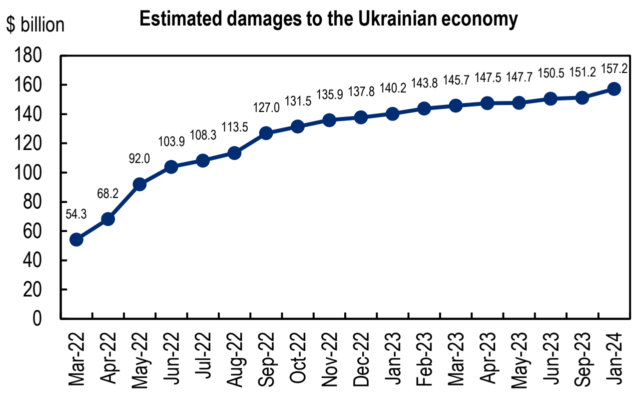
While we think it is possible that efforts of the new US administration could lead relatively quickly to a short-term cease fire in Ukraine, achieving a long lasting and sustainable deal may be more difficult and may take significantly more time. If previous similar negotiations, in particular Minsk agreements from 2014, are anything to go by, reaching the deal may take months rather than days. The difficulty would be to agree on conditions that ensure sustainability of the agreement, for example by providing some security guarantees to Ukraine.

Reconstruction plan

Reaching a deal would enable more intensive reconstruction efforts, going beyond the current short-term rebuilding projects which are mainly aimed at repairing damage to ensure the continued functioning of infrastructure.

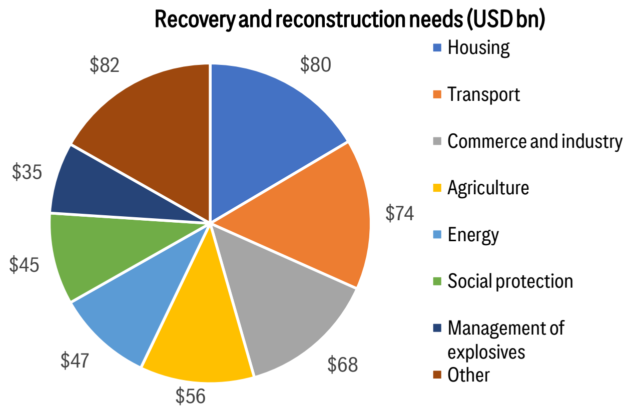
According to World Bank estimates, the recovery and reconstruction needs in Ukraine are estimated at USD 486bn or 270% of the country's GDP. This includes costs of repair, restoration and reconstruction, assuming the build back better principle (building in a way that takes into account modernization, improvements for energy efficiency). World Bank data shows that the biggest reconstruction needs are in frontline regions. However, given that nearly one fifth of the Ukraine's territory is currently under Russian control, the freezing of the front line would mean that reconstruction efforts would not extend to the occupied regions. Taking this into account, according to our rough estimates actual recovery and reconstruction needs might reach around USD 300bn. Spread over 10 years, this would be equal to approx. 17% of GDP annually, using 2023 GDP as a reference point.

Figure 1. War-related damages reached approx. USD 160bn, while reconstruction needs are approaching USD 500bn



Source: Kyiv School of Economics, Citi Handlowy

Figure 2. Biggest reconstruction needs are concentrated in housing, transport and commerce/industry



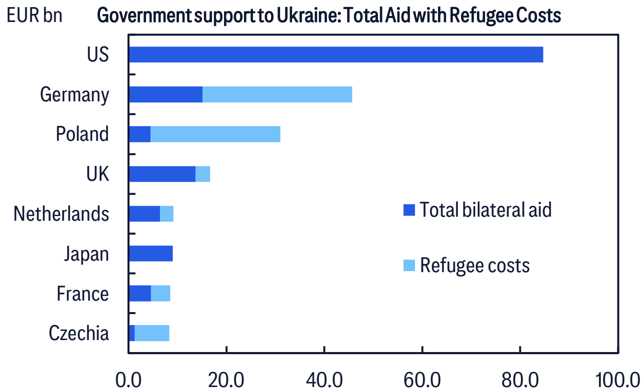
Source: World Bank RDNA3, Citi Handlowy

Looking at sectors, the biggest reconstruction needs are concentrated in housing (16%), transport (15%) as well as commerce and industry (14%). As for the energy sector, reconstruction needs were estimated at 47bn (10% of total), but this does not include the impact of intensified missile and drone attacks against the energy infrastructure since spring 2024. For this reason we expect actual costs in that particular sector to be even higher.

The sheer size of reconstruction needs (17% of GDP annually) may be overwhelming and creates a risk of significant delays. Large part of reconstruction efforts will be conducted by the state and will depend on the availability of financing. An additional constraint may by the ability to coordinate a large number of projects at the same time, especially in light of tight labour market. According to IFC estimates between one sixth and one third of the needs could be financed by the private sector. Apart from reconstruction projects, the IFC identifies private investment opportunities in the range of USD99-282 billion up to 2033. This means that reconstruction efforts can be accompanied by significant capital inflows to Ukraine while new projects may be beneficial for foreign firms and investors involved in reconstruction efforts.

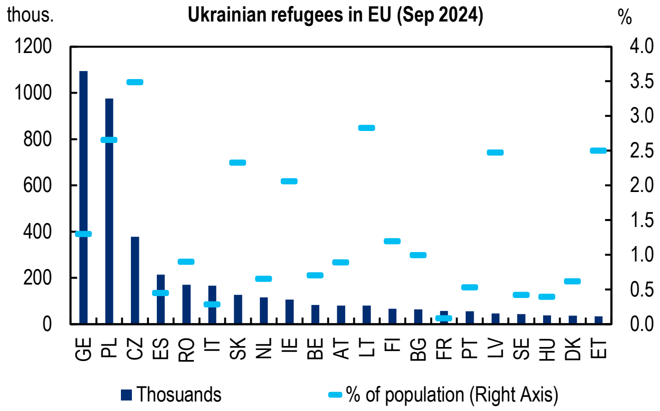
We would expect that most contracts may be awarded to companies from countries that were most involved in supporting Ukraine since the invasion in 2022. According to Ukraine Support Tracker published by Kiel Institute the government support from European countries is estimated at EUR 192bn, while the US support at around EUR 100bn (this includes already allocated and announced aid). Looking at a more granular breakdown, the biggest donors include: US, Germany, Poland, UK, Netherlands, Japan, France and Czechia.

Figure 3. Biggest aid to Ukraine was delivered by the US, a number of European countries



Source: Kiel Institute, Citi Handlowy

Figure 4. More than 4 million of Ukrainian refugees live in Europe



Source: Eurostat, Citi Handlowy

Labour market implications

Reaching an agreement between Russia and Ukraine might also have significant implications for Ukrainian labour market, though the exact impact may depend on details of the deal. Labour shortages remain one of key (economic) factors constraining the growth potential. Approximately 2.9mn of adult Ukrainian citizens live in Europe, benefiting from temporary protection and additionally 1.2mn Ukrainian men serve in the army (FT, November 22). Sustainable peace deal might encourage some of refugees to return to the country and simultaneously it would free a large part of currently mobilized men, thus significantly reducing labour market pressures.

However, if any such new peace agreement fails to provide sufficient security guarantees to Ukraine, the impact on the labour market could be mixed or even negative. In such a situation the demobilization might be slower as significant military presence would need to be maintained in some of Ukraine's regions. Furthermore, the risk of renewed military conflict would likely limit the number of refugees returning home. Finally, some of military age men who are currently not allowed to leave the country might actually emigrate to the EU to take advantage of the access to the EU labour market and higher wages. The latter scenario would mean that Ukrainian labour market would remain tight, which would reinforce inflation pressures that are likely to appear anyway in the reconstruction phase.

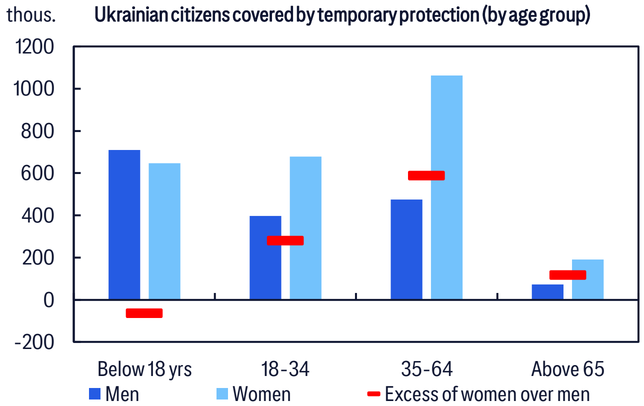
Impact on Central Europe

Ending the war in Ukraine would also have impact on other countries in Central Europe. The decrease in risk premium would likely be supportive for CEE currencies in the near term, though we doubt the impact would be lasting enough. Our own impression from conversations with investors is that the risk premium connected to war has narrowed since 2022 anyway.

Reconstruction efforts in Ukraine might provide some support for economic activity in the region, but the impact would not necessarily be large. Even if Poland and Czechia – countries that provided relatively large support to Ukraine in recent years – are involved in reconstruction projects, the scale is likely to be too small to be macroeconomically meaningful. Assuming that the involvement would be proportional to assistance provided by a given country, this would be in Poland's case equivalent to around EUR 1.5bn or 0.15% of GDP annually (for ten year).

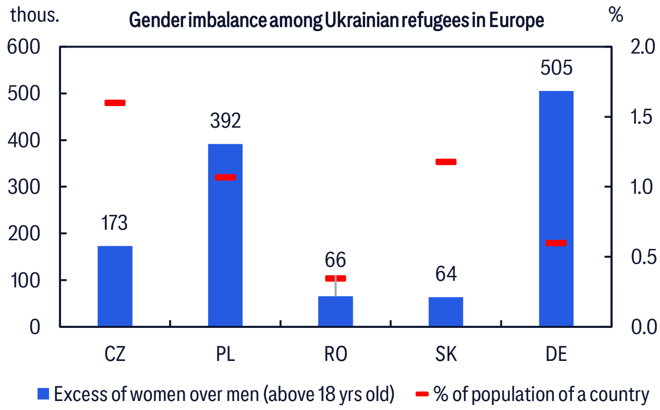
Although the end of hostilities in Ukraine might provide short term stability in the region, we think the sense of medium term geopolitical risks would not vanish. We expect CEE countries, in particular Poland, to remain committed to a high defense spending path. Currently Poland is planning to spend 4.7% of GDP on defense, well above the 2% threshold required by NATO. If the cease-fire agreement fails to provide sufficient security guarantees to Ukraine, it is likely Poland will maintain or even increase defense spending.

Figure 5. Number of Ukrainian women living in the EU exceeds the number of men, suggesting a possibility of migration inflows as a result of family reunifications



Source: Citi Handlowy Estimates, Eurostat

Figure 6. Among CEE countries Poland and Czechia might see the biggest inflows as a result of family reunifications



Source: Citi Handlowy Estimates, Eurostat

It will be particularly interesting to see how CEE labour markets are affected by potential Russia-Ukraine deal. Both Czechia and Poland host a large number of refugees, especially as a share of total population. These are also countries with lowest unemployment rates and thus tightest labour markets in the EU. A common concern among investors and economists is that the return of Ukrainian refugees home might potentially increase wage pressures in CEE. While such a scenario is possible, the likelihood of an opposite scenario seems to be underestimated. The end of the war would mean opening of borders for men who have been banned from travelling abroad. The number of Ukrainian women between 18 and 64 years old who live in Europe is significantly higher than the number of Ukrainian men in the same age group. If families were to reunify in EU countries, this would actually provide significant inflow of new Ukrainian citizens (mostly men). The gender imbalances among Ukrainian refugees suggest potential for significant inflows especially in Poland and Czechia (Figure 6).

All in the ending of the war in Ukraine might prove to be disinflationary for CEE economies in the near-term. Downward impact on inflation would materialize via slightly stronger currency, potentially higher migration flows and lower commodity prices (gas, wheat). This would be an additional argument opening doors to monetary easing by CEE central banks.

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