Assessing the Impact of Russia's War against Ukraine on Eastern Partner Countries

EU4Business

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Foreword

Russia's war of aggression against Ukraine is causing a humanitarian, social and economic tragedy for the Ukrainian people. However, the consequences of the full-scale military invasion of Ukraine are also reverberating across the entire world, disrupting the global supply of commodities, causing a sharp increase in the price of food and energy, and threatening the recovery from the COVID-19 pandemic.

Countries with established commercial and financial ties with the economies of Russia and Ukraine, both experiencing the worst recession seen in decades, appear particularly vulnerable. This report investigates the exposure of Eastern Partner countries (Armenia, Azerbaijan, Georgia, Republic of Moldova, and Ukraine) to the economic shocks caused by the war, and, in particular, through the impact that the war is having on inflation, migration, remittances, investment and trade.

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Abbreviations and acronyms

CPI	Consumer Price Index
DCFTA	Deep and Comprehensive Free Trade Agreement
EaP	Eastern Partnership
EBRD	European Bank for Reconstruction and Development
EU	European Union
FAO	Food and Agriculture Organisation of the United Nations
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GVC	Global Value Chains
ICT	Information and Communication Technologies
IMF	International Monetary Fund
LNG	Liquefied Natural Gas
M&A	Mergers and Acquisitions
MW	Megawatt
NPL	Non-Performing Loan
OPEC	Organization of the Petroleum Exporting Countries
PV	Photovoltaic
SME	Small and Medium-sized Enterprise
SPS	Sanitary and Phyto-Sanitary
SWIFT	Society for Worldwide Interbank Financial Telecommunication
US	United States
USD	Unites States Dollar
WB	World Bank
WTO	World Trade Organisation

Executive summary

Russia's war of aggression against Ukraine is a human tragedy on a scale not seen in decades in Europe, with tens of thousands dying and millions of refugees escaping Ukraine or being internally displaced. At the same time, the war has also sparked a series of economic shocks around the global economy, and Eastern Partner (EaP) countries, as a result of their geographic and economic proximity to both Russia and Ukraine, are strongly affected.

Supply chains are being disrupted as a result of export bans, Russia's threat to Ukrainian shipping in the Black Sea, and international sanctions, all of which make it harder to get goods in and/or out of Russia and Ukraine. The two countries' key role in the global supply of food and energy have caused huge volatility in commodity markets, with prices of key grains, energy and metals increasing dramatically. This has exacerbated inflationary pressure across the EaP region and pushed governments to consider strategies to preserve their countries' food and energy security, for instance by reducing dependence on imports of fossil fuel and invest in domestic renewable energy sources.

Following the macro-economic contraction in 2020 and the rebound in 2021 across the EaP region, the recovery in 2022 was expected to continue at a steady pace on the back of growth in private consumption, investment and exports. Russia's war against Ukraine, however, challenges established human, financial and commercial links between EaP countries and some of their major economic partners and affects the trajectory of the post-COVID-19 recovery that was underway.

Growth projections for all EaP countries have thus been revised several times in the wake of the war. With Russia's economy experiencing recession and the devastation of Ukraine hard to quantify, the economic outlook for EaP countries had to be adjusted downward in the initial phases of the war. The only exception was Azerbaijan, whose energy industry has been bolstered by soaring oil and gas prices. For Armenia and Georgia, the downward revisions that followed the outbreak of the war have been reconsidered in light of the positive macroeconomic development observed in the first nine months of the year, but these short-term effects may fade away, leaving the two countries exposed to the long-term, structural challenges described in this paper.

This report outlines the main economic shocks triggered by the war, such as supply chain disruptions, soaring commodity prices and exchange rate volatility, and discusses in detail EaP countries' exposure to key transmission channels, such as inflation, migration, remittances, investment, and trade. A section with a specific focus on small and medium-sized enterprises (SMEs) follows. Finally, the report suggests policy responses to ease the impact of the shocks in the EaP region, provide targeted support to the most vulnerable, support the refugee crisis, maintain open markets, diversify trade partners, and strengthen energy policies.

1 Introduction

On 24 February 2022, the Russian Federation launched a large-scale military invasion of Ukraine, causing a human tragedy in Ukraine and sending shockwaves across the world. This chapter provides an overview of the economic sanctions introduced by the international community to increase the economic costs of the war by putting pressure on Russia's real economy, isolating it from the global financial system and undermining its ability to finance military operations.

Overview

On 24 February 2022, the Russian Federation launched a large-scale military invasion of Ukraine[1]. While Russian shelling directed at all major Ukrainian cities continued for months, including the capital Kyiv, Lviv and Odessa, the situation on the ground has been subject to rapid changes. As of late August, the areas under Russian military occupation covered most of the Donbas region and a significant portion of the Kharkiv oblast in the east, the largest parts of the Kherson and Zaporizhzhia oblasts in the south, as well as Crimea, which had already been occupied by Russia in 2014. In the first days of September, however, the Ukrainian army launched a counteroffensive in the east and south, which allowed it to regain control of most of the Kharkiv oblast (Institute for the Study of War; AEI's Critical Threats Project, 2022[1]).

Russia's invasion of Ukraine is first and foremost a human tragedy. Estimates of the death toll in the first six months of the war were over 30 000, including more than 5 700 civilians (Reuters, 2022[2]) (U.S. News, 2022[3]). By early May, over 30% of the Ukrainian population was displaced, either within the country or abroad, including a majority of the country's children (OHCHR, 2022[4]) (ACLED, 2022[5]).

The war also sent shockwaves through a world economy still struggling to recover from the COVID-19 pandemic. While it carries an inevitable economic shock on the countries directly involved in the war, the combined effects of Russia's illegal attack on Ukraine and the international response are likely to have broad and deep negative economic consequences for the economies of the Eastern Partner (EaP) countries, which have close economic ties with both Russia and Ukraine.

Established human, financial and commercial links between EaP countries, Russia and Ukraine are being challenged or put under new stress by the war. They act as "transmission channels" through which the shocks of the war reverberate across the EaP region.

This paper aims to describe the exposure of EaP countries to these shocks, investigating how the war is affecting their economies through its impact on inflation, migration, remittances, investment, and trade. The primary focus of the analysis throughout is on the impact that the war is having on the region's private sector, with a dedicated section exploring the specific exposure of small and medium-sized enterprises (SMEs), in particular, as these are often at a greater risk of disruption from exogenous shocks. The paper concludes with an overview of potential responses for policy makers and development partners to consider supporting households and firms in EaP economies in the short and medium term.

International sanctions against Russia and Belarus

In response to Russia's invasion of Ukraine, and the support provided by Belarus, the United States, the European Union, the G7, and a number of other Western and non-Western partners imposed sanctions on Russia and Belarus, in order to increase the economic costs of the war by putting pressure on the real economy, isolating the two countries from the global financial system and undermining their ability to finance military operations.

[1] This note reflects facts, forecasts, and analysis based on the geopolitical, social and economic situation in the EaP region as of 15 October 2022.

Table 1.1. Overview of the main types of sanctions imposed on Russia

	Targeted institutions and sectors				
	Central Bank	**Financial sector**	**Energy sector**	**Technology sector**	**Other**
Selected examples of sanctions	**No access to assets** held at private institutions and central banks in the EU and US **Ban on banks providing loans, services, or assistance** to the government and CBR **Ban on all transactions** (asset transfers, foreign exchange transactions) with the CBR	**Asset freeze** and prohibition to make funds and economic resources available to entities and individuals on the sanctions list **Decoupling of major Russian banks from the SWIFT systems** **Prohibition of investments** in projects of the Russian sovereign wealth fund	**EU import ban** of Russian seaborne oil (90% of all oil imports from Russia to EU) **US import ban** on Russian oil, coal and LNG **UK import ban** on Russian oil and coal Opening of Nord Stream 2 on hold	**Western export ban** in the defense, aerospace, marine, oil refining, aviation, transportation equipment, luxury and electronics sectors **Export controls on dual-use technologies** (e.g., microchips, semiconductors) with Western-made/designed chips	**Road and maritime transport sanctions** for transport operators, airspace closure Russian oligarch and state official asset seizures Ban on Russian state-owned media outlets G7 countries ban imports of Russian gold
Expected impact on the Russian economy	Ruble exchange volatility, increased inflation and contraction of Russian economy Increased government debt servicing challenges	Complication of international payments Reduction of investments and economic activity Exclusion of Russia from global markets	Reduced economic activity and tax revenue	Supply chain difficulties	Supply chain difficulties Increased cost of supporting regime

Note: as of September 2022
Source: (European Commission, 2022[6]), (Bown, 2022[7])

By early October, the EU had issued eight sanctions packages against Russia. While countries targeted specific individuals and entities by freezing their assets and imposing travel bans, the major restrictive measures against Russia target exchanges in specific sectors. In the financial sector, the main sanctions consist of a ban on transactions involving the administration of reserves of the Central Bank of Russia, which implies the inability to convert assets held in US dollars and euros into rubles, hence a freeze of a large part of the Bank's foreign-exchange reserves. Furthermore, major Russian banks have been excluded from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system,[2] all transactions with certain state-owned enterprises have been banned, issuance of transferable securities and money-market instruments has been restricted, and new investments in the Russian energy sector have been prohibited (European Commission, 2022[8]) (European Council, 2022[9]).

Trade restrictions have also been imposed, with the most relevant measures concerning the energy sector, as various western countries are limiting, to different degrees, their imports of oil and gas, as well as exports of goods and technology suited for use in oil refining. In early June, the EU adopted a sixth package of sanctions, introducing an embargo on imports of all Russian seaborne crude oil and petroleum products (90% of the EU's current oil imports from Russia). A temporary exemption was granted to EU Member States with a particular pipeline dependency on Russia (e.g., Hungary, Czech Republic), as well as Bulgaria (due to its specific geographical exposure) and Croatia (which needs vacuum gas oil for its

[2] Russian banks excluded from SWIFT are Bank Otkritie, Novikombank, Promsvyazbank, Bank Rossiya, Sovcombank, VNESHECONOMBANK (VEB), VTB BANK, and Sberbank. (European Commission, 2022[174])

refinery). However, Member States benefiting from these exemptions will not be able to resell such crude oil and petroleum products to other Member States or third countries (European Commission, 2022[10]). The eight package of sanction approved in early October also lays the basis for the required legal framework to implement a price cap on Russian-origin crude oil and petroleum products envisaged by the G7 (European Commission, 2022[8]) (G7, 2022[11]).

Moreover, the export to Russia of high-tech products, luxury goods, and dual-use goods, including chemicals and lasers, has been banned. Further export bans involve goods and technology suited for the aviation and space industries, as well as those that could contribute to Russia's military, defence and security sector. On the other hand, restrictions on *imports* have also been imposed. Commodities affected by the bans include imports of iron, steel, coal, timber, cement, and liquor to the EU (Bown, 2022[7]).

Other sanctions include an airspace ban on aircrafts operated by Russian air carriers, a prohibition to Russian warships from entering EU ports and Russian and Belarusian automobiles from driving on EU roads, and the suspension of the broadcasting activities in the EU of the Russian state-owned outlets Sputnik and Russia Today (Funakoshi, Lawson and Deka, 2022[12]).

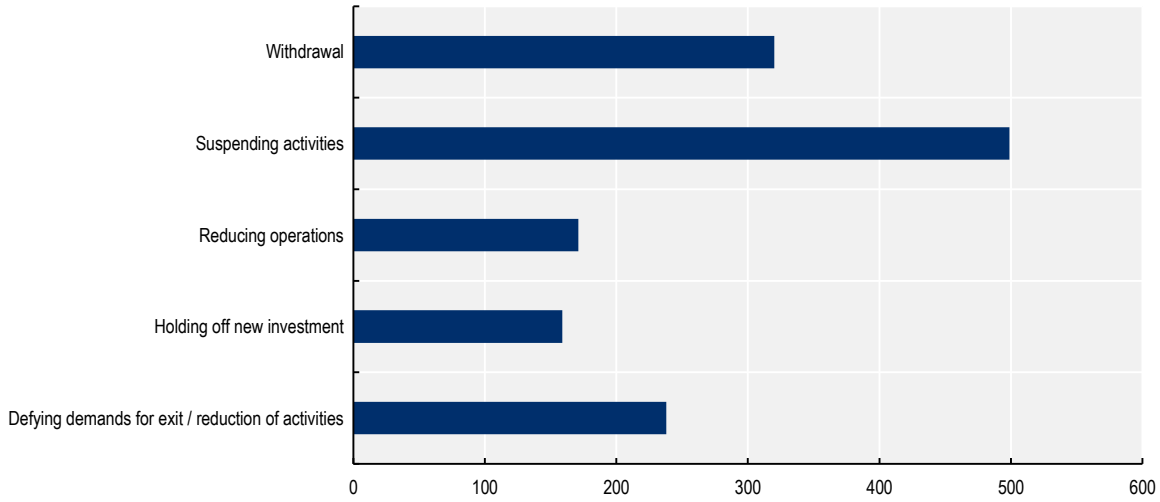
The United States joined in levying full blocking sanctions on Russia's largest financial institutions, banks, state-owned enterprises, elites, and family members, as well as by prohibiting new investments in the country. Overall, US sanctions include prohibiting the import of Russian oil, natural gas, and coal, sanctions on more than 200 individuals and entities, and various restrictions on Russian financial institutions, as well as a prohibition on the export of US dollar banknotes and many US technologies to Russia. The US also increased import taxes on goods from Russia to erase World Trade Organisation (WTO) membership advantages and suspended the "Normal Trade Relations with Russia and Belarus" act, effectively raising considerably US tariffs against both countries (US Department of the Treasury, 2022[13]).

The United States, the EU and other actors also condemned the involvement of Belarus in the invasion of Ukraine and imposed a number of sanctions against Minsk. The main measures mirror the ones imposed against Russia and envisage a prohibition on transactions with the Central Bank of Belarus and a SWIFT ban on three Belarusian banks. There are also sanctions against individuals, restrictions on trade, and a ban of a range of financial transactions with Belarus.

Furthermore, in addition to the sanctions imposed by countries, a multitude of private companies and organisations joined the international effort to put pressure on Russia and announced the suspension or termination of their businesses on Russian territory. As of mid-October, 320 companies had withdrawn from Russia, completely halting operations or exiting the country, and another 829 had curtailed their operations at least to some extent (Yale SOM, 2022[14]). The private players withdrawing from the Russian business environment include energy companies, aviation and industrial firms, credit card companies, media companies, management firms, tech giants, and banks. While it remains to be seen how lasting and complete these withdrawals will be, it is evident that Russia's aggression of Ukraine and the deterioration of its domestic business environment have pushed many multinationals to reconsider the scale of their operations in the country.

Figure 1.1. Multinational companies' responses to Russia's war against Ukraine

Number of companies



Note: data as of 15 October 2022
Source: (Yale School of Management, 2022[15])

Russia's response to international sanctions

Russia responded to Western sanctions by imposing retaliatory economic measures against so-called "unfriendly countries"[3] and companies that are trying to comply with the United States, European Union, United Kingdom and other sanctions regimes against Russia and Belarus.

The most wide-ranging set of responses from Russia are capital controls aimed at stabilising the ruble. The Russian Central Bank imposed severe restrictions on foreign exchange markets and capital movements in an attempt to prevent the depreciation of the ruble. One of the most significant of these is the limitation of the amount that Russian citizens can withdraw in dollars and euros to USD 10 000 (increased on 16 May to USD 50 000) per calendar month (Bank of Russia, 2022[16]). Further, all Russian exporters were initially required to convert at least 80% of their foreign currency revenue into rubles, a threshold lowered to 50% on 23 May. Other measures include allowing Russian debtors to pay off debts exceeding 10 million rubles to non-Russian creditors based in "unfriendly" states only in Russian rubles, prohibiting companies from "unfriendly countries" from buying non-ruble currency in Russia and demanding all international payments for gas in rubles. The efforts to strengthen the ruble have subsequently been tempered by the Russian Central Bank's moves to cut interest rates, from a high of 20% in March to 7.5% on 16 September (Bank of Russia, n.d.[17]).

Beyond capital controls aimed at stabilising Russian currency markets, Russia has banned exports of certain goods – to "unfriendly countries" and, in some cases, even to allies. On 8 March, Russia issued a decree listing over 200 items that can no longer be exported from Russia (except to EAEU member countries) including pharmaceutical products, agricultural machinery, manufacturing equipment, machine tools and hand tools, electrical devices, vehicles and their components. Russia even temporarily banned

[3] "Unfriendly countries" include the United States, all EU member states, Albania, Andorra, Australia, Canada, Iceland, Japan, Liechtenstein, Micronesia, Monaco, Montenegro, New Zealand, North Macedonia, Norway, San Marino, Singapore, South Korea, Switzerland, Taiwan, Ukraine and the United Kingdom.

the export of wheat, meslin, rye, barley, and corn to Eurasian Economic Union (EAEU) member states[4] until 31 August.

Finally, Russia has sanctioned specific senior members of government in “unfriendly countries” and limited access to Western media channels and social media networks.

[4] The EAEU member states are Armenia, Belarus, Kazakhstan, Kyrgyzstan and Russia.

2 Economic shocks triggered by the war

Russia's war against Ukraine has sparked a series of economic shocks around the global economy, and Eastern Partner (EaP) countries, as a result of their geographic and economic proximity to both Russia and Ukraine, are strongly affected. This chapter looks at the impact of the war on the overall macroeconomic performance in the EaP region, supply chain disruptions, commodity prices and exchange-rate volatility.

The impact of sanctions and the contraction of Russia's economy

While Russia is not experiencing destruction of its productive assets as a direct consequence of the war, international sanctions are affecting its ability to trade with the rest of the world and in particular to obtain critical technologies and capital goods. They are also isolating it from the global financial system. Industries such as automotive, which are heavily reliant on global value chains and foreign investment, are particularly vulnerable (Bloomberg, 2022[18]).

Since the war started, Russia's economy appears to have contracted less than initially projected. Crude oil and gas exports propped up by high global prices and a compression of imports (down 40% in the first half) sustained a widening trade surplus, while domestic demand showed some resilience thanks to the Central Bank of Russia's containment of the effects of sanctions on the financial sector and a milder-than-anticipated weakening of the labour market (IMF, 2022[19]). A range of command-and-control measures allowed the CBR to stabilise the ruble after its large depreciation in March. These have become less necessary over time as a result of very high export prices and restricted access to imports, which has restricted demand for dollars and euros.

In spite of these developments, Russia's economy remains severely affected by the war, with GDP expected to contract by 3.9 percent in 2022, effectively bringing the country into a deep recession (OECD, 2022[20]).Over the medium term, moreover, and as long as sanctions remain in place, Russia's economy will be set on a low-growth trend, as productivity is compromised by lack of access to key technological goods, new investment remains constrained by falling revenues, and a narrowing trade surplus is likely from 2023 onwards due to the EU's embargo on Russian oil and reduced gas imports, as well as a likely decline of global energy prices. The state of Russia's public finances is also likely to further deteriorate, as a consequence of a contracting economic base, shrinking export-duty collection on hydrocarbons exports, and the expenditures needed to prolong the war (World Bank, 2022[21]).

The devastation of Ukraine

Since the beginning of the war, the attacks on Ukraine have been unrelenting. With hospitals, train stations, ports, fields and countless buildings attacked and destroyed, the impact on Ukraine's productive capacity will be long-lasting. As of 5 September, direct damage to physical infrastructure, housing and non-residential buildings was estimated at around USD 115 billion (KSE, 2022[22]), to which must be added the cost of lost trade and economic exchanges forgone, to say nothing of the human losses. The government itself estimated reconstruction and recovery needs, as of June 1, at about USD 349 billion, more than 1.6 times the GDP of Ukraine in 2021. Current estimates suggest it will take at least a decade for the Ukrainian economy to recover to pre-war levels (Economist Intelligence Unit, 2022[23]). Manufacturing in the East has completely stopped or been drastically reduced, and agricultural production has been severely compromised due to destruction of farmland, limited availability of fertiliser and reallocation of labour from agriculture to the war effort.

By mid-October, 7.6 million individual refugees had been recorded across Europe and another estimated 7 million people were internally displaced within Ukraine (UNHCR, 2022[24]) (IOM, 2022[25]). The economic impact on Ukraine is enormous, and will cause the largest contraction in the country's recent history, with estimates of a drop in GDP in 2022 in the range of 30-45%, a contraction in exports by 60%, and poverty levels[5] rising from around 5% to over 25% of total population in 2022 (EBRD, 2022[26]) (IMF, 2022[27]) (World Bank, 2022[28]). While some signs of resilience and adaption can be detected, such as a growing share of companies resuming operations in the summer months (EBA, 2022[29]), increasing IT services exports (IT Ukraine Association, 2022[30]), and agricultural products finding alternative export routes

[5] Based on the global line for upper middle-income countries of US$6.85 a day (2017 PPP)

through the European Commission's "solidarity lanes" initiative (European Commission, 2022[31]), the outlook for Ukraine remains highly uncertain. On the one hand, reconstruction activities may start as soon as the war ends boosting aggregate demand, but, on the other hand, forecasts for Ukraine's economy remain prone to downside risks related to a deterioration of the war and potential energy shortages during the winter.

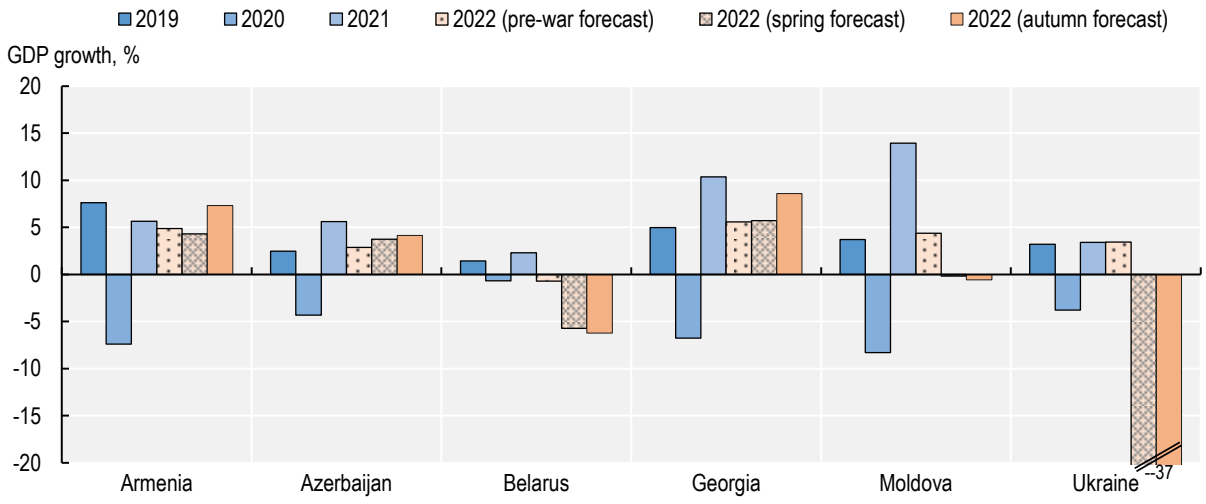
Large economic downturns in Russia and Ukraine will have profound, long-term repercussions for the other EaP economies, since both countries are key trading partners and important sources of investment, remittances and tourists for the EaP region.

The impact of the war on the other EaP countries

Russia's large-scale invasion of Ukraine threatens EaP countries' recovery from COVID-19, lockdown measures and weak global growth. All EaP economies shrank substantially in 2020 in the wake of the pandemic, with GDP contractions ranging from 3.8% in Ukraine to 8.3% in Moldova. Following the rebound in 2021 across the region, recovery in 2022 was expected to continue at a steady pace on the back of growth in private consumption, investment and exports.

However, the war forced international organisations to considerably revise their growth projections (Figure 2.1). Ukraine's economy is expected to contract by over 30% in 2022 and Belarus's by over 6%. Moldova's economy is also anticipated to contract this year, in contrast to its pre-war growth forecast.

Figure 2.1. GDP growth in EaP countries, 2019-2022



Note: actual values until 2021 (IMF), forecast values for 2022 (average of EBRD, IMF, and WB forecast)
Source: (EBRD, 2022[26]); (IMF, 2022[27]); (World Bank, 2022[21])

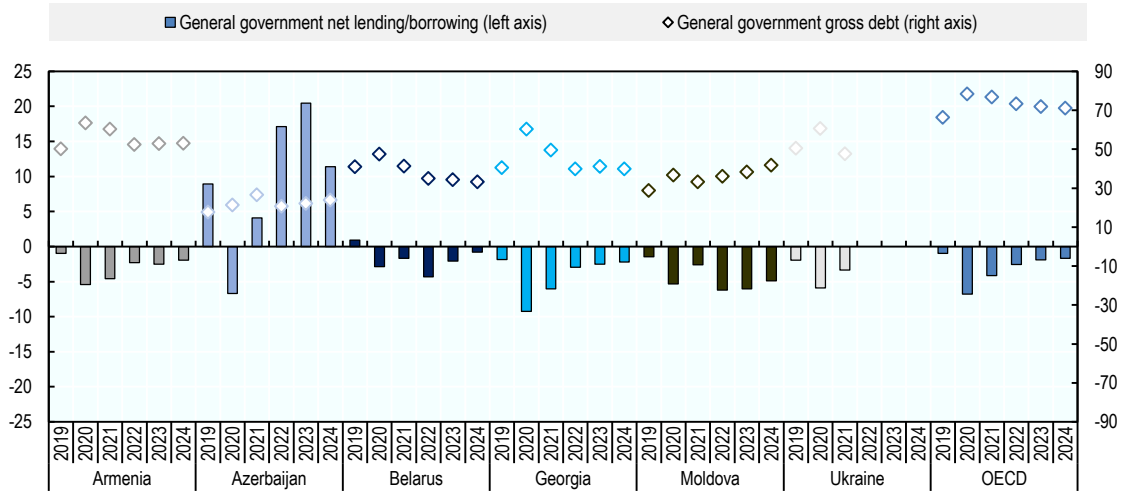
For Armenia and Georgia, the initial downward revisions that followed the outbreak of the war should be reconsidered in light of the positive macroeconomic development observed in the first nine months of the year. Higher-than-expected private consumption and tourism revenues, driven by a significant number of Russians relocating to the two countries, have supported aggregate demand and overall economic activity. While distributional effects should also be taken into account, for instance the rising cost of housing, food and energy, the initially negative outlook for 2022 has turned positive for Armenia and Georgia, as evidenced by rapid growth in the first half of the year which resulted in updated GDP forecasts for 2022 of 7.3% and 8.6%, respectively. It should be noted, however, that these positive short-term effects may fade

away beyond 2022, leaving the two countries exposed to the long-term consequences of the war described in the remainder of this paper.

Azerbaijan's growth forecasts have been revised upward since the beginning of the war, with an initial GDP outlook strengthening by 0.8 percentage and already exceeding these expectations in the first half of the year. The war has caused commodity prices to soar, including oil and gas prices, thus bolstering the energy industry in Azerbaijan. This is forecast to sustain Azerbaijan's growth such that the other downside risks from the war are overwhelmed by the additional revenues from oil and gas. Moreover, in the medium term Azerbaijan is well placed to capitalise on the EU's intention to reduce energy-dependence on Russia with investment in the expansion of the Southern Gas Corridor, opening the possibility of significant gas exports to Southern Europe (Ibadoghlu, 2022[32]).

Figure 2.2. Fiscal dynamics in EaP countries

% of GDP



Note: Estimates start after 2021 (2020 for Belarus)
Source: (IMF, 2022[33])

Ahead of the war, as countries started to slowly and steadily recover from COVID-19, governments were expected to withdraw pandemic-related support measures gradually and move towards fiscal consolidation. However, additional fiscal support might now be needed to protect the most vulnerable from the effects of the war. Even though available fiscal space varies considerably among them, fiscal positions have so far proved to be favorable and resilient in most EaP countries. In Armenia and Azerbaijan, during the first half of 2022, fiscal balances were in surplus, while in Georgia the fiscal deficit shrunk, overperforming the fiscal consolidation path planned for the year. In Moldova, the fiscal position proved to be resilient, with a deficit smaller than expected thanks to an increase in revenues that exceeded the increase in spending. Unsurprisingly, Ukraine was a major exception here, despite efforts to limit expenditures to critical public services and notwithstanding the agreement with external creditors for a two-year deferral in debt payments, total expenditures have been growing sharply and fiscal are expected to grow. Ukraine's budget is heavily reliant on donor support (World Bank, 2022[34]).

While the scope for additional fiscal support may have increased for 2022 to cushion the immediate effects of the commodity and food price shocks on households and companies, downside risks remain. Negative threats include a protracted war, a slowdown in main trading partners, and monetary tightening in advanced

economies. Downside risks are amplified in Moldova, due to its geographical proximity to the war (World Bank, 2022[34]; OECD, 2022[20]).

Supply chain disruptions

Global supply chains were already stressed by the COVID-19 pandemic, causing inflationary pressure, supply shortages and manufacturing delays across the world. The war made things worse, with the closure of airspaces, international sanctions and intense conflict in the Black Sea further disrupting the international flow of goods. The implications of these developments are best understood by looking at the position that Russia, Ukraine and Belarus have in global value chains.

Global trading routes

Global trade routes connecting markets, especially Europe and East Asia, have come under strain as a result of the war. In all major forms of transport (air, shipping and land-based), prices have increased, delivery times extended, and bottlenecks worsened.

Russia and Europe's reciprocal air-space bans have made air transport much more costly. Firstly, routes between Europe and East Asia are now diverted to avoid Russian air space, making air transport both slower and more expensive. Moreover, a significant share of global air cargo volume is in Russian air cargo planes, which can no longer fly to Europe. The result is a sharp fall in capacity for air cargo transport as well as more expensive routes between Europe and East Asia (IATA, 2022[35]).

Moreover, border uncertainty and sanctions are reducing the ease of land transport through Russia. Rail and trucking through Russia is the main land corridor for trade between East Asia and Europe – known as the "northern corridor" – and a key transport route for global supply chains. Border controls have become more stringent as export bans from both the EU and Russia demand increased attention on cross-border rail freight. Moreover, many large transport companies have ceased operations involving Russia out of solidarity with Ukraine, including Maersk and HHLA, and even manufacturing companies such as Zyxel Communications Corp have stopped transit through Russia (van Leijen, 2022[36]). This is increasing pressure on alternative routes with limited overland capacity between East Asia and Europe, such as the trans-Caspian "middle corridor" (Box 5.1), causing supply shortages and delays.

Global shipping routes have not been as dramatically affected. The main impacts of the war have been a surge in demand for available shipping services as a result of the disruption to other modes of transport and an increased risk of shipping through the Black Sea, which results in higher prices for insuring cargo. There are reports of underwriters charging as much as 10% of the ship's asset value as an additional "war-risk" premium (Koh and Nightingale, 2022[37]). Moreover, the ports of Ukraine have been damaged by Russian attacks and under blockade for months, severely limiting Ukraine's export capacity. In an effort to stabilise spiralling world food prices, a UN-brokered deal has been signed on 27 July allowing for significant volumes of commercial food exports from three key Ukrainian ports in the Black Sea (Odesa, Chornomorsk, and Yuzhny) to be resumed (United Nations, 2022[38]). The agreement brought important results, with up to 11 new vessels a day being cleared for shipment and contributing to the observed drop in global wheat prices in August. Developments in early October, however, remind us of the fragility of this agreement, since longer inspection times create a backlog of vessels waiting for clearance, and the risk of deterioration of the war may jeopardize the stability of the deal[6], with sudden repercussions on the global supply and prices of key food commodities (Financial Times, 2022[39]).

[6] On 29 October, Russia announced its withdrawal from the Black Sea Grain Initiative, and then re-entered it on 2 November after the U.N. and Türkiye secured assurances from Ukraine that shipping corridors would not be used for

Russia, Ukraine and Belarus in global supply chains

Russia is a key 'upstream' producer for a number of global value chains, exporting many inputs for manufacturing processes. As such, it has one of the highest degrees of "forward participation" in global value chains in the world, with 55% of its exported value added being used as intermediate inputs embedded in partner countries' exports (see Box 3.2).

A considerable share of this is energy exports, but Russia also exports important metals used in manufacturing. For example, Russia was the largest exporter of palladium in 2020, which is used for catalytic converters, as well as in semiconductors. With key industrial inputs now unable to leave Russia easily, firms are experiencing supply chain disruptions, higher prices and challenges to meet demand.

Ukraine and Belarus also play important, albeit lesser, roles in global supply chains, in particular with respect to agricultural production. After Canada and Russia, Belarus is the third largest exporter of potash (15.6% of the world's internationally traded supply), a critical component for the production of potassium-based fertilisers to support plant growth, increase crop yields and improve disease resistance. The EU's ban on Belarusian potash has resulted in supply chain disruptions in the food and agricultural sectors, adding to the upward pressure on food prices (FAO, 2022[40]) (UN Comtrade[41]).

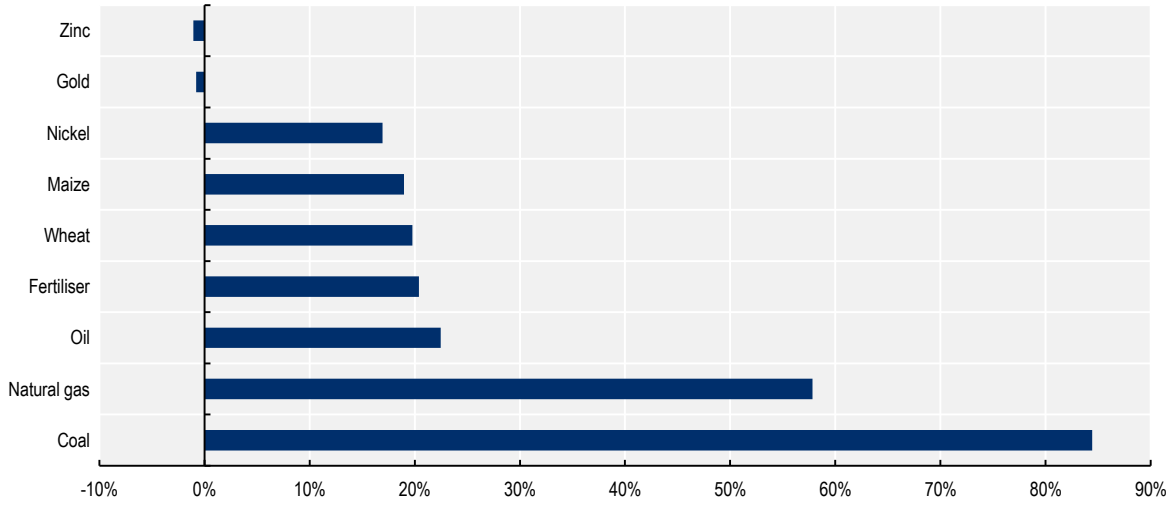
Soaring commodity prices

As a result of the war, sanctions and disrupted supply chains, market prices for key agricultural goods, energy and metals have been soaring. Figure 2.3 shows how selected commodities have increased in price since the beginning of the invasion. In 2020, Russia, Belarus and Ukraine together provided 24% of global exports of wheat, 17% of fertiliser, 24% of palladium and 11% of nickel. The market disruptions provoked by the war caused an immediate drop in short-term supply and high uncertainty over future availability of these key commodities (UN Comtrade[41]), which has caused prices to increase by over 50% for some of them, as well as delays in industries reliant on these commodities, such as car production. The price spikes pose significant inflationary risks and a particularly acute threat to low-income households, which spend a higher share of their income on energy and food.

military purposes. Yet, the announcement caused a spike in global wheat prices and raised new concerns over international food shortages. (NPR, 2022[196])

Figure 2.3. Commodity price increases

% change in price between Jan 2022 average and Mar-Oct 2022 average



Note: Fertiliser price refers to the Di-ammonium Phosphate (DAP) price, avg. Mar-Aug 2022
Source: (OECD, 2022[42]); (World Bank, 2022[43])

Energy

Globally, energy prices have increased sharply. Inflation was surging in many places even prior to the war following the re-opening of economies in mid-2020 (driven by both demand- and supply-side factors) (OECD, 2022[20]). The war reinforced price pressures: oil prices hit peaks of over USD 130 per barrel (for Brent crude) in the first weeks of the invasion, only dropping below USD 100 in early August. The persistency of this price hike is further shown by the fact that even fears of a global growth slowdown as a result of inflation, as well as OPEC+'s announcement to increase oil production over summer, have not lowered oil prices significantly below USD 100 (Slav, 2022[44]) (OPEC, 2022[45]). The price of Urals, Russia's flagship crude oil blend, plummeted compared to Brent in the days after the start of the war and consistently traded at a discount of around USD 35 per barrel, to compensate buyers for increased costs (e.g. shipping insurance, freight rates) and risks. This price gap, however, began to shrink in early August and was at around USD 18 per barrel in early October (Investing.com, 2022[46]), possibly due to alternative buyers for Russian oil and increased purchases ahead of the EU embargo on seaborne imports of Russian crude to be imposed at the end of the year (PIIE, 2022[47]).

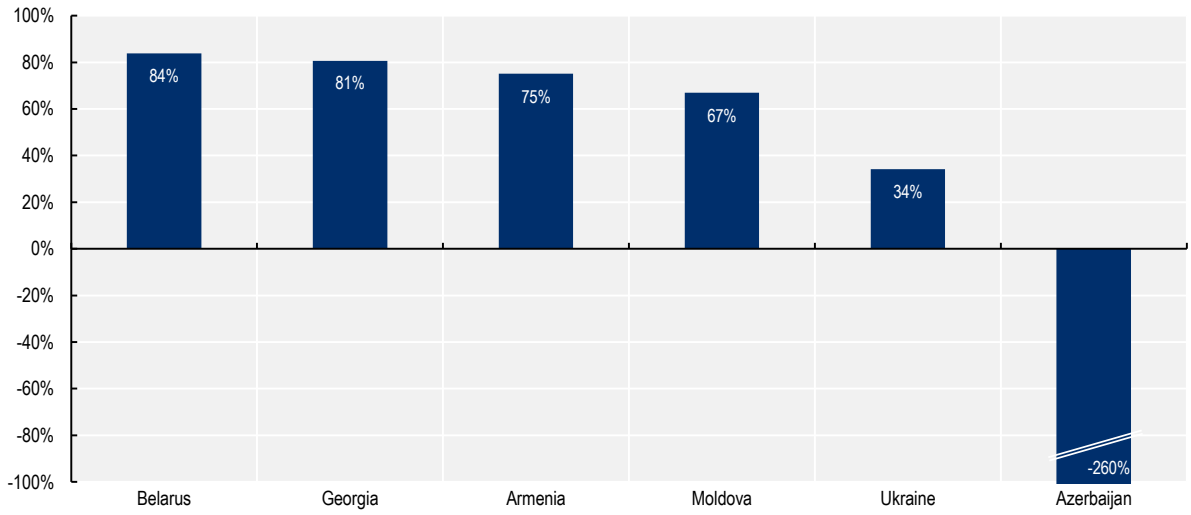
Furthermore, natural gas prices on international markets have more than doubled from before the war until end of August and have remained at much higher levels compared to 2021 (Nasdaq[48]). European consumers are trying to shift away from heavy reliance on Russian gas, but supplies are more challenging to re-route, as the transport infrastructure (pipelines) from supplying countries and the storage facilities must be in place. This can, in part, be overcome through imports of liquefied natural gas (LNG), which can be shipped and regasified with dedicated infrastructure by importing countries. To this end, European countries have accelerated their moves to upgrade their terminals to process LNG, reportedly with plans to secure 19 floating storage and regasification units (liquefied natural gas tankers with heat exchangers that use seawater to turn the supercooled fuel back into gas) in the coming years (Financial Times, 2022[49]).

High energy prices will put strong inflationary pressure on the EaP region, especially for countries that are heavily reliant on external sources to meet their energy needs. As shown in Figure 2.4, with the exception of Azerbaijan, all EaP countries are significantly dependent on imports of energy, with their energy

dependency rate ranging from 34% for Ukraine to 84% for Belarus. For all EaP countries, natural gas is the largest energy source – ranging from 28% of total energy supply in Ukraine, 47% in Georgia, 56% in Moldova, 63% in Belarus and 66% in Azerbaijan–, with some use of oil, coal, hydropower and thermal power. Armenia and Moldova import nearly all of their gas from Russia, which makes the two countries highly dependent on Russia for their energy supply (Figure 2.5), while Georgia imports the majority from Azerbaijan.

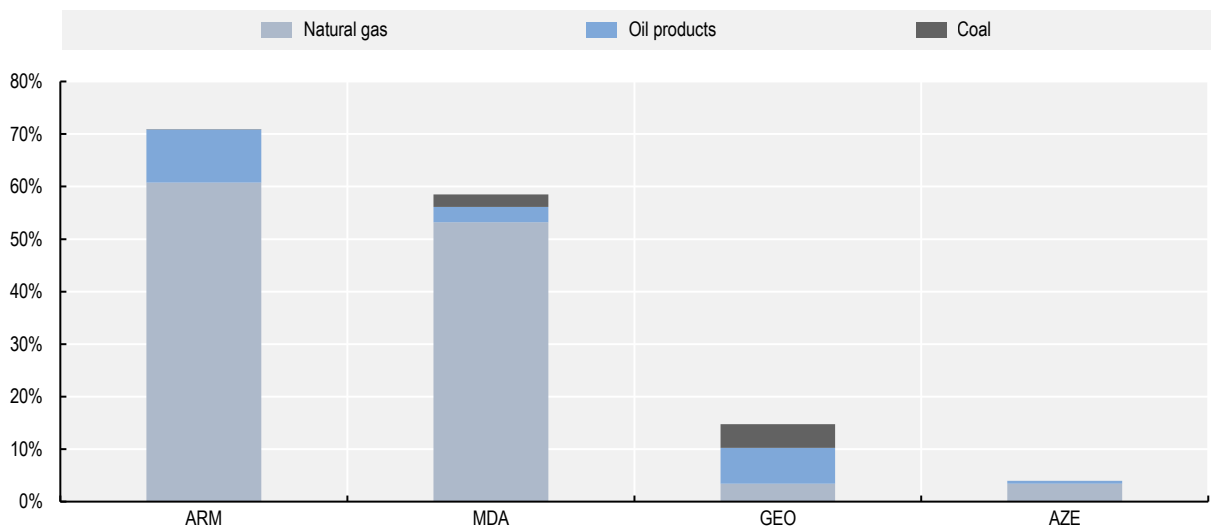
Figure 2.4. Energy dependency rate

Net energy imports as share of total energy supply



Note: Data from 2020 except Armenia (2019)
Source: IEA (energy balance sheets); UNComtrade; Georgian National Energy and Water Supply Regulatory Commission

Figure 2.5. Fossil fuel imports from Russia as share of Total Energy Supply (TES)



Note: data from IEA and UN Comtrade, average 2017-2019
Source: (OECD, 2022[50])

While Armenia has a long-term contract with Russia for the supply of gas which shields it from excessive price increases, in recent years Moldova is strengthening its energy security by making alternative supplies of natural gas possible through the Iasi-Ungheni-Chisinau pipeline (Box 2.1), reverse flows from the Trans-Balkan system, and the possibility to buy gas from EU markets and store it in Ukrainian underground gas storage facilities (IEA, 2022[51]).

In addition, there have been recent efforts from the EU to help Moldova and Ukraine transition away from Russian energy and strengthen their energy security. For example, both countries' electricity grid systems have been synchronised with the EU power grid, allowing them to use EU sources for electricity supply (European Commission, 2022[52]). Moreover, EU members agreed to set up a platform for common purchases of gas, LNG and hydrogen, which will also be open to Moldova, Ukraine and Georgia allowing these countries to benefit from cheaper energy prices (European Commission, 2022[53]).

EaP countries have also an opportunity to scale up renewable energy generation capacity to reduce fossil fuel dependency and advance their green transition. The rise in prices and price uncertainty for energy create major implications for countries' energy and climate policy, especially for those heavily dependent on energy imports (Box 2.1). The domestic use of fossil fuels is disincentivised by the expectation or risk of higher prices, which can push countries towards saving fossil fuels and investing in energy efficiency and/or increasing the share of renewables in their energy mix (OECD, 2022[50]). Increasing FDI in renewable energy could help advance this transition, particularly in Georgia and Ukraine which are already attracting significant greenfield investments in renewable energy.

Box 2.1. EaP countries' climate and energy policies

Armenia's short-, mid- and long-term climate policy will depend heavily on energy security, and its relations with Russia and regional neighbours. In late March, the government approved the energy efficiency and renewable energy programme for 2022-2030, which highlights energy security as a key driver for change, including setting a target of 15% solar of energy generation by 2030. This corresponds to 1000 MW of solar photovoltaic (PV) capacity and 300 MW of battery storage to be built. Initial plans exist for the first stage of implementation, which would see the tendering of five 120 MW solar PV projects. In mid-April a programme was also approved to support energy efficient renovations of apartments and residential buildings.

In **Moldova**, the main objectives of the Energy Strategy until 2030 include improving energy security, developing competitive energy markets, European integration, and climate change mitigation. According to upcoming renewable tenders from the government and the regulator, the capacity of wind, solar, biogas and hydropower plants is to be increased by 521 MW. In the gas sector, Moldova is striving to reduce its dependence on Russian gas, for instance through the extension of the Iasi-Ungheni gas pipeline to Chisinau, allowing Moldova's capital to receive gas from Romania, which in the medium term should replace Russia as its main source of natural gas. Due to high energy intensity in the country, increasing energy efficiency is another important pillar to enhance its energy security.

In **Georgia**, natural gas prices are mainly dependent on undisclosed long-term contracts with Azerbaijan. Thus, Georgia is expected not to be immediately affected by increased global natural gas prices. The cost of diesel fuel, which makes up a significant share of household expenditure, was up 45% y-o-y in August 2022. The government has announced its intention to build new large hydropower plants including in Khudoni, Nenskra, and Namakhvani, although the latter project has recently been abandoned in the wake of prolonged protests against its construction. New proposals for support schemes and revenue sharing arrangements between central and local authorities are currently being developed to attract private investors and mitigate local resistance. Overall, the short-term effects of the war are moderately increasing incentives to reduce consumption of road fuels and pursue additional investments in domestic renewable electricity generation capacities, which could positively impact emissions and climate policy.

For **Azerbaijan**, higher oil and gas prices will increase net income in the country. Government revenues for 2022 alone have been revised upward, affording Azerbaijan an expected budget surplus of 20% of GDP in 2022 (12% in 2023). As the EU looks to increase capacity in the Southern Gas Corridor, Azerbaijan's efforts to increase gas exports to Europe are bolstered by the crisis. In mid-July, the European Commission agreed with Azerbaijan to double its imports of natural gas to at least 20 billion cubic metres a year by 2027, having already increased imports from 8.1 in 2021 to 12 bcm in 2022 (European Commission, 2022[54]).

Source: (OECD, 2022[50])

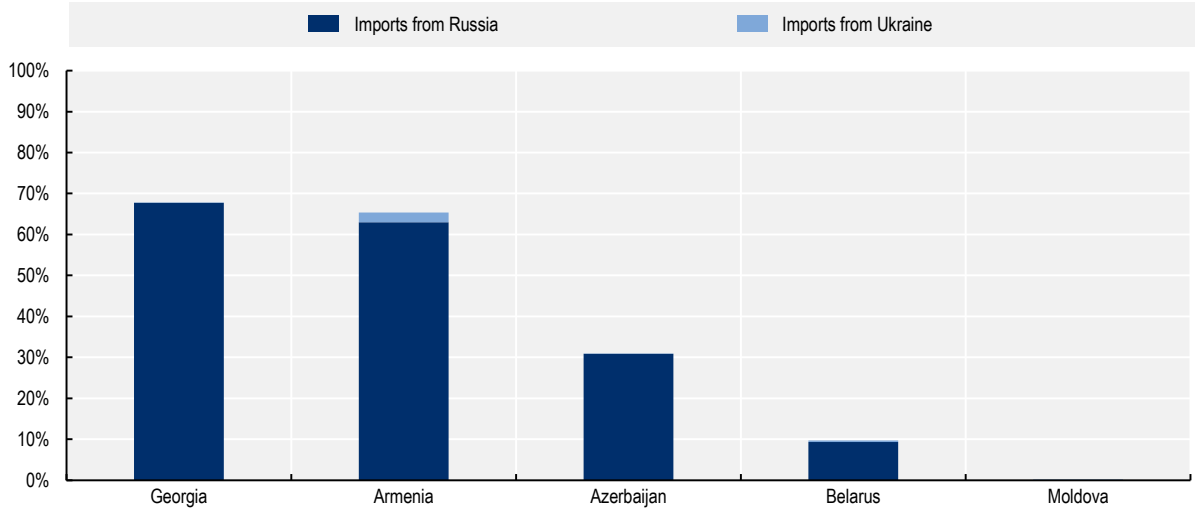
Food

Food price increases can have disastrous effects on food security, poverty and global hunger. In the EaP region, as in the rest of the world, food prices are rising sharply as a result of the war. Known as the "breadbasket of Europe", the region encompassing Ukraine and Southern Russia was responsible for 26% of global exports of wheat in 2020 (UN Comtrade[41]). War in this region caused prices of key grains to increase dramatically since the start of the war – wheat by as much as 90% and maize by over 20% in May 2022 (Markets Insider, 2022[55]). Much of this rise was driven by market panic about grain availability more than actual lack of grain (OECD, 2022[56]), as well as the blockade of Ukrainian seaports for export by Russia. These concerns were exacerbated by Russia's announcement of a temporary halt to all exports of grain to the Eurasian Economic Union, of which Armenia is a member, until August 2022. The Black Sea Grain Initiative, a recent deal between Russia, Ukraine and Türkiye allowing for the export of large volumes of commercial food cargo from the Ukrainian ports of Odessa, Chernomorsk and Yuzhny, has significantly reduced pressure on grain supply and resulted in wheat prices returning to pre-war levels (United Nations, 2022[38]). More generally, global food prices had almost returned to pre-crisis levels by October 2022 (OECD, 2022[20]), a phenomenon explained in part by lower demand (e.g., for cereals, dairy and meat) and improved production prospects in the case of sugar (FAO, 2022[57]),

Beyond price increases, supply uncertainties from Russia also pose a food security risk in EaP countries. As shown in Figure 2.6**,** all EaP countries except Moldova are heavily dependent on wheat imports from Russia, with Georgia and Armenia exposed for more than half of their total domestic consumption. Such reliance on Russia poses a risk since the country has previously used export controls of key commodities as political tools to put pressure on trading partners. Russia has also shown concerns about internal food security that has led to protectionist policies and, as the war continues, it may wish to further limit exports of wheat thus increasing risks of food security for EaP countries.

Figure 2.6. Dependence on wheat imports from Russia and Ukraine

Share of wheat imports from Russia and Ukraine in total domestic utilisation (2018-2020)



Note: data for Armenia covers only 2019 and 2020
Source: National Statistical Offices of EaP countries and FAO (food balance sheets)

Moldova is effectively self-sufficient in wheat, as it shares the same fertile geographic conditions as Ukraine. None of the EaP countries have a significant level of wheat imports from Ukraine, but the destruction of Ukrainian agricultural capacity and exports is a major factor in the increase in global prices, which still poses risks of food security for low-income households everywhere.

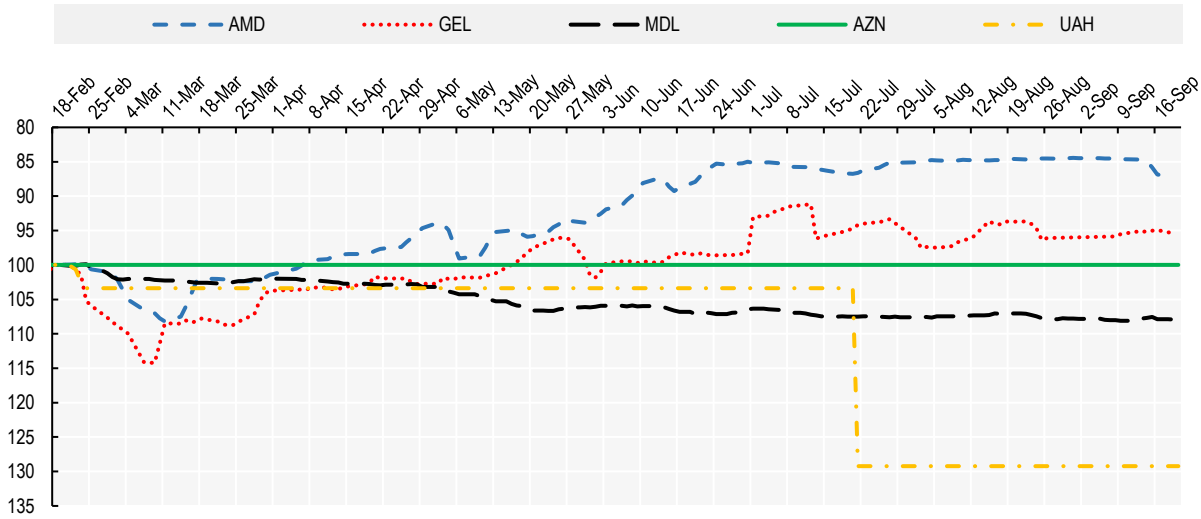
The risk of long-term supply shortages has prompted discussion of increasing domestic agricultural production in EaP countries. For example, in Armenia 50% of arable land is uncultivated which, given the greater incentives of farming in this high-price environment, could be used for wheat production (JAM News, 2022[58]). However, these efforts will take time and do not address the short-term pain-points of the high food prices and risk of shortages. Given their reliance on food imports, some EaP countries are introducing a variety of measures to secure supply of basic food items. For example, in an effort to simplify procedures for replacing products previously imported from Russia and Ukraine, the government of Moldova introduced a time-bound exemption from the certification procedure for food and staple products imported from the EU (bne IntelliNews, 2022[59]). Azerbaijan, on the other hand, is diversifying its sources of food imports, and as a result the share of cereals imported from Kazakhstan has increased tenfold in the first six months of 2022 compared to the previous year (Trend news agency, 2022[60]).

Exchange-rate movements

Since the beginning of the war, exchange rates of EaP currencies against both the dollar and the ruble have been highly volatile. As can be seen in Figure 2.7, markets' initial response to the war was an intense weakening of EaP currencies against the dollar, following the collapse of the Russian ruble during this period. However, since then, not only has the ruble significantly recovered as a result of strong forex and capital controls and high energy prices, but many EaP currencies have also re-appreciated, with the Armenian dram and the Georgian lari even exceeding their pre-war levels. In the weeks after the beginning of the war the dram and the lari lost up to 8% and 14% of their value against the dollar, respectively, but as of mid-June the dram was up 12%, and the lari by 1.5% (after peaking at +3.8%). Moldova's currency has not experienced a similar trend reversal, reflecting the country's weak economic performance and outlook. In July, the National Bank of Ukraine devalued the hryvnia by 25% against the USD, with the objective of supporting the competitiveness of Ukrainian producers and maintaining control over inflation dynamics (Reuters, 2022[61]).

Figure 2.7. Exchange rates dynamics

Exchange rates USD / local EaP currencies (Index: 18 Feb 2022 = 100, inverted scale)



Note: AMD = Armenian Dram, GEL = Georgian Lari, MDL = Moldovan Lei, AZN = Azerbaijani Manat, UAH = Ukrainian Hryvnia. Values below/above 100 correspond to an appreciation/depreciation against the USD.
Source: OECD calculations based on data from Central Banks of EaP countries

Several factors have contributed to the observed exchange-rate dynamics across EaP countries. On the one hand, the broad and steady pace of monetary tightening via interest rate hikes introduced by national banks across the region in response to accelerating inflation has increased the attractiveness of national currencies, pushing up their value. On the other hand, short-term changes in aggregate demand (both domestic and external) may have further increased demand for national currencies.

In Armenia and Georgia, the influx of Russian citizens (see below) is putting upward pressure on the dram and lari, respectively. Since the beginning of the war, Russians moving to the two countries are opening bank accounts[7] and exchanging a significant amount of foreign currency for the local ones, thereby increasing their demand and contributing to their appreciation. In the case of Georgia, a growth in remittances and a rise in tourism and export revenues are also responsible for the strengthening of the national currency. For Armenia, the decision to start paying for natural gas imports from Russia in rubles instead of dollars may also have helped to push up the value of the dram, as the demand for dollars falls (Finport, 2022[62]).

While the initial shock contributed to the accelerating price increase observed in March and April by making imports more expensive, the upward trend that followed, especially in Armenia and Georgia, is seen by some exporters as potentially making their products less competitive on international markets. This appreciation, however, is not being treated as a concern by the Armenian Central Bank, as it helps counter the many inflationary pressures arising from the war (Armenews, 2022[63]).

Nevertheless, the high volatility observed since the beginning of the war may reverse the recent upward trend and cause renewed depreciation of EaP currencies against the dollar, which would increase inflationary pressure by making imports more expensive. Imports are equivalent to between 36-66% of GDP across the region and thus an increase in the price of these goods will have a significant effect on the general price level and cost of living in the Eastern Partnership (World Bank[64]). An exception to this trend is Azerbaijan, which has a pegged exchange rate system with the US dollar and thus has not experienced any exchange rate volatility or ‘imported’ inflation.

[7] An estimated 27 000 foreigners, mostly Russians, have opened bank accounts in Armenia from 24 February to 22 March 2022 (RFERL, 2022[181])

3 Transmission channels to Eastern Partner countries

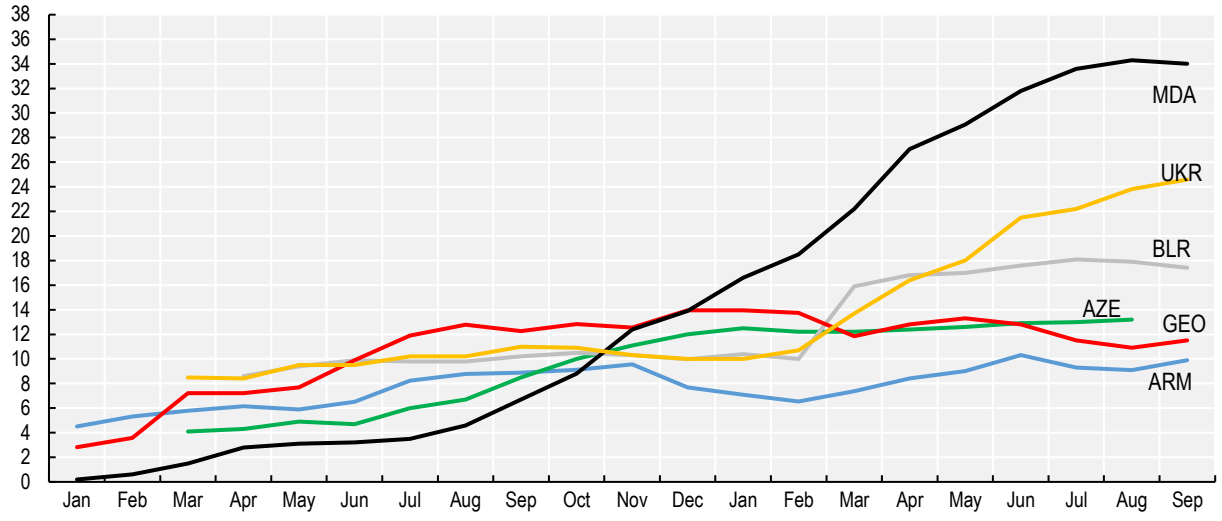
This chapter discusses in detail the exposure of EaP countries to the economic shocks triggered by the war through key transmission channels, such as inflation, migration, remittances, investment, and trade.

Inflation

In the wake of the war, prices are soaring globally, with inflation projections for 2022 exceeding 7% for the majority of OECD countries (OECD, 2022[65]). The EaP region is no exception. While the region was already experiencing rising prices before the war, primarily due to COVID-19-induced supply problems, the war has exacerbated the existing high-inflation environment, and the depreciation of local currencies in the weeks after the start of the war made imports more expensive, adding to inflationary pressures. The combined effects of these factors are captured by the generalised increase in aggregate price levels as shown in Figure 3.1.

Figure 3.1. Surging inflation across EaP countries, 2021-2022

Annual inflation (CPI percentage change over corresponding month of previous year), %



Source: Central Banks of EaP countries

Table 3.1. Price increases in selected products / categories in EaP countries

% price change in May 2022 vs. May 2021

	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Ukraine
Bread	-	-	-	+35.4	+29.3	+21.4
Vegetable oil	-	-	-	+17.5	+27.8	+8.0
Fuels and lubricants	-	-	-	+49.4	+52.7	+57.5
Food products	+13.8	+17.4	+19.3	+22.0	+32.5	+24.1

Source: Statistical Offices and Central Banks of EaP countries

Food and energy price increases are particularly worrying. In 2020, across the EaP region, the share of expenditure on “basic” needs (food, energy, housing, water, electricity, gas) for an average household ranged from 53% in Azerbaijan (State Statistical Committee of Azerbaijan, 2022[66]) to 59% in Moldova (National Bureau of Statistics of Moldova, 2022[67]). Within-country variations in income highlight how steep increases in food and energy prices are deeply regressive and can throw households into poverty (Box 3.1). In Moldova, for example, households in the highest income quintile allocate 44% of their

expenditure to cover basic needs, while for low-income households basic expenditures amount to 74% of the total, a considerably higher proportion (Statistical Office of Moldova, 2022[68]).

Box 3.1. Inflation and poverty

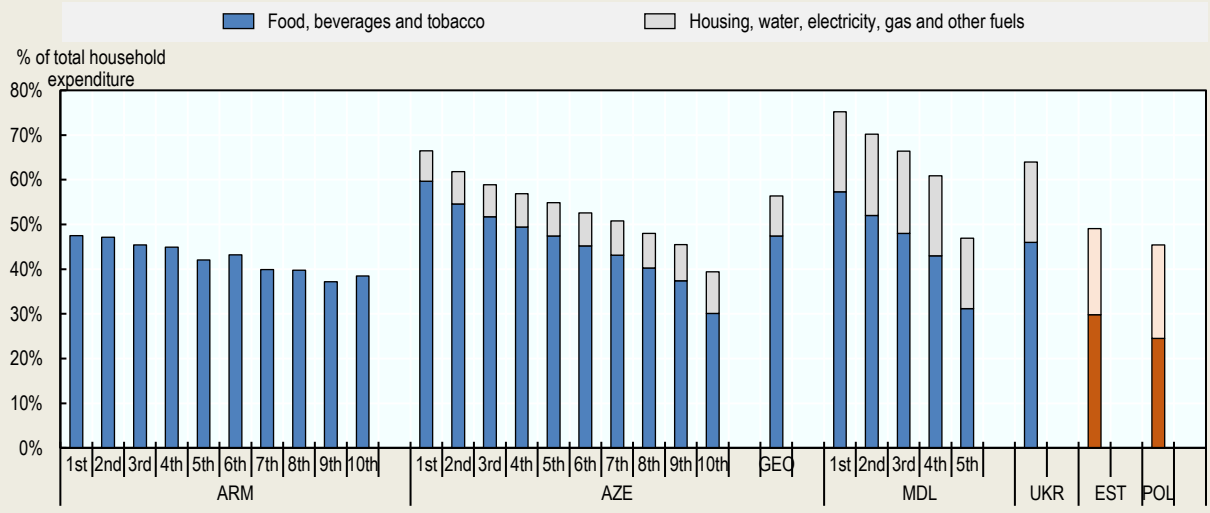
On average, households across the EaP region allocate 59% of their total expenditure on basic goods (defined as food, housing, water, electricity gas and other fuels) and thus an increase in the price of these goods will meaningfully impact their purchasing power. Ukraine has the highest average expenditure on basic goods (64%), while the lowest is Azerbaijan at 56% (data on housing and energy expenditure for Armenia are not available, so a comparison is not possible). These proportions are significantly larger than those observed in OECD countries such as Estonia (49%) and Poland (45%).

Inflation in the price of basic goods (food and energy) threatens those on the lowest incomes in the EaP region (Figure 3.2). In Azerbaijan, the poorest 10% of households allocate 69% of their expenditure to basic goods, compared to around 40% for the richest 10%. In Moldova, the contrast is even starker, as the difference between the bottom quintile and top quintile is nearly 30 percentage points.

Moreover, across the region the proportion of expenditure on food is particularly notable, averaging 44% of total expenditure compared to 30% for Estonia and 25% for Poland. For the poorest households in these countries, this proportion can reach up to 60%. Therefore, the increase in food prices caused by the war threaten many of the poorest households with food insecurity. In 2021, the FAO estimated that, on average, 27% of people in the Eastern Partnership are moderately or severely food insecure (FAO, 2021[69]).

Figure 3.2. Inequality in expenditure on basic goods

Proportion of total expenditure on basic goods, by income decile/quintile

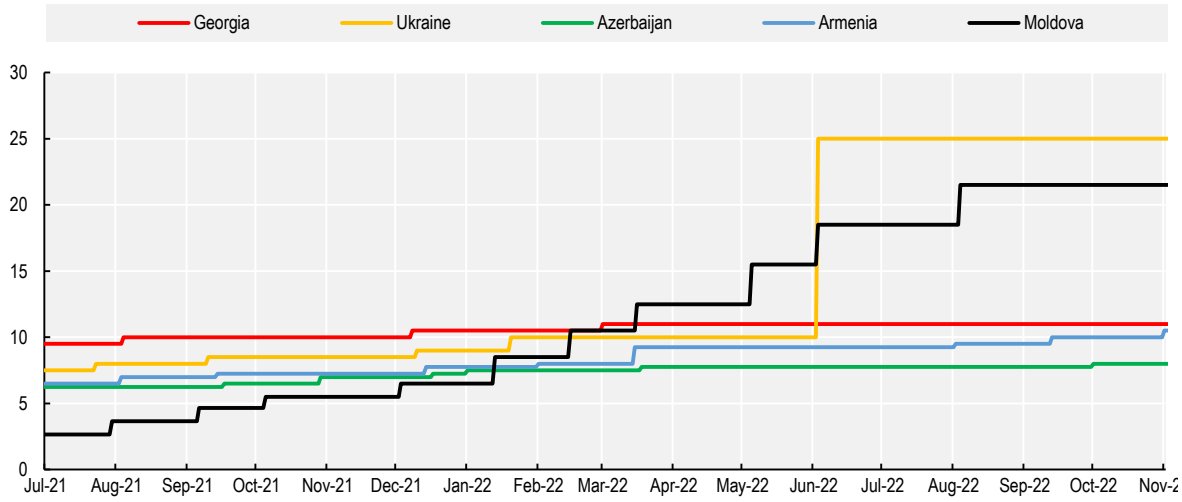


Note: i) Armenia and Azerbaijan have information on each income decile, Moldova on each income quintile. ii) Ukraine and Georgia do not have income-decomposed data. iii) For Armenia, the classification system for Armenia refers only to food expenditure, therefore comparisons with other countries should be done with caution. Data for housing, water, electricity, gas, and other fuels are missing for Armenia.
Source: Household surveys from National Statistical Offices of EaP countries. OECD.Stat for Estonia and Poland

Accelerating inflation has prompted central banks in EaP countries to respond with monetary tightening. Indeed, price pressures have led to more forceful policy rate rises than suggested by earlier forward guidance in many countries, so as to minimise the risk that high inflation expectations become entrenched. Thus, while monetary tightening was already visible in 2021, central banks in EaP countries have further increased their key policy rates several times since the start of the war (Figure 3.3).

Figure 3.3. Monetary tightening in EaP countries

Central banks' key policy rate, %



Source: Central Banks of EaP countries

Calibrating the scale and timing of the monetary policy changes required to steer inflation back to target ranges remains challenging, given difficulties in assessing the rate above which monetary policy becomes restrictive, the concurrent policy actions being undertaken in other countries and the speed at which tightening should occur. Clear communication about the policy stance, the key factors behind policy decisions and the expected pace of balance sheet reductions is crucial to minimise financial market disruptions (OECD, 2022[20]).

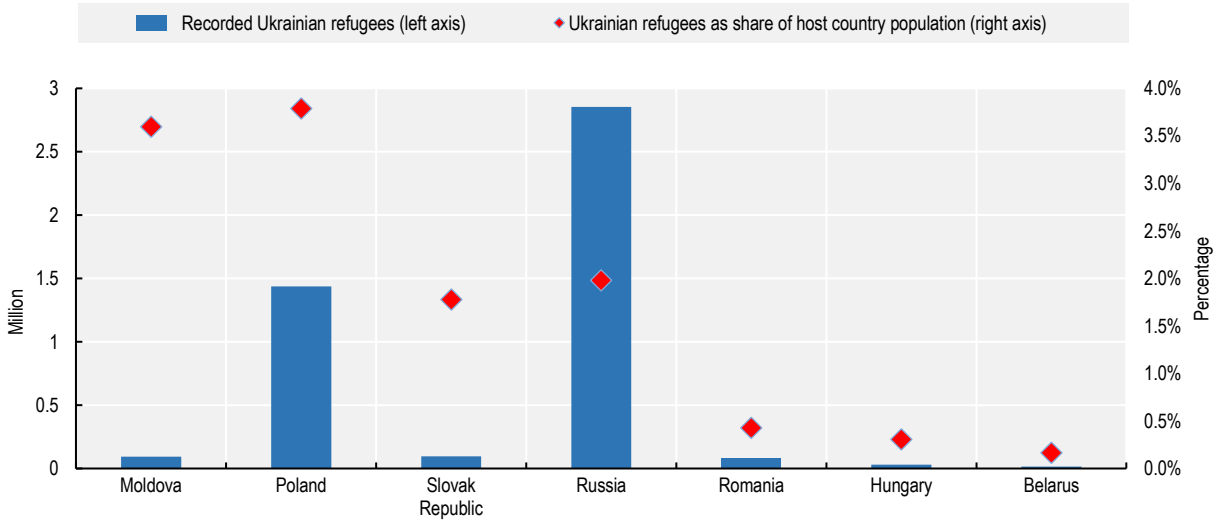
Migration

Russia's war against Ukraine has triggered the largest displacement of people in Europe since the Second World War, with millions of Ukrainians seeking refuge elsewhere in their country or abroad. This has put unprecedented pressure especially on neighbouring Moldova. Moreover, the economic fallout from the war and sanctions have encouraged many Russian citizens to leave, with Georgia and Armenia reckoned to be among the top destinations. While this may create significant challenges in the short-term, countries can turn this into medium-term opportunities if they can capitalise on the inflow of a relatively highly skilled labour force.

Refugees in Moldova

Since 24 February 2022, more than 14 million[8] border crossings took place from Ukraine towards neighbouring countries, primarily Poland, Hungary, and Romania. While return flows have also been increasing, by mid-October there were more than 7.6 million individual refugees from Ukraine recorded across Europe. Over 650 000 Ukrainians crossed the border to Moldova (UNHCR, 2022[70]). While other countries in Eastern Europe have welcomed larger numbers of refugees (particularly Poland), Moldova has received the largest inflow as a proportion of total population (25%). Around one in six Ukrainians arriving in Moldova remains in the country, while the others continue their journey to different countries (OHCHR, 2022[71]). Thus, a group equivalent to around 3.5% of Moldova's population has settled in the country as refugees.

Figure 3.4. Ukrainian refugee arrivals



Note: data as of 11 October 2022; population data for 2020
Source: (UNHCR, 2022[24]); (World Bank, n.d.[72])

This presents a huge demand for humanitarian assistance on Moldova. The short-term needs include the creation of infrastructure to process the refugees arriving in the country, to provide decent housing facilities and to respond to food and medical needs. All of this will put additional strain on Moldova's public finances, already put under stress by the spill overs from the war, and exacerbate the country's external financing needs.

To respond to this, the IMF has agreed to an *ad hoc* review under its extended credit facility to make about USD 245 million available to Moldova (IMF, 2022[73]) and EU donors quickly pledged EUR 659 million in financial aid and humanitarian help to assist Moldova in addressing these challenges (DW, 2022[74]). The main ambition of this package is to support the weakened fiscal and economic status of Moldova resulting from the refugee crisis. The funding will be used, in part, to broaden the provision of social services and support incoming refugees. Moldova has also received support from UNHCR in processing refugees, for example through the establishment of Children and Family Protection Support Hubs, so called "Blue Dots"

[8] As of 11 October 2022. The total outflow from Ukraine presented as border crossings from Ukraine (since 24 February 2022) reflects cross-border movements (and not individuals).

(Unicef, 2022[75]). Moreover, there are countless examples of private citizens and firms providing shelter, aid and jobs to refugees.

However, there are challenges ahead to integrate refugees into Moldovan society. Over 30% of refugees are school-aged children, who will need to be included into the local school system. This poses a significant problem as the language of instruction for two thirds of Moldovan schools is Moldovan. There are, however, schools providing programmes taught in Ukrainian and Russian as a result of the existing diaspora communities in Moldova. Around 6.6% of Moldova's pre-war population had Ukrainian as a first language. Therefore, the refugee population will increase the Ukrainian-speaking population in Moldova by around 50% (Moldovan National Bureau of Statistics[76]).

Moreover, adult refugees will need to be integrated in the local labour markets. This poses a challenge for Moldova, given the limited employment opportunities available before the war. Moldova's unemployment rate is relatively low (5% in 2019, 3.8% in 2020), but the level of economic inactivity is high and outward labour migration has long been a major feature of Moldova's economic life (see below). ILO's model estimates that, in 2019, only 47% of 15-64 year olds were participating in the labour force, significantly below the EaP average of 65%, and this figure has been steadily decreasing since 2000 (World Bank | ILO[77]).

Russian migration to South Caucasus

New migration patterns are emerging in the South Caucasus. The effects of international sanctions, fear of political turmoil, the risk of conscription and a deterioration in economic conditions and prospects at home are prompting many Russian citizens to move to Armenia and Georgia. While it is not yet possible to determine how "permanent" these relocations will be, surveys suggest that, between the start of the war and the end of June, over 40 000 Russian citizens had entered Georgia and were still in the country after at least one month, and 16 000 foreigners, mostly Russians, opened bank accounts in Armenia in the same period (IDFI, 2022[78]) (Central Bank of Armenia, 2022[79]).

A significant proportion of these emigrants seem to have entrepreneurial ambitions, with many working in the digital and IT sectors, as this is a more mobile industry and thus offers an easier option to work internationally. Anecdotal evidence and information from national administrations suggest a considerable number of new businesses, many of which are in the IT and digital sectors, being registered in both Armenia and Georgia: by 22 March, 268 Russian citizens had registered firms while another 938 had received official status as individual entrepreneurs in Armenia. In March, April and May, over 6 400 requests for business registrations were submitted to Georgia's authorities – seven times more than the annual figure for 2021 (Transparency International Georgia, 2022[80]).

EaP countries have an opportunity to capitalise on this inflow of human capital and technological skill. Armenia and Georgia, which already have growing IT sectors, could bolster their tech industries and diffuse more digital knowledge into their labour market. The creation of new IT companies in the two countries could also provide additional services for firms looking to digitalise, thereby assisting with broader ambitions for digitalisation in the EaP region.

Remittances

Remittances are one of the most significant contributors to capital inflows for EaP countries. Typically, remittances are earned by a member of a family working in a different country and sending money back to the home country either permanently or on a seasonal basis. Across Europe and Central Asia, remittances flows were as large as FDI, portfolio investment and overseas development aid combined in both 2020 and 2021 (World Bank Group, 2021[81]).

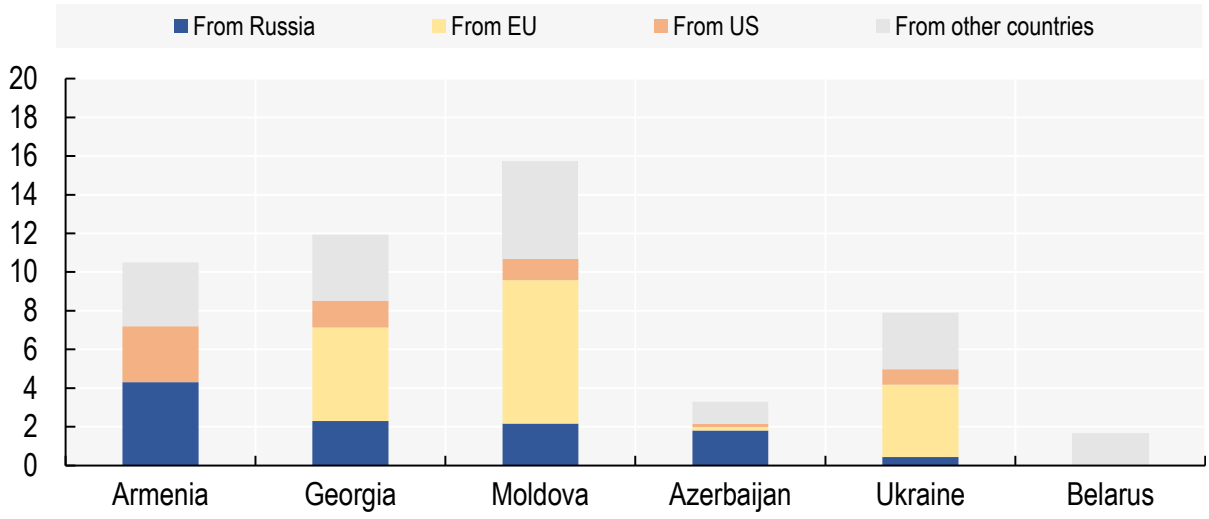
Remittances often support low income households (ILO, 2009[82]). They are largely used to finance consumption of basic needs (food, housing, medicine etc.) across the region and are rarely used for saving or investment. As such, they often represent a line of support that separates these households from poverty. Without policy intervention to offer protection from generalised price increases, a drop in remittances could plunge some of the poorest in the EaP region into poverty.

In all EaP countries except Azerbaijan and Belarus, net inflows of remittances were equivalent to 10% or more of GDP in 2020. Moldova relies on a particularly large inflow of remittances, equal to 15.7% of GDP in 2020, which puts the country among the 20 most remittance-dependent countries globally (IOM, 2020[83]). Azerbaijan has a notably lower level of remittances, corresponding to only 3.3% of GDP in 2020 (Figure 3.5). However, these flows tend to be geographically highly concentrated, with the city of Lankaran receiving 33% of remittances despite constituting only 12% of the population. Therefore, for certain regions in Azerbaijan, remittances still form an important source of income (EBRD, 2007[84]). This is also the case for Armenia, where around 40% of households in the provinces of Tavush, Gegharkunik and Shirak receive remittances compared to only 20% in Yerevan (IOM, 2015[85]).

The demographic profiles of remittance workers vary across the region. For example, in Moldova, it is largely younger people who have left and are sending money back to support their parents and grandparents. In other EaP countries, such as Armenia, there is a more significant number of seasonal migrants, who go abroad for a certain period of the year and then return home. A large share of these workers go to Russia during the summer to work in the construction industry and the harvest, returning home in the latter months of the year.

Figure 3.5. Inflows of remittances to EaP countries

Total inflows of remittances as % of GDP, by country of origin (2020)



Note: for Armenia, remittances from EU included in "From other countries"; for Belarus, geographical origins of remittances unspecified.
Source: World Bank Development Indicators; Central Banks of EaP countries and National Statistical Offices of EaP countries

The dependency on remittances from Russia varies significantly across the region. In relative terms, Armenia has the largest flow of remittances from Russia (4.3% of GDP in 2020), which is nearly double the size of the next largest. Georgia, Moldova and Azerbaijan all have similar exposure to Russian remittances – making up around 2% of GDP in 2020. For all EaP countries except Ukraine, there is a risk of a significant drop in remittances as a result of the war. The fact that Georgia and Moldova receive most of their inflows from EU countries does not fully shield them from the risks of a potential drop in transfers

from Russia, while, at the same time, exposing them to a likely economic slowdown in the EU. However, the short-term situation is also creating a temporary exceptional inflow of Russian money to EaP countries, detailed below.

As the Russian economy shrinks due to the war and sanctions, various industries have reduced their need for labour. As a result of their more precarious position within Russian labour markets, remittance workers are disproportionately affected by this contraction; they will be the first to be laid off, and seasonal workers will not be hired. Seasonal workers in Russia have reported being asked to work off the books or not being paid at all (Mejlumyan, 2022[86]).

Moreover, there are now many practical barriers to transferring remittances out of Russia. The foreign capital restrictions imposed in Russia limit the amount of foreign currency that is allowed to leave, the removal of several Russian banks from the SWIFT payment network makes transfers more challenging, exchanging rubles exposes remittance workers to a high exchange rate risk and to significant buy/sell spreads as a result of volatility in forex markets (Saha and Staske, 2022[87]). All of these barriers make it additionally challenging to send remittances out of Russia to the EaP region.

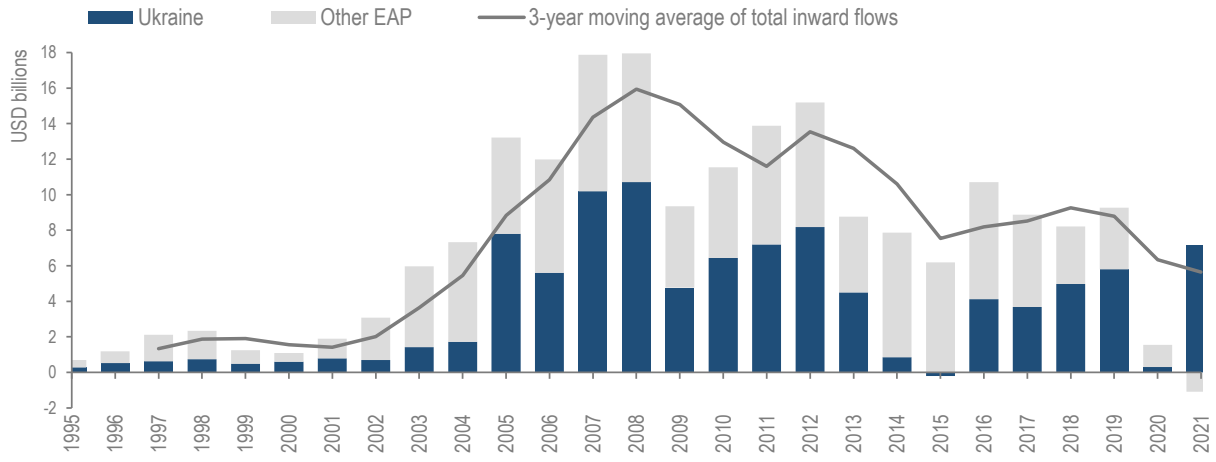
Available data for Georgia, Armenia and Moldova shed some light on how the war is affecting remittances in the EaP region. In Georgia, remittances from Russia dropped by 16% in March (year-on-year), but subsequently saw a staggering 560% average increase in the period April-June (National Bank of Georgia[88]). For Armenia, a 291% year-on-year increase was recorded in the same period (Armstat, 2022[89]). Moldova, by contrast, experienced a 94% year-on-year drop in money transfers denominated in rubles in the period March-June 2022 (National Bank of Moldova[90]). The large influx of Russian citizens moving to Armenia and Georgia is likely to underlie the observed jump in remittances in the two countries: once arrived in the new country, Russian citizens transfer their own savings to themselves. Another reason may be the progressive withdrawal of capital of Armenian and Georgian emigrants from Russia. These factors may be compounded by the fact that, because many Russian banks are sanctioned, part of the funds that would normally be sent via the banking system are now sent via money transfer systems (e.g. Western Union, Contact, MoneyGram, Zolotaia Korona) and recorded as remittances. However, it should be noted that the more “traditional” remittances from Russia tend to peak in late-summer as a result of the seasonality of construction and agriculture, as well as migrant workers returning in Q4. Therefore, the true “structural” impact of the war and of Russia’s economic downturn on remittances flows will only be fully appreciated in the last months of the year and, even more clearly, in the coming years, as the exceptional movement of Russian citizen and capital towards the South Caucasus observed in 2022 is unlikely to continue.

Investment

Russia’s war of aggression against Ukraine, in the wake of the COVID-19 pandemic, brings a further negative shock to the world economy, with a profound and immediate impact on foreign direct investment (FDI) and other capital flows. These impacts are primarily observed in Ukraine and Russia, but have knock-on effects for regional and global capital flows through supply chain linkages and displacement effects.

FDI inflows to Eastern Partner countries had already deteriorated as a result of the pandemic**.** EaP countries experienced significant contractions in FDI as a result of a series of shocks in the last fifteen years, starting with the global financial crisis in 2008-9, followed by Russia’s seizure of Crimea in 2014, and most recently by the COVID-19 pandemic (Figure 3.6). While Ukraine saw a considerable drop in FDI inflows in 2014 and 2015, FDI flows to other EaP countries rose during those years and were hardest hit by the pandemic. This suggests that the impact of the current war in Ukraine on investment flows to neighbouring countries may be moderate.

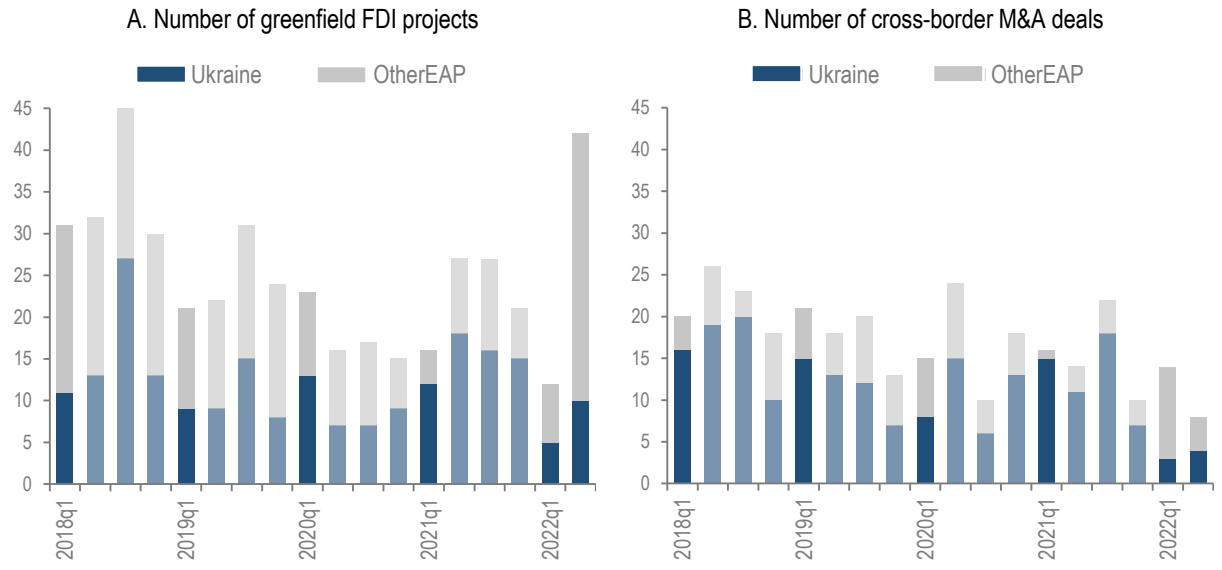
Figure 3.6. FDI flows into EaP countries



Source: OECD based on IMF BOP Statistics (2022[91])

The war has had varying impacts on investment across the region. Monthly project-level information shows that the number of new foreign investment projects in the region was 68% lower in the first quarter of 2022 than the first quarter of 2018, 52-57% lower than in the first quarters of 2019 and 2020, and 41% lower than in 2021 (Figure 3.7). Cross-border mergers and acquisitions (M&A) involving target companies from the region also dropped by 30% compared to the first quarters of pre-pandemic years and 13% compared to 2021. The bulk of the drop is observed in Ukraine, both in terms of new investment (-64%) and in terms of M&A flows (-81%). New investment flows to other EaP countries (excluding Belarus) were relatively higher in the first quarter of 2022 compared to 2020-2021 and only 25% lower than in pre-pandemic years, while M&A flows to other EaP countries almost tripled compared to pre-pandemic years. In the second quarter of 2022, new investment flows into Ukraine recovered somewhat, but the number of new investment projects in Armenia and Georgia increased by a factor of six, bringing the region to a peak level of new investment projects compared to previous years. This suggests that some investments that would otherwise have been made in Ukraine may have been redirected to neighbouring countries as a result of Russia's large-scale invasion.

Figure 3.7. Monthly FDI flows into EaP countries



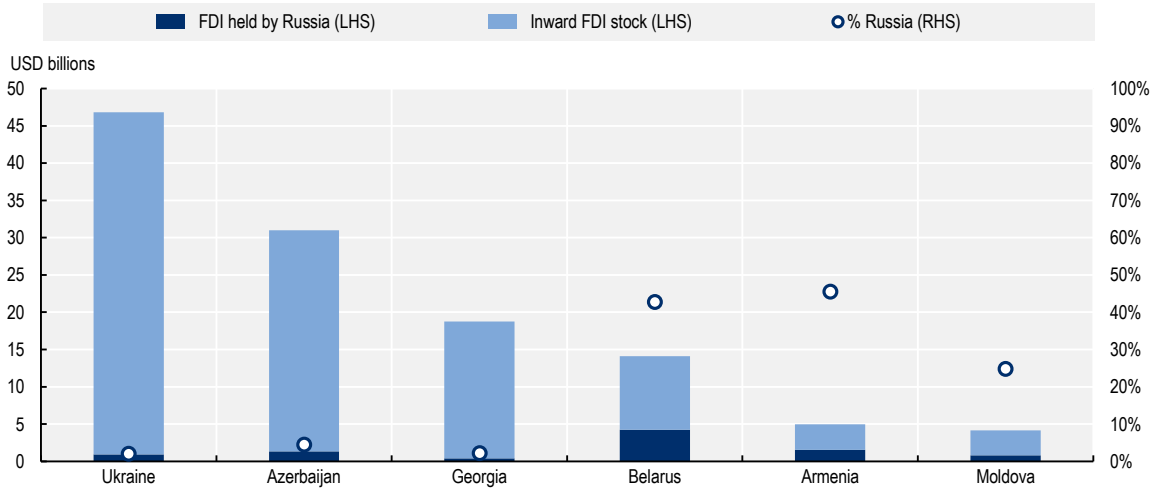
Source: OECD based on Financial Times (2022[91]) and Refinitiv (2022[92])

Smaller countries like Armenia and Moldova are relatively more dependent on Russian FDI. According to data on bilateral FDI positions, exposure to Russian investment varies considerably across countries in the region, ranging from 2% in Ukraine and Georgia, to 19% in Moldova and 31% in Armenia (Figure 3.8)[9]. While the greater dependence of Armenia and Moldova on Russian investments means greater exposure to the current political context, it also could imply that Russian-based investors will choose these countries as potential destinations to relocate their operations in order to circumvent economic sanctions.

The EU is the largest source of new investment projects in the EaP region. With the exception of Azerbaijan, the EU is the largest investor in all EaP countries, accounting for 38% of the value of new investments in the region over 2003-22, and 41% of direct jobs created by FDI (Figure 3.9) . Within the EU, the top investors are Germany (8%), Austria (4%) and France (4%), although Poland and the Czech Republic are also active investors in the region (3%). The United Kingdom accounts for 14% of capital investments in the region, but only 6% of jobs created by FDI, reflecting the high capital-intensity of these investments made predominantly in Azerbaijan. Russia accounts for the second largest share of investment in the region (13%), followed by the USA (8%). Other countries with high stakes in the region include China, Türkiye, the UAE, Switzerland and, to a lesser extent, Korea, Japan, India, Egypt and Iran. Azerbaijan and Ukraine also invest significantly in the region. Among recipient countries, Georgia has the most diversified portfolio of foreign investors, receiving sizeable shares of investment from Western, Middle Eastern, North African and Asian economies.

[9] In practice, Russian investment in the region may be higher than shown by bilateral FDI statistics since Russian investment is often re-directed through Cyprus and other countries with favourable tax regimes.

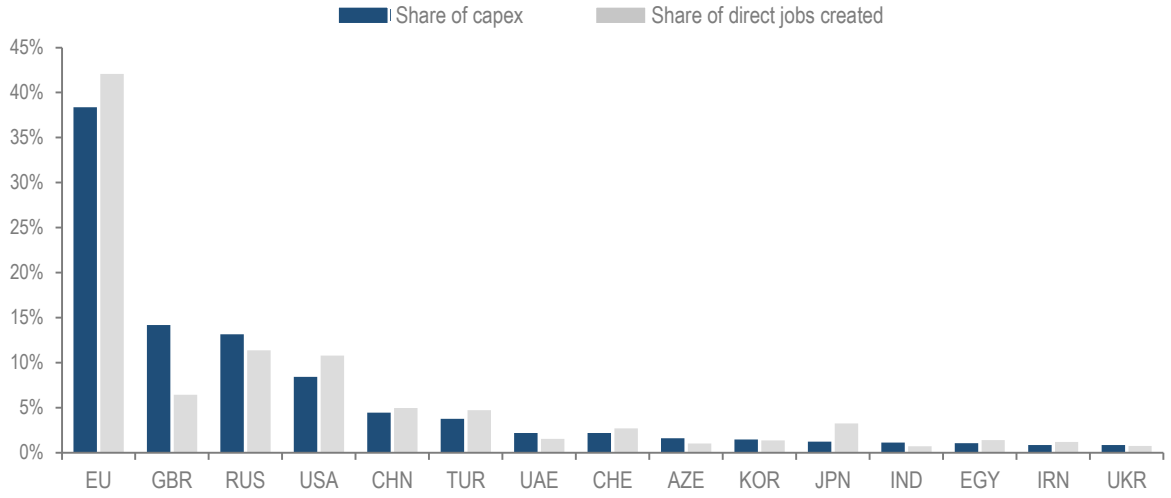
Figure 3.8. Exposure to Russian FDI and capital flows



Note: Value reflect inward FDI positions reported by host economy.
Source: OECD based on IMF CDIS (2022[93])

Figure 3.9. New investments in EaP countries

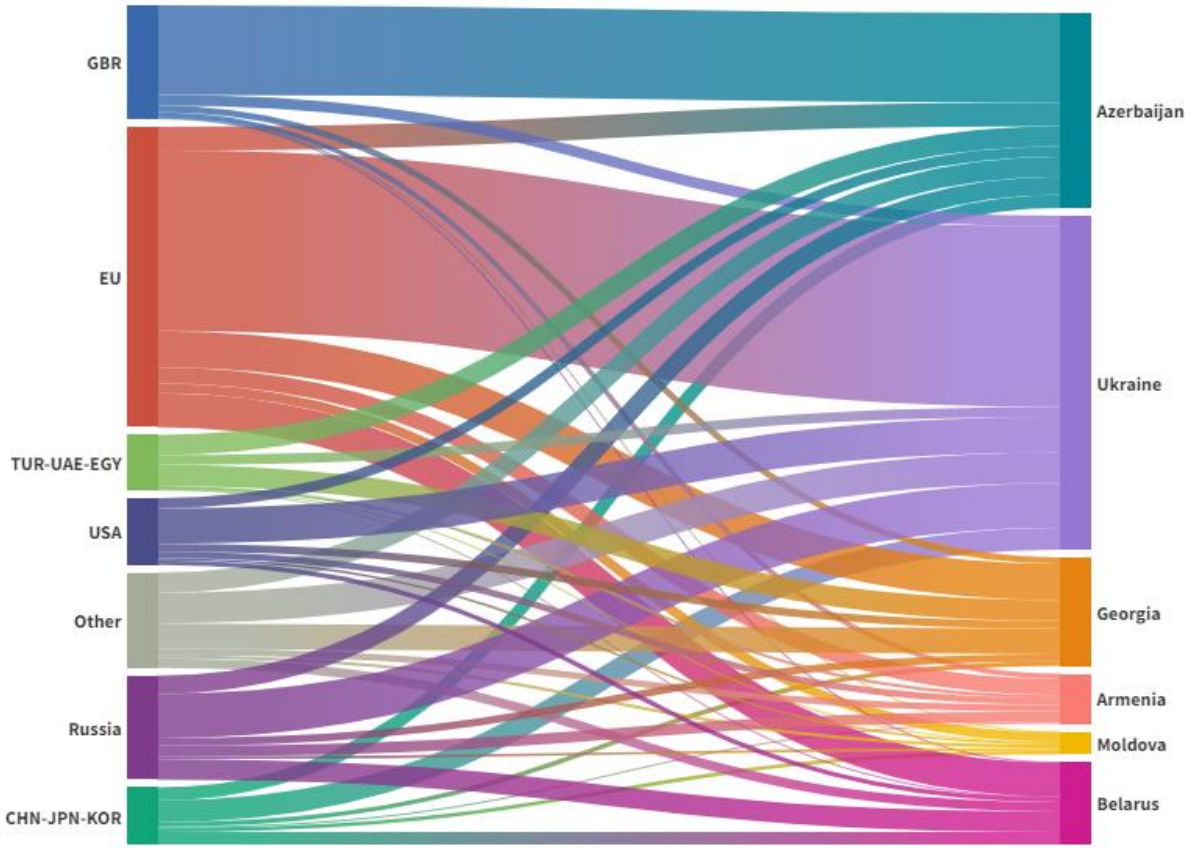
Capital expenditure and jobs created by greenfield projects over 2003-2022



Source: OECD based on Financial Times FDI Markets (2022[91])

Figure 3.10. New investments in EaP countries, by source and destination countries

Capital expenditure of greenfield FDI projects over 2003-2022, by source and destination

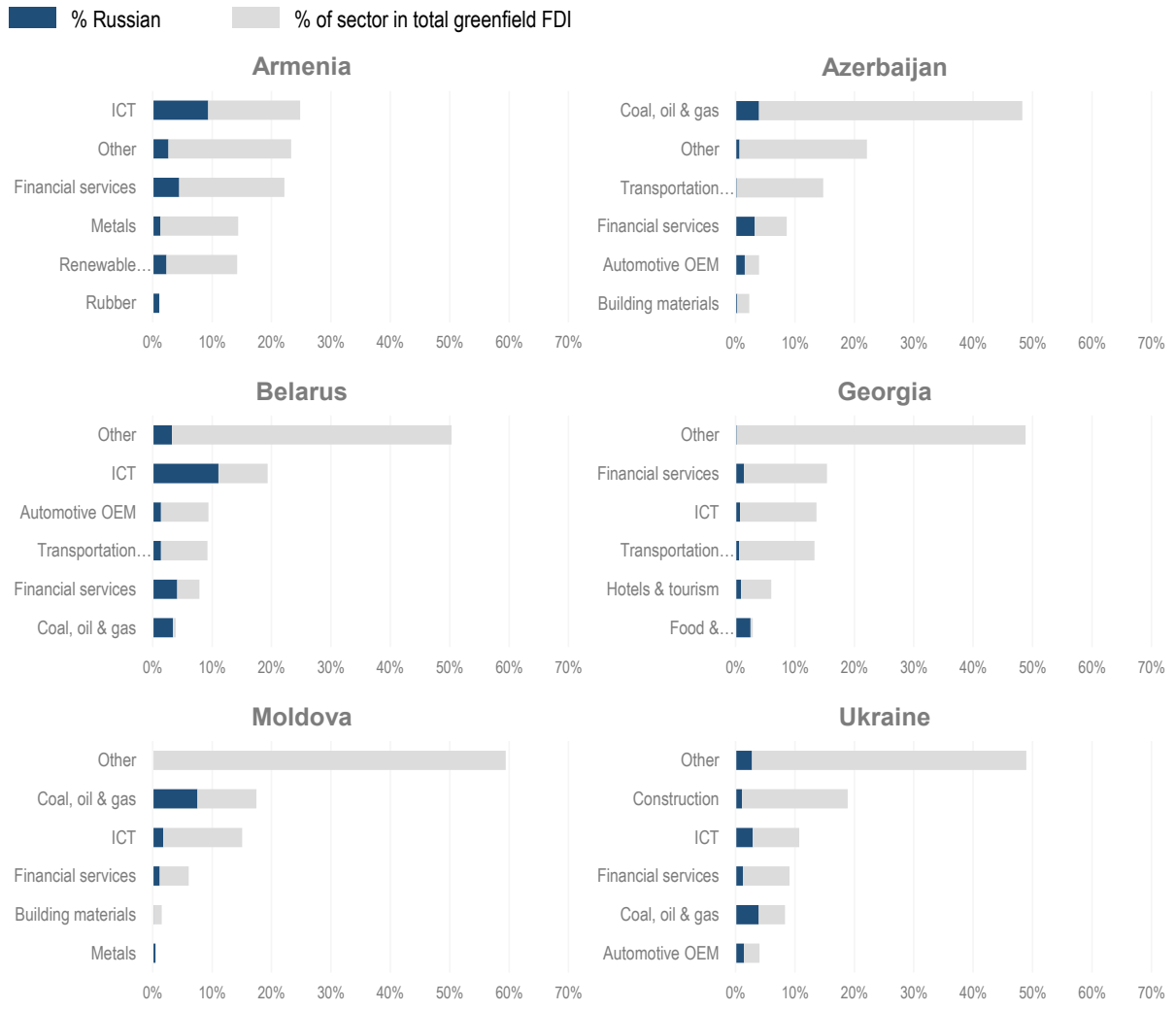


Source: OECD based on Financial Times FDI Markets (2022[91])

ICT and financial services are among the sectors that attract most Russian FDI in the region. The sectoral distribution of investments across the region varies by country, although some commonalities emerge (Figure 3.11). Coal, oil and gas dwarf other investments in Azerbaijan (48%) and also constitutes a sizeable share of FDI in Moldova (17%) and Ukraine (8%). Financial services tend to attract significant shares of investment in all countries, and particularly in Armenia (22%), Georgia (15%) and Azerbaijan (9%).

The ICT sector similarly attracts considerable greenfield investments in most countries in the region, and particularly in Armenia (25%), Moldova (15%) and Ukraine (11%), and a large proportion of these investments originate in Russia. Transport, tourism, and selected manufacturing activities, including metals, building materials and car parts, also attract sizeable investment shares, but to varying degrees across countries and with limited exposure to Russian investment. Manufacturing of food and beverages, a key exporting sector for Georgia, attracts investments almost entirely from Russia, and is likely to suffer significantly from the war, due to its heavy reliance on exports to the Russian market.

Figure 3.11. Distribution of investments in EaP countries, by top five sectors



Source: OECD based on Financial Times FDI Markets (2022[91])

Significant relocations of ICT companies are likely in Armenia and Georgia. Sectors with relatively low-capital intensity and high exposure to Russian investment, such as ICT, may experience an expansion in some EaP countries with more developed capabilities, such as Armenia and Georgia, due to relocations from Russia, Ukraine and Belarus. This trend may be particularly relevant for Armenia, where, according to interviews with local business associations, a large migration of qualified workers from Russia was already apparent in April 2022. A closer look at Russian investments in the sector, provides a better understanding of the types of activities favoured by Russian investors in ICT in each country. In terms of capital expenditure, ICT infrastructure attracts the largest value of investments in the region, with Ukraine accounting for over 50% of all investments, followed by Armenia. These projects include investments in new data centres and extensions of wireless telecommunications coverage. In terms of volume of investments, Armenia and Ukraine are on equal footing, followed by Georgia. Sales and marketing operations attract most investors to Armenia and Georgia, while ICT infrastructure and R&D activities attract numerous investors to Ukraine (Figure 3.12).

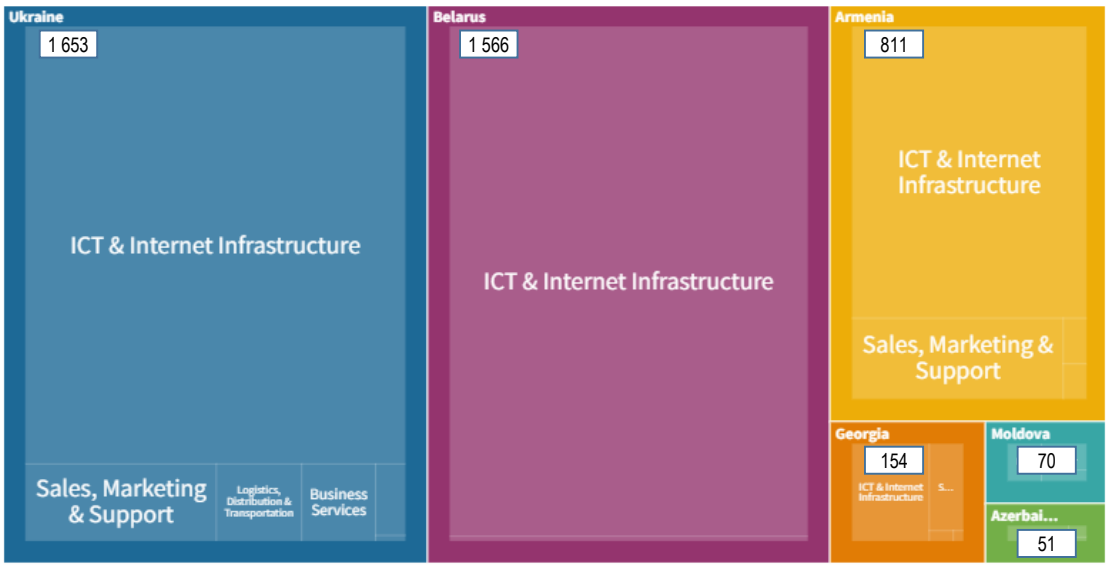
Figure 3.12. Russian FDI in the ICT sector, by number

White rectangle indicates absolute number of greenfield investment projects

Note: for each country, the size of rectangles reflects the number of investment projects in each sub-category relative to the total volume of Russian investment in ICT in the EaP region (i.e. 94 investment projects since 2003).
Source: OECD based on Financial Times FDI Markets (2022[91])

Figure 3.13. Russian FDI in the ICT sector, by value

White rectangle indicates absolute value of greenfield investment projects (USD Mln)



Note: for each country, the size of rectangles reflects the value of investment projects in each sub-category relative to the total volume of Russian investment in ICT in the EaP region (i.e. 4 305 USD Mln since 2003)
Source: OECD based on Financial Times FDI Markets (2022[91])

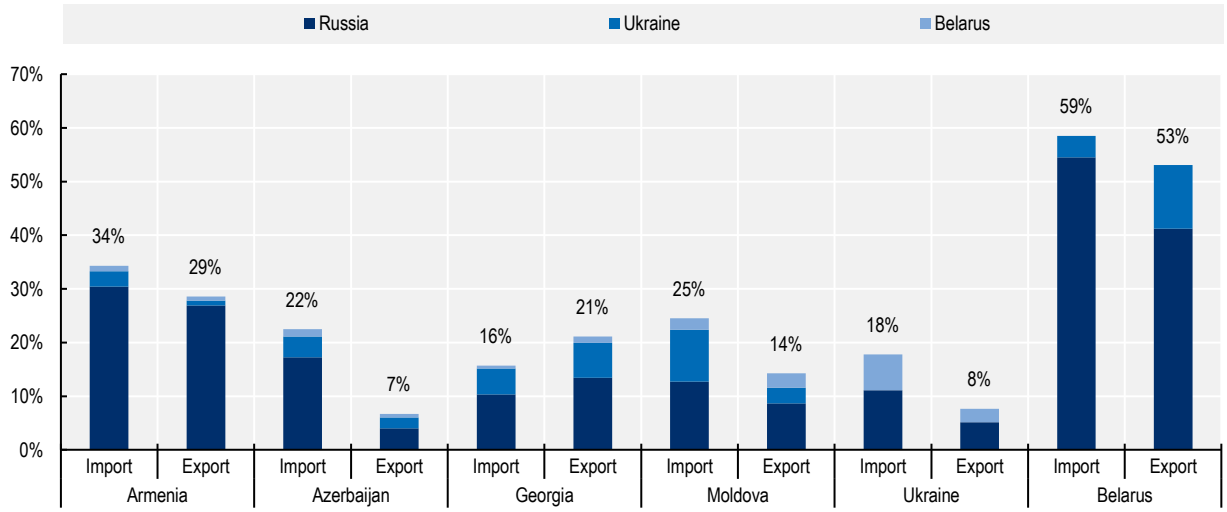
Trade

All EaP countries have significant trade relations with Russia, and some with Ukraine and Belarus. Through a combination of historical ties, geographical proximity and, in the case of Armenia, common membership of the Eurasian Economic Union, EaP countries are significantly exposed to Russia's export and import markets. A change in Russia's economic health, the inability to move goods through Ukraine, volatile exchange rates, sanctions and a changing international trade environment are having significant effects on all EaP economies. Further, the war is also dampening regional trade by weighing on external demand from the euro area.

Russia is consistently among the top three trade partners for all EaP countries. It originated between 10% and 54% of all goods imported by EaP countries in 2018-2021, as shown in Figure 3.14. After Belarus, Armenia has the greatest exposure to Russia, with natural gas representing over a third of the total value of imports from Russia, followed by aluminium and precious metals and gems (Armstat, 2022[94]). Georgia has a similar import profile with Russia, with fossil fuels and wheat accounting for 31% of imports from Russia in 2021. Azerbaijan's largest imports from Russia are wheat and wood (around 23% of total import value from Russia). Moldova imports largely mineral fuels and fertilisers from Russia. Moreover, Moldova is somewhat unique in the EaP region, in that it has a strong trade relationship with Ukraine, particularly on imports of iron, wood and plastics. Since Russia's seizure of Crimea in 2014, Ukraine has steadily reduced its trade with Russia, which in 2021 only absorbed 5% of Ukraine's exports and originated 8% of its imports (UN Comtrade[41]). Belarus is an exception in the region with regards to its dependence on Russia, which is the source of 54% of its imports and the destination for 41% of its exports.

Figure 3.14. Trade exposure to Russia, Ukraine and Belarus

Share of trade flows from/to Russia, Belarus and Ukraine (2018-2021)



Source: UNComtrade (merchandise trade)

In terms of exports, EaP countries are generally less exposed to Russia, although it remains an important market for them. In the period under consideration, only Armenia and Belarus had Russia as their largest export market. For Azerbaijan, Georgia and Moldova, Russia was one of the top three export markets and for Ukraine it was fourth. In the last 10 years, Moldova and Ukraine have re-oriented their exports away

from Russia and towards the EU (UN Comtrade[41]), further integrating within the EU economic space on the back of the Deep and Comprehensive Free Trade Agreement (DCFTA).

However, the picture is somewhat different when one looks at trade flows at the sectoral level. Certain industries still rely heavily on Russian demand. For example, in the wine and beverage sector, prevalent in Georgia and Armenia, 43% and 77% respectively of each countries' exports in this sector go to Russia. For Moldova, 44% of fruits and nuts exports (largely apples) and 62% of their pharmaceutical exports go to Russia[10].

[10] Data from (UN Comtrade[41]) for the period 2018-2021.

Box 3.2. EaP countries and their shifting role in Global Value Chains

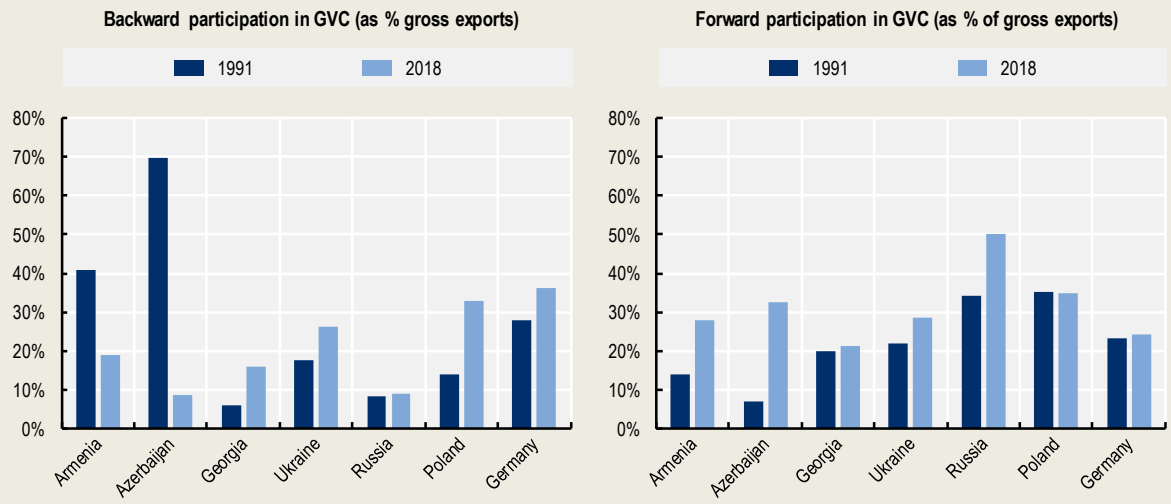
Global Value Chains (GVC) have emerged as a defining feature of the world economy over the last 40 years. The international organisation of production enabled by ICTs, declining trade costs, the integration in world trade of emerging economies in eastern Europe and Asia, and the rise of multinational enterprises have all contributed to an increase in countries' participation in GVC.

When production is fragmented across multiple countries and intermediate goods cross multiple borders before reaching consumers, traditional measures of gross exports can be subject to double-counting. To address these issues, the international community of trade researchers has developed the concept of "trade in value added", in an effort to map GVC and better reflect where value added is produced, effectively distinguishing in a country's export the portion of value added created domestically from the portion of value added of foreign origin, imported as intermediate inputs.

Two indicators can thus be considered for the analysis of participation in GVC:

- *Backward participation*: the foreign value added embodied in a country's exports
- *Forward participation*: the domestic value added of a country embodied in the exports of other countries

Figure 3.15. EaP countries' participation in GVC



Source: OECD analysis based on UNCTAD-EORA GVC database (data for Belarus and Moldova not available)

Participation in GVC enables countries to specialise in areas of comparative advantage, enhancing productivity growth and supporting wages and incomes. Over the last few decades, EaP countries have experienced an important shift in the degree of participation in GVCs, reflecting the changing structure of their economies.

While increasing for Georgia and Ukraine, EaP countries still exhibit lower levels of backward participation in GVC than more advanced OECD economies such as Poland or Germany. This is partly due to the lower sophistication of their manufacturing output that can be exported and requiring foreign components as intermediate inputs. The low values of exports for Armenia and Azerbaijan in the early 90s contribute to explain the evolution in both backward and forward linkages for the two countries: increasing exports of commodities extracted locally have reduced the relative contribution of foreign value added, while they have caused their forward participation to jump since energy and minerals (e.g., copper) serve as inputs in partner countries' production.

Source: (Cigna, Gunnella and Quaglietti, 2022[95]) (Casella et al., 2019[96])

The war in Ukraine is disrupting trade through four main channels: reduction in demand in target markets, sanctions against Russia, capital flow restrictions introduced by Russia and increased transport and logistical costs.

- As noted above, Russia's economy is projected to contract by around 4% in 2022, while Ukraine's is forecast to shrink by over 30% (EBRD, 2022[97]) (IMF, 2022[98]) (World Bank, 2022[21]). This economic crisis will translate into lower demand for EaP exports, as Russian consumers and firms have less available income to spend while exports to Ukraine suffer from both the recession and logistical challenges associated with getting goods in and out of the country. Therefore, EaP countries are likely to experience a significant fall in demand for exports in these markets with a disproportionate impact for the most exposed sectors. In particular, the impact of a contraction in Russia's economy will be more pronounced on those sectors that are more responsive to changes in income. For example, wine is likely to be affected as people tend to forgo leisure goods if they are concerned about their incomes, whereas other goods, such as basic food items, have a more robust demand that is relatively invariant to income changes.

  Ukraine's contraction has more of a concentrated impact on certain sectors in, primarily, Moldova. Ukraine is one of the top three importers of Moldovan fruits, iron and steel, therefore in these sectors the impact of Ukraine's economic contraction will be more severe (UN Comtrade[41]).

- The removal of many Russian and Belarusian banks from the SWIFT messaging system means that these banks encounter practical obstacles when trying to transfer assets abroad. Payments for imports are thus being delayed. Local sources in the EaP region have verified that numerous exporting businesses work on consignment, shipping goods to their clients under a promise of payment upon delivery. As the war continues, this will become an increasingly challenging way of doing business, putting pressure on firms' liquidity and ability to access credit.

- Russia has imposed several capital controls in an effort to prevent the further depreciation of the ruble. These include restricting the amount that Russian citizens and firms can transfer overseas to USD 50 000 per month (with certain firms now exempted from these restrictions). Anything above this amount, if requested in US dollars, is dispensed by banks in rubles. As the majority of international trade is conducted in dollars or euros, this restriction makes it complicated for exporters to Russia to receive payments. This compounds the effect of the sanctions on Russian banks and is more widespread – affecting all Russian firms and citizens.

- Finally, transport and logistical costs have increased as a result of the war. High energy prices have increased the cost of all forms of transport. Air transport has become slower and more expensive as a result of the closing of the airspace over Russia and Ukraine, which makes it more difficult for the South Caucasus region to trade with Europe. Sea transport has become more challenging for the region, due to Russia's blockade of Ukraine's ports on the Black Sea, with many severely damaged by the Russian army. This makes it near impossible for anything to get out of Ukraine by ship, also adding an additional level of difficulty for Moldova, which has lost access to its shortest route to the Black Sea through Ukraine. For Georgia, sea transport now has additional risks as a result of the war. The effect of this can be seen through the cost of insurance for cargo ships crossing the Black Sea (Koh and Nightingale, 2022[37]). This also affects both Armenia and Azerbaijan, which transit a significant proportion (or all, in the case of Armenia) of their goods through Georgia. The effect is an overall increase in the price of EaP exports, making them less competitive internationally. This may have an impact on EaP countries' existing trade relations, as well as making it more challenging to attract new trading partners,

Overall, three simultaneous effects should be considered to fully appreciate the impact of the war on EaP countries' exports (Movchan, Giucci and Staske, 2022[99]):

- An *income* effect. Recession in Russia, Belarus and Ukraine will mean lower incomes and thus reduced demand for goods exported to these countries. This dynamic will be at play beyond the EaP region since global slowdown and surging inflation will also dampen disposable incomes across the world.
- A *substitution* effect. Russia and Belarus could potentially turn to EaP countries for goods that are no longer being provided by the western economies that have imposed sanctions. This dynamic could also apply to EU economies, which, having dramatically reduced their imports from Russia and Belarus because of international sanctions, may now turn to EaP countries to source certain inputs. This is the case of energy imports for Azerbaijan, for example.
- A *reorientation* effect. EaP countries could try to compensate for the reduction in exports to Russia and Ukraine by diversifying their trading partners and start exporting to alternative markets. However, this option will be hampered by the increased transport costs discussed above.

Preliminary signals from Georgia's export performance since the start of the war support this[11]. While Georgia's overall exports increased by 33% in March-August 2022 compared to the same period of the previous year, export flows to Ukraine contracted (-21%) and those to Russia stagnated (+3%) compared to other major markets (+105% to Armenia, +58% to Türkiye, +17% to Azerbaijan, +11% to China). Correspondingly, when comparing average monthly trade flows since the start of the war (March-August) with the same period of the previous year, exports in some of the most exposed sectors in Georgia mirror the negative trend: exports of wine decreased by 7%, mineral waters by 41%, pharmaceuticals by 14%. As industrial activity in Russia contracts, demand for Georgian manganese is expected to be severely affected (although preliminary data for the first half of 2022 shows how Georgia's ferroalloys are able to find alternative markets, such as Kazakhstan and the United States) (National Statistics Office of Georgia, 2022[100]).

Armenia's exports to Russia fell by 21% y-o-y in March but rebounded in April (+34%) and have continued to grow steadily on the back of high commodity prices and a double-digit depreciation of the dram against the ruble for a considerable part of the year (Statistical Committee of Armenia, 2022[101]).

In Moldova, after a strong recovery in 2021, exports further increased by 72% in the first half of 2022, mainly driven by the agri-food sector (cereals and oil seeds), and due to high prices and record harvest in 2021. Exports to Russia, however, are on a negative trend and have contracted by 9% in the first half of 2022 (NBS, 2022[102]).

In Ukraine, the impact of the war on trade flows has been dramatic. The strong export growth observed in January and February (+57 and +20% y-o-y, respectively) has reversed to a year-on-year fall in exports of 52% in March and April, a trend that has continued over the summer months (-49% in May, -40% in June, -48% in July, -47% in August) (NBU, 2022[103]).

[11] The large swings observed in the price of many commodities in 2022 may act as confounding factors in the analysis of trade data. While nominal trade flows, expressed in monetary terms, may appear to have jumped dramatically in some cases, the growth in volume terms may be substantially lower. For example, the export of ferro-alloys from Georgia to Turkey in Jan-Sep 2022 grew by 51% year-on-year in value, while the growth in volume was only 7%. With this in mind, the analysis presented in this section is based on the only data broadly available at the time of writing, expressed in nominal terms.

4 Focus on the SME sector

This chapter assesses the risks to SMEs across the Eastern Partnership posed by Russia's war against Ukraine. First, an overview of the SME sectors in EaP countries is presented, followed by an analysis of the direct impact of the war on Ukrainian SMEs, as well as a reflection on region-wide effects, allowing for intra-regional and inter-sectoral comparisons.

The SME sectors in EaP countries

SMEs represent up to over 99% of all firms in EaP countries. On average, they account for 58% of employment and 49% of value-added in the business sector.

Table 4.1. SMEs' contribution to the economies of EaP countries

SMEs' share in total number of enterprises, employment and value added, 2020

	Armenia	Azerbaijan*		Belarus	Georgia	Moldova	Ukraine
		Total economy	*Excl oil/gas sector*				
Nr. of enterprises	99.8	99.7	-	-	99	98.6	99.8
Employment	69	42	44	35	63	60	75
Value added	64	17	24	30	61	39**	68

* In Azerbaijan, excluding the oil/gas sector SMEs share of employment and value added are 44 and 24 percent, respectively
** Turnover (value added not available)
Source: National Statistical Offices of EaP countries, Georgia's SME Strategy 2021-2025

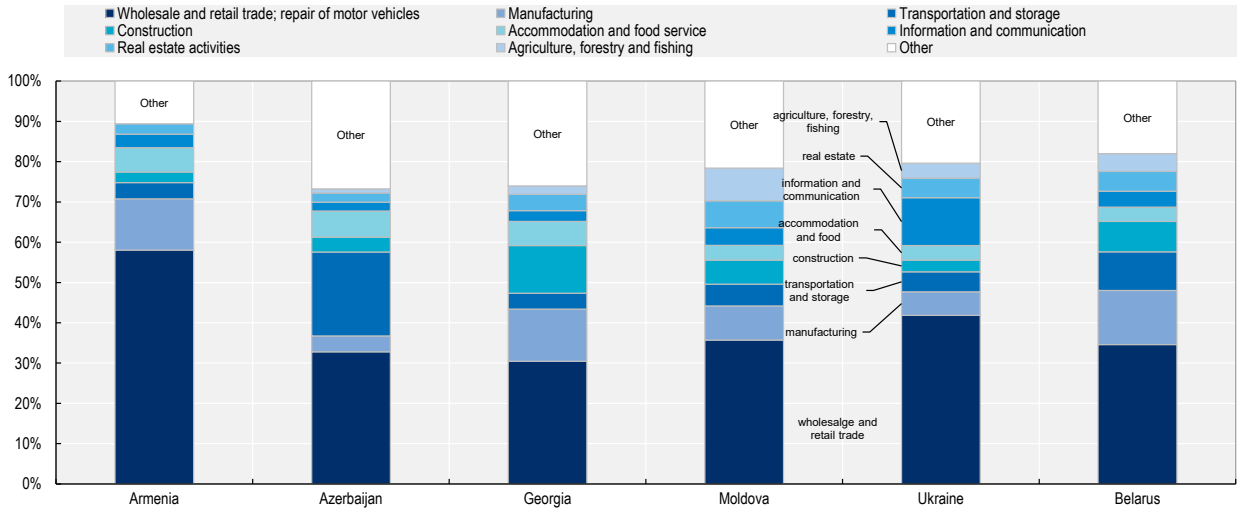
SMEs' contribution is particularly relevant in terms of employment generation, as shown in Table 4.1, accounting for 60 to 75% of all business-sector jobs in Armenia, Georgia, Moldova and Ukraine. This share drops to 43% in Azerbaijan and 35% in Belarus. In terms of value-added, SMEs' contribution is over 60% in Armenia, Georgia and Ukraine, but it drops significantly in Azerbaijan (24%, excluding the oil/gas sector) and Belarus (30%).

The picture emerging from these data is that the productive structure in Armenia, Georgia and Moldova mainly consists of small enterprises. Large enterprises play a leading role in Azerbaijan (oil and gas sector), Belarus (heavy industry and chemicals). In Ukraine, heavy industry, chemicals and manufacturing co-exist with a large population of small enterprises. Significant gaps in terms of labour productivity persist between SMEs and large enterprises in all EaP countries, with the exception of Georgia and Moldova, as the two countries do not host significant large-scale capital-intensive industries (OECD et al., 2020[104]).

The economies of the Eastern Partner countries are characterised by a high prevalence of micro-enterprises (fewer than 10 employees) and a very limited presence of medium-sized enterprises (50-250 employees). In terms of sectoral specialisation, as shown in Figure 4.1, the largest number of SMEs across all the EaP countries operate in the service sector. Sub-sectors such as retail trade, transport and food and hospitality are densely populated by micro and small enterprises.

Figure 4.1. Distribution of SMEs by sector, 2020

% of total SMEs



Note: data for Georgia are based on persons employed by SMEs; data for Armenia do not include agriculture; "other" includes: Professional, scientific and technical activities; Water supply, sewage, waste management and remediation activities; Electricity, gas, steam and air conditioning supply; Mining; Education; Human health and social work activities; Administrative and support service activities; Arts, entertainment and recreation; Financial and insurance activities

Source: National statistical offices of EaP countries

Over the last decade, the SME population in EaP countries has gone through a process of structural change, as a result of progressive integration with the EU economic space, the impact of the national and international technical assistance programmes, in particular those supported by the EU, such as EU4Business. This is also reflected in improvements in SME performance (in Georgia, for instance, nominal SME productivity has increased by 55% between 2014 and 2019) (Government of Georgia, 2021[105]) and goes in parallel with the emergence of a new class of entrepreneurs. One of the key features is the emergence of an advanced services sector, with the establishment of new enterprises developing software and other IT services, often for foreign customers. These services are driving the growth of the information and communication[12] sectors in Belarus (from 4.9% in 2016 to 7.1% of GDP in 2020), Ukraine (from 3.7% in 2016 to 4.5% in 2021), and Moldova (stable at 4.9% from 2016 to 2021), but it is also noticeable in Armenia (3.8% in 2021) and Georgia (2.9% in 2020).[13]

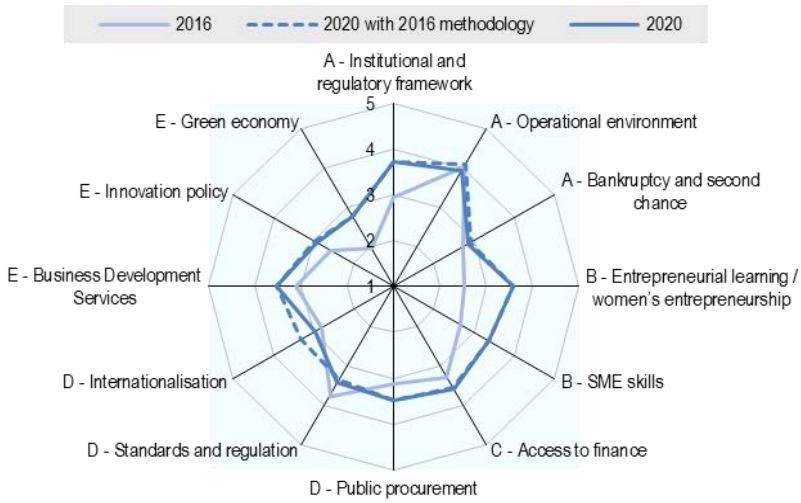
At the same time, SME policy across all EaP countries has evolved, as shown by the results of the two most recent OECD SME Policy Index assessments (Figure 4.2). Across the region, SME policy making generally benefits from stronger institutional frameworks through the design of SME strategies and the set-up of operational agencies to deliver tangible support programmes. Business-related legislation has been further simplified, e.g., by streamlining registration procedures, extending the scope of e-government services and strengthening the legal framework for insolvency. Moreover, EaP governments have

[12] This corresponds to section J in the NACE Rev.2 classification of economic activities, which includes Publishing activities, Motion picture, video and television programme production, sound recording and music publishing activities, Programming and broadcasting activities, Telecommunications, Computer programming, consultancy and related activities, and Information service activities.

[13] Data from statistical offices of EaP countries.

increasingly developed targeted support mechanisms to enhance SMEs' access to finance, skills and innovation. However, as in OECD economies[14], SMEs across the EaP region still struggle with numerous challenges that hamper their growth and productivity. More attention should be given to establishing level-playing-field conditions for companies of all sizes and regardless of ownership structure as a precondition for market-driven private sector growth. In addition, more tailored support programmes are needed to increase productivity and enable SMEs to be competitive in export markets. Finally, governments need to strengthen their monitoring and evaluation systems[15] to allow for informed SME policy making and to ensure optimal use of public resources (OECD, 2020[106]).

Figure 4.2. Progress towards SME-supportive policies in EaP countries



Note: Overall dimension scores are calculated based on five levels of policy reform, with 1 being the weakest and 5 being the strongest. Methodological changes have been introduced to the 2020 assessment and should be taken into account when observing trends in scores. For a detailed account of methodological changes, please see the chapter "Policy framework, structure of the report and assessment process" and Annex A. For an account of 2020 scores according to 2016 methodology, please refer to the relevant country chapters.
Source: (OECD et al., 2020[104])

The impact of Russia's war on Ukrainian SMEs

The impact of the war on the SME population in Ukraine has already been massive and it is expected to deepen further as the war continues. With SMEs already severely hit by the pandemic, the war would make the recovery more difficult.

A survey of local entrepreneurs highlighted how in the first phases of the war over 40% of SMEs had ceased operations, but the situation appeared to be less critical in the summer months (16% of SMEs not working), as active military actions have been concentrated in the East and South East of the country. SMEs are trying to adapt to the challenging operational conditions, transitioning online, reducing the geography of acitvities, and resuming production at lower capacity (EBA, 2022[107]).

[14] See for example (OECD, 2019[185]), where respondents to the OECD/ Facebook/ World Bank "Future of Business" survey highlight how the state of general market conditions, innovating and accessing strategic resources such as skills and finance are the most pressing challenges for SMEs.

[15] Useful methodological references can be found at https://www.oecd.org/cfe/smes/monitoring-policies.htm

The main negative shocks faced by SMEs in Ukraine relate to i) the material destruction of productive capacity, ii) displaced workforces, iii) disruptions to logistics and transport systems and iv) a significant drop in domestic demand.

Material destruction is likely to have an impact on SME operations, well beyond the end of the war, and it may possibly lead to changes in the structure of the country's productive capacity. Large energy-intensive plants, often inherited from the Soviet past, such as steel and iron manufacturing, as well as facilities producing chemicals and fertilisers, may not recover after the war, due to the lack of energy supply and the transport infrastructure. This will hit SMEs in their downstream value chains.

Conversely, the impact of workforce displacement on SMEs may be limited to the short-term, as people may progressively return to their homes once military operations have stopped, with the exception of businesses located in the cities and villages suffering a level of destruction which impedes the return of the local population. Much depends on the course of the war, since the longer people are displaced from certain places, the less likely they may be to return.

The impact of the disruption of the internal and external supply chains on SMEs' operations is difficult to assess at this stage. Supply chains continue to operate (albeit at lower levels) in large parts of the country and may return to close to normal operations once the fighting ends, excluding the areas that have suffered the highest level of war damages. However, marine transport is blocked, and rail and road transport infrastructures are subject to heavy congestion, with long delays on land borders between Ukraine and the EU (State Fiscal Service of Ukraine[108]).

An additional risk is that a continuation of the war and the high level of uncertainty about the reliability of supplies from Ukraine may induce foreign companies to review their economic relations with Ukrainian suppliers. For instance, Ukraine plays a relevant role in the European automotive sector, producing cables and mechanical components. Shortages in components made in Ukraine is already starting to disrupt production in EU car plants. European car manufacturers have already expressed their concerns (Winton, 2022[109]).

Conversely, activity in the fast-expanding IT sector appears to be less affected. Internet connectivity and services have continued to operate through the first phase of the war, excluding in the zones affected by the most intense fighting, and staff employed by IT companies could relocate to areas less touched by the war and continue working. At the beginning of May 2022, the sector was estimated to operate at 80% of its capacity (Noyan, 2022[110]). In 2021, Ukrainian IT exports grew 36% year-on-year to total USD 6.8 billion, representing 10% of the country's total exports. Meanwhile, the number of Ukrainians employed in the IT industry increased from 200,000 to 250,000 across start-ups, SMEs and large firms. In Q1 of 2022, the IT sector provided export earnings of USD 2 billion (+28% on the previous year). The war has caused severe disruption to the sector, but the increased international attention can unlock important opportunities for future development (OECD, 2022[111]).

However, the biggest threat to SMEs operating in Ukraine is coming from the collapse of domestic demand. With GDP expected to drop by over 30%, the loss of income may only partly be compensated by foreign aid and by a surge in remittances from Ukrainian workers in EU countries (estimated to increase by 20% in 2022) (The World Bank, 2022[112]). Domestic economic recovery, and with that the future of the SME sector, will depend very much on the size of the reconstruction plan and its timely implementation, once the war will be over.

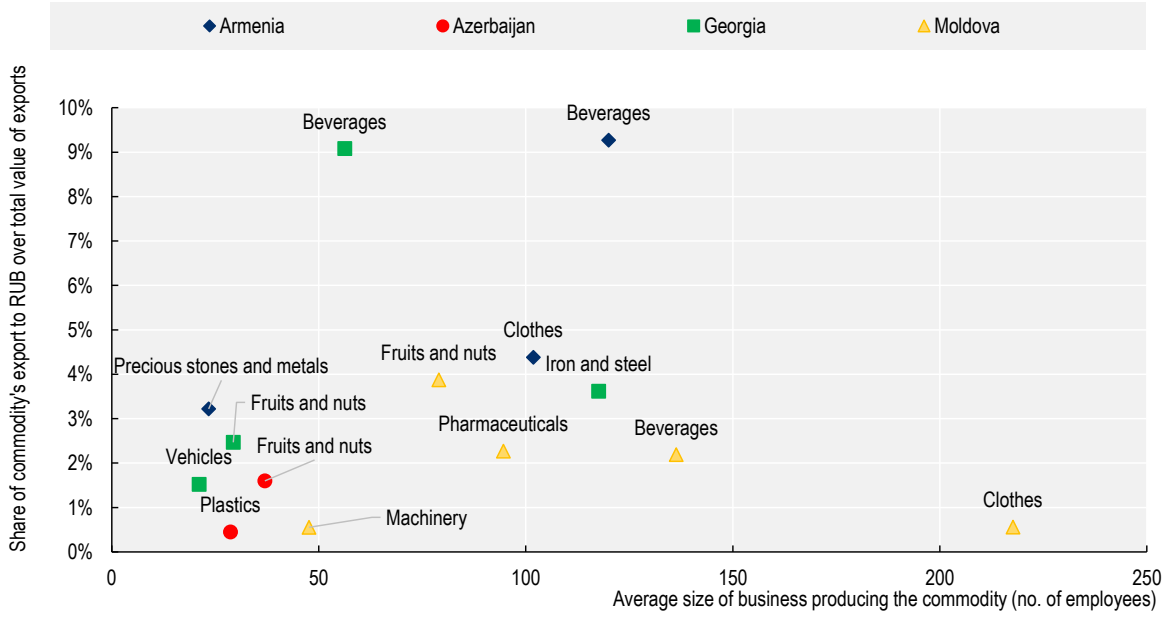
SMEs' exposure to Russia, Ukraine and Belarus

As discussed previously, exports to Russia, Ukraine and Belarus have become much more challenging, both because of reduced demand and logistical challenges. However, not all companies are equally exposed to these risks, as some sectors are particularly reliant on exporting to the three countries involved in the war. An analysis based on trade flows and the information collected via the BEEPS database (World

Bank, n.d.[113]) portrays a great deal of heterogeneity, and in particular highlights how businesses operating in some of the sectors most exposed are mostly populated by SMEs, with the average firm having have fewer than 100 employees Figure 4.3.

For example, in Armenia and Georgia, exports of beverages alone (e.g., wines and mineral waters) to Russia, Ukraine and Belarus, represent over 9% of the two countries' total exports. In Georgia, the average company operating in the sector has just over 50 employees. In Azerbaijan and Moldova, the producers of fruits and nuts export mostly to Russia and Ukraine and thus these SME-intensive industries will be severely affected.

Figure 4.3. Heterogeneous impact on SMEs in export-oriented sectors



Note: the selection of sectors considered in this analysis is determined by the match of the top 5 commodities exported by each country (excluding oil and gas) and the presence of companies operating in those sectors in the BEEPS database. The analysis based on the companies included in the BEEPS database, which does not consider micro-enterprises.
Source: (UN Comtrade[41]); (World Bank, 2021[114])

SME financing

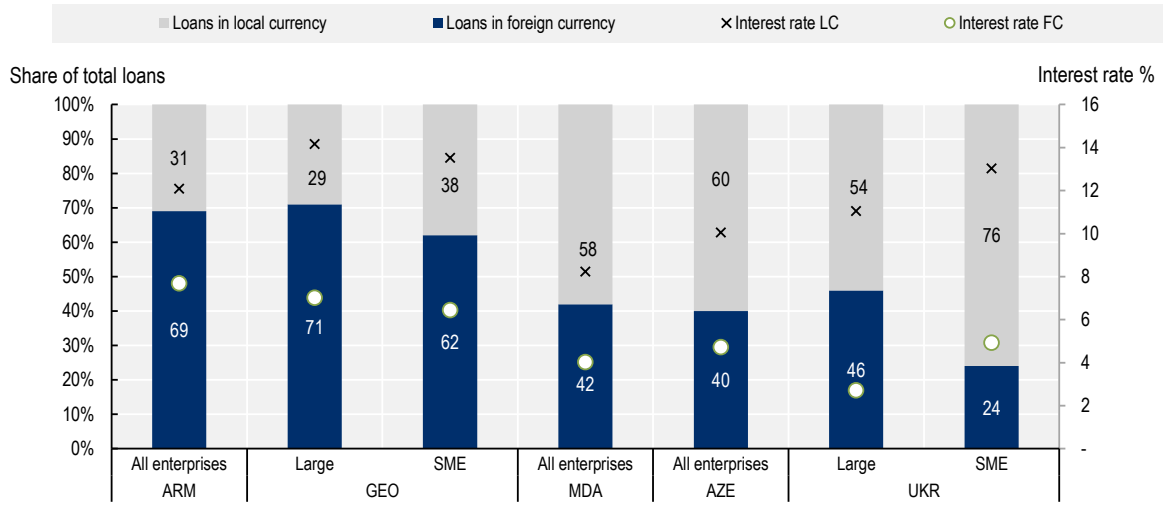
For most firms, external financing is a necessary step to invest, grow and develop as a company. The COVID-19 pandemic exacerbated the financing needs of many businesses, which experienced an erosion of cash flow as revenues shrank dramatically due to lockdown measures while operating costs (e.g., rents, wages, inventories) could only be partially adjusted. SMEs in EaP countries were particularly hard hit, with 70% to 90% of small and medium sized businesses experiencing decreased liquidity and cash flow since the beginning of the pandemic in Armenia, Azerbaijan, Georgia and Moldova (World Bank, 2021[114]).

To respond to this, as in many countries around the world, government-sponsored rescue packages in the EaP region allowed many companies to stay afloat during the pandemic years, but they also increased private sector debt[16], which may complicate further borrowing for already highly indebted businesses.

In emerging economies, a large proportion of loans is often issued in foreign currency – primarily US dollars and euros (a phenomenon referred to as 'dollarisation'). This means that, for these loans, the principal of the loan and the repayments are denominated in US dollars or euros and have to be paid in those currencies. As the dollar and the euro are seen as more stable currencies than local currencies, lenders, especially international ones, have a preference for lending in foreign currency and demand lower interest rates. Normally, this does not pose a problem for borrowing firms. However, in times of highly volatile exchange rates, dollarisation can create difficulties in debt repayment for borrowing firms.

As can be seen in Figure 4.4., a significant proportion of loans across the EaP region are issued in foreign currency. The most dollarised countries in the region, Armenia and Georgia, both have over 60% of corporate debt denominated in foreign currency, and Moldova and Azerbaijan around 40%. The trend is less pronounced in Ukraine, which still has a significant 24% of business loans issued in foreign currency. Where data are available, one can see how debt dollarisation applies to both large firms and SMEs. In Georgia and Ukraine, SMEs have a lower level of dollarisation than large firms, though still significant. This could be because large firms rely more on international creditors for loans whereas SMEs may take loans from domestic banks and credit unions which are more likely to accept loans in local currency.

Figure 4.4. Volume and average interest rate of outstanding loans, by currency



Source: OECD calculations based on data from Central Banks of EaP countries, as of Dec 2021 (Moldova), Jan 2022 (Armenia), Feb 2022 (Azerbaijan, Georgia, Ukraine).

The effect of a large currency depreciation can be seen in the case of Georgia during 2015-16. In this period, the lari depreciated by 15% against the dollar and a recession in Russia caused a drop in the demand for Georgian exports. The result of this was a 50% increase in non-performing loans (NPLs) as

[16] For instance, domestic credit to the private sector as a share of GDP between 2019 and 2020 jumped from 21% to 26% in Azerbaijan, from 23% to 28% in Moldova, from 60% to 72% in Armenia, and from 68% to 80% in Georgia (World Bank, n.d.[72])

firms saw the lari-value of their debts held in dollars and euros increase, while the value of their foreign currency revenue flows fell (IMF, 2021[115]).

5 Policy responses

This chapter suggests policy responses to ease the impact of the shocks of war in the EaP region, providing targeted support to the most vulnerable, supporting the refugee crisis, maintaining open markets, diversifying trade partners, and strengthening energy policies.

Measures to ensure a stable macroeconomic framework should be at the top of policy priorities for EaP countries. Poor macroeconomic policy responses would accentuate the shocks of the war and further harm well-being in the short-term, as well as future prospects for resilience and recovery. The fiscal stance, which was set to tighten in 2022 and 2023 due to the gradual withdrawal of pandemic-related support measures, may have to accommodate some targeted interventions to cushion the effects of the war and inflation on the most vulnerable. A return to prudent management of public finances and compliance with each country's fiscal rules, in many cases suspended during the COVID-19 pandemic, should also be considered. Monetary policy should also remain cautious, and policy rate reductions before inflation durably converges towards the central banks' targets should be avoided.

Nevertheless, short- and medium-term interventions to support households and firms to cope with the shocks of the war will require substantial public expenditures. International donors have already stepped in by pledging or supplying funds. The EU has mobilised around EUR 4.1 billion since late February to support Ukraine's overall economic, social and financial resilience (European Commission, 2022[116]). The EU is also providing considerable financial support to Moldova: as of late May, EUR 213 million to help the country meet its external financing needs and provide adequate resources to welcome Ukrainian refugees (European Commission, 2022[117]).

The EBRD has announced a Resilience and Livelihoods Framework of up to EUR 2 billion for Ukraine, to support trade finance, emergency liquidity finance and payment deferrals, and neighbouring countries taking in refugees (including Moldova) (EBRD, 2022[118]). The World Bank is preparing a USD 3 billion package of support for Ukraine, having already mobilised USD 723 million to assist Ukraine with critical services such as wages for hospital workers. It is also preparing additional support to neighbouring countries receiving Ukrainian refugees to assist with the provision of public services and labour market access for refugees (The World Bank, 2022[119]).

Help, protect and integrate refugees

The Russian full-scale invasion of Ukraine is first and foremost a major humanitarian crisis, and the massive flows of refugees and displaced persons from Ukraine require an adequate and timely policy response.

In the short-term, governments (particularly Moldova and Ukraine's) will need to provide emergency humanitarian assistance to the refugees upon their arrival to ensure that their basic needs are fulfilled. Efforts should be focused on guaranteeing new arrivals access to shelter, food and drinking water, hygiene and cleaning items, primary health care services, and emergency telecommunication services (OCHA, 2022[120]). Moreover, scaling up programmes that identify unaccompanied children should be established to ensure basic protection and services (Katsiaficas and Segeš Frelak, 2022[121]).

Short-term assistance should be complemented by support to ensure that refugees can be efficiently and successfully integrated in the society and the labour market of the destination country. This is of paramount importance to preserve refugees' human capital, while also stimulating their potentially positive impact on local economies, as the inflow of people can boost demand through increased private consumption, as well as expand the labour force. To this end, governments should consider initiatives aimed at overcoming language barriers targeted at both children and adults, incorporating new arrivals into education systems at different levels, providing vocational and study guidance, and finally initiatives specifically targeted at providing opportunities to integrate in local labour market (see below) (Katsiaficas and Segeš Frelak, 2022[121]; European Commission, 2017[122]). The speed at which refugees will be granted the right to work will be an important aspect of integration policies, as having the right of working upon arrival in the host countries will certainly improve not only their immediate access to the labour market, but also their long-term employment prospects (OECD, 2022[123]).

Shield local populations and businesses from the economic impact of the war

Governments across the EaP region should implement policies to protect their citizens from accelerating inflation, in particular of food and energy. To this end, they should provide timely and targeted support, especially to the most vulnerable low-income households, who spend a large fraction of their income on basic needs such as food, water, heating and electricity and are therefore hit harder by price increases (OECD, 2022[56]). Protecting vulnerable households might require targeting criteria that go beyond standard means-testing, such as housing location and quality, household composition and access to public transport (OECD, 2022[124]). Viable policy options include the use of targeted safety net interventions, such as cash and food in-kind transfers, as well as tax reductions. At the same time, governments should try to avoid measures to cushion the shock that serve to encourage greater consumption, such as subsidies or price controls. The preferred solutions require substantial public expenditures, which might pose considerable challenges. However, most EaP countries' fiscal positions appear favorable and resilient.

Timely, targeted, and means-tested assistance is also needed in support of businesses, and in particular of SMEs, which tend to have less resources and capacity to withstand the crisis and face economic depression. This applies to Ukrainian SMEs, ravaged by the war, but could also be considered by other EaP governments for businesses operating in those sectors most seriously affected by loss of export revenues and disruptions to global supply chains. Relevant initiatives could include (donor funded) job retention programmes aimed at preserving existing jobs and businesses, thus establishing the foundations for a rapid post-war economic recovery. Other instruments could include voucher schemes to encourage international co-operation between EU-based firms and local SMEs in EaP countries, with the development of business partnerships and networking. Additional and more conventional instruments could include temporary tax reductions, as well as loan and mortgage repayments freezes. More broadly, in line with the *OECD Recommendation on SME and Entrepreneurship Policy*, governments should consider mainstreaming SMEs policies across their policy actions. This could be achieved by including an SME angle in new policy proposals in different areas (e.g. tax reforms, credit guarantees) and ensuring that implications for SMEs and entrepreneurs are considered across the diverse policy areas that influence their prospects, in order to enhance policy synergies, address potential trade-offs and reduce administrative burdens (OECD, 2022[125]).

With inflation on the rise and central banks tightening across the region, governments could consider measures to ease the impact on borrowing costs, especially for SMEs. Credit guarantee schemes have proven an effective tool to support access to bank financing for SMEs during the COVID pandemic (e.g., in Georgia). These could be complemented by temporary subsidies on interest rate payments on bank loans, possibly limited to funding projects with high share of capital expenditure vs. current expenditure to incentivise long-term planning and investment. Similarly, in order to incentivise lending in local currencies, such support mechanisms could be limited to financial transactions denominated in the national currencies of EaP countries.

Maintain open markets and promote diversification

Governments should avoid cascading export restrictions and pursue trade openness and diversification. In the attempt to shield domestic consumers from price surges, policymakers can be tempted to restrict trade and curb exports. However, attempts to reduce the transmission of international food price shocks to domestic markets through protectionist policies risk compounding the volatility of world prices and have proved unsatisfactory in the past (World Bank, 2022[126]). In fact, while export restrictions can temporarily mitigate pressures on domestic food markets, they divert supplies from the world market, consequently inducing a further surge in world prices and triggering a multiplier effect (Espitia et al., 2022[127]). Moreover, the more governments attempt to use such policies to export price pressures to the

external sector, the worse off all will be – the classic paradox of such “beggar-thy-neighbour” policies. The experience of both the 2008 food-price crisis and the COVID pandemic shows that export restrictions should be avoided, given their potential snowball effects in already strained markets.

The right response is to facilitate trade, which can enhance food security globally. Governments could consider abolishing import duties from countries without a free trade agreement to diversify import sources. Advanced economies can also strengthen food security by providing the assistance necessary to facilitate the planting of new crops, including in Ukraine, and to address as quickly as possible the logistical barriers limiting food supply to those most at risk. Increasing transparency around trade in food and critical minerals, using tools like the inter-agency Agricultural Market Information System can also help.

EaP governments could also increase their marketing efforts and resources for trade representations to reorient and diversify their export markets. In particular, governments could consider additional measures to reorient exports to new markets, including the EU’s, for instance by further aligning regulatory requirements with EU standards. To complement this, more support could be provided to businesses to comply with quality standards and regulations of target countries, including awareness-raising, advisory and training activities. More could also be done to address institutional and limitations in the quality infrastructure (European Commission, 2016[128]). Digitalisation could also be leveraged in several ways, both to help reduce regulatory and administrative barriers to trade (by streamlining procedures, increasing transparency and facilitating exchanges) and to reach new customers via e-commerce practices.

In order to encourage trade with the EU single market, EU policymakers could also temporarily increase tariff rate quotas for selected products exported by DCFTA countries into the EU, thus increasing the pre-determined quantity of a product that can be imported at lower import duty rates than the ones normally applicable. In a similar vein, the European Commission recently proposed to suspend for one year import duties on all Ukrainian exports to the European Union, in an attempt to help boost Ukraine's exports to the EU and alleviate the difficult situation of Ukrainian producers and exporters in the face of Russia's military invasion (European Commission, 2022[129]).

Further, better integration into GVCs should remain a priority, although achieving such goal will require longer-term efforts. Policies seeking to integrate SMEs into GVCs should include programmes supporting them to better identify new opportunities and exploit their comparative advantage in the production of intermediate goods and services, promote domestic and international production linkages and integrate, directly or indirectly, into regional and global value chains (López González, 2017[130]).

Seize potential opportunities arising from a changing economic landscape

EaP policymakers could take action to strengthen the business environment to benefit from increasing arrivals of people and businesses. As individuals and businesses relocate to escape sanctions, EaP countries, especially in the Caucasus, could position themselves as valid destinations.

The influx of migrants, particularly of educated and skilled workers, represents an opportunity for receiving countries to expand and enrich the labour force. On this account, governments should implement initiatives aimed at best integrating migrants in local labour markets. Relevant measures can include early assessment initiatives to promptly test the experience, skills, and motivation of newly arrived immigrants, as well as employment matching services (Katsiaficas and Segeš Frelak, 2022[121]; European Commission, 2017[122]).

There is also evidence of numerous businesses, mostly Russian, relocating to the EaP countries to evade the sanctions and keep their activities operational. Armenia in particular appears to be an interesting destination, especially for companies operating in the IT sector (Azatutyun.am, 2022[131]). This is due to elements such as geographical proximity, diffusion of Russian language, and lower cost of living

(Eurasianet, 2022[132]). With the necessary due diligence, Armenia and all EaP countries should encourage and facilitate the influx of new businesses. Initiatives specifically targeted at assisting entrepreneurs seeking to relocate and guiding them navigate the red tape, e.g., the development of guidelines and FAQs to establish a business, should go hand in hand with efforts to promote investment and improve the overall business environment.

EaP countries could advance on their digital transformation and seize emerging opportunities to develop their services sector. Given the recent growth trends observed in the IT sectors across the EaP region and the relocation of IT specialists in particular to Armenia and Georgia, policy makers have an opportunity to capitalise on the influx of human capital to further grow their IT industries and advance the digital transformation of their SME sectors. In order to achieve this, countries should improve both their "framework conditions" for the digital economy (i.e. broadband connectivity, competitive markets, digital skills) as well as their institutional arrangements and specific support measures for the digitalisation of SMEs operating in "traditional" sectors (OECD, 2021[133]).

South Caucasus countries could also help to develop alternatives solutions to global trading routes. In the context of heavily disrupted overland trade networks connecting Europe and Asia, the South Caucasus has considerable potential to gain an increasingly relevant role. Given the uncertainty and challenges related to transporting goods through Russia into Europe, the trans-Caspian "middle corridor" – connecting East Asia to Europe through Kazakhstan, Azerbaijan and Georgia – is emerging as a valid alternative to the historically more important yet currently unviable Northern Corridor through Russia (see Box 5.1). On this account, South Caucasus countries have an opportunity to foster intra-regional co-operation to co-ordinate potential investment and reform efforts in order to fully realise the potential of this transport route in the coming years.

Box 5.1. Trans-Caspian International Transport Route

The Trans-Caspian International Transport Route (TCITR), also known as the "Middle Corridor", is a multi-modal transport network that is currently used mainly for petroleum products and other commodities, making up 45% of Georgian Railway's cargo traffic volume in 2020 (Georgian Railway, 2021[134]). It has, however, the potential to gain a larger share of the containerised trade between China and the EU, which is currently transported by sea and overland through the northern route via Russia. The Middle Corridor's development would support growth across the region, both through the jobs created in the transport and logistics sector and indirect regional trade effects.

The current capacity of the Middle corridor is estimated to be at most 5% of the volumes transiting the northern route (Rail Freight, 2022[135]). As such, it cannot absorb all the demand for transport services resulting from the disruptions to shipping routes traditionally passing through Russia. Nevertheless, while the Middle Corridor is structurally less competitive than the overland routes via Russia or maritime transport in terms of cost and travel times (Table 5.1), it could present a viable option for exporters and transport operators seeking to diversify their shipment routes.

Table 5.1. Cost and time estimates for main EU-China corridors

Per 40-foot container, from Chengdu, China

	Cost range (USD)	Average time (days)	Northern Europe time (days)	Central Europe time (days)	Balkans time (days)
Northern corridor	2 800 – 3 200	14 – 18	16	15 – 16	20
Middle corridor	3 500 – 4 500	16 – 20	18	17	14
Maritime route	1 500 – 2 000	28 – 40	28 – 40	28 – 40	28 – 40

Source: (World Bank, 2020[136])

There are, however, many challenges to overcome if the South Caucasus is to realise its potential as a transit option. Some of these extend westwards towards Europe and beyond the South Caucasus along the entire Middle Corridor. These involve the need for upgrading both "hard" transport infrastructure and "soft" procedures to facilitate movements of cargo across borders.

The "hard" infrastructure investments include improving capacity in ports, railways and highways across the region. Specifically, there is a need for greater investment in the Caspian Sea ports to ensure they can meet the capacity of the railway freight trade coming from China. The main recipient port in Azerbaijan, the Baku International Sea Trade Port (Alat Terminal) has an annual capacity of 15 million tons of bulk cargo freight, whereas the corresponding ports in Kazakhstan have a combined capacity of 23.7 million tons (Aktau and Quryq) (UNECE, 2019[137]). Additional vessels in the Caspian Sea would also be needed to meet the increasing demand (Rail Freight, 2022[135]). Another key problem for the Middle Corridor is its multi-modal nature, requiring loading and unloading for ferry journeys in the Caspian and Black Seas. This latter switch can be avoided with rail transport through Türkiye, but the rail infrastructure on this route would need to be further developed. Additional bottlenecks could be encountered in Europe, as rail connections would have to pass through Serbia which, as a non-EU member, would entail further border formalities, as well as rail speeds as low as 20-40km/h (Kenderdine and Bucsky, 2021[138]).

The "soft" reforms involve harmonising regulations and border controls to allow for international containerised trade, ensuring transparent and competitive tariff structures, improving the institutional framework for effective regulations. These reforms are required to reduce issues of visa bottlenecks and opaque tariff systems deterring trade (ADB, 2021[139]) as well as the additional benefits of bringing Georgia and Azerbaijan closer to EU standards on regulation.

Strengthen climate and energy policies

EaP countries reliant on Russian energy face a complex set of incentives. On the one hand, these countries may have access to discounted energy imports, and thus weakened incentives to conserve energy or invest in renewables. On the other hand, however, price volatility and political uncertainty in their relations with Russia emphasise the risk of dependency on fossil fuel imports from a single supplier and constitute a huge economic vulnerability.

This situation leads to the emergence of a “new energy security paradigm”, whereby energy importing countries might be better off by replacing fossil imports with domestic energy production through renewable energy sources. Even countries currently maintaining good relations with Russia face incentives to decarbonise in order to improve their long-term security of supply.

The new energy security paradigm, high long-term fossil fuel prices, and increased price uncertainty are expected to continue driving the expansion of renewable energy sources in the medium- to long-term. Although none of the EaP countries, with the exception of Moldova and Ukraine, have policies officially aimed at reducing their dependence on fossil fuels from Russia, many are working to strengthen their energy independence. Increasing energy efficiency efforts and domestic energy production, in particular from renewable energy sources, provide an attractive alternative (OECD, 2022[50]).

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Assessing the Impact of Russia's War against Ukraine on Eastern Partner Countries

Russia's war against Ukraine is causing a humanitarian, social and economic crisis for the Ukrainian people. The consequences of this full-scale military invasion are disrupting the global supply of commodities, sharply increasing food and energy prices, and threating the recovery from the COVID-19 pandemic. Countries with established commercial and financial ties with the economies of Russia and Ukraine appear to be particularly vulnerable.

Assessing the Impact of Russia's War against Ukraine on Eastern Partner Countries investigates the exposure of Eastern Partner countries (Armenia, Azerbaijan, Georgia, Republic of Moldova and Ukraine) to the economic shocks caused by the war, and in particular through the impact that the conflict is having on inflation, migration, remittances, investment and trade.

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