Economic Impact of Russia's Invasion in Ukraine

By Ioanna Skaliotou

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Table of Contents

1. Introduction

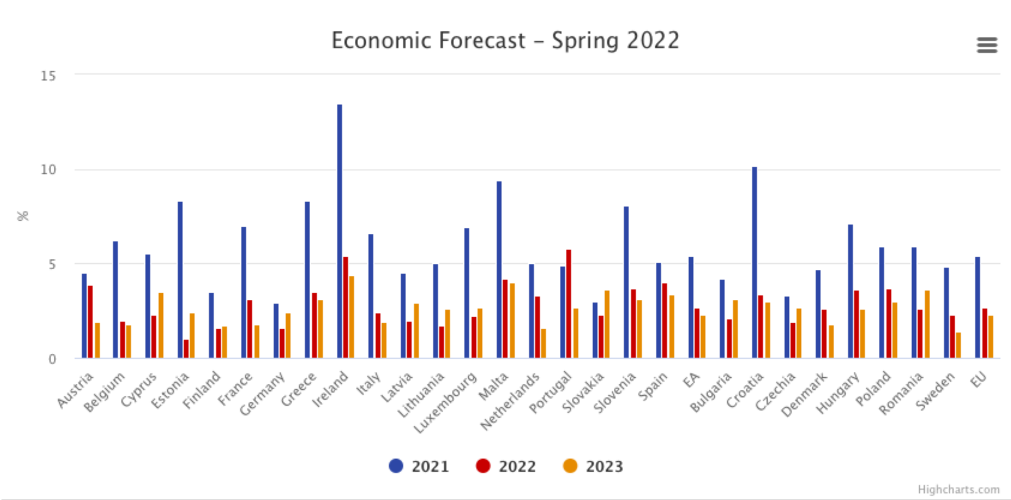
Economies around the world have been recovering from the COVID-19 pandemic, while facing significant inflationary pressures and supply chain disruptions. Consumer confidence and beliefs have also been gradually improving and the world economies have been steadily rebounding since the unprecedented crisis of the COVID-19 pandemic. Russia's recent invasion in Ukraine however, has heightened uncertainty and poses new threats and downside risks to the prospects of the world economy.

The war is expected to shrink Ukraine's economy by an estimated 45.1% this year while Russia's economy has already plunged into a deep recession with output expected to decrease by 11.2% this year. The sanctions imposed on Russia have exacerbated the supply chain problems already in place because of the pandemic, causing disturbances and delays in shipments of raw and intermediate materials, as well as amplifying global inflationary pressures. These challenges have created unsettling shockwaves spilling over more and more countries and sectors. This paper will analyze how Russia's invasion in Ukraine has undoubtedly overturned the picture of the world's recovery path and of Cyprus in particular.

The IMF has revised in April 2022 its global growth predictions downward for 2022 and 2023, stating that the economic impact from Russia's invasion in Ukraine will "propagate far and wide, adding to price pressures and exacerbating significant policy challenges". The IMF also predicts that the US inflation rate will reach 7.7% this year and 5.3% in the euro zone. This already seems too optimistic, when in May the US inflation rate has headed 8.6% and in the euro zone 8.1%. The growth in inflationary expectations does not gibe much room for hope.

Below we can see the estimated long-term change in annual gross domestic product to different countries due to the effects of the Russian invasion in Ukraine. The effects are clearly significant.

Figure 1: annual GDP changes to different countries



2. Worldwide Impact of the War

Russia is a major supplier of oil, gas and metals, and together with Ukraine, they are major suppliers of wheat and corn. Therefore, apart from the risks of famine, reduced supplies of such commodities have caused inflation to increase dramatically.

In advanced economies, average inflation projections are estimated at 5.7% whereas 8.7% in emerging and developing countries. Hence, the impact of inflation affects the poorest and weakest countries the most and contributes in rising inequalities worldwide.

As a response, Central Banks have tightened monetary policy and have significantly increased interest rates, increasing the cost of borrowing even more for consumers and producers. The rising cost of borrowing will also have a significant impact on the finances of indebted countries, which will be challenged to meet the higher interest payments. Overall, this will negatively affect investment and consumption. However, there are still some factors supporting economic activity and recovery, since households have accumulated savings during the pandemic period and strong labour market incomes, which will contribute to high spending levels with the reopening of economies.

The EU faces the greatest economic disruption due to the fact that Europe is heavily dependent on energy imports from Russia, such as natural gas, and the current EU sanctions on Russia will drive inflationary pressures on such commodities to a high peak. The EU is also considering new sanctions on Russian oil imports, whereas Germany is reluctant to do so because of its overdependence on Russian gas. Germany has already responded by returning to use coal to meet its energy needs. This will inevitably take back the progress on weakly environmental goals and restricting global warning.

The war will alter the structure of the overall economy, deepening existing fractures and creating economic blocs. On the other hand, it may create opportunities for new significant economic agreements between like-minded economies such as between the United States and Europe.

Importantly, there is some evidence that the freezing of Russia's Central Bank assets has pushed Central Banks to start moving out of the US dollar-denominated assets, which will lead to implications for the US economy and foreign policy if these de-dollarization efforts expand.

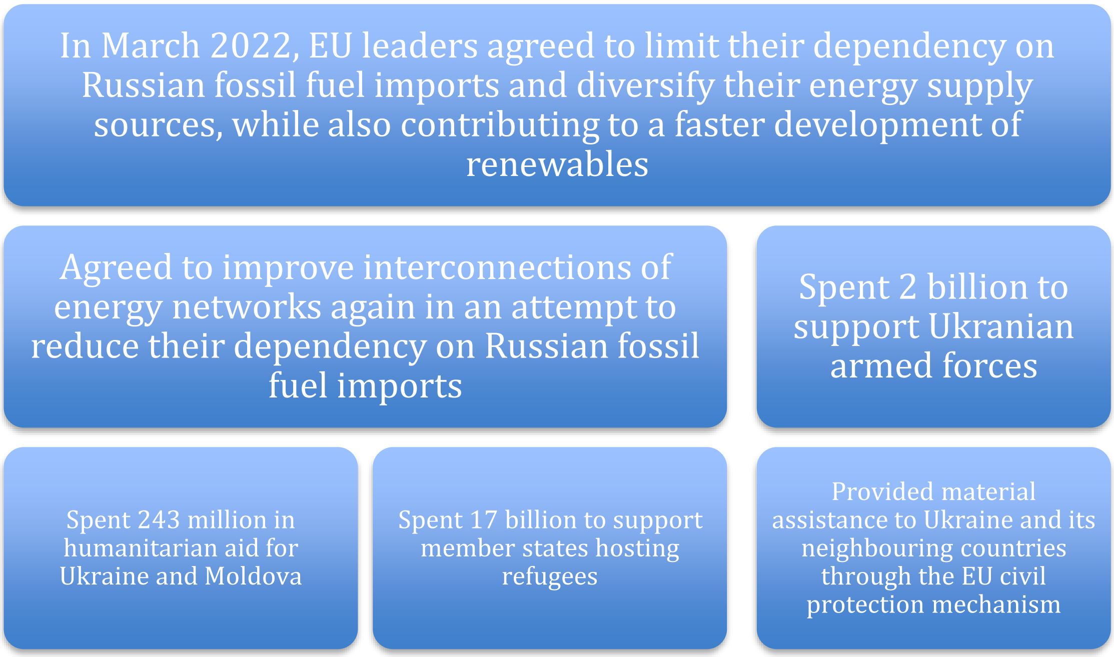
Lastly, the human cost of the war is unimaginable with more than 13 million people have fleeing their homes since Russia's invasion in Ukraine according to the UN, travelling to Germany, Czech Republic, Turkey, Poland etc.

3. Responses and Intervention

The EU has taken significant actions to support Ukraine and its neighboring countries. In particular, not only has it has granted Ukrainians the right to stay and work throughout its 27 member nations for up to 3 years, it has also entitled refugees to social welfare payments and access to housing, medical care, food and schools.

The World Bank is also looking at how to support refugees in host countries since the invasion has caused the largest refugee crisis in Europe since Word War II. It has also mobilized an emergency financing package of $925 million in support for Ukraine helping to pay wages for hospital workers, pensions for the elderly and social programs for the vulnerable.

Figure 2: Some of EU's responses to the war



It is of utmost importance to increase the pressure to bring Russia's president Vladimir Putin to stop the war and for countries globally to lead with ambition within the international institutions such as the United Nations, the World Bank etc.

Therefore, in an attempt to put economic pressure on Russia and undermine its ability to wage the war, sanctions have been imposed on Russia. The EU have imposed 6 such packages of restrictive measures which have been coordinated with international partners. [Table 1]

Table 1: EU sanctions on Russia

1) Oil import restrictions	23 February 2022	Member States of the Union for Foreign Affairs and Security Policy and the Commission decided to impose an embargo on the imports of crude oil and refined oil products from Russia
2) Oil transport services	25 February 2022	EU operators will be prohibited from insuring and financing the transport of oil to third countries, in particular through maritime routes, making it difficult for Russia to continue exporting its crude oil and petroleum products to the rest of the world since EU operators are important providers of such services
3) Financial and business services measures	28 February and 2 March 2022	Prohibition on transactions with the Russian Central Bank and on the provision of euro-denominated banknotes to Russia. Additional 3 Russian banks including Sberbank which is Russia's largest bank and one additional Belarussian bank have been removed from SWIFT, placing Russia's financial system at risk and making it harder for them to further wage the war. The provision of certain business-relevant services such as accounting, business and management consulting, public relations services to the Russian government and legal entities or bodies established in Russia have been prohibited
4) Broadcasting suspension	15 March 2022	The broadcasting activities of another 3 Russian State outlets have been suspended and barred from distributing their content across the EU in any shape or form. The advertising of products or services on sanctioned outlets have also been prohibited.

5) Export restrictions	8 April 2022	The list of advanced technology items banned from export to Russia has been expanded to include additional chemicals that could be used in the process of manufacture of chemical weapons. Moreover, the package expands the list of natural, legal persons or entities associated with Russia's military-industrial complex
6) Complete ban on all Russian seaborne crude oil and petroleum products	3 June 2022	This ban covers 90% of our current oil imports from Russia. In order to ensure the EU and its partners have alternative supplies and in order to minimize the global inflationary pressure impact of oil prices, this ban is subject to certain transition periods and a temporary exemption for pipeline crude oil.

One of the key economic impacts of the war is the impetus it has given to the already rising inflationary pressures since late 2021. As regards the fight against inflation, Central Banks have already started implementing a more restrictive monetary policy with rising interest rates. The ECB in particular has a particularly challenged role to play since on top of the traditional risk of inflation, it is faced with the so called 'fragmentation risk', which is the risk that individual countries' borrowing costs can change unevenly. In early June, yield costs of countries like Italy, Spain, Greece and Portugal have spiked compared to German yields. It is still unclear how the ECB will approach this problem while fighting inflation at the same time, particularly as governments are implementing substantial fiscal measures to mitigate the effects of the war, despite already high levels of public debt. It is expected that ECB will raise interest rates by 0.25% in July, and end bond-buying programme.

4. Impact on Cyprus

Even though the Cypriot economy has rebounded strongly from the recession caused by the Covid-19 pandemic, the Russian invasion in Ukraine will bring renewed uncertainty on the economic landscape. The subsequent sanctions imposed on Russia mainly affect the tourism and professional services sectors and is expected to reduce the level of GDP growth in 2022 by 1.3 percentage points, from 4.0% as the Ministry of Finance has predicted in October 2021, to around 2.7%.

Cyprus' ties with Russia

Russia has developed very strong links with Cyprus through time, both cultural and economic. In 2008, Russia and Cyprus signed a joint declaration aimed at enhancing bilateral cooperation and in 2010, they signed a key treaty to abolish double taxation, leading to a huge influx of cash and capital in Cyprus from Russian businessmen. The island's attractive tax rates, infrastructure and EU membership has drawn Russian investors to establish in Cyprus and benefit from protection under European laws and favorable business climate and investor protection agreements. Not only do Russians contribute to Cyprus from exports, investment and tourism, they also have significant shares in Cyprus' real estate and the banking sector. In Limassol, many Russians have invested in multimillion-euro beachside apartments. In particular, approximately one third of Cyprus' foreign investments and more than 25% of bank deposits came from Russia.

As a consequence, the Ukrainian crisis and counter-sanctions by Russia severely impacted the Cypriot economy. Cyprus stands to lose up to 2% of GDP in 2022 if the Russian flight ban remains in effect throughout the year, according to credit rating agency DBRS Morningstar. However, this impact will be much limited if airspace opens to Russia during the summer season or if Russian tourists find alternative routes to Cyprus. According to data from the World Travel and Tourism Council, the tourism sector contributed 13.8% of Cypriot GDP in 2019, hence the decrease in tourism from Russia is predicted to severely impact our economy. "We were expecting 800,000 visitors, mainly from Russia and some from Ukraine and Belarus", most of which will disappear, as stated by Mr. Savvas Perdios, Deputy Minister of Tourism. To make things worse, Russia has banned Nicosia's food exports, leading to major losses for the island. Other than exports, the main downside risk to the economy is due to higher prices, rather than supply disruptions, since Cyprus only imports 1% of its energy from Russia.

Net Exports

Export of services such as tourism, transport, financial and other business services in which Russia has a significant share will substantially decline. In particular, Russia is a relatively important trading partner in the tourism industry in Cyprus and the provision of business due to the familiar and trusted legal system that Cyprus offers based on common law and its reputational international financial center which provides a high quality of professional business, financial and consulting services. Due to the sanctions imposed, it is predicted that these companies will not be allowed to perform transactions with Russian counterparties and therefore their liquidity and profits might be reduced, also causing lower revenues for the government in terms of taxes received.

However, the impact may not be as damaging as perceived, since despite the fact that Russia is the second biggest market in arrivals, their daily expenditure is below the average daily and other countries like Switzerland and Israel have higher daily per capita expenditure. Therefore, looking at GDP from the revenue side, the impact of the lost Russian tourists is not as high.

Looking at imports on the other hand, Cyprus is faced with an increase in imports' value due to the significant higher international oil and gas prices since Cyprus is highly oil dependent. Consequently, the current account deficit is expected to deteriorate due to the expected slowdown of exports and especially exports of services in conjunction with the increased value of imports of oil.

FDI

Another significant economic linkage between Cyprus and Russia, is foreign direct investment (FDI), which accounted for approximately 8.1% of GDP on average in the period 2018-2020. FDI is split between real estate purchased in Cyprus, transfer of funds by SPEs with Russia taking advantage of Cyprus' favorable tax regime and transactions of non-SPE financial firms, which are the most connected with the real GDP. Due to the war, there is high uncertainty about the impact it will have on FDI flows in the country and therefor requires close monitoring.

Inflation

Even though Cyprus is not a Russian oil importer, Cyprus is an oil dependent country and hence affected by the significant increase in the international energy and commodity prices. These price increases will *indirectly* increase products costs through the production line channels and will therefore lower private consumption and construction. Higher energy prices will also affect total final consumption *directly* via electricity, which is around 2.4% of total final consumption and fuels.

It is predicted by international organizations that inflation will increase up to 5.2% in 2022, diminishing purchasing power and reducing consumption levels. Consequently, real GDP will also decrease and hence has been revised downwards to around 2.3% in the EU Commission's Spring forecast; that is 1.8 percentage points less compared to that of the Winter Interim forecast.

According to data published by the Cyprus Statistical Service, in May 2022, inflation was 9.1% with the CPI increasing by 7.4% for the period January-May 2022 compared to the corresponding period of the previous year. Many categories recorded an increase when compared to the May 2021 indices, with the prices of electricity increasing by 40.9%, Petroleum Products by 37.0% and Agricultural goods by 10.9%. Compared to May 2021, the categories Housing, Water, Electricity, Gas and Other Fuels, Transport and Non-Alcoholic Beverages contributed the most on inflation.

The exact magnitude of the impact of the sanctions on the Cyprus economy will largely depend on their duration and extension but also on possible new, stricter sanctions imposed by the US and the EU and countersanctions by Russia.

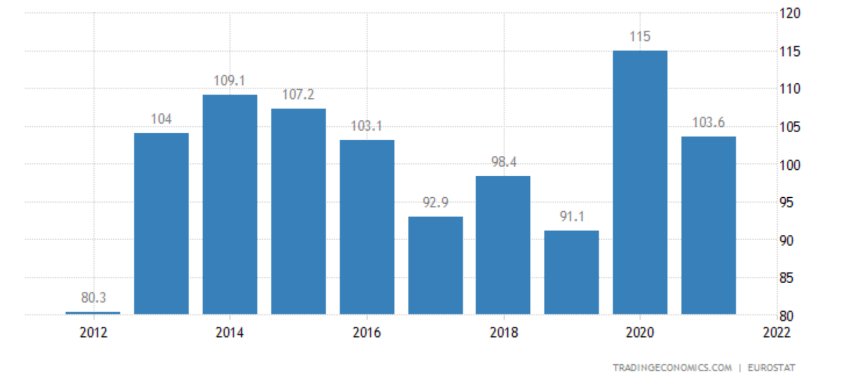
The increase in inflation is particularly challenging for governments, as it hits disproportionately the lower income groups, hence the recent rush to implement measures to alleviate the impact of rising prices. However, this will not be easy given the high levels of debt and rising interest rates.

Fiscal Position

The economic recovery boosted the fiscal position of Cyprus in 2021, with the government deficit decreasing from 5.8% to 1.7% of GDP. Government revenues significantly increased whereas government expenditures remained stable at 6.1%. While the budget deficit has indeed improved, it is still at significantly high levels and is anticipated to worsen even more due to the repercussions of Russia's invasion of Ukraine. In particular, tax revenue from tourism and professional services sector will decline, contributing to the high downside risks of Cyprus' fiscal policy.

According to the IMF Statistics for balance of payments, gross external debt is expected to gradually fall as a percentage of GDP from 825.2 in 2021 to 762.4 in 2022 and 719.7 in 2023. General government debt as a percentage of GDP reached 103.9 in 2021, falling to 97.7 in 2022 and 94.1 in 2023. Even though they are falling, they are still at a high level.

Figure 4: Cyprus' debt to GDP ratios



Related	Last	Previous	Unit	Reference
Government Debt to GDP	103.60	115.00	percent of GDP	Dec 2021
Government Spending to GDP	46.30	39.70	percent of GDP	Dec 2020
Asylum Applications	1805.00	1385.00	persons	Feb 2022

Source: Tradingeconomics.com

Financial stability

The Federal Reserve (FED) and the Bank of England (BoE) have increased the main interest rates, causing an increase in the borrowing cost for consumers and producers. This will negatively affect investment and consumption levels and possibly create new non-performing loans (NPLs).

Fortunately, Cyprus' banking system is much stronger than in 2013 with a better capital position and surplus liquidity. In addition, Cyprus has limited banking exposure to Russia and Ukraine, with just 0.8% of total loans and 4.7% of total deposits from the two countries respectively, and hence the first-round effects of the war don't pose a significant threat to Cyprus' financial and banking sector.

However, the RCB bank which has the third largest local authorized credit institution with Russian shareholding, is undertaking an orderly exit from its banking operations after sanctions were imposed on Russia following its invasion of Ukraine.

According to the CBC governor, the Central Bank of Cyprus reacted in a proactive and timely fashion in order to preserve financial stability, and hence successfully safeguarded all depositors without any impact on public finances and most importantly without any negative spillover effects to the rest of the banking sector.

Labour Market

Developments in the labour market for 2022 are surrounded by uncertainty due to the war. Following the invasion in Ukraine, the improvements in the labour market conditions are expected to be slower and annual employment rate is predicted to pursue a downward path, following a similar path with economic growth but with a delay, adhering to the norm that unemployment usually follows economic activity but with a time lag. The declining path of unemployment is projected to maintain pace during 2022-2025, falling to 7.1% in 2022, 6.4% in 2023, 6% in 2024 and 5.5% in 2025.

Implied Impact

According to the forecasts comparisons of real GDP, inflation and unemployment rates of different organizations as seen below, one can obtain the "implied impact" of this new shock to the Cyprus economy.

The impact on 2022 GDP ranges from 0.9% reduction to 1.9% reduction while for 2023 GDP results are mixed.

Ministry of Finance	**Predictions April 2022**			**Predictions October 2021**			Difference		
	2022	**2023**	**2024**	**2022**	**2023**	**2024**	**2022**	**2023**	**2024**
Real GDP growth	2.7	3.8	3.4	4.0	3.4	3	**-1.3**	0.4	0.4
Unemployment	7.1	6.4	6.0	6.7	6.0	5.5	0.4	0.4	0.5
CPI	4.5	1.5	2.0	1.5	2.0	2.0	3.0	-0.5	0.0
Central Bank	**Predictions June 2022**			**Predictions December 2021**			Difference		
	2022	**2023**	**2024**	**2022**	**2023**	**2024**	**2022**	**2023**	**2024**
Real GDP growth	2.7	3.6	3.7	3.6	3.7	3.8	**-0.9**	-0.1	-0.1
Unemployment	6.9	6.3	5.7	2.5	1.2	1.5	4.4	5.1	4.2
CPI	7.0	2.8	1.9	1.6	1.7	1.9	5.4	1.1	0.0

European Commission	Predictions May 2022		Predictions November 2021		Difference	
	2022	**2023**	**2022**	**2023**	**2022**	**2023**
Real GDP growth	2.3	3.5	4.2	3.5	**-1.9**	0.0
Unemployment	7.8	7.3	7.1	6.6	0.7	0.7
CPI	5.2	2.7	1.7	1.2	3.5	1.5

Cyprus' capacity to repay its debt remains sound and thus continues to have an 'investment grade' ranking from three major rating agencies. Public debt is projected to decline in the coming years, supported by GDP growth and primary surpluses. In addition, loan repayments to the ESM will only begin in 2025.

According to Standard and Poor's, the Cypriot economy's outlook prospects remain positive and on March 4, 2022, S&P Global Ratings affirmed its 'BBB-/A-3' long and short-term foreign and local currency sovereign credit ratings on Cyprus. Despite risks posed by Russia's invasion of Ukraine and the sanctions imposed on Russia, the performance of Cyprus is expected to be strong with the help of the disbursements from the EU Resilience and Recovery Facility together with progressive structural economic and budgetary reforms.

Standard and Poor's	Predictions March 2022			Predictions September 2021			Difference		
	2022	**2023**	**2024**	**2022**	**2023**	**2024**	**2022**	**2023**	**2024**
Real GDP growth	2.7	3.9	3.2	3.7	3.2	2.8	**-1.0**	0.7	0.4
Unemployment	6.5	6.0	5.0	6.5	6.0	5.0	0.0	0.0	0.0
CPI	2.6	2.0	2.0	1.5	1.8	2.0	1.1	0.2	0.0

Moody's	Predictions February 2022		Predictions April 2022		Difference	
	2022	2023	2022	2023	2022	2023
Real GDP growth	4.3	3.3	2.4	2.1	-1.9	-1.2
CPI	2.5	1.9	3.7	2.5	1.2	0.6

5. Recommendations

In order to counteract the effect of the reduced Russian arrivals in 2022, effort must be exercised to replace them by new tourist markets via new air connectivity routes and also from enhancing existing routes. In addition, tourist arrivals are expected to be supported by higher per capita expenditure. Hence, it is expected that tourist arrivals will remain at the levels reached in 2021.

Due to rising energy prices, the Cypriot government has taken fiscal measures to support households and the corporate sector. Since November 2021, the VAT rate on electricity use has been temporarily reduced for vulnerable consumers by 14% and for all other consumers by 10%. Moreover, excise duties on petroleum have been reduced since early 2022. So far, the fiscal impact of those measures has been moderate and amounted to 0.1% of GDP. However, the final impact will depend on the duration of Russia's invasion of Ukraine and the development of oil prices on the global markets.

Continued efforts to mitigate the impact of rising prices on the population must be based on the revenue potential of the government so as not to affect the overall debt levels unduly. Efforts must be prioritized to utilize as much as possible funds from the EU stability mechanism so as to direct the economy towards the technological and Green transition and reduce reliance on oil.

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