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Front-loading financial support to Ukraine:

It's now or never

Olga Pindyuk

The Vienna Institute for International Economic Studies
Wiener Institut für Internationale Wirtschaftsvergleiche

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OLGA PINDYUK

Olga Pindyuk is Economist at the Vienna Institute for International Economic Studies (wiiw).

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Abstract

As Ukraine must fight against an aggressor with an economy more than 10 times larger, its own resources have been far from sufficient to finance all its needs, which in turn has forced the country to rely on significant external financial support. Unfortunately, there have recently been interruptions, uncertainty and inordinate delays when it comes to providing military support and funding. Moreover, as loans (rather than grants) have been the main form of external financial aid, macro-financial imbalances have been accumulating in the economy.

Without sufficient military and financial support, Ukraine will not be able to withstand Russia's military aggression and prevent even more damage to its economy and social fabric. In addition to having a much smaller economy compared to Russia, Ukraine also has a much smaller population – which means it will eventually lose a long war of attrition. If sufficient aid is not provided, Ukraine's defeat would likely result in far higher social, political and economic costs to Europe in the form of additional refugee flows and greater security risks, including spill-over effects on other neighbouring regions.

The EU needs to expand its role as a donor of financial aid. Although it is already the main donor, there is still significant potential for the EU to scale up its aid to Ukraine. Increasing and front-loading macro-financial and reconstruction assistance – primarily via grants – would enable Ukraine to have an accelerating economic growth trajectory as well as benefit Europe by improving its security situation and boosting its prosperity. Additionally, the assets of the Russian Central Bank that have been frozen by Ukraine's Western allies, which amount to approximately USD 300bn, should finally be made available to Ukraine.

Keywords: Ukraine, Russia, EU, US, war, security, fiscal revenues, external financial aid, public debt, sanctions, frozen assets

JEL classification: E62, F35, F51, H81, H84, K33

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1. INTRODUCTION: UKRAINE'S ECONOMY IN TIMES OF WAR

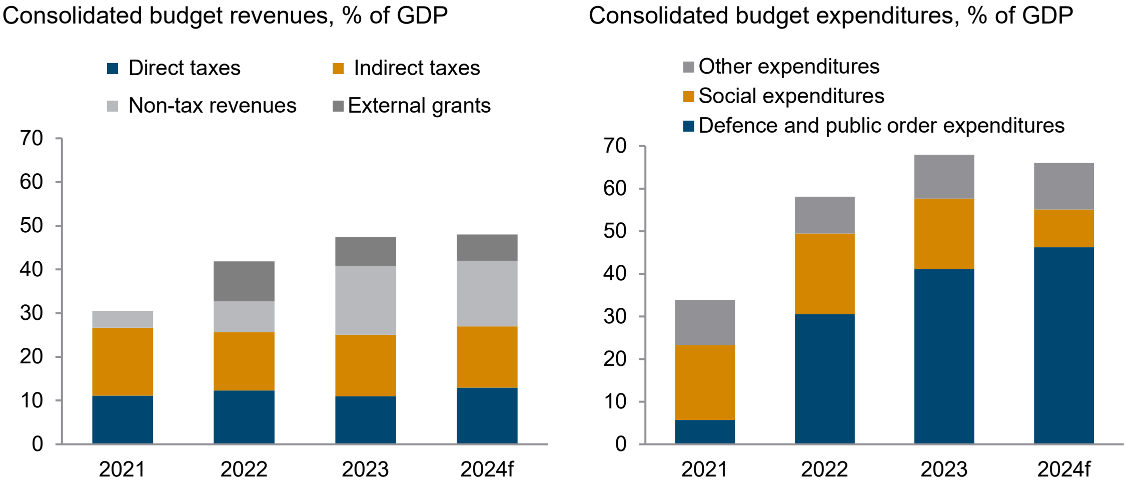
Russia's full-scale invasion caused a significant contraction of the Ukrainian economy in 2022, by almost 30% year on year. However, in 2023, the economy showed remarkable resilience, growing by 5.3% year on year. Growth was registered in many sectors, especially in agriculture and food processing; the manufacture of construction materials, weapons, motor vehicles and electronic equipment; and construction. The defence industry saw a rise in production, with drones being the fastest-growing segment. In fact, more than 200 drone-producing companies have been created, and the country is believed to be on track to produce a million drones in 2024. The country's military forces have secured the establishment of a new shipping route in the Black Sea, which has compensated for the losses caused by Russia's termination of the grain deal in July 2023 as well as softened the blow of both Poland's blockade of the border with Ukraine and the curbs on EU imports of many Ukrainian agricultural commodities and food products.

Despite the war, the Ukrainian government has managed to introduce many positive policy changes. The IMF completed the fifth review of the Extended Fund Facility (EFF) arrangement in September 2024 (IMF 2024b) and commended the government's performance on meeting the quantitative criteria and implementing structural benchmarks. Despite Russia's full-scale invasion in February 2022 and its brutal war of aggression, Ukraine has continued to make progress on democratic and rule-of-law reforms (European Commission 2023). The fact that the EU granted candidate status to Ukraine in June 2022 for accession to the bloc has further accelerated reform efforts. Ukraine admittedly still needs to strengthen its anti-corruption institutions and improve its track record on prosecutions and convictions for related offenses. But the reform progress was significant enough for the EU to start membership negotiations with the country in June 2024.

Public finances in Ukraine have been adjusting to the conditions of the full-scale war, with both fiscal revenues and expenditures rising significantly as a share of GDP (Figure 1). Fiscal expenditures have changed quite dramatically, rising by 24 percentage points (pp) – to 58.1% of GDP – in 2022. In 2024, the share of consolidated budget expenditures is expected to be around 66% of GDP. While the lion's share of expenditures is allocated for defence-related activities, social-, health- and education-related expenditures have been shrinking as a share of GDP. If such a trend continues, it will have long-term negative effects on human capital and exacerbate already significant demographic problems in Ukraine.

In 2022, the share of consolidated budget revenues was raised by more than 10 pp, to 42% of GDP, and the share of fiscal revenues is expected to reach 48% of GDP in 2024. The year 2023 saw a rise in revenues from indirect taxes – including VAT, excise taxes, and import and export duties – owing to the discontinuation of certain tax incentives and a surge in consumption. Non-tax revenues jumped from about 7% of GDP in 2022 to almost 16% of GDP in 2023, primarily driven by charitable contributions and transfers from the National Bank of Ukraine (Kyiv School of Economics 2024a). The one-time taxation of banks' profits for 2023, at the rate of 50%, allowed for a sharp increase in income tax revenues. Revenues from personal income tax did not undergo significant changes, but the military tax, which was introduced in 2014 as an additional personal income tax at the rate of 1.5%, began to be fully credited to the state budget instead of to local budgets.

Figure 1 / Fiscal sector of Ukraine in the 2021-2024 period



Note: "f" after a year means forecast.
Social expenditures include public spending on social protection and social security, health care and education.
Sources: Ministry of Finance of Ukraine, wiiw annual database; own forecast.

1.1. The importance of foreign financial assistance for Ukraine's economy and defence efforts

While Ukraine has done a lot to boost its fiscal revenues (and could feasibly still do more), without substantial external aid, there is ultimately no chance that it will be able to raise sufficient funds to win the war[1] against an aggressor with a much bigger economy. In 2021, Russia's GDP was more than nine times bigger than that of Ukraine, and the difference only got bigger – to more than 11 times bigger – in 2023. Moreover, Russia also accumulated significant fiscal resources over many years of tight fiscal and monetary policy to build up various buffers, which it has now been using to finance its war efforts. Thus, Ukraine has become strongly dependent on external financial aid to support its economy and defence efforts.

[1] As there is no clear vision in the West about what Ukraine's victory would look like, we assume that victory will mean either a complete defeat of Russia or at least a strong position to negotiate a peace that would allow Ukraine to control an acceptable part of its pre-war territory as well as either membership in NATO or an unequivocal security guarantee from the US/NATO.

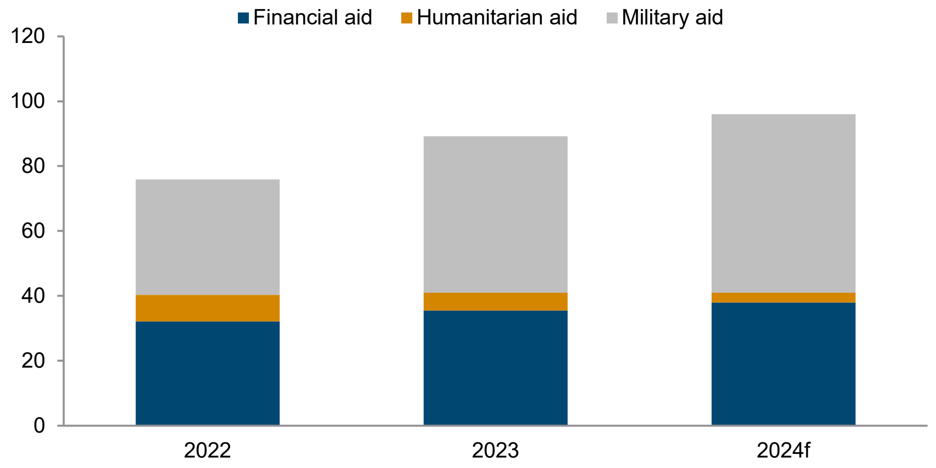
UKRAINE'S POLICIES TO BOOST ITS FISCAL REVENUES

In an effort to mobilise additional tax revenues, Ukrainian authorities are advancing the implementation of the National Revenue Strategy 2024-2030 (NRS), which was adopted in 2023 (IMF 2024a). They have put in place implementation plans for tax administration, customs administration and tax policy. Key actions taken so far in 2024 include: (i) submitting legislation to increase excise tax rates on tobacco and alcoholic products; (ii) launching the 2024 taxpayer survey; (iii) reinstating post-clearance customs audits; and (iv) criminalising large-scale customs fraud and smuggling. To increase fiscal revenues in 2025, Ukraine's government has introduced multiple measures, including: (i) increasing the rate of the military tax on personal income from 1.5% to 5%; (ii) setting higher taxes for self-employed people; (iii) retroactively doubling taxes on bank profits in 2024 to 50%; and (iv) raising taxes on the profits of other financial institutions to 25%, which should add about USD 3.3bn in fiscal revenues, or less than 10% of the planned budget deficit in 2025.

It should be possible for the government to implement additional measures to mobilise domestic revenue, such as: (i) strengthening tax administration (including on customs and compliance); (ii) phasing out preferential VAT rates; (iii) rationalising and improving the targeting of tax exemptions; and (iv) making taxation enforcement more effective via track and trace systems to ensure equity among taxpayers (ibid.).

In 2023, external aid inflows to Ukraine totalled around EUR 41bn, or about 25% of the country's GDP (Figure 2). This has allowed the government to increase fiscal expenditures by about 7% year on year in real terms in order to finance its defence needs and social spending. In addition, it has been essential for maintaining macro-financial stability in the country. About EUR 41bn in foreign financial aid is expected to be received in 2024.

Figure 2 / Aid allocated to Ukraine by type, EUR bn



Note: "f" after a year means forecast.
Sources: Ukraine Support Tracker of the Kiel Institute for the World Economy, Ministry of Finance of Ukraine; own forecast.

Military support has also been very important, as being able to successfully defend itself against Russia is a prerequisite for Ukraine's economic recovery. In 2023, according to the Ukraine Support Tracker of the Kiel Institute for the World Economy, Ukraine received commitments of military equipment, weapons and ammunitions with a combined estimate value of more than USD 40bn (although the actual figure is probably higher because value estimates were not available for many transactions). The US, which accounted for more than half of the value of these commitments, has played a crucial role in preventing Ukraine's military defeat, but it has also been very cautious and reluctant to give Ukraine the weapons (or permission to use the weapons) that would allow it a chance to win (Kimmitt 2024). Ukraine's requests to receive various types of weapons (e.g. tanks, fighter jets, long-range missiles and anti-missile defence systems) have been initially declined and then eventually granted after significant delays. Furthermore, Ukraine has been forbidden to use long-range missiles received from its partners to strike military targets inside Russia even though Russia has been conducting indiscriminate missile attacks on Ukraine's civilian and energy infrastructure over this entire period. The US mainly justifies this cautious approach by pointing to two fears: that Russia will escalate the war if certain 'red lines' are crossed, and that chaos and instability will ensue in Russia should lose the war. In the opinion of many experts (see e.g. Hooker 2023; Brands 2024), these fears are unjustified. Indeed, keeping Ukraine in the fight without allowing it to win is not only morally problematic, but also a very expensive strategy for both Ukraine (which is losing much more than just financial resources, most notably people) and its external supporters.

In providing aid to Ukraine, the West has not been able to present a united front, as was the case during the Cold War, when the commitment of the collective West could more or less be taken for granted. Increased unpredictability of politics, which in many countries have been shifting towards the far right, also means increased friction when it comes to arriving at a consensus on the shape and size of military and financial assistance to Ukraine. In 2024, provision of foreign financial and military aid has been disrupted by the delays in approval of the promised funds by the US Congress and in approval of aid by the EU. As a result, between January and February 2024, Ukraine only received USD 809m in foreign aid (even though it needs to receive at least USD 3bn each month), which forced Ukraine's government to issue domestic bonds to finance the fiscal deficit. Although a positive development, the EU's approval of its Ukraine Facility (worth EUR 50bn over four years[2]) does not solve the issue of the fiscal financing gap over that same four-year period. For example, in 2025 alone, Ukraine's fiscal deficit is expected to exceed EUR 35bn. What's more, the Ukraine Facility would not make up for the US funds that would presumably be missing were Donald Trump to win the presidential elections this year and fulfil his promise to reduce or perhaps even eliminate support for Ukraine.

Dwindling ammunition stocks and inadequate air defence against Russian missile attacks pose a grave threat to Ukraine. In fact, a lack of anti-missile defence capabilities in Ukraine allowed Russia to destroy about a half of the country's power-generation infrastructure in 2024 through missile and drone attacks. Energy providers have been forced to introduce nationwide rolling power outages that are expected to continue for at least another year, which is putting the brakes on Ukraine's economic recovery.

Thus, Ukraine is in dire need of stronger support from its allies – in terms of both financial and military resources. In addition to having a much smaller economy than Russia does, Ukraine also a much smaller population, which means that it will eventually lose a long war of attrition.

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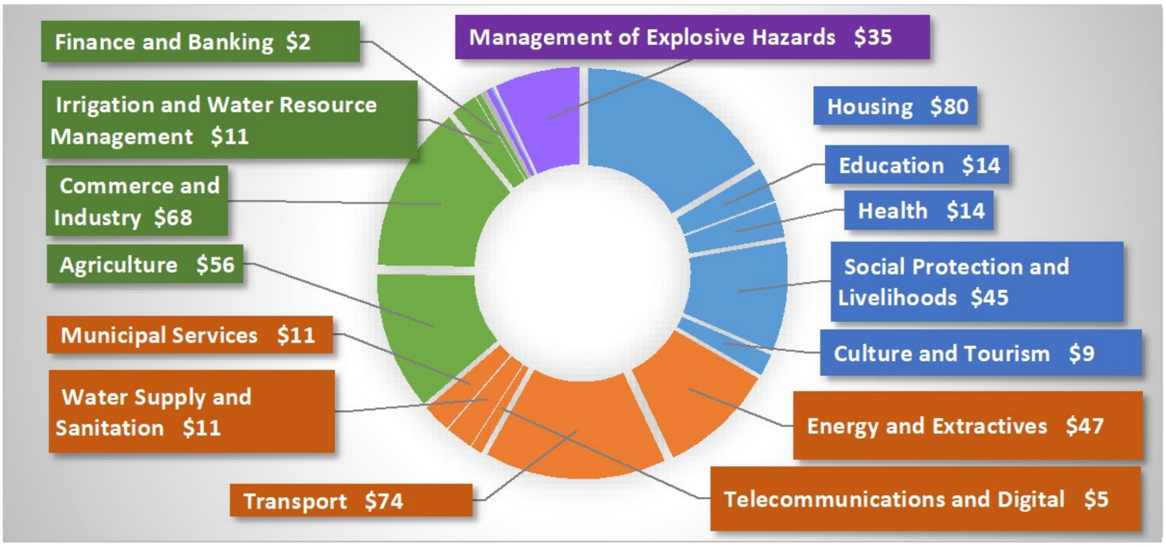
[2] As of 23 August 2024, EUR 13.8 bn had been disbursed under the Ukraine Facility.

1.2. Reconstruction will require significant resources – and some of it already needs to be done now

Ukraine's needs in terms of external financial support are even bigger if one considers reconstruction costs. Rebuilding the country will be a colossal task requiring the mobilisation of significant resources. An updated Rapid Damage and Needs Assessment report (World Bank 2024) released in February 2024 – which was jointly prepared by the World Bank, the government of Ukraine, the European Commission and the United Nations – estimates that the costs of reconstruction and recovery in Ukraine have grown to USD 486bn (EUR 439bn) (see Figure 3).The costs are expected to be spread out over 10 years and to use a mix of private and public funds. As reconstruction and EU accession will proceed in parallel, the EU will need to devote greater financial resources to Ukraine than to any previous accession country (Grieveson et al. 2023).

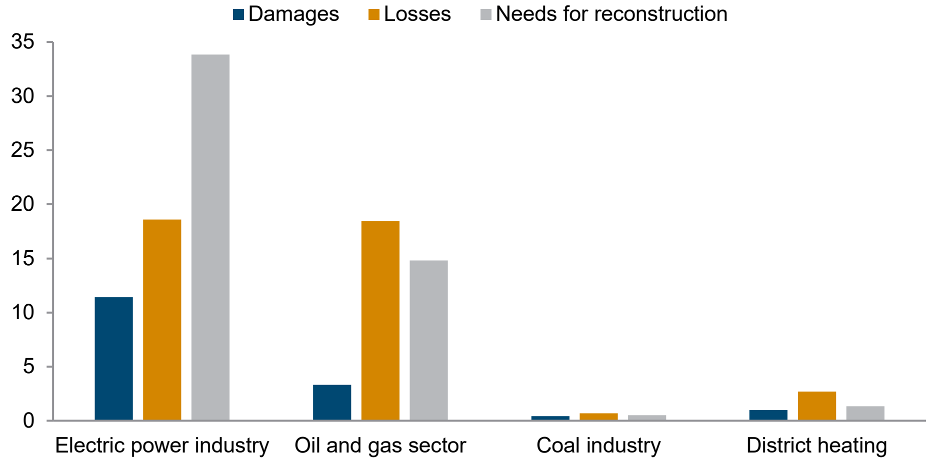
Figure 3 / Total recovery and reconstruction needs of Ukraine (USD 486bn)



Note: Needs relate to total estimated needs covering the 2024-2033 period. Figures in USD m.
Source: World Bank (2024).

The cost of reconstruction continues to grow with each Russian missile attack on Ukraine, and the damages to the energy-sector infrastructure since the last Rapid Damage and Needs Assessment report have been mounting. The latest assessment by the Kyiv School of Economics (2024b) finds that Ukraine's energy sector has suffered damages and losses totalling USD 56.5bn, while the recovery needs, which include the complete reconstruction of destroyed facilities in keeping with the principle of 'Build Back Better', amount to USD 50.5bn (Figure 4).

Figure 4 / Damages, losses and needs of Ukraine's energy sector as of May 2024, USD bn



Source: Kyiv School of Economics (2024b).

Reconstruction should not be postponed until the war has ended. Conducting some parts of it already during wartime is seen as a vital prerequisite for Ukraine's victory and future economic prosperity (Herbst, Khakova, and Lichfield 2024). According to the World Bank (2024), the following areas are critical priorities for reconstruction:

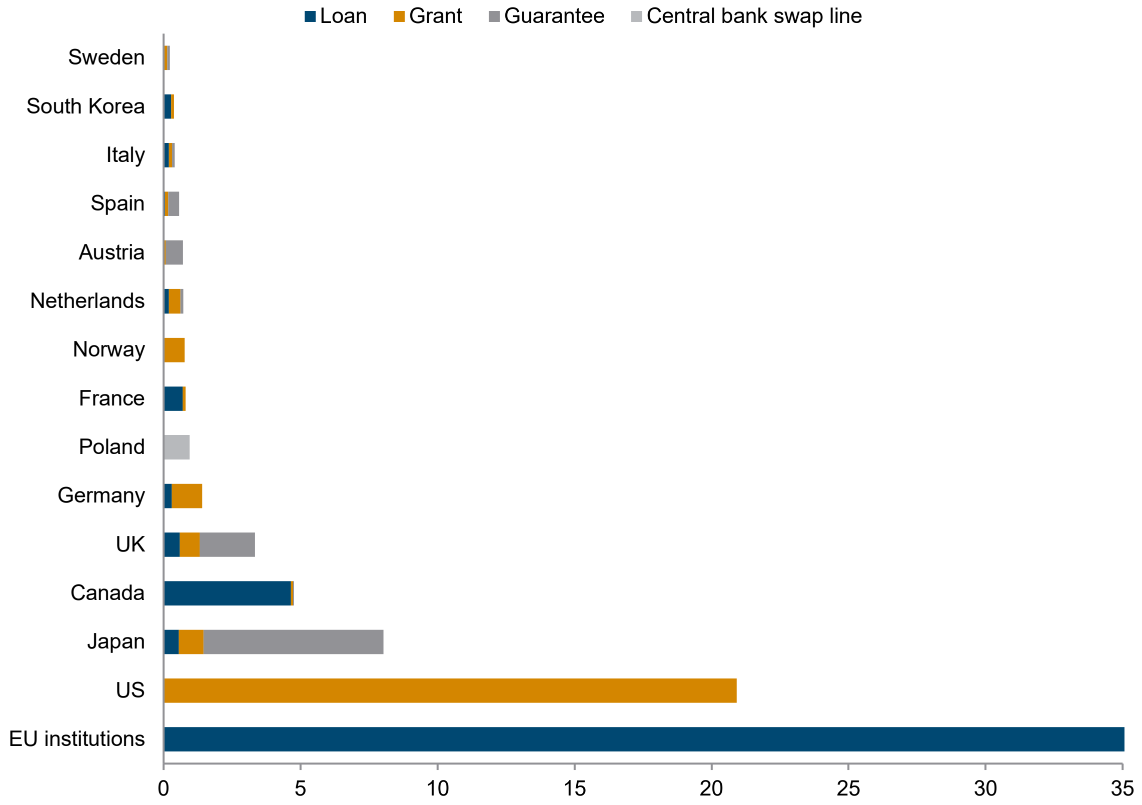
- Energy, including restoration and repair of transmission and distribution lines and restoration and decentralisation of generation capacity.
- Transport, with a strong focus on internal and cross-border connectivity, including repair and reconstruction of road, rail, bridges, ports, border crossings and postal services.
- Housing and utilities, including routine repair and capital reconstruction of housing, as well as reconstruction and service restoration of central heating, energy efficiency, water supply and sanitation services, and waste management services.
- Social infrastructure and services, including repair, reconstruction and service restoration of schools and health facilities, as well as social and cultural infrastructure and services.
- Industry and services, encompassing the main support to the private sector, including industry and commerce, agribusiness and irrigation, with a focus on de-risking investment and trade.
- Cross-sectoral priorities, including demining, telecommunications, digital and cybersecurity, emergency response and civil protection.

The recovery and reconstruction priorities for 2024, as identified by the Ukrainian government, will require USD 15.3bn in public funding. In addition, according to the World Bank's assessment, Ukraine's private sector could contribute up to USD 11bn in addition funds to help meet the most urgent needs.

2. MACRO-FINANCIAL IMBALANCES ARE ACCUMULATING

Most of the financial aid that Ukraine has been receiving has come in the form of loans (and guarantees), while grants have accounted for less than one third of total financial aid (Figure 5). While the US has been the main provider of grants as a form of aid, the EU has almost exclusively been providing loans. If the foreign policy of the US dramatically changes following the upcoming US presidential election, the share of loans in the extremal financial aid will likely rise significantly, leading Ukraine to shoulder an even greater public debt burden.

Figure 5 / Financial bilateral allocations – top 15 donors, between 24 January 2022 and 30 June 2024, EUR bn



Source: Ukraine Support Tracker of the Kiel Institute for the World Economy.

For the long-term economic sustainability of Ukraine, it is crucial that the external aid it receives comes in the form of grants or debt that does not have to be paid back for decades. Although most of the loans provided over the last three years have been highly concessional and very long-term,[3] the issue of debt sustainability is quite serious. The emerging consensus is that Ukraine's debt is not likely to be sustainable and, consequently, that significant debt relief will have to be negotiated. According to the IMF (2023), 'the overall assessment remains that debt is unsustainable in the baseline and downside scenarios without debt restructuring, financing on appropriate terms, and fiscal adjustment.'

[3] In case of the EU's Macro-Financial Assistance Plus (MFA+) instrument for Ukraine, loans have a 35-year maturity, including a 10-year grace period, as well as subsidised interest rate costs.

DEBT SUSTAINABILITY FOR COUNTRIES AT WAR

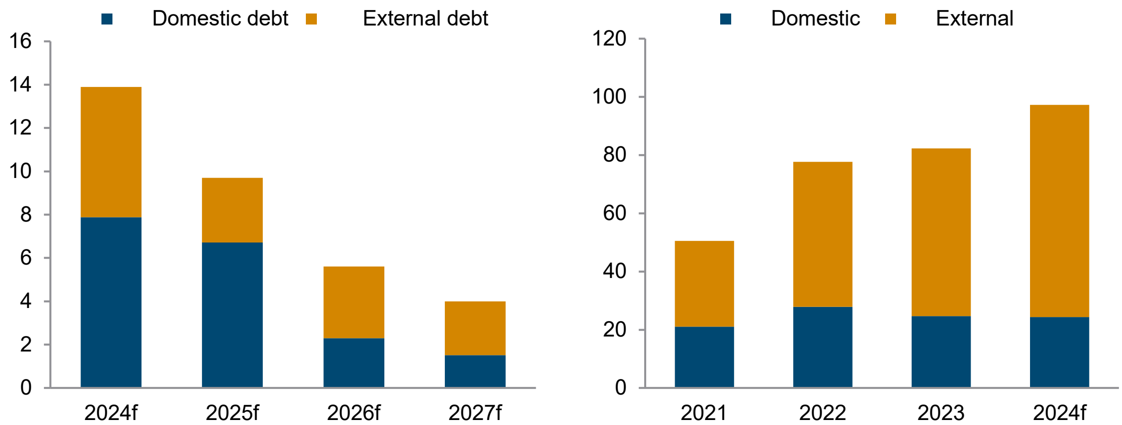
A typical debt sustainability analysis (DSA) is not very applicable for a country at war. While the realities of scarring effects of major crises are recognised in the literature, current DSA frameworks do not feature a stress test scenario or capture the impact of large shocks with scarring effects (Raga 2024). Persistent upward pressure on the budget deficit due to continued expenditures may lead to rising debt levels and debt vulnerabilities, which would limit fiscal space in the event of new recessions and adversely affect future economic activities and risks (Larch et al. 2022).

Many factors of standard debt sustainability models are hard to forecast with a reasonable degree of plausibility. To a large extent, the economic growth of Ukraine will depend on a successful outcome of the war. This, in turn, will depend on the military capability (and performance) of Ukraine, which is highly dependent on external support, which is mainly driven by (geo-)political factors. Inflation and exchange rates are also strongly impacted by the size of the external funding.

Figure 6 / Ukraine's public debt as a share of GDP, %

Estimated government debt repayment profile for the 2024-2027 period under the existing agreements (as of 1 September 2024)

Total public and publicly guaranteed debt

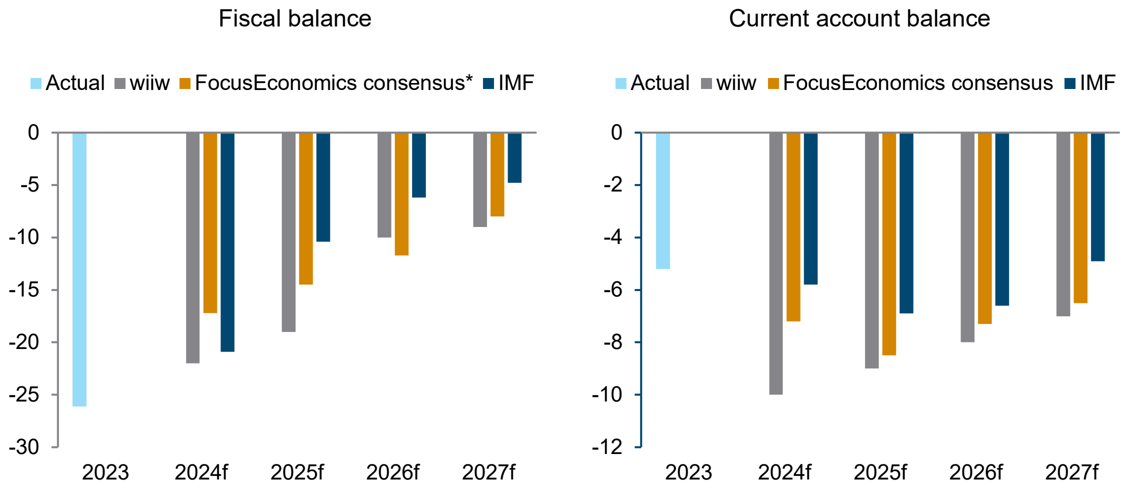


Note: "f" after a year means forecast.
The debt repayment forecast takes into account the debt restructuring of August 2024.
Sources: Ministry of Finance of Ukraine, IMF, wiiw annual database; own estimates and forecast.

In August 2024, Ukraine managed to restructure sovereign eurobonds and one series of the Ukravtodor sovereign-guaranteed eurobonds, with approximately USD 20.5bn of outstanding principal amount (around USD 24bn, including accrued interests), into eight new eurobonds series with a combined USD 15.2bn in principal amount. As a result of this transaction, Ukraine's state and state-guaranteed debt has been reduced by about USD 9bn. The restructuring decreases immediate debt-servicing payments by 93%, leading to savings of USD 11.4bn over the next three years. Nevertheless, in the 2024-2027 period, Ukraine will have to spend on average more than 6% of its annual GDP each year on debt repayments (Figure 6). In addition, it is possible that the debt repayment will actually be higher in the 2026-2027 period if the Ukrainian government is forced to increase borrowing on the domestic market in the absence of a sufficient amount of external financial support. As Ukraine's public debt burden will remain high for its wartime economy, additional debt relief is likely to be needed in the future.

Under these conditions, Ukraine's economy has been increasing its structural imbalances, which can create issues for its sustainable recovery (Figure 7). Although forecasts vary among forecasters (which is not surprising given that forecasts need to be made under the conditions of extremely high uncertainty about war developments and the external geopolitical environment), the size of fiscal and current account deficits is generally forecasted to be quite high in the years to come.

Figure 7 / Forecasts of Ukraine's fiscal and current account balances as a share of GDP, %



Note: "f" after a year means forecast.
Sources: IMF, FocusEconomics; own forecast.

Even in the case of sizeable fiscal and current account deficits as well as public debt, Ukraine's future needs in terms of external financing remain high. It is therefore important that external lending should not lead to any further increase in the public debt-to-GDP ratio, which would further exacerbate the existing macro-financial imbalances. This means that it should be provided primarily in the form of grants.

3. HELPING UKRAINE QUICKLY CONCLUDE THE WAR ON FAVOURABLE TERMS IS A WIN-WIN FOR THE COUNTRY AND ITS ALLIES

We developed the following three scenarios to assess possible trajectories of economic developments in Ukraine based on the amount and types of external support it receives.

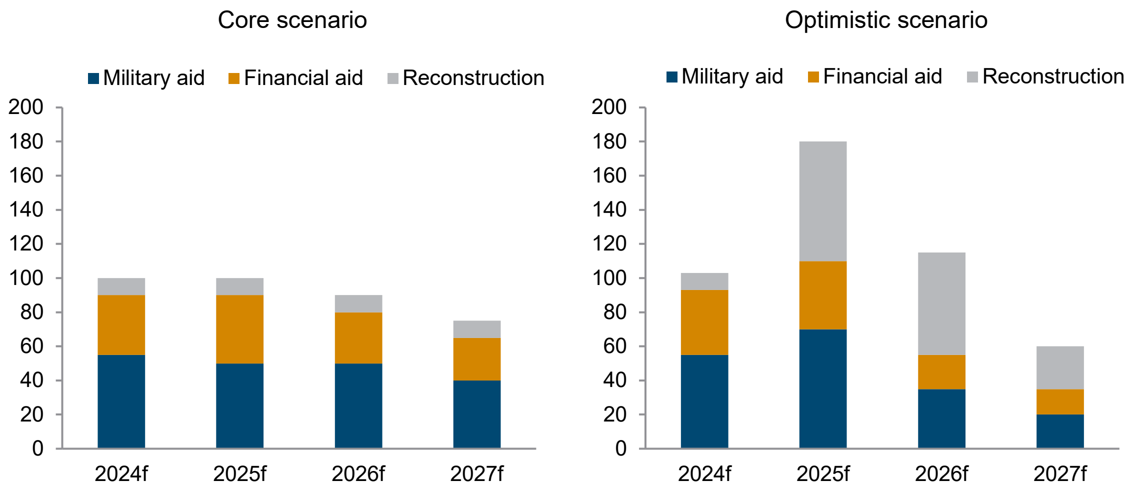
› **Core scenario:** An active phase of the war lasts for at least two more years; external assistance continues but will gradually decrease, and the amounts will be insufficient for a decisive victory and fast reconstruction of the damaged infrastructure.

› **Optimistic scenario**: Significant amount of external aid is front-loaded (likely using frozen Russian assets); Ukraine concludes the war on favourable terms by 2026; speedy reconstruction, financed by a mixture of public and private capital, is already underway in 2025; economic growth accelerates; and

FDI inflows to finance recovery will already increase substantially in 2027 (Figure 8). In this scenario, the need for external aid will decrease in 2027, as Ukraine will no longer have to intensively finance defence-related activities and private capital will be flowing in to be invested in reconstruction projects. In addition, compared to the core scenario, a much higher share of the external financial aid will be directed to reconstruction projects in this optimistic scenario.

› **Downside scenario**: Low external aid, especially if Donald Trump wins the US presidential election and Russia-friendly parties win elections in several EU member states; more damage to infrastructure; Ukraine is defeated by Russia; increased outflows of refugees.

Figure 8 / External aid to Ukraine in the 2024-2027 period under the core and optimistic scenarios, USD bn



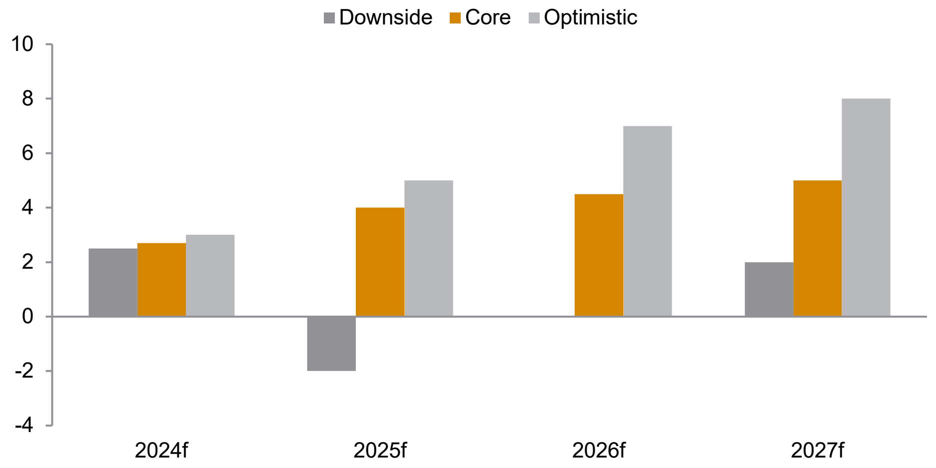
Note: "f" after a year means forecast.
Source: own forecast.

Our analysis shows that front-loading macro-financial and reconstruction assistance – primarily via grants – would allow Ukraine to have an accelerating economic growth trajectory (Figure 9) as well as greatly improve the security situation in the EU. After all, a more prosperous Ukraine would have better chances to finalise the EU accession process, and the EU in turn could benefit from an opportunity to integrate Ukraine into EU supply chains so as to support the EU's digital and energy transitions (Kosmehl et al. 2024). EU enlargements have been shown to lead to substantial gains in GDP for both acceding and existing member countries through a significant reduction in trade costs, enhanced trade integration, and deepening participation in cross-border value chains within the Single Market (Pasimeni 2024).

Furthermore, Ukraine could offer EU companies a potentially big consumer market as well as access to high- and medium-skilled labour. Additionally, the country's comparative advantages in IT, defence, green energy and agri-food sector could significantly contribute to improving various aspects of the EU's security, such as military, cyber, food and energy ones (see e.g. Kosmehl et al. 2024). Since the US – regardless of the outcome of 2024 presidential election – will have to devote more resources to the Pacific region over time and since Europe will accordingly have to be able to shoulder more of its defence responsibilities, Ukraine's role in maintaining European security will be increasingly more important and the country's defence sector is likely to become one of Europe's most important suppliers of military equipment.

Ukraine's accession will especially benefit the EU member states with which it is neighbours – through increased trade, energy supplies (traditional and renewable), and stability and security on the border. In addition, there will be major spill-overs from the reconstruction process, as there will be huge demand for expertise, materials and workers from neighbouring countries (Grieveson et al. 2023).

Figure 9 / Ukraine's annual real GDP growth under the three scenarios, %



Note: "f" after a year means forecast.
Source: own forecast.

4. WHERE CAN NEW SOURCES OF EXTERNAL FINANCING BE FOUND?

As established in the previous section, if Ukraine is to be empowered to win the war and successfully reconstruct its economy, it needs external aid to be front-loaded. This means that the country's Western allies would have to provide more sizeable financial assistance, and that this assistance needs to come in the form of grants rather than loans. To date, the sources of such funding have not been found. The EU has already front-loaded a big share of the Ukraine Facility funds, and the political situation in the US has increased uncertainty about the likelihood of its continued support for Ukraine. In September 2024, the Ukrainian government announced that, for 2025, there is an external financing gap amounting to roughly USD 15bn (about 9% of GDP) for which financing sources need to be found.

THE EU'S UKRAINE FACILITY: EUR 50BN FOR THE 2024-2027 PERIOD

› Pillar 1: EUR 39bn (out of which grants make up EUR 6bn)
For this support to be disbursed, the government of Ukraine will prepare a plan in close consultation with the European Commission, which will then be presented to the European Council for adoption. The terms of the loans are similar to those of the Micro-Financial Assistance Plus (MFA+) instrument.

› Pillar 2: EUR 8bn
EU budget guarantee to de-risk operations of public development banks (e.g. BEI, EBRD, etc.) and mobilise EUR 17.8bn in private investments.

› Pillar 3: EUR 3bn
About EUR 1bn for assistance and capacity-building programmes for national, regional and municipal governments as well as civil society to adopt the EU acquis, prepare for EU accession, and cover the interest rate subsidies for the loans granted to Ukraine under Pillar I.

The agreement reached at the G7 summit in June 2024 to provide Ukraine with USD 50bn in new financing by bringing forward the interest earned on frozen Russian sovereign assets (Extraordinary Revenue Acceleration (ERA) Loan initiative) was reassuring, but the progress in implementing the decision was painfully slow. For the plan to function, the EU had to significantly extend the duration of EU sanctions imposed on Russia (which are currently rolled over every six months) – ideally indefinitely, but at least to 36 months. This has proven to be impossible, as the 27 EU members have not been able to reach the required unanimous decision owing to Hungary's persistent opposition to any proposed options (Sandbu 2024a).

In October 2024, the EU came up with an alternative mechanism to implement G7 commitment by providing exceptional macro-financial assistance (MFA) loan as a part of the ERA Loan initiative[4]. G7 leaders reached an agreement on the operationalisation of the initiative on October 25[5]. According to the agreement, USD 50 bn will be provided to Ukraine as bilateral loans between 1 December 2024 and 31 December 2027, with the US providing the biggest loan of USD 20 bn, followed by the EU with EUR 18.1 bn. The loans provided by each lender, both principal and interest, will be paid back using the extraordinary profits from the Russian immobilized sovereign assets.

Still, the amount of funds would not be sufficient to solve the country's external financing (and military) needs in the next three years. As uncertainty regarding the reliability of US assistance has greatly increased (Grieveson 2024), the EU may soon face a very stark choice: either massively increase financial aid to Ukraine or face a Ukrainian collapse and then see Russia turn its attention to other countries to attack or destabilise, such as the Baltic states, Georgia, Moldova or Poland. Consequently, the EU may have to expand its role as the main donor of financial aid (as well as potentially of military aid should it manage to scale up its defence sector).

4 https://www.consilium.europa.eu/en/press/press-releases/2024/10/23/immobilised-assets-council-greenlights-up-to-35-billion-in-macro-financial-assistance-to-ukraine-and-new-loan-mechanism-implementing-g7-commitment/

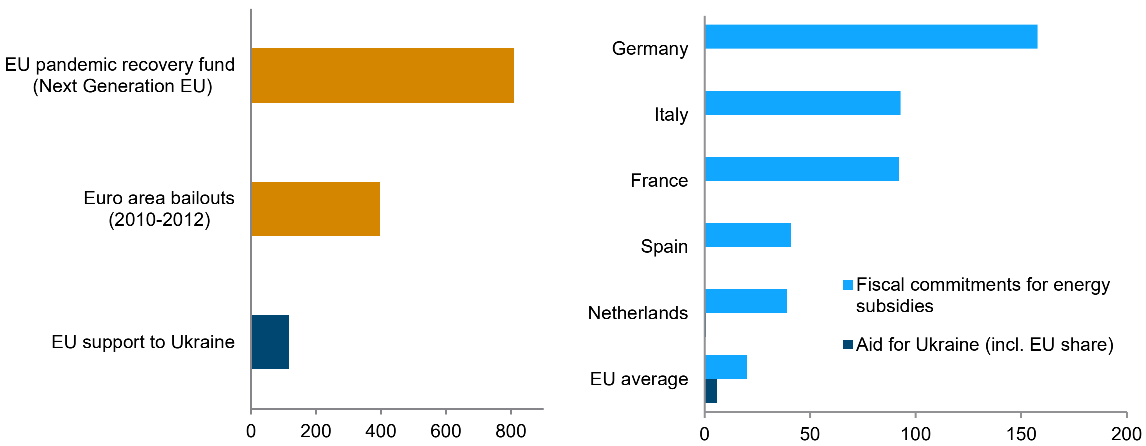
5 https://www.whitehouse.gov/briefing-room/statements-releases/2024/10/25/g7-leaders-statement-on-extraordinary-revenue-acceleration-era-loans/

There should still be significant potential for the EU to scale up aid to Ukraine. As Figure 10 shows, the amount of aid that the EU and its member states have provided to Ukraine collectively pales in comparison to the amounts it has dedicated in response to other major crises in the recent past. For example, the financing allocated for the euro area bailouts in Greece, Ireland, Portugal and Spain in the 2010-2012 period was more than three times larger than the support that the EU and its members states collectively provided to Ukraine between January 2022 and July 2024. Comparing the EU's energy subsidies in the period between September 2021 to January 2023 with EU aid to Ukraine yields a similar ratio. Moreover, on the bilateral basis, the biggest EU economies have spent a negligible amount to support Ukraine in comparison with their fiscal commitments for energy subsidies at the national level. In fact, the only EU country in which aid to Ukraine has exceeded its fiscal commitments for energy subsidies has been the Netherlands – though, notably, only by 1%.

Figure 10 / Aid to Ukraine compared to other spending programs in Europe, EUR bn

Europe's response to major crises – commitments

Fiscal commitments for energy subsidies vs. aid for Ukraine



Note: The graphic on the left compares the EU's total commitments to Ukraine between 24 January 2022 and 30 June 2024 with the commitments announced during the euro area crisis (bailout funds for Greece, Ireland, Portugal and Spain) as well as with the European Commission's Next Generation EU (NGEU) pandemic recovery fund announced in July 2020. The graphic on the right compares the amount of aid to Ukraine with the size of the respective domestic spending programs of Germany, Italy, France, the Netherlands and Spain as well as an average across all EU member countries in the period between September 2021 and January 2023.
Sources: Ukraine Support Tracker of the Kiel Institute for the World Economy, Bruegel.

IMPLICATIONS FOR THE EU IF UKRAINE LOSES ITS WAR WITH RUSSIA

Although Ukraine is not yet a member of the EU, Russia's war on its territory is not just a local conflict, but a crisis with immense repercussions for the EU. According to US President Joe Biden (Lopez, 2024), Russia's war in Ukraine is not just a threat to the invaded country itself or to the nations that share a border with it, but to all of Europe and the rest of the world. This war has to be considered a part of a broader pattern of Russian pressure and assault on the US-led western post-Second World War security order, which Putin seeks to dismantle so that Russia can exercise greater power both regionally and internationally (Covington 2024).

If Putin is allowed to destroy Ukraine as a sovereign state, this will have grave implications for the West, and especially for the EU (Ash 2024; Bond 2024; Lange and Masala 2023; Goncharenko 2024):

› The West would be disavowed as a guarantor of stability, security and order, and autocratic regimes would be strengthened globally and would impose their ideas of international order. At the same time, the fall of Ukraine would leave NATO demoralised and discredited, as NATO leaders would have already demonstrated that they are afraid of escalation and inclined to back down when confronted by the Kremlin.

› A new round of global nuclear proliferation would be likely, as having nuclear weapons will be perceived as more reliable security than promises of help from allies. And no country will ever voluntarily give up its nuclear arsenal again.

› The rest of Europe would face a threat from militarised Russia, which might even be tempted to test the solidity of NATO's Article 5 guarantee, particularly if Donald Trump were to become US president again.

› Millions more Ukrainians would migrate to Europe, fleeing from the kind of atrocities already seen in the occupied territories.

› There would be significant damage to global food security, triggering increased migration from vulnerable countries in the Middle East and Africa to Europe.

Thus, it can be argued that it is in the EU's own interest to scale up support for Ukraine to ensure the latter's victory against Russia.

The assets of the Russian Central Bank (RCB) frozen by Ukraine's Western allies, which amount to approximately USD 300bn, should finally be made available to Ukraine. There is a consensus in the West that Russia should pay for the damages and losses it has caused to Ukraine over the course of its unprovoked war of aggression, which have probably already exceeded USD 500bn by now – or almost three times the level of Ukraine's GDP in 2023. The G7 has publicly stated that the assets will not be returned until Russia pays for the damage that its war has caused (European Council 2024).

There have been numerous studies showing that, although legally complicated, confiscating these frozen Russian assets is feasible. According to the recent study commissioned by the European Parliament (Webb 2024), the most promising options in terms of compliance with international law are: (i) States justifying confiscation of RCB assets as third-party countermeasures with a conditional element (e.g. the frozen RCB assets are given to Ukraine as a loan that is repayable in principle if and when Russia complies with its obligation to make full reparation); or (ii) States confiscate RCB assets based on an exception to immunity for the enforcement of international judgments ordering damages.

Sotnyk and La Cour (2024) go further and state that, rather than breaking international law, confiscating frozen Russian state assets to support Ukraine would actually safeguard international law. Plus, they add, in not confiscating the frozen assets, Europe is rendering perceived economic interests more important than the international law it claims to uphold. In addition, as Nixey (2024) argues, not confiscating assets is a policy choice in itself – and with policy consequences potentially just as profound, as it sends a signal to third countries that military aggression and violations of the international legal order can go unpunished.

Estonia set an example for other EU members that legal mechanisms of confiscation are possible by passing a law to provide for the transfer of public and private assets linked to Russia's war to Ukraine according to specified criteria and procedures (i.e. sanctions must be in place, and Ukraine must make a request for compensation as well as document the damages to be compensated). However, since there are no known Russian state assets in Estonia, the example will only be set for private assets, and the legal principle applying to sovereign ones will only exist in theory for now (Sandbu 2024b).

There is also the objection that confiscating frozen Russian assets will damage the international role of the euro and US dollar, but this has also been refuted (Kuzhdin and Sulzhyk 2023). If the supposed negative effect of seizing Russian assets on other countries' willingness to deposit funds in the US and Europe were real, they argue, it would have become apparent when these funds were frozen in early 2022. What's more, there has not been any capital flight from the US or Europe, as heightened political risk is now largely priced into the asset allocations of banks around the world (Ziskina, Firestone and Nesterchuk 2024). And, of course, since Russia has already been seizing assets from G7 investors, seizing and transferring frozen Russian reserves will not affect Russia's incentives to continue this practice.

Effectively, the RCB assets are already seized in all but name, and the only thing preventing the EU from going through with the reallocation plan is a lack of political will among its biggest members due to the fear of potentially unfavourable economic ramifications. At the same time, delaying the seizure of Russian state assets until Russia agrees to pay reparations to Ukraine is unrealistic, costly and harmful to the internationally recognised rights of victims of Russia's war of aggression (ibid.).

These two options (i.e. a scaling-up of assistance by the EU and confiscating the frozen RCB assets) appear to be the most feasible solutions, but they will require strong political will on the part of the EU to be realised. As we have shown, it is in the EU's interests to do this, and the financial assistance it would provide to Ukraine can be viewed as an investment that will bring high returns to the EU.

CONCLUSIONS

As Ukraine must fight against an aggressor with a significantly larger economy, its own resources have not been sufficient to finance all of its state needs. Since the country's fiscal revenues are fully devoted to financing its defence efforts, all social and other expenditures must be financed through external aid. While running budget deficits of more than 20% of GDP, the country has become strongly dependent on external financial aid.

Ukraine's needs in terms of external financial support are even bigger if one considers reconstruction costs, which are likely to exceed USD 500bn over a 10-year period – almost three times higher than the country's GDP in 2023. Rebuilding the country will be an enormous task requiring the mobilisation of significant resources, and some part of it will need to be conducted already during wartime to prevent further outflows of its population, to deal with the highly uneven regional impacts of the war, and to maximise future economic prosperity. Efforts to rebuild energy infrastructure, in particular, need to be launched immediately and sustained.

External aid has recently been delivered with significant delays and in amounts that do not fully cover the fiscal financing gap. As a result, the country has had to prioritise defence expenditures at the cost of social-, health- and education-related expenditures, the share of which in GDP has been shrinking. If continued, this trend will have long-term negative effects on human capital and exacerbate the country's existing demographic problems.

Moreover, as most of the financial aid to Ukraine has been in the form of loans, its public debt has soared and become unsustainable. Macro-financial imbalances have been increasing, which can create issues for the country's sustainable recovery.

Covering Ukraine's financing gap in the next several years is a pressing issue, as without sufficient external funding, Ukraine will not be able to withstand Russia's military aggression and prevent even bigger damage to its economy. Front-loading macro-financial and reconstruction assistance – primarily via grants – will allow Ukraine to accelerate its economic growth trajectory as well as greatly improve the security situation of the EU.

Military aid has been also inadequate. Dwindling ammunition stocks and insufficient air defence capabilities against Russian missile attacks pose a grave threat to Ukraine's very existence. The US, which has accounted for more than half of the value of these commitments, has been critical for preventing Ukraine's military defeat, but it has also been reluctant to give Ukraine the weapons (or permission to use the weapons on Russian territory) that would allow it a chance to win. The main justifications for taking this approach are the fear of escalation by Russia after crossing some 'red lines' as well as the fear of chaos and instability in Russia should it lose the war, both of which have been shown to be unjustified by many experts. Keeping Ukraine in the fight without allowing it to win is not only morally problematic, but also a very expensive strategy for Ukraine (which is losing much more than just financial resources) and for its external supporters. As the country also has a much smaller population than Russia, it will inevitably lose in a protracted war of attrition.

As uncertainty regarding the reliability of US assistance has greatly increased, the EU needs to expand its role as the main donor of financial aid (as well as of military aid over time once the EU's defence sector has been sufficiently expanded). There should still be significant potential for the EU to scale up aid to Ukraine, as the amount of aid that the EU and its member states have collectively provided to Ukraine to date pales in comparison to the amounts dedicated in response to other major crises in the recent past.

The assets of the Russian Central Bank that have been frozen by Ukraine's Western allies, which amount to approximately USD 300bn, should finally be made available to Ukraine. Since this solution will not require using money from EU taxpayers, it is more likely to receive voters' support. There have been numerous studies showing that confiscating frozen Russian assets, although legally complicated, is feasible and does not pose risks to the global financial system. Effectively, the assets are already seized in all but name, and the only thing preventing the EU from going through with its reallocation plan is the lack of political will due to the fear of potentially unfavourable economic ramifications. Not confiscating assets is a policy choice in itself – and with consequences potentially just as profound.

A more prosperous Ukraine will have a better chance to finalise the EU accession process, and the EU in turn can benefit from an opportunity to integrate Ukraine into EU supply chains so as to support the EU's digital and energy transitions. Ukraine can offer EU companies a potentially big consumer market as well as access to high- and medium-skilled labour. Its accession will especially benefit those EU members neighbouring Ukraine – through increased trade, energy supplies (traditional and renewable), and stability and security on the border. There will also be major spill-overs from the reconstruction process, as there will be huge demand for expertise, materials and workers from neighbouring countries. Additionally, Ukraine's comparative advantages in IT, defence, green energy and agri-food sector can significantly contribute to improving various aspects of the EU's security, such as military, cyber, food and energy ones, which will be increasingly more important as the focus of US foreign policy 'pivots' to the Pacific region.

Conversely, Ukraine's defeat would likely result in far higher social, political and economic costs to Europe in the form of huge refugee flows, greater security risks and greatly increased defence spending to counter the threat of Russian aggression. Thus, Ukraine's loss of the war would be detrimental for Europe, whereas Ukraine's victory – in whatever form it comes – and European integration would be a win-win situation. It is a 'now-or-never' moment for providing substantial – and, most importantly, sufficient – support to Ukraine.

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Postanschrift: A 1060 Wien, Rahlgasse 3, Tel: [+431] 533 66 10, Telefax: [+431] 533 66 10 50
Internet Homepage: www.wiiw.ac.at

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