RUSSIA'S WAR AGAINST UKRAINE AND ITS IMPACT FOR CENTRAL & EASTERN EUROPE

Implications for investors as the war continues

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Issues & Sectors	**Russia's War on Ukraine, Geopolitics, Energy Dependence, Political Stability, Economic & Investment Risks**
Stakeholders	**Bulgaria, Czech Republic, Croatia, Estonia, Hungary, Lithuania, Latvia, Moldova, Poland, Romania, Slovakia, Slovenia, EU, Russia, Ukraine**

Central & Eastern Europe is the most impacted region of Russia's war on Ukraine. CEE countries have been among the primary targets of Russian geopolitical efforts, with Russia's war consequently elevating concerns around security and political stability. The war is also heavily impacting CEE economies, with a significant regional economic downturn looming over the region, while the EU's mission to rid itself of dependence on Russian energy is even more pressing for CEE markets.

Despite the challenges unleashed by the war, however, the region's underlying stability and progress means CEE remains both open for business and a safe destination for investors. Multinational companies in all sectors have committed further to the region and local business communities are remaining resilient.

Below, Aretera provides an introduction into the political, economic and social challenges facing key CEE markets as Russia's war against Ukraine continues.

This memo will cover:

REGIONAL OVERVIEW

Due to their geographic proximity and economic interdependence, all CEE countries have been profoundly impacted by the political, economic and business fallout that has followed Russia's invasion of Ukraine. Risks looming over Central and Eastern Europe and challenges brought by the war include:

Geopolitical risks: Central & Eastern Europe is the most exposed region to the war, particularly if the conflict further escalates and expands beyond Ukraine's and Russia's borders. After Central Asia[1] and the South Caucasus, the region is also the main target sphere of influence for Moscow's geopolitical ambitions. While every EU member state in CEE condemned Russia for the invasion, Poland, Romania and the Baltic states – Estonia, Latvia and Lithuania – are the most exposed when it comes to security risks, given their strategic positions on NATO's eastern flank.

Economic risks: Russia's war is profoundly impacting the economic trajectory of all CEE markets. All CEE countries were already facing a downward growth trajectory, rapidly increasing inflation, currency volatility (in case of the non-Eurozone countries), supply chain disruptions and rising prices, particularly in the energy sector. An escalation of the war could also push the economies of the region into recession.

Sanctions risks: The European Union has implemented five sanctions packages to respond to Russian aggression against Ukraine, including not only individual and political but economic and financial restrictions. Under the planned sixth sanctions package, the EU now plans to phase out Russian oil completely, as well as to overall cut dependence on Russian energy. A potential sanctions escalation could profoundly impact the outlook of CEE economies, most of which are heavily dependent on Russian energy imports of oil and gas.

Political risks: The question of how to handle Russia's aggressive actions and meaningfully support Ukraine at the same time (while staying out of the conflict militarily) has caused severe political debates across the European bloc. While countries such as Poland are united when it comes to supporting Kyiv even with military weapons, other states in the region, including Hungary and Bulgaria, are more reluctant to do so. Consequently, the war has the potential to trigger political instability in CEE countries where the handling of the situation is provoking disagreement and conflict within coalition governments.

Investment risks. Russia's actions initially dealt a massive blow to the investment potential of the CEE region, as many feared a subsequent downgrading of its economic prospects, particularly if the conflict were to spiral out of control and beyond the Russian and Ukrainian borders. While the latter has not happened, the worsening economic trajectory and the geographic proximity of the conflict could be a discouraging factor for international businesses.

A humanitarian crisis: More than five million Ukrainians have arrived in or transited through neighbouring CEE countries, constituting an unprecedented refugee crisis in Poland, Hungary, Slovakia, Romania and Moldova. All CEE member states, as well as their population and businesses, have committed to supporting Ukrainian refugees, bringing huge financial challenges and labour market reorganization.

In the following section, Aretera summarizes the political, economic and social challenges facing a selected number of CEE EU member states, as well as Moldova.

[1] See here for our overview of the impacts of Russia's war on Ukraine on Central Asia

ECONOMIC FORECAST FOR SELECTED CEE MARKETS (2022-2023)

Country	GDP Growth (2022)	GDP growth (2023)	Inflation (2022)	Inflation (2023)
Bulgaria	3.2	4.5	11	3.3
Croatia	2.7	4	5.9	2.7
Czech Republic	2.3	4.2	9	2.3
Estonia	0.2	2.2	11.9	4.6
Hungary	3.7	3.6	10.3	6.4
Latvia	1	2.4	10	3.9
Lithuania	1.8	2.6	13.3	4.3
Moldova	0.3	2	21.9	6.5
Poland	3.7	2.9	8.9	10.3
Romania	2.2	3.4	9.3	4
Slovakia	2.6	5	8.4	4.1
Slovenia	3.7	3	6.7	5.1

(Source: IMF World Economic Outlook Spring 2022, Figures in %)

POLAND & THE BALTIC STATES

Poland and the three Baltic states – Estonia, Latvia and Lithuania – have been among the strongest supporters of Ukraine's independence and territorial integrity in Europe ever since Russia annexed Crimea in 2014. By far, Poland and the Baltic countries are the most exposed to the war in Ukraine geopolitically, but also to further potential Russian aggression, largely due to their active role in NATO's eastern flank, massive military support for Kyiv and their geographic proximity to Russia and its Baltic enclave, Kaliningrad.

The war in Ukraine will inevitably negatively impact the Polish economy, particularly through inflation, to which the country's government responded with a series of social measures. Price increases have also put a burden on the Baltic economies, with inflation in the region likely to be among the highest in Estonia, Latvia and Lithuania. Poland's trade with Russia is not overly significant for the economy.

In retaliation to Russia's actions in Ukraine, the EU is planning to completely phase out Russian oil in the short term and meaningfully decrease dependence on Russian gas in the long run. While this will be a huge challenge for CEE countries, which are generally more dependent on Russian energy than their Western European peers, Poland was planning to get rid of Russian gas well before Russia invaded Ukraine on 24 February, deciding not to renew its long-term gas contract with Russia that expires in late 2022.

Lithuania recently became the first EU country to abandon all Russian gas imports, while Estonia has decided, in principle, to do the same by the end of 2022. All four countries have been among the main supporters of EU sanctions against Russia, also pushing for more restrictive measures.

Accordingly, the loss of Russian energy means short-term economic risks, however, all four countries have been determined to reduce their dependence on Russia, primarily via Western and other energy sources.

For Poland, accommodating the huge of influx of Ukrainian refugees (the highest in the region at 2.6 million) is an additional challenge. As in most CEE EU member states, Poland has taken steps to integrate Ukrainian refugees to the domestic job market, aside from offering social support. All four countries have strong political consensus about standing behind Ukraine as it faces Russian aggression, with support for each government remaining stable.

HUNGARY

Russia's war on Ukraine has been significantly impacting Hungary, both politically and economically. Under the rule of Prime Minister Viktor Orbán, Hungary has established strong political relations with the Russian leadership in a bid to foster stronger economic ties. The war also took centre stage in the 2022 Hungarian parliamentary election campaign and the messaging of the ruling Fidesz party on the neighbouring military conflict likely contributed to Viktor Orbán's larger-than-expected electoral victory on 3 April[2].

Although trying to avoid the use of anti-Kremlin rhetoric for domestic political reasons, Hungary largely supports Ukraine, handling a massive refugee influx and offering direct humanitarian aid to Kyiv. At the same time, Hungary is one of the few EU countries not transferring arms and/or ammunition to Ukraine directly, with the government also threatening to veto the EU's oil embargo plans.

For Hungary, the main risk in relation to Russia's war is economic in nature. Hungary is the most dependent EU country on Russian gas, with the government having signed a long-term gas contract with Moscow only a few months before the invasion began. Russia's energy giant Rosatom is also the primary contractor behind the planned extension of Hungary's sole nuclear power plant at Paks, a project that is now hangs in the balance.

Despite its close relations with the Kremlin, Hungary has constantly supported EU sanctions against Russia before and after the invasion in late February. However, PM Orbán is also the most vocal opponent of the currently discussed EU oil embargo against Russia. Regulating household gas prices based on cheap Russian gas and putting price caps on fuel and essential goods has become Orbán's flagship domestic policy; this is now in jeopardy due to the war and the economic fallout. Despite this, the government is now exploring the idea of finding ways to cut dependence on Moscow.

An additional political risk for the country is the potential deterioration of ties with the EU as Hungary – just like Poland – is yet to secure post-pandemic recovery funding from Brussels and has become the first target of the EU's new rule-of-law mechanism. In theory, this could strip countries of EU funds under the bloc's 2021-2027 budget, of which Hungary is a main beneficiary. At the same time, a settlement between Brussels and Budapest, primarily due to maintain the focus on handling the war, also looks possible.

[2] See here for our overview of the Hungarian parliamentary elections held on 3 April 2022

ROMANIA, BULGARIA & MOLDOVA

Similar to the Baltic states and Poland, Romania is also among the key supporters of Ukraine as Kyiv continues to face Russian aggression. Romania's grand coalition government – led by the centre-left Social Democrats (PSD) and the centre-right Liberals (PNL) – is united when it comes to the issues of the neighbouring war, largely due to the considerable level of both geopolitical and economic risks.

Romania is a key NATO member in the Black Sea region, directly facing not only the Russian-occupied Crimea but also the risk of a conflict that could spiral into neighbouring Moldova, a country with a Romanian-speaking majority population. Fears are high that Transnistria, a Moldovan breakaway region entirely dependent on Russia, could be dragged into the war in Ukraine, which would bring huge security concerns for Romania.

The fears of an escalating war in Ukraine also prompted Moldova to formally apply for EU membership, while aiming to rid itself of Russian energy. Given Moldova is 100% dependent on Russian gas and largely dependent on Russian electricity, this poses additional risks, which Moldovan authorities aim to counter by buying electricity from Ukraine and gas from the open market. Inflation in Moldova is expected be the highest in the region, posing an additional economic challenge.

Alongside the downward economic impact and rising inflation, to which the government has responded with a €3.4 billion aid package for households and small businesses, Romania faces challenges to ensure energy security. Bucharest also relies on Russian gas, although to a significantly less extent than other CEE markets, as 80% of gas production is covered domestically.

Bulgaria's economy is similarly affected to a high extent, with the country expecting an economic slowdown – to a projected 2.6% GDP growth this year instead of a 4.8% recovery – due to the war. Rising prices of essential products and energy are among the most pressing economic issues, as is Bulgaria's almost entire dependence on Russian energy, except for coal imports.

Unlike in Romania, the war in Ukraine has the potential to negatively impact Bulgaria's political stability. In late April, the pro-Russian Bulgarian Socialist Party (BSP), a member of the country's four-party governing bloc threatened to leave the coalition if Bulgaria were to send military weapons and ammunition to Kyiv.

The country's four-party government – led by Prime Minister Kiril Petkov – has considered arming Ukraine but the Bulgarian parliament eventually decided to repair Ukrainian military equipment in Bulgarian factories. Should the BSP leave the coalition over the government's response to the war, stability issues could return to Bulgarian politics, with scenarios including a minority government, as well as snap parliamentary elections.

CZECH REPUBLIC & SLOVAKIA

The governments of the Czech Republic and Slovakia have been strongly supportive of Ukraine. Aside from accommodating a vast number of refugees, both countries have provided Kyiv with financial aid and military weapons. While the government of Czech PM Petr Fiala has so far remained united on questions related the war and its impacts, Slovakia's four-party coalition government, led by Prime Minister Eduard Heger, faces grave stability concerns. although rather related to domestic political issues.

Both Central European countries are highly dependent on Russian energy, which is the main reason why Prague and Bratislava – as well as Budapest and Sofia – are looking for temporary exemption from the EU's potential embargo on Russian oil. At the same time, both countries look determined to decrease their energy dependence on Moscow. The Czech Republic is aiming to cut Russian oil imports with assistance from Germany, while the Slovak government is considering an increase of LNG supplies. In addition to the region-wide economic implications, the Czech Republic will also face issues when it comes to the automotive industry. Škoda, the largest car manufacturer in the country, to which Russia was one of the most important markets, pulled out of the Russian market shortly after Russia's invasion began on 24 February.

CROATIA & SLOVENIA

Southeastern Europe's two EU member states – Croatia and Slovenia – are also facing a downward economic outlook with rising inflation, although both with a growth trajectory for 2022. In light of the upcoming EU strategy to decrease dependence on Russia, the two countries are widely expected to cooperate in new energy investments. Croatia is aiming to expand the capacity of its seaside LNG import terminals, while Slovenia is hopeful that Zagreb could provide gas as Ljubljana looks to terminate its Russian gas contracts.

Although Croatian President Zoran Milanović has made contradictory remarks on Ukraine, both the Croatian and Slovenian governments are supporting Kyiv, with Slovenia's incoming green-centrist coalition government – led by Robert Golob[3] – expected to maintain the same policy stance. Given the political consensus in support of Ukraine and the lower level of economic exposure, the impact of the war on the two countries, although far from negligible, remains limited, in comparison with other CEE markets.

ENERGY IMPORT DEPENDENCY IN CEE

Country	Dependency Rate	Share of Russian Gas
Bulgaria	38	76
Croatia	54	2
Czech Republic	39	100
Estonia	11	47
Hungary	57	95
Latvia	46	100
Lithuania	75	42
Moldova	76	100
Poland	43	56
Romania	28	24
Slovakia	56	85
Slovenia	46	10

(Source: Eurostat, Figures in % from 2020 or latest year available)

[3] Please see here for our overview of the Slovenian parliamentary elections held on 24 April 2022

LOOKING AHEAD AS RUSSIA'S WAR CONTINUES

With support from the West, Ukraine has continued to resist Russian occupation forces, however both the outcome and duration of the war Russia has unleashed currently both remain uncertain. Given its geographic location, Central & Eastern Europe remains the most impacted region of the war, with a number of risks looming over CEE countries.

From a CEE perspective, the overall risk is economic in nature as most regional countries are highly dependent on Russian fossil fuels. The planned oil embargo would bring significant economic impact and supply chain difficulties for a number of countries, particularly Hungary and Bulgaria.

While the stability of most regional governments is unaffected, debate around countries' reactions to the war has become a significant factor in domestic regional politics, most notably in Bulgaria, where the four-party coalition is experiencing a major challenge of unity as a result.

With CEE countries among Russia's major targets in terms of its 'sphere of influence' campaigning, the geopolitical risks are also considerable, particularly in the cases of Poland and the Baltic states, should the war endure and even escalate. An aggressive Russian state response to potential Swedish and Finnish NATO membership bids could also elevate security risks for the countries constituting NATO's eastern flank.

Despite all the challenges, however the CEE region remains relatively robust and interesting for international investors. FDI inflows into Poland hit a record high in 2021, ranking 14th in the world in terms of new investments last year. FDI into Romania, the second largest CEE market after Poland, more than doubled in 2021, with the vast majority of flagship international investments across CEE set to continue as planned. CEE governments are also actively mitigating the impacts of the crisis, with the digital, green, defence and energy sectors among their main investment priorities.

In addition to the political and social responses to the war, many multinational companies have committed further to the region, strengthening their local presence. The corporate response from international businesses in CEE has delivered major humanitarian and economic support to the countries and communities affected, strongly indicating that Central and Eastern Europe, while heavily impacted, will be continue to be viewed as an interesting and strategically important region for businesses.

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