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Policy Position

Ukraine's recovery: A huge challenge ahead

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#Ukraine
#Reconstruction
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Ukraine's post-war recovery will require concerted, long-term EU commitment, leveraging substantial private investment, Sascha Ostanina argues in this policy position.

Seventeen months on from the Russian invasion, its army continues to impose heavy losses on Ukraine. The human casualties, economic devastation and physical destruction have already reversed Ukraine's post-Soviet progress. Its fully-fledged reconstruction will take more than just a cessation of the fighting.

Ukraine and the European Union have begun developing measures to rebuild the economy and infrastructure. But these do not amount to a long-term recovery strategy. Ukraine is fighting for survival against an old, 'realist' power, while seeking to transcend Russia's sphere of influence to join the Europe of universal values. This is costing it dearly.

Ukraine will need €383 billion over ten years to recover from the damage induced only during the first year of the war. This sum—which does not account for the Nova Kakhovka dam destruction in June—amounts to nearly three times Ukraine's 2022 gross domestic product.

Last month, Ukraine presented a nationwide reconstruction roadmap. In turn, the European Commission proposed to commit €50 billion in grants and loans to Ukraine's recovery by 2027. There is a mutual understanding that, on their own, public funds will not be enough to rebuild Ukraine. Only a quarter of the reconstruction expenditure is required for sectors traditionally financed by public spending, such as public building reconstruction and demining. The private sector would need to take on the rest.

Market drawbacks

Ukraine needs a sustainable cessation of fighting to attract investment. A stable ceasefire alone is however not a sufficient condition for successful recovery. It is estimated to require €170 billion in foreign direct investment (FDI) and €325 billion in domestic private investment to implement its reconstruction projects. To attract these funds, Ukraine needs to fix above all three main market drawbacks.

A shortage of (re)insurance offers: a sustainable insurance market is a precondition for long-term reconstruction. Insurance encourages long-term planning and innovation by spreading risks over time through transfer or pooling. Ukraine's insurance market is however not fit to fulfil these functions. Even before the invasion, it lagged behind Europe's. In 2015, insurance policies covered only 10-15 per cent of risks in Ukraine, while the most developed countries have a 90-95 per cent insurance-density rate.

After Russia's 2014 annexation of Crimea, most of the 20 largest international private insurers stopped providing coverage in Ukraine. In 2022, this became complete under war-exclusion clauses. Reinsurance firms simply imposed a blanket moratorium. The United Kingdom, Germany and France are designing *ad hoc* war-insurance mechanisms but this scattered, bilateral approach cannot replace a comprehensive insurance market.

Limited access to SME financing: before 2022, Ukraine's small and medium enterprises amounted to 99.9 per cent of the business population. Despite their economic significance, Ukrainian SMEs tended however to have only a short-term horizon for planned investment, opting to finance it using domestic savings. As a result, the gap between demand for and supply of SME financing grew in 2016-21 from €9.3 to 10.3 billion, even as the EU was deliberately increasing its SME financing in Ukraine.

Russia's war has additionally depleted business savings and reduced the availability of bank loans and equity. Interest rates for corporate loans denominated in the national currency sit at around 20 per cent, in foreign currencies at 8-9 per cent.

Unstable access to the EU single market: following Russia's invasion, the EU fully liberalised trade with Ukraine until June 2024, although it subsequently reintroduced import restrictions on some grain and seeding materials. This limited opening neither supports the EU's commitment to Ukraine's reconstruction nor helps investors plan for the long haul. It also contradicts studies demonstrating that a country's accession to the single market has the second largest positive impact on FDI inflows—only EU membership surpasses that, with a 60 per cent increase in investment.

Long-term strategy

The €50 billion Ukraine facility proposed by the commission has three planks: support Ukraine's financial sustainability, incentivise investment and provide technical assistance. It signals an important shift from short-term, emergency relief to a medium-term recovery framework. It will not however suffice to guarantee stable recovery. To shift to a long-term strategy, the EU should ramp up its assistance mechanisms for Ukraine's insurance market, SME financing and access to the single market.

Insurance mechanisms: the European Bank for Regional Development and the commission, among others, last month agreed to 'explore the possibility' of a Ukraine Recovery Guarantee Facility. If it goes ahead, this would facilitate access to war-risk corporate insurance, with an initial focus on trade and international shipping.

In the next 15 years, four-fifths of Ukraine's €500 billion foreign and domestic investment will require insurance. EU-supported insurance mechanisms should thus expand beyond protecting trade in wartime. Two types of (re)insurance mechanism should be introduced: for flagship projects in the economically prioritised sectors and 'pocket-sized' policies for SMEs. An insurance facility for Ukraine should also cover, in addition to war, the risks of political violence.

SME financing mechanisms: the EU needs to ensure Ukraine's recovery plan prioritises SMEs. Tailored supports need to focus on enhancing the availability of funds for those industries contributing the highest value to national output: retail and services (including logistics), industry and agriculture.

Medium- and long-term assistance should be clearly geared towards the eastern-Ukraine regions, which have suffered the greatest war damage and will require the largest investment incentives. The EU should design an adjustment mechanism for any Ukraine facility to revise its allocations at any given time in 2024-27.

Access to the single market: Ukraine cannot be expected to turn into an investment magnet without guaranteed full access to the single market. The EU should suspend all barriers to Ukraine's exports for the long term. The next step could be accepting Ukraine into the European Free Trade Association. This is no substitute for EU membership but would represent a tool for Ukraine to attract investment, while progressing along its EU-accession path.

Unimaginable sacrifices

Since February 2022, Ukraine's war losses have cancelled out decades of progress. Its recovery will 'take a village' of international actors to step in and assist. By 'outsourcing' security risks from Russia beyond its borders, the EU had reaped peace dividends and enjoyed significantly reduced defence spending—but those times have passed.

Ukraine is now making unimaginable human and economic sacrifices in its commitment to Europe. Helping the country fully to recover and become an EU member state will serve as a geostrategic investment in the sustainable security and economic performance of the continent.

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