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NEWSLETTER

German Economic Team

UKRAINE

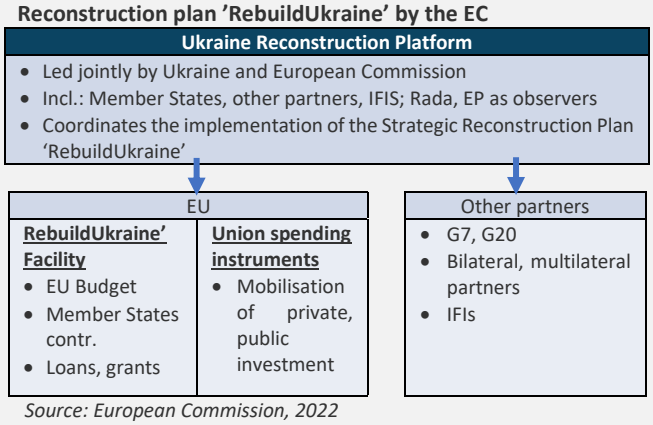
How to implement a green reconstruction for Ukraine

While Russia's full-scale war continues to rage, preparations for the post-war reconstruction are getting underway. Following the recovery conference in Lugano, plans for the overall reconstruction process need to be aligned in the ongoing process. Currently, the Ukrainian government's vision is more central and top-down, whereas international partner prefer multilateral, decentralised approaches. While the importance of green reconstruction is universally acknowledged, implementation will require two main factors: firstly, redoubling reform efforts in the energy sphere to ensure that investments will flow into modern technologies and not be distorted by pre-existing flawed policies and regulations. Secondly, the commitment to provide the financing for green technologies that are generally more expensive up-front compared to dirty technologies, but will deliver huge efficiency gains through their life-cycle.

Plans on reconstruction are not yet aligned

Preparations for the post-war reconstruction of Ukraine have gotten underway even though the Russian war in Ukraine still rages. At the recent Ukraine "Recovery Conference" in Lugano, the Ukrainian government presented its own proposal for the reconstruction. It estimated a total investment need of USD 750 bn, to be spent under 15 sectoral programmes. Out of this, the immediate needs, are classified in the amount of USD 60-65 bn. The remainder of the sum would be spent on a combination of reconstruction with a comprehensive modernisation agenda in a ten-year framework. However, the Lugano conference was only the beginning of the process of aligning the concepts and plans for reconstruction between the Ukrainian government and its international partners. Currently, some differences are clearly visible: whereas the Ukrainian government proposes a very centralised approach, the European Commission's (EC) proposal emphasises joint Ukrainian and EU political leadership.

Reconstruction plan 'RebuildUkraine' by the EC



Source: European Commission, 2022

This approach supports a much more decentralised implementation including a coordination and monitoring body of financial spending as well as aligning of Ukraine`s economy to EU standards.

Agreement on need for green reconstruction

An uncontroversial element of the Ukrainian plan, however, is the need for a green recovery, to "build back better": It will not be sufficient to recreate the pre-war asset and infrastructural base to secure a sustainable future to Ukraine's economy, but rebuilt assets need to incorporate modern technologies, be efficient and largely emissions-free.

The "Low Carbon Ukraine" (LCU) project by Berlin Economics, financed by the German Federal Ministry of Environment, Nature Conservation, Nuclear Safety and Consumer Protection, has been advising intensively on the why and how of green reconstruction. In a first piece, the project argued that green reconstruction is not a well-intended luxury feature, but indeed economically vital for Ukraine. The country faces rising and volatile global fossile fuel prices, security of supply issues, policy pressure from international partners and due to EU candidate states and the emergence of exterritorial CO_2 pricing schemes as EU-CBAM. Reconstructiong dirty, fossil-fueled assets would risk these becoming economically unviable "stranded assets" only a short while into their economic lifespan.

Considerations for implementing green reconstruction

In order to address the challenge of getting green reconstruction implemented in the plans under construction, a workshop was organised together with the NGOs Ecoaction and CEE Bankwatch. The idea was to discuss what green reconstruction means in individual sectors – what new technologies should and replace old, dirty technologies – and what policy and organisational challenges need to be overcome. In the workshop, attended by over 60 invited experts, the following main topics emerged:

- **Implementing green reconstruction requires a combination of programme design and policy**. To ensure that decentralised decision-making is guided towards green reconstruction, existing obstacles to green investment such as highly regulated wholesale market prices in the electricity sector need to be eliminated. The reconstruction programme itself must be designed to favour long-term efficiency over initial investment costs to encourage investment in green technologies. Coordination challenges between sectors, such as the electrification of the economy will require a strategic policy approach.

- **A strategic decision is needed whether to make Ukraine a showcase for frontier technologies.** Many of the technologies needed for a truly green reconstruction are already widely in use and commercially efficient. But some technologies such as green steel production or heat pumps are still in earlier stages of deployment. While a reconstruction using some of these frontier green technologies would be comparatively costly, reconstructing with old technology would risk creating stranded assets in future. International donors need to form a view on whether the higher upfront costs should be accepted. This could turn Ukraine into a showcase for new, green industrial and other technologies, including sector coupling and coordination e.g. due to faster electrification and large-scale use of green hydrogen.
- **Affordable financing is vital for green reconstruction**. The costs of capital were already high in Ukraine before the war. Without affordable financing, the higher capital costs of green investments cannot be outweighed by lower operational costs. International donors and IFIs will need to play a vital role and their concerns must be taken seriously in designing the institutional framework of reconstruction.
- **Efficient administration of green reconstruction projects is necessary**. Replacing old, dirty and inefficient assets which are damaged or destroyed by the war with newer and clean technologies will generally require more sophisticated planning and construction processes that can otherwise lead to a lower speed of implementation. To avoid stalling or impeding the green reconstruction, effective and fast project management and implementation processes are needed.
- **Governance practices and a continuation of reforms are required to attract financing**. Ukraine's international partners declared their willingness to substantially assist Ukraine's post-war reconstruction. Still, Ukraine will need to provide the conditions to allow this investment to take place. Most notably, the actual reconstruction programme vehicles need to reflect international best practice in governance. Anti-corruption, rule of law efforts (i.e. judicial reforms), and other reforms, many of which were not showing much progress in the period preceding the war, need to be restarted with redoubled effort and can be linked to the path of EU accession.
- **Bailing in international private investment will require political risk insurance.** Private investors will be very cautious in a post-war situation, with security concerns likely not fully resolved. But they could complement and enhance the financing provided by countries and international financial institutions and improve productivity through joint ventures or more competition on previously monopolistic markets. The availability of investment insurance, covering relevant risk categories such as military risk, will be a necessary precondition to attract any such investment. As it would reduce the need for public financial assistance, the provision of investment insurance should be a win-win for international partners.

Outlook

Green reconstruction will be a key ingredient in the envisioned post-war modernisation of the Ukrainian economy and its path to EU membership. The opposite of an expensive luxury, it would ensure that Ukraine has a cost-efficient asset base that can deliver competitive outputs and exports in a world characterised by high and volatile fossil fuel prices as well as internationally binding schemes to price carbon emissions. To effect this reconstruction, policy refoms must be restarted in the energy and climate dimension and the above considerations should be built into the reconstruction institutions from the outset.

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**Advisory activities in Belarus are currently suspended.*