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NEWSLETTER

German Economic Team

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War in Ukraine impacts countries in the region very differently

Since the beginning of the Russian invasion of Ukraine, the German Economic Team has been analysing the economic consequences for the countries in the region. Three channels of impact in particular have been identified: rising energy prices, the weakening of the Russian economy and significant migration movements from Ukraine, but also from Russia. An analysis of the impact of these three shocks on Moldova, Georgia and Armenia shows that the economic consequences for these countries differ greatly: while Moldova is particularly negatively affected, the negative impacts on Georgia and Armenia are rather small. On the contrary, Armenia and especially Georgia benefit from the influx of skilled workers from Russia; moreover, Armenia's exports to Russia have increased significantly - despite a weakening of the Russian economy.

Three shocks in the context of the war

The Russian invasion of Ukraine and the subsequent economic sanctions against Russia have far-reaching implications for the entire CIS region. In this newsletter, we focus on the implications for Moldova, Georgia, and Armenia. All three countries continue to have close economic ties with Russia; so the war and sanctions could potentially have a strong negative impact. In various studies, we have identified and analysed three shocks: 1) an increase in energy prices, 2) a general weakening of the Russian economy and 3) migration movements. However, the impacts of these three shocks are not symmetric, but differ significantly per country. After a more detailed description of the individual shocks, these are examined in more detail below.

Increased energy prices

The global rise in energy prices, which already began in mid-2021, was significantly exacerbated with the start of the war in Ukraine. Since the average energy consumption of private households, but also of companies, is comparatively high in the CIS region (due to a lack of energy efficiency, among other things), a price increase poses significant risks. First and foremost, this has a negative impact on consumer spending, as a higher proportion of income is spent on energy. In addition, government support measures are often needed to mitigate the shock of higher energy prices; this eats into public finances and allows less government spending in other areas such as infrastructure and education. However, some countries have long-term gas contracts at fixed prices. Moreover, the price of Russian oil ("Urals") has risen much less than Brent and is now even lower than before the war. Thus, countries that import only Urals, would not face a negative shock at this point.

Weakened Russian economy

The costs of the war in Ukraine and the international sanctions against Russia are a significant burden on the Russian economy. The real GDP decline in 2022 could be up to 6%. Russia is an important trading partner for the region. The economic crisis is reducing incomes in Russia, which could lead to a decline in imports. In addition, Georgia and Armenia face the risk of declining tourism revenues from Russia, which in turn is linked to the declining income of the Russian population. On the other hand, exports from Western countries to Russia have fallen significantly. Besides payment difficulties, sanctions and reputational risks play a role here. The resulting gap could in some cases be filled with exports from the CIS states.

Migration

Due to the war, more than 6 million people (net) have left Ukraine, some of whom have fled to countries in the region. Providing basic necessities for and supporting the refugees has resulted in higher government spending and thus an increase in the deficit and debt. However, other migration movements are also taking place in the context of the war. Many people from Russia and Belarus have also left their home countries. In most cases, these are highly qualified, young professionals with high incomes. The influx of these people could have a positive effect on consumer demand, so that a positive shock is also conceivable.

Moldova: negative impact of all three shocks

Moldova was already in a very unfavourable position before the start of the war due to its high dependence on Russian gas for the generation of both heat and electricity. Since October 2021, the country has a new supply contract with Russia, which is based on international gas prices. This caused a significant increase of gas import costs. As a result, the gas consumption of private households had to be subsidised during the heating period, which placed a heavy burden on the national budget. Furthermore, exports of goods to Russia pose major logistical challenges. Although the overall decline has so far been smaller than expected, it is quite significant for individual products such as apples and medicines. As a direct neighbour of Ukraine, Moldova has taken in a large number of refugees, some of them in transit to Western Europe. In total, more than 500,000 refugees came to Moldova, a country with a population of about 2.6 million. Currently, there are about 75,000 refugees in the country.

Moldova has thus been hit hard by all three shocks. The country is experiencing stagflation with a rapid increase in inflation (Aug-22: 34.3%) and an expected real GDP decline of 0.4%. The fiscal situation is difficult, with energy subsidies and refugee-related spending weighing on the budget.

Georgia: positive shocks predominate

The situation in Georgia is quite different. Gas is purchased from Azerbaijan under a long-term contract, so the negative impact is small. A challenge are the higher oil prices (additional expenditures of approx. 2.1% of GDP). After initial difficulties, exports of goods to Russia have so far proved stable. In particular, important export goods such as wine have remained at the level of 2021 after adjustment difficulties in the first months of the war. The number of refugees from Ukraine have remained relatively limited. Instead, the country has seen the influx of around 45,000 skilled workers from Russia and Belarus (as of end-May). Most of them are well educated and have high incomes, so that they represent a positive shock to the Georgian economy of 1.8% of GDP through higher consumer spending. As a result, real GDP growth forecasts have been revised upwards to 9% at present. The strong appreciation of the lari is also due to the immigration and the accompanying inflow of money. Inflation is high, but so far under control, partly thanks to stable gas prices. The war has had no impact on the Georgian budget. Overall, in the case of Georgia, one can therefore speak of positive shocks due to the war in Ukraine.

Armenia: positive impacts of the shocks

Due to its close economic ties, Armenia has a high overall exposure to Russia. Nevertheless - or precisely because of this - the individual shocks have had a largely positive effect so far.

Until now, the country has hardly been affected by the global rise in energy prices. For one, the country has long-term supply contracts for gas. In addition, Armenia buys the relatively cheap Urals oil. Exports to Russia have also developed very positively so far – contrary to initial expectations (7M2022: +70%). Besides high commodity prices and the substitution of Western exports to Russia, re-exports (e.g. cars) also play an important role. Armenia also benefits from an influx of about 24,000 skilled workers from Russia (as of end-May), which is reflected in additional consumer demand amounting to about 1.2% of GDP. Tourism from Russia has also increased significantly. The GDP forecasts have already been adjusted several times: after an initial negative correction, the figures have been revised upwards several times. While the recent conflict with Azerbaijan may have a negative impact, double-digit growth could still be feasible. The budget deficit for 2022 is expected at 2.1% of GDP, as the good economic situation allows for budget consolidation.

Conclusion and outlook

The comparison between Moldova, Georgia and Armenia shows that the regional impact of the war in Ukraine differs strongly by country. While Moldova has been negatively affected by high energy prices, the weakened Russian economy and migratory movements, similar effects are hardly felt by Georgia and Armenia. On the contrary, both countries benefit from the substitution of Western exports to Russia and especially the influx of highly skilled workers with high incomes. This results in a very difficult economic situation for Moldova, while the impact is rather positive for Georgia and even clearly positive for Armenia.

This newsletter is based on the Policy Study: Economic outlook in Moldova, Georgia and Armenia in the context of the war in Ukraine: regional comparison

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