How are European SMEs impacted by the Russian invasion of Ukraine?

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Cover picture from the EU 4 Ukraine campaign 'Moving forward together'

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Executive summary

The Russian invasion of Ukraine is a tragic humanitarian crisis affecting millions of men, women and children. Politically it has sent shockwaves into the geopolitical scene while its economic consequences are also considerable and affect Europe's businesses through a number of channels, directly as well as indirectly.

Trade between the European Union and the Russian Federation has been strongly affected by the outbreak of war, reflecting the logistical and other practical implications it has had on economic activity, as well as the economic sanctions that the EU has imposed on Russia in response, and the Russian countermeasures.

Sanctions have been imposed on many types of goods, from energy sources such as coal and oil to raw materials such as steel, wood and iron, to technologies e.g. quantum and inputs for the space industry, as well as many types of machinery and transportation equipment, to luxury goods such as cars and accessories. The European airspace has been closed to Russian operators and ports closed except for shipment of specific goods such as agriculture and energy. A number of large Russian banks have been cut off from the global SWIFT payment system and European companies prohibited from making payments in rubles. A large number of persons including prominent Russian businessmen have been sanctioned. As a consequence, European companies must take care to scrutinize ownership structures and business relationships so as to not conduct business with companies owned by individuals who are subject to sanctions. The public perception has prompted many Western companies to exit the Russian market, and practical difficulties concerning regulation, travel and making payments have complicated trade relations considerably. Insurance e.g. for shipping in Russian waters has become considerably more expensive or impossible to obtain due to higher risk premiums. In turn Russia has mined seaports in the Black Sea, closed its airspace to European carriers, and imposed bans on exports of a number of commodities to the EU.

The EU's trade with Russia has dropped massively in recent months. Before the war, Russia was the EU's fifth largest trading partner, accounting for 89.3 bn euro exports and 158.5 bn euro imports in 2021[1]. In May 2022, exports in goods to Russia were 47% lower than a year ago in May 2021. On the import side total EU imports from Russia in April were 45% higher than in May2021 when measured in values amidst skyrocketing commodity prices, but 18% down when measured in volumes. Meanwhile EU trade with Ukraine has also nosedived as a result of the war.

Investments between Russia and the EU Member States are also negatively affected. Not only has it become difficult on practical grounds to prepare and carry out investments, the heightened uncertainty about political and economic developments both in Russia and Ukraine and in the global economy more widely puts a damper on investments and reverberates through the European and world economy. Moreover, the war has led to massive drops in economic activity, which often causes investments in the affected countries to be less profitable than investing into high-growth markets. Russian GDP is expected to fall by more than one-tenth this year, and Ukrainian GDP may shrink by almost half.

The *direct* economic damage caused by the war will be significant for Europe's SMEs. European businesses will by all accounts be more adversely affected than companies in other large economies due to their higher exposure to the Russian market, which is geographically close, has been a major supplier in particular of energy and has been an important market for many European SMEs.

The *indirect* consequences of the war may well prove to be more significant for European SMEs, however.

Ukraine and Russia are key suppliers of a number of commodities that are necessary for a modern economy to function. To illustrate, they account for a total of around one-seventh of global wheat production and roughly a tenth of global production of nickel and platinum, which have important applications in industrial production. Ukraine produces around half of the world's neon, an input needed inter alia in the production of microchips, so the Russian invasion has further exacerbated the global shortage of microchips.

The war has had destructive effects on Ukrainian production and caused widespread damage and logistical disruptions, which alongside economic sanctions and countersanctions have upended supply chains, already in disarray as a result of the far-reaching effects of the COVID-19 pandemic, and led to shortages of materials and significant price hikes in a number of commodities. A record 51% of European companies reported access to materials as a constraint on their production in the first quarter of 2022, up from around one in ten before the pandemic, and almost double the proportion of companies that indicate that access to labour is a production constraint. Waiting times for many production inputs have increased. As a result of Russia's actions the price of wheat has increased by around 60%, giving rise to concerns over famine and impoverishment in low-income countries. The price of energy has skyrocketed with coal prices up around 70% and oil up around 30%. Key raw materials used in industrial production have also become more costly for European producers with nickel prices for instance up more than 45%, and palladium prices up by roughly one-sixth. Construction materials such as steel and wood have also become more expensive and waiting times have increased. One measure, the Global Supply Chain Pressures Index, suggests that current levels of supply chain pressures are still at very high levels, roughly on par with what we witnessed during the lockdowns at the height of the pandemic.

The immediate implication is cost increases throughout the European economy, including higher construction costs, energy consumption costs and various production costs. While initially affecting certain sectors in particular, such as manufacturing through higher raw material prices, transportation

[1] Eurostat (2022) Energy represented 62% of EU imports from Russia - Products Eurostat News - Eurostat (europa.eu)

through higher fuel prices, and construction through higher prices for materials, the effects are transmitted downstream throughout value chains, leading to rising expenses for businesses as well as households.

There is a clear risk that these developments will be disproportionately harmful for SMEs, that often lack the resources and global reach to seek out alternative suppliers and diversify their inputs in response to higher prices and longer waiting times. Moreover, as higher costs are passed on throughout value chains SMEs may in many instances find that they have less bargaining power than larger companies meaning they will end up bearing a larger part of the burden of higher input prices.

In response the consumer mood has soured with the consumer confidence index dropping to levels comparable to what was seen during the pandemic lockdowns, and business sentiment is also sharply deteriorating. This puts downward pressure on spending, which will harm companies across sectors and means that SMEs must brace themselves for experiencing strong economic tailwinds.

As a result of these adverse developments, while still growing, the European economy is decelerating. In May the European Commission revised its EU27 growth forecast for 2022 down from 4.0% to 2.7%, and its inflation forecast upwards from 3.9% to 6.8%, with the July interim forecast supporting the growth projection but revising inflation expectations further up to 8.3% for 2022. The war came at a time where the world economy was already at a dangerous precipice with very high inflationary pressures that central banks needed to take decisive steps to counter. By having caused prices to rise even further as a result of supply link breakages and heightened economic uncertainty, and by negatively affecting trade and investments, the outbreak of war has exacerbated the economic situation in the world and for European economy.

While the economic ramifications are felt throughout the EU, some Member States and some sectors are more exposed than others. At country level a number of Eastern European countries, in particular the Baltic states, as well as Germany, have deeper trade links with Russia. At sectoral level the impact varies considerably. At aggregate level, production output in retail, construction and manufacturing have been suppressed, whilst economic activity in the service sector is still showing high growth rates. This divergence reflects the fact that service industries tend to consume less energy and raw materials and are also typically more oriented towards domestic sales rather than exports. Manufacturing and construction in contrast tend to consume larger quantities of raw materials as well as energy, and are hence more directly affected by the economic backlash resulting from the invasion of Ukraine. The European tourism sector will feel the loss of income from Russian tourists, and will also suffer from higher fuel prices translating into less willingness to book flights or go on longer car rides to holiday destinations. The transportation sector is similarly deeply affected by higher fuel prices, and in the case of shipping and airlines also more directly by the sanctions that, among other things, have led to Russia and the EU closing their airspaces to each other.

Adding to the economic turmoil, around 1.4 million Ukrainian citizens were residing inside the EU prior to the outbreak of war. Many have returned home to join their armed forces. This has increased labour shortages in industries such as truck transportation and construction.

While all businesses will be affected by a darkening economic outlook, Europe’s SMEs are likely to feel the effect more strongly than larger companies that often have higher overseas export intensity. Europe’s SMEs tend to be more dependent on the domestic European market which is likely to be more severely affected by the economic fallout from the Russian invasion, due to its close proximity.

The direct exposure of European banks to the Russian market is low, although specific large banks in some Member States have larger exposure. Regardless, there are early indications that banks have begun tightening financial conditions in the face of heightened uncertainty, as well as in anticipation of the ECB adopting a less accommodative monetary policy stance in order to curb inflation. A net 12% of Euro Area banks tightened their margins on riskier loans in the first quarter of 2022, followed by a net 16% tightening in the second quarter. Looking ahead, in the third quarter of 2022, a net 18% of banks in the Euro Area expect to tighten credit standards for loans to firms. We know from previous experience that SMEs often find it harder to obtain credit or loans than their larger competitors. It is also harder for them to access alternative sources of funding e.g. corporate bond issuance and non-bank intermediaries, so the prospect of credit tightening will add to the troubled outlook SMEs in Europe are increasingly facing.

In response, policy-makers should take steps to improve the competitiveness and economic vitality of Europe's millions of SMEs. We must appreciate that the tumultuous situation calls for permanent adjustments, as companies that have lost access to export markets or import-side suppliers in Russia must seek alternatives and establish new supply chain links.

The policy response to date includes measures such as the temporary state aid framework, or public procurement practices that accept reasonable force majeure claims from contractors affected by longer waiting times for materials or due to other effects of the war. These types of measures can help cushion the worst blow.

However, the breathing room awarded by such temporary measures must be used well. Emphasis needs to be laid on permanent improvements for SMEs operating in the Single Market or trading abroad. This will require a number of initiatives.

We should cultivate new markets for imports and export destinations for our SMEs to offset the loss stemming from the Russian invasion of Ukraine. Trade promotion activities e.g. through diplomatic representations and overseas offices of European business federations to support SMEs have an important role to play, as do support services such as the Enterprise Europe Network. Trade promotion and support activities have traditionally focused on helping exports, but we must also pay close attention to imports to help SMEs reorganize their supply chains and find alternative sources of imports.

We should also strive to ensure good economic conditions conducive to growth within the EU Single Market, so that greater intra-EU trade can provide an alternative for SMEs to exporting to the Russian market. Removing remaining barriers across the Single Market must remain a key priority. Administrative burdens must be reduced, and providing clear instructions and guidance for SMEs must be seen as a priority. Harmonizing implementation, preventing gold-plating and adhering to the EU Better Regulation guidelines are also important priorities. The SME-filter must be implemented in a strong manner, and public procurement must remain open to SME participation.

Many SMEs find it difficult to navigate the sanctions which are often seen as complex and difficult to understand. It is important to put efforts into providing guidance for SMEs. One-stop-shops for sanctions-related questions could be envisaged, and provision of even more guidance in consolidated versions of sanctions documents, and dedicated training, could be helpful to advise and support SMEs.

Europe is and will always be dependent on imports of a wide range of raw materials and manufactured products. Maintaining and deepening trade relationships will be central to ensuring our security of supply and our economic prosperity. It is therefore imperative we continue to deepen trade links with allies, partners and reliable suppliers, both through free trade agreements and comprehensive arrangements such as the Trade and Technology Council (TTC) with the United States. Decision-makers should also be mindful that significant gains can be reaped if European SMEs and large companies were able to better utilize the opportunities already available through our existing free trade agreements.

Many companies, not least SME's, have become more wary of geopolitical risk and are now looking to diversify, reshore or otherwise rearrange supply linkages to reduce their exposure. As SMEs tend to have less global outreach and fewer resources available for monitoring and providing strategic foresight compared to larger companies, it would be worth considering, among other initiatives, a common typology and approach for the criticality of various import products to provide analytical clarity and predictability so as to help SMEs navigate in a context of growing geopolitical risk.

At political level many decisionmakers are similarly considering the implications of fast-changing economic and geopolitical realities. We should continue to spearhead initiatives that will increase Europe's competitiveness and comparative advantages, finding appropriate solutions to boosting our productive capacity and technological knowhow including in the high-growth industries of the future.

The public sector can play an important role by ensuring that public contracts affected by the development in relation to the Russian invasion of Ukraine are handled with fairness and reasonable flexibility when SMEs through no fault of their own find themselves unable to fulfil e.g. strict project deadlines.

We must also not forget the well-tested policy levers to help businesses and strengthen our economy, such as addressing skills mismatches and ensuring upskilling so that we can boost labour productivity and ensure SMEs have access to the desired specialist or non-specialist workers.

1. The economic consequences of the war

The Russian belligerence has had significant ramifications for Europe's millions of SMEs.

Trade has dropped massively as a consequence of the war, and as a result of the sanctions that have been imposed against Russia and Belarus in response, as well as countermeasures taken by Russia against "unfriendly states".

Overseas shipment of grain from Ukrainian ports has been impossible, and the effectiveness of the recently concluded agreement between the warring parties to allow for grain exports remains to be proven. Fields in Eastern Ukraine have been left unsowed this year. Many European companies have chosen or been compelled to withdraw from the Russian market. Investment flows between Russia and the EU have come to an abrupt halt. As both Russia and Ukraine are significant suppliers of a number of important commodities, energy and commodity prices have surged, reflecting heightened uncertainty as well as bottlenecks and other disruptions of supply chains. Businesses feel the effects in the form of shortages, longer waiting times and higher costs. Uncertainty about future developments remains high, which causes firms to put off investment decisions and puts downwards pressure on economic activity.

The full effects of the war have not been played out yet, with its consequences and knock-on effects still cascading through the European and the world economy.

This report takes stock of these developments and assesses their implications for European SMEs. We first look at the direct impact of reduced trade, before turning our attention to the indirect channels through which these events affect the EU economy, in particular price hikes for energy and other commodities, as well as disruptions in supply chains and shortages of raw materials. Finally we put forward a number of policy recommendations that would help Europe's millions of SMEs weather the current storm and emerge stronger and more competitive.

2. Direct effects: EU trade severely affected by the outbreak of war

The Russian invasion of its neighbour has upended EU trade with Ukraine and Russia, both as a consequence of the war itself, as a result of the EU sanctions that have been imposed against the Russian Federation in response, as well as the Russian countersanctions.

Trade with Russia deeply affected

The size of the Russian economy is about one-tenth of that of the EU[2]. Despite its relatively small size at pre-war levels the world's 11th largest economy, on par with a geographically much smaller country such as South Korea, the Russian Federation has been an important trading partner for the EU, especially for energy and raw materials imports, due to its proximity, and the heavy focus of its economy on natural resources needed by Europe's industry.

The sanctions imposed by the EU following the invasion directly prohibit trade in a number of raw materials, such as coal, crude oil[3] and refined petroleum, as well as steel, wood and iron, a variety of goods spanning areas such as aviation and space industry goods, various technology including quantum and other cutting-edge technologies, many types of machinery and transportation equipment, to luxury goods such as cars and accessories.

Asset freezes against and prohibition of trading with specific persons in the Russian leadership, higher officials, prominent businesspeople and other notable figures in Russian society, have also been enacted[4].

A number of Russian banks[5] have also been subject to sanctions and can no longer access the SWIFT system for international bank transfers. European companies have been prohibited from carrying out ruble-denominated purchases e.g. when purchasing energy resources from Russian companies.

A general ban on Russian vessels accessing EU harbours has been imposed, with exemptions for agricultural products and energy. The EU has closed its airspace for Russian airline companies, and Russia has reciprocated with a similar move.

Trade insurance e.g. for shipping through Russian waters has become more expensive or impossible due to very high risk premiums following the outbreak of war. Fuel has also become more expensive, further exacerbating the logistical challenges for companies operating on the Russian market.

As a result of these measures implemented in response to the Russian full-scale invasion of Ukraine, at a practical level, commerce between Western and Russian companies has become rather difficult. As most transport links are no longer operating, it is hard to serve clients, carry out outreach activities to markets, and maintain normal operations across Western and the Russian markets more generally. The

[2] European Commisison (2022) European Economic Forecast. Spring 2022 (europa.eu)
[3] 2/3 of the EU's imports from Russia are covered, with exception given to imports through the Druzhba pipeline, Bruegel (2022) Europe's Russian oil embargo: significant but not yet | Bruegel
[4] EU sanctions against Russia explained - Consilium (europa.eu)

[5] Q&A on the fifth package of sanctions against Russia (europa.eu)

sanctions against a number of Russian banks make it hard to conduct payments which in turn obviously impedes commerce. To illustrate, in a survey carried out in April 2022 by the business association Eurochambres a third of the Chambers of Commerce and Industry surveyed highlighted that sanctions are causing considerable difficulties in the day-to-day running of business[6].

Sanctions oblige European companies to ensure that they do not trade with individuals on the EU's sanctions list. This requires comprehensive due diligence and scrutiny of often complex ownership structures. Many firms have preferred to voluntarily cease operations on the Russian market, or at least to refrain from exploring new business opportunities, instead of spending considerable resources on untangling ownership while running the risk of unintendedly breaching sanctions if something is overlooked.

Additionally many European companies have voluntarily decided to withdraw from the Russian market even if their activities are not covered by sanctions, rather than incurring the reputational damage of being associated with the Russian war efforts.

As a consequence, the effects of the sanctions are felt broadly, including by Europe's SMEs. Nevertheless certain sectors are more directly affected by specific sanctions than others. For example, the machinery industry will be heavily hit by export bans and sanctions, as many of the products of EU machinery builders can be qualified as dual-use goods and Russia is an important importer of such products from the EU. Another example is the European tourism industry which will suffer from the absence of Russian tourism, with one estimate putting the number of Russian tourists at around a quarter of the total number of nights extra-EU tourists spend in EU accommodation[7].

EU exports to Russia have collapsed. They had begun the year strongly 26% up in January 2022 in comparison to the same month in 2021. However, in May 2022 EU exports to Russia were down 47% relative to April last year, whereas total EU exports were 28% up in May 2022 compared to May 2021.

However, the situation is vastly different for imports. Shortly before the outbreak of war, in January 2022, EU imports stood at roughly twice the level from January 2021. Even in May 2022, several months into the war, the total value of the EU's total imports from Russia was 45% above the May 2021 level. This however reflects surging energy and commodity prices that are only partially caused by the war, so European SMEs would in any case be undergoing economic hardship, now further acerbated by the effects of the Russian invasion of Ukraine. Thus, whilst the various events have caused a very strong negative shock to the EU's exports to Russia, the effects on EU imports have been more ambiguous.

[6] Eurochambres (2022) flash survey on the economic impact of the war in Ukraine
[7] UNWTO European Union Tourism Trends (2016)

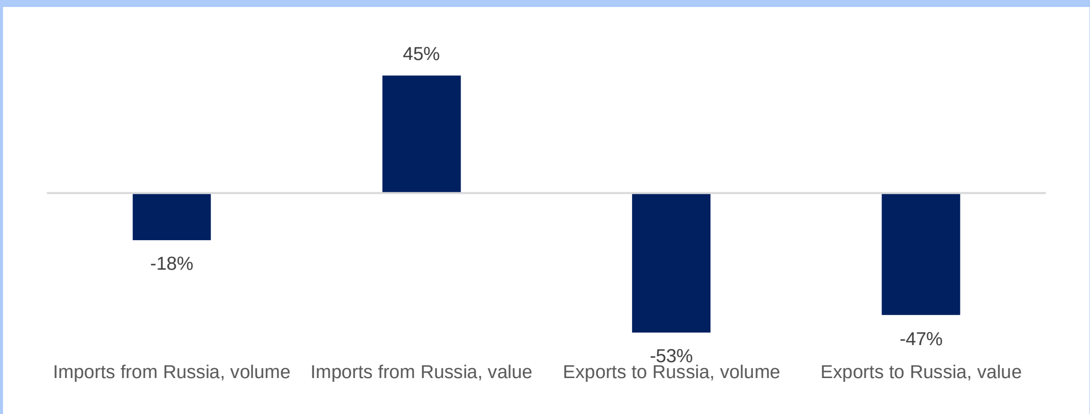
Graph 1: Value of total EU trade with Russia, change from same time period previous year

	EU exports to Russia	Total extra-EU exports
January 2022	26%	21%
February 2022	11%	17%
March 2022	-52%	13%
April 2022	-61%	11%
May 2022	-47%	28%
January to May 2022	-29%	18%
	EU imports from Russia	Total extra-EU imports
January 2022	95%	54%
February 2022	112%	46%
March 2022	108%	41%
April 2022	76%	46%
May 2022	45%	56%
January-May 2022	95%	54%

Own calculations based on Eurostat

The fact that EU imports from Russia have been less affected than exports reflects the offsetting dynamics of price movements. As seen in the graph below, the total volume of EU imports from Russia in May 2022 was 18% below the volume of imports in May 2021, but the value of the imports had increased by 45%. In other words, the price of the commodities that the EU countries are buying from Russia has soared, which more than makes up for the fact that EU importers are importing less in absolute terms. Russian export sales to European companies are very natural resources dependent, and the price of oil and commodities have shot up sharply.

Graph 2: Change in EU trade with Russia from May 2021 to May 2022



Own calculations based on Eurostat

However, as the EU has committed to stop importing Russian energy as quickly as possible, and is currently considering additional sanctions, imports from Russia are set to decline markedly in the future.

The United States has also enacted wide-ranging sanctions against Russia, as have other large economies including Japan, Canada and the United Kingdom[8]. In response Russia has enacted

[8] Atlantic Council (2022) Global Sanctions Dashboard: Russia and beyond - Atlantic Council

countersanctions against “unfriendly countries”[9], including the EU. This further aggravates the shock to the world economy and global trade resulting from the Russian invasion, with additional second-order economic effects for the EU economy.

One estimate puts the likely loss of GDP in Russia in 2022 at between 10.4% in 2022[10], another suggests a fall in economic activity in 2022 between 12.5% and 16.5%[11]. The result of the economic backlash will invariably be to increase the downward pressure on the EU’s exports to Russia.

It should be borne in mind that the effects on trade of the Russian invasion of Ukraine vary between Member States depending on their exposure to the Russian market (in terms of share of imports and share of exports), as well as their energy mix (share of Russian energy sources in total energy consumption). To illustrate, while at EU27 level 1.7% of goods exports go to Russia, the share of total goods exports to the Russian Federation is 11% in Latvia and Lithuania, almost 6% in Finland, 3.0% in Poland, around 2% in Germany, but in contrast only 1.3% in France, 0.7% in Spain and 0.5% in Greece.

Trade with Ukraine deeply affected

For Ukraine, the economic effects of the war have been very severe with normal economic activity having been interrupted by the outbreak of hostilities. People have left their jobs to join the military, businesses have suspended operations, and logistics cannot function as they would in peacetime.

The EU’s goods exports to Ukraine stood at €24.2 bn in 2019 (around a quarter of the exports that goes to Russia), predominantly machinery, transport equipment, chemicals and manufactured goods[12].

EU trade with Ukraine has nosedived as a result of the onset of war. Exports were down 60% in March 2022 relative to March 2021. Ultimately these are early days of what could be a long ordeal, but it is feasible that economic activity including trade with the EU will bounce back partially now that the initial Russian campaign targeting capture major Ukrainian cities including the capital have been thwarted, with export numbers from May 2022 showing an increase relative to the same month last year, although this could be on the back of temporary catching-up from withheld export sales.

On the import size the economic repercussions of the war appear to have been even more pronounced. In the first two months of this year EU imports from Ukraine had risen far above the level in the corresponding months of 2021 (74% up in January, 60% up in February), but by March and April imports from Ukraine were back at the same levels as the corresponding months of 2021, and whilst the May 2022 figure was above the level of the corresponding month in 2021 it was also well below the pre-war trend.

[9] E.g. Gibson Dunn (2022) Russia Responds to International Sanctions – An Overview of Russian Countersanctions and Further Measures against So-Called “Unfriendly States” - Gibson Dunn

[10] European Commission (2022) European Economic Forecast. Spring 2022 (europa.eu)
[11] Vox EU (2022) Macroeconomic effects of the 2022 sanctions on Russia | VOX, CEPR Policy Portal (voxeu.org)
[12] EU trade relations with Ukraine (europa.eu)

Graph 3: Total EU trade with Ukraine, change from same time period previous year

	EU exports to Ukraine	Total extra-EU exports
January 2022	38%	21%
February 2022	4%	17%
March 2022	-60%	13%
April 2022	-31%	11%
May 2022	7%	28%
January-May 2022	-13%	18%
	EU imports from Ukraine	Total extra-EU imports
January 2022	74%	54%
February 2022	60%	46%
March 2022	-1%	41%
April 2022	-2%	46%
May 2022	15%	56%
January-May 2022	27%	54%

Own calculations based on Eurostat

Since the Russian aggression has led to war on Ukrainian soil there have been many direct and immediate consequences for the Ukrainian economy. Feedback from the Ukrainian Chamber of Commerce and Industry in April indicated that about 30% of businesses in Ukraine had by then entirely discontinued their activities, while about 50% were operational at limited capacity. The World Bank estimates that Ukrainian GDP may contract by 45% this year[13], with obvious negative repercussions for the EU's trade with Ukraine. As well as the direct effects this will inevitably have a number of indirect knock-on effects for Europe's SMEs. Ukraine is one of the world's largest producers of wheat, but the sowing season has been disrupted in parts of the country, and shipments out of Black Sea ports have been blocked by Russian naval presence, with uncertainty remaining concerning the effectiveness of the recently concluded UN-brokered agreement between the two parties to allow for grain exports. Another concern is the fact that Ukraine produces roughly half the world's total output of neon, a component needed for microchips production[14]. Microchips are key to the modern digital economy and were already in short supply prior to the outbreak of hostilities.

Significant negative economic consequences for Europe's businesses

These developments will cause significant economic damage to the EU economy. In May, the European Commission[15] revised its EU27 GDP growth forecast for 2022 down from 4.0% (in February 2022) to 2.7%, and its EU27 inflation forecast up from 3.9% to 6.8%, and its July interim forecast kept the same GDP forecast whilst raising the inflation forecast further to 8.3%. In June, the OECD estimated that the war following the Russian aggression against Ukraine could reduce global growth by over a quarter of a percentage point this year[16]. Due to their geographical proximity Europe's businesses are more exposed and should expect to bear the brunt of the backlash. Such estimates are highly uncertain and contingent on the future trajectory of the war and further sanctions or other steps that may be taken by the EU. Nevertheless, it seems inevitable that Europe's SMEs now experience a gloomier economic outlook than expected at the beginning of the year. SMEs with exposure to the Russian and Ukrainian markets now

[13] World Bank (2022) Russian Invasion to Shrink Ukraine Economy by 45 Percent This Year (worldbank.org)

[14] How Russia's war against Ukraine could make the chip shortage worse - Vox https://www.fierceelectronics.com/electronics/ukraine-war-could-hurt-supplies-neon-palladium-needed-chips

[15] European Commission (2022) Spring 2022 Economic Forecast: Russian invasion tests EU economic resilience | European Commission (europa.eu)

[16] OECD (2022) 1. General assessment of the macroeconomic situation | OECD Economic Outlook, Volume 2022 Issue 1 : Preliminary version | OECD iLibrary (oecd-ilibrary.org)

risk being disproportionately affected by these adverse developments. They tend to be less export-oriented than large companies, and to have less resources and knowhow needed to establish alternative supply links or to expand into alternative markets. Larger companies in contrast often have more diversified sales.

In addition, financial and trade sanctions imposed on Russia following its aggression against Ukraine also threaten to increase business bankruptcies, particularly in Europe, due to its high reliance on Russia for energy. A prolonged escalation of the crisis will also hurt businesses that are vulnerable to commodity shocks and it is likely to increase bankruptcy risks. This will require keen political attention and potentially new policy measures in response to the situation as it unfolds.

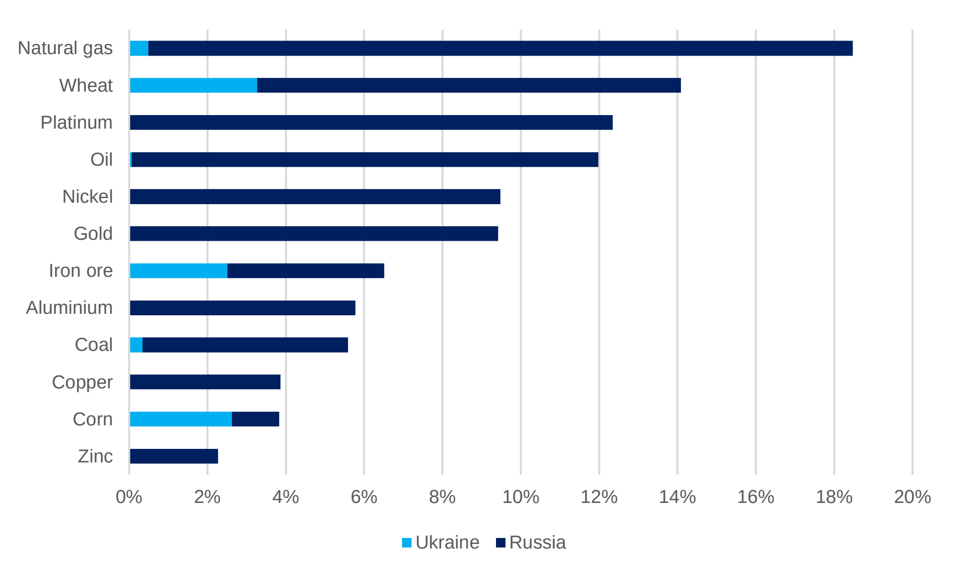
3. Indirect effects: Price hikes, supply chain disruptions, shortages and bottlenecks

Whilst the Russian invasion of Ukraine has had immediate direct effects on trade, its indirect effects will probably have the largest impact on the EU economy. There have been steep increases in commodity prices, which in turn raise costs for businesses and households, as well as pronounced shortages of materials and labour, alongside other disruptions in global value chains, with important consequences for European SMEs.

The main economic effects of the war may well come through its impact on commodity markets

The OECD notes in its June Economic Outlook that the war could directly reduce global growth by over a quarter of a percentage point this year, but that the main impact will result from its effect on commodity markets. Russia and Ukraine for example account for large proportions of total global wheat and corn exports, as well as world production of mineral fertilizers, natural gas and oil, as shown in the graph below.

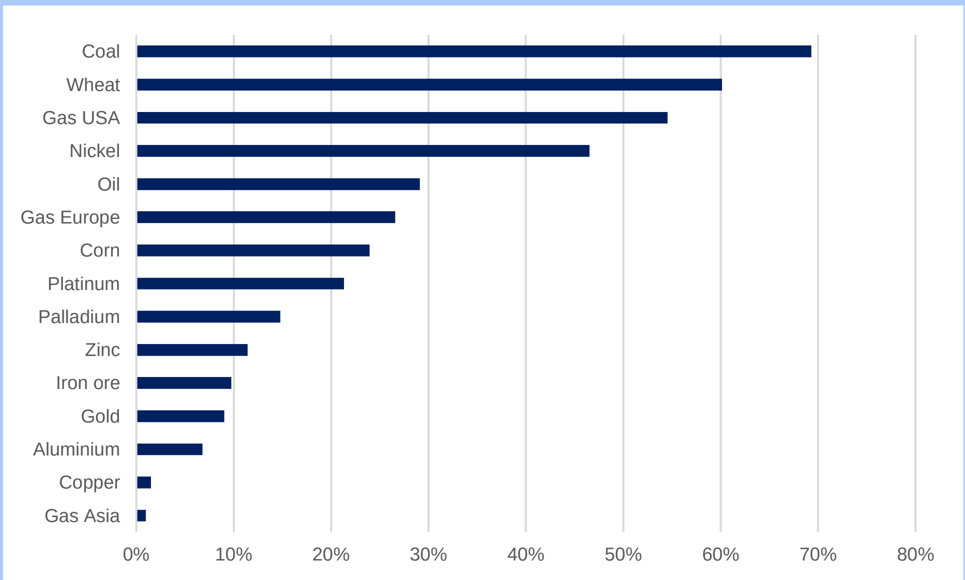
Graph 4: Share of world production 2020



OECD: Economic outlook, June 2022

As we explore in greater detail below, commodity prices have spiked following the Russian invasion of Ukraine. For example, as shown in the graph below, the price of wheat has increased by some 60% and oil by around 30% since January.

Graph 5: Change in commodity prices from January 2022 average



OECD: Economic Outlook, June 2022

Higher costs will be passed on through supply chains. Small and medium-sized companies often find themselves with less bargaining power when that happens. They also tend to have fewer resources and less global outreach and presence to identify alternative sources of supply. Finally SMEs will probably find it harder than their larger peers to hedge against prolonged periods of high inflation as they often lack the financial acumen and resources of larger corporations.

Energy price hikes

Europe has been highly reliant on Russian oil and natural gas for its energy supply. While the degree of dependency varies between Member States, the effect of rising prices will be felt everywhere, with energy prices skyrocketing following the invasion of Ukraine as shown in the graph above.

Looking ahead, the World Bank forecasts a 50% overall energy price increase in 2022, with natural gas prices in Europe set to rise 111%[17].

Such energy price hikes will impose significant burdens for large companies as well as SMEs. Moreover, rising energy prices will by all accounts have greater ramifications for businesses in Europe than in other large economies due to our higher reliance on Russian energy sources. This will in turn result in a relative loss of competitiveness for the EU.

Adverse price developments in key commodities

The Russian invasion has affected the prices of a number of commodities, from energy to agricultural products such as wheat and corn, to raw materials such as zinc, platinum, palladium, and various minerals such as phosphate and potash that are used to produce fertilizers.

Looking ahead, prices are expected to increase further, with the World Bank for example forecasting significant price increases for important commodities such as aluminum (+38% in 2022), nickel (+52%), potash (+147%) as shown in the graph below.

Graph 6: Expected price developments in selected categories

	Expected price change, 2022	Expected price change, 2023
Energy	50,5%	-12,4%
- Crude oil, Brent	42,0%	8,0%
- Natural Gas, Europa	111,0%	-26,5%
Agriculture	17,6%	-7,7%
- Wheat	42,7%	-15,6%
- Corn	19,4%	-9,7
Fertilizer	69,3%	-11,4%
- Phosphate	42,0%	-8,6%
- Potash	147,4%	-9,6%
Metals and minerals	15,8%	-10,5%
- Aluminum	37,5%	-8,8%
- Nickel	51,6%	-21,4%
- Tin	26,6%	-14,6%
- Zinc	23,2%	-13,5%

World Bank April 2022, Commodity Markets Outlook.

As a result, many sectors of the EU economy are deeply affected, from enterprises within agriculture where fertilizer and fodder are vital to maintain normal levels of output, to manufacturing where lack of reasonably affordable raw materials can force factories to close down, and in transportation sectors experiencing higher fuel prices.

This causes massive ripple effects across industries. To illustrate, Russia and Ukraine have been important sources of raw materials such as aluminum (35% of EU demand comes from companies controlled by Russia) and carbon black for tyres (1/3 of EU imports come from Russia or Ukraine), meaning that sectors such as the automobile industry have been severely affected by disruptions in their normal supply chains. Similarly, the European steel industry obtains 21% of its iron and unwrought imports from Russia. Higher input prices thus spread downstream throughout value chains, as price

[17] World Bank (2022, April), Commodity Markets Outlook

hikes are passed on, fully or partially, to other sectors that then experience higher costs for various inputs, transportation and other services, energy consumption and other expenditures that they incur for their own production.

Labour shortages aggravated by exodus of Ukrainian workers

Labour markets are already tight in many EU Member States, with the EU job vacancy rate 0.4 percentage points above its pre-pandemic level. They have come under increased strain as many of the 1.35 million Ukrainians that were residing in the EU prior to the outbreak of the war[18] have returned home to join the war efforts.

The exodus of Ukrainian workers has been particularly pronounced in a number of male-dominated sectors such as construction and transportation (truck drivers)[19]. In Poland, which houses many Ukrainian workers, an estimated 11% of construction workers and 13% of truck drivers were Ukrainians before the war.

Additionally, prior to the outbreak of hostilities, Ukraine was an important location for ICT activities and outsourcing of software developments and other similar business services for European companies. Many of these operations have been disrupted as a result of the war. Setting up or expanding operations further in Ukraine is obviously very difficult under current circumstances.

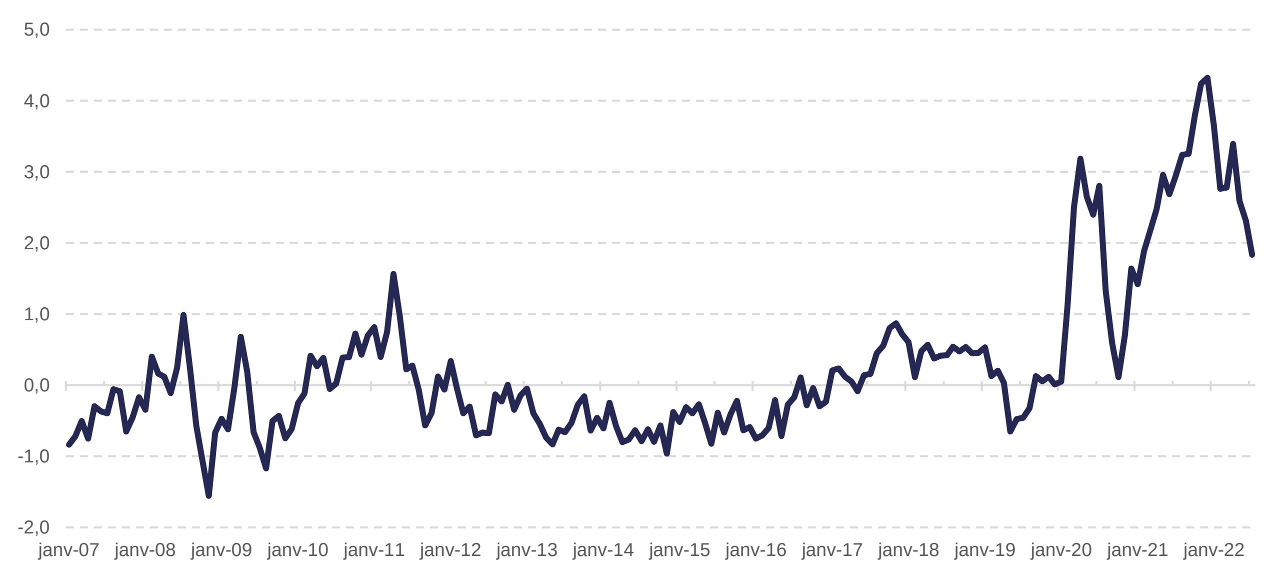
Widespread bottlenecks, material shortages and global supply chain disruptions

Global supply chains had not fully recovered from the bottlenecks and other disruptions caused by the COVID-19 pandemic. They have now been put under increased strain due to the Russian aggression in Ukraine, as well as the reimposition of pandemic lockdown in a number of Chinese provinces, including Shenzhen and Shanghai that constitute key arteries in the world economy.

The Global Supply Chain Pressures Index measures global shipping costs and airfreight costs, delivery times, backlogs and purchased stocks from seven large economies including the Euro Area. The steep rise, as shown in the graph below, indicates a number of problems affecting large companies and SMEs alike, with both direct impact for importers and exporters and downstream effects. In fact, current levels of supply chain pressures are on par with the levels witnessed at the height of pandemic lockdowns.

[18] How many Ukrainians hold an EU residence permit? - Products Eurostat News - Eurostat (europa.eu)
[19] Polish wind sector warns of construction delays due to Ukrainian workers returning home to fight | Notes From Poland

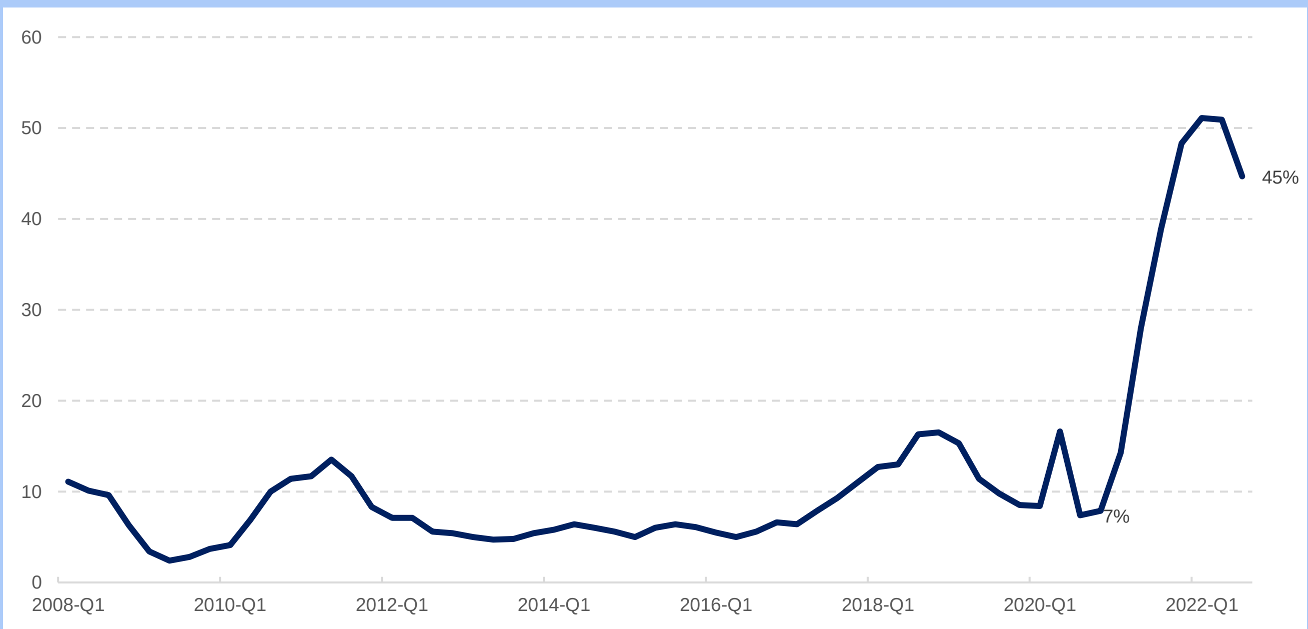
Graph 7: Global Supply Chain Pressure Index (standard deviations from average value, end-of-month value)



New York Federal Reserve (based on Bureau of Labour Statistics, based on Bureau of Labor Statistics; Harper Petersen Holding GmbH; Baltic Exchange; IHS Markit; Institute for Supply Management; Haver Analytics; Refinitiv)

Another indication of strong pressures on supply chains is the fact that shortages of materials are now prevalent across the EU economy. Half of EU companies indicate that materials shortages impose a constraint on their production, up from around one-tenth of companies a few years ago. Bottlenecks can be observed both in relation to raw materials, intermediate and end-products, with a myriad of supply chains now experiencing significant disruptions. There have been reports of factory closures due to a lack of raw materials[20]. Shipping costs remain high[21].

Graph 8: Percentage of companies that report the following as a factor constraining their production: Shortage of Materials or Equipment (seasonally adjusted, Industry)



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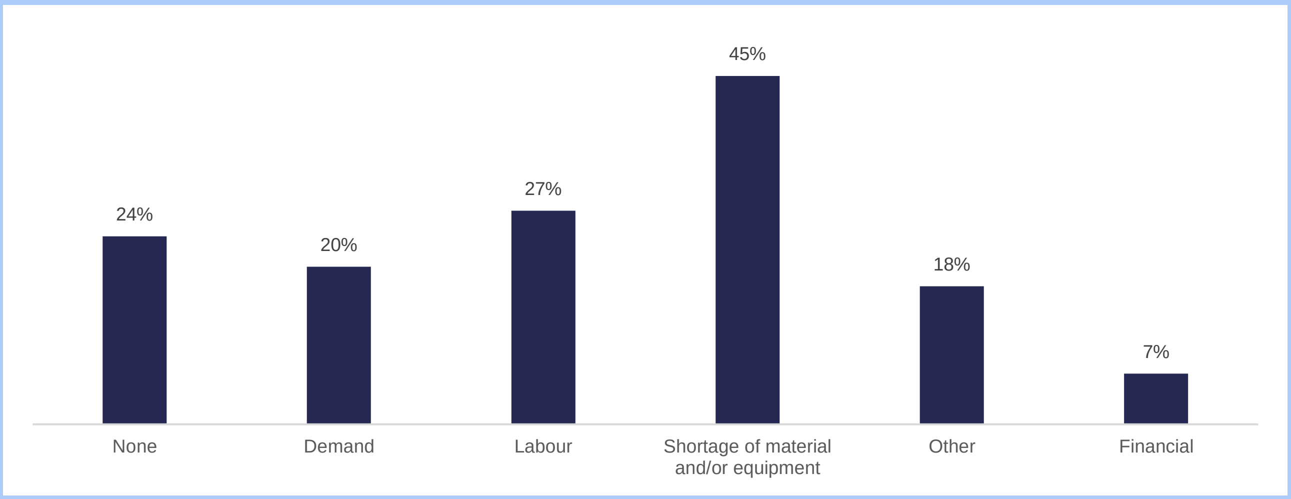
[20] Wall Street Journal (2022) [Volkswagen Faces Production Stoppages Due to Ukraine Supply Issues (wsj.com)]
[21] [Freight Rate Index / Freightos Baltic Container Index] [RWI/ISL Container Throughput Index | Institute of Shipping Economics and Logistics]

Further highlighting the difficulties facing Europe's businesses, materials shortages are now the most prevalent factor constraining production. Around half of EU companies mention shortage of materials or equipment as a constraining factor, whereas only around a quarter indicate that shortage of labour is a constraint.

Graph 9: Percentage of companies that report the following as a factor constraining their production, 2022Q3 (seasonally adjusted, Industry)



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As a result, many companies will probably struggle to remain profitable, and some may be pushed towards insolvency. Moreover, cost increases in turn reduce disposable income for households and companies, putting further downward pressure on economic activity.

Although many SMEs are not directly exposed to the Russian or Ukrainian markets as such, they still suffer very strong indirect effects through higher costs as well as longer waiting times. Steep price increases may also often have a disproportionate impact on SMEs because large firms tend to have more resources and global reach to seek out alternative suppliers in order to keep costs down. Larger companies may also have larger stockpiles. Moreover, large companies tend to have considerably more market power, which makes it easier to resist price rises being passed on to them. This may also mean that suppliers could decide to prioritize deliveries to large companies over SME customers or even renege on contracts with SMEs citing force majeure.

Heightened sensitiveness to geopolitical risks and rewiring of global supply chains

These developments demonstrate the risks and vulnerabilities posed by global supply chains, especially when suppliers are situated in countries with high geopolitical risk levels.

European SMEs and large companies have responded by reevaluating their value chain. Sensitivity to geopolitical risks appears to have increased. Many companies, large as well as SMEs, now seek to restructure and diversify supply chains, partly as an immediate response to the Russian aggression in Ukraine, and partly to preempt future disruptions. Some analysts have suggested this will trigger comprehensive economic "decoupling" and restructuring of value chains[22], and that some of the economic gains from three decades of globalization may now be exchanged for greater security of supply.

[22] Financial Times (2022) Russia's war will remake the world | Financial Times (ft.com)

Navigating in a context of heightened geopolitical risks and possibly comprehensive restructuring of global value chains will prove challenging for all companies. SMEs may find it particularly difficult, however, since they often do not have the same levels of global reach and supply chain management expertise as large companies that are able to seamlessly explore new opportunities and develop alternative supply links and other types of operations.

4. The economic situation is deteriorating, putting further strain on Europe's businesses

Dark clouds have been gathering over the EU and the world economy through the course of the year.

The macroeconomic environment was already precarious before the beginning of the Russian invasion, as central banks including the ECB were preparing to tighten monetary policy in 2022 to combat unsustainably high inflationary pressures. The price spikes in recent months following the outbreak of war have aggravated the challenge posed by inflation. At the same time, the economic outlook has worsened, meaning that the European economy is faced with the unpleasant prospect of high and still rising inflation coinciding with decelerating growth.

The European economy is slowing down and its future growth trajectory is uncertain

While still growing, the European economy is slowing down. In May the European Commission revised its EU27 growth forecast for 2022 downwards from 4.0% to 2.7%, and its EU27 inflation forecast upwards from 3.9% to 6.8%, with its July interim forecast leaving the GDP projection for this year unchanged, whilst revising the inflation forecast further upwards to 8.3%.

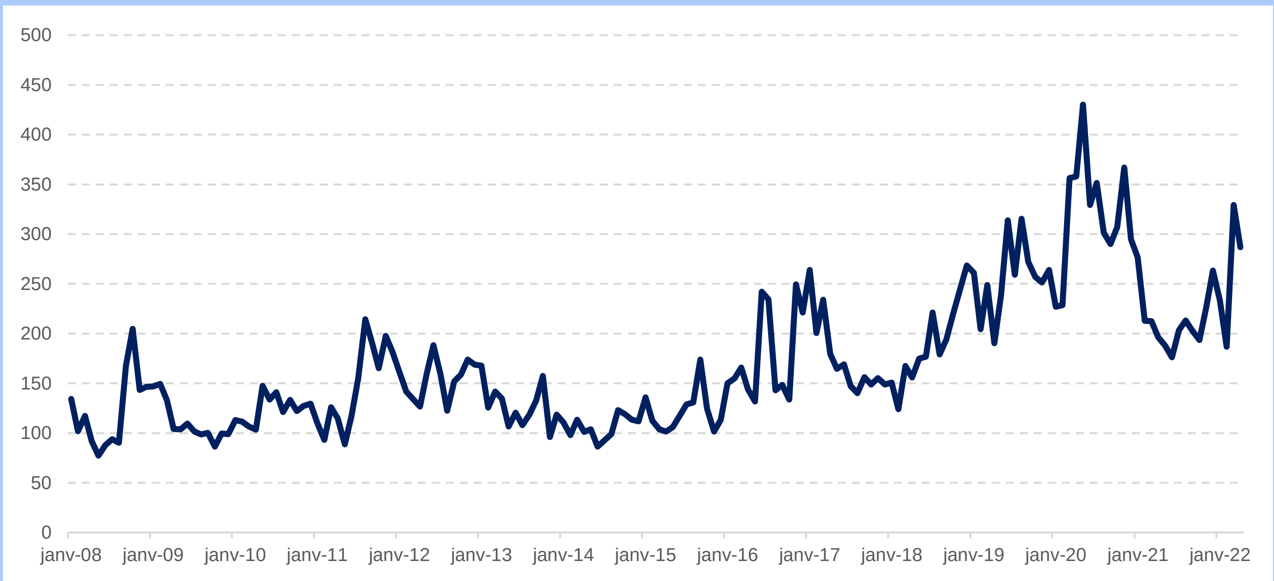
This makes for a difficult business climate for Europe's millions of SMEs that had only just weathered the storm of the COVID-19 pandemic, but must now brace for another hit.

Heightened uncertainty makes firms and households less prone to invest and consume

Global uncertainty is high. One widely used measure of global economic uncertainty suggests that current levels of economic and political risk are well above other previous periods of significant economic stress such as the Financial Crisis and EU Sovereign Debt crisis[23].

[23] Economic Policy Uncertainty Index

Graph 10: Economic and political risk

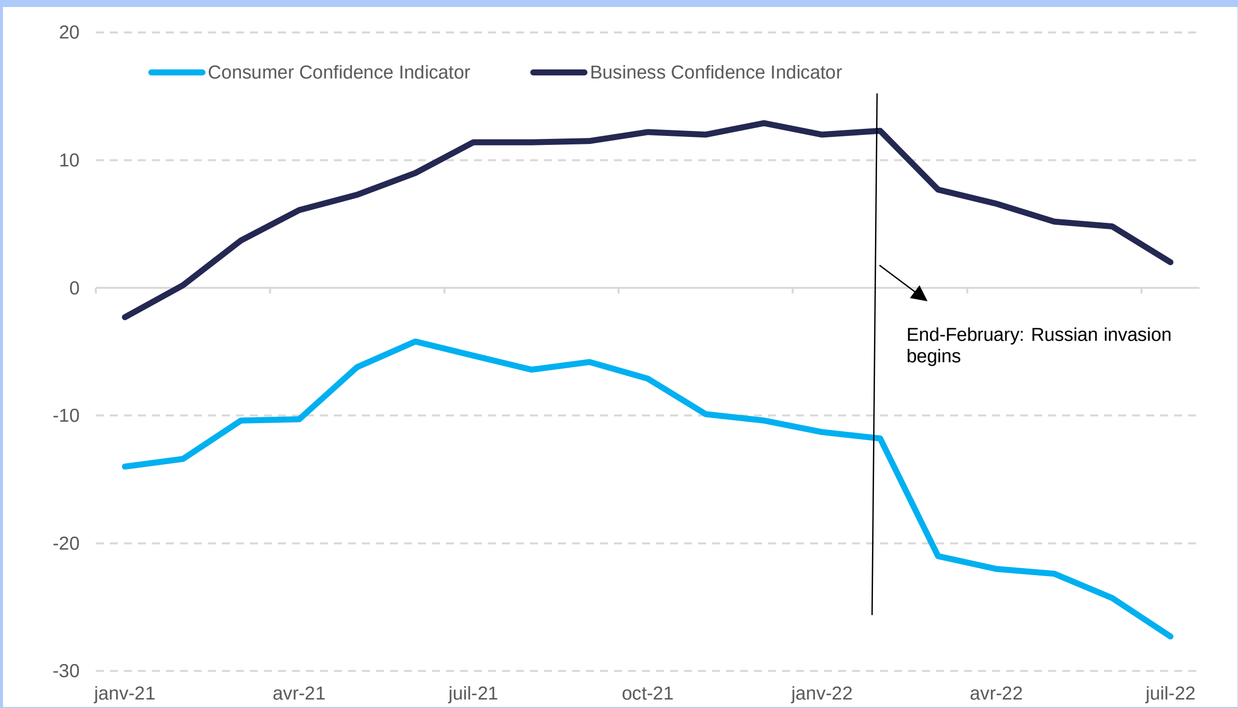


The global EPU index, indexed so the average level at 1997=100

As shown in the graph below, the Consumer Sentiment Indicator had recovered after the pandemic, but in recent months fallen to very low levels amidst rising geopolitical tensions and rising prices. It now stands at record-low levels comparable to what was seen at the height of the pandemic. As the consumer mood deteriorates, private consumption will lose steam in the coming months, making conditions more difficult for SMEs in retail and related sectors.

On the business side, the general economic sentiment has also undergone a downwards shift, although it is less pronounced than on the consumer side.

Graph 11: Consumer and Business confidence, 2021-2022



European Commission data

Significant sectoral differences as industries are impacted to varying degrees

The EU economy is operating at different tempi with uneven economic developments across sectors.

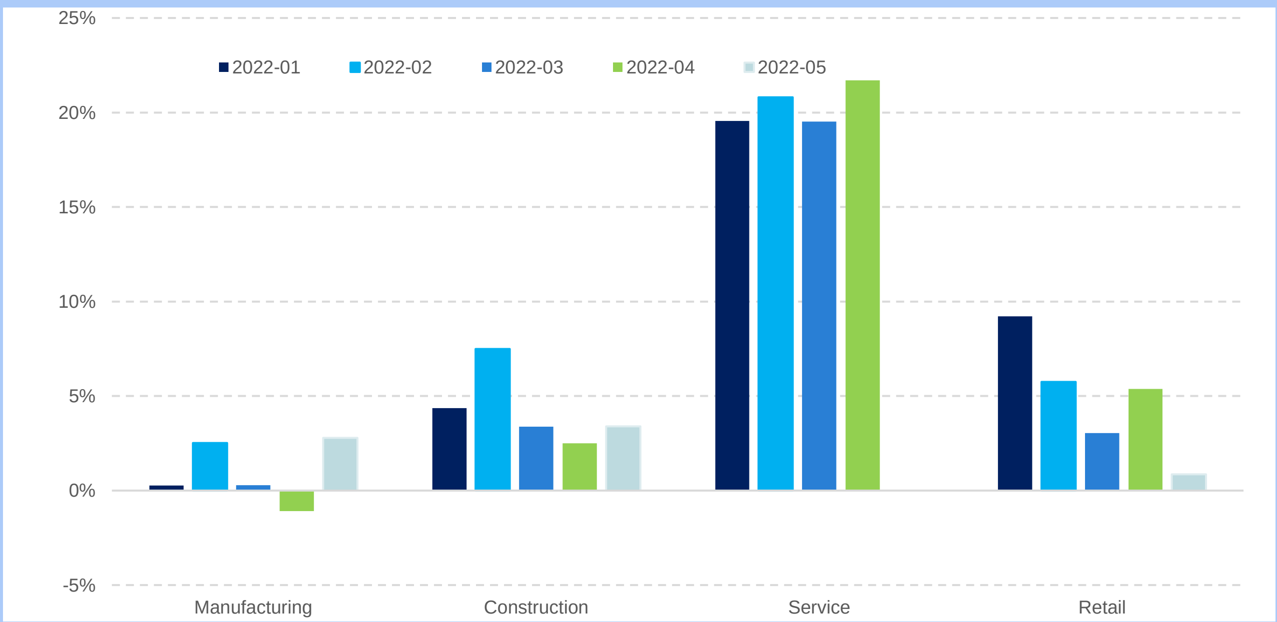
Manufacturing displays weak growth as industrial firms are disproportionately affected by global supply chain disruptions and higher input including energy prices.

The construction sector is suffering from rising prices and shortages and economic activity in the sector has lost steam recently. The sector is deeply dependent on a number of inputs that have seen marked price rises such as steel (With Russian exports accounting for some 7% of world exports[24]) and aluminum (Russia holds a 6% share of world production[25]).

The retail sector has experienced a rapid deceleration in sales growth as price increases including energy have caused household disposable income to drop, whilst the consumer mood has soured amidst higher costs and a more clouded economic outlook.

Services in contrast have so far maintained a strong growth momentum. Services tend to be highly focused on domestic markets, and less dependent on energy than other sectors. They also have less need for inputs that are affected by rising raw material prices.

Graph 12: Production across sectors in the EU27 economy, change from same month previous year, seasonally and calendar days adjusted



Own calculations based on Eurostat. Data for Service not available for May (Service is ex Retail, for Retail the index of deflated turnover is shown)

Forward-looking surveys of purchasing managers (PMI) suggest that these trends are set to continue with some growth expected in the service sector, which is traditionally heavily oriented towards home markets and less dependent on high energy consumption or raw material inputs, whilst growth prospects for the manufacturing sector are subdued in the face of supply chain disruptions, material shortages and rising commodity prices[26].

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[24] Russia Exports Report 2018 Annual (trade.gov)
[25] OECD (2022) 1. General assessment of the macroeconomic situation | OECD Economic Outlook, Volume 2022 Issue 1 : Preliminary version | OECD iLibrary (oecd-ilibrary.org)
[26] S&P Global, Purchasing Managers Index (2022) https://www.pmi.spglobal.com/Public/Home/PressRelease/62c985d513f64e0eb84c37255281a39f https://www.pmi.spglobal.com/Public/Home/PressRelease/738d25f220d445ab83768337ffa783cc

Delving deeper into the sectoral differences, the table below shows the degree to which specific sectors are exposed to trade with Russia. Specifically, it shows the share of total value added generated in the EU that can be attributed to trade with the Russian Federation. For the total EU27 economy, 1% of the value added produced can be attributed to inputs from Russia. However, the importance of economic exchanges with Russia is more pronounced in a number of sectors. In Industry 3% of total value added is derived from trade with Russia. In line with the outlined disparity between production growth in services relative to manufacturing, a number of specific industries such as mining and the production of petroleum are highly dependent on Russian inputs, whilst the exposure is low in the various service-sector industries.

The implication is that whilst all sectors will be affected by higher prices of energy and other commodities, we should expect a number of industries with above-average exposure to trade with Russia to be more severely affected. It may therefore be necessary to devote particular attention to SMEs within those sectors that are principally affected by the Russian invasion.

Graph 13: Share of total value added that can be attributed to trade with Russia, Percent

Total economy	**1,0**
Agriculture, hunting, forestry	0,4
Fishing and aquaculture	0,8
Mining and quarrying, energy producing products	18,5
Mining and quarrying, non-energy producing products	5,6
Mining support service activities	12,5
Food products, beverages and tobacco	0,2
Textiles, wearing apparal, leather and related products	0,2
Wood and products of wood and cork	1,1
Paper products and printing	0,6
Coke and refined petroleum products	18,5
Chemical and chemical products	1,6
Pharmaceuticals, medicinal chemical and botanical products	0,1
Rubber and plastics products	0,3
Other non-metallic mineral products	0,5
Basic metals	5,0
Fabricated metal products	0,4
Computer, electronics and optical products	0,3
Electrical equipment	0,3
Machinery and equipment, n.e.c.	0,2
Motor vehicles, trailer and semi-trailers	0,1
Other transport equipment	1,5
Manufacturing, nec, repair, installation of machinery and equipment	0,4
Electricity, gas, steam and air conditioning supply	1,2
Water supply, sewerage, waste management, remediation activities	0,4
Total industry (incl mining, utilities)	**3,0**
Construction	0,2
Wholesale and retail trade; repair of motor vehicles	1,3
Land transport and transport via pipelines	2,5
Water transport	1,0
Air transport	2,2
Warehousing and support activities for transportation	2,0
Postal and courier activities	0,4
Accommodation and food service activities	0,1
Publishing, audiovisual and broadcasting services	0,3
Telecommunications	0,4
Computer programming, consultancy, information services	0,5
Financial and insurance activities	0,5
Real estate activities	0,3
Professional, scientific and technical activities	0,5
Administrative and support services activities	0,5
Public administration and defence, compulsory social security	0,0
Education	0,0
Human health and social work activities	0,0
Arts, entertainment and recreation	0,1
Other service activities	0,0
Activities of households as employers	0,0
Total services	**0,5**

Europaen Commision based on OECD TiVA

Early indications of credit tightening

One worrying development would be significant credit tightening, as this would suppress investments and other economic activity and put additional pressure on many SMEs that find themselves in a difficult financial situation.

We have seen early indications that banks have begun tightening financial conditions in the face of heightened uncertainty, as well as in anticipation of the ECB adopting a less accommodative monetary policy stance in order to curb inflation.

The direct exposure of European banks to the Russian market is low, although specific large banks in some Member States have larger exposure[27]. Regardless, the general slowdown in the European economy, supply chain disruptions, and geopolitical tension, will likely have some negative effects for corporate bank lending.

A net 12% of Euro Area banks tightened their margins on riskier loans in the first quarter of 2022, and by net 16% did the same in the second quarter of 2022, as shown in the table below. Looking ahead, in the third quarter of 2022, a net 18% of banks in the Euro Area expect to tighten credit standards for loans to firms[28].

Graph 14 Changes in terms and conditions and credit lines to enterprises - net percentage of Euro Area banks than have tightened

	Overall terms and conditions	Banks' margins on average loans	Banks' margins on riskier loans
2020Q1	3%	4%	12%
2020Q2	12%	6%	16%

ECB Euro Area Bank Lending Survey for 2nd quarter 2022

We know from previous analysis that large companies seeking credit tend to have higher success rates than SMEs[29], and that credit tightening often affects SMEs disproportionately[30] because large corporations usually find it easier to raise capital by other means e.g. by issuing bonds, and accessing non-bank financial markets.

Prompt payment to SMEs becomes even more important in this context: there is a need to speed up verification procedures for contracts so that payment can be finalised promptly. Contracting authorities could prioritize payments to SMEs, if the invoices are valid and undisputed.

Growing pressure on Europe's SMEs must be met with a growth-oriented policy response

Europe's SMEs are thus faced with numerous pressures, from early indications of more tight lending conditions to decelerating economic activity, very pronounced in some sectors already, with others likely to also lose steam as the world and European economies are increasingly affected by deteriorating macroeconomic conditions.

[27] European Banks' Russia, Ukraine Exposure Insignificant | Morningstar
[28] ECB (2022) https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2022q1~fd61911ffd.en.html
[29] ECB (2022) Survey on the Access to Finance of Enterprises in the euro area - April to September 2021 (europa.eu)
[30] ECB (2022) Survey on the Access to Finance of Enterprises in the euro area - April to September 2021 (europa.eu)
https://www.ecb.europa.eu/stats/ecb_surveys/safe/html/ecb.safe202005~c4b89a43b9.en.html

Policy-makers should respond by redoubling their efforts to ensure that firms, not least the SMEs that make up 99% of Europe's companies, can benefit from a regulatory environment conducive to growth.

5. How to help SMEs emerge stronger from the current turmoil

The Russian aggression in Ukraine has massively increased the economic strain experienced by Europe's SMEs, and comes at a time when the macroeconomic environment was already worsening due to the strong inflationary pressures.

The EU and Member States should respond to these events by finding ways to strengthen our economy and competitiveness, paying close attention to our SMEs that are in many cases disproportionately affected especially by the indirect effects and the uncertainty in markets.

Important steps have already been taken. A temporary state aid framework has been set up to allow Member States to support companies that are long-term viable but face short-term problems due to the suddenness of the geopolitical and economic events. The activation of the general escape clause has been prolonged to allow governments to support their economies through the current turmoil without the constraints of EU public budgetary rules. The financing from the REACT-EU and the Recovery and Resilience Facility provides a temporary window of opportunity that can be instrumental in helping provide survival and growth opportunities for businesses, especially SMEs. But the breathing room allowed by these temporary measures must be used well to achieve permanent improvements in SME competitiveness and economic conditions. In this respect it is of key importance to ensure that our economy is flexible and resilient and that the response is a joint European approach with the European Commission taking a lead role and coordinating efforts.

In particular, in stark contrast to the recent COVID-19 induced crisis, where it was a viable strategy to freeze the economy through furlough schemes, the currently unfolding situation necessitates substantial and permanent adjustments. At this point it seems unlikely that trade relations with Russia will be normalized in the foreseeable future. Rather than short-term interventions, therefore, the focus should be on helping firms adjust, e.g. by cultivating new export markets or finding new suppliers, as well as longer-term improvements in the business climate for SMEs and ensuring that they remain competitive despite the massive increase in costs we are currently witnessing.

The above analysis has shown four main developments that need to be considered:

a) A need to diversify and find new markets as a direct consequence of the crisis
b) Security and stability of supply / rethinking value chains
c) Risks to the security of energy supply at affordable and predictable price
d) Increasing prices of raw materials and general inflation.

Further steps to help Europe's SMEs regain competitiveness and emerge stronger from the current turmoil could include the following:

Helping SMEs explore market opportunities abroad

EU and national trade promotion activities and other support services such as the Enterprise Europe Network and the European Cluster Collaboration Platform should be mobilized to assist companies that are seeking new markets to replace lost exports to Russia and Belarus, as well as to help European firms seeking to diversify their supply chains. Specific attention needs to be given to the needs and conditions of SME companies including in terms of exploring market opportunities abroad.

Trade promotion has traditionally focused on boosting exports. However, there is also a need to pay close attention to imports in order to help companies that want to find new suppliers and reorganize their supply chains.

Ensuring a vibrant Single Market

The best way to cushion the blow against European companies from lost export markets is to help ensure good economic prospects for trade and economic growth elsewhere. As one of the world's largest markets the EU Single Market continues to offer vast economic opportunities for those companies that can benefit from it. Our policy response to the fallout from the Russian invasion of Ukraine should therefore include a focus on initiatives that will help boost economic growth and increase the ease of conducting business within the Single Market.

Removing remaining barriers to trade and free movement across the Single Market must remain a key priority. This will be particularly beneficial to SMEs since they tend to be more focused on the EU's domestic market rather than foreign markets. Moreover small and medium-sized companies often lack the resources of their larger competitors to assess regulatory frameworks in depth and understand how to best navigate the complexities of new rules and barriers.

Administrative burdens hamper growth for businesses. They are often disproportionately harmful for SMEs that often do not have the time, resources or regulatory knowhow that would make it easier to navigate a complex field of regulatory and administrative requirements and rules. The EU Better Regulation agenda is vital, and must also be supported by predictable, transparent and effective implementation and enforcement on the ground. Providing clear instructions and guidance to businesses is important to help companies, especially SMEs, understand regulatory requirements. Harmonizing implementation and preventing gold-plating must remain important priorities, and the SME-filter must be implemented in a strong manner at national and at EU level.

Better Regulation must remain an important agenda for the EU. In particular, comprehensive legislative proposals must be accompanied with thorough impact assessments and consultation of relevant stakeholders to ensure new legislation is designed to minimize burdens.

The Single Market is also key in relation to ensuring supplies to companies. Already today many companies have most of their value chains within the Single Market which can increase regulatory certainty and security of supply. While some studies show that global value chains can also make companies more resilient in a crisis situation[31], focusing value chains in Europe ensures regulatory certainty and control of supplies. Attention must also be paid to ensuring that public procurement is open to participation of SMEs. The upcoming Single Market Emergency Instrument (SMEI) must focus on ensuring that member states do not impose new rules in an emergency situation that would hamper the Single Market. This will boost resilience in the face of disruptions and crises, and should be particularly helpful for SMEs that would lack the resources to navigate the complexities of fragmented crisis responses across the Single Market.

Remaining unnecessary barriers must be scrutinized and removed. In this field, the work played by the Single Market Enforcement Taskforce (SMET) as the main tool for identifying and addressing unnecessary obstacles to the free movement of goods and services across borders, is of the utmost

[31] EPICE (2021) Global Trade Today is Global Value Chains | (ecipe.org) ECIPE (2022) Processing Trade and Global Supply Chains: Towards a Resilient "GVC 2.0" Approach | (ecipe.org)

importance. Regardless, it is unfortunate that many of the barriers previously identified by the SME Envoys Network are still in place (see for example the 2018 report from the SME Envoys Network, “Barriers for SMEs on the Single Market”)[32].

Free trade agreements

Europe is and will always be dependent on imports of a wide range of raw materials and manufactured products. Maintaining and deepening trade relationships will be central to ensuring security of supply, even as we in some specific cases reassess our particularly critical dependencies in light of geopolitical and other risks.

Secure and reliable supply of critical commodities and products does not necessarily equate domestic production, however, but can also be ensured by pursuing trade agreements with reliable supplier countries or by diversifying supply chains. A relatively large share of EU imports come from countries that we do not have trade agreements with, or where trade could be deepened through more comprehensive free trade agreements and investor protection agreements.

It is therefore imperative that we continue to deepen our trade links with allies, partners, and reliable suppliers, both through free trade agreements and more comprehensive arrangements, such as the transatlantic Trade and Technology Council (TTC) with the United States.

Policy-makers should also be mindful of the gains that can be reaped by exploiting free trade agreements that are already in place. For example, a report from UNCTAD has suggested that EU exporting companies lose 72 bn euro annually by failing to take advantage of preferential tariffs awarded through free trade agreements[33]. Similarly the WTO members represent 96% of world GDP[34], so despite the difficulties in reaching agreement, global trade negotiations still hold the promise of significant economic gains for all participating countries and must be continued with a strong momentum now that in-person ministerial meetings have been resumed.

A related point is that international outreach is important to ensure that the sanctions are not undermined by third countries trading with Russia, so that SMEs and other companies experience a level playing field. This will require extensive political engagement by the European Commission and Member States with third countries. Coordinating sanctions and their subsequent enforcement is paramount to ensuring that the imposed sanctions regime is effective.

Further information on sanctions for SMEs

Many SMEs find it difficult to navigate the sanctions which are complex and difficult to understand. Therefore, as many efforts as possible should be spent on guiding SMEs so they do not unintentionally break the sanctions or hold back on commercial activities that are legal. This will help avoid situations where an SME discontinues an activity simply due to uncertainty about the scope or depth of sanctions. More specifically a one-stop-shop for sanctions-related questions could be envisaged in each Member State and the Commission should provide even more guidance and consolidated versions of sanction documents and offer training to the different networks that advise and support businesses, such as the Enterprise Europe Network and the European Clusters Alliance.

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[32] Danish Business Authority (2018) Barriers for SMEs on the Single Market – November 2018 (danishbusinessauthority.dk)
[33] UNCTAD (2018) The Use of the EU’s Free Trade Agreements Exporter and Importer Utilization of Preferential Tariffs | UNCTAD
[34] Confederation of Danish Industry/DI (2022), “GATT, WTO og den 12. Ministerkonference” di-analyse---gatt-wto-og-mc12---juni-2022.pdf (danskindustri.dk)

An analytical approach to dependencies to provide strategic foresight for SMEs

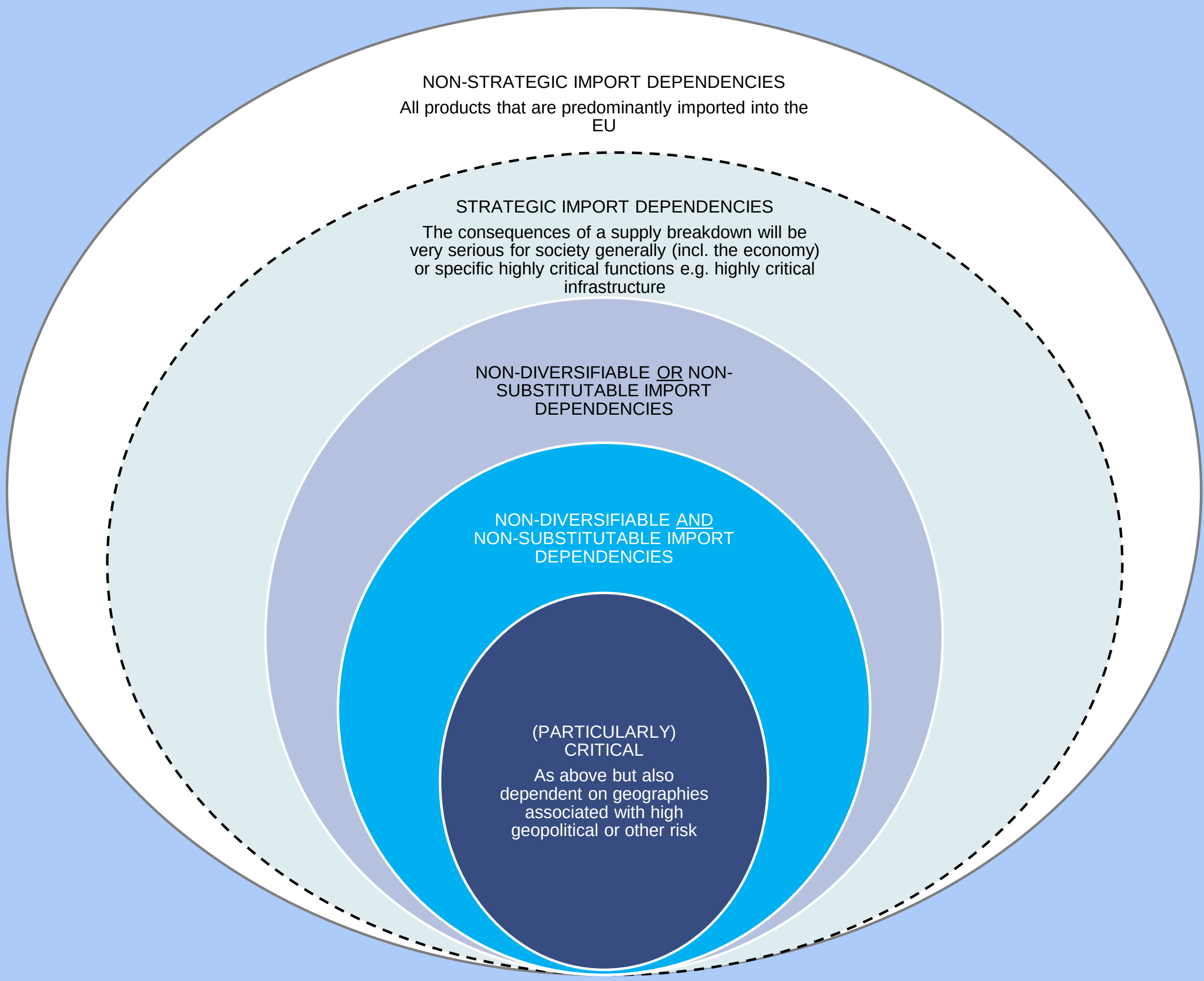
Recent years with trade tensions followed by the pandemic lockdowns and most recently the Russian aggression in Ukraine has caused many businesses to pause and reassess. Many European businesses are looking to restructure supply chains to reduce their exposure to geopolitical risk. At political levels decision-makers are similarly weighing approaches that could reduce dependencies in light of fast-changing geopolitical realities while still maintaining the immense gains from global trade and geographical specialization we have accrued over the past decade of globalization.

In this context business would benefit from transparency about risks and the stability of a systematic approach to how import dependencies are tackled. This is particularly relevant for SMEs who usually do not have the resources or analytical capacity to monitor developments, assess whether their supply links need reassessment in light of geopolitical or other risks, and provide foresight and early warning of adverse developments.

The European Commission has in its analytical work around dependencies[35] helpfully distinguished between those that can be mitigated through substitution and diversification strategies and those that cannot and where Europe is particularly vulnerable. Further analytical work to deepen our understanding of the EUs' dependencies would be helpful to help policy-makers and businesses act with foresight and preempt supply crunches. Many approaches are no doubt possible and could yield different insights. One potential approach would be to complement the work on substitution and diversification of our import dependencies with considerations about the extent to which the damage from a supply shock would be unacceptable for society or particularly critical functions within, and whether we are dependent on friends and reliable partners, as sketched out below:

[35] European Commission (2021) "Strategic dependencies and capacities" swd-strategic-dependencies-capacities_en.pdf (europa.eu)

Graph 15 One possible approach to typologizing import dependencies as a framework for analytical foresight



Source: The Danish government

Among the tools for addressing the dependencies are for example an increased circular economy, diversification and further sourcing of raw materials from within the Single Market.

Bolstering Europe's open strategic autonomy

Europe's aspiration of achieving greater open strategic autonomy is even more pertinent today with the outbreak of war on the European continent, following growing geopolitical and trade tensions globally, and in light of the COVID-19 induced lockdowns which demonstrated the significant vulnerabilities of non-diversified "just in time" global supply chains.

Europe will always be dependent on imports and trade with third countries, also for highly important commodities and other inputs. Nevertheless, it is at the same time crucial to assess our place in the world, and the economic and political risks that we face, including in terms of the role of SMEs within global supply chains, and the external dependencies they entail.

Strategic partnerships with reliable third countries, especially like-minded countries, will be vital, and help large companies and SMEs alike in terms of securing reliable and resilient supplies of critical inputs to our industry, including energy where rapid action to revamp Europe's energy mix is particularly important.

Engaging in strategic thinking and exploring appropriate solutions is particularly important in the context of the digital and green transitions, which are expected to massively increase the need for a number of highly sought after raw material inputs needed for the production of specific key technologies such as electric vehicles and wind turbines[36]. If left unaddressed, the result could be severe shortages that could adversely affect European business, and likely be particularly pronounced for SMEs that have less market power and lesser global reach than larger competitors.

At the same time, we should continue to spearhead initiatives and policies that can increase European production while boosting competitiveness and comparative advantages in high-growth industries and the high-potential industries of the future. Possessing the capacity and technological knowhow to produce market-leading products that third countries desire is in many respects the best way to reinforce our resilience in a more volatile world economy through the deepening of mutual dependencies.

Skills

Business needs talent and competencies to thrive in an increasingly competitive global marketplace. European firms need the best and the brightest to stay at the forefront of technological progress, and access to workers with the requisite background and skills is necessary to ensure that SMEs can maintain or expand operations in accordance with commercial opportunities and market developments.

The Russian aggression in Ukraine has had a negative impact on the availability of labour in the EU, due to the many Ukrainians who have left the European Union. Solutions could include greater automatization and using free trade agreements as a lever to facilitate the outsourcing of activities or similar means that allow European companies to draw upon the expertise and manpower abroad.

Regardless reports and survey data continue to suggest Europe experiences persistent hiring difficulties when it comes to ICT specialists, as well as general shortages of labour, with 27% of European companies now reporting access to labour as a constraint on their production. The situation is rendered worse by the fact that some of the activities that were outsourced to Ukrainian subsidiaries or partner companies have been deeply affected by the war. While the outflux of Ukrainian refugees seeking refuge in Europe could potentially in time have offsetting effects on labour market shortages, it should be borne in mind they may be derived from different demographic groups than most migrant workers, and at any rate it remains to be seen how developments play out.

For SMEs the dearth of talent and workers poses a twin challenge since they often lack the reach and knowhow that larger competitors have to attempt to recruit from the larger global pool of talent. At the same time they also often struggle in the competition for talent with large-sized firms that may have, among other things, greater name recognition.

It is of particular importance to focus on the skills for the green transition, so the challenges linked to the green transition and in particular the energy transition can be addressed.

[36] https://eurometaux.eu/media/jmxf2qm0/metals-for-clean-energy.pdf

Liquidity and payment issues

Only 40% of businesses in the EU are paid on time, and these delays are reportedly the cause of a quarter of all SME bankruptcies[37]. The public sector can play an important role by ensuring that public contracts affected by the developments in relation to the invasion of Ukraine are handled with fairness and reasonable flexibility when SMEs, through no fault of their own, e.g. due to shortages of materials, find themselves unable to fulfil contractual terms within certain project deadlines. The same can be said as regards the relationship between SMEs and large corporations who should also show flexibility in rapidly changing market conditions. Also, late payments are particularly problematic in an inflationary environment where the value of outstanding payments are eroded faster, and the constraints on liquidity due to outstanding payments will also be more serious in a context where growth prospects are weakening.

Another factor affecting SMEs is the response of banks to the sanctions. It is important that banks are not "over-compliant" to the detriment of SMEs and their possibilities both regarding international payments and transfers and regarding their general possibilities for obtaining credit.

[37] European Commission (2020) Unleashing the full potential of European SMEs (europa.eu)

About the SME Envoy network

The network of SME Envoys was set up in 2011 as part of the review of the Small Business Act. Each EU country has nominated a national SME Envoy to complement the role of the EU SME Envoy who chairs the network. The group of SME Envoys makes up an SBA advisory group that promotes SME friendly regulation and policy making in all EU countries. The SME Envoy is an active interface with the SME business community, considering their specific interests and needs in EU programmes and policies. The main objective of this function is to establish a close, direct link between the Commission, SMEs and their representatives