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IN BRIEF

The Long View: A Centre Right Response to the Economic Fallout of War in Ukraine

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Introduction

Much has been written on the economic impacts of Russia's invasion of Ukraine. For the European Union, the already visible impacts of rising energy and food prices presage more fundamental economic challenges in the longer term. Coupled with the lingering side effects of the COVID-19 pandemic the global economy is facing unprecedented turmoil.

Unfortunately, the ongoing humanitarian crisis in Ukraine is also being followed by economic consequences which are already impacting both European and global economies. The uncertainty of this war is eroding confidence and will pose a threat to eco-nomic stability should it continue in the long term. As European Commissioner for the Economy, Paolo Gentiloni noted, 'the duration of the war will deter-mine its cost, both humanitarian and economic'.

This *In Brief* provides a broad overview of the principal macroeconomic impacts of the Ukraine war on the EU. It also provides a set of recommendations designed to guide the EU's policy actions in the future. Further publications in this series will deal with specific issues related to the impacts on agriculture, energy prices, European security/defence policy and the longer-term effects on the wider European integration process.

Principal Macroeconomic Impacts:

Slowing Growth, Increasing Anxieties

On a macroeconomic level, the war in Ukraine is reducing global growth and is disproportionally impact-ing the EU given its direct exposure to both the Ukrainian and Russian economies, particularly relat-ing to energy and food production. Latest projections from the International Monetary Fund (IMF) estimate global growth slowing to 3.2% in 2022 (down from 6.1% in 2021). For the Eurozone, economic growth is expected to decline to 2.9% in 2022 and just 1.2% in 2023. For 2023 this represents a downgrade of over 1 percentage point from their April 2022 projections. Further downgrades are likely given the potential for a further deterioration in the coming months.

In 2022, the Eurozone is following a global pattern of reducing global economic activity. Economies includ-ing China (3.3%), Canada (3.4%), Britain (3.2%) and the US (2.3%) are all currently experiencing a signif-icant moderation in growth. The latest projections from both the European Commission and the Euro-pean Central Bank support the IMF's downgrades of economic activity with only a "partial rebound ex-pected in the medium term". Economists now view a recession in Europe (and the US) as "increasingly likely" in the coming months.

Slowing economic growth is also weakening eco-nomic confidence across Europe. Coupled with wider global uncertainties – the possible future trajectory of COVID-19 and the response to it from key global

economies such as China – it is clear that the war is significantly corroding economic confidence. Consumer surveys in Germany show confidence at all-time lows (levels are now lower than at any time since such surveys began in 1991).

Surveys of EU businesses are clear in highlighting concerns over rising energy prices, supply chain disruptions and sourcing raw materials. Manufacturing is showing a particular fragility with new orders contracting sharply. European businesses are "sinking into an increasingly steep downturn, adding to the re-gion's recession risks. New orders are already falling at a pace which, excluding pandemic lockdown months, is the sharpest since the debt crisis in 2012, with worse likely to come".

Rising Inflation is Eroding Price Stability

Eurozone inflation is estimated at 9.1% in August 2022. Prices in the Baltic states are now rising at over 20% on a rolling 12-month basis. In member states as diverse as Slovakia, Poland, Romania and the Netherlands, inflation is over five times the ECB's benchmark for price stability (2%).

The ECB is projecting that Eurozone inflation will moderate to 3.5% in 2023 and 2.1% in 2024. However, these projections are based on the normalisation of energy and food prices over the next six to nine months. The "assumed decline" of these prices is unlikely given the worsening economic outlook.

Global policymakers now agree that central banks face their greatest challenge in decades and that combatting high inflation will be much harder than previously anticipated. The ECB's reluctance to raise interest rates (when compared to other global central banks) has ensured that inflationary pressures are now embedded across Eurozone economies. De-mands for higher salaries, to compensate for rising prices, are resulting in industrial unrest across Eu-rope. Thus further increasing the potential of a broadly based wage-price spiral in the medium term.

And while it is correct to say that Russia's aggression has supercharged price increases in several economic sectors (energy and food being the most notable), the ECB's current approach ignores two important points.

First, inflation had firmly taken hold across much of the Eurozone prior to Russia's invasion of Ukraine (it was already 5.1% and rising in January 2022). Thus, even the normalisation of energy and food prices will not resolve underlying inflationary pressures.

Second, the ECB's inflation estimates, quite remarkably, continue to ignore housing as a driver of rising living costs. This, in a Eurozone economy where housing costs remain a critical component of real expenditure patterns and where property prices have risen dramatically in many member states. Even the ECB itself has acknowledged that Eurozone property markets are now at risk of significant price corrections as interest rates rise.

Ultimately, the Ukraine war has exacerbated existing inflationary pressures across the Eurozone. With current inflation now higher than anticipated, the ECB will likely have to raise interest rates quicker (and higher) than is currently expected. This will likely worsen the economic turbulence in the months ahead and make recession in Europe unavoidable.

Eurozone Instability is back on the Menu

The combination of low growth, high inflation and increasing interest rates pose real challenges for the future of the Eurozone. The vulnerability of the single currency area should not be underestimated. Even before accounting for the additional fiscal costs aris-ing from the Russian invasion (e.g. increased spend-ing on security and defence, higher energy/food costs) the overall debt to GDP ratio for the Eurozone stood at 95%. Seven countries in the Eurozone (in-cluding France and Italy) now have public debt levels in excess of 100% of GDP.

The Ukraine war – in magnifying the uncertainty around the European economy – is fuelling renewed market doubts about the current structure of the Eurozone. Italy, owing to its elevated public debt levels and recent history of low growth, is the primary focus of concern. Already, the ECB has been forced to announce a new "anti-fragmentation tool" to "contain divergence in borrowing costs" between more vulnerable Eurozone members and Germany. However, this approach does nothing to address the longstanding structural flaws within the single currency area.

As was evidenced in the Great Recession beginning in 2007, the Eurozone remains vulnerable to the consequences of unforeseen external shocks. Although launched in 2014, the Eurozone's Banking Union remains unfinished with no clear timeline for completing its final pillar (a common deposit insurance scheme). As was the case a decade ago, the Eurozone remains susceptible to financial market speculation against individual members and has not closed the "doom loop" between national debt and domestic banks. Its longer-term growth potential remains anaemic.

Ultimately, the impact of the Ukraine war on the sta-bility of the Eurozone is dependent on the length and severity of the conflict. In the short term, its most ob-vious economic impact on Europe – rising prices - will actually reduce debt to GDP levels for most member states. Thus, offsetting expected increases in interest rates and reductions in economic growth.

However, in the longer term and as already noted, increased economic turbulence arising from an extended military conflict in Ukraine will lead to a more prolonged bout of inflation. This in turn will require a more robust monetary policy response resulting in higher interest rates. In this scenario, the Eurozone will be subject to increasing structural instabilities arising from depressed growth and investment.

Fuelling the Political Extremes

The economic impacts of the war in Ukraine are also influencing political debates across the EU. In France, the public backlash against rising prices – *le pouvoir d'achat* (purchasing power) – has strengthened feelings of discontent and economic malaise. The recent Presidential and Parliamentary elections witnessed an increasing drift to the political extremes. *Le Rassemblement National*, headed by Marine Le Pen, gained over 40% of votes in the Presidential election by focusing, almost exclusively, on the cost of living crisis facing French families.

This is a narrative that will become more pronounced in the months ahead. The likelihood of escalating en-ergy prices, prolonged inflation, lower growth and in-creased economic uncertainty will further challenge Europe's political landscape. Energy and food prices (discussed in two forthcoming *In Briefs*) are set to re-main elevated in the medium term. This, in turn, will feed into narratives demanding more and more public action to protect the spending power of ordinary workers.

The European Commission has already signalled a much more interventionist approach is being developed to curb energy price rises for consumers. This is necessary, but will likely further increase public spending and feed into broader debates concerning the stability of debt levels and the Eurozone. A situation likely to become most acute in the Baltic states (owing to the direct impacts of the Ukraine conflict) and economies such as Italy (due to hold national elections in the coming weeks).

Politically, as was evidenced in the French elections, the economic spill-overs of the Ukraine war could potentially fuel a concerted move to the political ex-tremes. A risk that will increase the longer the conflict continues and prices remain elevated. Such an effect would also weaken the ability of Brussels to respond coherently at a European level. The election of more populist-led governments in 2023 would weaken the ability of the EU to develop the pan-European eco-nomic policy responses that may be required to help stabilise European economies in the future.

Recommendations:

The current geopolitical landscape – although dominated by the issue of energy prices – exhibits a wide range of economic impacts that will shape the EU's future direction for decades to come. From a macroeconomic perspective, the coming months and years will pose a significant challenge to the stability of the EU which should not be underestimated.

As previously noted, specific recommendations concerning energy or agricultural policy will be contained in future *In Briefs* in this series. However, in a wider political economy context, we argue that:

1. **Price Stability is Key**

Price stability is the key to ensuring the future sustainable development of the European Union. With-out stable prices, the EU's core ambitions in areas such as combatting climate change and increasing digitalisation will not be achieved. Economic history has shown that periods of high inflation also erode public support for the political process and reduce the

standard of living of working and middle-class families. The ECB should stick clearly to its mandate of ensuring price stability in an independent and transparent manner notwithstanding the short-term economic environment.

2. Banking and Financial Leadership

The external shocks of the pandemic and war in Ukraine have significantly reduced Europe's medium-term growth prospects. The EU should take advantage of this uncertainty to further strengthen the EU's capacity to lead the global economic recovery. Europe's financial resilience should be improved by completing Banking Union.

In areas like digital finance, the digital Euro and artificial intelligence the EU should continue to set global benchmarks. Proposals for introducing a digital Euro should be expeditated. Finalising and implementing the Markets in Crypto Assets (MiCA), Digital Operational Resilience Act (Dora) and Artificial Intelligence Act should be prioritised.

3. Growth as the Driver of Debt Reduction

Europe's societies are fragile following the last two decades of crises. As a result, economic growth should become the principal mechanism for reducing debt burdens in the longer term. A growth-induced debt reduction programme, underpinned by a commitment to a credible (and simplified) EU fiscal framework, could significantly cut debt relative GDP without placing any additional burden on working and middle-class families.

The experience of Belgium in the 1990s provides a template for future policy. Then, a clear political commitment to the Euro (and its fiscal rules) was complemented by a gradual process of debt reduction which shielded Belgium from the worst impacts of the Eurozone debt crisis notwithstanding still elevated debt levels.

4. A Simplified, Incremental and Responsive Eurozone

Associated with Recommendation 3 is the understanding that if the Eurozone is to thrive in the future, its governance rules must be updated to reflect pre-sent-day realities. The Eurozone's future rules should be based on four key principles – Simple, Incremental, Investment led and Responsive.

In effect, this involves developing a governance framework which facilitates – when needed - a mix of (a) gradual debt reduction; (b) fiscal policies driving sustainable growth; (c) public and private investment; (d) simplified and consistent enforcement of rules which reflect the prevailing economic realities facing each member state.

As part of this process, the criteria allowing use of the "general escape clause" should be formalised allowing for greater transparency in future times of crisis. The aim being to create a more flexible, yet credible, Eurozone framework.

5. A Normalising Fiscal Framework

The pandemic and the ongoing war in Ukraine understate the importance of creating fiscal buffers during periods of economic growth to facilitate additional spending in times of crisis. It must become the vital underpinning of a future, normalised fiscal framework, as it allows greater fiscal space to counter unfore-seen shocks without causing immediate debt pres-sures from the financial markets. This is vitally important as the Eurozone moves away from a neg-ative interest rate environment.

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