The War Economy in The Russian-Ukrainian Conflict

Cristian Moșnianu
"Ovidius" University of Constanta, Romania
cristianmosnianu@gmail.com

Abstract

The paper below represents the result of research from an economic point of view since the outbreak of the Russian-Ukrainian conflict. The governments' response to the overlapping economic crises generated by the war in Ukraine has generated various macroeconomic imbalances whose correction will have to be realized in the coming years. The list of crises to which Europe will have to respond in the coming years does not refer only to pandemics or war, but to a more volatile list, a "permacrisis". The only European chance to overcome these challenges lies in the fact that the EU states must work together.

It will be interesting to study if in the future the governments, which have the impression that they can control the effects of energy crises, will manage to implement, together, the measures necessary to calm the energy markets and not only that.

Key words: economy, war, crisis, energy, inflation
J.E.L. classification: Q40, E60, O40

1. Introduction

Contemporary conditions degraded by Russia's invasion of Ukraine as well as European governments' reactions to them force governments to switch to a wartime economy, to manage its impact with global chaos. How have world economies reacted to previous conflicts and how have governments, even those not directly involved, reacted to this military conflict? The shocks on countries' economies derive from three directions that are amplified by testing internal economic balances. What was the reaction of governments in times of war and what remained, in times of great turbulence, of market economies? What was and is the evolution of macroeconomic indicators, from inflation to external debt, from deficits to capital expenditures? It is known that at the macroeconomic level, the economic consequences of a war are like the economic consequences of a deadly pandemic.

Russia, the main belligerent, has made natural gas supplies a veritable weapon used against Europe, with the aim of undermining European economies, respectively breaking their solidarity with Ukraine, the invaded country.

The result: Europe's economies changed radically and went into a war paradigm (the reduction in the volume of natural gas led to a chain of explosive price increases that penetrated all markets. Governments were put in a situation where a multitude of economic crises simultaneous shocks rocked the cost of living for citizens and the economies themselves. Thus, government interventions in the private economy were explosive in scope through the adoption of policies unthinkable in peacetime and liberal economies.

We are facing a behavior specific to belligerent situations, where classic weapons are complemented by the weapons of natural resource management that bring national economies to their knees and intoxicate society.

All this war behavior is done with massive loans and when the long-desired peace is returned, they will represent the bill that will have to be paid for years to come. The condition will be that this bill does not represent the motivation for the emergence of a new war.

2. Theoretical background

“Inflation represents a monetary-real macroeconomic imbalance reflected in the increase in the monetary mass in circulation over the needs of the economy, a fact that leads to monetary depreciation and the abnormal, cumulative, and generalized increase in prices”. (Ignat I., 2002). “In monetary terms, inflation represents the fact that the prices of goods and services increase, the amount of money (physical and on account) increases, and the purchasing power of a monetary unit decreases” (Țugui A., 2000). The war economy represents, in the classical sense, that economy that has restructured to meet the needs of a production affected by the support of large-scale military conflicts. In its current meaning, the war economy implies either the operation of the war economy on its territory, or a process of material reconstruction to eliminate the destructive, physical consequences of armed conflicts.

“The variant of an economy with specific potential for aggressions is currently taking shape, which develops branches capable of providing war material or simply of supporting the threat of the use of nuclear, chemical, biological weapons, etc.” (Economic Dictionary, 2001).

3. Research methodology

The methodology used here derives from the concepts related to energy crises, war economy and recession. The main purpose of this article is to present the energy crisis that started last year, its impact in Europe and the measures taken by the European Union authorities, using the qualitative research method. The article begins with a review of the concepts of energy crisis and war economy and providing at most representative definitions, then presented the impact of the war in Ukraine on the community economies and the measures taken to counter its effects.

This research is divided into sections as follows: in the first part it is presented the manipulation of energy prices by Russia and the premises of the armed conflict, and the research question was formulated: what were the signals that predicted the invasion of Ukraine by Russia. Second, it is presented the concept of inflation and the economic situation in some European countries. The last part of this paper highlights the findings regarding the impact of the war on European economies and the measures that governments are trying to implement to counter the effects of the war economy. The multiple crises at the European level as well as the measures taken by the authorities I formulated are among the main conclusions of my research.

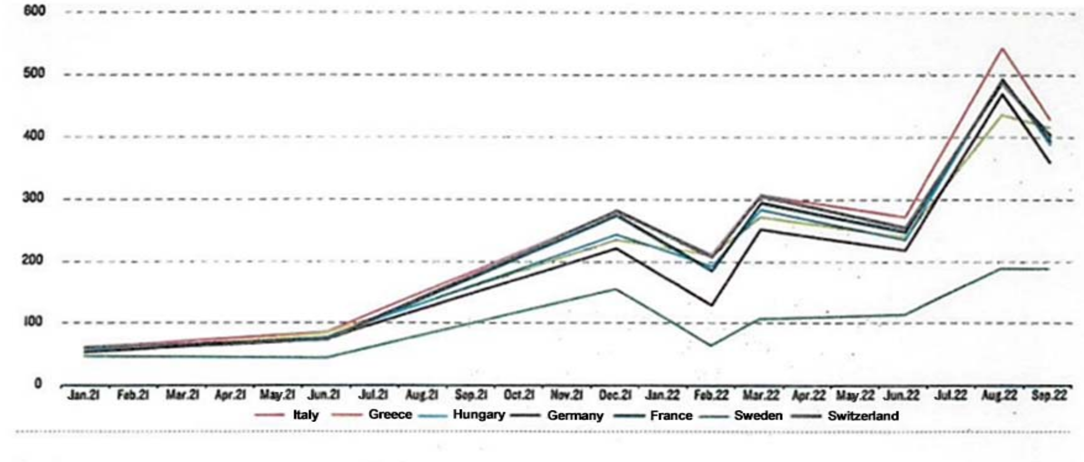
4. Findings

The war economy involves pouring out all the resources of a country in conflict, exerting not only maximum military effort, but also putting production at the service of the army's needs.

The use of the Russian economic weapon (natural gas) increased in intensity with the merging of troops with conventional weapons on the borders with Ukraine. This form of major Russian pressure began as early as 2021, on emerging European economies, before the invasion of Ukrainian territory. In the second half of 2021, Russia manipulated energy prices, through Gazprom, draining European gas reserves where extraction was cheaper. Combined with the forcing of the Nord Stream 2 gas pipeline into operation, the blackmail on European governments is being recognized late by them.

In 2022, until October, the volume of gas exported through land pipelines decreased almost five times (to the value of 536 million cubic meters). Consequence? The explosion of electricity prices (even by 1000%) in most European countries (800% in Romania). The pressure exerted by Russia was highlighted in December 2021 by the price peaks on emerging economies (Figure no. 1).

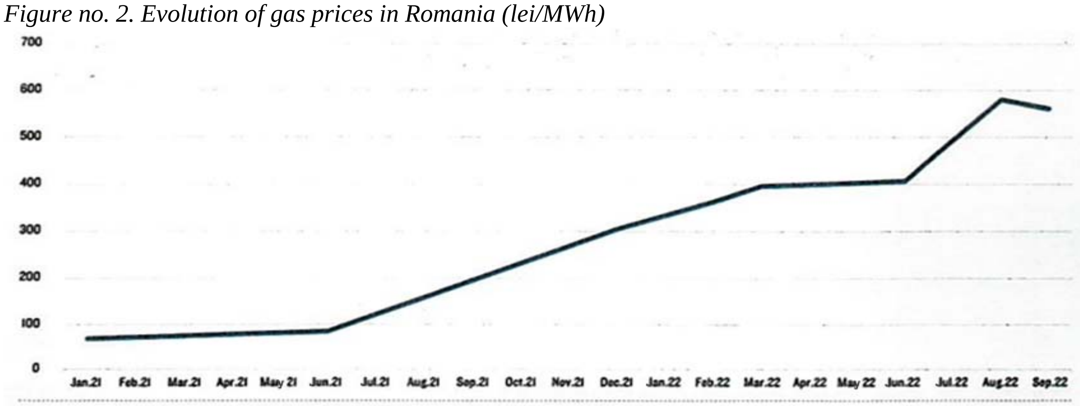
Figure no. 1. Evolution of wholesale natural gas prices (euro/MWh)



Source: https://insse.ro/cms/

The same thing is happening, in parallel, on the electricity market, as an effect of the war, and the setback in September 2022 is the clearest proof (Figure no. 2).

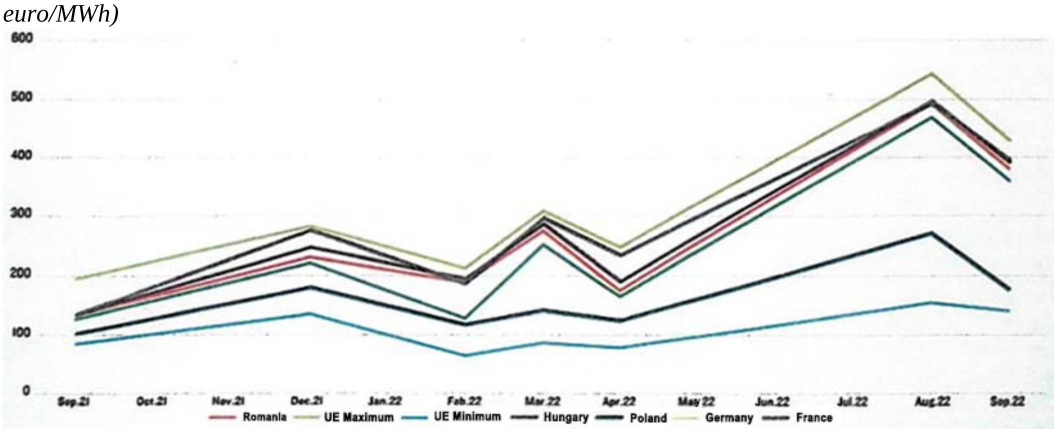
Figure no. 2. Evolution of gas prices in Romania (lei/MWh)



Source: https://insse.ro/cms/

The market reacted extremely aggressively, evidenced by the fact that the difference between the minimum and maximum price for wholesale electricity transactions, with next-day delivery, is more than double the minimum (Figure no. 3).

Figure no. 3. Price evolution of wholesale electricity prices with next-day delivery (average price, euro/MWh)



Source: https://insse.ro/cms/

The phenomenon found the necessary foundation also through the lens of the fact that the "single market" is far from being what was wanted, being more fragmented. All this culminated in the fact that Germany shut down most of its nuclear power plants and the drought reduced hydroelectric capacities.

Romania has also registered on the same downward slope since 2019, to industrial production which decreased by 2% in 2022 compared to the similar period in 2021 (the first 8 months). The locomotive of the European bloc, Germany, registered a decrease in industrial production by 0.5% in August, compared to July, and in July by 0.4% compared to June, for the second time in a row. France nationalized the most important electricity company, E.D.F., by purchasing the last percentages it did not own (16%), to reduce dependence on fossil fuels.

Romania recorded the second highest annual rate of industrial inflation at European level (70.9%), after that of Ireland (97.4%), in August 2022. The European Commission is trying various extended emergency intervention plans, for the redistribution to the population of the amount of 140 billion euros from exceptional taxes. Small governments, like Romania's, with budget deficits, can barely compensate for capping energy prices to the population. The big consumers stopped or reduced their activity, waiting for the much-promised aid: Azomureș, ALRO, the Galati iron and steel plant, Chimcomplex. Sectors such as chemical fertilizers, aluminum and steel were the most affected by the explosion in electricity prices. The upheaval of the energy markets was also manifested in other markets, especially in those where Ukrainian and Russian exports mattered. Foods suffered major price increases, raising many uncertainties for analysts.

Wheat prices rose from $795/bushel (1 bushel = 27.2 kg) to $1,252 on March 7. The price of aluminum (in which Russia counts) reached an all-time high of $4,073/ton in the first quarter of 2022. Uncertainties of war caused demand to scale back again, and the price of aluminum lost another 47%.

There are several reactions of governments, several measures of central banks and several ways of propagating imbalances that make this crisis different from a financial or "ordinary" crisis. Among the particularities of the war economy, we distinguish:

1. The focus is on the "survival" of the population and on the protection of the population with public money: energy security, food security and medical security.

2. The priority is no longer economic growth but the preservation of macroeconomic balances, inflation control and energy independence from Russia.

3. Increasing war expenditures and prioritizing these expenditures in the government procurement list: restoring ammunition reserves, contributions to NATO, and supplementing expenditures with national armies.

The paradigm is already known that in times of war, liberal economies are unable to provide prompt and effective solutions to emerging needs. This led to changes in public policies. The state began to make its presence more intensely felt through its involvement in national economies. Companies in strategic fields are nationalized or aided. State aid rules have been relaxed at the European level, with governments given the green light to intervene and support community economies.

Brussels is considering the adoption of legislation that would give the European executive powers to impose on companies the creation of stocks or the termination of some delivery contracts, to support the supply chain in crisis situations, such as the one during the COVID 19 period.

Governments in Europe have allocated around 500 billion euros to protect their citizens and companies from the spectacular increase in energy and gas prices, either in the form of caps, or compensations, or state aid or tax reductions. Community states allocated 314 billion euros for measures to mitigate the impact of the energy crisis, while Great Britain allocated 178 billion euros for this purpose.

If the money for the nationalization of certain companies, considered strategic, is added, then the amount reaches over 450 billion euros. Germany alone spent the sum of 29 billion euros for the nationalization of the Uniper company, the largest importer of natural gas from Russia. Even in Romania, legislation was introduced to protect consumers, the anti-speculation law, a law that allows the government, in exceptional situations, to intervene and correct in real time the inappropriate behavior of traders, producers of goods and services or service providers.

"Wars inevitably cause shortages and inevitably generate windfalls for some at the expense of others. In the past, those who profited from war were executed. Today, among those who profit are many energy producers and traders - instead of being led to the gallows, they should pay otherwise, be subject to an exceptional profit tax" - Joseph Stiglitz, Nobel Prize laureate in economics the year 2001.

The illustrious laureate believes that peacetime policies do not yield results in wartime. Markets are deregulated and government intervention to stabilize them is inevitable. In his view, wars, where they occur, produce shortages due to the fragmentation of the supply chain. He believes that, in such moments, measures that are otherwise criticized should be implemented. An example would be the over taxation of energy companies, the "winners" of this armed crisis. "Markets are simply moving too slowly for the kind of major but necessary structural moves," the great economist said. If markets move too slowly then governments risk going too far with good intentions.

A few economists very seriously draw attention to the fact that the current inflationary crisis was also possible since in the last decade, central banks have pumped thousands of billions into the great economies of the world. Similarly, the current "interventionism" of the states will have a bill that could surprise in the coming years.

Among the most visible disruptions generated by macroeconomic shocks is their impact on public budgets. The belligerent situation between Russia and Ukraine has forced European governments to increase defense spending by at least 2% of GDP. Added to this are the expenses for protecting consumers against the energy crisis which represented 2.5% of GDP. The scale of government actions reminds us of the 2007-2008 crisis when "too big to fail" became a slogan for saving institutions private finance with direct government funding, a move that backfired on Wall Street.

The ingredients of a war economy are: 1. Recession; 2. Inflation; 3. Debts

Recession – is a price everyone will pay to bring inflation back under control. This fact does not scare investors as much as the phenomenon of stagflation scares them: the decrease in the rate of economic growth or even a contraction of the P.I.B. combined with high inflation. Europe is currently facing stagflation, a phenomenon it will face until at least the end of 2023. Anti-inflation tools - high interest rates that discourage consumption and demand, leading to a reduction in prices can exacerbate the economic contraction. Similarly, increasing defense spending can further fuel inflation.

As if that were not enough, governments will also face public debt pressures, fueled by record public deficits that have financed the recovery from the COVID-19 medical crisis and will finance the mitigation of the cost-of-living crisis. The increase in public debt overlaps with the fight against inflation, which involves the accelerated increase in interest rates, which implicitly leads to increased funding costs for the states. To roll over the credits, the states borrowed larger amounts, at higher interest rates than when they borrowed in the "cheap money era". And this fuels larger public deficits, as the days of government borrowing are paid annually from the consolidated state budget. In the second half of 2022, the public debt of the euro area was 94.2% of GDP, and that of the EU was 86.4% of GDP.

The situation in the community area, with the highest public debts, is Greece (182.1%), Italy (150.2%), Portugal (123.4%), Spain (116.1%), France (113, 1%) and Belgium (108.3%) and the lowest are found in Estonia (16.7%), Bulgaria (21.3%) and Luxembourg (25.4%). The "press" of the European Central Bank (ECB) stopped once inflation forced a switch from an expansionary monetary policy, designed to support economic development, to a restrictive policy, designed to combat inflation.

In the European Union but also in the USA two reasons were behind the increase in defense spending: the first consisted in the fact that governments are trying to increase their military arsenal to face an aggression by Russia, the escalation of the current conflict that can anytime expand and involve other states; the second reason is the replenishment of N.A.T.O.'s stockpiles of weapons. because of the aid given to Ukraine amid the state of belligerence with Russia. Global spending has increased since 2021 to a historic level of 2.1 trillion dollars, but it will surely increase against the background of the Russian-Ukrainian conflict. Only 6 member countries of N.A.T.O. now fulfill the obligation of 2% of G.I.P. for defense: Poland, Greece, Romania, Latvia, Lithuania, and Estonia. France increased its defense budget by 7.4%, reaching around 44 billion euros.

In September 2022, France officially announced that it would switch to a war economy and intensify the production of military equipment. Orders of two billion euros are forecast for 2023 indicating that France wants to replenish its stocks.

Romania has fulfilled its obligation of 2% of GDP for defense since 2015 and in 2023 it will increase it to 2.5% as it wants to purchase armored personnel carriers, fighter planes, but also submarines and tanks. The total bill will be around 12 billion euros. The most important investment was around 4 billion euros and consisted of the purchase of a PATRIOT battery that became operational. This is the most modern version of the PATRIOT missile defense system, consisting of radars, command, and control technology, as well as several types of interceptors capable of detecting, identifying, and destroying tactical ballistic missiles, cruise missiles, drones, aircraft advanced, etc.

An indicator of the pressure of defense spending on governments is that 9 governments say that arms spending should be increased without worrying about the EU bloc's ceiling on budget deficits. These rules were suspended during the COVID-19 pandemic, and the commission suggests that the period should be extended amid the Russian-Ukrainian crisis.

Relative to economic performance, Estonia, Lithuania, Letonia, and Poland provided the largest military and civilian aid to Ukraine in the period immediately following Russia's February 24 invasion. Poland offered 200 tanks to Kiev, of Soviet origin.

5. Conclusions

Every crisis of the last fifteen years has been followed by a spectacular increase in public and private debt to stimulate economic growth and support the current standard of living. The European Central Bank must act forcefully to fight inflation and preserve public confidence. Community monetary policy will therefore have to remain tight for a longer period. Central banks, by reducing aggregate demand, can act to bring inflation back as close to 2% as possible, which is not expected to happen before 2024.

It is also important that governments design fiscal support programs that do not fuel inflation again because this will lead to an even higher rise in the level of interest rates. Finance Ministries are more willing than Central Banks to accept higher inflation to reduce debt, in parallel with fiscal repression. But it is extremely important to remember that they recognize the harmful effects of high, double-digit inflation on economic, social, and political stability and accept the costs associated with reducing inflation. It is equally important that the Central Banks stop aspiring to reach their inflation figure of 2% and content themselves with bringing inflation back to a decent area (4%-5% / year).

States have borrowed massively during the pandemic and through inflation they will repay less purchasing power and reduce their level of indebtedness. The energy crisis will be a lasting one and we must adapt to the fact that energy will cost more in the future. In addition, fiscal-budgetary policy must work with monetary policy to reduce inflation and reduce economic imbalances.

In the long term, war could fundamentally alter the global economic and geopolitical order if energy trade changes, supply chains are reconfigured, payment networks are fragmented. Rising geopolitical tensions heighten the risks of economic fragmentation, particularly for trade and technology.

6. References

- Ignat, I., 2002. *Political economy*. Bucharest: Economica Publishing House.
- International Energy Agency (IEA), 2019. *Energy security. Ensuring the uninterrupted availability of energy sources at an affordable price*. [online] Available at: https://www.iea.org/areas-of-work/ensuring-energy-security [Accessed 11 of March 2023]
- International Monetary Fund (IMF), 2022. *Beating the European energy crisis*. [online] Available at: https://www.imf.org/en/Publications/fandd/issues/2022/12/beating-the-european-energy-crisisZettelmeyer [Accessed 21 of March 2023]
- Tugui, A, 2000. *Inflation*. Bucharest: Economica Publishing House.
- Winzer, C., 2012. Conceptualizing energy security. *Energy Policy*, 46, pp. 36-48. https://doi.org/10.1016/j.enpol.2012.02.067

- World Economic Forum, 2022. *3 charts that show the state of Europe's energy crisis right now*. [online] Available at:https://www.weforum.org/agenda/2022/10/europe-energy-crisis-gas-report-iea/ [Accessed on 14 of May 2023]
- * * * *Economic Dictionary,* 2001
- https://insse.ro/cms/