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GEORGIAN FOUNDATION FOR STRATEGIC AND INTERNATIONAL STUDIES

RUSSIA'S WAR AGAINST UKRAINE AND ITS IMPACT ON THE EUROPEAN UNION'S ECONOMY

DAVIT SHATAKISHVILI

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EXPERT OPINION

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საქართველოს სტრატეგიისა და საერთაშორისო ურთიერთობათა კვლევის ფონდი
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Introduction

The Russian military aggression in Ukraine was followed by retaliatory political and economic decisions from the West which were reflected in seven packages of unprecedented-scale sanctions. The coordinated actions of the partners dealt a heavy blow to the aggressor country, affecting almost all its sectors, critical industries and financial institutions. However, the West itself could not avoid the severe consequences due to the scale of economic globalization. On the one hand, the current difficult economic conditions are caused by the war itself because Russia and Ukraine are one of the largest players in global trade and they occupy the leading positions in the world in terms of the production of basic consumer products such as wheat, grain, oil and others, not to mention energy resources and technological components. On the other hand, the situation is aggravated by the sanctions - which in turn have damaged supply chains and increased consumer prices. All of this is happening when the global economy had not yet recovered from the shocks caused by the pandemic and it was returning to a normal state of functioning from the beginning of this year. However, Moscow's war against Europe's territorially largest country turned economic forecasts and plans upside down.

The West's retaliatory sanctions against Russia's aggression have great political significance and are aimed at exhausting the war machine of Moscow's authoritarian regime. Even though the countries imposing the restrictions are also suffering, these steps were crucial so that other European countries would also not become the victims of military attacks. More than 200 days have passed since the beginning of the war and the world economic landscape has changed significantly, something which pushed countries to make extreme decisions. High inflation, disruptions in production and supply chains and low rates of economic growth, if not recession in some cases, are just a few of the problems many countries have recently faced. In the case of Europe, the situation is further complicated by its high dependence on Russian energy resources, especially when a long and cold winter is ahead.

The European Union is the third largest economy in the world after the United States of America and China. Thus, the challenges it faces have a chain reaction and spread to many countries. In the context of supporting

Ukraine, together with the USA and Great Britain, on the one hand, the EU was the main initiator and implementer of the restrictions that created tangible problems for Moscow's regime and, on the other hand, it plays a major role in terms of sheltering refugees and helping Ukraine with financial resources and military equipment. It is interesting to discuss the difficulties faced by the European Union states, the steps they have taken to deal with the aforementioned problems and the forecasts for its economic growth.

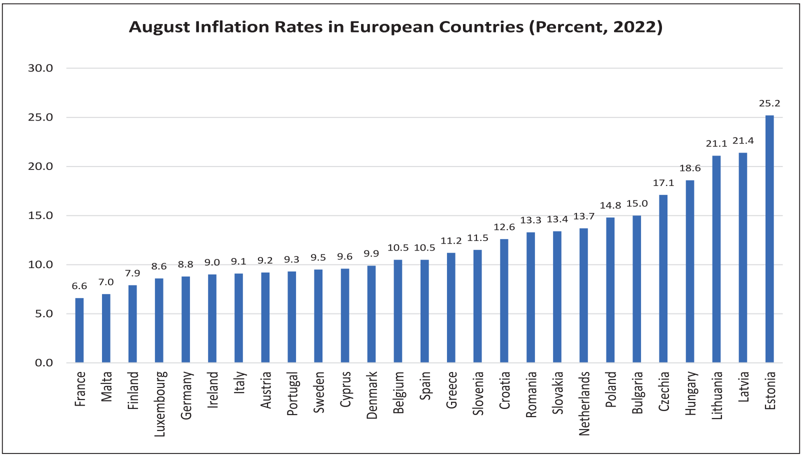
Inflation

Inflation is one of the primary and noteworthy challenges for the European Union because the increase in the general level of prices directly affects the purchasing power of the population, their general socio-economic well-being and their quality of life. Against the backdrop of the problems caused by Russia's invasion of Ukraine, prices in the European Union have increased significantly. For example, according to Eurostat data, the annual inflation rate reached 9.1% in August of this year which is much higher than the current expectations (Eurostat, 2022). For comparison, the annual rate of inflation was 3% in the same period last year. The prices of basic consumer products, as well as alcohol, tobacco, consumer goods and cars, have increased whose costs have grown by 5-7% as compared to last year.

According to the statements of the European leaders, the main driver of the high inflation in the EU countries is the increase in the prices of energy resources which amounted to about 38% (Eurostat, 2022). This, of course, has a major impact on the proper functioning of manufacturing sectors and, in turn, it hurts trade and supply chains. As winter comes, European experts predict a further increase in the prices of energy resources and food products. The main question concerns the severity of the consequences and the length of this process for the European states (Ward-Glenton, 2022).

In August, the lowest inflation among the EU countries was in France which amounted to 6.6% and the highest was in Estonia - 25.2%, Latvia - 21.4% and Lithuania - 21.1% (Eurostat, 2022). Graph 1.1 shows the annual inflation level for August in European countries.

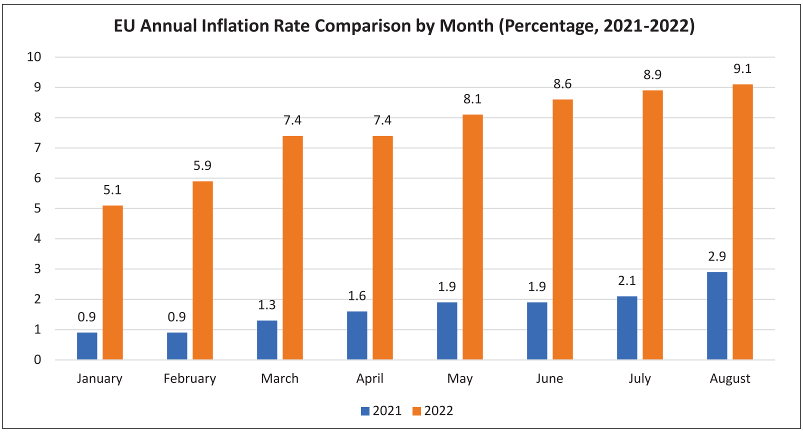
Graph 1.1



Source: European Statistical Office (Eurostat)

Graph 1.2 presents the EU annual inflation level by month and compares the years 2021 and 2022. It is clear from the graph that there is a noticeable increase in the overall price level this year as compared to the same period last year.

Graph 1.2



Source: European Statistical Office (Eurostat)

Europe's political leaders fear that the highest inflation during the latest decades, which is already nearing double digits, will rise further and affect household savings and hinder investments and other economic activities. Ultimately, everything hurts the people of Europe and has a direct impact on their quality of life. The European Central Bank has also updated its inflation forecasts. The Bank indicates that inflation will be 8.1% this year, 5.5% in 2023 and 2.3% in 2024, thus returning to the annual rate of 2021 (ECB, 2022).

To deal with high inflation, the European Union countries implement various support programs in consideration of their potential risks. Their goal is both to alleviate the problem of increased consumer prices for the population and help the private sector pay less to the state budget while having more financial resources for both domestic consumption and reinvestment. Such stimulus programs include - cash assistance to the population, pension increases, partial tax write-offs or deferral programs for businesses, tax rate reductions, unemployment assistance, etc. To the extent that such types of allowances may only provide short-term relief for the population, there are consequences for the individual nations because the amounts are deducted from their state budgets, thereby using funds targeted for various priority directions to ensure the long-term stability, development and economic growth of the countries.

Monetary Policy

The European Central Bank (ECB) has significantly tightened its monetary policy due to the high inflation and the lowest value of the euro against the US dollar in the last 20 years. On September 8 of this year, the Governing Council of the European Central Bank increased the refinancing rate by 75 basis points and it reached 0.75% while this indicator had hitherto been 0% (ECB, 2022). The abovementioned decision affected 19 countries of the Eurozone and aims to reduce inflation to the target of 2% in the medium term. Presumably, this step would have had a positive effect on the exchange rate of the Euro in the short term if not for the decision of the Federal Reserve System (FED) of the United States to tighten its monetary policy as well. At its meeting on September 21 of this year, the FED's steering committee voted to increase the refinancing rate by 75 basis points, bringing the key rate to 3.25% (FED, 2022). This has negatively affected the value of the Euro which in turn is one of the causes of high inflation in Europe. It is expected that even tougher decisions will be taken by both the American and European financial authorities at the next meetings of the committees. However, experts say the ECB's decisions are overdue and they will need several more months to match the Federal Reserve System's pace of growth.

Generally, the refinancing rate is one of the main mechanisms to control inflation, although it hurts the proper functioning of the economy and contributes to its slowdown. Given the global economic difficulties and risks, the European Central Bank has to maintain a difficult balance between controlling rising inflation and maintaining economic growth.

The rate of refinancing is the main determinant of the interest rate of loans issued by commercial banks. However, in free markets such as the Eurozone, it is also affected by credit demand and supply factors - in other words, the amount both individuals and the business sector can spend and invest. If, for example, these individuals want to invest but find it difficult to get enough cash from banking institutions, this will lead to an increase in the interest rate which means that borrowing money will become more expensive. When the European Central Bank increases the monetary policy rate, it increases the interest rate on both loans issued by commercial banks and interest on deposits. Thus, considering the annual benefits, keeping and saving funds becomes a priority for the population and the demand for bank money decreases. As a result, the overall demand for various types of products and services decreases and, accordingly, the price as well as trade becomes less active and the flow of national currency out of the country also reduces. A tighter monetary policy alone cannot eliminate the problems nor can it counter the external factors causing inflation, although it can bring inflationary expectations under control which is one of the most important levers of its management.

Economic Growth

There are different expectations about the economic growth forecasts of the EU member states which changed along with the course of Russia's war against Ukraine and the retaliatory sanctions imposed by the West. The fact is that the European Union is currently facing both high inflation and challenges such as the disruption of supply chains, restrictions in obtaining components necessary for production, transport and logistics delays, energy resources, subsidy needs for the population and the private sector, among others. All of this has a major impact on the proper functioning and productivity of European economies which directly affects the gross domestic product. The general uncertainty and the impulsive actions of Moscow's regime make the situation even worse and less predictable.

Rising energy prices, declining consumer spending and reducing business activity across European countries are putting their economies under enormous stress and increasing the risks of a potential recession. Despite the difficulties, the EU's economy grew by 0.6% in the second quarter of this year as compared to the previous quarter and by 4% as compared to the same period last year (ECB, 2022). Now, this process is likely to be hindered somewhat by the tightening monetary policy and the forthcoming winter season.

The economic growth forecasts for the European Union provoke different opinions. The European Central Bank does not share the views about the possible recession of its economy, although the latest data indicate a slowdown in the economic growth of the Eurozone and stagnation is expected both in the last quarter of this year and in the first quarter of next year. The opinion of the Central Bank is that this process will not turn into a recession. According to its forecast, the Eurozone economy will grow by 3.1% in 2022, by 0.9% next year and will reach 1.9% in 2024. Commercial banks and financial institutions have different forecasts regarding economic growth. For example, the German Deutsche Bank predicts a 2.2% decline in the EU's economy in 2023 (Kollmeyer, 2022).

Despite the existing difficulties, the labor market contributes to the implementation of economic activities. According to Eurostat data, the unemployment rate in the Eurozone was at a record low of 6.6% in July of this year while the unemployment rate was 7.7% in the same period last year (Eurostat, 2022). As for industrial production, Eurostat data indicate that production in the EU increased by 0.6% in June as compared to May and by 2.4% as compared to the same period last year. However, production fell by 1.6% in July as compared to the previous month (Eurostat, 2022). It seems that Europe still has more problems ahead in terms of production. According to Bloomberg, the German car manufacturing company Volkswagen is thinking about moving its production to Eastern Europe, citing limited access to natural gas as the reason (Bloomberg, 2022). Additionally, several sources are reporting that metal producing and processing companies in European countries are also facing serious problems for this same reason (Desai, 2022). Consequently, companies may face even more tangible problems in terms of production in the coming months.

Energy

With the continuation of Russia's aggression and the forthcoming winter, the energy future of Europe is becoming a more urgent issue. On the one hand, this is due to Europe's high dependence on Russian natural gas and, on the other - the long process of finding alternative suppliers alongside the barriers artificially created by Moscow to gas supply to Europe. Seven packages of Western sanctions were not able to target Russian natural gas while restrictions have hit energy resources such as crude oil and coal. It is a fact that Europe had a hard time giving up Russian gas, although Russia itself started creating problems in this regard and using this resource as a tool for blackmail. Thus, the European Union faces the threat of significant energy challenges which increase both the risks of economic recession in European countries and calls into question the ambitions of the region vis-à-vis climate change.

As a result of the sanctions imposed by the West in response to Russia's aggression, the Kremlin significantly reduced gas supplies to European countries in March-July of this year and even stopped some of them completely. It is a fact that natural gas is the most important weapon of political and economic influence for Moscow. When Europe receives 40% of its gas supply from Russia, it is clear that its reduction and the subsequent blockade were a huge blow for the union which caused both production delays and significant inflation. According to the calculations of German analysts, the increase in the overall level of prices may even exceed 10%.

The largest gas pipeline for transporting Russian gas to Europe is the Nord Stream 1 which supplies gas to Germany, Austria, France and Italy. Already last year, the Russian state company Gazprom began to reduce the supply of natural gas to Europe. Along with the imposition of sanctions, this process took on a more radical character. As a result, Moscow reduced the load of the aforementioned gas pipeline from 40% to 20% in July (Meredith, 2022). Thus, the Nord Stream 1 transported about 33 million cubic meters of gas per day during spring-summer period while this figure reached 220 million cubic meters per day last year (Steitz, Escritt, 2022). The Kremlin explained this decision as the necessity of technical work and the lack of technological components, although this argument was unconvincing for European leaders.

The limited amount of natural gas from Gazprom was immediately followed by the decision of EU member states to reduce their gas consumption by 15% (Schmitz, 2022). This step from Europe may be perceived as a signal that it will not be under Russian pressure and it is not going to withdraw sanctions nor stop helping Ukraine with military weapons in exchange for replenishing its natural gas reserves. As far as it is known, most of the EU countries have already filled 80% of their gas reserves. Germany, France, Italy and the Netherlands have the largest amount of natural gas reserves while the smallest are - Latvia, Bulgaria and Hungary.

To increase the supply of Russian gas to Europe, the Nord Stream 2, an 11 billion dollar project, was built and started working in test mode at the end of last year. This project was opposed by the United States of America and most of the European countries. According to them, the pipeline would allow Moscow to have even more of a political and an economic influence on Europe. On the second day of Russia’s aggression against Ukraine, Germany, as the main supporter of the project, stopped its certification process. On September 26 of this year, the operator of Nord Stream 2 reported that the pressure in the pipeline dropped from 105 to 7 bars and there was probably a gas leak in the Baltic Sea (Lawson, 2022). As it became known, 300 million cubic meters of gas were loaded into the pipeline before the start of the war, although it was not officially put into operation. On the second day, a similar case was observed in the Nord Stream 1. EU leaders see Russia’s hand in this process and accuse it of sabotage.

The European Union is actively working to overcome the crisis. Additionally, negotiations are ongoing with individual countries regarding the increase in natural gas supply. European countries are also signing agreements with various states on the purchase of gas for domestic consumption. One of the main alternatives is liquefied natural gas which is transported by tankers. In this regard, the leading country is the United States of America which has increased the export of liquefied gas to Europe three times in recent years. Germany has started to construct appropriate infrastructure and build storage terminals. Further, Europe has invested 155 billion US dollars in the development of renewable energy sources; however, tangible results are not expected from them in the short term.

At the current stage, the most sensible step on the part of the European Union is to save energy. Some analysts estimate that a 15% energy saving, along with other alternatives, may be enough to get through the winter, although this process is not easy to achieve. In this regard, several countries have already started making efforts. For example, the palace of the German president in Berlin is no longer illuminated at night, hot water was turned off in sports halls and swimming pools in Hannover during the summer and municipalities are taking various measures to deal with the winter cold, including finding alternative sources for heating (Dezem, Wilkes, Delfs, 2022). Leading countries are also trying to use coal-fired power plants instead of gas.

To deal with energy problems, European countries are actively implementing population and business assistance programs. For example, Germany has announced that it will help the Russian gas importing state company Uniper with 15 billion euros so that consumers do not have to increase their fees. Additionally, it plans to temporarily remove state taxes on gasoline and diesel fuel to make public transportation more affordable and accessible for citizens. France's parliament presented a 20 billion euro inflation relief package on August 3, boosting pensions and allowing companies to pay employees bonuses that will be exempt from mandatory state taxes. These decisions are aimed at strengthening the purchasing power of households. On August 4, the Italian government approved an aid package worth 17 billion euros aimed at reducing electricity and gas bills. This amount will be added to the 35 billion euros that have already been spent since January to ease the impact of electricity, gas and petrol costs (Euronews, 2022).

With the start of the war and the use of global restrictions, Europe hoped that natural gas would be an inviolable resource for Russia because it would be one of the main sources of income under the conditions of severe sanctions from which the financial resources received would have to be used for the war and– for creating an imitation of a normal functioning economy. Additionally, the EU hoped to find alternative suppliers quickly which unfortunately did not happen while the process took a great deal of time and resources. Even though Russia tried to eliminate Europe's desire to fill up its reserves and face the winter without too many problems, Europe more or less managed to achieve this goal. In this regard, one of the interesting questions is the destination to which Moscow is exporting the gas intended for Europe and the source of the funds necessary for the war. First of all, it should be noted that the price of natural gas has increased by about 60%. According to approximate calculations, the Kremlin received approximately 95 billion US dollars from the sale of gas and oil in the first three months of the war alone. In addition, it has partners such as India, China, some African states and the Persian Gulf countries which are ready to buy Russian energy resources, especially when Russia offers them a discount.

Conclusion

Along with the continuation of Russia's aggression, the economic indicators and corresponding forecasts change almost every week. Even so, the recent information about the announcement of a partial mobilization in Russia raises certain expectations which directly affect the financial markets and the general economic environment of countries. Undoubtedly, European Union members have faced the greatest difficulties and have to react immediately to each issue against the impulsive decisions of the authoritarian Russian regime.

Despite the current challenges, Europe has the resources to overcome any difficulties and act as much as possible against the factors that cause its financial problems. For example, there is noticeable progress in terms of the diversification of energy resources where alternative suppliers have already appeared. However, this process is not very fast and thus, European countries cannot expect tangible results in the short term. Along with the current difficulties, the European Union is helping Ukraine with military equipment and financial resources while it is also ready to fully engage in Ukraine's recovery process. It is in Europe's direct interest that millions of refugees return safely to their homeland.

The global pandemic of 2020 has put the world economy in a difficult situation and the current war launched by Russia against Ukraine has given rise to more problems. Despite the difficult situation, the economic indicators are still promising and there are expectations for its rapid recovery even in the case of a slight recession in Europe's economy. First of all, the greatest problem is inflation which is influenced by many factors. Europe's leaders appeal more to energy resources and accuse Russia of creating artificial difficulties. Along with the growth of inflation, monetary policy is tightened which in itself causes the economy to slow down.

On the other hand, Russia, facing the most severe economic challenges, is ready to strike Europe hard in the form of a gas blockade even if it means losing additional financial resources. The fact is that this very process is currently in an active phase. It can be said that the European Union is well aware of the danger that increases with the coming winter. Additionally, the EU has to give up Russian gas at any cost because it simply has no other choice. Unfortunately, Europe does not have many alternatives for action other than to reduce consumption, actively negotiate with potential suppliers and find alternative sources of gas. In the case of more radical decisions from Russia, something which is highly likely, Europe will probably face a more critical period. For example, there are the recent reports of the leakage of the Nord Stream gas pipelines for which Russia is blamed. According to the statements of some analysts these pipelines will not be able to provide gas transportation during this year's winter even if a political agreement is reached. There is the serious damage to some of their sections and the gas leakage may last for weeks.

The European Union is preparing the eighth package of sanctions against Russia which was presented by the President of the European Commission, Ursula von der Leyen, on September 28 of this year. This package is related to the annexation of temporarily occupied Ukrainian territories, illegal referendums and Russian war crimes. The new sanctions include a ban on imports of certain products from Russia which means the country will lose 7 billion euros in annual revenue. In addition, she proposes banning the export of certain types of goods to Russia from the European Union, including additional aviation equipment, electronic components and chemicals. It also proposes to expand the list of individual sanctions and impose additional restrictions on those who try to circumvent the sanctions (European Commission, 2022). Despite the complicated social and economic situation, let us hope that Europe will pass the winter without further problems and start the economic recovery process along with the victory of Ukraine.

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