

°234

Economic Consequences of the Russian Invasion of Ukraine

The war in Ukraine is not only a military and geopolitical turning point. It is also changing the economic situation. This affects both the short-term economic trend and the medium-term prospects for growth and prosperity. The previously expected economic recovery will be weakened. There is a threat of stagflation, i.e., a combination of weak growth and high inflation. Monetary policy faces a dilemma: while interest rate hikes can curb inflation, they would further dampen growth.

Fiscal policy also has little effect: it can redistribute the burdens of rising prices, but not eliminate them. In the medium term, diversification of the energy supply will lead to greater security of supply, but also to higher energy costs. Germany risks losing ground as a location for energy-intensive industries. Rising military spending is a necessity, but in the long term will require tax increases and cuts in public spending in other areas. The global economy is disintegrating into an American-dominated and a Chinese-dominated bloc, with Russia and the EU countries as junior partners. The biggest loser will be Russia, but prosperity will also decline in Germany.

War in Ukraine Weighs on the Economy

Before the Russian invasion of Ukraine, all forecasts said that the German economy would experience an economic upswing after a difficult winter. High coronavirus infection figures and supply bottlenecks are currently weighing on the economy, but the Omicron wave is expected to be overcome by spring. Many households have built up significant savings during the pandemic as vacations and other social consumption were put on hold. This money should lead to a boom in consumption demand in the summer, while intermediate goods and energy are still in short supply. The result could be a new surge in inflation.

Up to now, everything suggested that the supply bottlenecks would slow down the upswing, but not prevent it. The war in Ukraine has darkened this outlook. Energy prices are now rising further. This is weighing on the economy in several ways. Consumers have to spend more money on heating and at the gas pump. Other goods are also becoming scarcer and more expensive as companies face higher production and transportation costs and therefore produce less and raise their prices. If the sanctions lead to a drastic reduction in imports of gas, oil, and coal from Russia, there is a threat of production losses in energy-intensive industries.

Increasing uncertainty about future developments is causing investments to be postponed. In addition, frictions and large price movements are likely to occur on financial markets as investors withdraw from risky assets in large numbers. This will put an additional damper on the economy.

Secure Energy Supply in the Short Term

How should policymakers respond to this? Conventional stimulus policies in the form of higher public spending or tax relief do not help here. There is no lack of demand, but a shortage of supply. Policymakers cannot eliminate the costs of rising prices; they can only redistribute them. In this situation, it would be a mistake to reduce gasoline or oil prices by lowering fuel taxes. That would tear holes in the national budget. The majority of consumers are perfectly able to pay the higher energy prices without getting into economic difficulties. It is better to provide targeted help to low-income households that are overburdened as a result.

Many will now demand that the ECB further postpone the reduction in bond purchases, but that won't solve the problems either. On the contrary. Since the US economy is less affected by the crisis, the Federal Reserve will continue to tighten its monetary policy. If the ECB steers in the opposite direction, the external value of the euro will fall. The consequence would be imported inflation.

Policymakers in Europe should now focus on securing energy supplies, especially through gas supplies from other sources, including liquefied natural gas. It would also be worth examining whether the phase-out of nuclear energy and coal-fired power generation in Germany can be postponed and the expansion of renewables accelerated in the short term.

Medium Term: Become Independent of Russia

This leads to the medium-term consequences of the Ukraine war. Assuming that the Russian government remains in office and that fundamental changes leading toward democracy and the rule of law fail to materialize, Germany will have no choice but to limit its energy cooperation with Russia, which is very attractive in purely economic terms but risky in terms of security policy, and to permanently diversify its gas supply. This will make energy supplies significantly more expensive. It will also create incentives to accelerate the switch to a hydrogen economy and renewable energy. The phase-out of nuclear power and coal already poses high risks for Germany's energy supply. If gas is also restricted as an energy source, the situation will become even worse. This will make Germany unattractive as a location for energy-intensive industries. Temporarily, the state could counteract this with subsidies, but permanently compensating for locational disadvantages with subsidies is self-defeating. Germany must look for other ways to maintain its prosperity.

Long Term: Possible Winners and Losers of the Crisis

The United States will be among the winners as an industrial location with cheap energy supplies and as a producer of liquefied natural gas. Fewer energy imports from Russia will be accompanied by falling German exports. Currently, trade with Russia accounts for only 2 percent of German overall foreign trade, but Russia's isolation will affect economic development throughout Eastern Europe. However, the main loser from the fragmentation will be Russia itself. It will try to find a new buyer for its gas exports in China, but China will make Russia feel its market power; at the same time, China itself faces major burdens such as the aging of its population, overinvestment in the real estate sector, and conflicts with the US and other Pacific Rim countries.

Another consequence of the Ukraine war is the end of the peace dividend in the form of falling arms spending. Germany has already announced that it will increase its defense budget by at least EUR 20 billion per year. This means cuts in public services in other areas and higher taxes, so ultimately less prosperity.

All of these considerations are necessarily speculative because there is considerable uncertainty about the further course of the crisis and its consequences. Contrary to what is assumed here, it could be that the Russian government falls over the Ukraine war and Russia fundamentally reforms itself in the direction of democratic structures based on the rule of law. This would then provide a new basis for cooperation. One might wish for such a scenario, but one should prepare for the worst.

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