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DETERMINANTS OF EUROPEAN ECONOMIC DEVELOPMENT: FROM PANDEMIC TO WAR AND SANCTIONS

Abstract

- *Goal* – to analyze the influence of the main determinants in the development of the European economy at the beginning of the 3rd decade of the 21st century.
- *Research methodology* – the article includes both an analysis of the ideas and views on economic processes of the world's leading theorists and practitioners of economic science, and confirmation of the conclusions made on the basis of data from international organizations and institutions (Eurostat, ECB, IMF, FRS, etc.).
- *Score/results* – the coronavirus lockdowns are highlighted as the first determinant. The second determinant was specially created by the authorities of the EU countries and provided a unique financial stimulus for the economy in order to prevent a chain reaction of demand contraction. The third determinant was expressed in the acceleration of inflation. Its consequence was, to a large extent, the turmoil in the banking sector. Russia-Ukraine war and the sanctions that followed have added to the uncertainty. These four determinants have accelerated the change in business cycle phases and changed some of their typical characteristics. As a result, the authorities are forced to find a balance between curbing inflation and preventing recessions with the help of very fine regulation.

▸ *Originality/value* – the article represents one of the attempts to look at the ongoing processes through the prism of economic theory in order to form the basis for further actions.

Keywords: economic growth, economic development, business cycle, economic policy, inflation, sanctions.

1. Introduction

Growth successes and the stability of many parameters in the early 2000s led to two important phenomena in the world of economy and science. These are assumptions about the normality of growth and development and the gradual disappearance of large fluctuations in the economic activity. Suffice it to mention the Nobel Prize for 2004, awarded to F. Kydland and E. Prescott for the theory of the real business cycle, which denied the importance of financial shocks as triggers of crises [Prescott, 2004]. It is paradoxical that the theory lived without interference for only four years until the financial crisis of 2008, after which a severe recession started. The struggle with the recession dragged on for several years. In the course of this, new quantitative easing approaches were used, which brought Ben Bernanke the Nobel Prize in 2022, but already for the fight against banking crises [Bernanke, 2022].

As a result, the exit of the developed countries of Europe from the crisis into the rise of the second decade of the 21st century turned out to be rather peculiar: a long period of credit contraction under the influence of Basel III; relatively weak investment recovery; way out of the debt crisis instead of entrepreneurial expansion. The European economy has approached the fateful year 2020 in an unusual state. Growth did not indicate an overheating of the economy, commodity prices were rather stable, interest rates were low, debts were traditionally high, but stable. True, global regulation in the world was clearly in decline, and there were not too many achievements in these areas. So, strictly speaking, there was no big overheating by 2020, but friction between countries was already significant, and coordination of actions on climate and other areas was weak.

The shock of the lockdowns in Europe came on the broad back of the 2020 recovery. This is an amazing development: the massive lockdowns of Q2 and Q3 2020 disrupted the logic of the recovery in several ways, and this happened before the economy overheated, interest rates skyrocketed and beyond similar. But a key feature of the crisis itself meant that the recovery was interrupted not only before a liquidity squeeze and one trigger or another, but before the significant accumulation of imbalances and excessive debt growth. The long period of credit crunch and rather strict Basel III measures generally gave the impression that a normal recession could take the form of a growth cycle.

B. Bernanke's work on understanding the experience of the Great Depression in the United States in 1929–1933 turned economic thought from the need for rigidity in the financial system to easing monetary policy. And the European economy has lived in this somewhat artificial environment of low interest rates under the control of the Basel tightening of credit until 2019. This created a regime not only of low inflation and interest rates, but also of large debts and low deposit rates. Now the rise in interest rates for other (anti-inflationary) reasons creates the effect of a suddenly discovered bubble. In an environment of high inflation and uncertainty for regulators and economists, one can turn to Friedrich von Hayek's Nobel Lecture on December 11, 1974. In it, already during the then crisis, he noted something quite relevant for the current situation in Europe [Hayek, 1974].

2. COVID-19 lockdowns: things could be worse

In relation to the foreseeable past, we see that periods of rapid economic growth had both their drivers and their shocks. After World War II, we saw the rapid growth of the United States, Western Europe, and Japan in the 1950s and 1960s, then the consumer booms in the oil-exporting countries after 1974, and then the Asian tigers. The Eastern European countries (Soviet Union and COMECON) gradually slowed towards the end of the 1980s, but at the same time Japan stagnated and the growth slowed down in the European Union, which tried to solve this problem through expansion as soon as the opportunity appeared after the collapse of the planned economy in the Eastern Bloc. In the 1990s, the markets of Russia and other former socialist European countries opened, which initiated an influx of cheap skilled labor and raw materials, which was comfortable for exporters of manufactured goods. Immediately, the gigantic mechanism of growth and export of China, and then India, turned on. So the composition of growth factors has changed every decade and a half, but global growth has generally retained its parameters.

Against this background, the conditions for the functioning of the global business cycle were modified. Fluctuations in business activity themselves never stopped, although the two world wars and the Great Depression produced such shocks that had long-term consequences for both structural shifts and fluctuations in activity, however we classify them.

In the 2000s, despite the severe recession of 2008–2010, as well as the growing imbalances in the world economy and difficulties in global governance, there was no high inflation in Europe. But in March 2020, lockdowns threatened to shut down the services sector, crash jobs and artificially squeeze liquidity. A sudden non-economic shock in the form of a stoppage of services, especially transport and tourism, is something completely opposite to the usual entry into a crisis phase through a squeeze on liquidity and consumption of durable goods [IMF, 2020].

The first lockdown shock, for the first time in the history of crises, paralyzed a significant part of the European service sector: especially tourism, travel and leisure. The European economy, one might say, was lucky that the pandemic did not fall during a period of normal liquidity contraction, when the chain reaction of falling production, falling financial markets and bankruptcies would be exacerbated by the contraction in economic activity due to lockdowns. Also, the rate of contraction of activity played a rather positive role, since the resources of the financial authorities were not depleted by lengthy attempts to prevent a recession. While the recession quickly spread to most industries, from services to commodity markets, it was for businesses and households that had been in a normal upswing just yesterday. It was an object of anti-crisis regulation in the best condition of those that could be in such a situation. The overall high debt, in particular the state, could not be discounted, but the threatening situation in all areas required a broad anti-crisis experiment to prevent a severe crisis on an unfinished upswing [FRE Data, 2023].

In a more practical sense, lockdowns caused a drop in employment and income in the European service sector, for small and medium-sized businesses, for personal consumption, and in addition, resulted in a contruction in accumulation and commodity production, that is, the liquidity of contraction, there was a decrease in spending, characteristic of an acute crisis stages. Sectors and spheres of economic activity were affected extremely unevenly. In the area of capital investment, significant declines were seen in tourism (postponed projects) and hydrocarbon production (cancelled projects).

The determinant of lockdowns and the decline in economic activity immediately caused the emergence of the second determinant of fiscal and savings financial incentives for businesses and the population. The speed and drastic nature of the lockdowns and fiscal stimulus, introduced almost simultaneously, were quite extraordinary. The fiscal incentives of the financial authorities were aimed at supporting the poor segments of the population of Europe, but some of it also went to the wealthy. In the US and the EU, the total savings rate of the population jumped in the second quarter of 2020 from 10–12% of disposable income to 24–25%. These huge financial resources were partially visible in the financial markets, giving stability to stock indices uncharacteristic of crises. But they also appeared in consumer markets: in the purchase of durable goods and in housing construction in a number of developed countries, which was supported by low mortgage rates.

3. Fiscal stimulus and rising inflation: something went wrong

The second determinant of 2020 is the massive fiscal and monetary stimulus through the injection of cheap money during the COVID-19 lockdowns, which created a simulation of bailout financing within one to two quarters of that year. In 2020, the European countries, without much scientific debate, took an innovative approach to flood the credit crunch with cheap money. And after a huge injection of funds by the financial authorities, everything about this crisis became unusual: high stock prices, incentives for a housing boom, a decrease in firm bankruptcies, despite a significant drop in GDP. The growth of involuntary savings among the more affluent segments of the population in connection with the deferred consumption of services is also of fundamental importance.

This situation quite clearly shows the first panic injections of liquidity into the economy from the ECB in the first 5–8 months of the crisis in 2020, and then the continuation of injections, which took a total of two and a half years until June 2022 [ECB; Board of Governors of the FRS, 2023]. The ECB managed to prevent the development of a liquidity squeeze and the transition to a financial crisis. Further, monetary policy supported the recovery of production and consumption in the commodity sectors and financial markets, while the recovery in the services sectors was relatively delayed. After a short stabilization, the process of an outflow of financing and an increase in the cost of credit began, and continued until March 2023. The external shock of the pandemic set in motion a "carousel" of the cycle, which seemed to spin three times faster and circled in three years instead of nine or more years.

In early March 2023, the banking crisis in the United States, Switzerland, and possibly other European countries presented financial regulators with a difficult choice: either step up the fight against inflation or repeat quantitative easing, albeit on a much smaller scale. This was due to the need to quickly respond to inflation with the growth of the economy. There is an addiction process in 2019–2021 concerning the financial sector, in particular the banking sector, to relatively low interest rates on long-term government bonds, which are considered non-defaultable and acceptable to the most cautious investors [OECD, 2023]. However, the sharp increase in key rates of central banks: up to 3.5% (ECB) and 5% (FRS) means that liabilities are becoming more expensive at a faster rate than low-cost 10-year bonds in assets are being refinanced. Now a host of financial institutions are trying to close gaps in returns on long-term assets and sources of funds that are rapidly expanding.

4. EU switch from climate programs to energy security

The third determinant is the early rise in commodity prices as early as late 2020, which was associated with three factors: a marked recovery in the commodity sectors of the economy, an abundance of cheap money in the economy, and the consequences of underinvestment in traditional energy industries since 2012 and especially in 2020. This determinant has developed in the oil and gas sector, has given impetus to the renewable energy and coal sectors, and along the way has complicated the food situation in the world. The accelerated energy transition announced around the world will likely be slower than previously expected, not only due to technology constraints, but also due to a lack of global coordination, dispersal of the goals of the main players, and increased complexity mobilization of financial resources for the purpose of leveling climate threats.

The determinant of high energy prices has become more or less a natural result of a rapid recovery in commodity markets with cheap credit and falling investment in hydrocarbon production. Something similar happened in 2003–2008. In this case, the effect was enhanced by four circumstances. Firstly, the long-term political pressure of government officials and greens on business: for renewable energy and against hydrocarbons. It can be said that the EU overdid it in the struggle for renewable energy with the breakdown of global governance. Secondly, a liberalized market benefits consumers in a buyer's market. Thirdly, in 2021 there was the first natural crisis in the supply of RES in Europe (and not only). And fourthly, Russian Gazprom was considered responsible for the rise in prices.

The energy transition as a way to support growth in the future and a new source of demand, certainly has good prospects, but the speed of inclusion and the intensity of the impact of this factor have their own logic and limitations. The lack of mature commercial technologies and their production capacities is perhaps a difficult constraint for the rapid spread of the green transition. Declarative statements about the speed of the impact of this transition on the economic recovery are usually very optimistic, but the restrictions on finances that are immediately needed for anti-crisis purposes, replacement of existing capacities in the energy sector, etc., are assessed much more cautiously. And there is less and less time left for humanity to solve this problem.

The underinvestment in the oil and gas sectors has been going on for a long time. Goldman Sachs noted on the eve of the banking crisis that underinvestment in oil refining in the world is permanent [Goldman Sachs, 2023]. A report by the Institute of Energy and Finance shows an increase in global oil and gas investment in 2022 to $499 billion. This is above the level of 2019, but not enough in the medium term. Non-OPEC production could drop significantly by 2025 and 2030 [IEF, 2023]. So the pressure on prices from the industry in general remains for objective reasons, in addition to political tension and uncertainty.

Be that as it may, against the backdrop of initially low inflation of industrial goods and services, the energy industry (together with violations of supply logistics and the labor market) gradually “unwound” inflation in the US and the EU. A mild winter and a decrease in gas consumption in the EU due to savings of expenditures and the closure of some industrial enterprises caused a reduction in gas prices by March 2023 to a level of about $500 per thousand cubic meters. This indicates that a similar price cut could have occurred in the spring of 2022 if not for the war.

The development of inflationary processes in 2021–2023 in the EU took place despite the increase in interest rates. Apparently, we will have to state that the change in the growth regime from low to high inflation rates, has its own patterns, which cannot be quickly stopped by turning the “faucets” of the interest rate of central banks. After two years of price growth, indexation mechanisms are activated that reinforce this process. And inflation for two years looks very serious [OECD, 2023]. The persistence of inflation puts monetary and political authorities in a difficult position, and the social aspects of the problem will affect every electoral event.

Due to a series of unpredictable events and attempts by regulators to quickly respond to them, the picture of the last three years has acquired a recognizable amazing character. Decision-making mechanisms in companies and even families that form their inflation expectations work more slowly and rationally. These players translate the intentions of the regulators into their actions not as quickly as they would like, but with lags and/or inertia, with waiting. As a result, we see inertia on the side of inflation, deceleration of investment. By March 2023 (exactly three years after the lockdowns) there was a risk of recession: even if the looming threat of a banking crisis did not materialize.

EU investment in reducing the consumption of Russian hydrocarbons and the costs of this are not equivalent to an effective fight for the climate. A recent Synthesis Report of the Intergovernmental Panel on Climate Change indicates that in order to limit the increase in temperature within 1.5°C, it is necessary already in the 2020s. to take radical steps: everything must be decided before 2035 [IPCC, 2023]. It seems that the lack of global coordination and the escalation of conflicts will lead to a huge increase in the costs of adaptation to the effects of climate change with warming of 2 °C or more. To some extent, this is the result of the third and fourth determinants, the effect of which will be felt for a long time for three reasons: this is the temporary switching of projects in the world to traditional sources (including the USA and China); focus on energy security (each has its own) in many regions of the world; limited financial opportunities with the aggravation of social and debt problems of states.

The EU's de facto switch from climate programs to energy security is a slowdown in efforts to prevent climate change. The decision to move out of dependence on Russian energy supplies has brought some commercial benefits to American, Norwegian, Arab and African natural gas suppliers. True, switching to LNG means a 25% increase in greenhouse gas emissions compared to pipeline gas. The consequences of all the events related to the switching of gas transportation in 2022 and the prices for it, led to an increase in the cost of gas imports to the EU from $80.5 billion in 2021 (31 billion in 2020) to $290.5 billion, and the price of gas for retail consumers in the EU as a whole increased by 30% [Eurostat, 2023].

5. Russia–Ukraine war and the subsequent sanctions: it will be bad for everyone

The fourth determinant regards the wide-ranging economic sanctions against the Russian economy for military invasion of Ukraine in 2022. Sanctions against the Russian economy have been introduced since 2014, and in particular, since

March 2022. Elements of global planning in the sanctions process have resulted in a reorientation of areas for cooperation and development. Elements of the global regulator were expressed in bans on certain shipments and deliveries with the introduction of control over them. The world community was unable to establish a clear coordination of development within the framework of the UN Sustainable Development Goals of 2015 and did not demonstrate impressive results in the fight to preserve the planet's climate. But on sanctions, a certain coordination has been established, at least among the G7 countries and the EU.

For an economic analysis of the effects of the Russian invasion in Ukraine, we will focus on several key positions related to the problems of the global economy. By the latter, we mean both the G7 countries themselves, the EU, the OECD, which imposed sanctions against Russia, and the entire economy of the world as a whole as an inevitable recipient of the consequences. The Russian economy is 1.5–2% of the world GDP. A fall in Russia's GDP by 2% means a change in only thousandths of the world GDP.

Regardless of the political reasons for the sanctions and the intentions and of the governments regarding their results, it can be stated that the choice was made by government officials. It was produced very quickly and within the limits of their ideas about the nature of the world economic relations, Russia's place in them and its stability. This meant intrusion into the processes of trade, financial flows and expectations of companies and investors, as well as administrative influence on the energy sector. The blocking of Russian financial reserves and transactions of financial institutions, the ban on the import of goods and technologies, restrictions on the export of Russian energy resources to the G7 countries and the EU automatically meant a multi-level impact on world economic processes.

We note here the applicability of W.R. Ashby's theorem on the nature of the stability of large systems with a large number of subsystems and interconnections. In such systems, the impulse is transferred between subsystems and it is extinguished longer than in the systems with weak couplings. An example of the net cost of sanctions is the administratively conditioned reorientation of oil exports from the Persian Gulf countries from India and China to Europe, and from Europe to India and China. This is an increase in transportation distances, risks, insurances and costs with the same global oil consumption as a whole. The same applies to a host of other commodities, which creates additional risks for companies in the field of capital investment [IMF, 2023].

The first category of sanctions regarded the restriction of exports of various industrial goods to Russia. It is possible to calculate the effects of trade multipliers, but they do not seem dramatic for the exporting countries, although they are certainly painful for exporting companies.

One can speak with great caution about the loss of growth due to the sanctions themselves and the whole complex of uncertainty. In the spring of 2023, it was still difficult to assess the slowdown in the global economy in the medium term. But the decline in growth rates due to sanctions can be shown by the example of developed countries, taking 2022 and reducing forecasts for 2023. For the Eurozone, the IMF forecast from January 2022 promised GDP growth of 3.9% in the same year, but in fact it was 3.5%; for Germany, the forecast assumed 3.8%, but in fact it was 1.8%; for all the developed countries, the forecast and actual growth rates were 3.9% and 2.7%, for the USA 4% and 2.1%. As for 2023, we can compare two forecasts for it from January 2022 and April 2023. They give the following figures: world: 3.8% and 2.8%, respectively; USA 2.6% and 1.6%; Eurozone 2.5% and 0.8%; Germany 2.5% and -0.1% [IMF, 2023].

While there is a risk of harsh judgments on such an important issue, we can talk about a loss of one percentage point of global growth in 2022–2023, and much more for the Eurozone and Germany, which accounted for the main costs and problems in the fields of inflation, energy and gas industry. This is an unpleasant, but, in general, an obvious fact. The channels of inhibition are clear: the uncertainty of investments and their decline, high interest rates on long-term loans, high energy prices. In the future, it will be clear how inflation, the rising cost of capital and uncertainty have affected economic growth. At the same time, there is already a stream of scientific papers on inflation and on the formation of a regime of high price dynamics in 2021–2023 [IMF, 2022].

Apparently, autumn 2022 and winter 2022–2023. marked a turning point in the reversal of investment dynamics. In January 2023 at Davos businessmen hoped for the best, although the eminent scientist K. Rogoff was much more cautious [Rogoff, 2023]. The banking crisis in the Silicon Valley and then in Zurich began just a few days later. Already on March 16, The Economist publishes the article *Is the Global Investment Boom Turning to Bust?* [The Economist, 2023]. There are already forecasts that the world's big technology firms are going to invest 7% less in 2023 than in the previous year. It turns out that since 2019 the global economy has managed to slip from a late recovery through a full set of phases of the cycle to a new decline in investment amid high inflation and anti-inflationary measures of central banks.

The uncertainty of the situation is increasing, which, according to observations, potentially leads to deeper recessions [Kose, Terrones, 2015]. Earlier this year, a new World Bank report, “Falling Long-Term Growth Prospects”, as the title suggests, expressed concern about the modest performance of capital investment growth in the world, and also mentioned inflation and other factors discussed in this paper, but not banking problems [Kose, Ohnsorge, 2023]. According to this report, an overall slowdown in growth is expected. The IMF’s annual financial stability report generally orients central banks towards maintaining financial stability rather than fighting inflation [IMF, 2023].

The secondary difficulties in the economic policies of many countries in terms of raising interest rates to curb inflation are related to this situation. Global growth has of course slowed down, at least in 2022–2024, and as the innocent bystander, the poorest and countries have been most affected and so were the climate programs. Without returning to the theme of the complexity of implementing large-scale (not in the EU, but in the world) energy transition measures, let us once again turn to the IPCC Synthesis Report. Keeping the Earth’s temperature rise within +1.5–2°C, according to the report, should be based on a radical reduction in emissions from 2021 [IPCC, 2023]. Unfortunately, nothing of the kind is happening: global coordination has been disrupted, and instead of a radical reduction in emissions, they are increasing above the level from 2019. The potential incremental costs of adapting to a new climate are difficult to calculate.

Structural shifts, especially in the energy sector, will have a positive impact in the medium term. And the banking crisis of March 2023 was the natural result of the first three determinants. It put the financial regulators of the US and the EU in front of a difficult dilemma: to continue to raise the interest rate in the fight against inflation, or to again provide banks with cheap financial resources.

The tightening of the debt policy of the leading countries and the IMF is taking place on macroeconomic grounds due to the inertia of the transition from low interest rates to higher, anti-inflationary ones. Financial uncertainty will dampen stagflation-threatening global growth in 2023, which in turn will make it harder to block banking turmoil.

From the point of view of almost forgotten theories, we are apparently dealing with an analogue of the political cycle of Nordhaus [Nordhaus, 1975]. In it, in order to achieve certain political goals, the authorities take measures which, as a side effect, will result in an increase of the inflation. Upon reaching a certain goal or after exhausting the resources and possibilities for implementing this policy, regulators are forced to move to curbing inflation manually.

6. Conclusions

The 2020–2022 reviewed determinants are a surprising array of impacts that have generated responses that were largely unanticipated by regulators of European countries. The first and fourth, coronavirus and sanctions, determinants were non-economic and unpredictable. The second and third are a consequence of the first, but their nature was unexpected for economists. The impact of shocks on growth and the further development of the cycle is not yet completely clear, although it is time to calculate the huge costs for the European economy. Whether and in what proportion this set of determinants will become a means of slowing down the European economy for adaptation and structural changes remains to be explored. Problems of inequality and social discontent in European countries can naturally escalate in accordance with electoral cycles. It will be difficult for East European countries to return to growth at the level from the period 2010–2019. An additional deterrent will be the costs of climate change prevention required by the developed countries. But debt problems will continue.

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