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Strategic Economic Resilience and Financial Vulnerability of EU

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I. Introduction –

The European Union (EU) economy, already battered by the aftermath of the COVID-19 pandemic, faced further turmoil with the onset of the Russian-Ukraine conflict. This paper delves into the compounded risks businesses, in general, and governments, in particular, have encountered and the escalating threat of poverty among populations. We will first examine the pandemic’s severe disruptions, from supply chain interruptions to widespread job losses, setting the stage for an economic landscape fraught with challenges. The subsequent war added to these pressures by inflating energy costs and compelling governments to allocate substantial resources to defence, further straining financial systems.

The core of our analysis focuses on the various interventions implemented to mitigate the crises’ impacts, from economic stimulus packages to regulatory adjustments. We also aim to understand the full spectrum of these measures’ effects, including potential drawbacks and unintended outcomes.

Understanding the Economic Shock of Covid-19 –

The COVID-19 pandemic has left a deep imprint on people, businesses, and communities throughout the EU, deepening existing inequalities and putting our sense of togetherness to the test. Swift and targeted actions, especially those driven by the Cohesion Policy, have been crucial in softening the hardest hits. The economy was braced for a contraction of 8.7%, and a recession seemed unavoidable. Yet, the real question lies not just in the fact of the recession, but in its nature and the shape of recovery that might follow. At the heart of this is the strength of supply chains—the lifeblood of an economy, encompassing everything from raw materials to the workforce and overall productivity. The greater the disruption to this network, the tougher the climb back to economic vitality. With this backdrop, we need to understand the three main types of recession shocks, arranged from the mildest to the most severe.

i) *V-Recession Shock*: This is a one-time dip. If credit continues to flow, productivity and labour are less affected. Growth dips but then recovers to its pre-crisis level and rate.

ii) *U-Recession Shock*: This is much more costly. Credit flow is disrupted, and growth drops precipitously. Never rebounding to its pre-crisis path. The rate of growth recovers, but there is a gap between the old and new paths, representing severe damage to the supply side.

iii) *Recession Shock*: Credit is severely disrupted, not once but perpetually, and there is very little investment. This economy never recovers its prior output path, and the rate of growth also declines.

Combatting the Economic Shock of Covid-19 –

In response to the COVID-19 pandemic, the EU implemented a series of swift and decisive measures aimed at mitigating the economic and social fallout. The cornerstone of this response was the adaptation of Cohesion Policy frameworks, notably through the Coronavirus Response Investment Initiative (CRII) and CRII+, alongside the introduction of the Recovery Assistance for Cohesion and the Territories of Europe (REACT-EU) initiative. The CRII and CRII+ measures were designed to offer immediate liquidity to affected sectors and ensure the flexibility of fund usage. The key provisions of these measures include:

i) *100% EU Financing:* Recognising the sudden financial strain on member states due to the pandemic, the EU provided the option for projects to be fully financed by the EU, temporarily relieving national and regional co-financing obligations. This was aimed at ensuring that critical projects, especially those contributing to the health response and economic support, could continue without financial hindrance. This unprecedented move ensured the swift redirection of funds towards emergency responses, including healthcare system support and SME assistance, ensuring these critical areas remained robust in the face of the pandemic's challenges.

ii) *Fund Reallocation*: By allowing for more flexible fund reallocation, the EU enabled member states to prioritise funding towards the most impacted sectors and regions. This adaptability was crucial in responding to the dynamic challenges posed by the pandemic, where needs varied greatly across different areas and sectors. Significant resources were redirected from long-term investment projects towards immediate crisis response measures, notably bolstering healthcare capacities and providing financial support to businesses facing liquidity crises.

iii) *Support for SMEs and Healthcare*: SMEs, recognised as the backbone of the EU economy, received targeted financial support to maintain operations, retain employees, and adapt to new market realities. This support ranged from grants and loans to financial instruments designed to ensure liquidity. Investments in healthcare infrastructure and services were prioritized to increase the capacity for patient care, procure essential medical equipment, and support the health sector's overall resilience against the pandemic.

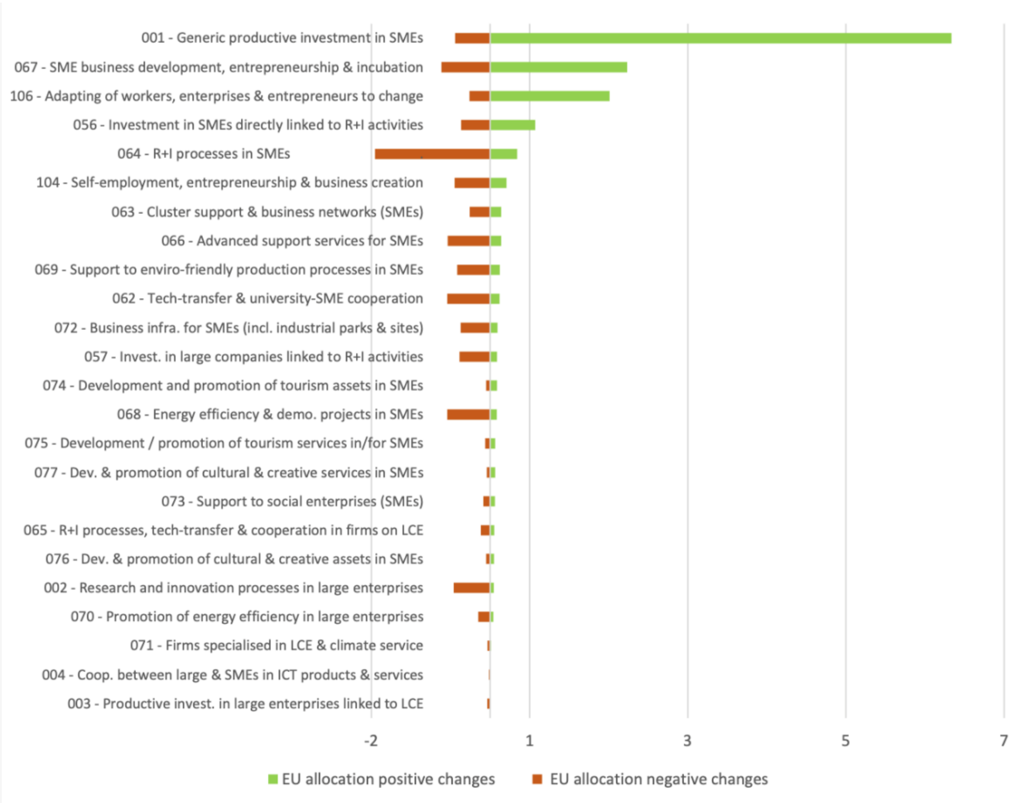
REACT-EU – As part of the Next Generation EU initiative, REACT-EU provided an additional financial injection to foster crisis repair and prepare for a green, digital, and resilient recovery. The key aspects are:

i) *Increased Budget*: The additional EUR 47.5 billion under REACT-EU represented a significant boost to existing structural funds, aimed at addressing the immediate effects of the pandemic and supporting the recovery phase, with a focus on employment, SMEs, health care, and social services. The injection was designed to bolster economic and social cohesion, ensuring that the recovery would be inclusive and support the most affected communities, thereby contributing to a balanced recovery across the EU.

ii) *Flexibility and Simplification*: Simplifying the procedural requirements for fund access was pivotal in accelerating the deployment of resources. By reducing bureaucratic hurdles, member states could more rapidly implement vital projects, from job preservation schemes to healthcare enhancements. The increased flexibility in fund usage allowed member states to adapt their strategies in real-time to the evolving situation, ensuring that funding could be directed to emergent priorities, thereby maximizing the impact of EU support in mitigating the pandemic's effects.

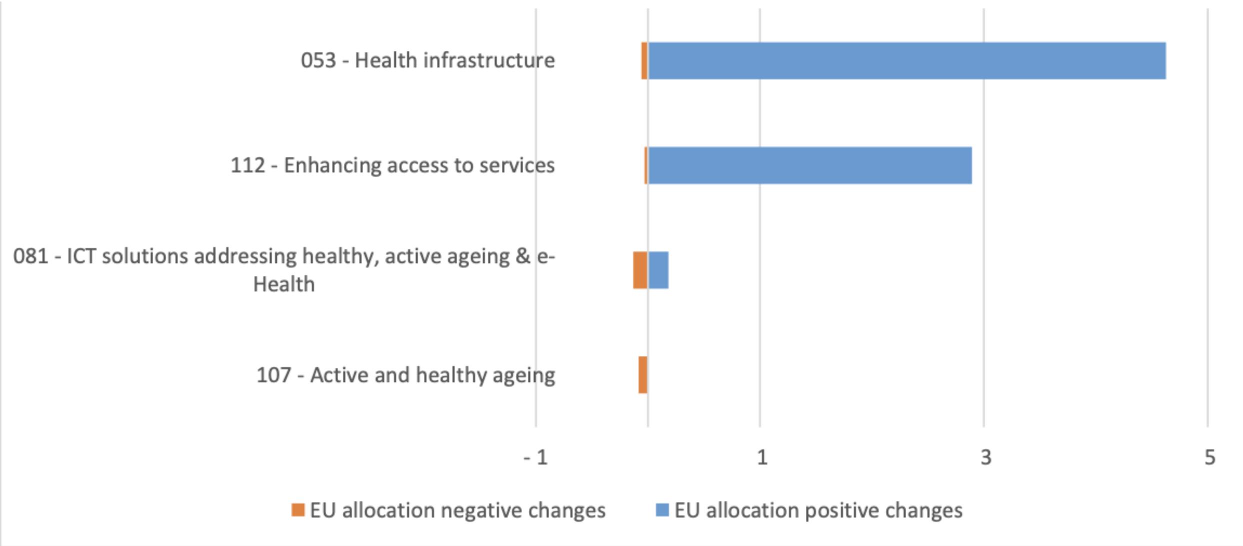
Impact Assessment –

The EU swiftly implemented measures targeting the regions and sectors hardest hit by the pandemic, aiming to sustain critical projects and underpin the broader economic framework. These initiatives have been instrumental in averting a more severe economic downturn, according to initial evaluations. Specifically, redirecting funds towards small and medium-sized enterprises (SMEs) and healthcare systems has been a crucial lifeline for numerous businesses, simultaneously strengthening the resilience of health services amidst the crisis. Furthermore, the adoption of precise COVID-19-related indicators, focusing on SME support and healthcare investments, has facilitated a more focused and quantifiable strategy for tackling the pandemic's obstacles.



Source: https://cohesiondata.ec.europa.eu/, own elaboration (2021)

^ *Changes in planned EU support to enterprise intervention fields since February 1, 2020 – CRII/CRII+*



Source: https://cohesiondata.ec.europa.eu/, own elaboration (2021)

^ Changes in planned EU support to healthcare intervention fields

Blow of the Russian-Ukraine War on the Economy –

The war's onset significantly slowed the European Union's post-pandemic economic recovery. Originally, the European Commission's 2021 Autumn Forecast anticipated a growth in GDP of 4.3% for 2022 and 2.5% for 2023. However, the actual growth turned out to be lower, registering at 3.5% for 2022 and an estimated 0.5% for 2023. The EU also faced an acute energy and cost-of-living crisis in 2022, with the price of energy driving inflation to exceptionally high levels, particularly in October 2022. This situation created challenging conditions for EU citizens and companies, further compounded by the European Central Bank's decision to raise interest rates to combat inflation, affecting those with large variable-rate loans.

Sanctions Imposed on Russia –

In response to Russia's aggression, the EU, in coordination with its allies, prepared and imposed several sanctions aimed at weakening the Russian economic base and curtailing revenues generated from Russian energy sales to fund the war effort. These sanctions covered various sectors, including finance, energy, and transport, and aimed to block access to key technologies and markets while freezing Russian assets in Europe.

i) *Financial Sector*: Sanctions targeted at the financial sector were designed to restrict access to European financial markets and services for Russian banks, institutions, and individuals, thereby hampering Russia's ability to finance its military operations.

ii) *Energy Sector*: The sanctions also focused on the energy sector, aiming to reduce Europe's dependence on Russian oil, gas, and coal, and to diminish the revenues Russia earned from energy exports to Europe.

iii) *Technology and Dual-Use Goods*: Restrictions on the export of technology and dual-use goods to Russia were intended to limit Russia's access to advanced technologies and goods that could be used for military purposes.

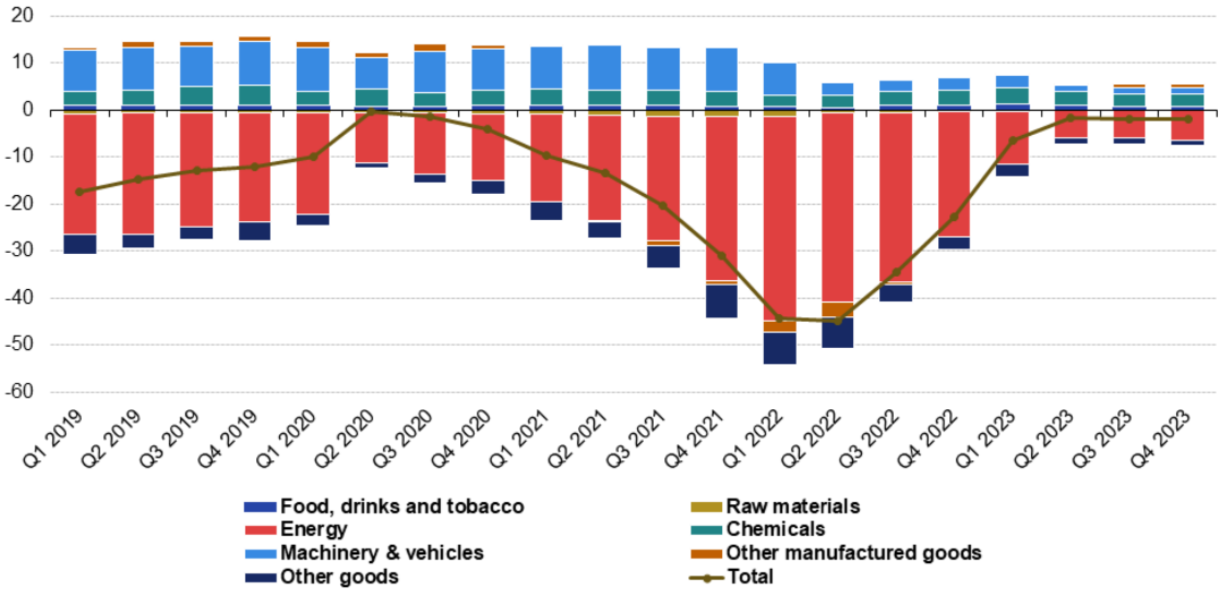
iv) *Transport Sector*: Sanctions in the transport sector aimed to restrict Russia's access to goods and logistics channels, further isolating the country economically.

v) *Visa Policy and Asset Freezes*: The EU implemented visa restrictions and frozen the assets of individuals and entities deemed to be supporting or engaging in activities that undermine Ukraine's sovereignty and territorial integrity.

Outcomes of the Sanctions –

The sanctions were intended to directly impact the Russian economy, reducing its capacity to fund the war. Initial data suggested a contraction of the Russian GDP by 2.1% in 2022. The sanctions also aimed to foster the EU's strategic autonomy and reduce reliance on Russian energy. However, despite the sanctions, the Russian economy showed resilience, with an estimated GDP growth of 2.6% in 2023. This rebound has led to debates on the effectiveness of sanctions. Furthermore, the sanctions led to reciprocal measures from Russia and exacerbated the EU's energy crisis by hastening the reduction of energy imports from Russia, contributing to the energy price surge. The economic outcomes of the sanctions aimed at pressuring Russia had two-way effects. It also had implications for the European Union, both positive and negative.

i) *Energy Crisis*: The reduction in energy imports from Russia, a major supplier to the EU, contributed to an energy crisis in Europe. This led to soaring energy prices, which in turn fueled inflation across member states, affecting households and businesses alike.
ii) *Inflation*: The increased cost of energy significantly contributed to exceptionally high inflation rates in the EU, particularly in the latter part of 2022. This inflationary pressure was exacerbated by the European Central Bank's decision to raise interest rates in an attempt to control inflation, which had a considerable impact on citizens and companies with large variable-rate loans.
iii) *Trade Disruption*: The sanctions and counter-sanctions led to a significant decline in trade between the EU and Russia. According to Eurostat, the value of exports to Russia fell by 62% between February 2022 and September 2023, while imports from Russia declined by 81% during the same period.
iv) *Economic Slowdown*: The combined effect of the sanctions, the energy crisis, and inflation contributed to an economic slowdown in the EU. The European Commission's growth forecasts were adjusted downward from the initial predictions made before the conflict escalated.
v) *Supply Chain and Sectoral Impacts*: The sanctions and the broader geopolitical tensions disrupted supply chains, particularly for raw materials and goods where the EU was dependent on Russian supplies. This has had knock-on effects on various sectors, including manufacturing, agriculture, and energy.



^ EU-Russia trade balance by product group, Q1 2019 to Q3 2023 (€ billion)

II. Conclusion

In response to the economic challenges posed by the Russia-Ukraine conflict, the European Union has embarked on a multi-faceted strategy to reinforce its economy and ensure long-term resilience. Central to this strategy is an economic security plan aimed at enhancing strategic autonomy, underscored by nearly €88 billion in multifaceted aid to Ukraine, showcasing the EU's commitment to stability and recovery. To combat rising inflation, primarily driven by an energy crisis, the European Central Bank initiated a series of interest rate hikes, with a focus on maintaining the disinflation process. However, the EU faces ongoing challenges in bolstering economic resilience and growth amidst global uncertainties, including the need to reduce strategic dependencies in critical sectors and navigate a complex geopolitical landscape marked by significant global elections in 2024. This intricate balance of immediate responses and long-term strategic planning highlights the EU's proactive yet cautious approach to navigating the current economic tumult and future uncertainties.

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