Accuracy

WAR AND THE ECONOMY

March 2022

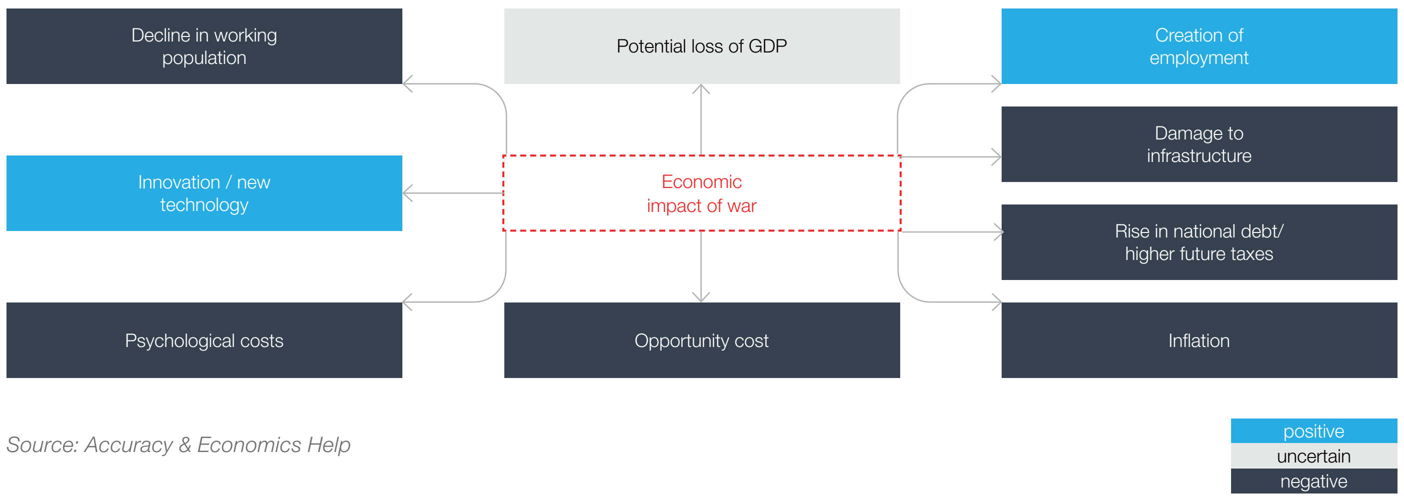
In light of the current context, this month's edition of the Economic Brief will focus on the relationship between war and the economy. In particular, we will look into links between the two; we will delve into economic theory in relation to war; and we will examine some of the impacts of the ongoing crisis in Ukraine on the world economy.

War and the economy are inextricably linked. Indeed, war has multiple economic effects, some positive and some negative, depending on the perspective of the warring parties.

If we look at the negative effects, of course, we must first consider the human cost, but this does not solely relate to loss of life; the human cost also includes psychological impacts on a devastated population and a reduced workforce as refugees leave the warzone. The destruction of infrastructure must also be factored in to the impact of war, as well as opportunity costs, such as reduced healthcare and education spending due to the diversion of funds to the war effort. War can also lead to ballooning national debt and the perspective of high taxes for many years to come to repay it. And we must not forget inflation. During times of war, inflation can rise drastically due to high levels of government spending and shortages of workers, goods and services, as well as increases in raw material prices, like oil and gas.

The positive effects of war tend to be more limited. A war economy generally sees unemployment fall as new jobs are created, though this may be offset by the decline in the working population. But perhaps more importantly, war can be a driver of innovation and new technology that can prove useful beyond the context of war. For example, radar developed significantly over the course of World War II, and its use subsequently extended to many other areas outside of war.

Economic impact of war chart



Source: Accuracy & Economics Help

In economic literature, three diverging positions on the impact of war arise: the mercantilist view, the classical view and the Keynesian view. The mercantilist view proposes that trade is like war, but through other means. Essentially, in this view, the state must accumulate reserves, which serve as the source of its power. To accumulate these reserves, the state must generate trade surpluses and ensure their sustainability over time. War is useful in this context as a means of protecting or expanding a state's trade.

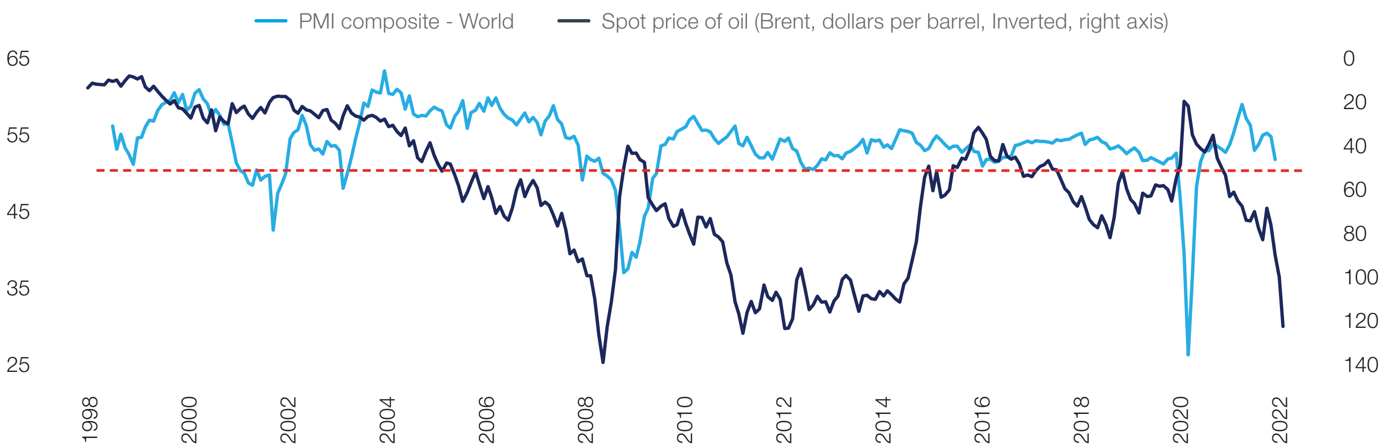
By contrast, the classical view posits that work is the source of wealth, rather than trade surpluses. However, it is necessary to distinguish between productive work (e.g. manufacture of white goods, cars, etc.) and unproductive work (e.g. governmental administration). As military services would fall into the category of unproductive work, military spending should be kept to a strict minimum and war should be avoided where possible.

Finally, the Keynesian view argues for a world without war entirely. War encourages spending over saving, and regard for the present over the future. Indeed, war is seen as the gravedigger of the ultimate economic objective – the objective of securing a wealth accumulation rate that outpaces demographic growth. In sum, the two are mutually incompatible.

The war in Ukraine is already having an impact on global macroeconomic trends. From the West's perspective, we can imagine these effects in concentric circles representing proximity to Russia: the closer to Russia a country is, the greater the effects will be. For example, for the time being, the US and the UK seem to be less affected by the conflict than the EU, protected as they are from significant exposure to Russian energy sources. The EU, which relies heavily on Russian oil and gas, will also experience the bulk of the refugee crisis, with the countries bordering Ukraine already welcoming millions of refugees.

Further impacts will be seen in the prices of raw materials, as economic sanctions take effect and as Russia retaliates. For example, Russia and Ukraine are huge exporters of wheat and maize, the prices of which have skyrocketed since the onset of the war. Oil and natural gas prices are also hugely volatile at the moment, with oil reaching highs of around USD 130 per barrel in the past few days before falling again as demonstrated in the graph below (figures presented up to early March 2022).

Global activity: very high oil prices



Sources: Accuracy & Bloomberg

As we have seen, war and the economy are inextricably linked. Though views on the fundamental effects of war may vary, it is clear that the conflict in Ukraine in particular is having an impact worldwide, and this on a global economy that has only recently been convalescing after the ravages of COVID-19. However, as in all conflicts, the true extent of its effects will not be known until after the war is over.

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