



Daniel DĂIANU, 27 June 2024

### **Will the peace dividend fade away?\***

It is being discussed, including by European leaders, about transitioning to a “war economy” regime, losing the *peace dividend*<sup>1</sup>. This is already seen in the increase of defense spending in European countries after Russia’s invasion of Ukraine; the latest NATO data (for the year 2023) are revealing: 23 countries have exceeded 2% of GDP, Poland making a jump to 3.9% of GDP, and the Baltic countries reaching between 2.4 and 2.8% of GDP. The average for NATO countries exceeded 2% of GDP for the first time. Romania is in the middle of the hierarchy, with approximately 1.6% of GDP defense spending in 2023, while countries like Belgium and Spain have just over 1% of GDP. In the EU, there is an attempt to adapt the common budget to the needs of defense and deterring military adversaries.

In a broader sense, defense spending can include those dedicated to combating terrorism, cyber-attacks, intelligence activities, and military research.

#### **1. A new “cold war”**

The discussion about a new “cold war” and a new arms race is no longer a working hypothesis; it is a moving reality that concerns deeply European economies and societies. This evolution takes place in a multipolar world – the “unipolar geopolitical” moment, which signified the overwhelming economic and geopolitical preeminence of the USA in the global space and that was reinforced by the collapse of communism, coming to an end over time.

It is necessary to make a distinction between *hot war* and *cold war*. The Second World War (WW2) was a “hot” war, fought through military battles over several years, on large areas (especially in Europe, Asia, and Africa), with tens of millions of human casualties and unimaginable atrocities. WW2 involved the mobilization of huge human and material resources, reallocation of resources for military purposes, and privations for the civilian population. In the US, in 1945, the war effort represented about 40% of the GDP. Great Britain also consumed an

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<sup>1</sup> Kenneth Rogoff, Nobel laureate in Economics, spoke immediately after the invasion of Ukraine about the loss of the peace dividend (“Is the peace dividend over?”, Project Syndicate, 2 March 2022).

enormous amount of resources. Defense spending decreased significantly after 1945 in the US, with production returning to a peacetime regime, but during the Cold War period, it was still around 6% of the GDP (in the 1980s). The former Soviet Union, according to some estimates, had defense spending that reached 17-18% of its GDP during the Cold War years, with much higher spending during WW2 as a proportion of the GDP, due to a total war mobilization of the economic system.

During WW2, input-output models were developed to help allocate resources to priority areas. Probably, input-output models, structural models (which also help formulate industrial policies) will come back into focus.

What is happening now in Ukraine has no equal since the end of WW2; perhaps only the breakup of Yugoslavia and the military confrontations in the Balkans in the first decade after 1989 offer a certain benchmark for comparison.

However, the distinction between hot war vs. cold war, given the situation in Ukraine, is somewhat biased to a Eurocentric view, as military conflicts, civil wars, have been around the world for a long time; the Middle East, Africa, Latin America, Asia have been grounds for actual wars, civil wars, military insurgencies, inter-ethnic conflicts, with interventions from foreign powers in one form or another – big countries, arms producers and geopolitical rivals. directly and indirectly supplying means of combat to warring parties. Let us think about inter-ethnic conflicts and civil wars in Rwanda, Sudan, Somalia, Yemen, Myanmar, Haiti, Honduras, Nicaragua, El Salvador, etc. – the list is long. And arms trafficking is a curse for the world we live in.

The tragedy in Ukraine proves that democratic European countries need to strengthen their defense and deterrence capabilities. At the same time, security arrangements are needed to prevent a nuclear catastrophe and to limit the lethal, highly destructive use of artificial intelligence (AI).

## ***2. Context and long-term trends***

There are long-term trends that provide a context for examining the process of losing the peace dividend; there are also concrete elements of the loss of this dividend, economic and social, political effects.

In the conditions of multiple strong adverse shocks (the pandemic, the energy crisis, the invasion of Ukraine), while many economies have shown resilience, the blows have left deep scars; public debts have increased significantly, there has been a resurgence of inflation (although it has been decreasing since 2023), interest rates have risen as a result of central banks' tightening of monetary policies, which has increased the cost of financing deficits and debt refinancing. There is also a crisis of the cost of living. This resilience cannot be judged therefore without caution and qualifications.

There are structural changes in the global economy, with a shift of economic power towards the Pacific area. The explanation is simple: among the most dynamic economies in recent decades are those in Asia, and China has become the second largest economy in the world when GDP is measured at purchasing power parity, while its scientific and technological progress is noted by think tanks and serious publications<sup>2</sup>. This shift of economic power can also be seen by comparing the G7 (the group of the most powerful democracies – USA, Japan, Germany, UK, France, Italy, Canada) and the BRICS group (Brazil, China, Egypt, Ethiopia, India, Iran, Russia, UAE and South Africa), if one examines IMF and World Bank data.

The US has considered China to be its great economic, technological and geopolitical rival for quite a while, a fact highlighted in their national security doctrine. The geopolitical confrontation has been accompanied for years by commercial disputes, hybrid conflicts. The US and China are states with major interests in the Pacific region. For the US, the Euro-Atlantic space is not the only one of paramount significance.

Against this background, there is a resurgence of protectionism and industrial policies (e.g., the “Inflation reduction Act” in the US) and a fragmentation (de-globalization) of the world economy along geopolitical lines. The formation of BRICS is also an expression of the dissatisfaction of some states with the functioning of the financial institutions created after WW2 and that considered to be dominated by the Western world.

There is also growing nationalism in many countries; the very tense situation in the Western Balkans, in other regions, illustrates this situation.

There is an economic and ideological competition unfolding between liberal democracies (LD) and autocracies. LD can turn into “anocracies” through the erosion of democracy from within, as noted by the university of San Diego professor Barbara F. Walter; anocracies are in a vague area, between democracies and autocracies (“How civil wars start”, New York, 2022). There are developed countries with visible such features. There has also been a thinning of the middle class as a consequence of unchecked globalization, of a paradigm that underestimated the harmful effects of the financialization of economies, of the rise in inequalities in developed countries.

The thinning of the middle class has fueled extremism, has weakened democracies, and this is reflected in political developments, in electoral results. Martin Wolf, one of the most well-known journalists of Financial Times, talks about a “crisis of democratic capitalism” (The Crisis of Democratic Capitalism, 2023).

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<sup>2</sup> The Economist (“The Rise of Chinese Science”, 21 June 2024), New York Times (“How China pulled so far ahead on industrial policy”, 27 May 2024) etc.

An increase in authoritarian temptations can be observed in developed countries, in democracies. The major crises of recent years (the financial crisis, the pandemic, the energy crisis, the invasion of Ukraine) are a plausible explanation<sup>3</sup>.

The EU is losing in global economic competition, as shown in EU documents, including what has leaked from the Draghi and Letta's reports<sup>4</sup> – which speak of a loss of competitiveness in the face of a large investment deficit (amounting to approximately 800 billion euros), very expensive energy that is hurting the European industry.

In Africa and Latin America, there is an offensive from China (especially economic) and Russia (particularly military), to the detriment of EU and US interests. This offensive is also linked with a struggle for access to resources, energy, and rare materials. The so called *Global South* comes into the picture in this regard.

There has been a deterioration of the habitat, which is to be related to climate change and human actions (e.g. reckless deforestation). Access to water resources, affordable food prices are daily quests in many countries, intensifying internal and interstate conflicts, causing population movements, migration.

Finally, there is the AI revolution, which brings many benefits, also has a downside, as it can turn into a new Armageddon, along with the nuclear threat.

### **3. *Loss of the peace dividend in concrete terms***

The most visible expression of the loss of the peace dividend is the increase of defense spending, which is reflected by various statistics. The increase of defense spending means a reallocation of resources for military purposes, which implies fewer resources (in relative terms, but sometimes also in absolute terms) for other domains. This reallocation is also seen in the structure of investments. In many EU countries, such a process is taking place, although there are considerable differences between them, which can be judged through the prism of geography and history (see, for example, the historical dispute between Greece and Turkey). The Baltic countries and Poland have speeded up in this regard, as they are among the most exposed to the war in Ukraine.

The reallocation of resources for increasing production for defense/military purposes cannot be done quickly, and this has been seen in the difficulties that EU countries have in

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<sup>3</sup> I have examined these trends in "Liberal democracy vs. illiberal democracy – why authoritarian inclinations are growing", Hotnews and Contributors.ro, May 14, 2018, and "The new protectionism: where does it come from and where does it lead?", Opiniibnr.ro, February 2, 2017, "The Inward-looking syndrome: where does it come from and where could it go", World Commerce Review, Spring 2017. These texts are included in my volume "Economy and Pandemic", Polirom, 2021.

<sup>4</sup> Under the leadership of former Italian prime ministers Mario Draghi and Enrico Letta, reports that have not yet been published.

supporting Ukraine. This remark also applies to the USA, which, no matter how powerful and technologically advanced, faces limitations in using resources on multiple fronts (what Paul Kennedy called “overstretch” years ago in “The Rise and Fall of Great Powers”).

Pressure on public budgets is increasing as more countries have entered the excessive deficit procedure in the EU this year; alongside Romania, France, Poland, Hungary, Slovakia, Italy, Belgium, and Malta are now included. Some EU countries have public debts exceeding 100% of GDP (Greece, Italy, France, Belgium, Spain). And if we think about monetary policy rates, which have become positive in 2023, there is a heavier burden of servicing public debt.

Governments need to find additional resources as they cannot practice large budget deficits indefinitely. The new fiscal rules in the EU impose strict control over “net public expenditure” (temporary expenditures and public debt servicing are deducted from the total), on a path that ensures the sustainability of public debts. One can imagine a situation in extremis, where central banks might once again resort to unconventional operations (quantitative easing, bond purchases) to help finance the defense industry, but this would lead to a complicated and risky game for economic policies, stimulating inflationary expectations and increasing risk aversion.

In the EU there has been talk for some time about forming a “common defense capacity”. Currently, there are national industries, with the only Western European countries possessing nuclear deterrent capabilities being the United Kingdom (which is no longer in the EU due to Brexit) and France. However, the EU is far from having a relevant common capacity and adequate coordination of defense measures; interoperability is a major issue. It is likely that closer cooperation between European countries in the military field will be among those with superior military capabilities. There is a concern among Europeans about the scenario of the US reducing its military presence on the European continent in the future - after the cessation, in one form or another, of the war in Ukraine.

NATO does not have its own military capacity, with resources coming from member states, mainly the US. Except perhaps for France and the United Kingdom (which had colonial empires to manage), Europeans have been sort of “free-riders” after WW2. They have also operated under the security umbrella of the US. Additionally, West Germany was prohibited from having significant military capacity after WW2, similar to Japan in Asia. The war in Ukraine has changed the situation, and Germany, Japan, and other countries are committed to increasing military spending.

The loss of the peace dividend is also evident in the effects of the fragmentation of the global economy - the emergence of geopolitical blocs. The fragmentation and redirection of trade flows, although they may have military security benefits, can lead to higher production costs. Sanctions (often ineffective in a multipolar world) are also part of the logic of fragmentation and the associated costs.

New industrial policies can help develop defense/military production. In the short term, they can boost economies. However, in the long term, the sustainability of economic growth is questionable if it leads to larger deficits and increased public debt. Potential GDP can increase if military innovations bring about commercial applications that improve productivity significantly. However, this involves guesses and uncertainties. The fact is that defense production should not be seen as an end in itself, as an “economic good”, but as a means to address security challenges.

There is also a gradual shift in the general mood, with a world more clearly divided into geopolitical blocs.

There will be increasingly difficult trade-offs in public policies due to climate issues, energy transition, and resource reallocation towards the defense industry.

#### ***4. Pressures on Romania’s budget***

The new cold war will put pressure on Romania’s public budget, on the economy in general. The private sector will not be able to avoid the effects of the changing international environment, at least because there will be resource reallocations, perceptions of risk will be affected.

Romania, despite undeniable economic progress in the last two decades, has major macroeconomic imbalances to reduce (budget and external deficits), and modernization has to continue.

The macroeconomic correction, on which Romania’s financial stability depends, will be extremely difficult. The budget deficit has to come down to around 2% of GDP over several years (with fiscal space compared to the 3% of GDP threshold that is a reference value in the EU fiscal framework). Without fiscal correction, joining the eurozone is inconceivable.

Compared to the current deficit of over 6% of GDP, a fiscal correction of 4-4.5% of GDP would be necessary. And this adjustment cannot be made only on the expenditure side, given the level of tax revenues. Pension and salary reforms complicate the macroeconomic correction. The budget imbalance is also reflected in the size of the current account deficit, which is around 7% of GDP – half of which is covered by foreign borrowing.

Defense spending will probably rise from 1.65% of GDP, as it was in 2023, to 2.5% of GDP in the coming years. If the additional military expenses of approximately 0.9% of GDP is added to reach the commitment of 2.5% of GDP, the needed macroeconomic correction (compared to a budget deficit target of 2% of GDP, that includes fiscal space) is 6% of GDP. It remains to be seen how this adjustment will be made until the end of this decade.

Analyses by the OECD, other international institutions, and the European Commission note what the Fiscal Council has been lamenting for years: the very low level of tax revenues (including contributions), below 27% of GDP – compared to an EU average of around 40% of GDP.

With such low revenues, it is very difficult to adequately finance education and health, infrastructure modernization, absorb strong adverse shocks, and increase defense spending. And the PNRR (the national recovery and resilience plan) cannot fill this chronic underfunding.

We need to be more self-sufficient in terms of budget resources. Especially since after 2026, the PNRR will no longer exist, and Romania, due to the increase in average income compared to the EU average, will likely benefit from less structural and cohesion funds (relative to GDP).

Macroeconomic correction cannot be done in three years (2025-2027), and reforms can prolong the correction period. Adjustment requires a fiscal regime reform (tax reshuffle) and much better tax collection. Good investments and reforms need to increase economic competitiveness (to reduce external deficits).

Further modernization of Romania cannot be put on automatic pilot derived from policy recommendations from international institutions. Romania needs better ownership of formulating and implementing public policies, which should outline national interests cleverly, take into account power relations in the EU and internationally, try to create competitive advantages in relation to available resources – in a very complicated geopolitical environment, amidst the fragmentation of the global economy, and a new cold war. More solidarity among citizens is also needed in such difficult times, as well as political responsibility.

Romania's security must be judged within the framework of the collective security arrangements of NATO, and the measures taken at the EU level. Romania must have a strong voice regarding strengthening defense measures on the eastern flank of the Union. At the same time, it should advocate for the EU budget to deem a "common defense capacity" as a public good, with adequate funding.

## ***5. Final observations***

The times are very difficult, complicated, with a geopolitical confrontation that brings numerous exceptional threats, including nuclear Armageddon and the destructive use of artificial intelligence. It is the most dangerous period since World War II, which questions benchmarks and rules of conduct in interstate relations. In this context, large and small countries must find solutions to immense challenges and dilemmas of public/economic policy.

We have entered a new cold war, that has become more visible after Russia's invasion of Ukraine. An escalation of the conflict in Europe which could lead to a nuclear cataclysm must be avoided. Regardless of how the war in Ukraine ends, Europe needs security arrangements - something like Helsinki2, which should enable the control of the arms race; of course, China must be included in the equation.

The economic effects of losing the peace dividend will be felt at the macroeconomic level (inflationary pressures and pressures on public budgets), structurally (with significant

reallocations of resources), in the lives of citizens. The old dilemma of “guns vs. butter” shows its teeth.

There is a legitimate question: what will we do with “global public goods”, which concern the control of the arms race to avoid a nuclear catastrophe, the control of the use of artificial intelligence, combating pandemics and the bad effects of climate change, securing aid for the poorest population in the world etc.

Even in the face of high geopolitical tensions, there must be channels of communication, a dialogue between the great powers. Systematic contact between senior American and Chinese officials show that this is possible, be the Taiwan question so complex to deal with. The very recent discussion (June 25) between the Pentagon chief, Lloyd Austin, and the Russian Defense Minister, Andrei Belousov, comes at an opportune moment and it is desirable for this channel of communication to be maintained.

If there is no wisdom and care for the fate of humanity as a whole, the world will be engulfed by much disorder, as Robert Kaplan prophesied over two decades ago (“The Coming Anarchy”, New York, 2000), or even worse.

\* The author is fully responsible for this text.