PSL Quarterly Review

vol. 76 n. 306 (September 2023)

Special issue on the economic consequences of the war

Energy shock and inflation: Re-examining the relevance of the Russian-Ukrainian conflict

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Abstract:

This special issue of PSL Quarterly Review discusses the economic consequences of the Russian-Ukranian one year and a half after its outbreak. Firstly, Joseph Halevi re-assesses the conclusions drawn in the special issue published by Moneta e Credito in June 2022. Secondly, Araujo et al. point out that the EU is particularly vulnerable to external shocks since it adopts an Inflation Targeting Regime (ITR). Both Storm and Cucignatto, Fora-Alcalde and Garbellini deal with the distributive conflict triggered by inflation, while Lampa and Oro focus on the worsening of Eurozone's external position and internal imbalances in distribution and finance. Finally, Giangrande explores the evolution of the material conditions of the working class.

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How to cite this article:
Garbellini N., Lampa R. (2023), "Energy shock and inflation: Re-examining the relevance of the Russian-Ukrainian conflict", *PSL Quarterly Review*, 76 (306):211-214.

DOI: https://doi.org/10.13133/2037-3643/18254

JEL codes:
G01, F51, F55

Keywords:
Russia, economic crisis, international monetary system, international trade

Journal homepage:
http: //www.pslquarterlyreview.info

The Russian-Ukrainian war is triggering a long series of adverse effects on the economies directly involved, regional economies, and, in a chain, the rest of the world. In a special issue published by *Moneta e Credito* in June 2022, four months after the outbreak of the conflict, we argued that the magnitude and severity of the shock on the current industrial, trade, and international monetary order are such as to suggest that the current war events would represent a breaking point for many of the tensions that had been building over the past decade; these have often been referred to with confusing and at times misleading terminology such as "de-globalisation".

It is now time, almost a year and a half later, to reconsider the conclusions drawn at that point.

The present issue of *PSL Quarterly Review* opens with an essay by Joseph Halevi, who points out how the considerations elaborated in the special issue of *Moneta e Credito* and the scenarios outlined there were correct in three respects. First of all, the Russian economy did not collapse. At the beginning of the war, the World Bank (2022) predicted that Russia would see a fall in GDP of 11.2% for 2022 and an increase in inflation to 22% year-on-year, with a return to moderate growth and a significant drop in inflation for 2023 and 2024. However, after a higher-than-expected decline in the second quarter of 2022, GDP contraction forecasts were revised downwards in the third and fourth quarters. Consequently, the overall decrease in Russia's GDP was -2.1%, well above the World Bank's forecasts. GDP started growing again in the second quarter of 2023, registering a +4.9%. When this article was being written, the actual rate of GDP growth was +1.5%, with a projected annual growth of +2.2% for 2023 (Central Bank of Russia, 2023a). Similarly, the pessimistic forecasts about inflation did not prove right: the CPI increased by +11.9% in 2022, almost half of what had been predicted by the World Bank. In this case, the favourable change in the USD/rouble exchange rate – from 73.7 (2021) to 67.4 (2022), driven by the increased average price of the Urals petrol barrel (from 69 USD in 2021 to 76 USD in 2022) – played a pivotal role. In 2023, as a predictable effect of both monetary tightening by the central banks of the Global North and the decrease of the Urali oil barrel to 61 USD, the USD/ruble rate increased to 85.5, resulting in the CPI's projected annual increase of +5.7% (Central Bank of Russia). On September 15, the Central Bank of Russia increased the discount rate by 100 basis points to 13.00% per annum. The monetary authority stressed the inflationary pressure in the Russian economy, resulting from domestic demand growth outpacing the output expansion capacity and the depreciation of the rouble during the summer months (Central Bank of Russia, 2023b).

A key element of Russia's resilience was the capacity to redirect its exports to India and China to a massive extent. In addition, gas flows from Russia to the EU via pipeline have seen a sudden growth since July 2023, adding to the record volumes of LNG sold by Moscow (Bellomo, 2023). Consequently, the trade balance thoroughly improved from 170 billion USD (2021) to 291 billion USD (2022), reflecting both the higher exports (from 550 to 639 billion USD) and the reduced imports (from 380 to 348 billion of USD) (Central Bank of Russia).

Secondly, and connected to the previous point, sanctions on Russia accelerated the fragmentation of the international monetary system based on dollar hegemony (Lampa, 2022; Fantacci et al., 2022; Esposito and Tori, 2022). As summed up by Halevi, "Russian trade shifted massively to China being denominated in yuan. Later during the year, the same happened between Saudi Arabia and China while between India and Russia, it is being now conducted in rupees".

Finally, the economic response of the European Union in such a convulsed outlook has been barely understandable and, at times, even suicidal.

The most critical point has been the return of the hawks at the ECB and the consequent increase in the key interest rate. Comparing the current situation with the Yom Kippur crisis of 1973 (the closest historical antecedent), we can observe how the 1973 oil crisis caused the Federal Reserve to raise the Fed funds to a significantly higher level than the current one (13% in July 1974). On the other hand, it should also be noted that the rate of growth of Fed funds is significantly higher today than in 1973: from October 1973 (the beginning of the Yom Kippur War) to July 1974 (Fed funds' peak), rates increased by three percentage points, well below the current five percentage points.

After an initial valuation difference, which led it to leave interest rates unchanged until July 2022, the ECB embarked on a path very similar to that of the Federal Reserve, moving its reference interest rate from –0.5% in July 2022 to 4% in May 2023. This evidence suggests that the pace of interest rate growth, and therefore monetary tightening, has been even more robust in Europe than in the United States, even though the current discount rate is still lower (4.75% vs. 5.33%). This aspect must be carefully considered to establish whether the response of the European monetary authorities has been an excess of zeal, which could configure an overkill of current inflation.

As we pointed out last year, "central bankers have as their only tool monetary tightening [...]. By doing so, not only can central banks only partially contain inflation but, by curbing demand, they will interrupt the post-Covid recovery, risking undoing the progress made over the past two years" (Lampa and Garbellini, 2022, own translation). This is precisely what is taking place, with high inflation and negative growth rates, even in Germany. From this perspective, one should remember that the EU was purposefully constructed to be functional to its "locomotive", Germany, and its export-led development model. A model that – as witnessed by the German GDP growth rates that, starting in the first quarter of 2023, have a minus sign due to declining exports – cannot work anymore. As Halevi suggested last year (Halevi, 2022) and confirmed in the present contribution, the cause is the breaking of the link with China, on which Germany had pivoted its development strategy as a "synergistic set of relations [...] in which the Germany-China axis featured prominently. Its viability depended on energy imports from Russia as they enabled the new Germany-centred system of international linkages to function" (Halevi, 2023).

This gloomy view is shared by Lampa and Oro in this issue, whose contribution stresses that – as was easy to predict given that Russia was the first energy supplier of Europe – imported inflation and the side effects of the sanctions imposed on Russia have interrupted the Eurozone's post-pandemic growth path, worsened its external position, and produced internal imbalances in distribution and finance.

As pointed out in the contribution by Araujo et al., the EU is particularly vulnerable to external shocks since they are more likely to cause inflation and have recessionary effects in countries adopting an inflation targeting regime (ITR).

However, as stressed by Storm, in "the U.S., the Netherlands and also other Eurozone economies, the rise in profit mark-ups has been the main driver of (gross output price) inflation"; Cucignatto et al. share this view, suggesting that the introduction or strengthening of price controls would be beneficial to rapidly bring inflation under control, protecting the purchasing power of the working class.

The material conditions of the working class are also at the heart of Giangrande's analysis (see Giangrande, 2022, for a comparison), which emphasises how Italy has been unable to react to the consequences of the 2008 crisis, followed by the Covid pandemic and now the war, and therefore needs an economic policy primarily aimed at full and good employment.

In such a context, we can see one of the contradictions of the EU: projected to the East by its structural dependencies, as masterfully exposed by Halevi – in terms of supply chains and also trade outlets – but geopolitically harnessed to the West by the Atlantic Pact: "[t]he European Union is simply not institutionally configured to undertake Keynesian policies for domestic purposes". The entire EU/Germany development model, based on Russia's cheap energy and China's domestic demand, is stripped of its foundations.

The EU can no longer compete internationally on prices – nor is this 'beggar thy neighbour' strategy desirable, nor somehow compatible with a green, just transition path. Moreover, "Central Asia and Western Asia are becoming the focus of a rather intense infrastructural activity in which, within the BRICS framework, China, Russia and India will play leading roles. [...] The EU, we believe, will play a minor role in Eurasia and Western Asia. The EU is also likely to be a marginal factor in large segments of Africa" (Halevi, 2023).

Such stylised facts suggest that the EU should respond to the ongoing reconfiguration of economic blocs by focusing on its internal market by setting itself the strategic objective of building an industrial system that is as self-sufficient as possible – think of the semiconductor sector, in which the EU lags far behind – and planning the production specialisation of member countries to create full and good employment everywhere. At the same time, it should minimise the distance travelled by intermediate goods, since the transport of goods is one of the most significant determinants of air pollution and fossil fuels consumption and, also, one of the critical determinants of post-2019 increasing inflationary pressures, as exemplified by the 2021 Suez channel crisis.

In order to reach this goal, however, we need a paradigm shift. It is necessary, in particular, to stop thinking that technical progress can only be labour-saving and that productivity increases are always desirable. There could even be labour-consuming – but fatigue-, energy- and pollution-saving – technical progress, entailing an increase in production costs and therefore impossible to attain within market logic; but this is possible only with a solid active role of public institutions at the European level.

Unfortunately, this is not the prevailing position within the ranks of the EU, which intends industrial policy only to create the most favourable framework for private companies in which to compete (see Cucignatto and Garbellini, 2022). From this specific angle, the recovery and resilience plan risks being a massive redistribution of public resources to private (often multinational) companies, going in an opposite direction than the one depicted above.

Everything else unchanged, the future is rather dark for the European working classes, who, without a decisive change of direction, will pay the price for a transition to a new regional and global order, made once again at their expense.

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