Sunday Wrap

Happy Sunday,

I am back at my favorite café here in Berlin's Mitte after a restful August on the Danish coast – and so is the Sunday Wrap. I hope you too have had a great summer, all things considered.

Inflation remains at extremely elevated levels, and while everyone seems busy revising their GDP forecasts further down (for Europe, most, including my research colleagues here at UniCredit, are now expecting a recession during the winter), the Fed and the ECB have both been sending increasingly hawkish messages in recent weeks: The Fed seems determined to hike by 75bp later this month, and there appears to be a distinct possibility the ECB might do 75bp as well already next week, although Philip Lane has reservations, if I understood his speech on Monday correctly.

As the inflation shock turned more prolonged – and severe – than originally expected, criticism of central banks has gained momentum. As a result, increasing concern about their reputation and – related - a determination to eliminate the probability of the tail risk of de-anchoring expectations and price-wage spirals will very likely lead the ECB (and probably the Fed) to overdo the tightening. In her Jackson Hole speech, Isabel Schnabel identified two possible paths for monetary policy in the present environment: Caution vs determination. She argued forcefully for the latter "even at the risk of lower growth and higher unemployment". I think she meant "relative to the present situation", even though that's hardly "a risk", but "a virtual certainty" because that's exactly how monetary policy works.

I'll argue in today's note that there is a major risk that this "determined" approach by the ECB will not only lead to lower growth and employment than now, but lower than needed to tame inflation. A more cautious approach, combined with a comprehensive fiscal and structural plan, would be much better for two reasons:

First, there's a huge difference between the US and Europe in terms of the drivers of inflation, which is not sufficiently appreciated. Much greater fiscal support has delivered a measurable demand effect on inflation in the US. In contrast, in Europe, inflation is still overwhelmingly the result of the supply shock. Second, any hope that this energy supply shock is temporary has now evaporated. Instead, we are almost certainly being hit by a permanent regime change, as highlighted just these past few days with Russia now completely shutting down Nordstream-1. With such a shock, fiscal and structural policies need to be mobilized aggressively, while monetary policy should take a backseat.

In his excellent piece on Tuesday, the FT's Martin Wolf argued for monetary determination, but more importantly, he laid out the differences between the US and Europe, concluding "monetary policy will play a part in the European story. But the core of its current crisis is the energy shock … A high level of fiscal co-operation will be needed in the eurozone. A political understanding of the need for solidarity within countries and among them is a precondition." His piece is highly recommended in its entirety: Tough economic times lie ahead

In today's note:

- **I'll elaborate on this critical observation that European inflation is predominantly, if not exclusively, the result of a permanent energy price shock, which stands to cost the EU economy more than 3% of GDP per year. This calls for bold strategic and fiscal policy action with a more careful role to be played by monetary tightening.**

- **Bold action requires great political courage. Mikhail Gorbachev, who died this past week, certainly had that in spades. I'll summarize what I think he unleashed, why and how it shapes today's world.**

1. The real issue with inflation – and the prospect of a terrible policy mix.

There are various estimates of the importance of the relative sources of the presently elevated inflation levels in Europe. However, there is no serious dispute that the huge increase in energy (and other commodity) prices – which started about a year ago and then accelerated after the Russian attack on Ukraine and subsequent sanctions – was, and is, the key driver.

Yet, as higher commodity prices have made their way into core inflation (as input prices for almost everything have gone up and businesses need to pass on some of the pain), confusion between cost-push and demand-pull inflation has become more prominent. This confusion has been further fueled by the big sectorial shifts in demand as we are all in the process of adjusting our consumption patterns back towards the more traditional mix between goods and services which existed before the pandemic.

Admittedly, the present situation is difficult to read, but as far as I can see, the elevated inflation level in Europe remains virtually all the result of cost-push inflation stemming from the supply shock and its subsequent ripple effects. The simplest way of seeing this is in total domestic demand, which for the eurozone, in real terms, remains below its end-2019 level. I simply cannot fathom that we should have lost so much potential output during the pandemic that the output gap has now all but closed.

Jason Furman of Harvard (former Chairman of President Obama's Council of Economic Advisors) illustrated the same point in a tweet this past week by comparing nominal GDP levels in Q2 with their trends: While US nominal GDP is now 5.5% above trend, eurozone nominal GDP struggles at best around trend with only Germany and Italy, among the major countries, having exceeded their nominal trend GDP - and then only by about 1%. These differences reflect to a very large degree the differences in fiscal responses to the pandemic. The US did a lot (maybe too much?); in Europe, Germany and Italy delivered the best fiscal responses, as I argued at the time. (For Italy, this is credit to Draghi's policies, made possible by the unprecedented support from the EU in the form of NGEU – just noting this as a hopefully useful reminder ahead of Italian elections on 25 September ...)

Put differently, Europe's energy bill has gone up tremendously this past year, imposing a huge "tax" on growth and society at large – paid, unfortunately not to our governments (from where it could be invested, spent on the most vulnerable groups or used to reduce public debt), but to our external energy providers, who are not equally friendly towards Europe these days. As a result, European living standards have been cut by more than 3% of GDP on a permanent basis, while the competitiveness of European industries are suffering a blow as they face gas prices some ten times higher than during the five years prior to the pandemic, while gas prices in, e.g., the US, have barely moved since Russia invaded Ukraine.

This is the "permanent shock" which has hit Europe at least until new and cheaper energy sources have been found, developed and delivered. In other words, we are in the midst of a supply shock with a big effect on inflation and hence real income, but it's almost certainly not a classic shock in the sense of being transitory, but much more likely the effect of a permanent shift in something fundamental, namely Europe's energy supply and the price of it.

Let me illustrate the magnitude of this shock, with thanks to my old research team, and particularly Edoardo Campanella, for the discussions we have had on this topic.

During the five years before the pandemic (i.e. 2015-19), the EU imported annually about EUR 400bn worth of oil and gas – EUR 300bn for oil (at an average price of USD 55/bbl) and EUR 100bn for natural gas (at EUR 20/Mwh). If we – for the sake of illustration - assume that oil prices stay at around USD 100/bbl (and EUR/USD stays around parity, if it drops below parity, as I think likely, it'll be worse), while natural gas prices turn out to be EUR 100/Mwh (i.e. some five times higher than the average of the past five years, but only half of present prices), then this "new annual tax" on the EU economy amounts to about EUR 600bn, or roughly 4% of GDP - a year each year going forward. This is money to be transferred to primarily the Middle East, North Africa, Russia and Norway. When the world was hit by the oil crisis in the 1970s, the "petro-dollars" were generally channeled right back to US (and a bit of European) treasuries. Now it is different, to put it mildly, which only goes to emphasize the need for the energy price cap which was agreed among the G7 this week, difficult (and fundamentally problematic) as it is.

Of course, price increases of such proportions will lead to a significant reduction in energy consumption. Some of that will be desirable savings through smarter and more careful use of energy, but it'll also put big chunks of previously viable industries out of business with potentially serious ripple effects via supply chains. If you then add the risk of outright shortages of energy due to rationing, the concern about the European economy is no longer whether we'll have a recession in coming quarters, but how deep and how long it'll last.

But, for pure illustration, even if we assume the higher energy prices will lower consumption by, say, 25% and without knock-on effects, Europe will still be facing an additional "external tax burden" on the order of EUR 450bn, or more than 3% of GDP, per year until we manage to shift our energy needs to other, cheaper and more sustainable, sources.

Accelerating to complete this energy transition as soon as possible must be of the highest priority for European policymakers, while putting in place incentives to reduce the consumption of oil and gas in a non-destructive way. This requires big increases in both public and private investment, over and above anything envisaged just one year ago. The sharp increase in borrowing costs already hitting the European economy on account of the ECB's forward guidance this year, which has delivered one of the largest tightening in financing conditions in decades, will not help kick-start the already massively compressed environment for investment – and I'm being polite here…

In addition, the private sector would almost certainly need sizable tax incentives to invest in the desired sectors – which will burden public finances at a time of lower growth and a need to protect the most vulnerable groups and key sectors. Doing so is of utmost important for both social and political reasons.

In other words, this is not the time for monetary tightening along with fiscal consolidation and fine-tuning operations for the vulnerable, as we are seeing now. If there ever was a good time for a big pan-European strategy on policy coordination – between countries and between fiscal and monetary policies – to address this new 3%+ annual tax on the European economy, it's now. As much as NGEU is helping Europe recover from the pandemic, a new and adjusted NGEU-2 would do wonders to help Europe adjust to this new environment brought about by Russia's war in Ukraine.

2. My thoughts on Gorbachev and what he left behind.

After hearing the news of Mikhail Gorbachev's death, I cycled down to Neue Wache, the memorial to the unknown soldier on Unter den Linden here in Berlin, and paused for a moment.

It was here, on the sidewalk on 6 October 1989, that Gorbachev deviated from the normal protocol and replied to questions shouted his way from the crowd about the emerging crisis in East Germany. An estimated 100,000 East Germans had fled the country during the previous months, particularly after the border between Hungary and Austria had been opened in August, raising widespread fear of another Soviet military intervention in its Central European satellite states. But when he told the crowd that "the important thing is what the citizens of East Germany want" it became clear that there would be no Soviet intervention this time to help the ailing East Germany leadership, or that of any of the other struggling Central European countries.

It was later reported that he used his speech at the formal celebration of the 40th anniversary of the East German state, the occasion that had brought him to Berlin, to lecture its leader, Erich Honecker, of the need for reforms because East Germany could not continue to depend on loans from the Soviet Union and others. A month later, on 9 November, the Berlin Wall came down – and the rest is history (although only after he had deployed the military in Georgia, Latvia and Lithuania in a futile attempt to keep the Soviet Union together).

Less than three years after Gorbachev's comforting message to the Germans on Unter den Linden, Russia and the now independent states of the former Soviet Union, joined the IMF and World Bank and I became one of the economists at the World Bank dedicated to help the new Gaidar government in Moscow design and finance its economic reforms. I remained involved in Russian economic policy matters for almost ten years, and have been a keen – if more distant – observer ever since.

I have no illusion that I can capture the enormity of what Gorbachev unleashed those 30-odd years ago, or of the lessons of it all, but having thought a lot about it in recent years, and particularly since February, these are my very brief thoughts on the matter:

First, to be clear, Gorbachev "attempted to reform a system that was in terminal decline, and thereby triggered a revolution that he could not control", as so succinctly put by Quentin Peel in Friday's FT.

Second, why did he do it? In his autobiography, he speaks of his horror of learning the truth about Stalin's regime, and it is clear that his moral compass was further enforced by his wife, Raisa. In addition, however, necessity drove him towards reforms and to letting Central Europe go. The Soviet system of central planning, which overwrote all price signals, including for energy, was broke – a system brilliantly laid out in a 2008 Brookings paper, titled "Russia's virtual economy". And Gorbachev was honest enough to recognize how far behind the West they had fallen. On his and his wife's first visit to Washington, the Americans took them to Safeway, the food store, on Wisconsin Avenue just north of Georgetown. When seeing the goods on offer, Gorbachev's first question was "so, who can shop here?" The answer: "Everyone" (including me, btw) – although his interlocutors apparently left out a reasonable qualifier, like "who can afford it".

Third, the social and economic pain hitting Russian society in the early 1990s was of a magnitude I had never seen before (and hope never to see again). The numbers showed it, but were often dismissed with a claim that much of the economic activity had simply moved to the informal sector. True, but it takes no knowledge of economics to see something is terribly wrong when elderly women line the streets of the capital city during daytime trying to sell their few belongings for almost nothing, only to be replaced in the evening by young women prostituting themselves for survival. Meanwhile, the mortality of men sky-rocketed on the back of alcoholism and organized crime. We economists, Russian and foreigners alike, were – in general – hopelessly naïve in our belief in "shock therapy." To a large extent, we relied on the lessons from Central Europe, particularly Poland, but we underestimated by a wide margin the differences in economic structures and social fabric between the "satellite states" in Central Europe and Mother Russia.

Fourth, most of the Russian population, including its elite and leadership, never came to terms with the loss of empire. They therefore never accepted Russia's demotion from one of two superpowers to just another large country (with a very small economy) in the global rules-based system; a system the Russian leadership came to see as US-dominated, organized to benefit the US – (not an entirely unreasonable claim, although the rest of the OECD has surely benefitted mightily from that very system ever since it was established in the aftermath of the Second World War.)

Fifth, with the collapse of virtually all economic, institutional and social structures, the one all-powerful institution still standing by the end of the 1990s, the KGB, then took over, spearheaded by Vladimir Putin. Following his relatively democratic election as president in 2000, it was reported (in state media) that he told a gathering of KGB seniors that their order to take back control of the country had been executed – delivered as an opening joke, but I have no doubt that it wasn't meant as a joke. As he proceeded to dismantle the democracy through which he had ascended (sounds familiar?), even Gorbachev endorsed his dictatorship as necessary to restore order.

Sixth, the key objective of policy design in the 1990s was to bring about a market-based economy in which manufacturing and services would become the drivers of growth. But it didn't happen because Yeltsin, through the deeply compromised privatization process, gave away the key existing raw material producing companies to the new class of oligarchs. When Putin arrived at the very end of the century and brought in some respected advisors, I – naively – thought that this critically important structural change would finally get under way. But the opposite happened as Putin's cronies replaced most of the original oligarchs (and the rest of them fell in line with the new regime or ended up in prison or dead.) And we now know that a strategic decision was made to use the money generated by the commodity sector for political influence abroad, including by undermining the key western democracies and the unity among them (and, of course, to enrich the rather small circle of people around Putin). The first, to my knowledge, to explain this policy strategy in a comprehensive way was Catherine Belton in her brilliant 2020 book "Putin's People".

Seventh, Putin's economic model of crony capitalism didn't work. (It never does; anyone flirting with the idea that this may be just a small and acceptable economic price in their country for some bigger political objective should take notice.) Living standards for the vast majority of Russians continued to decline after Putin took over (although they received a boost in the early years on account of massive oil price increases and stabilization of the exchange rate.) For a while, the increasingly controlled media tried to tell a different story, but ultimately Putin needed an external enemy to blame. In his speech to the Munich security conference in 2007, he named the enemy: The US and NATO. The speech was followed by a number of small wars, and then the Russia annexation of Crimea in 2014, followed by the all-out attack on Ukraine in February. (Gorbachev made no public statements about the war, but his long-term friend and interpreter says that he had opposed it in private.) If this analysis is broadly right, and I think it is, then only one of the following outcomes of the war is possible: (i) A "frozen" conflict for the next few decades in which Russia controls big parts of Eastern and Southern Ukraine, with occasional attacks on each other, while the rest of the country will be squeezed economically; (ii) a complete collapse of Ukraine if, e.g., the present leadership should be assassinated or flees the country, then to be ruled by a puppet regime controlled from Moscow; or (iii) a devastating escalation by Russia, e.g., with nuclear or chemical weapons, following a threat of military defeat.

Eighth, there is still a risk that Putin’s geopolitical strategy of undermining Western democracies and dividing Europe will be successful. Our democracies have proven less robust than I grew up to believe. One has to take note of the sizable share of our fellow citizens who have bought into the identity politics of the far right, much of which encouraged, if not even directly supported, by Russia. There are credible reports that Putin interfered successfully in the 2016 UK Brexit vote and US election. Neither of these two proud democracies have recovered politically from those 2016 outcomes. In Europe, Russia has supported virtually all the far-right parties campaigning on nationalistic and anti-EU agendas, which probably helped bring Italy’s Lega into the previous government and Le Pen close to the presidency in France. Meanwhile, Russia has weaponized gas. This past week, Hungary signed an agreement with Gazprom to have gas delivered while the rest of Europe is working on a pan-European energy approach of reducing the use of Russian energy, accepting the necessary hardship, until the shift to other sources can be completed.

While Putin’s troublesome footprints are there to be seen all over Europe, the irony is that he – and Gorbachev – so far has done wonders to unite Europe (with the sad exception of the UK) while reinvigorating the links to the US.

For the one exception, the UK, the next chapter will unfold tomorrow when the roughly 160,000 UK Conservative party members almost certainly will elect Foreign Secretary, Liz Truss, as their leader and thereby the new prime minister. In no way am I suggesting that Truss is being supported by Russia, but her ascent to No 10 is one of several outcomes of the chaos in UK politics that emerged after Brexit – which (it has been reported) was supported by Russia, both financially and logistically.

If Truss’ campaign promises and announcements are anything to go by when it comes to her government, it’ll be chaotic across the board, including with respect to EU relations. The next general election in the UK must take place no later than 25 January 2025. Few observers think she’ll last that long. It’s a sad time for us Anglophiles.

I think I’ll wander down around Neue Wache one more time this afternoon and see if the spirits will tell me whether Gorbachev had any idea what he unleashed that afternoon 33 years ago: For sure, he made German – and Berlin’s - reunification possible, and as part of that came another huge step in European integration, namely the euro. For all of that, I’ll be eternally grateful.

Best

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