

Russia-Ukraine War: inflation and growth impacts

The war of aggression waged by the Russian Federation on Ukraine and its people is a human and geopolitical catastrophe which strikes at the heart of Europe. It is also a major geopolitical event which has – and will continue to have – major repercussions, not only for Ukraine but also for its neighbours, which are hosting millions of refugees, and for the whole world thanks to the war's impact on the energy and food security of many countries, already weakened by two years of Covid.

Several highlights emerged from the discussion:

- The shocks unleashed by the war are setting the EU economy on a path of lower growth and higher inflation;
- Central Banks need to move quickly to tackle record inflation in the eurozone;
- The fiscal stimulus, amplified by the pandemic has led to a considerable deterioration in the euro area's public finances: enhancing the EU fiscal rules is therefore essential to make them more effective, reduce the growing heterogeneity in terms of budget and debt across EU Member States and prevent debt distress; and
- The successful implementation of the Recovery and Resilience Facility (RRF) is key to foster growth across the EU.

1. Russia's invasion of Ukraine is severely setting back the global recovery and European economies are experiencing the greatest shockwaves of the conflict amid advanced economies

The Chair introduced the session by stating that these are very challenging times, as there is the double shock of Covid and the war in Ukraine. That has tremendous repercussions on the EU economic outlook, creates a great deal of uncertainty and risks to lead the international economy working with a higher degree of fragmentation. The war in Ukraine has disrupted Europe's strong economic recovery from the Covid shock while adding to inflationary pressures. The pandemic and the war in Ukraine have widened the gap between the EU and its main global competitors.

This opening session underlined that Ukraine requires support to its real economy for a protracted period of time to weather the storm, and the war in Ukraine is slowing economic activity and elevating inflation. The energy crisis is taking centre stage in Europe. The gas

shutoff by Russia will have significant economic impacts in Europe and increase the cost of living for EU households. Despite sizable debt currently outstanding across many sectors, the balance sheets are generally in reasonable shape compared to prior periods.

1.1 Ukraine needs to rely on external support

An official stated that Ukraine has managed the war economy well in the last six months, as it has maintained a market mechanism and has been able to maintain macroeconomic stability during the war. The Ukrainian government has ensured that macro stability has been maintained, hyperinflation has not occurred, an exchange-rate devaluation has not happened, and savings have not been eliminated. This will allow a restart of the economy as soon as the territory is freed up. Significant external support has also been provided. The war will take longer than expected, but the principal parameters remain the same. Ukraine will need to rely on external support, and the Ukrainian authorities will need to continue to be agile in order to adjust to the demands of a war economy and to keep its objectives of managing through this war with its economy intact.

1.2 Economic activity is slowing, and the risks of stagflation are increasing in the EU

An official agreed that there has been a big shock to the global economy. The Organisation for Economic Co-operation and Development (OECD's) projection for world GDP growth in December 2021 was 4.5% for 2022, and in June the OECD cut that to 3%. The OECD weekly tracker is showing activities starting to fall off in Europe. On an EU 2022 average, purchasing managers indices (PMIs) are down into contraction territory in Europe, the United States and China. In December 2021 the OECD was projecting 2.7% inflation in 2022 for the euro area, and in June it forecasted 7%. Energy prices continued to surge over the summer, which is going to hold inflation higher and for longer. Europe has also had idiosyncratic issues, such as a severe drought, nuclear plants out for maintenance, and a large fire at a major US liquefied natural gas (LNG) facility.

An official added that Europe is having one significant shock after the next. Europe had a good exit from the pandemic, based on good policy settings, with one issue to struggle and fight with which was inflation. Russia then invaded Ukraine, which drastically changed the outlook. The IMF revised the outlook down for 2023 already in the July forecast and will do so again in October.

A policy-maker stated that the European Commission shares the economic outlook and the risks that have been mentioned. The expectation for the European Commission's autumn forecast is that it will substantially revise downwards its growth and inflation estimates for 2023. The baseline is that, in the medium-

term, growth will recover and inflation will return to the target of the European Central Bank (ECB). Stagflation is a risk and will depend upon policy responses in three key areas, one of which is energy policy. Discussions are ongoing with energy ministers in terms of an emergency intervention to try to alleviate some of the immediate impacts.

1.3 The energy crisis is taking centre stage in Europe

A policy-maker noted that surging energy prices have worsened the terms of trade in Europe and are expected to increase the cost of living for households. Country policies to soften the impact of high energy prices have varied, with price-suppressing measures being widespread. Energy measures need to be targeted at the most vulnerable, and high energy prices should be passed onto consumers to help price signalling and promote energy efficiency.

A public representative observed that if Eurofi had taken place two months earlier the main topic would probably have been inflation, implications for economic growth, and a proper reaction to the decline in real income. Two months have passed, and it is obvious that Europe is facing a huge energy crisis. He stated that Europe did very well in securing supplies, but it is now struggling with extreme prices. Before the crisis, Czech businesses and households only paid for electricity and gas energy, without taxes or distribution costs, calculated at around 3% of GDP. At the current prices it would be potentially 10% more, so the situation is very serious. It is important to work out how to make economies, countries, and the European Union more resilient to such crises.

A policy-maker observed that a policy issue to watch is on the fiscal side. Important fiscal interventions have and will support the most vulnerable in Europe, and also to support companies in order to get through the energy shock. A price signal needs to be maintained to keep encouraging savings on the energy side. Deficits of high debt have risen as a result of Covid. When the European Commission looked at the direct measures on energy in May it estimated that on average for the EU it was 0.6% of GDP. That figure is now probably closer to 1% of GDP. The European Commission has also been monitoring whether these measures are ones that act on the price side and have an impact on the marginal cost of energy, or whether they are operating on the income side. In May around 60% of the measures had been acting on the price side, but the percentage of that has probably gone up in recent months.

An official noted that support to households and firms is very important. Targeting is ideal, but there are advantages to the blanket support that has been provided, such as administrative simplicity.

1.4 The gas shutoff by Russia would have significant economic impacts in Europe and increase the cost of living for EU households

An official stated that two risks are currently on everybody's mind. One is the gas shutoff by Russia. An IMF study showed that if gas had been shut off in June or July it would have meant a shortfall of supplies in some central European countries over the winter

months of between 15% and 40%. The IMF estimated that for these countries over a 12-month period the impact on GDP would be a drop of between 2.5% and 4% of GDP. The IMF believes Europe is currently on a knife edge where, if Russian gas is cut off completely, Europe would not need to go into a rationing scenario for these countries, and the price mechanism could deal with moving energy to where it is needed most. This is because policymakers took action, looked at alternative supply in order to bring those online, and dealt with infrastructure bottlenecks in order to deal with those.

An official added that a second issue is the cost-of-living crisis, related to the gas issue. The IMF estimated in July that the cost of living of average European consumers had increased by 7%, which is a huge increase in terms of cost of living. When looking at Estonia and the UK, the impact on the lowest-income versus highest-income quintile of this energy crisis is double. This calls for allowing prices to pass through to end consumers, because a demand response is needed in order to cut back on energy consumption in order to make it through. It also calls for targeted subsidies in order to protect the most vulnerable in society, because this is going to be expensive. The IMF estimated that, if the lowest quintile is made whole for the cost-of-living rises, it would cost an average of 0.4% of GDP in Europe for 2022. That was before the last increase in gas prices. If the lowest 40% of consumers in terms of income are bailed out, it would cost 0.9% of GDP. It is vital to ensure that targeted subsidies are part of the mix in order to protect the poorest, and that prices are passed through in terms of getting a demand response on the energy side.

1.5 Despite sizable debt currently outstanding across many sectors, the balance sheets are generally in reasonable shape compared to prior periods

An industry representative stated that, despite sizable debt currently outstanding across many sectors, the balance sheets are, in general, in reasonable shape compared to prior periods. Overall default rates and transition rates are relatively low at the moment and are below the 10-year average still at this time but rising. However, the current Moody's forecast at the moment is for 2023 growth rates dropping to 0.3% for the euro area. That forecast came out just days before Nord Stream 1, recognising that there are other pipelines for oil. When Moody's look at the different risks across the sectors, there is the short-term risk that has been discussed regarding dealing with inflation and the need to find different transmission mechanisms across the energy sector. Moody's has identified multiple ways that can curtail the impact and the pressures from energy across societies, and they can fall into the supply side or the demand side.

An industry representative added that there are different exposures when thinking about the sovereign space, the banking space and the non-financial corporate space. There are still a number of countries across Europe that are exposed to a stagflation scenario due to the wage-setting mechanism and indexation. There is an expectation that throughout this next three to five-year period there will be a weakening of debt affordability as

a result of rising rates and policy responses. Moody's estimate that only about 20% of its non-financial corporate portfolio would be in severe stress, should there be a full curtailment of Russian gas, because of the measures that many of those companies have taken in the short term.

2. Normalising monetary policy to tackle record inflation in the eurozone

2.1 Central banks have an exclusive responsibility to keep inflation under control

A public representative stated that the EU economic framework still contains shortfalls, such as central banking. Central banks have lost part of their credibility in recent months because people are losing the value of their savings. Central bank should go back and focus on price stability, which should be the goal. Central banks must be run by professionals, and political influence should be kept low and be strongly resisted by those professionals.

2.2 No current sign of a wage price spiral

A policy-maker noted that an important policy area to watch for is in terms of wages and the avoidance of a wage-inflation spiral. There has been an uptick in terms of nominal wage settlements in recent months, but they still remain substantially below projected inflation rates. Structural changes in the labour market have taken place, indexation of wages is much less prevalent than in the past, and wage negotiators have been prioritising job security over wages.

2.3 Real interest rates remain very negative, and central banks have to continue to move

An industry representative stated that if the war in Ukraine was the only factor driving up European inflation, then the policy response would be primarily, maybe even solely, about restoring supply or identifying alternative sources over a period of time. Monetary policy would not necessarily play a major role. However, the Eurozone all-items HICP began to rise in early 2021. The HICP was rising at a 5.9 percent year-on-year rate in February 2022 as the war began. In other words, inflationary pressure was already asserting itself before the war-related disruptions exacerbated matters. In addition, the energy situation passed through into wages and other prices, so the central banks cannot ignore what is happening.

Central Banks have to act. The arguments about inflation being transitory were illusory. The Fed has begun to move. The divergence of US and eurozone monetary policies has resulted in much wider interest rate differentials. Consequently, there has been a depreciation of the euro down to parity and which traded at its lowest levels in two decades is being seen. This favours European exporters, but Europe is paying more for energy because of that depreciation. It is difficult to know whether the Fed will 'overdo it', but the

current inflation rate in the US is in the high single digits while the Fed funds rate is at about 2.5%. What is priced into the futures curve may not be enough.

3. Enhance EU fiscal rules to make them more effective and prevent debt distress

3.1 This is not the time to relax fiscal rules in Europe

A public representative stated that fiscal policy is a big issue that EU countries will be confronted with in the years and months to come. Sustainable fiscal policy in all parts of the EU is needed. EU member states must have a fiscal policy that does not rely on zero interest rates. It must be economically sound, transparent and must work in the short term.

An industry representative noted that while the policy coordination that takes place during the European Semester and the Stability and Growth Pact (SGP) have the potential to address this vulnerability, a lack of policy tools is not the barrier to reducing the significant differences in credit quality among member states. Adhering to the existing EU rules will be a key driver to de-risking sovereigns' credit profiles. Some countries have been bound by the EU's fiscal rules and therefore have reduced debt during periods of economic expansion and, more recently, during periods of low interest rates. In contrast, a number of larger member states have not been particularly constrained by their fiscal rules and have failed to rebuild the fiscal space lost over the past decade, despite a period of historically low funding costs.

3.2 The limits of current EU fiscal rules

An official noted that the IMF recently brought out a paper on its proposal for a reform of the European fiscal rules. Existing fiscal rules did not prevent deficits and debts ratios that have threatened the stability of the monetary union in the past and continue to create vulnerabilities today. The fiscal rules in place did not deliver on one key principle: when times are good, fiscal buffers need to be created for bad times. The existing EU fiscal framework also did not also support EU-wide macro-stabilisation.

3.3 IMF proposals to strengthen the EU fiscal framework

An official noted that the IMF's proposal is to enhance the whole system, not to scrap the 60% debt limit under Maastricht or the 3% budget deficit limit. The first pillar of that enhancement is to have the speed and the ambition of any adjustment under the fiscal rules determined by the fiscal risks coming from a country. The IMF proposal is for a high-risk country to have a fiscal-adjustment target specified country by country, but to adjust the overall fiscal balance over a period of three to five years towards zero or positive. Countries need to be more ambitious the further they are away from the 60% target.

An official explained that the second pillar of the IMF proposal is to have a greater number of stronger national institutions in place. Multi year expenditure caps need to be in place on an annual basis, so that policymakers have clarity on what the targets are, and that the targets are tangible and visible to the population. The third pillar deals with the macro stabilisation part and the issue of common goods. Macro fiscal stabilisation should be part of the new fiscal rules. Central fiscal capacity should be enhanced through a climate fund to deal with climate issues and energy security. It also needs to examine common public-good issues where it makes sense to operate across the European Union.

3.4 Keeping the 3% of GDP deficit rule is a reasonable option while the 60% of GDP debt rule would be personalised on a case-by-case basis, depending on available margins and debt sustainability

An industry representative agreed with focusing on the 3% deficit target, but the 60% debt level is more problematic. Most European countries are currently far above the 60% debt level. France is at about 112%. EU government debt to GDP is at about 95% overall. To go toward 60% would be trouble economically, because it implies a big deflationary impact.

An official asked whether the specific fiscal targets should be set at the international or supranational level, and whether it should be a more principles-based fiscal framework where sustainability is a principle. The exact targets should potentially be set at the national level because a key component is political commitment.

3.5 The Commission's proposals on the reform of the Stability Pact are expected in the fall of 2022

A policy-maker stated that the intention of the European Commission is to come forward with proposals and suggestions in the autumn, ideally well in advance of member states submitting draft budget plans which are due at the end of October. The intention is to move ahead. It is very important that consensus on the medium-term fiscal framework is agreed as soon as possible because the general escape clause applies in 2023. There is a great deal of consensus on the objectives. Public investment is well below the levels that will be needed to meet the digital and climate transition. The fiscal rules need to be supportive of that. A critical issue will be ownership. In building ownership, it will be important to build upon the positive experience of the Recovery and Resilience Plan (RRP), where Europe seems to have found a better approach to getting engagement on a quasi-contractual basis, where difficult structural reforms and important investments are committed in response to financial support coming from the EU.

A public representative stated that the EU should have a good market infrastructure with good policies, resilient systems and different support measures. Europe has not progressed the European Deposit Insurance Scheme (EDIS). The impact of the energy crisis on society and businesses is enormous, and it is very difficult to address it with non-targeted measures. The hope is that there will soon be a discussion about

taking some market-consistent measures that will cut the peaks of the electricity price.

4. The successful implementation of the Recovery and Resilience Facility (RRF) is key to foster growth across the EU

A policy-maker stated that the implementation of the RRF is key. The RFP was legally adopted 18 months ago and became operational 12 months ago. 25 national recovery and resilience plans have been adopted, with the Netherlands soon to be the 26th. The European Commission has already received 13 payment requests. Seven payments have already been made, for a total of €112 billion. €112 billion dispersed in one year is probably equal to or more than what the European Commission disbursed last year for all of its structural funds and agricultural funds combined. For the countries that have submitted payment requests, the European Commission has seen the most progress in euro area countries with high deficits and high debt. In Italy the European Commission is putting hundreds of millions of euros into the operational capacity of the justice system to recruit 20,000 legal assistants to support the judges, and to modernise the IT system and the justice system.

A policy-maker added that the European Commission is expecting 25 payment requests by the end of 2022. Countries have made commitments in terms of difficult reforms, and now is the time to deliver. €113 billion has been disbursed, but there is still €550 billion available, of which 40% has gone into climate objectives. €250 billion has gone into the area of the green transition. 30% of that is directly related to energy efficiency, 15% to renewable energies, and 30% to sustainable transport. This funding is already available to tackle the immediate crisis around the transition that needs to be accelerate in the face of the current crisis.

An industry representative observed that that the NextGenerationEU (NGEU) economic recovery programme offers an opportunity for some of the EU's most indebted countries to improve their credit fundamentals. It is a once-in-a-generation opportunity that has to be recognised for the changes that need to be made by the recipient countries. Simplicity and transparency are vital.

An official stated that the NGEU approach is working. The link between reforms and money is important, and that is helping in terms of productivity increases. Most of the money goes to those countries most affected, and they are the most engaged.

An official stated that the EU programme is going in the right direction. It is putting money into digitalisation, which is an area where Europe is clearly behind the United States. The United States has around 70% of digi tech firms in the top 100 by market capitalisation and Europe has 6%. OECD research shows that those top 100 firms are the ones that drive productivity growth.

Europe had a vaccine that came much faster than any scientist said would come. Policy makers decided to keep the economy supported for a vaccine that they thought would not be coming for a long time, so they overstimulated. Inflationary pressures then came out of the pandemic. Russia then illegally invaded Ukraine. More surprises would come.

A public representative stated that bad politics or bad policy can cause huge harm, even in the short term. There is no space to make huge mistakes, because recovering from mistakes takes time. The level of unity shown by western countries in response to Russia's invasion of Ukraine has been excellent, but people now doubt whether there will be solidarity in Europe over gas or electricity. Success is not a given, and the challenge can be failed if Member States do not reach a functional compromise. However, the track record is not bad. Big issues with a social dimension can only be solved at the EU level. Member States are complementing each other strongly.