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And now, the Ukraine shock

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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Abstract

The Ukraine shock comes at a most inconvenient time, when the inflation surge generated by the recovery from the pandemic requires urgent attention. The Eurosystem must proceed with policy normalisation, raising interest rates and shrinking its balance sheet, which can trigger financial instability. Defining and communicating its strategy is essential.

This paper was provided by the Policy Department for Economic, Scientific and Quality of Life Policies at the request of the committee on Economic and Monetary Affairs (ECON) ahead of the Monetary Dialogue with the ECB President on 20 June 2022.

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LIST OF ABBREVIATIONS

APP	Asset purchase programme
ECB	European Central Bank
EU	European Union
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
LNG	Liquefied natural gas
NGEU	Next Generation EU
OMT	Outright Monetary Purchases
PEPP	Pandemic emergency purchase programme
QE	Quantitative easing
QT	Quantitative tightening

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EXECUTIVE SUMMARY

- **For the European economies, the Ukraine invasion affects both supply and demand**. The increase in oil, gas and food prices is an inflationary and contractionary supply shock. The likely weakness of consumption and investment expenditures is a deflationary and contractionary demand shock.
- **We do not know yet which effect will be larger**. We observe a rapid increase in inflation while overall activity has not declined much, yet. Sanctions on Russia are still evolving and counter sanctions by Russia are gradually and selectively phased in, so that much can change in the coming weeks and months.
- **The Ukraine shock hit at a time when the effects of the pandemic shock were still filtering through**. Disentangling the impacts of each of these shocks is nearly impossible, so that interpreting the data is very hazardous.
- **The standard principle is that monetary policy should not attempt to deal with the direct impact of a supply shock**. It should be used to stunt the secondary impact through the wage and price spiral. This requires keeping expectations well anchored, which calls for precise central bank communication. Given the conjunction of both pandemic and Ukraine shocks, this is highly challenging, especially now that we observe the secondary impact of the pandemic shock.
- **Normally, monetary policy is expected to alleviate a demand shock, but the ECB has run out of instruments**. In addition, the ECB has finally accepted that the inflation surge generated by the recovery from the pandemic is not temporary and needs to be dealt with. This provides the long-awaited opportunity to normalise monetary policy, and this opportunity should not be missed. This implies that the task to deal with the demand shock should be borne by national fiscal policies, even though it comes at a time when budget deficits are unusually large.
- **The Ukraine shock is highly asymmetric, affecting more some countries than others and, within each country, more some people and firms than others**. Furthermore, some governments are already highly indebted, which raises the spectre of instability and financial fragmentation within the euro area. Monetary policy normalisation stands to heighten the risk, as interest rates rise and the reduction of the Eurosystem's balance sheet will result in sales of public bonds.
- **Both the Eurosystem and governments need to anticipate financial instability and fragmentation**. The ECB should not give up on fighting inflation and reducing its balance sheet, but it should be prepared to provide support to governments under duress, using previous instruments like OMT and PEPP. The governments need to consider mutual support, possibly extending NGEU. Communicating intentions can play a major stabilising role.
- **Current expectations of how far the interest rates will have to rise seem far too modest**. In order to avoid future bad surprises and attendant instability, the ECB ought to define and clarify its intentions, and let it be known.

1. INTRODUCTION

The first ten years of the European Central bank (ECB) were the easy years: there was no serious shock or challenge. Then, over the next fifteen years, the euro area has faced an unprecedented series of seriously adverse shocks: the global financial crisis, the European debt crisis, the COVID-19 pandemic and now the invasion of Ukraine. These shocks have accumulated increasingly fast so that the economy had not fully recovered from the previous one when the next one hit. Ordinary people are dazzled and policymakers are overwhelmed.

The invasion of Ukraine by Russia is first and foremost a major geopolitical event and an unfolding humanitarian disaster, which can spread to many countries in Europe and beyond. It also has important economic implications. Poorer countries are particularly exposed to higher food and oil prices, with little or no way to protect their populations. In Europe too, the Ukraine shock is pushing the prices of several products sharply up, just as the recovery from the pandemic is already fuelling a surge of inflation. It is also likely to reduce growth as consumers react to rising uncertainty by cutting spending. This evolution presents the ECB with a new challenge. As it debates its policy to deal with the post-pandemic inflation surge, the Ukraine shock worsens the trade-offs under consideration:

- How to calibrate the interest increases when it is not known whether the inflation surge will spontaneously end or whether there already is a spiral under way?
- How quickly should the asset purchase programme (APP) be withdrawn so that quantitative easing (QE) is replaced with quantitative tightening (QT), raising the risk of triggering financial instability?
- In particular, how careful should the ECB be about the impact of its actions on debt sustainability and the risk of fragmentation withing the euro area?

There is no clear answer to any of these questions, because of the extreme level of uncertainty. Some uncertainties arise because of the lack of experience with the situation (the end of a decade of stubbornly low inflation, the post-pandemic inflation surge, the war in Ukraine) and with the policies under consideration (QT and, more generally, the normalisation of monetary policy). In addition, the traditional fears of financial market reactions to uncertainty itself weigh on policy options. The Ukraine war is the next shock, with its own implications and uncertainties.

This paper starts with a characterisation of the economic impact of the war in Ukraine. Of course, we do not know how this conflict will evolve nor how long it will last, which means that any assessment is highly premature. It is hoped, though, that the characterisation is robust. The next section draws the implications of the fact that the Ukraine shock is coming at a time when the economies have not yet exited the COVID-19 shock – which may not be over yet. The following three sections are dedicated to the policy implications. Section 4 looks at monetary policy, Section 5 at fiscal policies inasmuch as they interfere with monetary policy, while Section 6 focuses on asymmetries across people and across countries. Section 7 considers the so far mild exchange rate effects. Section 8 concludes.

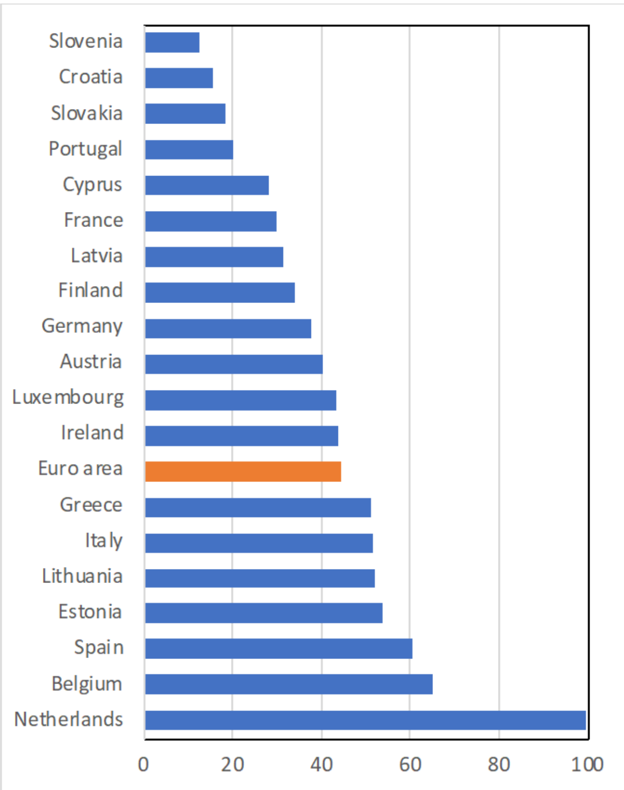
2. THE ECONOMIC NATURE OF THE UKRAINE SHOCK

2.1. Both supply and demand

The war in Ukraine triggers three main categories of economic effects: (1) It is a supply shock, which raises inflation and reduces growth; (2) It is likely to reduce demand; (3) It will also affect national budgets.

The supply shock is driven by sharp increases in oil, gas and other commodities prices. In fact, it started September 2021, before the invasion, when Russia slowed down deliveries of oil and gas not guaranteed by long-term contracts. This is when prices started to rise. The open conflict has now stopped these deliveries. Embargoes imposed as part of sanctions and Russia's pre-emptive suspension of deliveries have further driven prices up sharply. Figure 1 shows that, by the end of March, energy prices faced by final consumers have increased by some 50% on average in the euro area. The wide variation across countries likely reflects measures taken to reduce the pass-through from wholesale to retail markets through subsidies or caps.

Figure 1. Increase in HICP Energy – March 2022 relative to previous year (%)

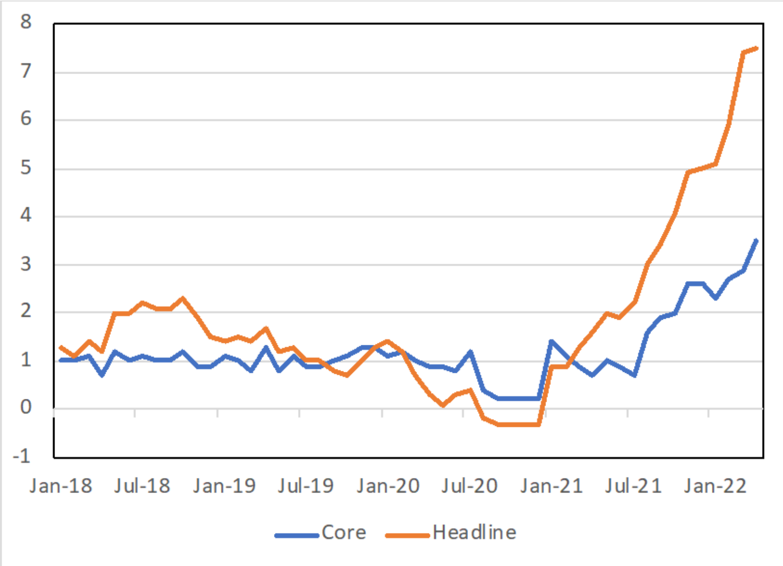


Source: Eurostat.

Such a sharp increase in energy prices produces widespread effects, resulting in higher inflation and reduced growth. The higher prices of energy directly affect the consumer price index and generate further effects that eventually surface in final consumption. As they face higher production costs, firms will tend to increase their own prices, further adding to inflation. If they cannot recoup the costs, some firms may reduce their activities. This could be the end of the story, as reflected in initial assessments that the inflation surge would be temporary and accompanied by a modest growth slowdown. Even if energy prices stop growing and stabilise at their new higher level, employees will have suffered losses in their purchasing power. They are likely to press for wage increases, which would further raise production costs and incite firms to increase prices. These secondary effects stand to trigger the much-feared wage-price spiral that stands to transform a one-off energy price increase into persistent inflation. Figure 2 shows that headline inflation has reached 7.4% by April 2022 in comparison a year before (more on core inflation below).

Figure 2. Increase in HICP inflation, headline and core

January 2018- April 2021 (% over 12 months)



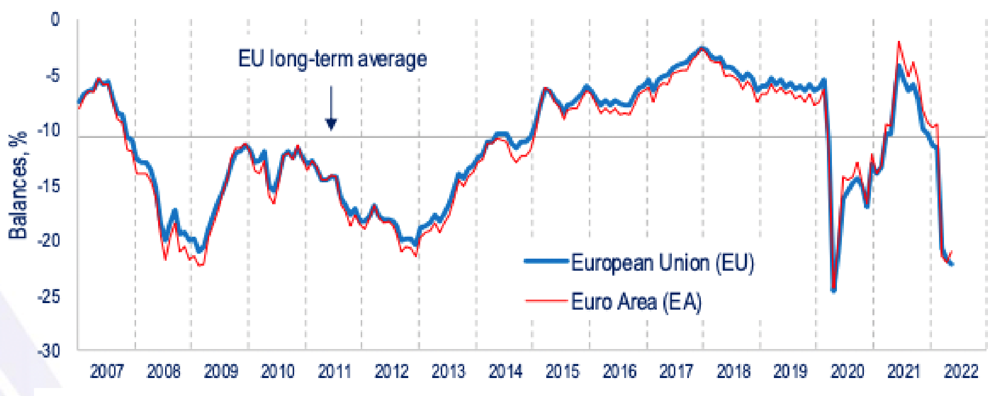
Source: Eurostat.

Note: Core inflation excludes energy, food, tobacco and alcohol.

There is also a demand side to the story. A war on European soil is a worrisome event, including the potential that the armed conflict spills over beyond Ukraine. This is confirmed by the Commission's May survey of consumers' confidence, displayed in Figure 3. Confidence has markedly declined in March, followed by a very small recovery in May. Obviously, the situation is volatile. As is often the case, there may be a succession of bad and good news regarding consumers' confidence but current levels are similar to those seen during the pandemic. Concerned consumers spend less, and they spend differently, typically shunning durable goods. When consumption declines, or is just volatile, firms slow down their own purchases of productive equipment. Such a demand shock is contractionary and is expected to gradually reduce inflation.

Summarising, the supply shock predicts a rapid increase in inflation followed by a gradual reduction in growth while the demand shock implies a fall in growth and a gradual decline of inflation. All in all, therefore, growth should be durably reduced while inflation is expected to surge and then decline over time. The relative sizes of the two shocks will matter, but it is too early to assess this issue as the situation is far from settled. The sanctions concerning oil and gas are continuously evolving, as is the military situation that affects consumer confidence.

Figure 3. Consumer confidence indicator



Source: European Commission.

2.2. Sanctions on oil and gas

The nature of the sanctions also matters. Currently, Europe is focusing on reducing its imports of oil and gas, while Russia has started to cut deliveries of gas to some countries. Europe is therefore looking for alternative sources, which contributes to higher prices. However, Russia is also looking for alternative customers, including large countries like China and India, which can bargain for lower prices. Absent delivery issues, a plausible outcome would have Russia sending more oil and gas to non-European countries, which would imply an equivalent re-routing of oil and gas from these countries to Europe, with limited overall price effect. (The re-routing would probably be based on higher prices in Europe and lower prices elsewhere.) However, while re-routing oil tankers is fairly straightforward, Europe receives much of its gas from Russia through pipelines and Russia does not have a significant possibility to expand pipeline gas deliveries to potential new customers. Liquefied natural gas (LNG) could be re-routed like oil, but the existing equipments (ships, LNG stations) cannot be expanded fast. Until they are, Europe will have to pay higher prices to scrap as much LNG as possible from other producers, while Russia will have few possibilities to send its gas to alternative customers and therefore it will have no reason to cut its prices.

An alternative sanction, favoured by most economists, is to impose tariffs on oil and gas imports from Russia (Gros, 2022; Sturm, 2022). Tariffs are not a black-or-white measure like a purchase embargo. Under plausible assumption, a tariff will result in Russia's cutting its prices so that European consumers would face a smaller price increase than the tariffs. They would also benefit from lower prices than in the case of an embargo since the global supply would not decline as much since Russian oil and gas would remain available. Instead of paying a higher rent to Russia, income from tariffs would be collected by the European countries, partly paid by their own households and firms, but also partly by the Russian exporters when they reduce their prices.

The wild card is that Russia might decide to retaliate against the sanctions by unilaterally stopping all its exports, as it has already partially started to do. This would be very costly for Russia since it exports about 80% of its oil and gas to the countries currently imposing sanctions (the EU, the UK, Turkey, Japan). Such a global subtraction of deliveries would be very costly to oil and gas consumers around the world. As prices further rise and bottlenecks occur, the supply shock would be magnified.

3. BAD TIMING?

3.1. The pandemic and its recovery

Coming on the steps of the pandemic, the shock is badly timed, just when the recovery was firming up. A new recession would prolong the misery of the last couple of years. The recovery has been accompanied by a sharp increase in inflation. Initially, most central banks have argued that the inflation surge would be temporary because it was the result of a very dynamic recovery, which was creating supply-chain bottlenecks that would be progressively erased. That argument was dubious, however, as it ignored the expansionary impact of fiscal expansions and of lax monetary policy. It also ignored the risk of a second round involving wage increases feeding into higher prices – the wage-price spiral. As unemployment has been declining in the wake of the recovery' rapid pace, the odds of a wage-spiral were quickly rising.

Just as central banks were recognising that "temporary" could be "persistent", the impact of the Ukraine shock is hurting employees and reinforcing the wage-price spiral. Figure 1 shows that headline inflation – measured by the increase in the consumer price index HICP – in the euro area took off in January 2021. The core price index – which excludes traditionally volatile prices and is seen as a more reliable indicator of inflation – remained quite stable until the end of the second semester of that year. Then, however, core inflation too started to rise relentlessly, indicating that the price hiking process was becoming more widely spread, and therefore unlikely to be temporary. The reason is that a new inflationary shock coming soon after the previous one increases the possibility that inflationary expectations rise. Indeed, Afunts et al. (2022) and Seiler (2022) respectively provide early evidence that the Ukraine shock has had a significant impact on inflation expectations of German consumers and Swiss firms. Importantly, this shift concerns inflation expectations for both the short and the long run. Since actual inflation is partly driven by expectations, which guide wage and price decisions, these results suggest that inflation is likely to be both higher and longer lasting.

3.2. The older shocks

By the time of the pandemic's outbreak, most countries had not yet fully recovered from the previous shocks, including the global financial crisis of 2008. Central banks in general, and the ECB in particular, still kept their interest rates at extremely low levels and had not significantly reduced their balance sheets. As a result, monetary policy was highly expansionary. Yet, inflation remained below target and banks were keeping massive excess reserves, even though the returns on these reserves were very low and even negative. Explanations for the persistence of low inflation in the face of the expansionary stance of monetary policies abound but remain debated.[1]

Whatever the interpretation, monetary policies had not been normalised more than ten years after the global financial crisis when the pandemic hit. Eager to bring inflation up to their targets, the central banks could not cut their interest rates much further and essentially expanded their already bloated balance sheets. Even though these actions removed the spell of a financial crisis, their macroeconomic impact was at best limited.

Fortunately, governments have stepped in and managed to circumscribe the economic damage wrought by the pandemic. They could have been deterred by the high levels of public indebtedness inherited from the previous shocks, but the Next Generation EU (NGEU) programme and the ECB's pandemic emergency purchase programme (PEPP) alleviated the risk of a debt crisis. Thus, fiscal

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1 Wyplosz (2021b) provides a review of this debate.

policies have achieved what monetary policy alone could not: they powerfully raised demand and inflation started to climb. However, with rapid post-pandemic dissaving by consumers, the resulting boost to demand proved too much for a slower supply response hampered by a host of bottlenecks along the global production chains.

4. IMPLICATIONS FOR MONETARY POLICY

4.1. Principles meet reality

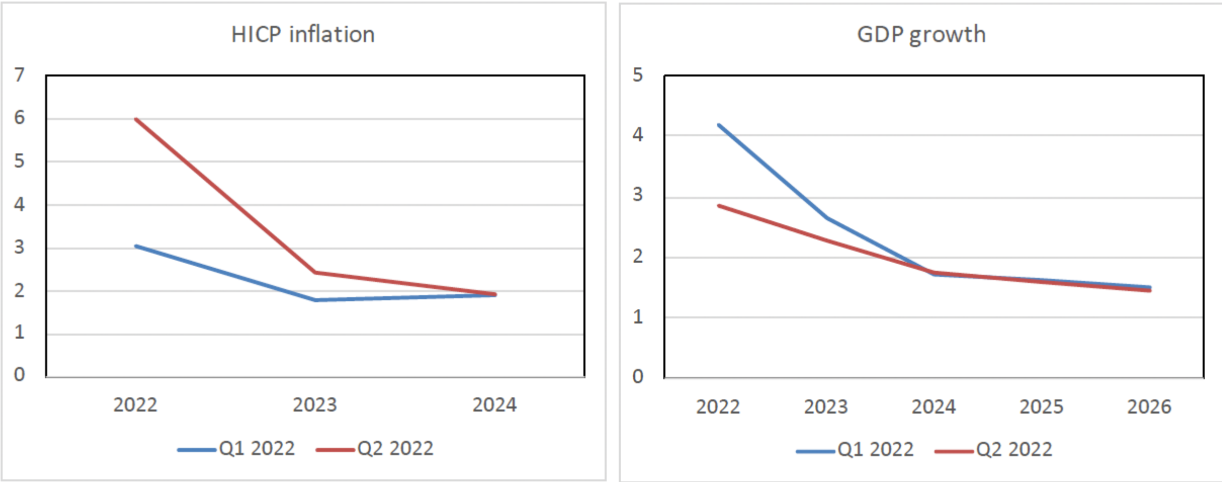
The generally admitted principle is that central banks should not respond to supply-side shocks. They should neither combat inflation at the risk of deepening the economic slowdown nor support growth at the risk of fuelling inflation. They should also make clear that they will not ratify the secondary development of a wage-price spiral, even at the cost of mounting unemployment. Keeping inflation expectations anchored is seen as the yardstick of an adequate stance.

This is a "blue sky" principle, corresponding to a situation where the shock affects an otherwise well-balanced economy. As argued in the previous section, this is not the case. Before the invasion, most central banks were starting to normalise. They were reducing QE interventions and policy interest rate increases were either under way or planned. The principle implies that normalisation should proceed as intended, with no interference from the Ukraine shock. In practice, however, such a clean separation is impossible, for the following three reasons:

- First, the Ukraine shock is not a pure supply shock, it also includes a weakening of demand. Monetary policy is meant to deal with demand shocks. This would call for a slowdown of normalisation.
- Second, the inflation surge that preceded the war in Ukraine was also driven by a mix of supply and demand shocks. Supply was being restrained by supply chain disruptions and by a progressive restart of activity. Demand was being driven by dissaving as customers caught up with delayed spending and firms were also catching up on investment. Central banks indeed argued that they should not respond to the transitory supply restraints and were keen to let the resumption of demand run its course in order to bring GDPs back to their pre-pandemic levels. This view was correct, except that it assumed that there would be no secondary effects, essentially the wage-price spiral. Increasingly tight labour markets settled the debate.
- Third, before the Ukraine shock, the central banks correctly argued that the normalisation process would be guided by data. They would raise interest rates and gradually shift to QT, calibrating their actions according to the evolution of inflation and growth. In other words, they intended to proceed with pragmatism as they deal with an unprecedented situation. The Ukraine shock is perturbating this approach because the data will combine the previous trends and the effects of the Ukraine shock. It is one thing to stick to a flexible data-dependent normalisation plan and another thing to disentangle the previous trend from the impact of the new shock.

An example can illustrate this issue. We do not yet have reliable data for the post-Ukraine shock period. Figure 4 instead displays forecasts collected in early April by the ECB among professional forecasters, concerning inflation and economic growth. The figure shows that inflation expectations are sharply revised upward from where they stood three months before, while growth expectations are cut down. Does the difference correspond to the Ukraine shock? Some of it, probably, but views were already moving in this direction before the invasion started. Furthermore, the professional forecasters expect these disturbances to disappear in two years, but we do not know what they expect the ECB (and the governments) to do to achieve this result.

Figure 4. Forecasts for the euro area of the Ukraine shock (% per annum)



Source: Survey of Professional Forecasters, ECB

An optimistic reading of Figure 4 is that the inflation expectations of professional forecasters are well anchored: they trust the ECB to act in a way that brings inflation to its target within two years. This is in line with the ECB's repeated statements that keeping inflation expectations well anchored is a major objective. However, as noted in Wyplosz (2022), inflation forecasts by professionals often go astray and are significantly more optimistic than those by households and firms, which drive the wage-price spiral.

4.2. An incomplete monetary strategy

The monetary strategy review of last year does not help. It makes it possible for the ECB to overshoot its target, as it has undershot it in recent years. This is quite unprecise, though. Is it willing to countenance a large but brief overshoot? Can the overshoot last for a few years as the previous undershoot lasted for about a decade? The ECB will need make its strategy clearer over the complicated period ahead.

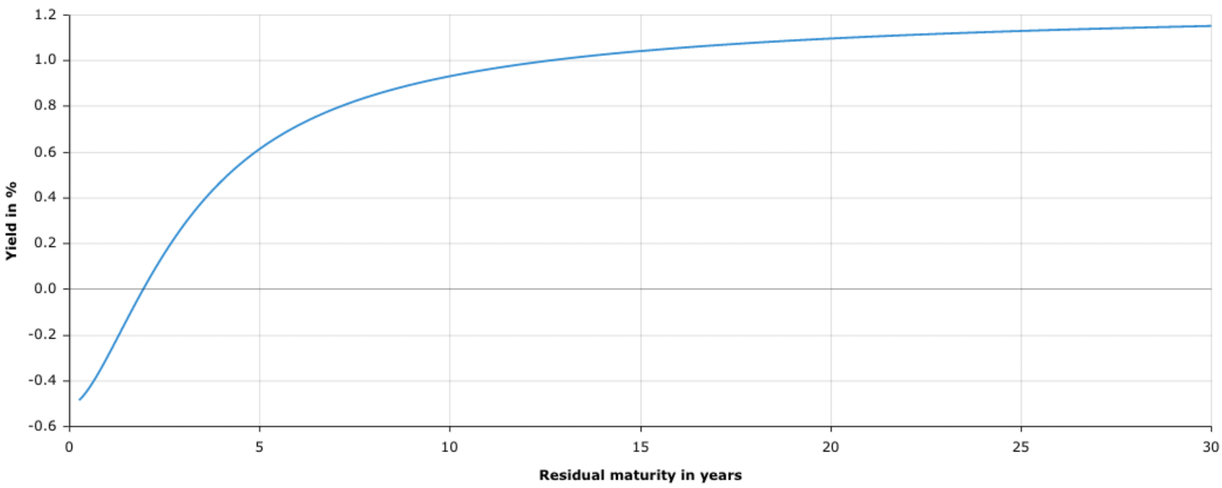
Traditionally, it commits to bring inflation to its target over "the medium term". That commitment could be credible if we can assume away another unexpected shock. If a new shock occurs, it will provide an excuse for the ECB not to deliver on its commitment. Professionals will easily accept this excuse as they understand that the unexpected may happen. But the broader public's reaction is far from certain. This is not a risk that the ECB should take after many years of turmoil and missed commitments.

Instead, the ECB should explain its intentions regarding the setting of its instruments. The focus should be on the normalisation process, mainly because monetary policy effectiveness is currently limited. By missing out on normalisation after the global financial and euro area debt crises, the ECB was in a weak position when the pandemic broke out, as explained in Wyplosz (2021a), as it failed to achieve its inflation target. This is in line with Schnabl (2022) who states that "given the exceptional accommodative monetary policy measures still in place and the growing risks of inflation settling above our target over the medium term, continuing the process of policy normalisation that we started in December 2021 remains the appropriate course of action for monetary policy." She refers to the decision to phase QE out but, in contrast with Federal Reserve, she does not provide any specific strategic information on the interest rate and QT. Very recently, however, President Lagarde has announced that the policy interest rate (the deposit rate) would be brought from -0.5% to zero by the end of September. Chief Economist Lane subsequently indicated that this would occur in tow steps of 0.25% each.[2]

4.3. Confusion about where the policy interest rates are heading

In particular, how far can we expect the policy interest rate to go? As long as the interest rate remains below inflation, monetary policy remains accommodative. This will have to change. Even if the inflation surge is temporary, a return to the 2% target will not happen until after the interest rate has been raised high enough. The current market-based expectations of interest rates as embodied in the yield curve displayed in Figure 5, suggest interest rates below 2%. Dispelling these expectations should be the first order of business.

Figure 5. Europe area yield curve for AAA bonds (as of 12 May 2022)



Source: ECB, Euro area yield curves.

Assuming that the ECB intends to raise the interest rate above expected inflation, what should the inflation benchmark be? Figure 4 illustrates the challenge. Measures of expected inflation are changing by significant amounts, making any target highly unreliable. In addition, professional forecasters see a quick return to the 2% target, suggesting that this should be the benchmark. However, the forecasters have been predicting such a quick return for quite a while and they were proven wrong repeatedly. As noted above, they trust the ECB to do whatever it takes, but what does that mean, really?

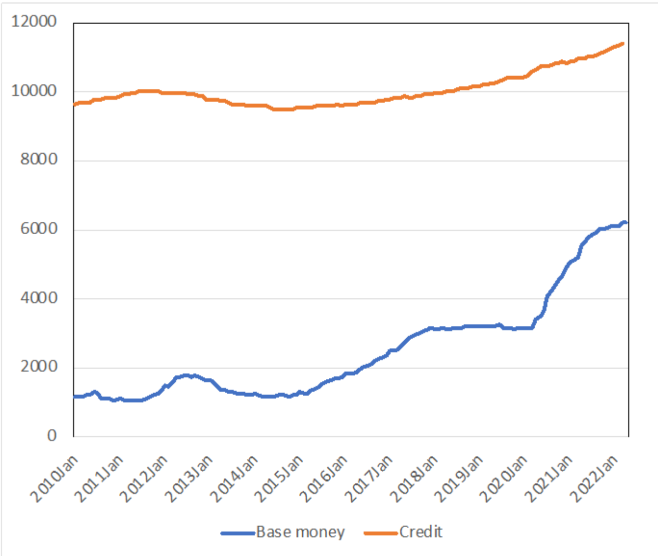
That means that it is nearly impossible for the ECB to explicitly specify how far it intends to raise the interest rate. What it can do, however, is to publicly share its reasoning and acknowledge the depth of the uncertainty that it faces. This would be the natural next step after Schnabl (2022). A key advantage of clear communication is that it stands to move the longer-term interest rates, which are a key channel through which monetary policy affects the economy, in the desired direction. As the conditions change, possibly in unanticipated directions, the ECB will need to update its reasoning. Sharing this evolution with the public, will be a key condition for effectiveness.

[2] These statements can be found in https://www.ecb.europa.eu/press/blog/date/2022/html/ecb.blog220523~1f44a9e916.en.html and in https://www.ecb.europa.eu/press/inter/date/2022/html/ecb.in220530~bc5cf9621c.en.html, respectively.

4.4. Quantitative tightening and financial stability

QT is the other component of normalisation. The ECB should also develop a strategy. QT will matter for financial stability – to be discussed below - and for the evolution of long-term interest rates. The large injections of central bank money through QE mean that the financial system is awash with liquidity. This abundance has allowed governments to borrow at very low interest rates but it has not triggered a rapid growth of credit to the private sector. This can be seen from Figure 6, which displays the evolution of the monetary base of the Eurosystem (roughly the size of its balance sheet) and the stock of bank credit to households and firms (non-financial corporations). Before the financial crisis, bank credit typically followed the evolution of the monetary base more than proportionally. Since then, bank credit barely responds to QE.

Figure 6. The Eurosystem's monetary base and the stock of bank loans (EUR billions)



Source: Author's computations based of data from the ECB.

Three tentative conclusions seem to be warranted. First, QE has had a limited impact on credit distribution, and hence of the level of activity. Its main effect has been to flatten the yield curve, that is to lower longer-term interest rates, which in turn has pushed share prices sharply up. Second, by symmetry, it is plausible that QT – the reversal of QE – will have a muted impact on credit growth and the level of activity. Third, there is no need for the balance sheet of the Eurosystem to be so large.

Normalisation will therefore have to include a significant shrinkage of the balance sheet. It is generally agreed that the balance sheet will not return to its pre-global financial crisis size, mainly because bank and financial institution regulations adopted since then require them to hold more liquidity. The question is how far the balance sheet is likely to be reduced. The answer cannot be given with a great degree of precision, but the ECB can provide an order of magnitude: should it be twice (relative to GDP) what it was before the global financial crisis? Less? More? Even though the answer involves a complex set of issues, work must be undertaken to narrow down the range of possibilities and publicly discuss.

Since a key achievement of QE has been to preclude a financial crisis, could QT dangerously weaken the financial system? The the size and speed of QT could test the limits, in particular concerning the stock markets that have witnessed large increases on share prices and are now falling. Beyond assessing the ultimate size of its balance sheet, the Eurosystem needs to make preparations in case financial stability is threatened. The strategy review has recognised that the ECB is in charge of financial stability, but it has provided limited information about what it would mean in practice. For example, falling share prices are not necessarily systemic in the sense that they seriously affect ordinary citizens. Should the ECB suspend the reduction of its balance sheet in that case? Normalisation requires that this issue be examined in detail.

A particularly important aspect of financial stability is the sharp increase in public debts over the last years. Governments have been able to borrow large amounts at very low interest rates, even at negative rates. Normalisation should lead to significantly higher rates, which stand to fragilise countries with very large public debts. The risk here is that normalisation be postponed to avoid a return of financial fragmentation within the euro area. As explained in Wyplosz (2021a), this would represent a dangerous instance of fiscal dominance, which may require collective action by the Member States. Again, this possibility must be anticipated, as discussed in the following section.

5. IMPLICATIONS FOR FISCAL POLICY

In normal times, the ECB would deal with the inflation surge and governments would not have to be involved in any way. However, a war on the European soil is a major geopolitical event, which concerns, first and foremost, the European governments. This was already the case with the pandemic. In fact, in both events, the central bank is merely playing a secondary role, focusing on its core objectives of price and financial stability.

Governments are involved in the diplomatic, military, humanitarian and migration aspects of the shock. From a purely economic perspective, they also must deal with both the supply and demand effects. The supply side shock disrupts production and cuts into the purchasing power of citizens, especially the less well-off. The demand shock is contractionary, which could directly concern monetary policy if it were not taking place in an inflationary context, as explained above.

Diplomacy, defence and income distribution are all national competences in the EU power-sharing organisation. Humanitarian assistance and migration are a shared competence, which has proved difficult to coordinate in the past. This time however, the governments are cooperating quite closely. The economic implication of these policies is that they entail increases in public spending at a time when most budgets already are in deficits. In addition, spending on climate change should also increase. Unless spending on other programmes is reduced or taxes are raised, the deficits are unlikely to be reduced.

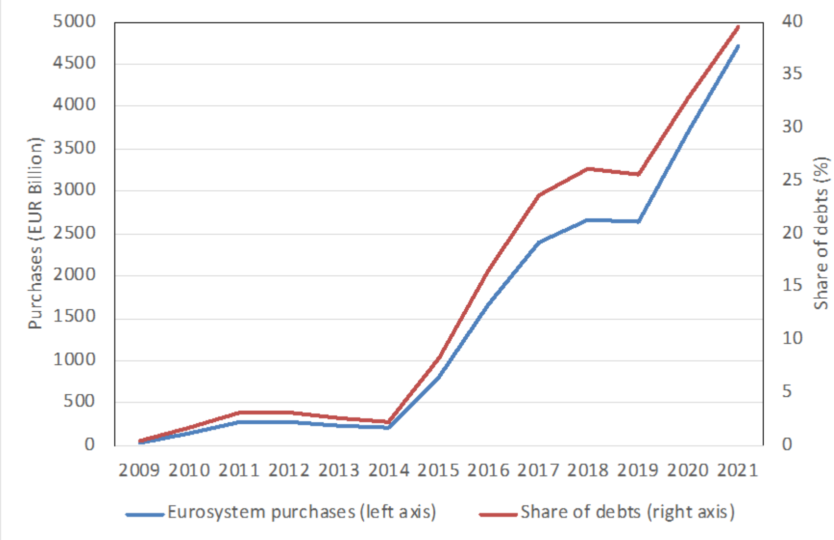
During the pandemic crisis, the ECB has increased its monetary base by more than the deficits of member countries. In order to do so, it purchased debt instruments on the financial markets, paying with newly created money. Much of its acquisitions concerned national public debts so that, indirectly, it financed roughly all the deficits in 2020 and 2021. The end of QE implies that governments will have to borrow from the markets to cover their deficits.

Figure 7 displays the cumulated purchases by the Eurosystem of assets, most of which are public debts. It also shows the estimated share of existing public debts held by the Eurosystem, which reached 40% at the end of 2021. Removing public debts from the financial markets effectively suspends debt service since governments pay interest to their central banks, which in turn transfer their profits back to their governments.[3] When QT starts, the amounts of public debts held in the financial markets will increase, effectively increasing debt service. This represents a potential challenge for the more highly indebted governments.

With one exception, the Eurosystem purchases national public debts in proportion to each country's "key", its share of ownership of the ECB. Interest received on these debt holdings is thus exactly equal to the payments of profits to member governments. This implies that asset purchases by the Eurosystem concern the same proportion of each country's public debt, thus precluding any income transfer among Member States. The exception is the PEPP created during the pandemic, which aimed at providing support to the more highly indebted governments. QT will eliminate this support, potentially putting these governments under financial pressure. The combination of higher public spending and of QT stands to worry the financial markets, which could result in financial instability.

[3] When the interest rate is negative, the mechanism works in reverse but the conclusion, that the debts held by the Eurosystem are suspended, remains.

Figure 7. Eurosystem holdings of gross public debts



Source: Author's calculations from ECB and European Commission data.

It is sometimes argued that the low real interest rates offer a protection against financial instability. Indeed, as a proportion of GDP, debts mechanically grow along with the interest rate and decline with the economic growth rate, both measured in nominal terms. Currently low interest rates and high inflation tend to reduce the debt/GDP ratio. Thus, the latest forecasts from the European Commission for the euro area see this ratio decline from 97.4% to 94.7% over 2022, even though the budget deficit is expected to stand at 3.7% of GDP. These forecasts assume that the interest rates will not increase by more than inflation in the short to medium run. The previous section argues that this will not be sufficient to tame inflation, which would be a case of fiscal dominance. Over the long run, it is often asserted that the interest rates will remain very low, because the natural real interest rate is structurally low, see, e.g. Blanchard and Pisani-Ferry (2022). This is possible, but equally unlikely. Evidence is weak and controversial.

6. ASYMMETRIES

So far, the Ukraine shock has been described in its broad macroeconomic aspects. However, its effects differ across countries and, within each country, across people and across sectors of activity. These asymmetries significantly affect the desirable policy responses.

Across countries, geography plays a major role. Eastern countries face immigration pressure as Ukrainians flee fighting. They also are more dependent on imports from Russia, chiefly energy. On both counts, this calls for more public spending. Within countries, higher energy prices affect some citizens more than others and the less well-off are not equipped to bear the costs. Firms that trade with Russia and those that have energy-intensive production processes are hit especially hard, unless they can raise their prices, which then fuels inflation. This calls for transfers, if possible targeted to those less able to cope.

Like during the pandemic, highly indebted governments will face a difficult trade-off between providing relief and deepening existing budget deficits. The possibility of sharing the burden between countries will naturally emerge. During the pandemic, the ECB has created PEEP to support some countries, while the NGEU programme has provided grants and loans. Both PEPP and NGEU were explicitly created as exceptional responses to an exceptional situation that was beyond the control of member countries. The Ukraine shock is obviously an exceptional event. A similar response is well-justified, even though the idea of transforming an exceptional collective response into a possible precedent triggers opposition.

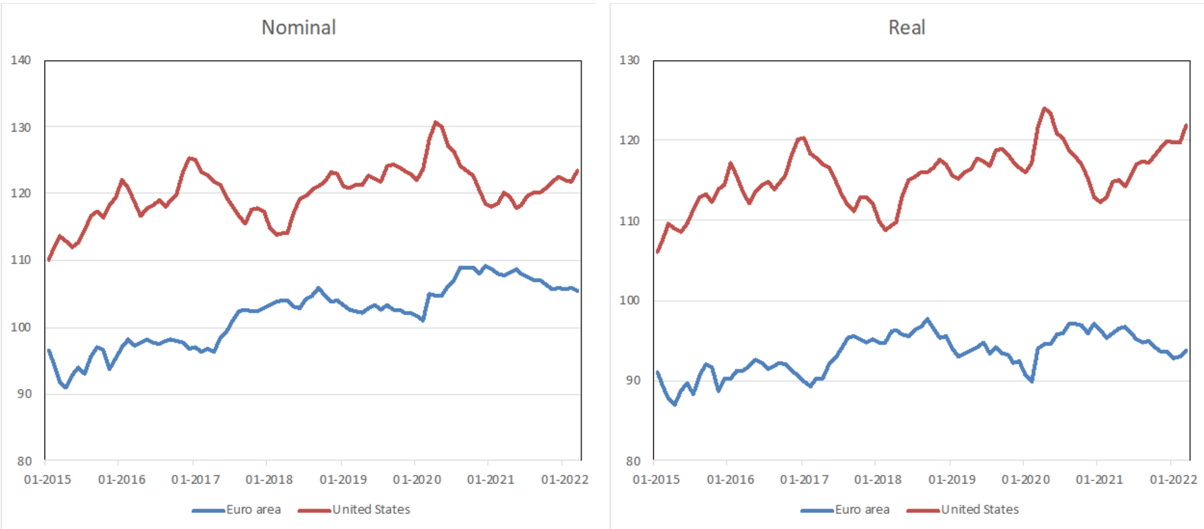
In the case of the ECB, restarting a PEPP-style programme runs against the need to control inflation and normalise its policies, eventually through QT. Two solutions are possible. First, the Eurosystem could use QT to reduce its holdings of all public debts and then it could conduct PEPP, on a smaller scale to normalise its balance sheet, in order to acquire some specific countries' public debts. Alternatively, it could restart the outright monetary transactions (OMT) programme, pledging to support some countries' public debts to preclude the risk of fragmentation.[4]

[4] OMT was created in 2012, in the midst of the euro area debt crisis. The "whatever it takes" statement by President Draghi was sufficient to bring the crisis to its end, without any actual intervention.

7. THE EXCHANGE RATE AND INTERNATIONAL ISSUES

Figure 8 shows that the effective exchange rates[5] of the US dollar and of the euro have little changed during the pandemic and since the invasion of Ukraine. At the broad level, the reason is that the economic impact of these momentous shocks is reasonably similar. Since 2021, the dollar has appreciated a little, while the euro has slighted depreciated. This reflects the fact that the Federal Reserve has changed its stance earlier than the ECB, and seems intent to raise its interest rate more forcefully. The recent acceleration of the real appreciation of the dollar reflects the strength of inflation in the US. The Ukraine shock is weaker in the US than in Europe. On the other hand, the ECB will have to catch up with the Federal Reserve on normalisation, which could mean a small reversal of euro depreciation.

Figure 8. Nominal and real effective exchange rates (Index: 2010 = 100)



Source: Bank for International Settlements, Effective exchange rate indices.

The stability of exchange rates indicates that, so far, at least, there is no hint of a serious instability in international financial markets. In recognition of the asymmetric impact of the Ukraine shock on central and European countries, the ECB has extended until January 2023 its swap/repo lines that had been put in place at the outset of the pandemic and were expiring at end of March. This is a precautionary step with no immediate effect and no particular significance beyond a confirmation that the ECB remains mindful of the role of the euro in its neighbourhood.

[5] The effective exchange rate looks at the average change of each currency relative to a large number of trading partners, weighting each bilateral rate according to the importance of bilateral trade.

8. CONCLUSION

The succession of crises faced by the euro area and the world has made the task of the ECB significantly more complicated. The Ukraine shock is no exception. It adds to the inflation already under way and it has a contractionary impact. On both counts, it raises the odds that fighting inflation will lead to a recession.

It is partly a supply shock, which central banks are not supposed to react to, unless wage and price second-round increases take a hold. It comes on the footsteps of the post-COVID-19 inflation surge, partly a supply shock. The surge has not been foreseen and is still under way, with likely second-round effects under way. As it is practically impossible to untangle the impacts, direct and secondary, of these two supply shocks, the ECB will need to develop a clear and transparent reasoning. More than ever, candid communication will be a condition for effectiveness.

The Ukraine shock may also include demand effects if the consumers are concerned enough by the unfolding events to cut spending, with a knock-on effect on investment expenditures by firms. As it focuses on its primary objective of price stability, the ECB is unlikely to try to alleviate this shock. The task of protecting the most adversely hit people belongs to governments.

A key objective of the post-pandemic recovery is to normalise monetary policy. The ECB should not be derailed from this endeavour. It should raise its interest rate back to positive territory. Based on current forecasts, driven by ECB pronouncements, the interest rate is not expected to be raised enough to bring inflation down to target. At stake is the risk that inflation becomes entrenched because of secondary effects resulting into a wage-price spiral increasingly more difficult to break. The development of such a spiral raises the odds that the Ukraine shock quickly adds to the wage-price spiral. It would greatly help if the ECB would provide a detailed analysis of how far it sees the interest rate rising.

Normalisation also involves shrinking the ECB's balance sheet through QT. This is bound to have a contractionary effect, but most likely a small one. The risk is that QT fragilises the financial markets, which have sailed through the pandemic crisis thanks to abundant liquidity. A correction of financial exuberance, fuelled by low-for-long interest rates, is part and parcel of normalisation. Unless the correction threatens the real economy, the ECB may not want to change its QT strategy. It should clarify this issue.

Finally, highly indebted governments may struggle when interest rates rise and the ECB starts selling the public debts that it acquired during QE. The natural solution, to aim at budget surpluses, may often be at out of reach as governments need to raise spending on health, defence, inequality and climate change. The threat of a new debt crisis is real, and the ECB will not be able to look in the opposite direction.

Given the massive level of uncertainty on all these issues, the ECB cannot expect to have worked out solutions for each of them. Yet, it should resist the temptation to keep all its options open by not discussing its intentions. The financial markets need to reduce the range of possibilities. Governments, which will be involved one way or another, must prepare their own actions and understand the limits of monetary policy. The public at large will not want to be surprised as it has been by the inflation surge. The European Parliament should want to know how the ECB appraises the huge challenges that it faces.

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The Ukraine shock comes at a most inconvenient time, when the inflation surge generated by the recovery from the pandemic requires urgent attention. The Eurosystem must proceed with policy normalisation, raising interest rates and shrinking its balance sheet, which can trigger financial instability. Defining and communicating its strategy is essential.

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