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CONSIGLIO
PER LE **RELAZIONI**
TRA **ITALIA**
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EUROPE'S ECONOMY ON A KNIFE EDGE

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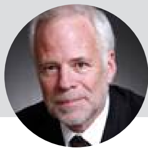

Barry Eichengreen, Professor of Economics, University of California Berkeley; former senior policy adviser at the International Monetary Fund; author of "Defense of Public Debt"

Before Russian President Vladimir Putin's attack on Ukraine, Europe's recovery from the damage wrought by the COVID-19 pandemic was solidifying. But now European policymakers have exactly zero control over whether their economies' rebound continues.

BERKELEY – Europe's economy is finely poised between recession and growth. The knife edge is sharp because European policymakers have exactly zero control over the outcome.

Before Russian President Vladimir Putin's attack on Ukraine, Europe's recovery from the damage wrought by the COVID-19 pandemic was solidifying. Industrial production rose in January, and retail trade rebounded. Economic sentiment improved in the first half of February, surpassing pre-pandemic levels. But then the war dented consumer confidence by heightening uncertainty and raising energy and commodity prices. In March, the EU Commission's consumer confidence indicator fell to its lowest level since the start of the pandemic.

So far, however, the data show only a mild softening of demand and limited disruptions to supply. They signal nothing remotely resembling the collapse in activity that accompanied 2020-21 pandemic lockdowns. The OECD's weekly tracker of economic activity, which uses machine learning and Google Trends data to infer real-time changes, similarly points to only a mild slowdown. Box office receipts are stable. Restaurant receipts are stable. Data from the navigation service TomTom do not suggest much decline in mobility-related activity.

In response to the war and energy shock, the European Central Bank, appropriately, has downgraded its forecast for eurozone growth in 2022 from 4.3% to somewhere in the 2.3% to 3.7% range, depending on what happens to oil and gas prices. Nonetheless, even its "severe scenario" of sustained high energy prices still anticipates above-trend growth in 2022.

More costly energy will no doubt be a drag on growth. But if Russian gas continues to flow, higher prices will not bake in a recession. Inevitably, profits will be squeezed by more expensive inputs. Even so, European producers can take steps to economize on energy use and keep the wheels turning.

But using less gas is one thing; using none at all is quite another. In the latter scenario, gas-powered factories won't be economizing; they will be shutting down. Over time, US natural gas can be substituted. But Germany has no liquefied natural gas terminals and will need the rest of 2022 to install its first floating LNG terminal – a converted supertanker – even if all goes according to plan. In the meantime, German gas consumption will fall by 30-40%. Even assuming that the monetary and fiscal authorities respond forcefully to prevent second-round business-cycle effects, this could drive German growth in 2022 from 1.8%, the most recent forecast of the German Government Council of Economic Advisers, into negative, recessionary territory.

And here Europe's lack of control comes into play. Whether gas supplies are suspended depends entirely on Putin, who could decide to terminate shipments in retaliation against Western sanctions. He may need the revenues, but this would not be the first time that anger and pride trumped economic logic. If the West makes payments not to Gazprombank but into escrow accounts, Putin will lose his last remaining incentive to keep the gas flowing. He knows that those accounts will ultimately be used to finance Ukrainian reconstruction rather than topping up Russian government coffers.

Above all, if Putin allows his army to continue committing atrocities against Ukrainian civilians, Western European publics and policymakers will unite against him. Given their country's history, Germans will not be able to sit back comfortably, in homes heated by Russian gas, in the face of this monstrous behavior. If Chancellor Olaf Scholz won't lead, then other members of his coalition, such as Defense Minister Christine Lambrecht, almost certainly will step in. And at some point, the German people will drag Scholz along with them. Whether it comes to this depends on Putin's next steps.

It is easy for an American, heated by natural gas from Texas and the Dakotas, to say that Europe should endure a recession in order to ratchet up the pressure on Putin. But if President Joe Biden's administration and the US Congress think it crucial to intensify the pressure on Russia, then they can make it worth Europe's while.

Europe will take the lead in Ukraine's postwar reconstruction. The logistics are easier. Ukraine is in Europe's neighborhood, as Ukrainian President Volodymyr Zelensky reminds us. The European Union can deploy its cohesion funds, trans-European transport and other infrastructure projects, and common energy policy even without – or preferably before – admitting Ukraine.

But if Europe is the logical party to do the legwork and administer the aid, then the United States can provide the bulk of the finance, beyond that portion financed by escrow accounts and Russia's other external assets. This will be an appropriate humanitarian gesture once the war is over. But a US commitment now to compensate Europe for the steps it must take, starting with a ban on imports of Russian oil and gas, is also a way to incentivize it to help bring the war to an early end.

AN INTERVIEW WITH ESWAR PRASAD

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Eswar Prasad, Professor of Economics, Dyson School at Cornell University; senior fellow, Brookings Institution; author of "The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance"

Last year, you warned that the pandemic recovery would be uneven, with the 2020 recession leaving "long-lasting scars on both GDP and employment" in most regions, including Europe and Latin America. How is the Ukraine war, and the Western sanctions leveled against Russia in response, likely to affect the trajectory of the global recovery?

This year will be a tough one for global growth, not only because of the Ukraine war, but also because of the resurgence of COVID-19 in China and the limited policy space that most governments have for responding to the economic pressures they face. The pandemic's disruptive impact seems well contained in most parts of the world, but with new variants continuing to emerge, the coronavirus remains a wildcard. In China, however, an apparent determination to stick to an increasingly unviable zero-COVID strategy, which has recently necessitated lockdowns of major cities like Shanghai, already poses serious risks. China might have to resort to further stimulus measures to maintain decent growth.

Meanwhile, escalating geopolitical tensions have exacerbated global supply-chain disruptions. With prices surging even before the invasion, and demand having generally held up in most major economies, this is likely to compound inflationary pressures around the world. And if demand begins to flag in the face of mounting economic uncertainty and financial-market volatility, the ability of most governments and central banks to use fiscal or monetary policy to bolster it will be limited.

The US economy continues to power along, with the labor market having healed to pre-pandemic levels, at least in terms of headline employment and unemployment rates. But the US Federal Reserve could well control of inflation and be forced to tighten monetary policy even more aggressively than it has signaled, raising the risk of a marked slowdown in growth. These factors will further tighten the vise on developing countries, many of which are already suffering from surging inflation, a strengthening US dollar, and tightening financial conditions that will restrict their access to foreign funds.

In 2020, you predicted that China's new digital currency and its cross-border payments system would enhance the renminbi's role as an international currency, as long as the country continued pursuing liberalizing reforms. Nonetheless, you argued, the US dollar would retain its status as the dominant global reserve currency. Have Western financial sanctions against Russia – which have frozen Russian assets and excluded some Russian banks from the SWIFT financial messaging system for international payments – altered your outlook? How might China leverage the crisis to expand the renminbi's global role?

New financial technologies have been driving several changes, all of which could now gather steam. For

example, new technologies are facilitating direct transactions between pairs of emerging-market currencies. By reducing reliance on "vehicle currencies," this is likely to erode the US dollar's role as an international payment currency.

At the same time, China's Cross Border Interbank Payment System, which facilitates direct payments and settlement with other countries' payment systems, could bolster the renminbi's role as an international payment currency. The CIPS also has messaging capabilities that could sideline SWIFT. What will not shift the balance of power among major payment currencies is China's digital renminbi; after all, international payments are already digital.

In any case, the fundamental structure of global finance, including the relative importance of the major reserve currencies, will not be easily shaken. Digitization will not, on its own, elevate the renminbi's status as a reserve currency. And while China has made progress in areas that could make a difference here – such as liberalizing cross-border capital flows, bolstering exchange-rate flexibility, and giving foreign investors greater access to Chinese bond markets – the government has disavowed institutional changes, including central-bank independence and rule-of-law guarantees. Such changes would be essential to win the trust of foreign investors.

Given all this, the US dollar is likely to retain its role as the dominant global reserve currency. And while its use as a payment currency might be eroded, even this is not guaranteed. Global investors might embrace private stablecoins backed by US dollars over those backed by other currencies, thereby bolstering the dollar's prominence. The likeliest prospect is a reshuffling of the relative importance of other currencies, with the US dollar retaining its primacy.

At our upcoming Finance 3.0 event, you will participate in a discussion about what lies ahead for crypto and crypto-adjacent industries amid tightening financial conditions and massive geopolitical upheavals. During the Ukraine crisis, some policymakers, such as European Central Bank President Christine Lagarde, have worried that cryptocurrencies will undermine the West's response to the Ukraine war by enabling Russia to evade sanctions. Will they? More broadly, how will cryptocurrencies factor into the strategies of countries seeking to reduce their dependence on a Western-dominated international financial system?

Decentralized cryptocurrencies such as Bitcoin do not yet offer the scalability to enable the evasion of economy-wide financial sanctions, especially since they must be converted into more widely accepted currencies to make international payments. Even if Russia accepted Bitcoin as payment for its exports, it would struggle to use a cryptocurrency to pay for imports. And cryptocurrencies cannot prevent a country's currency from collapsing in value relative to major reserve currencies, because those values are determined in formal financial markets.

While governments cannot count on cryptocurrencies to provide a reliable and scalable sanctions workaround, citizens might view them as a better option than a plunging domestic currency. In this sense, crypto might make things worse for Russia: citizens could dump rubles – in particular, ruble-denominated deposits – in favor of crypto, which would facilitate capital flight. Many central-bank consortiums are working on using new digital technologies, including wholesale versions of central-bank digital currencies, to improve the international payment system. But these approaches will be regulated; they will hardly help a rogue government to subvert sanctions.

In your latest book, The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance, you show how new financial technologies can help developing economies, such as by improving their access to global financial markets. But you also argue that these technologies could hurt them, say, by making them more vulnerable to major central banks' policies or even threatening the survival of their native currencies. How can regulators and international institutions maximize the benefits and mitigate the risks?

New financial technologies can do significant good, but it is becoming clear that neither new technologies nor decentralized frameworks are sufficient to mitigate the risks such technologies raise. Government oversight is necessary to minimize the risks to consumers and investors, and to limit negative spillovers into traditional financial markets.

As developing economies attempt to manage new cross-border payment systems and other frameworks that facilitate international capital flows, they will also need to confront increased capital-flow and exchange-rate volatility. But a key tool on which governments have long relied – capital controls – is less potent in this new context. This raises serious challenges for national regulators, especially because it is often not clear which entities must be regulated or how certain products and services should be classified. Moreover, many new technologies are not constrained by traditional borders, so international coordination will be vital.

The United States may be poised to assume a key role in defining global standards for regulating new financial technologies and products, including cryptocurrencies, stablecoins, and blockchain-based finance. US President Joe Biden's recent executive order on "ensuring the responsible development of digital assets" sets out an ambitious agenda for such regulation. But key challenges remain, including determining which agencies should be responsible for regulating particular products and technologies, and developing specific regulatory policies that mitigate risks without hampering innovation excessively.

You also predict that cash is on its way out. What are the biggest obstacles to this transition, and what dangers does it entail?

As consumers, businesses, and governments worldwide embrace digital payments, the era of physical currency or cash is coming to an end. Digital payments have distinct advantages over cash, which is susceptible to theft, loss, and counterfeiting. The shift away from cash will bring economic activity out of the shadows and preclude the use of official money for illicit commerce. But for all its flaws, cash does have many advantages. Perhaps most important, cash allows for privacy in commercial transactions, which digital payments simply do not. Cash is also easily accessible and requires no electronic device or internet connection. During a natural disaster or other emergency, when communications networks might collapse and electricity might be cut off, cash will still do its job.

There are concerns that the shift away from cash will disenfranchise the elderly, the poor, and the technologically disadvantaged. But new technologies and systems – such as for conducting transactions using basic mobile phones – will mitigate these risks. Moreover, by enabling widely accessible, low-cost digital payments, central-bank digital currencies might broaden financial inclusion.

In a recent interview, you noted that cryptocurrencies like Bitcoin "have not proven they are efficient" and "have very unstable value," but "the technology Bitcoin has bequeathed to us" – blockchain – is "really going to have legs." Can you give us some examples of interesting, unexpected, or promising applications of blockchain?

This future is upon us; innovative decentralized finance (DeFi) products built on blockchains are already operational. For example, flash loans can be taken out without collateral, used for a transaction, and then repaid, all for a small fee. A flash loan is initiated, executed, and completed instantaneously, using just computer code. This helps to minimize default and liquidity risks. Financial products like flash loans can, for instance, help arbitrage price differences across markets, bolstering market efficiency. Computer tools can perform rigorous economic-risk assessments of smart contracts and specific DeFi products. The open-source nature of DeFi applications enables the discovery and elimination of security and other weaknesses.

Blockchain technology could soon be adapted for a broad range of uses, such as buying a car or house, managing ownership records for electronic and physical assets, and maintaining digital registries of public records. Smart contracts facilitate the exchange of financial and other assets for money or different assets. Such transactions can be executed and recorded on the blockchain through computer algorithms, without the involvement of trusted third parties like attorneys or bankers.

THE INCREDIBLE BOUNCING ROUBLE

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Sergei Guriev, former Chief Economist, European Bank for Reconstruction and Development; former rector, New Economic School in Moscow; Professor of Economics, Sciences Po

The Russian ruble's return to its pre-war exchange rate should not be mistaken as a sign of strength or resilience. Rather, the currency has benefited from factors that will eventually become major drags on both the federal budget and the real economy.

PARIS – After plummeting in value following Russia's invasion of Ukraine, the ruble has clawed its way back to its pre-war levels. But this should be of little comfort to the Kremlin, because the factors that drove the ruble's rebound augur additional problems for Russia's economic performance.

The West has exhibited near-unprecedented unity and resolve in its response to Russian President Vladimir Putin's war on Ukraine. Within just three days of the invasion, Western governments had frozen much of the Russian central bank's foreign-currency reserves within their respective jurisdictions.

This move triggered financial panic within Russia – and spurred a powerful policy response. On February 28, the central bank imposed strict capital controls, tightened currency-trading restrictions, and hiked its key policy rate from 9.5% to 20%.

Russia's government then ordered all Russian exporters to repatriate and exchange 80% of their export revenues for rubles, and the central bank introduced a 30% commission (later reduced to 12%) on foreign-currency purchases. Various categories of buyers were banned from purchasing US dollars, and holders of foreign-currency-denominated bank deposits faced major constraints withdrawing their savings.

Despite this swift policy response, however, the ruble's official exchange rate moved from 81 rubles per dollar before the war to 139 per dollar on March 9 (though the black-market rate reportedly was much higher). Inflation accelerated substantially, with the growth rate of the official consumer price index rising to 2% per week (181% in annual terms) in the first three weeks of the war, before slowing to 1% per week (68% per year).

The ruble has since returned to the 80-per-dollar range. But its appreciation is not necessarily real. If a currency's trade is severely restricted, its exchange rate does not reflect its market value. During the Soviet era, the Communist Party's flagship newspaper, Pravda, consistently reported that the ruble's official exchange rate was 0.6 per dollar, but nobody viewed that as a proxy for the currency's real strength.

To be sure, there are tangible signs that the pressure on the ruble is subsiding. Late last week, the central bank removed the 12% fee for purchasing dollars, relaxed certain limitations for currency-denominated deposits, and – most importantly – cut its policy rate from 20% to 17%, while signaling further easing to come. These actions speak louder than any official statements about the strength of the Russian economy.

Even so, growth projections for Russia this year remain bleak. According to the central bank, GDP will decline by 8% this year; before the war, it was expected to increase by 2.4%. The Institute of International Finance predicts a 15% fall in GDP, while the European Bank for Reconstruction and Development (EBRD) and most international investment banks forecast a 10% recession. The head of Russia's Accounts Chamber, Alexei Kudrin, agrees.

The ruble's recent appreciation does not invalidate these pessimistic views, because the exchange rate's recovery is merely a reflection of unprecedented restrictions on imports and higher oil and gas prices. Western governments have imposed severe sanctions on technology exports to Russia, which have been reinforced by a private-sector boycott, with more than 600 Western companies having withdrawn from Russia. Households and enterprises have lost access to many imported consumer goods and intermediate inputs at home, while airspace closures and boycotts by Airbus, Boeing, and major insurers and leasing companies have made it all but impossible for Russians to travel to the West.

Because these restrictions have substantially reduced Russian demand for imports, note economists Oleg Itskhoki and Dmitry Mukhin, they have also lowered demand for dollars (which are needed to purchase such goods), thereby driving the ruble's exchange rate upward. But that is not good news for Russia's economy, which is bound to slow down.

Just as the COVID-19 pandemic forced firms around the world to reckon with their dependence on global supply chains, Putin's war has shown Russian enterprises that they cannot function without imports. Even those that source their supplies domestically have come to realize that their suppliers depend on imports from the West. That is why Russia's automotive industry has ground to a halt, with sales in March falling to a third of their level in March 2021.

Moreover, the demand for dollars has been further reduced by financial sanctions that essentially outlaw Russia's use of dollars even to pay off its dollar-denominated debt. These measures have already resulted in a technical sovereign default.

The second factor driving the ruble's appreciation is the high price of oil, which has returned to its 2014 levels. Back then, the ruble was trading at 38 per dollar, or 52 per dollar in today's prices (after adjusting for inflation in both Russia and the United States). Today's oil prices thus imply the possibility of further ruble appreciation, save for the fact that geopolitical risk and capital flight have made the ruble weaker than it otherwise might have been.

Today's exchange rate indicates that Russia's balance of payments is strongly supported by current oil prices, which implies that fiscal performance is holding up well, too. While the early sanctions froze much of Putin's stock of cash, high oil prices have ensured substantial daily inflows.

But this, too, could become a problem for Putin. As EU High Representative for Foreign Affairs and Security Policy Josep Borrell recently pointed out, the EU has sent €35 billion ($38.1 billion) to Russia since the start of the war, but just €1 billion in aid to Ukraine. This appalling disparity has not been lost on European leaders, as the growing support for an oil and gas embargo attests. In fact, Europeans are already speaking about the embargo not in terms of "if" but rather in terms of "when."

An EU-wide decision to stop importing Russian oil and gas will have catastrophic consequences for Russia's federal budget and make the ruble's recent recovery unsustainable.