The Tests Yet to Come

Global Economic Implications of the Ukraine Crisis

By Ed McKenna

Unlike the wars in Yemen, Syria, Myanmar, Iraq and many others, the Western media has chosen to fully televise the horrors now occurring in Ukraine as a result of the Russian invasion. Thus far, it is largely Ukrainian people and Russian soldiers who have borne the steep cost levied by this brutal war. Of course, the Russian population is also certainly bearing a heavy, and increasing, burden brought on as the result of Western sanctions. This, however, occurs largely unseen due to the almost complete lack of media coverage of what is taking place in Russia. Eventually, however, most of the world will experience great hardship as a result of inflation, recession, and shortages of essential goods like energy and food; hardships that will become increasingly grave as long as the war persists and which will not be borne equally by all.

Even before the war in Ukraine, a great debate was taking place among economists regarding the cause of inflation that began in the latter part of 2021. Initially, most economists believed that price increases were largely the result of supply chain issues resulting from COVID-19, issues that would naturally resolve themselves as the epidemic was brought under control. Over time, however, the majority of economists have changed their minds and have come to believe that inflation is largely the result of total demand being too high relative to supply, and that the problem can only be brought under control through actions undertaken by monetary authorities. My own view is that such a conclusion is premature. I will leave my reasons for believing this for another time. Here what I would like to do is to accept the general argument that the problem is one of demand being too high relative to supply, but to question whether the generally accepted view that the problem must be brought under control by the action of monetary authorities is one to which we should all acquiesce.

The questions we must ask are the following: 1) What action must the monetary authority take to bring inflation under control? 2) Will this action succeed in bringing inflation under control?

The answer to the first question is fairly straightforward. The traditional economic view is that the central bank should increase the rate of interest. This increase will then raise the cost of borrowing, which will lower the amount of investment that occurs in the economy. Since investment is one of the major components of aggregate demand, this will mean less of a demand for labor, resulting in lower wages (or at least a reduction in the rate of growth of wages). Since wages comprise the largest component of cost, cost will be reduced and hence prices will cease to increase. Thus, monetary policy works by reducing wages and increasing unemployment, an increase that results from the drop in aggregate demand. In effect, some portion of the labor force must bear the cost of unemployment so that the rest of us can be freed of the burden of inflation.

The call for an increase in interest rates is becoming increasingly prevalent in Western economies. Indeed, the central bank of the United States, the Federal Reserve, has just this past week raised the rate of interest and promises that further increases are forthcoming. Of course, as noted above, this policy change will only work if it succeeds in raising the rate of unemployment. That is, some people must lose their employment. But we must ask if this policy is likely to succeed. There are multiple reasons why we should question whether this is really the appropriate stance to take in dealing with the current inflation. Here I will limit discussion to what I see as the two most important reasons for questioning whether such a policy is likely to be successful, though many other reasons exist.

First, using the interest rate as a tool for lowering inflation is simply too blunt of an instrument. There is a great deal of empirical evidence that suggests that investment is not very sensitive to changes in the interest rate. There are certainly sectors of an economy that do respond to interest rate increases, for example, the building of new houses. When interest rates rise, loans become more expensive and hence people take fewer loans, lowering the demand for new houses. Construction costs also rise, as businesses in the construction industry face increases in the cost of debt, increasing the cost of supplying houses. Both of these effects lead to a drop in the construction of new homes, increasing unemployment in the construction sector, and lowering aggregate demand.

Other sectors of the economy, such as the oil sector—which is playing an important role in the current inflation—are far less responsive to interest rate changes. Energy experts point to the fact that the price of oil is set in world markets, markets that are dominated by a small number of oil-rich nations and large corporations, whose actions are little influenced by interest rate increases. Moreover, the essential nature of energy means that the demand for oil does not change much even for large price increases. Both of these factors lead to the conclusion that interest rate changes will have to be unusually steep to lead to a reduction in the demand for oil sufficient to have a meaningful impact on prices.

This leads to the second reason why an increase in the interest rate is an ineffective tool for dealing with inflation. The channels through which monetary policy works are not understood by economists precisely enough to know what amount of change is sufficient for bringing about the desired change in aggregate demand. Moreover, the timing of interest rate changes is also not sufficiently understood to ensure that the change in the interest rate changes aggregate demand at the appropriate moment. Because the lag between a change in the interest rate and a change in aggregate demand is long and variable, it is quite possible that an increase in the interest rate does not take effect until after aggregate demand has already fallen. The subsequent further drop in aggregate demand means that a recession is deeper than necessary. Indeed, the work of economist Alan Blinder has demonstrated that the Federal Reserve has only been successful in 2 out of its last 11 attempts at bringing about a soft landing, i.e., bringing about a change in aggregate demand sufficient to end an inflation without causing further economic problems.

The problem with using monetary policy to end inflations, then, is that the tool may not be capable of working in those sectors where inflation is actually occurring, and even when it does work the tool is too blunt to avoid causing a recession and hence unemployment, unemployment that is born unequally across the economy.

Now one can reasonably ask whether there are other tools that might be utilized to deal with inflation, tools that might place a burden more on those who are capable of bearing it. And the answer is yes, there are such tools. I will recommend here just one, though others are possible. If the problem is that we need to reduce aggregate demand, then we can reduce aggregate demand through the imposition of taxes. The type of tax increases that we might utilize can be varied to adjust to the nature of inflation. If inflation is taking place in a relatively small number of sectors of the economy, and if these sectors produce goods that are essential for living, then the tax should be a progressive tax whose aim is to reduce total demand but to do so in a way that is not unduly burdensome to lower and middle income groups. Suppose that price increases are largely taking place in energy and food sectors—such increases can occur because fertilizers used in the production of food also require oil. Energy and food being essential elements for existence, we would not want to decrease the quantity obtained by lower and middle income people, at least not by a great amount. So, we would reduce demand by placing a tax on higher income groups, groups that ordinarily use much more of these goods and that could easily reduce their demand without undue sacrifice.

Of course, the problem here is that it is precisely the higher income groups that have the political power that enables them to resist such tax increases. And here we see why problems such as inflation will continue to be dealt with through conventional policy, such as interest rate increases, rather than the use of the kind of tax policy I have recommended above. Many of the economic problems we will face will require a redistribution of burdens from those at the bottom in the middle to those at the top of the income and wealth ladders. Take climate change, for example. It is becoming increasingly obvious that some type of limitation on growth will have to occur if we are to avoid environmental catastrophe. But we cannot reasonably ask the poor nations of the world to accept lower growth rates when they are already suffering deep levels of poverty. So, it is the wealthier countries that will have to bear more of this burden if we are to have a chance at lowering growth rates to avoid intolerable increases in temperature. But will the wealthier countries be willing to accept this?

We are likely very soon to have a preview of the answer to this question. Pressure is rising among Western nations to extend sanctions on Russia to include no longer purchasing oil, gas, and coal from Russia. Increasingly, Western authorities are concluding that only such sanctions will actually impose a sufficient cost on Russia to bring its leader to the negotiation table (I will leave it to experts on international relations to discuss whether such a policy is likely to succeed in a manner that can be justified). But this will mean that some areas of the world, such as parts of Western and Eastern Europe, will face severe energy shortages Moreover, the fact that Russia and Ukraine produce 25% of the world's wheat supply means that the current war will likely lead to food shortages sometime in the next six months. Unless rather dramatic redistributions of food and energy among those nations supporting Ukraine against the Russian invasion occur, it will be extraordinarily difficult to maintain the present coalition of nations supporting Ukraine, in spite of this conflict being presented as a great battle between Democratic and Authoritarian nations by Western authorities and the media. In a recent television interview I heard a commentator ask the following question: How long can the people of the United States be asked to pay more than four dollars per gallon of gas for the purpose of supporting the people of Ukraine? Astonishing! I would have been more understanding if the interviewer had asked how long we can expect lower and middle income people to pay such prices without a subsidy provided for by a tax on the wealthy. But this was not the question asked, and this is why the answer to the question of whether the wealthy will take on the necessary burdens remains, at best, uncertain.

Like any other problem, great or small, there is only one way to solve economic problems, and that is through genuine love for humanity. This love will give people guidance; it will show them what to do and what not to do. It is not necessary to study great numbers of books or to rely upon those who speculate with the future of the silent masses. The only essential requirement is to look upon humanity with genuine sympathy.

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