

“Price of Embargo”

Why inflation is not the worst consequence of sanctions

Published in Forbes, 2014/08/28

Article summary

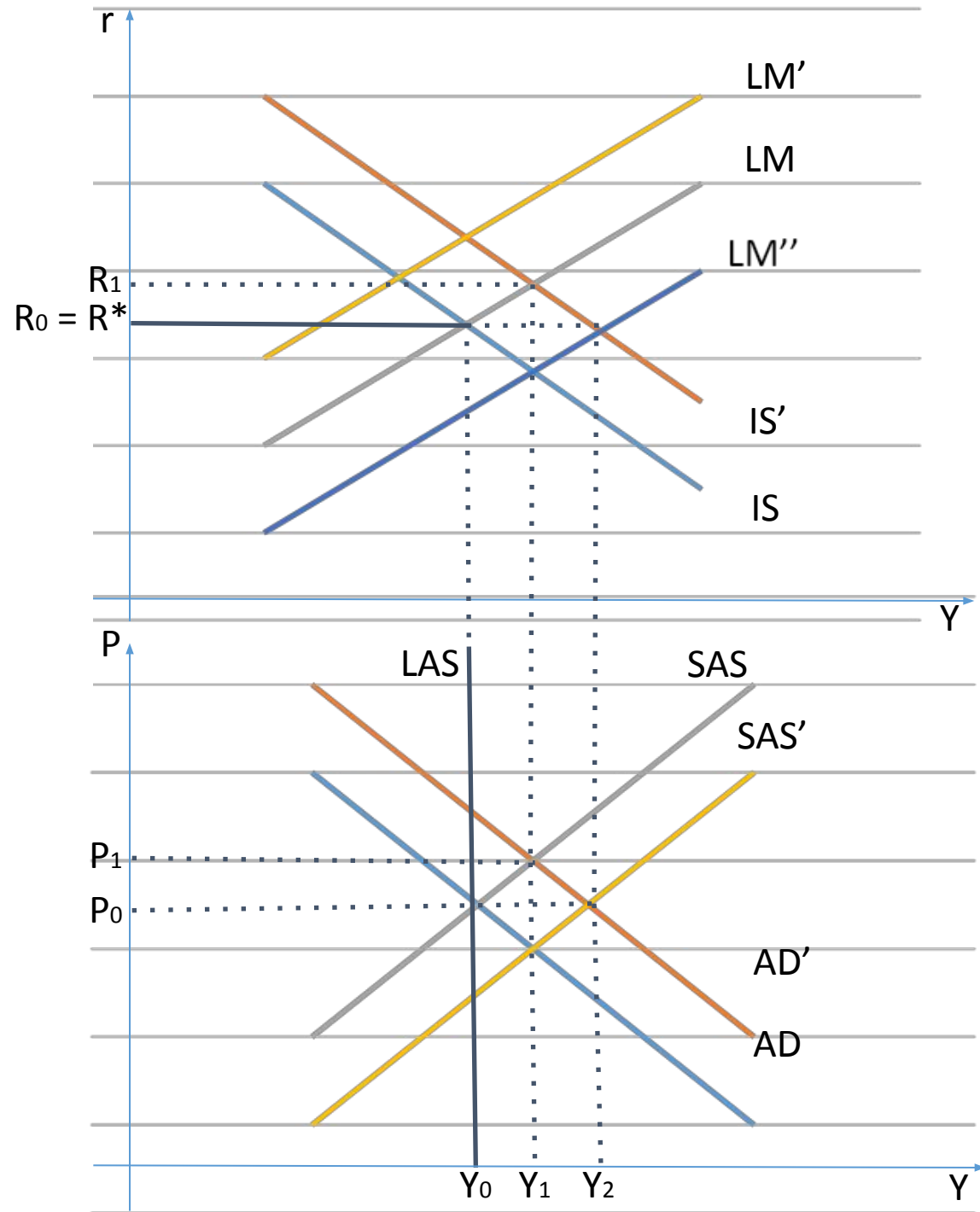
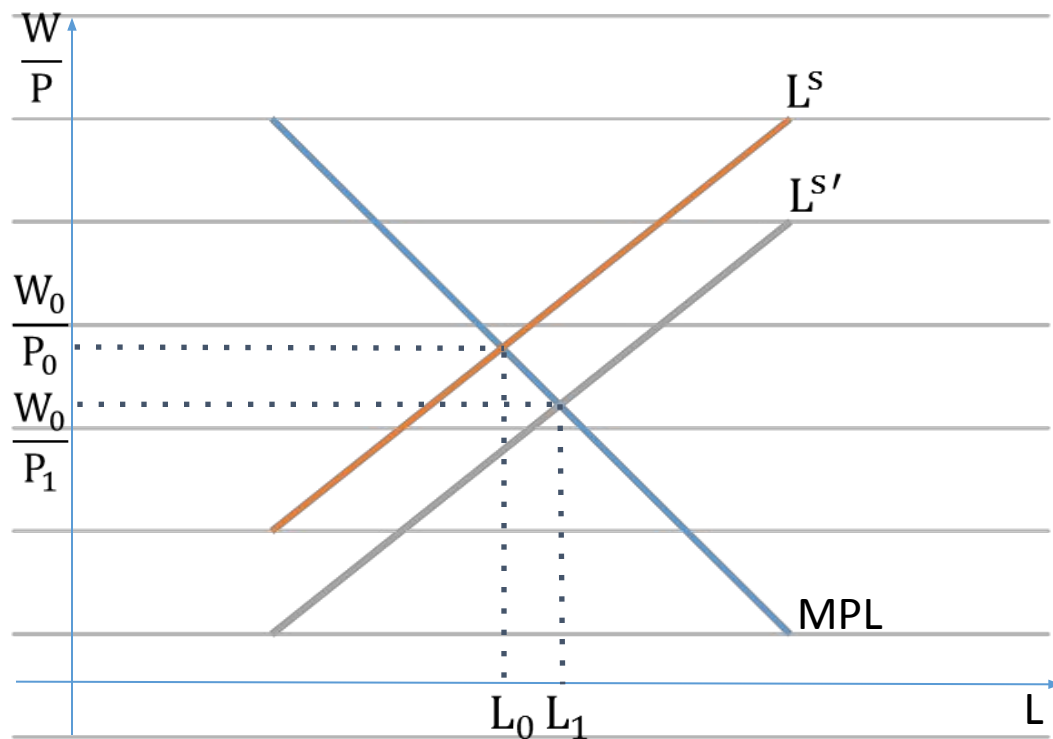
- **Due to embargo price level has gradually increased**
Import embargo (restriction of imports of food items and raw materials) was introduced as a counter-sanction after imposition of EU and US anti-Russian sanctions. Import restrictions lead to high level of inflation.
- **Bad geopolitical climate**
Bad geopolitical climate, decrease in oil prices, worsening of Russia's investment ratings has caused a significant cash outflow and policy of CB to increase the discount rate discourages lending and spending by consumers and businesses.
If geopolitical climate was better our real situation would have been as theoretical model suggests: capital inflow and output growth.
- **Possible solutions**
Several policies to stimulate the economy are known. Those are: an increase in government spending or decrease in taxes (fiscal expansion) and monetary expansionary policy.
- **Positive influence of monetary policy in SR**
Discount rate increased, interest rate has risen and people started taking less loans from banks. Due to panic in November/December 2014 rise in deposits started only in 2015. Because of more deposits money supply has increased when discount rate has started to fall.

Main assumptions

- Short run
- Open economy
- Fixed wages
- Flexible prices
- Perfect capital mobility
- Switched exchange rates
- Internal & external equilibrium
- Bad political climate

Theoretical situation

$Im \downarrow \rightarrow Nx \uparrow \rightarrow IS \uparrow \text{ \& \ } AD \uparrow \rightarrow P \uparrow \rightarrow \frac{M}{P} \downarrow \rightarrow LM \uparrow$
 \searrow
 $L \uparrow$



Possible solutions

Fiscal expansion

- Increase in government spending ($\uparrow G$) and/or decrease in taxes ($T_x \downarrow$)
- Increase in output \rightarrow Increase in interest rate \rightarrow Decrease in investment \rightarrow Decrease in output
- Due to positive LM slope overall effect is positive: Increase and AD and Increase in IS

Monetary expansion

- Discount Rate or Reserve Ratio decrease
- Money supply increase \rightarrow Interest rate decrease \rightarrow Increase in investment \rightarrow Increase in output \rightarrow Money demand increase \rightarrow Increase in interest rate \rightarrow Fall of investment \rightarrow Decrease in output
- Due to negative IS slope net effect is positive

The real situation

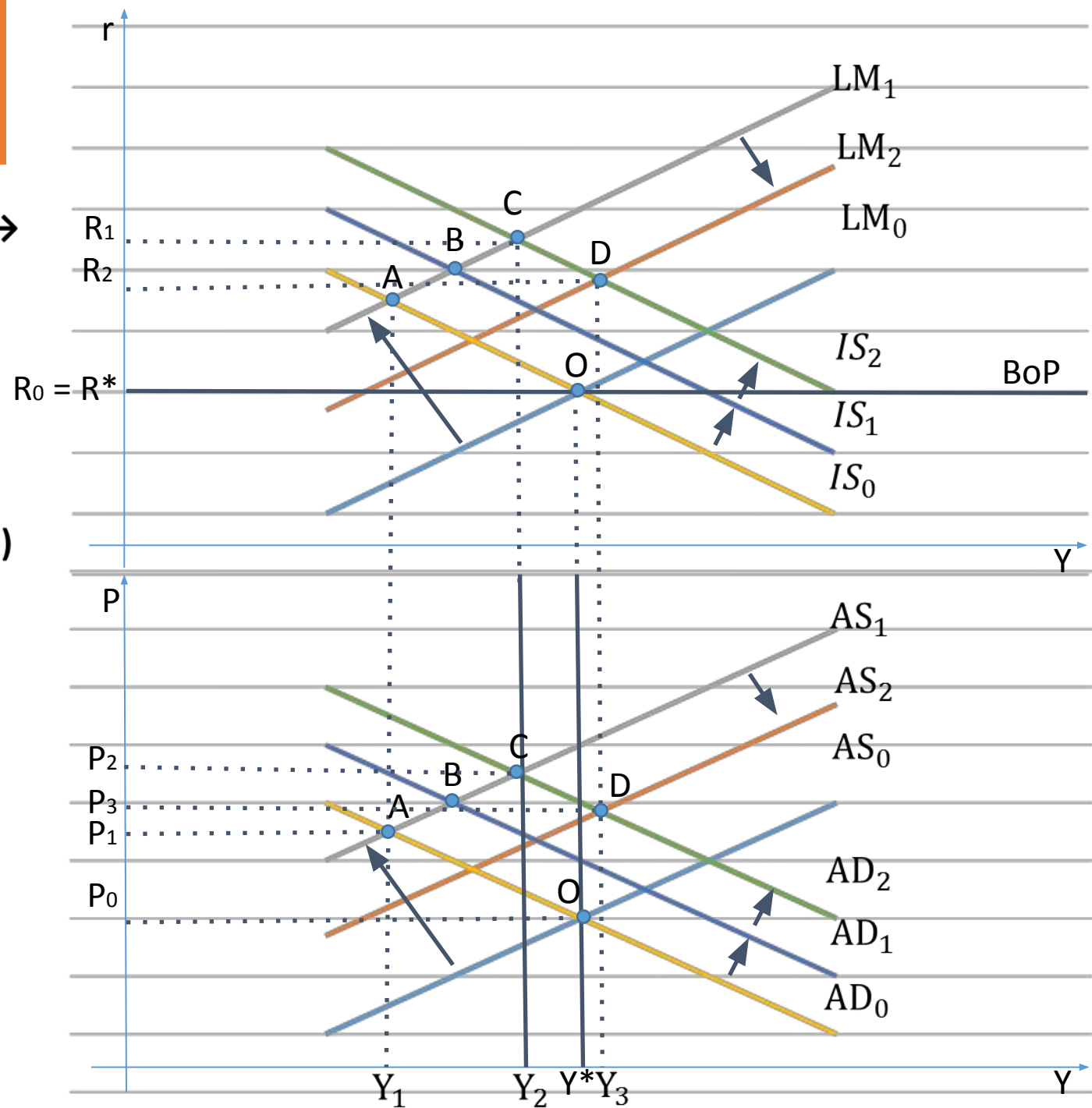
Embargo \rightarrow $Im \downarrow \rightarrow Nx \uparrow \rightarrow IS \uparrow \text{ \& } AD \uparrow \rightarrow r \uparrow (r > r^*) \rightarrow$

- External factors
 - Geopolitical Climate
 - Decrease in Oil prices
- Internal factors
 - Central Bank's policy
 - Panic in market

\rightarrow Capital Outflow $\rightarrow LM \downarrow \rightarrow$ Switch (Fixed \rightarrow Flexible)

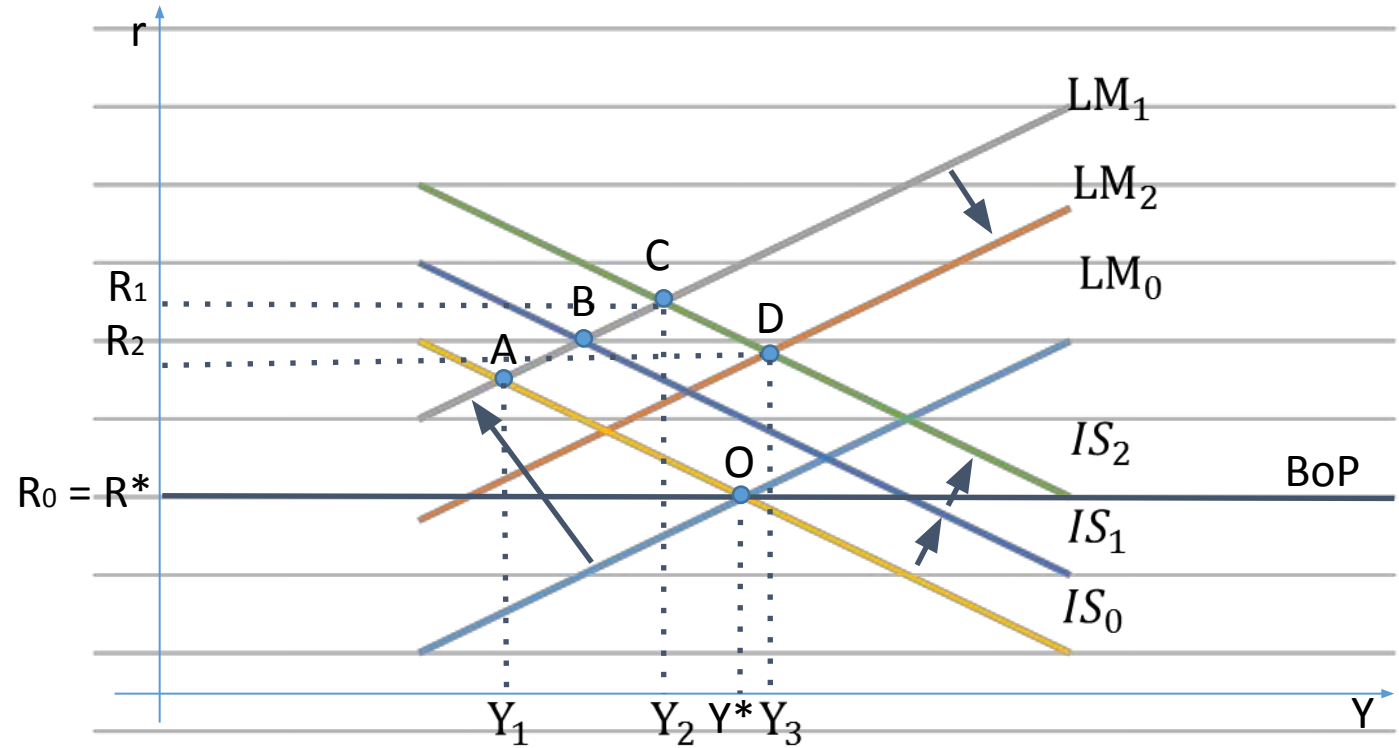
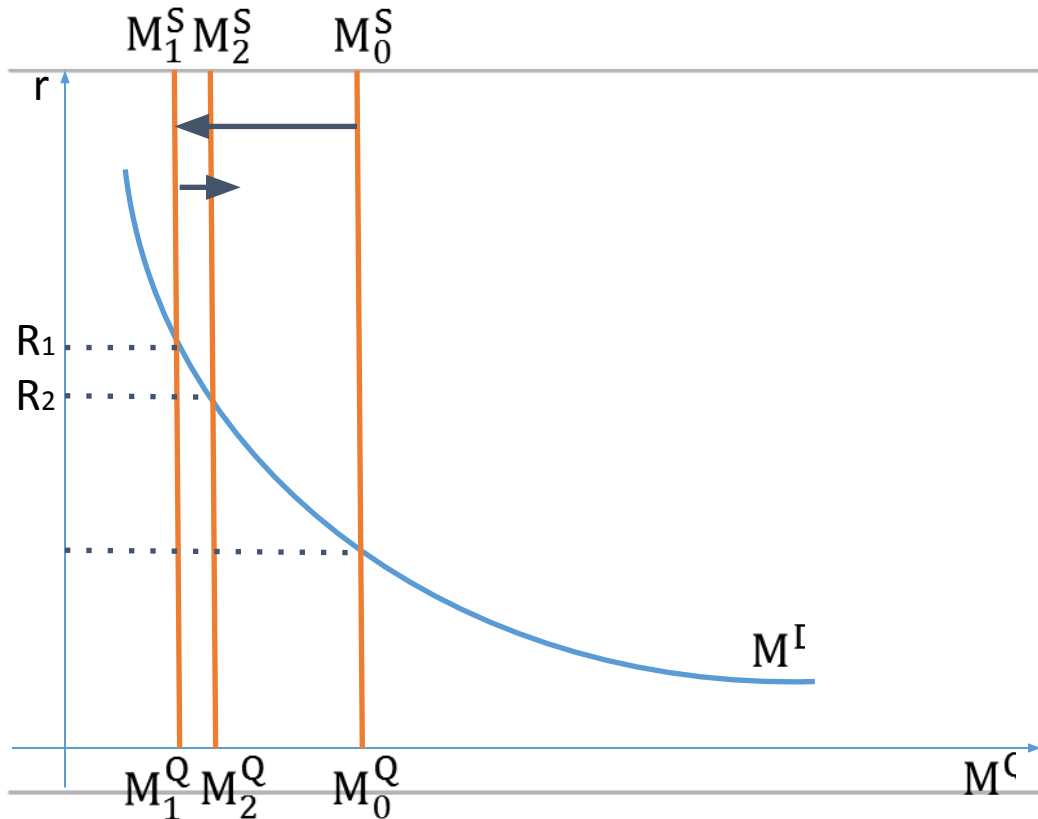
$P \uparrow \rightarrow P_1 * Y_0 \rightarrow Y_{nominal}$

$P \uparrow \rightarrow L^s \uparrow \rightarrow L \rightarrow \frac{W}{P} \downarrow$ (identically to theoretical)



The real situation, money market

$M^D \downarrow \rightarrow \text{Loans} \uparrow \rightarrow M^S \uparrow \rightarrow \text{LM} \uparrow$



Conclusion

- Due to external forces (oil prices and geopolitical situation) actual situation is significantly different from scientific framework.
- Output increases in Short Run by 0,5%
- Results of our analysis do not contradict to the opinions of the author.