

CHAPTER ONE

# INTRODUCTORY REMARKS

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The work of the Economic Policy Working Group at the Hoover Institution is long running, and it has profoundly impacted economic policy debate in our country and abroad. Today, given these unprecedented times, I cannot think of a better moment to discuss the Federal Reserve, its current and potential policies, and the general state of the economy.

The United States and the world have experienced a number of shocks over the last twenty years. I was national security advisor and John Taylor was under secretary of the Treasury for the Bush administration when we experienced the terrible shock of September 11. The United States had not been attacked on its territory since the War of 1812, and it was a day that we thought we would never see. Facing attacks on New York, the Pentagon, and potentially the White House, the country soon found itself suddenly at war, which was an enormous shock with repercussions that would continue to follow long after.

Before we would leave office, the global financial crisis of 2007–8 occurred. This was another crisis that seemed to destabilize the international economy as we knew it, a crisis that some would say was a black swan event but nevertheless was a huge shock to the American and global economies. Then, in 2020, we would learn the name of a virus that would launch a pandemic. COVID-19 turned out to be not just a health crisis but a crisis in every aspect of our lives: social, educational, and especially economic.

Just as the world was beginning to recover from the COVID-19 crisis, another enormous shock has occurred with the Russian war on Ukraine. The idea that a large, powerful state like Russia would decide to simply absorb its neighbor and do so by brutal military means makes one think we are living in 1939 instead of 2022. It is hard to understand that Vladimir Putin has launched this war because it is his aspiration and his intention to reestablish the Russian Empire—not the Soviet Union, but the Russian Empire. This reality has implications for Europe that are beyond anything that anyone can predict.

During all these crises, of course, the role of the Fed and monetary policy will be under a microscope for the short-term effects. But it is also critical to remember the potential long-term effects of the shock that we are seeing in Europe.

We must remember that this war in Europe is essentially a geopolitical earthquake. It is reshuffling the deck in terms of security in Europe. NATO will emerge a much stronger alliance after this. Finland and Sweden, countries that not too long ago maintained strict neutrality policies, are now seeking full membership in the NATO alliance. In just a few weeks, Vladimir Putin ended German pacifism and Swedish neutrality.

Given these shifts in attitudes on neutrality and pacificism around Europe, it is likely that there will be extraordinary pressures on national budgets for huge increases in defense spending going forward. The Germans sometimes talk about as much as doubling their defense budget. While it is hard to imagine that this will be achieved, the very fact that a long-term reshuffling of European security is occurring and being intensively discussed means that nations are going to be forced to spend more on defense. These effects will certainly have impacts on debt ceilings and national economies.

Secondly, it is likely that we will see a major reshuffling when it comes to energy supply. As much as the world might like to make a quick, uninterrupted transition to a low-carbon or carbon-free economy to fight climate change, hydrocarbons are still a big part

of our energy mix in the short term, especially in transportation. Indeed, the question of how countries provide those hydrocarbons is now not just a question of energy but also a question of energy and its relation to national security.

A number of countries have found themselves overly dependent on Russian oil and gas, and after Russia's invasion, they are now trying to end or at least minimize that dependence. Some countries have already successfully done it. Poland, for instance, after the 2014 Russian invasion of Crimea, started changing its energy sources, significantly decreasing its dependence on Russian oil and gas. Due to these proactive measures, the announcement by Vladimir Putin that Russia was going to cut off natural gas to Poland and Bulgaria was barely an issue for them. They had already made the necessary arrangements to not be negatively impacted by these potential scenarios with Russia, which are now reality.

The Germans, however, who have been warned since Ronald Reagan was president about their dependence on Russian pipelines and Russian oil and gas, find themselves in a difficult situation by having also decided not to use nuclear energy. The French, on the other hand, get 80% of their generating power from nuclear sources, allowing them to mitigate the impacts of the loss of Russian energy supplies.

This leads to perhaps the most important point: Russia under Vladimir Putin is going to be isolated from the international economy for the foreseeable future. No matter how long the war with Ukraine continues, sanctions are unlikely to be lifted anytime soon. The self-sanctioning that is taking place by companies and countries around the world who do not want the reputational risk or uncertainties of dealing with Vladimir Putin's Russia will leave Russia with very little international business engagement or investment for a long time to come.

With Russia's likely long-term isolation, at least from the West, there will be new questions on where those hydrocarbon resources

will come from moving forward, which will drive new decisions about energy supply and the production of oil and gas in North America. I agree with the view that if you are going to continue to need hydrocarbons, let's make sure that they come from North America, not from Iran, Russia, and even to a certain extent, Saudi Arabia.

In addition, when energy prices are up, we see other impacts on the economy, including on food supply, which is often overlooked. I was secretary of state in 2007 when oil prices rose to over \$140 a barrel and transportation costs spiked over 50%. Consequentially, food riots occurred in places like Egypt, which is completely dependent on the import of food. The transportation costs from energy shocks will lead to new supply-chain issues, including on food, which could potentially lead to increased instability in various places around the world.

I want to underscore how dramatic what we are seeing in the world today really is. We have never tried to isolate an economy of Russia's size and importance from the international economy. Back in the days of the Soviet Union, it was self-isolating. The Soviet Union never accounted for more than 1% of its GDP in international trade. By contrast, the modern Russian economy, in fact, has been very integrated into the international economy.

We have isolated economies before. We isolated North Korea with sanctions. But there was very little, if any, impact on the American or global economy given that the North Koreans produce and sell counterfeit cigarettes, counterfeit dollars, and nuclear parts. The Trump administration isolated the Iranian economy and the Iranian Central Bank, something that the Bush administration chose not to do because of its potential shock to the economy.

But the Russian economy on any given day, whether you think of it as the eleventh or fifteenth largest economy in the world, is fully integrated. Russia and Ukraine combined account for almost 30% of the world's wheat supply. Russia accounts for 20% of titanium, and Russia and Belarus account for 40% of potash and thus, fertilizer.

Therefore, it seems the international community does not yet fully understand the potential unintended consequences of the medium- to long-term isolation of the Russian economy.

This isolation of Russia, as long as Vladimir Putin is in power, will also have an effect on Russia itself. A brain drain has already occurred, with approximately 500,000 people having left Russia since the war began on February 24, and the number will continue to grow. They are among the country's best and brightest—its entrepreneurs, its software engineers, and its intelligentsia. This exodus of the sort of talent that drives a country's development forward will have a long-term impact on Russia, perhaps for generations to come. Russian oil fields, even if sanctions are lifted, will suffer, because the major oil companies of the world are not going back. And without their technology, Russia cannot develop some of its most vulnerable and older oil fields in places like Sakhalin Island.

And so, as we go back and look at all the shocks that we have experienced over the last twenty years, the shocks that have been thoroughly discussed through these conferences, it is important to understand the magnitude of the geopolitical earthquake that the world is currently experiencing. The global economy is in uncharted waters, experiencing inflation and pressures on growth.

Major economies across the world will be reacting to what has happened in Europe for some time to come. With that in mind, this is an important time to consider the Fed and how far it may already be behind the curve, and where we go from here.