INFOCUS

MACRO COMMENT

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Surging energy prices and stagflation

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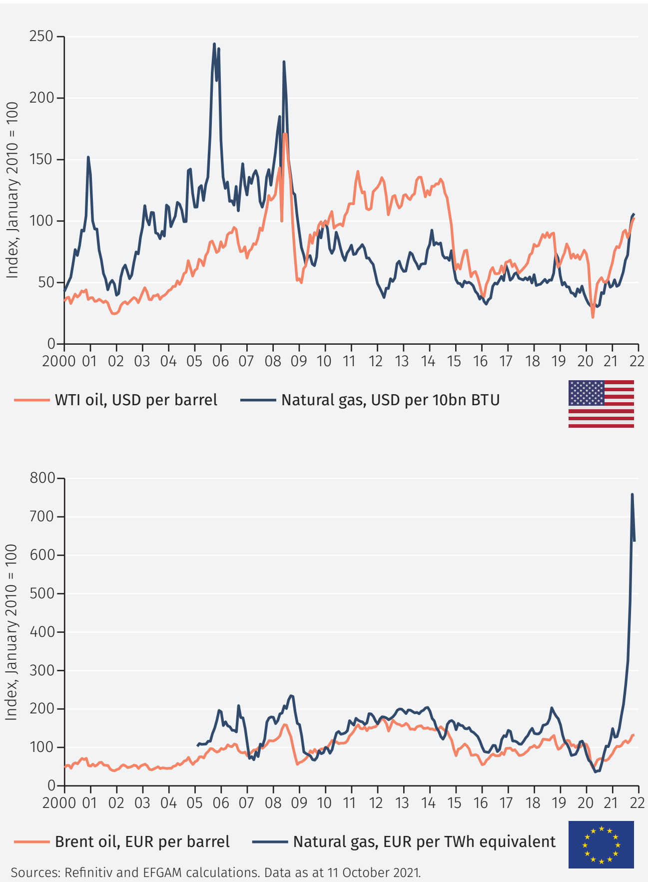
Energy prices have risen sharply of late and there are fears that an associated inflationary spiral could jeopardise the economic recovery. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the transmission of shocks from energy prices to consumer prices.

Energy prices are under pressure and many observers fear the return of stagflation, a situation where inflation is high and economic growth stagnates as it did in the 1970s after the oil price shocks. The price of Brent oil, the European benchmark, is close to USD 83 per barrel and the US WTI price is close to USD 80 per barrel. The prices of both have doubled in a year (see Figure 1). The price of natural gas in the US market has also doubled since October 2020, while the benchmark price in Europe temporarily shot above EUR 150 per Terawatt hour (TWh), ten times the price in March; it was last trading around EUR 90 per TWh.

It is not unusual for oil and natural gas prices to move together as both are used to produce electricity. According to estimates by the Saudi Arabian oil company Aramco, the explosion in natural gas prices has prompted some power generators to switch to oil, increasing its demand by up to 0.5 million barrels per day.

1. Oil and natural gas prices in the US and EU



Sources: Refinitiv and EFGAM calculations. Data as at 11 October 2021.

Two questions arise: what has caused prices to rise? And what could be the impact on inflation?

What is driving prices higher?

Several factors explain the surge in energy prices. In the early months of 2021 relatively cold weather and work-from-home conditions drove demand for home heating. The economic recovery has led to higher than expected electricity and fuel consumption since last spring. In addition, China has increased gas imports from Russia to compensate for the closure of coal-fired power plants to reduce CO2 emissions. Finally, droughts in Latin America and unfavourable weather conditions in Europe during the summer have reduced electricity production from renewable sources and increased demand for fossil fuels.

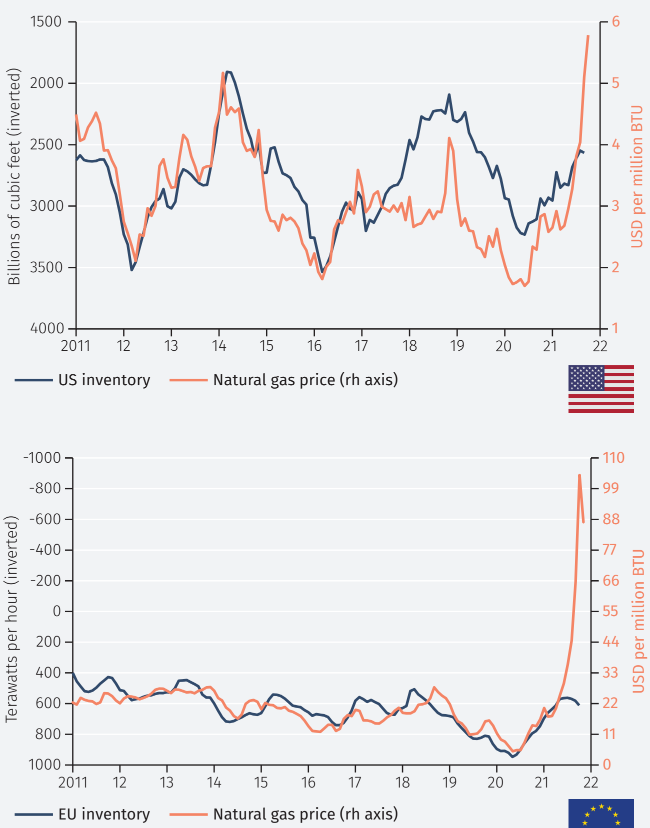
On the supply side, OPEC+ production limits – which were intended to help clear the oil stockpile caused by the pandemic – have pushed up the prices of both crude oil and natural gas, which is often extracted with the same rigs. In addition, Hurricane Ida in late August limited US shale oil production for much of September. Finally, Russia has been exporting less natural gas to Europe as a means of increasing its own domestic supplies for the winter, and possibly also to put pressure on the German energy regulator to accelerate approval of the Nord Stream 2 pipeline.

The result of all this is that stocks of energy raw materials are low. Petroleum product inventories in OECD countries have fallen below the 2015-19 average, the benchmark for OPEC+ decisions. The same is true for natural gas, with many observers pointing out that the low storage capacity utilisation rate in Europe of only around 75%, compared to the seasonal average of around 90 %, is the main cause of the recent steep rise in prices.

However, increased gas storage capacity means that the current level of stocks is overall in line with the historical average. As Figure 2 shows, the decline in stocks from the high levels of 2020 justifies prices being higher than the depressed levels of a year ago, but not as high as those reached in early October.

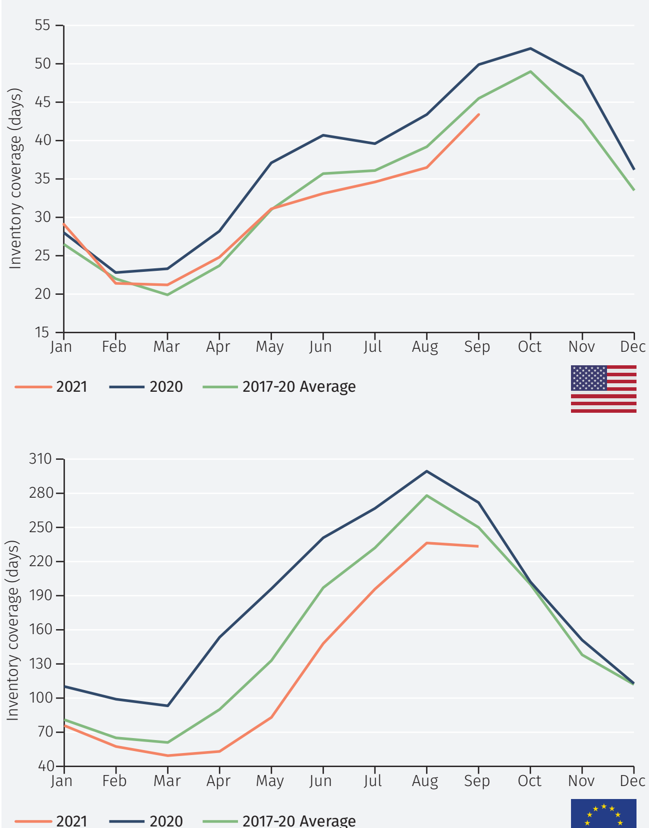
The overall adequacy of natural gas stocks is also evident from the observation that in terms of consumption days, the September level is less than 7% below the 2017-20 average in both the US and Europe (see Figure 3). This suggests that natural gas prices may decline in the coming months, especially in Europe where they remain well above the historical average.

2a. Natural gas inventories in the US and EU



Sources: Refinitiv and EFGAM calculations. Inventory data have been seasonally adjusted with Tramo-Seats. Data as at 11 October 2021.

3. Natural gas stocks in days of demand – US and EU



Sources: Refinitiv and EFGAM calculations. Data as at 11 October 2021.

With regard to oil, while OPEC+ dashed hopes of a faster normalisation of its production at its meeting on 4 October, the increases planned for the coming months and the additional output expected from other producers, especially the US, should keep the market well supplied.

So there seems to be no reason to fear a structural shortage of energy commodities. This is also what investors seem to think: the oil and gas futures contracts see falling prices in 2022.

How big is the risk to inflation?

Nonetheless, there are widespread fears that the energy price shock will lead to a persistent rise in inflation, with negative repercussions for growth. Recovery from the pandemic is also likely to suffer as high energy prices constrain the production of goods and services, exacerbating the supply chain disruptions that have emerged over the past twelve months.

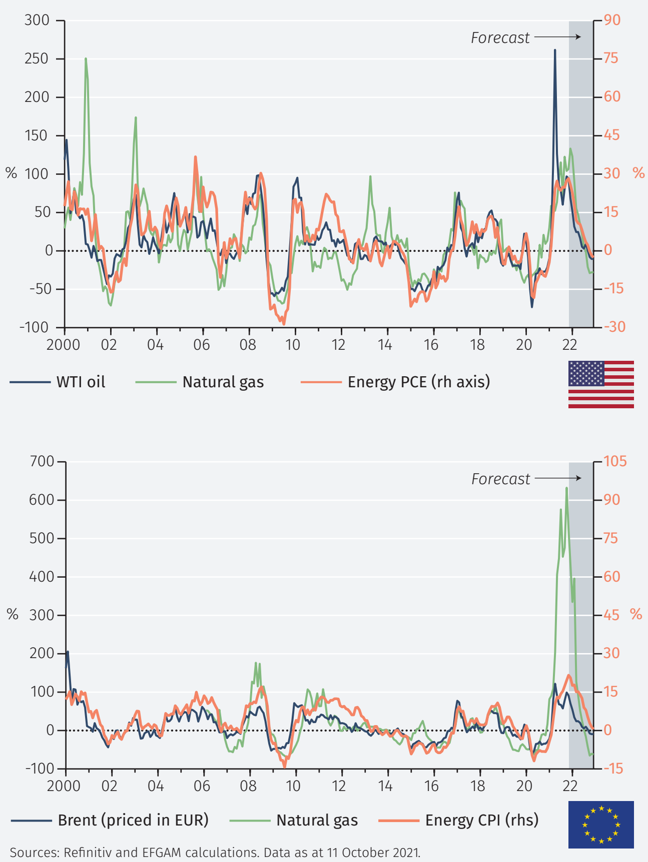
It is important to recognise that for inflation to rise persistently, goods and services prices must continue to rise. A shock to the price level inevitably has an impact on the purchasing power of the private sector, but its impact on the inflation rate will be transitory unless it is followed by so-called second round effects, including a rise in wages.

Tensions over the price of European gas could ease if Russia increases its gas exports. It should not be forgotten that, despite increased demand from China, the EU absorbs about 75% of Russian gas exports, so it is in Moscow's interest to find a solution as soon as possible. It is therefore not surprising that Putin has recently voiced his support to increasing gas flows to Europe and that this has been enough, even in the absence of details, to push prices down.

If futures are a good guide to the evolution of oil and natural gas prices, energy commodity inflation is expected to peak by the end of 2021 and fall in 2022, especially in the second half of the year.[1] While the energy price shock will increase the inflation rate in the coming months in both the US and the eurozone, its direct impact will be less severe over the coming year.

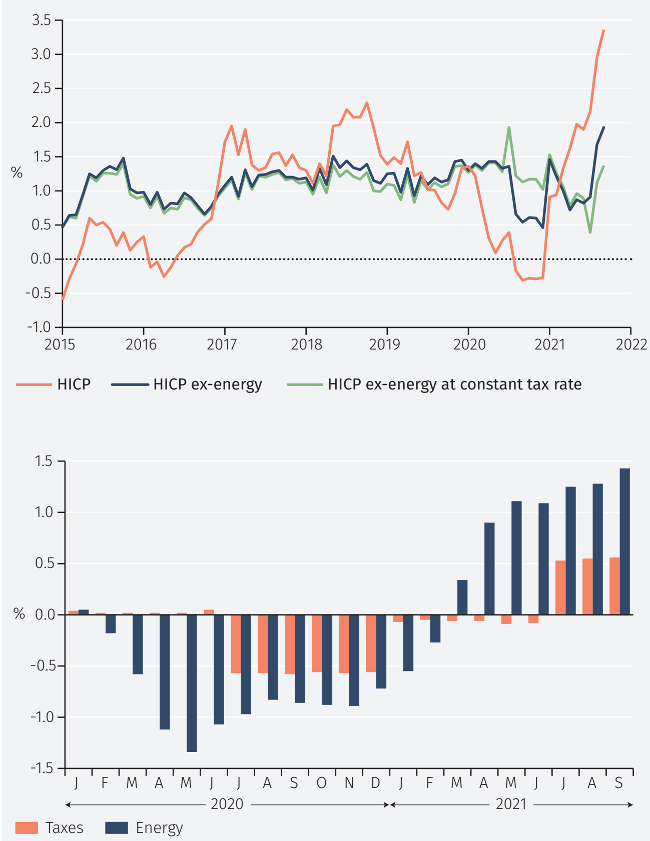
[1] The forecast of consumer energy inflation is obtained by modelling monthly changes in the energy price index expressed as a function of changes in oil and natural gas prices for the United States and the eurozone. The model is estimated over the period September 1990-August 2021 for the US and September 2009-September 2021 for the eurozone. Future Brent values in EUR are calculated based on the average EUR/USD exchange rate at the beginning of October 2021 of 1.158

4. Energy price and inflation (US: PCE; EU: CPI))



Sources: Refinitiv and EFGAM calculations. Data as at 11 October 2021.

5. Energy and tax effect on eurozone inflation



Sources: ECB, Bundesbank, Refinitiv and EFGAM calculations. Data as at 11 October 2021.

Inflation in the eurozone will also fall in 2022 due to the removal of some German tax measures from the calculation. The German VAT rate was reduced by 3 percentage points (pp) between July and December 2020 to support the economy at the height of the pandemic. The normalisation of the VAT rate in 2021 has increased the eurozone inflation rate by an estimated 0.5 pp between July and December (see Figure 5). In addition, in January 2021 Germany implemented its climate package, increasing fuel taxation. That was only partially offset by a reduction of the surcharge on electricity tariffs levied to support the development of sustainable energy sources. On balance, according to Bundesbank estimates, in 2021 the climate package added 0.3 pp to German inflation and 0.1 pp to eurozone inflation. Overall, the base effect of the German fiscal measures will remove 0.6 pp from eurozone inflation as of next January.

Conclusions

Rising energy prices are complicating the economic recovery. However, conditions in the oil and gas markets do not justify the fears of stagflation expressed by many observers. There is no evidence of severe energy shortages as in the 1970s, and futures prices suggest that energy inflation will fall in 2022. Barring second round effects, overall inflation will also be progressively lower.

In the eurozone, the decline in inflation will also reflect the removal of the effects of German taxation, which currently adds 0.6 percentage points to the eurozone price index. Indeed, excluding the effects of the energy shock and German taxation, eurozone inflation remains stuck near 1%, half the European Central Bank's target.

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