

Eurozone energy shock to have ripple effects on inflation and consumption

The current energy shock is set to increase inflation forecasts and dampen the consumption recovery. For European Central Bank hawks, this means a welcome argument in favour of earlier tapering



The energy crisis that Europe is currently facing is one of the big unknowns for the economic recovery, and the inflation path, in the months ahead. The spike in gas prices, accompanied by oil prices at a seven-year high, is causing a lot of uncertainty for households as it results in large question marks surrounding energy bills for this winter and possibly beyond. The outcome of this crisis remains quite uncertain, and the severity of the European winter will matter a lot, but currently futures contracts imply a rapid decline of prices over the course of 2022. Even if that's the case, the impact on consumers is likely to last for quite some time, denting private consumption and keeping inflation at elevated levels.

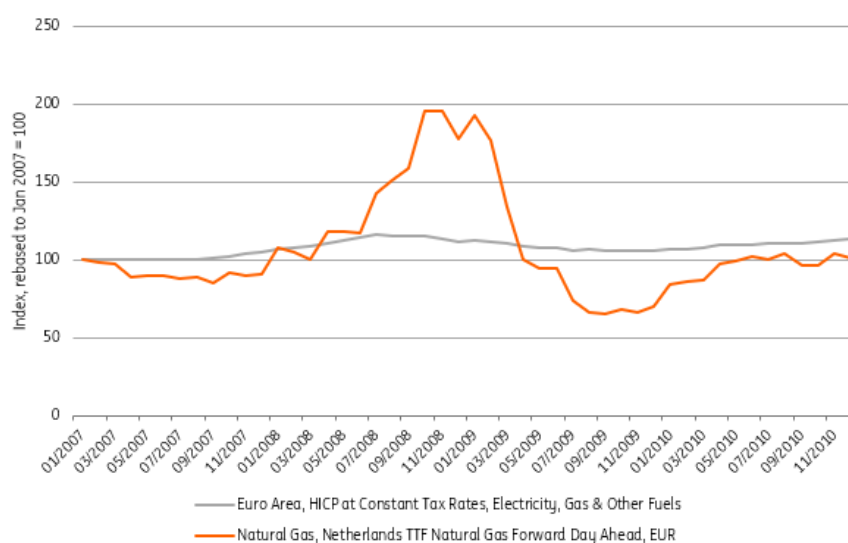
Energy will push headline inflation higher for some time

Clearly, the impact of the gas price shock and higher trending oil prices is inflationary. The question is, just how much will prices rise? Looking at the relationship between consumer prices for electricity, gas and heating fuel and the natural gas spot price, we find some evidence that the impact of a gas price increase on energy inflation is more lagged than for oil price increases,

indicating that the effect of the gas price shock could last for quite some time. This has to do with different pricing regimes across the eurozone.

A good illustration of this is the impact of the 2008 gas price shock, which resulted in elevated eurozone consumer gas prices for a protracted period. A year after the initial spike, market gas prices had fallen back to levels below the pre-shock readings, but consumer prices were still about 12% higher. This means that the impact of the gas price shock on consumer prices is set to last well into 2022, delaying the negative base effect of energy prices on headline inflation and complicating ECB policy.

The 2008 gas price shock illustrates the lasting impact on consumer energy prices



Source: Eurostat, IMF, ING Research

Those negative base effects from energy were expected to kick in by early 2022, but the soaring gas prices have mitigated the dampening effect of energy prices. Furthermore, oil prices themselves have risen more than forecast, so this has also pushed up energy inflation more than expected. From here on, we do expect a moderation in oil as well, but this effect will be dampened by elevated gas prices over the course of 2022. We expect the energy contribution to inflation to only turn negative in the third quarter next year. That contributes to a higher headline inflation rate than we initially expected for a large part of 2022.

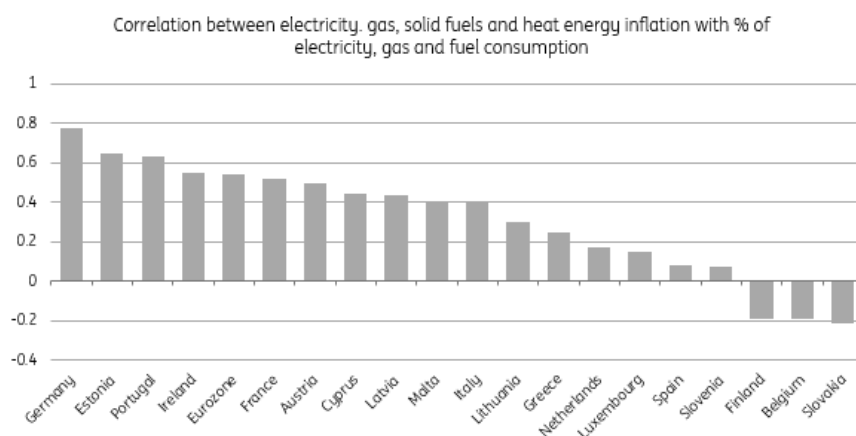
Consumption is set to be affected through crowding out effects and expectations

The impact on consumption will come from a crowding out effect. When prices of household energy rise, this results in the share of energy consumption in total consumption rising in the eurozone. It's interesting to note though that this is not the same for all eurozone countries. In fact, some countries actually see the energy contribution decline, indicating that households adjust their energy consumption when prices go up. In Finland, Belgium and Slovakia, for example, available data shows that people tend to wear an additional jumper during the winter rather than change their consumption patterns. For the eurozone as a whole though, the higher energy bills

are likely to result in some crowding out effect of other consumption.

Because of this, we expect a modest reduction in our household consumption forecast for the winter months. While this will not derail the overall GDP recovery, we do expect a reduction of 0.2ppt to our GDP forecast for 4Q 2021.

A jump in electricity and gas prices results in a higher share of consumption of energy, implying a crowding out effect



Source: Eurostat, ING Research

Note: the inflation rate taken is measured at constant tax rates

Heated ECB debate in December

In our view, higher energy prices and their impact on inflation and private consumption are clearly stagflationary forces, though this is by no means [a return to the 1970s](#). The ECB can keep the flower shirts and flared trousers in the wardrobe for now, but higher energy prices will clearly heat up an already heated debated at the ECB's December meeting. A further upward revision to the ECB's inflation forecasts now looks unavoidable. Yes, the more dovish ECB members can still call the inflationary period transitional but the transitional period is set to last much longer. At the same time, weaker private consumption could be used as an argument not to withdraw monetary stimulus too early. For the hawks, another upward revision to the inflation forecasts should be a welcome argument in favour of tapering. To some extent, the eurozone energy crisis could accentuate the rift between the doves and hawks and specifically between the 'inflation is transitional' and the 'inflation will be structurally higher' camps. To keep tensions at bay, a decision to start tapering earlier and more significantly than markets currently believe could be a good compromise.

Authors

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.