

Surging oil prices: a new concern for central banks

Life for central banks has become even more complicated as surging oil prices add to the trilemma of how to balance slowing economies, the delayed impact of the rate hikes so far and still too-high inflation



Oil prices are currently up by more than 25% this quarter

Surging oil prices have become the new concern for central banks, aggravating the current trilemma: how to balance slowing economies, still too-high inflation and the delayed impact of unprecedented rate hikes. Interestingly, the answer to this conundrum differs between major central banks.

Looking ahead, the recent surge in oil prices will make things even more complicated as it will both worsen the economic slowdown but also push up inflation (or at least reduce the disinflationary trend). Balancing growth and inflation will become even harder, and future interest rate decisions will not only be determined by these two variables but also by central banks' credibility.

In this regard, central banks most concerned about their credibility and the longer-term impact on inflation expectations could end up continuing to hike interest rates.

Oil price rally likely to continue, but it's not sustainable in the longer run

Oil prices are currently up by more than 25% this quarter and even briefly reached \$95/bbl. Our commodities analyst Warren Patterson expects oil prices to break above \$100/bbl in the near term as supply cuts by OPEC+ countries more than offset weaker demand due to the global economy's slowdown.

However, he doesn't see oil prices remaining above \$100/bbl for long as weaker demand and political pressure to increase supply should help to bring oil prices back to levels slightly above \$90/bbl.

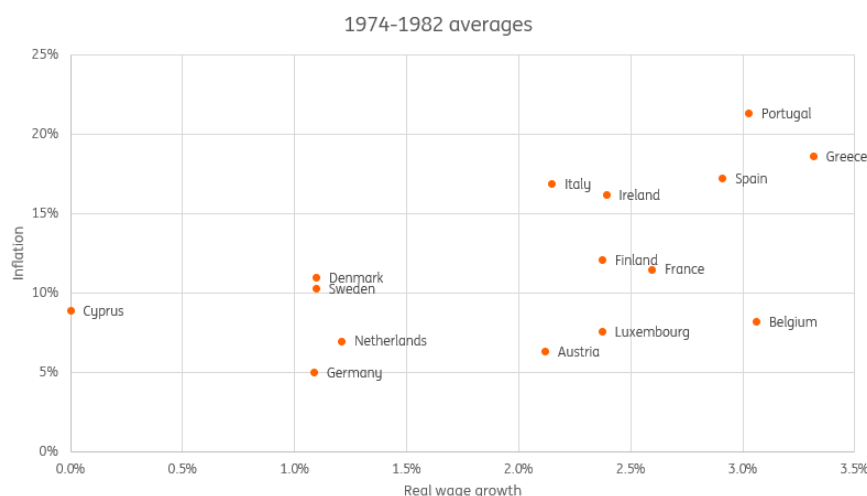
In our September Monthly update, we argued that the current inflation situation is [not the same as the 1970s](#) and that a second inflation wave looked highly unlikely. However, we also admitted that in the late 1970s, the second energy crisis was the main driver for the second inflation wave in many countries.

In the eurozone, there were three peak periods for inflation in the 1970s. The first was in 1974, when headline inflation was close to 14%; the second in 1977 with headline inflation above 10%, and then again in late 1979 and early 1980 with headline inflation back at double-digit levels. Back then, real wage growth remained positive even during the spikes of the oil crises, which allowed inflation to remain above 7% for more than a decade (1972-84). Indeed, the countries that experienced higher real wage growth for the period also experienced the highest inflation over this period (see chart below).

The current surge in inflation is different in that real wage growth turned negative quickly, which has slowed consumer demand drastically. This makes the chances of a prolonged second spike in inflation much smaller. With inflation currently trending down and wage growth stabilising above 4%, real wage growth is set to turn positive again soon, but we wouldn't expect it to erase the losses from the past two years.

At the same time, it is important to note that government support and employment growth have limited disposable income losses quite substantially.

In the 70s, countries with higher real wage growth also experienced higher inflation



Source: European Commission AMECO

Inflation is measured as the average annual growth in the national CPI and real wage growth as average annual growth in real compensation per employee, with private consumption as deflator.

How do current oil prices change our inflation forecast?

While this won't be a replay of the 1970s, expectations of further disinflation will be impacted by higher oil prices. This could result in a slower decline of inflation to 2%. Given that our expectations for oil prices do include a drop in the first half of 2024 again, the effect on our own forecast is rather moderate. Plus, a smaller decline in energy prices has materialised this year compared to expectations (which impacts next year's base effects).

The estimates below give a sense of how inflation could vary under alternative scenarios for oil, but also natural gas. Assuming oil prices stay at \$95/bbl for all of 2024, however, the eurozone headline figure would rise by 0.3ppt next year, with a peak of the energy price contribution of 1ppt in the second quarter. At the same time, higher oil prices would probably further dent consumer confidence and spending, thereby contributing to the current disinflationary trend due to weaker demand.

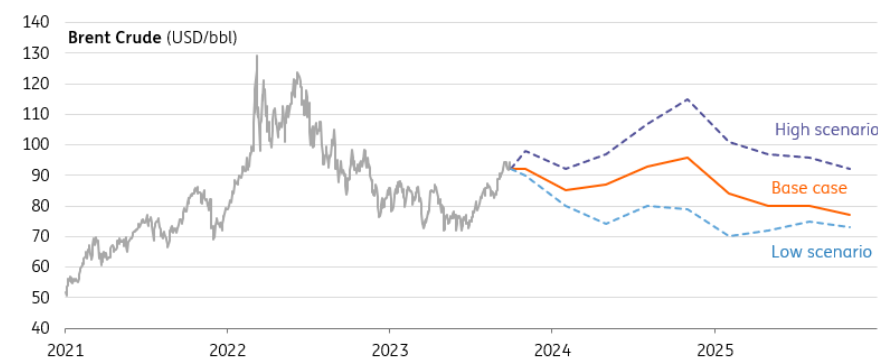
It's a similar story in the UK, though even in a higher oil/gas price scenario, the contribution from energy is still likely to be negative in the first half. The impact of lower natural gas prices comes through with more of a lag, and will offset the impact of higher petrol prices. The impact of rapidly slowing food price inflation also means that headline CPI still falls back through 2024 even with a 'high' energy price scenario, though it would mean that inflation would be unlikely to hit 2% until 2025 when we've assumed oil/gas prices start to come lower again.

In the US, state and federal taxes account for less than 15% of the pump price of gasoline versus 50%+ in Europe so this means the effect of oil price moves on retail prices and household spending power are much more apparent, amplified by the higher driver miles covered in the US. Air passenger travel is also higher in the US while long-distance logistics distribution lines also mean the impact from energy price changes comes through more quickly than elsewhere. Consequently, price changes are felt in headline inflation rapidly, but given the impact on spending

power, it can help to have a weak inverse relationship with core inflation over the longer term. Nevertheless, we have to remember that while energy has a high weighting within the CPI basket, it is dwarfed by housing components which will continue to exert the main directional pull on inflation overall. Given rapidly slowing rents this should continue to mean inflation slows over the next 12 months.

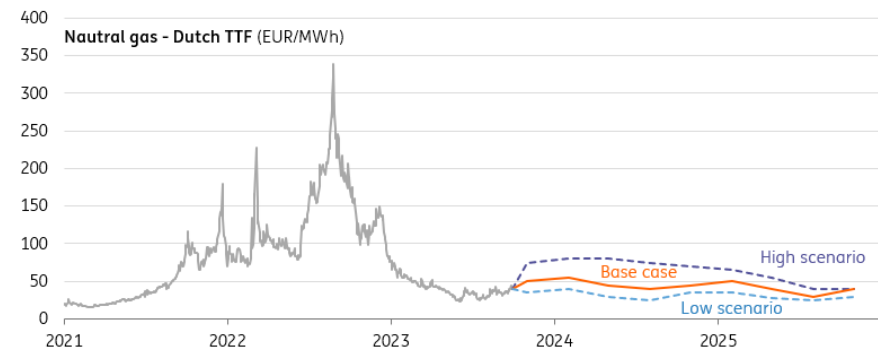
It's worth saying that these don't fully incorporate potential second-round effects like we saw last year. Instead, they simply assume that any new oil price shock will ultimately be more deflationary than inflationary. Still, if labour markets remain as tight as they are currently and economies bounce back a bit in early 2024, there is a risk that higher energy input costs would also put core inflation further above 2%.

Scenarios for oil



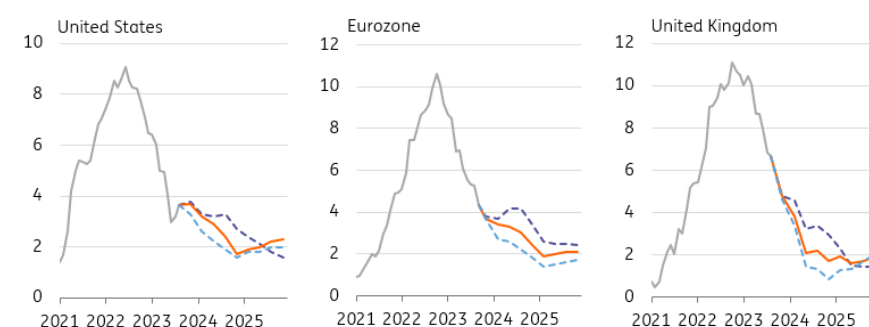
Source: Macrobond, ING calculations

Scenarios for natural gas



Source: Macrobond, ING calculations

Impact of scenarios on headline inflation (YoY%)



Source: Macrobond, ING calculations

What this means for central banks

Prior to the pandemic, most central banks would probably have looked past surging oil prices. Some even considered rising oil prices to eventually be deflationary, undermining purchasing power and industrial competitiveness. However, we are no longer in the pre-pandemic era, but the era of stickier-than-expected inflation. The ECB has emphasised in recent months that doing too little is more costly than doing too much in terms of rates.

For the ECB, the recent staff projections were based on the technical assumption of an average oil price of \$82/bbl in 2024. If oil prices were to average \$95/bbl next year, this would probably push up the ECB's inflation forecasts to 3.3% for 2024 (from 3.2%) and more importantly to 2.4% in 2025 (from 2.1%). As a result, the return to 2% would be delayed to 2026.

The delayed return to 2% would not be the only reason for the ECB to consider further rate hikes. Even though the ECB would still acknowledge the deflationary nature of a new oil price shock, the risk that this new oil price shock could lead to a de-anchoring of inflation expectations will definitely add to the ECB's concerns, making not only an additional rate hike more likely, but also that they stay higher for longer.

For the Federal Reserve, the favoured inflation measure has long been the core personal consumer expenditure deflator, which of course strips out energy. However, the focus has increasingly been on areas that they feel are more influenced by labour market strength and where inflation could be stickier. This has led to a growing awareness of the so-called super core services - services excluding housing & energy. Energy prices in themselves are unlikely to warrant a change in Fed policy, but if they risk making inflation stickier elsewhere via second-round effects they will be prepared to act. Set against this, the squeeze on household spending power is likely to be swifter and greater than elsewhere which has the potential to dampen price pressures over the medium to longer term.

The Bank of England will be acutely aware that the key reason we have high service inflation right now is that we had sky-high energy prices in 2022. On paper, higher energy prices today might give policymakers pause for thought, though we doubt the moves we've seen so far will be enough to meaningfully shift the dial on the inflation outlook for 2024 and 2025. That suggests the Bank is unlikely to hike again in November solely because of higher energy prices, and we'd still expect rate cuts next year - albeit the risk is they come later rather than earlier.

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