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ON ECONOMICS

The ECB Will Likely Resist Hiking Despite Inflationary Pressure

This would set it on a different path than other central banks.

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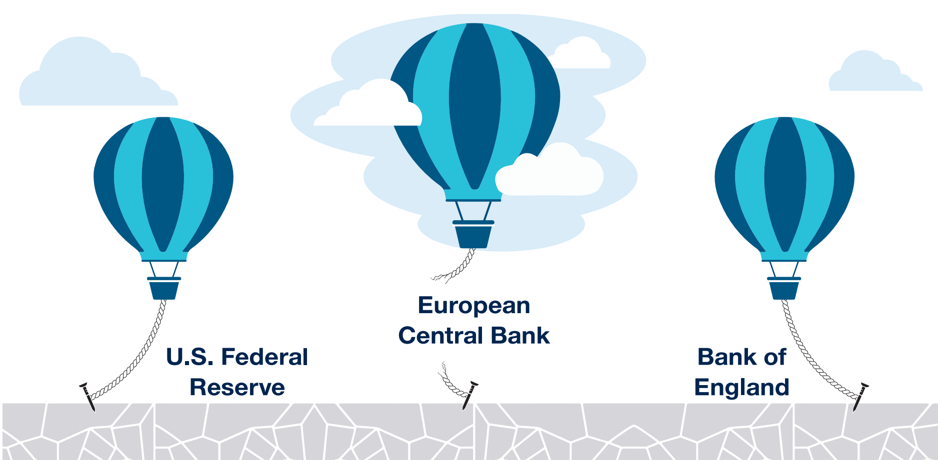
KEY INSIGHTS

- Gas prices are rising much faster in the eurozone than in the U.S., creating inflationary pressures in the currency union.
- While it is likely that inflation in the eurozone will come down eventually, the risk of sustained high inflation is higher than in the past two decades.
- The ECB is likely to resist raising rates and use rising inflation to reset inflation expectations, putting it on a different course than the U.S. Fed and BoE.

The eurozone faces inflationary pressures due to rising gas prices. However, the European Central Bank (ECB) is likely to resist raising rates and instead use higher inflation to reset inflation expectations in the currency union. This will put it on a different path than the U.S. Federal Reserve and the Bank of England (BoE), with implications for asset prices in the eurozone, U.S., and UK.

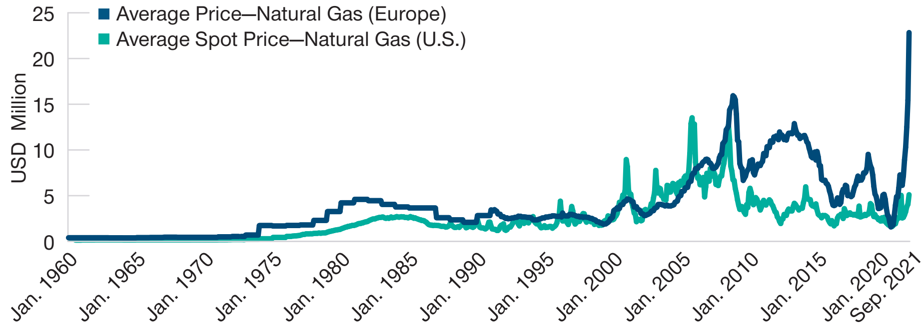
Diverging Central Bank Responses to Inflation

(Fig. 1) The ECB is likely to take a different approach than the Fed and BoE



Gas Prices in the Eurozone Have Soared

(Fig. 2) They have decoupled from U.S. gas prices



As of September 30, 2021.

Past performance is not a reliable indicator of future performance.

Source: World Bank/Haver Analytics.

In the past, natural gas prices in the United States and the eurozone have risen and fallen together. However, this historically strong correlation decoupled in the 2000s with the introduction of shale gas in the U.S. The eurozone is now uniquely experiencing very large gas price rises—last year alone, the price of gas rose by 500%.

Why have gas prices in Europe risen so much recently? Largely because a cold 2021 winter left European gas inventories at very low levels and these were not replenished in the summer, partially due to maintenance and partially due to gas scarcity. Given the political movement to accelerate the net zero transition in Europe, it is also plausible that Russian firm Gazprom, a major supplier, reduced supplies to accelerate European approval of the Nord Stream 2 pipeline, which was completed in September.

This has several potential consequences for inflation. Clearly, households receive gas bills directly as part of their heating expenditure. However, gas is also used to generate electricity, and the use of electricity has risen in recent decades as European countries have shifted away from coal toward less polluting means of generating energy. Food production is energy-intensive, suggesting that food prices (another large item in Consumer Price Inflation) are also likely to rise. And to the extent that countries can substitute oil for gas in electricity generation, oil prices will likely rise as well, creating further inflationary pressures.

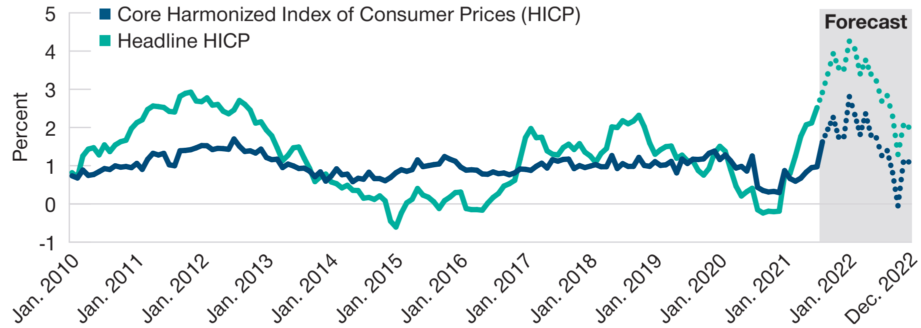
In many European countries, gas and electricity prices are partially regulated, meaning that changes in gas prices are only passed through to consumers once every so often (in some countries, this repricing only happens once a year, when consumers renew their contract with their energy company). Likewise, energy companies are often temporarily shielded from rising prices because they have insurance policies that enable them to buy at an agreed price for a certain period. Eventually, however, both consumers and energy firms will be exposed to rising energy prices—and this staggered pass-through means that eurozone inflation will likely stay at an elevated level for six months after the energy price shock.

Energy price shocks affect core CPI eurozone inflation. Businesses also face higher energy costs, and, historically, businesses in the eurozone have also passed these on to consumers. This leads to a potential rise in the price of all goods and services, not just the energy components. This could therefore feel—temporarily at least—like broad-based inflation to most consumers.

> “The eurozone is now uniquely experiencing very large gas price rises...

Core Inflation Likely to Remain Elevated

(Fig. 3) Fiscal policies set to mitigate upward pressure on prices



As of October 15, 2021.
There is no guarantee that any forecasts made will come to pass.
Sources: T. Rowe Price and Eurostat.

Because this rise in gas prices has been historically unprecedented, governments have mitigated its impact with fiscal policies. In many European countries, taxes and levies make up a third of the actual energy retail price. As a result, headline and core CPI inflation will likely remain above the ECB's new 2% target until at least the middle of 2022.

Energy Price Shocks Can Lead to More Persistent Inflation

Energy price shocks are typically transient in nature. That is, they are a one-off shift in the level of prices that would normally drop out of the inflation dynamic (the change in prices) at some point. However, there are several channels through which large and persistent energy price shocks could lead to permanent inflation.

One such channel is what is known as a second-round effect. If there is a large rise in inflation, workers can ask for compensation in terms of wage growth. Higher wage growth, if not accompanied by higher productivity, will in turn likely lead to higher future inflation. This in turn will lead workers to again ask for a higher wage growth the following year. In this self-reinforcing way, a one-off energy shock could lead to permanently higher inflation.

In the past, unions in Europe and specifically in Germany have asked for such inflation compensation but rarely have been successful. However, the next round of negotiations beginning next year could be different for a number of reasons. In Germany, households will have seen the highest inflation levels since the 1970s. Furthermore, the parties that are currently forming a government have agreed to raise the German national minimum wage to EUR 12 per hour, a 25% rise from the current level. As such, a rise could affect up to 20%[1] of the German workforce, and this could lead unions to ask for higher wages than usual. Finally, Germany's working age population will shrink by 10%[2] by 2035, handing workers more bargaining power over this time period. This means that employees become more valuable over time, leading employers more likely to agree to higher wage settlements in the medium term.

One (often forgotten) reason for the high inflation of the 1970s is that the large change in energy prices made some of the capital stock obsolete. Several energy-intensive industries were just not sustainable in a world of higher oil prices, which temporarily reduced

> "…it seems certain that a fraction of the current capital stock will become obsolete…

[1] Source: DESTATIS (German Federal Statistical Office), analysis by T. Rowe Price.
[2] Source: European Central Bank.

…I believe the ECB will accommodate the current inflationary risks…

the supply side of the economy, leading to much higher inflation. It is not yet known if gas prices will come back down or remain permanently higher, but it seems likely that a fraction of the current capital stock will become obsolete with the transition to net zero. This makes it even more important that governments ensure that this transition is gradual and coordinated with the demand side of the economy to avoid a prolonged period of high inflation, as in the 1970s. While I believe that inflation will probably come down eventually, these risks are higher today than in the past two decades.

ECB to Reset Inflation Expectations

The ECB was one of the first central banks to tighten monetary policy in response to the energy price shocks of both 2008 and 2011. In the event, both moves were unfortunately timed: The first happened just ahead of the global financial crisis, and the second occurred just before the European sovereign debt crisis. The ECB should have learned from the past, and I believe that this time, their policy response will be different.

Unlike the Federal Reserve and the Bank of England, I believe the ECB will accommodate the current inflationary risks and, indeed, use them to help reset inflation expectations and inflation dynamics in the eurozone. In the past decade, underlying inflationary pressures in the eurozone were 1% rather than the targeted 2%. The ECB will likely keep interest rates low and policy easy to help reset inflation closer to 2%. This has important implications for asset prices: While current levels of two-year inflation-linked bunds already price higher inflation over the next two years, 10-year inflation-linked bunds are still at lower levels, reflecting the view that the ECB will fail to restore inflation dynamics back to 2%. Given the ECB commitment, I therefore believe that 10-year inflation-linked bunds still offer good value. The U.S. dollar and sterling will likely appreciate against the euro in 2022 as the Federal Reserve and Bank of England tighten policy while the ECB will likely keep rates low for a long time.

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