The Energy Shock

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Oil and gas prices have literally exploded, imposing a burden on consumers and businesses. Rising energy prices will give the already high inflation rates another push, while the headwind for growth will increase. This situation poses a dilemma for central banks and politicians. We analyze the background.

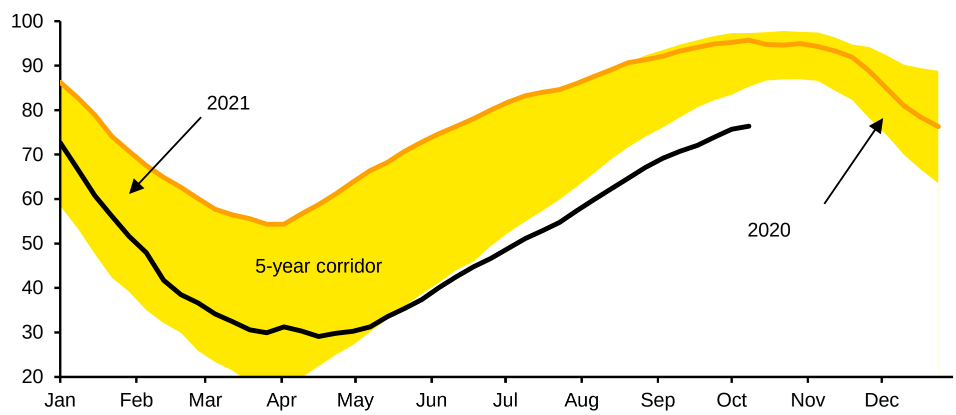
Energy prices have only known one direction so far this year: up. Since the beginning of the year, the price of crude oil has risen by over 60%. The price jump for natural gas was even more dramatic. In Europe, gas prices have increased more than fivefold (chart on front page).

What is going on? For one thing, a similar dynamic is apparently at work in the energy markets as in other markets, which are currently suffering from considerable tensions. After the Corona-induced slump in the economy, the subsequent recovery was underestimated. Energy demand increased more than expected. Supply, on the other hand, could not be expanded again quickly enough for many reasons.

The drama on the gas market

This has particularly dramatic consequences for natural gas. The collapse in demand last year led to a significant reduction in exploration activity. The resurgence in demand was therefore met with a rather inelastic supply, especially since there were production shortfalls in Norway and gas production is falling in the Netherlands due to the depletion of reserves. The Americans have noticeably increased exports of liquefied natural gas, but stronger increases have been prevented due to limited capacities of liquefaction plants. The comparatively harsh winter of 2020/21 further increased gas consumption, and in the UK a prolonged lull reduced wind power production and required the increased use of gas-fired power plants. In Europe, this emptied the natural gas storage facilities, whose fill levels are well below normal just before the start of the heating season (chart 1).

Chart 1 - Gas storage significantly below average
Gas storage utilization in % of capacity in the EU and the UK, weekly data. 5-year corridor: spread between minimum and maximum 2016-20



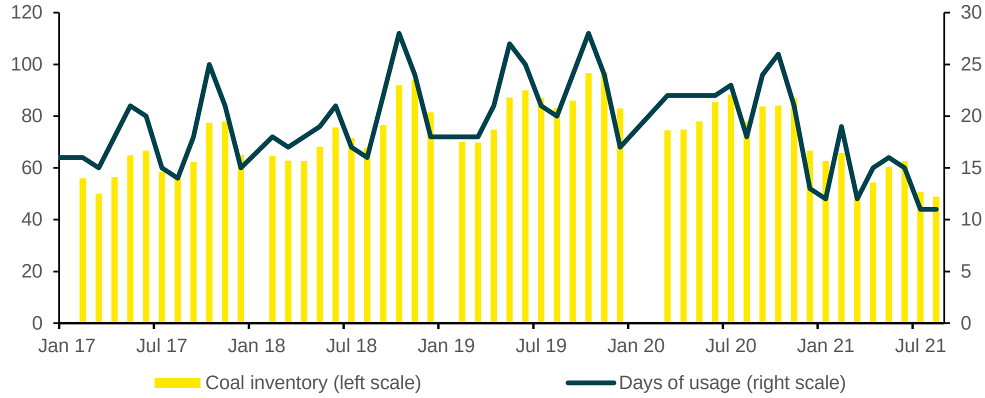
Source: GIE, Commerzbank Research

Everything is connected to everything else: Coal is also becoming more expensive ...

In electricity production, natural gas and coal are substitutes. A massively rising gas price therefore initially makes coal more attractive for electricity generation. The then rising demand for coal also leads to higher prices there. In China, by far the most important consumer of coal, there are also some special factors. For example, the Chinese government has massively reduced imports of Australian coal for political reasons; Australia was previously China's second most important coal supplier. Added to this are China's increased environmental protection measures and difficulties in the domestic production of coal. This leads to bottlenecks in the supply of coal to power plants; in August, the coal stock had melted down to 11 days (Chart 2). In September, stocks are likely to have fallen further.

As electricity prices are set administratively in China, the rising coal price caused economic problems for utilities. In addition, electricity prices for manufacturing firms have been cut by 25% since 2018 to strengthen their competitiveness. Utilities thus have little incentive to supply more electricity to manufacturing, which can lead to production cuts there. The authorities have now approved an electricity price increase of about 20% and ordered an increase in coal production. But the rising cost burden on manufacturing is likely to make it more difficult for Chinese exporters to maintain their prices. China could thus export inflation.

Chart 2 - China - coal supply bottlenecks emerging
Coal inventory at major power plants in million tons and inventory in days of usage.



Source: WIND, Commerzbank Research

... and there is too little supply on the oil market

Finally, the oil market is also suffering from tensions. Unplanned production outages, for example in the Gulf of Mexico, have caused supply to lag behind rapidly normalizing demand. In addition, OPEC+ has so far refused sufficient production increases, and US oil producers – unlike a few years ago – have not immediately reacted to rising prices with a strong production expansion and increased exploration (here they are under pressure from investors to increase profit margins first). The result is a "deficit" on the oil market that can probably only be made up in the course of the coming year.

"Perfect tailwind" for rising energy prices....

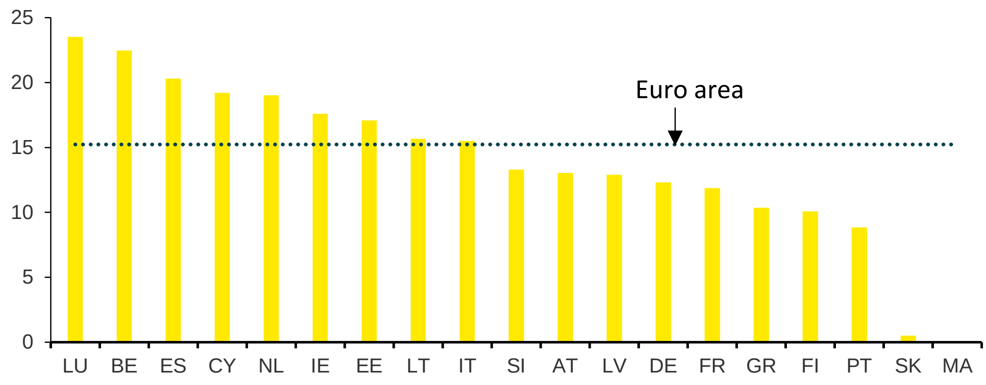
Thus, problems in one market exacerbate tensions in other energy markets. Prices are soaring, and it will probably take some time before the situation calms down. In the background, an additional and longer-term factor plays an important role: the structural change of the energy industry accelerated by political decisions. This has already led to an increase in the price of fuels for consumers via CO_2 taxes. The phase-out of coal-fired power generation in many countries increases the demand for other energy sources and puts additional pressure on the gas market in particular, which is impressively demonstrated in the UK.

... and it is above all the consumers who are paying the bill

Higher energy prices are tearing deep holes in consumers' wallets. In the euro area, the increased costs for electricity, heating energy and fuel reduced the purchasing power of private households by 1.5 percent in the first nine months of the year. The burdens vary considerably from country to country. In Luxembourg, Belgium and Estonia, consumers have to pay more than 20 percent more for energy than at the end of last year, in Portugal, Slovakia and Malta it is less than 10 percent (Chart 3).

But prices for non-energy goods are also likely to rise. Thanks to buoyant demand, companies should be able to pass on much of the energy price-induced higher production costs to consumers. However, some electricity and gas traders who have entered into longer-term supply commitments with price guarantees could find themselves in a bind. For them, higher purchase prices reduce profits.

Chart 3 - In some euro countries, energy has become more than 20% more expensive since the beginning of the year
HICP energy, change September 2021 versus December 2020, in %.



Source: Eurostat, Commerzbank Research

Stagflation?

The loss of purchasing power will leave traces on private consumption in the developed countries. Even if one assumes that private households will finance part of the additional costs by drawing on the savings forced during the Corona-related lock-downs, private consumption is likely to lose noticeable momentum in the coming quarters. The economic slowdown we expect in the U.S. and the euro area in the winter half-year 2021/22 thus becomes even more likely. At the same time, inflation rates on both sides of the Atlantic could turn out even higher than generally expected in the coming months. This would also increase the risk of second-round effects – i.e. higher wage settlements to compensate for inflation.

How will governments react ...

On Wednesday, the EU Commission submitted **proposals** on how the burdens of higher energy costs can be cushioned for private households and businesses. Among other things, targeted income subsidies for low-income households and government aid for small and medium-sized enterprises would be in line with EU regulations. Governments in Spain, France, Italy and Greece have already announced that they will help low-income households pay their energy bills. This will tear new holes in state budgets.

... and the central banks?

Central bankers also face a dilemma. The tried and tested tactic of simply ignoring temporary influences is unlikely to work this time. The shock is too great for that, especially since inflation has risen strongly anyway in the course of the economic recovery after the Corona crisis. Without any reaction, inflation expectations could become unanchored, causing even more problems.

The Bank of England is therefore apparently prepared to bite the bullet and adjust key interest rates at least somewhat. We expect a rate hike in the spring at the latest. In recent statements, individual BoE representatives even held out the prospect of such a step at the next meeting in November. The Fed is expected to start tapering its bond purchases next month. More and more Fed officials are also in favour of a hike in key interest rates as early as 2022, according to their projections.

A majority in the ECB's Governing Council, on the other hand, probably thinks little of a rate turnaround. ECB President Lagarde stressed last week that the ECB should "not overreact to supply bottlenecks or rising energy prices, as our monetary policy cannot influence this directly". And ECB chief economist Lane even warned this week that an energy price shock increases headline inflation but could depress the core rate of inflation. Also, a one-off increase in wages due to a "temporary unexpected rise in the price level" would not lead to a new trend in the core rate.

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