ECONOMY AND ECOLOGY 14.03.2022 | Peter Bofinger

Taking the heat out of energy prices

Rising energy prices and inflation are causing energy poverty in Europe. The EU should rethink carbon pricing and consider VAT relief

Last month, annual inflation in the euro area reached a record 5.8 per cent — it was just 0.9 per cent a year earlier. The wellspring is the unprecedented rise in energy prices.

Energy raw materials are around 130 per cent more expensive, on a euro basis, than a year ago. For consumers, this means an increase in energy prices of almost 32 per cent over that period. As spending on energy accounts for around 10 per cent of a household's basket of goods, this results in an increase in the overall index of around three percentage points — the inflation rate, excluding energy, is accordingly 3.0 per cent.

The need for price stability

The explosion of energy prices is a huge challenge for Europe. It is detrimental to the reputation of the European Central Bank, especially in Germany, although the shocks on energy markets cannot be related to its monetary policy. It has serious social consequences, as poor households spend a much larger share of their income on energy than wealthy households — energy poverty is a rising problem. And it threatens public acceptance of financially-mediated climate policies — carbon taxes and the European Union Emissions Trading System — as key instruments to reduce greenhouse-gas emissions.

The view that excessive monetary stimulation is the culprit for inflation is countermanded by the fact that in 2021 households in the euro area consumed less as a share of gross

So how should policy-makers deal with this shock? The ECB, whose mandate is to ensure price stability, is first in the frame. Many who have long been critical of the ECB's expansionary monetary policy see high inflation as their vindication.

domestic product than ever.

The view that excessive monetary stimulation is the culprit for inflation is however countermanded by the fact that in 2021 households in the euro area consumed less as a share of gross domestic product than ever. Private demand can therefore be safely ruled out as a driver of inflation.

Were the ECB to raise interest rates now, it would merely dampen overall demand, already suffering from the loss of purchasing power due to high energy prices and the political and economic uncertainty triggered by the Ukraine war. The effect on energy prices specifically would be indirect and, given the current tensions on the energy markets, insufficient.

From a theoretical perspective, it is well-known that monetary policy is not well equipped to deal with a supply shock. This draws attention to the possibilities of economic and fiscal policies. Note in this context article 1 of Germany's Stability and Growth Act of 1967, which explicitly commits policy-makers to the goal of price stability:

'The Federal Government and the *Länder* shall observe the requirements of macroeconomic equilibrium in their economic and fiscal policy measures. The measures shall be taken in such a way that, within the framework of the market economy, they contribute simultaneously to the stability of the price level, a high level of employment and external equilibrium with steady and adequate economic growth.'

A similar statement can be found in article 3 of the Treaty on European Union:

'The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability…'

Is VAT relief the answer?

Compared with the ECB's toolbox, economic and fiscal policies can directly affect the price of energy. One option, proposed by Sebastian Dullien and Isabella Weber, would be price controls. But these are difficult to reconcile with a market economy and would place the burden of higher commodity prices unilaterally on energy suppliers.

The better solution, practised by Spain, is to relieve consumers by temporarily reducing value-added tax on energy. This can provide

targeted relief for households. From a social point of view, such a measure can be justified by the disproportionate burden faced by lower-income households. One could think of adding into the social balance a surcharge on income tax for rich households; in addition, a windfall tax on the profits of energy providers could be considered. In principle, however, the VAT relief should be financed by government deficits.

This is comparatively unproblematic, as the fiscal rules in the Stability and Growth Pact remain suspended this year. Indeed, sustaining the exemption in 2023 should be considered in light of the economic and, above all, energy-policy challenges posed by the war in Ukraine.

Until a few days ago, the price of carbon-dioxide certificates had risen very sharply, tripling within a year to a peak of €96 per ton and so contributing to the inflation in energy prices.

What are the other possibilities for action at the European level? Here, the Emissions Trading Scheme would be the prime focus. Until a few days ago, the price of carbon-dioxide certificates had risen very sharply, tripling within a year to a peak of €96 per ton and so contributing to the inflation in energy prices. It has however slumped very recently, as markets have anticipated temporary suspension of the system.

Consequences for CO_2 pricing

One reason for the CO_2 price explosion is the rise in the price of natural gas: electricity is increasingly being produced by coal-fired power plants, which require more CO_2 certificates than gas-fired. But there are signs that the CO_2 price is more and more being driven by hedge and investment funds which have discovered certificates as an attractive investment alternative.

The energy price shock is thus exacerbated by certificate trading. The principle of CO_2 pricing by the financial market should therefore be put to the test once again.

At its core, climate policy aims for a CO_2 price that rises steadily over time. To give companies planning certainty, the price path to 2030 should be as predictable as possible. But this predictability opens up almost risk-free profits for speculators. With interest rates close to zero, they immediately drive the certificate price up to the level expected in 2030. Contrary to what policy-makers intend, this results in an abrupt price increase, which overwhelms the economy and consumers.

Thus, instead of the dysfunctional certificate trading, one should also rely

on a CO_2 tax in the EU. An experimental study shows that direct pricing through taxes leads to significantly lower CO_2 emissions.

As a short-term measure, the ETS could be suspended temporarily until the situation on global energy markets has calmed down. For the target of CO_2 reduction, current energy prices are much higher than envisaged, even by ambitious climate activists.

This is a joint publication by Social Europe and IPS-Journal.



Peter Bofinger
Würzburg

Peter Bofinger is professor of economics at Würzburg University and a former member of the German Council of Economic Experts.