SIMPLY SHORT

Energy crisis pushing up general price level – Adverse impact on economic growth still to come

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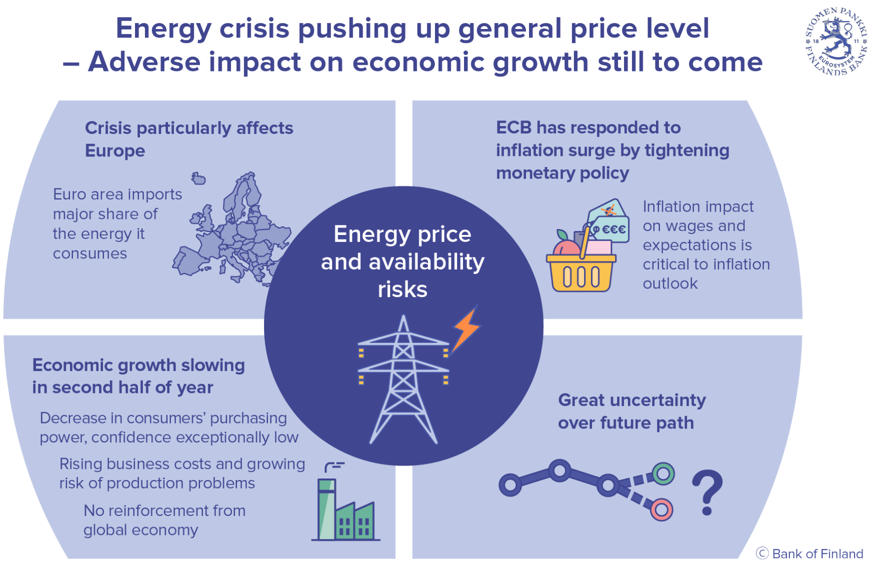
Energy prices have risen substantially within the euro area. Natural gas and electricity, in particular, have become more expensive as a consequence of Russia's war in Ukraine. The effects of the energy crisis on the economy of the euro area could be prolonged. The euro area countries purchase a significant share of their energy from outside the euro area. In 2020, this imported share was more than 60% of the total energy consumed in the euro area.

The cost of goods imported to the euro area has risen considerably as a result of soaring energy prices. The value of exported goods has risen at the same time, though by substantially less than that of imports. This means greater costs for businesses and households and higher public expenditures.

The energy crisis is very much evident in the form of higher prices for goods and services, but the adverse growth impact of the crisis is largely still to come. The euro area economy will also be unable to rely on world trade to bolster it. Economic growth has slowed in both the United States and China, and this adversely affects the export outlook for the euro area. The possibility of a recession, or a marked decline in economic activity, in the euro area cannot be ruled out.

In the first half of 2022, the euro area economy was still recovering from the COVID-19 pandemic. Growth in the April–June period was actually higher than anticipated. This was due to the easing of pandemic-related supply chain disruptions and an increase in the demand for leisure services. This growth spurt is fading, however, and growth in the economy is expected to weaken in the second six months of 2022. The September forecast of the European Central Bank (ECB) indicates that the full year's growth in the euro area economy will be 3.1%, falling to just 0.9% in 2023. The ECB has also made a forecast under a weaker, 'downside' scenario, and this indicates that the euro area economy will shrink noticeably in 2023.

Chart 1.



Increased uncertainty over inflation outlook

Inflation, or the general rise in prices, in the euro area and many other key economies has risen sharply this year. In August, euro area inflation was 9.1%. Higher energy and food prices have been major factors driving up inflation, but the prices of many other products have also begun to climb during 2022. According to the ECB's forecast, euro area inflation will average 8.1% this year but will fall to 5.5% in 2023 before levelling off in 2024 at about 2.3%. The ECB has responded to the surge in inflation by tightening its monetary policy.

Uncertainty surrounding the inflation outlook has grown, and there is also a chance of unexpected developments occurring. There are risks concerning energy prices and availability, in particular. If the current high level of inflation becomes reflected in wage increases and inflation expectations, this could lead to a more prolonged period of high inflation than anticipated. The surge in consumer prices has not so far been reflected very strongly in euro area wage trends, and inflation expectations have remained at around 2%. The economic outlook could also be affected by unforeseen developments in the Ukraine war. The ability of the euro area economy to adapt to the energy market transformation will be critical for the inflation and growth outlooks.

ECB tightens its monetary policy

As a consequence of rising inflation, the ECB has begun tightening its monetary policy by raising policy rates at its July and September meetings by a total of 1.25 percentage points. The combined effect of monetary policy tightening and of expectations related to this is that various different interest rates – such as interest rates on government and corporate bonds – have risen in the euro area. Banks' lending rates have also begun to rise.

The ECB Governing Council expects to have to raise interest rates further in several future meetings to ensure demand is dampened and that expectations of high inflation do not take root in the economy. It is important that higher prices do not lead to an upward spiral of wage and price rises. The purpose of interest rate rises is to ensure inflation is brought down to 2% over the medium term.

The energy crisis also sets new challenges for public finances in the euro area. Even before the energy crisis began, there were considerable concerns over debt sustainability in more than one third of the countries in the euro area. Sustainable public debt helps monetary policy achieve its price stability objective.

Tags

euro area, energy, inflation, monetary policy