by Roberto Tamborini | 30th November, 2022

The Inflation Shock in Europe

The resurgence of inflation we are witnessing in the advanced economies has different causes despite a similar appearance. A long-standing distinction can be found in the literature between demand-pull and cost-push inflation. In the former type, a generalised pressure on prices arises from a tendency of the various components of aggregate demand to grow faster across sectors than does production capacity on the supply side. In the cost-push type, by contrast, the inflationary impulse comes directly from production costs, which may increase as a result of factors 'exogenous' to the other macroeconomic conditions. This is more typically the case with the costs of imported production inputs, such as raw materials, energy and intermediate goods. The usual consequence is also known as stagflation, that is, inflation accompanied by a fall in economic activity. Note that this may happen independently of any monetary restriction.

The channels through which stagflation takes hold run through both the supply and the demand side of the economy. On the supply side, depending on the different market structures they face, firms can, at least in the short run, either seek to transfer higher costs to sale prices, and/or have to economise on more costly inputs, which may entail a cut in production, too. On the demand side, the energy shock raises the consumer price index and, as long as nominal incomes are not immediately and perfectly linked to it, households suffer from a loss of purchasing power.

From this point of view, Europe seems more affected by imported cost-push inflation than demand-pull inflation like other advanced countries, notably the United States and the United Kingdom. The worldwide factors behind the cost-push component of inflation have been detected since the early phase of the rapid post-pandemic recovery in the second half of 2021, namely, disruption and bottlenecks of global supply chains and transport routes, shortages of raw materials and intermediate inputs for industrial production, and tensions on energy (oil and gas) markets. The outbreak of the Ukraine war has further exacerbated these factors, in particular – but not only – on the energy front with Russia.

As is intuitive from this simplified formulation, the stagflationary shock is more intense the more a country is energy-consuming and energy-dependent on abroad. Considering economies comparable to European ones, like the US or UK economies, it may be said that the former are somewhat less energy consuming but significantly more dependent on abroad. Overall, it seems that so far the negative impact of the imported energy shock is more pronounced in Europe than elsewhere. According to the European Central Bank (ECB) staff calculations, the ratio of the energy component to the consumer price index - also called the real energy price - in the euro area has escalated from 100 in 2020 to 200 in the first semester of 2022.

Important implications for monetary policy follow. Number one, cost-push, and specifically importedcost-push inflation is first and foremost a change in relative prices with both demand and supply-side real effects. Number two, stagflation is intrinsic in imported energy shocks, independently of any monetary restriction. Number three, central banks, especially the ECB, may feel committed to take action against inflation, but conventional wisdom asserts that monetary policy is ill suited, if not counterproductive to correcting real, structural shocks. We should be aware that monetary tightening will reduce demand across the board of all sectors, whereas the correct reallocation response would require a shift of demand away from higher-price imported (energy) goods towards lower-price domestic goods. Number four, the transmission channels of stagflation are different in different countries. As was the case with the global financial crisis 2008/2009 and the Covid-19 pandemic, the Monetary Union should be prepared to tackle a 'symmetric shock' with 'asymmetric effects' across countries.

The bottom line is that Europe has got the worst variant of the inflation virus. Economic downturn and inflation are both under way and both dangerous. There is nothing magical about money and inflation; the outcome depends on the intricacies of the transmission mechanisms through the economy, and there are no 'free lunch' solutions. Hence the prudent strategy of monetary 'un-easing' on the part of the ECB may be justified.

Italy and the Energy Crisis

Italy largely shares the overall picture drawn above with the other major European countries. The acceleration of the overall Harmonised Index of Consumer Prices (HICP) took hold in the third quarter of 2021, soaring from an annual rate of 1.3 per cent in June to 2.9 per cent in September and 4.2 per cent in December 2021. This was led mainly by the energy and food component, as testified by its incidence, ranging between 65 and 75 per cent. 'Core' inflation remained subdued throughout the first quarter of 2022, but it has been accelerating since then. In September 2022 the overall HICP reached an annual rate of 9.5 per cent, about half of which is accounted for by the 'core' components.

As explained in the first section, market structure and firms' pricing policy play a key role in the transmission of cost-push impulses. The widening gap between 'core' and 'non-core' inflation in Italy throughout 2021 and early 2022 is largely reflected (and explained) by the differentials among production input prices, gross sale prices, and retail prices. According to the Centro Studi Confindustria (the research centre of the Italian Industrial Association), in 2021 the index of production input prices rose by 34 per cent, gross prices of intermediate products by a half (17.5 per cent) and retail prices by 3.5 per cent. These differences indicate by how much, and at which point in the supply chain, the cost shock has been passed through or absorbed by firms' operational margins.

As to the role of energy dependence in the transmission of imported cost-push inflation, Italy lies at the top of the European spectrum, in particular for natural gas, close to Germany, but at some distance from France and others.

At the dawn of the new millennium the energy mix of Italy consisted of oil (52 per cent), gas (34 per cent), renewables (6 per cent), and fossil (8 per cent). In the meantime gas and renewables have increased (41 and 19 per cent, respectively) substituting for oil (36 per cent) and fossil (4 per cent). Gas has therefore been the strategic alternative to oil so far, but the larger share of renewable sources is also noticeable, marking one of the strongest increases in Europe. A second feature to be considered is that Italy is highly dependent on imported energy: in 2019, 78 per cent on average, 96 per cent for oil and 94 per cent for gas. Italy is the second biggest importer of gas in Europe after Germany. Finally, while oil imports are diversified across world suppliers, imports of gas are concentrated on Russia. Before the Ukraine war Russia provided more than 40 per cent of total imported gas; in the first semester of this year, however, Russian imports were cut to 18 per cent. The main geographic diversification is now towards North Africa and the Middle East, while liquid natural gas provides diversification in kind.

The incidence of energy in total production costs is estimated to reach 8.8 per cent in 2022, more than double that of France (3.9 per cent) and one-third more than in Germany (6.8 per cent). As to manufacturing, the incidence is slightly lower (8 per cent), but the gap is getting larger relative to France, less so Germany. Depending on different hypotheses on the correlation between energy prices on international markets and on domestic markets, the impact on Italy's energy bill is expected to be of an order of magnitude from 5.7 to 6.8 billion euros on a monthly basis, and from 2.3 to 2.6 billion euros for the manufacturing sector alone. These data provide further evidence that changes in relative prices and costs are an essential by-product of the imported cost-push inflation which triggers important sectoral real effects across the economy.

As I have explained, the other critical channel in the evolution of stagflation is that of households. As long as nominal incomes do not catch up with inflation, households suffer losses of purchasing power, absorb higher energy bills, and hence cut demand in non-energy goods and services. To the extent that wages start catching up, inflation is spurred further. So far, Italy, much like (or more than) the rest of Europe, seems involved in the development of the first phase.

Neither the Bank of Italy nor ISTAT (the Italian Statistic Institute) see major tensions in the labour markets, except for some sectoral bottlenecks and demand-supply mismatch. Wage growth is expected to remain modest in the coming months. The share of private sector employees with expired contractual agreements remains high at around 40 per cent. In April 2022 ISTAT signalled a growing gap between hourly wage increases and HICP acceleration, with the former projected to be close to or below 1 per cent by the end of the year.

The response of household consumption remains mixed. On one hand, the post-pandemic recovery is continuing, also thanks to access to large (forced) savings accumulated during lockdowns, though not uniformly across sectors (housing, food and tourism lead the recovery). On the other hand, early signs of erosion of purchasing power, and of loss of confidence, are also visible. In this respect, an important fact to be considered is that the negative income effect of stagflation is distributed unequally across classes of households. 'For the lowest income quintile, inflation is on average greater than for the higher quintiles, with more ample dispersion around the respective averages. In fact, the goods whose prices are rising more rapidly (energy and food) occupy more space in the baskets of less well-off households'.

Policy Challenges

Overall, for the time being the depressionary effect of stagflation is perceptible more in projections and forecasts than in the data, and seems delayed to the end of the year 2022. After a weak first quarter, the latest release by ISTAT reports an unanticipated rise in gross domestic product (GDP) for the second quarter, securing annual growth above 3 per cent, which is beyond the end-of-2021 forecasts. However, there are reasons to think that the ongoing inflation surge is not purely temporary, because the underlying combinations of cost-pushes are likely to persist over the medium term. Thus, a critical role will be played by the search for the right policy mix in order to keep both inflation and economic activity on a feasible balanced path.

As long as the ECB is able to maintain its strategy of 'normalisation' launched in July 2022, gradual, suitably targeted fiscal policies, at the national as well as at the EU central level, can usefully complement monetary policy in the fight against stagflation. On this basis, in the course of 2022 the Italian government has enacted a string of interventions in three tranches - the first in spring, the other two in the following months - totalling about 60 billion euros (3.5 per cent of GDP). The resources have been found within the current budget without increasing the borrowing requirement for this year (5.6 per cent of GDP), mostly thanks to (in decreasing order of importance): (1) extra revenues coming from the economic recovery, (2) the effect of price increases on indirect taxes, (3) taxation of extra-profits in the energy sector, and (4) recalculation of some items in the National Resilience and Recovery Plan to take into account the increase in costs.

Each of the three instalments contains a variety of measures broadly aimed at supporting firms and households. A range of different instruments are in place. Relief for households, and consumers more generally, typically comes in the form of direct subsidies (for example, a one-off bonus of 200 euros, a public transport bonus of 60 euros) or tax cuts on petrol and electricity (prolonged until November 2022). Measures directed to firms concentrate on cuts in their tax liability proportional (from 25 to 40 per cent) to their extra energy bill. Also significant is the provision of public guarantees in order to ease access to credit for firms facing liquidity shortages as an effect of huge increases in their energy bill.

Intertwined with these are also measures, mostly incentives and facilities, directed towards energy diversification and green transition. Particularly important, and controversial, is the so-called '110 per cent bonus', that is to say, the deduction from the personal tax liability of 110 per cent (that is, total discount + a subsidy) of the certified cost of energy-saving restructuring of buildings (apartments, condominiums, family houses and so on). As a matter of fact, buildings in Italy are on average aged and energy-consuming. The gross cost for the public finances has been estimated at about 38 billion euros, although it may fall to 20 billion if account is taken of the additional revenues created indirectly. According to ISTAT, the consequent strong impulse to the housing sector has been, on one hand, a major driver of the brisk recovery of Italy's GDP in 2021 and 2022, but, on the other hand, also fuel for prices in a sector that was on its knees during the pandemic but is now affected by bottlenecks in the supply of raw materials. This is an interesting case that can be seen as an appetiser for the kind of double-edged choices that European governments will face along the road towards the green horizon of the EU recovery instrument 'Next Generation EU'.

The large, albeit heterogeneous, parliamentary majority of 'National Unity', which supported the government until President Draghi's resignation in July 2022, helped to approve and implement the fiscal packages, with minor tensions. The trade unions and other social bodies were also involved and consulted, achieving substantial agreement on priority ends and means (if not on total figures and time coverage).

Overall, these fiscal packages are showing a double effect that mitigates stagflation. They cool down the price index and sustain economic activity and employment, acting on both the demand and the supply side. The Bank of Italy estimates that these measures have reduced the inflation rate by around 2 percentage points in the second and third quarters, averaging around a 1.5 percentage point decline in 2022 as a whole. How effective reliefs are at the lowest end of the income distribution is controversial, however.

The fact that Italy is implementing this kind of relatively novel anti-stagflation fiscal policy without additional deficits, and with projections of further reduction of the debt/GDP ratio in 2022 after 2021, contains some lessons for everyone. Besides the programmatic attention to debt sustainability by the Draghi cabinet and some (not all) parties in its 'National Unity' majority, some favourable contour conditions should be emphasised. As is well known, (moderate) inflation, with all its harms, also helps fiscal consolidation. More importantly, we should also look at the changed institutional context of the Monetary Union. First, the dogmatic compliance with the doctrine of 'monetary dominance' over fiscal policy has given way to a more pragmatic phase of monetary-fiscal synergies. These emerged clearly at the time of depression and deflation during the 2010s, but are also emerging now that stagflation is the enemy, allowing the ECB to take a tighter policy stance, with limited damage to economic activity and employment, and almost no political backlash. Second, the creation and implementation of Next Generation EU, as predicted by its supporters, has revived citizens' trust in the EU, and has made it easier for national governments to meet their local needs with no major tensions on public finances. Third, and as a result, the suspension of the fiscal rules has nowhere triggered irresponsible fiscal behaviour, proving that better design of the 'common house' is as important as the rules that bind the inhabitants.

Admittedly, however, these favourable conditions are fragile. Governments change, and recent election rounds in Europe show that the momentum of populist and nationalist forces remains strong. Short- and long-term consequences of the post-pandemic legacy, the stagflation shock, the new international stances of Russia and China, and the EU Member States' commitments to a green transition, all make an increase in the borrowing requirements of governments more likely. In the euro area context of sharp differences in Member States' indebtedness, the ECB's choice of future path for interest rates will be critical. With headwinds that jeopardise EU stability, we should hopefully reinforce, instead of dismantling, the progress achieved with the institutional innovations mentioned above.