

Back to the Future: will the 2020s be the new 1970s?

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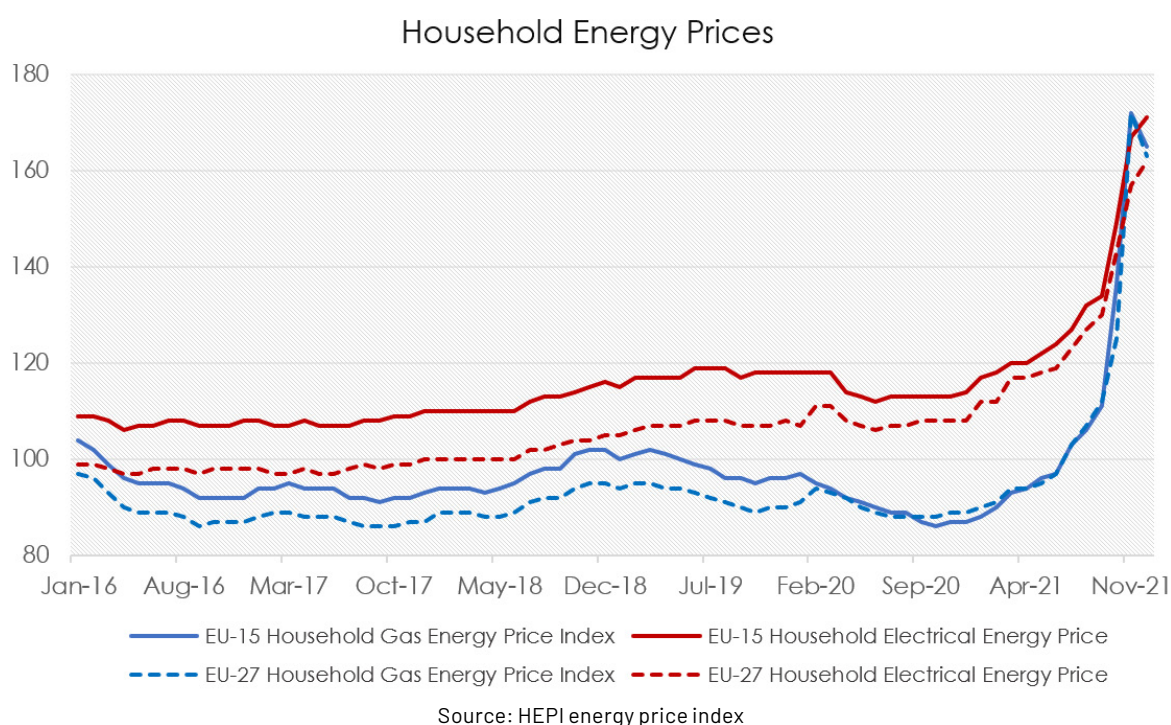
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Back to the Future: will the 2020s be the new 1970s?

At the [ECB's December press conference](#), Christine Lagarde announced a considerable revision in the ECB's inflation forecast – two-third of which was attributed to skyrocketing energy prices. More recently, ECB Executive Board member Isabel Schnabel suggested in a [speech](#) that while in the past energy prices often fell as quickly as they rose, the need to step up the fight against climate change may imply a persistent increase in fossil fuel prices and prompt the ECB to assess whether such a rise in the contribution from energy to headline inflation is tolerable and consistent with the price stability mandates.

A few months ago, we published our first Green Leaf [note](#) focused on the inflationary implications of the energy transition. We argued that the early spikes in energy prices that were already visible back then were just the dawn of what we called 'climate inflation', i.e. structurally higher growth in prices from the internalisation of climate change externalities in the form of higher costs due to the energy transition. Much of what we anticipated in that note has become reality by early 2022, and geopolitical tensions between Russia and Western Europe add steam to the already powerful structural drivers of climate inflation. As a result of this drastically changed environment, and of the revamp in the pandemic due to the spread of the Omicron variant, many have started wondering whether the roaring 2020s will take Europe on a trip down memory lane to the stagflating 1970s. How justified is this concern? While the world and the nature of economic activity has clearly changed a lot in 50 years, we think Europe will feel the crosswind from three structural forces (geopolitics, the green transition, and domestic politics) that make this scenario far from unthinkable.

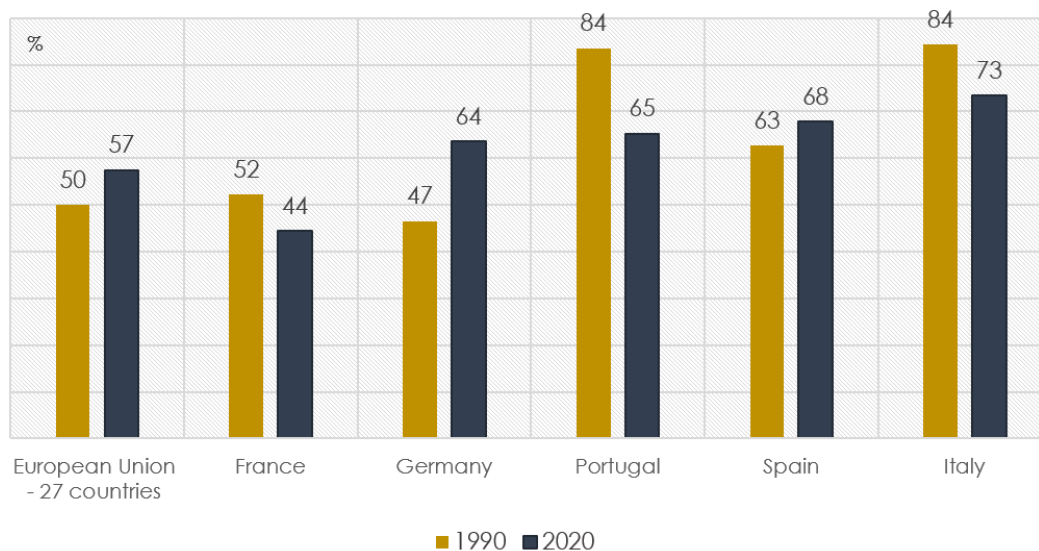
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The revenge of geopolitics

Europe's limited fossil fuels energy production has been declining over the past 20 years (-70% for Coal, -55% for Oil, and -20% for Gas¹), and reliance on imports has become more and more crucial. About 60%² of the EU's total energy needs is met with imports from foreign producers. Germany – whose import dependency rate increased from 46% in 1990 to 63% in 2020 – strikingly exemplifies this case. As a result of the decision taken in 2011 by the German government to progressively shut down nuclear reactors, Germany phased out of nuclear power: three more reactors ceased activity in December 2021, with the last three expected to switch off by the end of 2022. The decision forced the country to substitute in the short term nuclear with other fossil fuels sources, while accelerating the plan to add on capacity to in-state renewables such as on/offshore wind. At the broader EU level, import dependency has increased from 50% in 1990 to 57% in 2020.

Import Dependency Rate



Source: Eurostat³

Such a high external dependence on energy imports forces Europe to play a complicated chess game where economic and geopolitical considerations need to be carefully balanced. Notably, the fact that Russia shows at the top of the list of exporters to the EU for all gas, oil, and solid fossil fuels creates important geopolitical risks to the security of EU energy needs – which materialised in 2021 at a very unfavourable time. Strong demand in the first half of 2021, when economic activity bounced back from the pandemic, did not allow for a significant build-up of gas reserves in storage facilities prior to the winter period. Moreover, a prolonged season of low wind speed led to RES underproduction for those countries that have already installed and connected to their grids large off and onshore wind capacity – most notably Germany and the UK. Curtailment in gas flow from Russia added significant stress to this already unfavourable outlook.

By the end of July 2021, storages facilities controlled by Gazprom – the Russian state-controlled gas distributor – were storing between -43% and -60% less fuel with respect to the same period one year ago, while other storage units didn't show major suffering. A [database](#) of weekly gas flows maintained by the think tank Bruegel shows that, in the last quarter of 2021, Russian gas flows through the

Polish Yamal route fell six times below the minimum ever recorded in the past 5 years. Flows through the Ukraine transit route, after having been close to the five-year minimum throughout 2021, have set a new low in early 2022 and are unlikely to recover in view of the recent escalation of military turmoil in the area. Besides the long-lasting – and recently revived – dispute over Ukraine territorial integrity, Russia and Europe are also at odds over the controversial Nord Stream 2 pipeline. The project, which is strongly opposed by the US and has not yet received approval, would feed directly into Germany's gas grid, further increasing the reliance of the country and of the EU on Russia.

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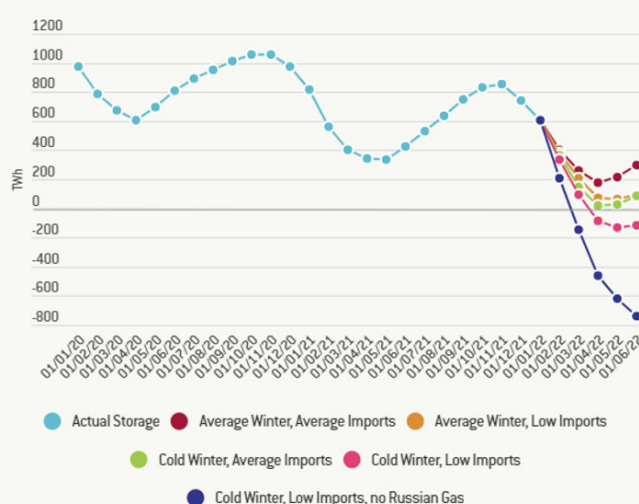
As a result of all these factors, Europe's natural gas position was particularly uncertain heading into 2022. As of December 2021, storage levels were below the minimum volume recorded for the same time of year in any of the previous five years.

In mid-December 2021, Europe had 690 TWh of gas in storage. A simple scenario analysis shows that in the event of a colder than usual winter, low imports in the absence of a revival of Russian gas flows would take Europe very close to exhaust its gas storage, if not even to exceed it (Figure 3, below).

Prices untamed

As basic economic theory suggests, in an environment of increasing demand and constrained supply, prices can only go up. After falling sharply in 2019 and 2020, wholesale electricity prices reversed course in 2021. The European Benchmark for wholesale prices⁴ rose to 160 EUR/MWh in December. This in turn has started to feed into retail prices, as European households have seen a near doubling of retail gas prices and a 50% increase in retail electricity prices so far in 2021⁵.

Figure 3: Simplified EU27 gas storage scenarios



Source: Bruegel own calculations

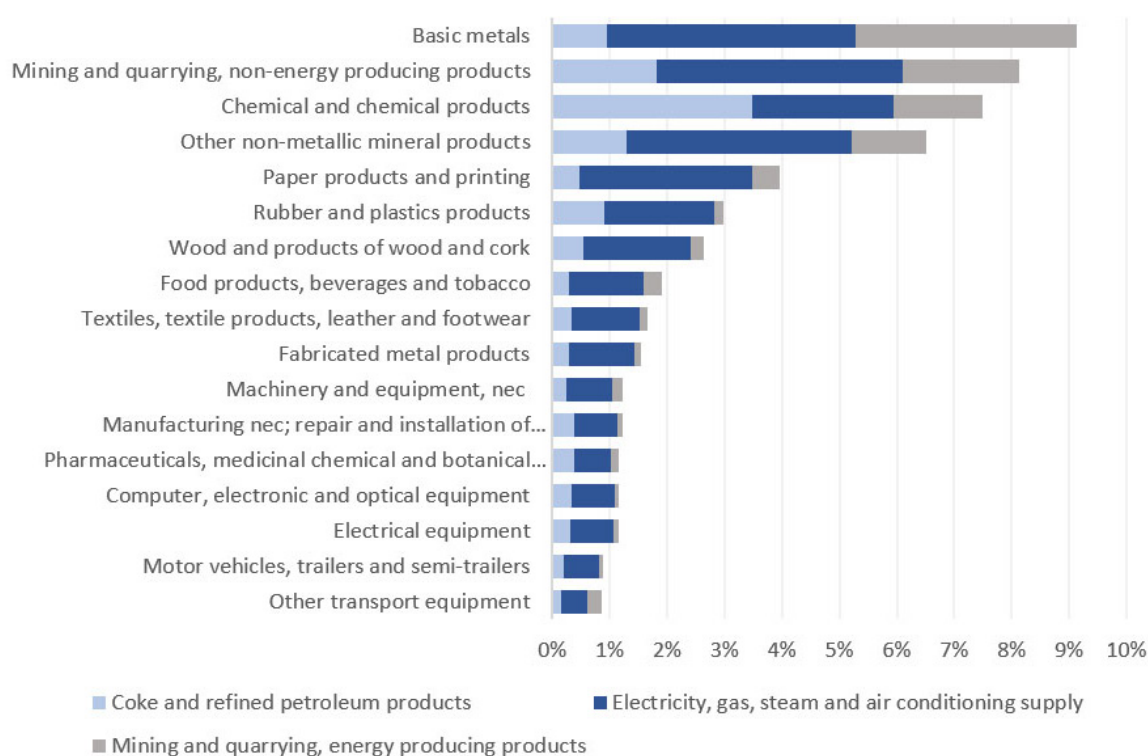
Source: Bruegel⁴

Energy poverty – defined as the inability to keep one's home adequately warm – was estimated to affect up to 31 million people (6% of the population) in the EU as of 2019, including a significant share of low-income households but also middle-income ones. To shield the most vulnerable from the current spike in energy prices governments have started to introduce targeted measures to prevent or contain purchasing power losses, especially for low-income families⁶. While consumers are suffering, however, so too are energy retailers – whose indicative gross margins (the difference between wholesale spot price and retail energy components) [moved](#) into negative territory in 2021. The French government recently made the headline when it confirmed plans to force EDF to sell more power at a steep discount to protect households from surging wholesale electricity prices – a move that could cost the state-controlled utility 7.7 billion euros. While politics plays an important

role in the French decision – as Emmanuel Macron would understandably prefer to avoid any yellow vest-type unrest ahead of the presidential elections – similar measures could be considered by other European governments if pressure on energy prices persist.

The impact on corporates is more complex to disentangle, as it depends on multiple factors at play. The input cost for energy products for manufacturers is usually a small fraction of their output value (less than 5% for most sectors). Unsurprisingly, this ratio is higher for companies involved in heavy metals and chemical sectors. The extent to which higher energy prices will negatively affect companies' profitability depends also on the contract with their suppliers: for fixed tariff contracts it might take some time before any notable difference might be found. However, as Europe is proposing that no long-term contracts for supply of unabated fossil gas shall be concluded with a duration beyond the end of year 2049, spot prices will become increasingly more relevant. In the longer term, if hub-prices continue to remain elevated companies will likely decide to pass on the increased cost of their products' energy content to the final consumers or cut production – both of which would put pressure on inflation.

Energy Input as a share of Industrial Output - EU (%)

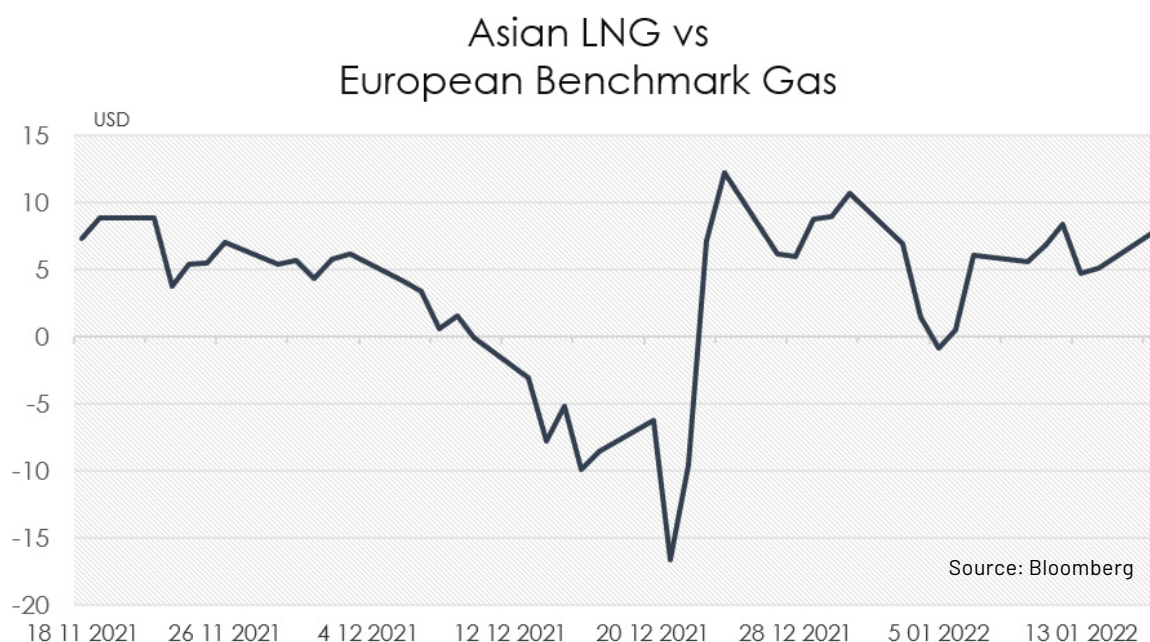


Source: HEPI energy price index

In its October 2021 Communication on Energy Prices, the European Commission held to its line that the clean energy transition is the best insurance against price shocks in the future, but national political interest may not be aligned. Historically, European energy efforts have in fact concentrated on promoting a just green transition by triggering a rapid acceleration in renewables capacity addition, while progressively reducing fossil fuels production capacity. But as the cases of the UK and Germany show, relying too much on renewables during the transition towards a greener energy mix may cause significant shifts in the energy supply and amplify the stress from coincident negative factors. At the same time, scaling up energy storage systems will be crucial to address the hour-to-hour

variability of wind and solar PV and achieve Net Zero emissions targets – but it will necessarily take time. The pressure of skyrocketing energy prices has therefore led to intensification in the political bickering surrounding the EU taxonomy – particularly for what it concerns the inclusion of gas and nuclear power as activities aligned with or facilitating the EU ambitious goals of green transition.

On this front it's worth noting that – while still over-dependent on Russian gas – Europe has been trying to diversify its supply by adding new US Liquefied natural gas (LNG) imports. European imports from the US were almost null in 2015 but have been growing since, with volumes in 2019 increasing sixfold compared to the previous year⁷ – almost closing the gap with Russian imported LNG. Most of the US export usually heads toward Asia, although higher European prices for gas in Europe with respect to the Asian benchmark may entice more US vessels to re-route towards European docks (as seen already in December 2021). In the end, the further expansion of EU-US trade is welcomed, especially if this might erode Russian LNG import share, thus diversifying Europe suppliers. However, all these are nothing but temporary patches to a problem that required a long-term fix. In this complex and fast-moving environment, we therefore stand by our [conviction](#) that price volatility in European energy will persist in the coming years – a structural change to inflation dynamics.



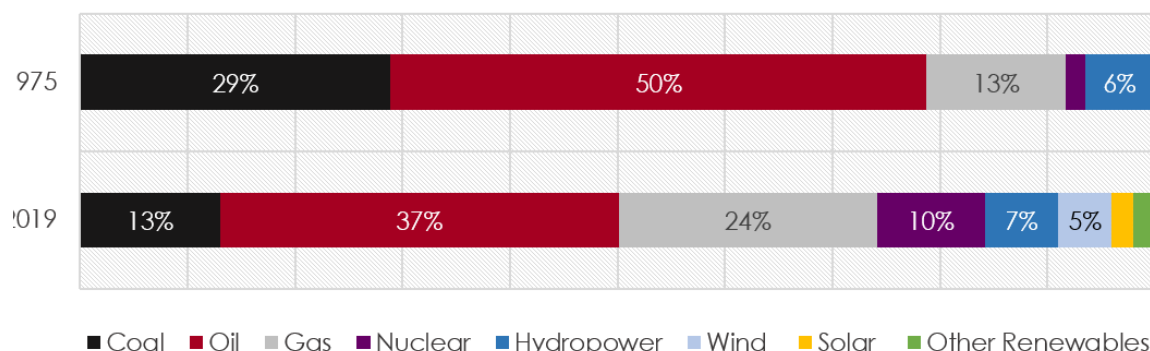
Stagflation Reloaded?

With energy inflation skyrocketing, many have been wondering whether the 'roaring 20s' will bring back to Europe the specter of stagflation – i.e. the rare combination of high inflation and weak growth, last seen during the 1970s Oil Crises. How justified is this concern?

The inflationary part of stagflation is certainly among us. Compared to the 1970s, the energy mix has changed – with oil shifting from covering an absolute majority of Europe energy needs to just one third – and today other sources play a key role in supplying our economies, as is the case with gas and nuclear. Differently from the 1970s, however, the negative shock from constrained supply is only part of the story. Structural factors that did not exist in the 1970s – most notably the higher costs from

the green transition – point to energy prices remaining elevated for longer than during the Oil Crisis episodes. The post-pandemic energy inflationary pressures are also being accompanied by rising food prices (up 2.9% in the EU in November 2021 year on year) and the increase of other costs – such as shipping [rates](#) – that amplify the already inflationary impact of supply chain disruptions.

Per capita primary energy consumption by source, Europe



Source: Our World in Data

To some extent, the oil price increase of 2002 and 2008 may constitute a counterargument to the risk of stagflation: at that time, oil prices tripled in real terms without causing any major economic disruption nor spikes in the inflation rate.

Economists gave three main explanations for that phenomenon. First, in the 2000s workers in advanced countries saw their bargaining power significantly curtailed – partly because of globalization and foreign competition. That allowed firms to pass through the increasing energy prices as lower real wages, hence tempering the impact. This is hardly the case now, however, as unions and [workers bargaining power](#) is making a comeback while the Great Resignation is exerting independent upwards pressure on wages. In some countries, price increases are starting to trigger second round effects: the German government, for example, [agreed](#) in November 2021 to increase the minimum wage by 25%, in a move that would lift the income of nearly 2 million people.

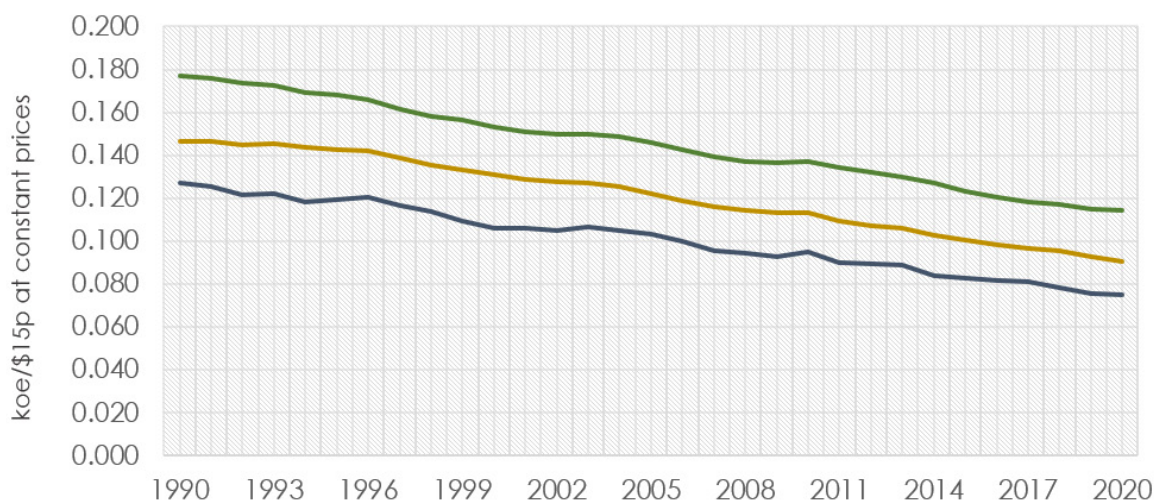
Second, in the sixties and seventies central banks were not eager to respond to oil prices going up with monetary tightening and prioritized low unemployment over price stability. In the end, the well-known Volker hikes were needed years later to put an end to the inflation cycle. On the other hand, during the 2000s the dominant

By waiting too long to act, the ECB allows second round effects to nest into inflation expectations.

view in monetary policy circles was one more keen on maintaining price stability and more focused on expectations. Yet, [central banks have arguably been in denial about post-pandemic inflation and very slow to respond](#). In recent years central banks have been putting more weight on closing output gaps and sustaining public finances rather than avoiding inflation risks. Although the overall stance of central banks is unlikely to be as accommodative as it was 50 years ago – with the Fed now talking about raising rates fast – their policy function seems less tilted towards inflation control that it was in the early 2000s. This is especially true in Europe, where the ECB needs to set the monetary policy for a diversified monetary union with asymmetric debt loads and an especially delicate political cycle in 2022 (with France and Italy facing important moments of political truth). As discussed by Schnabel

in her recent speech, the risk from the Central Bank's perspective is that by waiting too long to act it allows second round effects to nest into inflation expectations, in a self-fulfilling cycle that could get out of ECB's control.

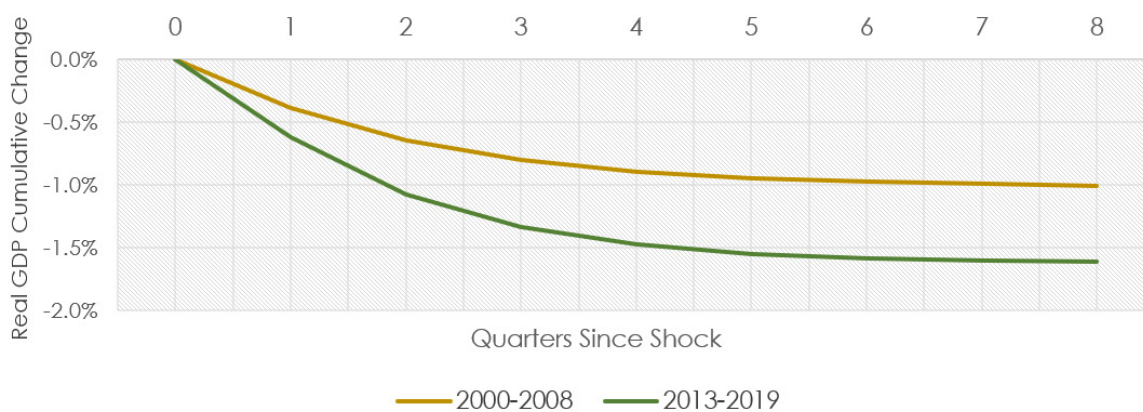
Energy intensity of GDP



Source: IEA

Third, compared to the 1970s, the energy intensity of GDP (the amount of energy needed to produce a unit of output) has been decreasing almost linearly in the following decades. This implies that the economy should be less sensitive to energy shock with respect to what was the case during the first shocks. Still, a note of caution is due: while energy intensity kept falling in the long term, the impact of energy prices on GDP has been somewhat increasing again in recent years. In the years leading up to the Financial Crisis the sensitivity was very low, while the years before COVID saw a hint of a reversion⁸.

GDP response to doubling Energy Prices



Source: Algebris Investments

So, will the stagnation leg of stagflation kick in this time too? Economic growth across much of the world has been robust throughout most of the year and unemployment rates, although generally above pre-pandemic levels, had been falling. But the recovery seemed to be losing momentum in

the last quarter of the year. The IHS Markit Eurozone PMI Composite Output Index [fell](#) to 53.3 in December, down from 55.4 in November, signaling the softest expansion in combined manufacturing and services output since March. The spread of the Omicron variant later in December and January is likely to have further amplified this effect. PMI data also show that Eurozone productivity growth nearly stalled in December 2021 – another parallel with the 1970s, when stagflation was amplified by the sharp decline in productivity growth.

Overall, the current state of the European economy seems to be walking a tightrope between two scenarios: not as close to stagflation as in the 1970s, but also not resilient enough to conclusively rule out the risk yet. European inflation will remain highly vulnerable to energy prices, as the Green Transition is an intrinsically inflationary phenomenon. At the same time, heightened geopolitical tensions in the East add pressure to inflation or – if not staved off – much worse. Moreover, Europe in 2022 enters a very delicate political cycle that will open with presidential election in Italy, continue with elections in France, and be dominated by the very thorny discussion on the reform of EU fiscal rules – which may induce the ECB to wait too long to respond. Central banks know how to deal with nominal shocks, but physical ones require large reserves and in-house production to be addressed – something that Europe does not have yet. As uncertainty about the pandemic horizon will continue to pose downside risk to economic activity, the rise of what we called ‘climate inflation’ will put the ECB’s ability to stave off stagflation to a hard test.

Notes

1

IEA

2

https://ec.europa.eu/eurostat/databrowser/view/NRG_IND_ID__custom_1866726/default/table?lang=en

3

https://ec.europa.eu/eurostat/databrowser/view/NRG_IND_ID__custom_1926026/default/table?lang=en

4

<https://www.bruegel.org/2021/12/how-serious-is-europes-natural-gas-storage-shortfall/>

5

TTF Natural Gas Netherland Benchmark

6

See <https://www.vaasaett.com/european-retail-energy-prices-reach-record-levels/>

7

Country by country <https://www.bruegel.org/publications/datasets/national-policies-to-shield-consumers-from-rising-energy-prices/>

8

https://ec.europa.eu/eurostat/databrowser/view/NRG_TI_GAS__custom_1895966/default/table?lang=en

9

Results based on VAR impulse response function of Eurozone quarterly real GDP growth to Energy PPI.

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