Inflation: the high price to pay for Europe’s dependence on fossil fuels

In the run-up to Putin’s invasion of Ukraine, rising prices in the euro area were catalyzing a great amount of political attention. Inflation peaked to 5.1% in January and 5.9% in February, putting the European Central Bank (ECB) under the spotlight. Hawkish voices in the political arena, despite being the minority, got progressively louder, calling for an increase in interest rates to tame inflation. Instead, the ECB opted for a cautious approach and decided to keep its interest rates unchanged.

In the middle of this debate, Putin invaded Ukraine. More than a month after the outbreak of the war, the latest data show that euro area inflation was up to 7.5% in March, with the figure hitting 9.8% in Spain. The record rate led to increased pressure on the ECB to revise its monetary policy decisions. All this time inflation has been overwhelmingly driven by soaring energy prices, which explained more than 50% of the increase in consumer prices. This figure only reflects the direct impact, but energy costs have been also pushing up prices across many sectors, which makes the overall effect higher. And that is not all: the rise in energy prices is dominantly linked to fossil fuels, namely oil and gas. The ECB called it “fossilflation”.

Two observations can be drawn from this fact. First, it is no coincidence that energy prices increased even more after Russia’s attack. Europe relies heavily on Russian gas and Putin is setting higher prices on its fossil fuels exports to finance its deadly war. This means that when importing fossil fuels from Russia, Europe is not only financing Putin’s war but it is also importing high prices to the bloc. Second, the assumption that no matter where inflation comes from, it should automatically lead to a tightening of monetary policy does not consider the underlying drivers of inflation. A more restrictive monetary policy would be the right choice if higher prices were driven by higher demand, as it is currently the case in the United States. But this is not the case in the euro area, where inflation is mainly due to higher costs of energy supply. Not only won’t higher interest rates counter higher energy prices, but if monetary policy stops being accommodative too early this would be extremely costly for our economy. With the war posing a serious threat to the European economy, quick monetary tightening could result in extra negative effects on an economy already under pressure: economic activity would slow down further, unemployment would increase, and wage growth would slow down. The ECB seems committed to not repeat the mistake made in 2008 and 2011, when it tightened its monetary policy too early when exactly the opposite was needed.

Rather than raising interest rates, the appropriate response to surging oil and gas prices translating into higher bills for European citizens is stopping Europe’s high dependence on import of fossil fuels that have been driving up overall prices. Speeding up the energy transition by investing in energy efficiency measures and in renewables is the most effective policy solution to the current spike in inflation. This is especially important as inflation hits lower incomes harder than higher incomes. And it is why, on top of a swift green transition, redistributive policies and taxation are very much needed in the current context.

At the same time, the current energy crisis clearly shows that the real risk for price stability in the euro area is delaying the energy transition and sovereignty. While there are strong arguments against raising interest rates in the current context, this does not mean that the ECB should not contribute to the overall objective of a cleaner energy mix. On the contrary, the ECB should be in the front line of energy transition, considering how much this has been affecting its primary mandate of keeping prices stable. Not only does the current energy mix affect the ECB’s ability to keep prices stable because of the current fossil-driven inflation, but also because physical risks will lead to more persistent and dramatic price pressures, if we do not stop climate change. It follows that the ECB should act swiftly, starting from greening its targeted long-refinancing operations and stop buying assets that contribute to climate change and environmental degradation.

Some fear that the green transition is putting further pressure on overall prices: the so-called “greenflation”. But greenflation has had so far much less of an impact on final consumer prices than “fossilflation”. This means it is inaccurate to claim that the greening of our economies is to blame for the painful rise in energy prices. On the other hand, if we are serious about meeting the 2030 and 2050 climate targets, a massive mobilization of green investments will be needed. And
like any extensive fiscal stimulus, this is likely to boost inflation. But there is a substantial difference between an increase in prices driven by more expensive imports from Russia and the implications of Europe mobilizing resources for its energy sovereignty. The former is a pure cost: countries buy gas, they burn it, and it's over. And it comes with a very high geopolitical cost to bear, namely the economic dependence from its energy provider, in this case an aggressive petrostate whose economic prosperity depends on inaction to cut emissions. But if Europe puts money into a well-functioning green energy infrastructure that remains in its hand, that's an investment and not a cost.

From the point of view of the ECB, inflation driven by an increase of public and private spending in renewables is manageable with standard monetary policy tools. This would be inflation driven by higher demand, which the ECB has the proper arsenal to tackle. The same cannot be said by high prices due to external supply shocks, and that's why monetary policy seems rather powerless at the moment. One should also consider the size of the impact. From a price stability perspective, longer term inflation stemming from extreme weather events, resource shortage, and high energy import prices imposed from oppressive regimes abroad is a much more dramatic outlook than temporary higher prices during the green transition period.

Europe's dependence on fossil fuels has been impacting its ability to protect its citizens from geopolitical threats and high prices. What both the inflation spike and the situation in Ukraine have been showing is that Europe's dependency on fossil fuels makes it too vulnerable to the unpredictable changes of the global gas and oil market, be that increase in prices or the implication of a war in the East - which are two sides of the same coin. In both cases we have to tackle the root of the problem and not fall into the trap of short-sighted policy responses. Raising interest rates and diversifying Europe's import of gas are not the ultimate solution. Accelerating the energy transition is. This would pay off with more stable prices and energy security.

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