

Meeting the challenge of the energy price explosion

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Thank you very much for inviting me to your New Years Conference. In my short intervention I want to focus on an unexpected but at the same time serious challenge of the pandemic: the strong increase in inflation rates all over world.

As far as Europe is concerned, this development is mainly due to the extreme price increases in natural gas and electricity. But a surge in the prices for crude oil have also lifted the consumer prices for gasoline and heating oil.

The **explosion of energy** prices is a huge challenge for Europe.

- It is detrimental for 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 for energy than wealthy households. Energy poverty is a rising problem.
- It threatens the public acceptance of **climate policies** which operate with carbon taxes and the EU Emissions Trading System as key instruments for reducing greenhouse gas emissions.

While some member countries (especially the Czech Republic, Spain, and the Netherlands) have already reduced taxes on energy, so far there is no comprehensive European solution for coping with the challenge of exploding energy prices.

In my opinion, we should take this challenge as an opportunity to fundamentally reconsider the strategy of reducing carbon emissions either by pricing them with the EU Emissions Trading Scheme (EU ETS) and with national carbon taxes.

At first sight, the idea of internalizing the costs of pollution by putting a price on is very intuitive. It was developed a hundred years ago by the famous Cambridge Professor Arthur Cecil Pigou and there is a broad consensus among economists from all schools of thought that this constitutes the best practice for reducing greenhouse gas emissions. But at closer look, one can identify a major flaw of this approach: It is based on an **assumption** that is rarely made explicit. It assumes that the base prices of natural gas, gasoline, or heating oil are **market-determined equilibrium prices**.

We all know that this assumption has little to do with reality.

- **Crude oil prices** are set by the OPEC cartel in conjunction with Russia.
- The current price increase of **natural gas** seems to be heavily influenced by Russia's political agenda.
- And the huge fluctuations of crude oil prices in the past are an indication of strong speculative forces on these markets. T

There is no reason to expect that this will be any different in the future.

With such volatile base prices, does it make sense to operate with fixed carbon taxes and auction prices for emission certificates? The current public discontent with high consumer prices for energy indicates that this is probably not the best way to decarbonize our economies. What is needed from

a climate policy perspective are energy prices for households but also for industry that rise steadily and predictably over the medium term.

What need in my view are therefore **adjustable carbon taxes** that at least partially offset the volatility of the base prices. Thus, in the current situation, carbon taxes could be temporarily lowered without jeopardizing the medium-term decarbonization target.

And as soon as the supply situation normalizes, the reduction would be terminated again. And if in the future crude oil prices and natural gas prices fall more sharply, carbon taxes could be increased to keep consumer prices on a stable trajectory over the medium term. Revenues from such compensating taxes should be passed on to low-income households.

What about the **emissions trading system**? Due to a higher demand for coal and probably also due to speculation, the price of allowances has increased by more than 250% since the beginning of 2021. Thus, in a world with volatile base energy prices and major supply shocks, the ETS has become completely dysfunctional. Instead of stabilizing consumer prices, it acts as an additional destabilizer.

In my view, as an immediate solution, market intervention would be needed to bring the ETS price back to of around €40 per ton, at least as long as base prices for energy remain at such elevated levels.

There is no doubt that consumer prices +for energy will have to rise in the medium term if we are to reduce carbon emissions significantly. But to make this approach politically, economically, and most importantly, socially acceptable, carbon pricing must act as a stabilizer that ensures stable and predictable long-term consumer price trends. As we see today, this goal cannot be achieved with fixed carbon taxes or even destabilizing market prices for allowances.

In other words: If we want to avoid the failure of EU climate policy, we need a paradigm shift in carbon pricing. Instead of being rigid and destabilizing carbon prices must become flexible and stabilizing.

This would also help to reduce the pressure on central banks and to relieve the burden of energy prices for low-income households.