Article #2

German Inflation Soars to Double Digits for First Time in Decades

Consumer prices rose 10.9 percent over the year through September, much higher than expected, driven by high energy and food prices.

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Consumer prices in Germany rose by double digits over the year through September as energy and food costs soared, leading the government in Berlin to impose a cap on natural gas prices amid growing anger from people and businesses squeezed by accelerating inflation.

Inflation rose at a 10.9 percent annual pace in September, up from 8.8 percent the month before, official data released on Thursday showed. It was the first time since the creation of the euro, in 1999, that the bloc's largest economy recorded such a large leap in prices. In fact, by some measures, it was the highest rate of inflation that Germany had seen since 1951, well before the reunification of the former East and West.

Energy prices rose nearly 44 percent in September, the biggest contributor to the higher-than-expected overall result, and have broken successive records since Russia invaded Ukraine in February.

Rebates on public transportation and for gas that had helped limit price increases over the summer expired at the end of August, contributing to the jump, economists said, but they warned that prices had not yet peaked. The country's four leading economic research institutes are predicting the German economy will contract in 2023, before recovering the following year.

"The high energy and food prices, which are likely to rise further in the coming year, are causing significant losses in purchasing power," said Torsten Schmidt, the head of economic research at the Leibniz Institute for Economic Research.

The rapid German inflation will complicate efforts by the European Central Bank to get price increases under control. The E.C.B. has been raising interest rates aggressively to tame inflation across the eurozone, where some member states, including the Baltics, have already reached double-digit inflation.

The latest data on consumer prices in the eurozone will be released on Friday; economists expect the annual pace of inflation to have hit 9.6 percent in September, according to FactSet, up from 9.1 percent in August.

This month, the E.C.B. increased its key rate by three-quarters of a percentage point, matching its largest rise since the euro's founding. Traders and economists expect a similar increase at the central bank's next meeting, in late October. Germany's inflation data present an "upside risk" to Friday's eurozone numbers, Claus Vistesen of Pantheon Macroeconomics wrote in a research note. The eurozone rate could hit 10 percent, he wrote, which would be “more than enough” to justify another rate increase of three-quarters of a point.

The German government announced a package of subsidies worth 200 billion euros ($195 billion) on Thursday, in addition to proposing a limit on how much individuals and industrial users will have to pay for natural gas. The goal is to “cushion rising energy costs and the most severe consequences for consumers and businesses,” the government said.

“Prices have to come down,” Chancellor Olaf Scholz told reporters on Thursday when announcing the package, flanked by his economy and finance ministers. “To make prices drop, we are rolling out a wide defense shield.”

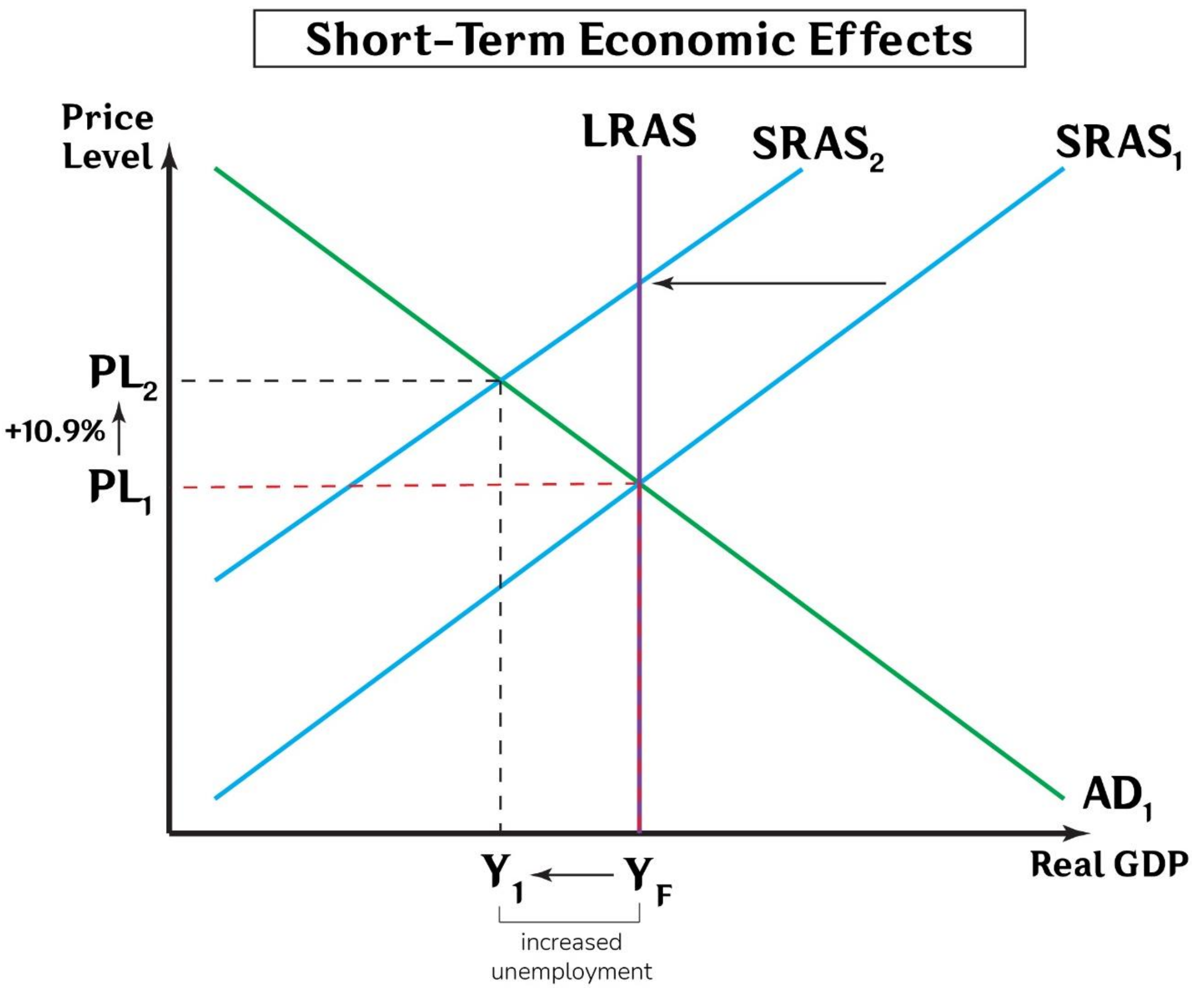
Details about how the price cap will work have not yet been announced.

Commentary #2

This article is about the soaring inflation experienced in Germany from the raising energy and food prices in 2022 and how the German government plans to use fiscal policy to control this inflation.

This relates to the key concept of **economic well-being** as the raising prices of energy and food directly impact the financial security of individuals and businesses as they are necessities. The government intends to use expansionary fiscal policy and government spending to subsidize production and place a price ceiling on natural gas to "cushion rising energy costs and the most severe consequences for consumers and businesses." Thus, could monetary policy have been used instead to control this inflation?

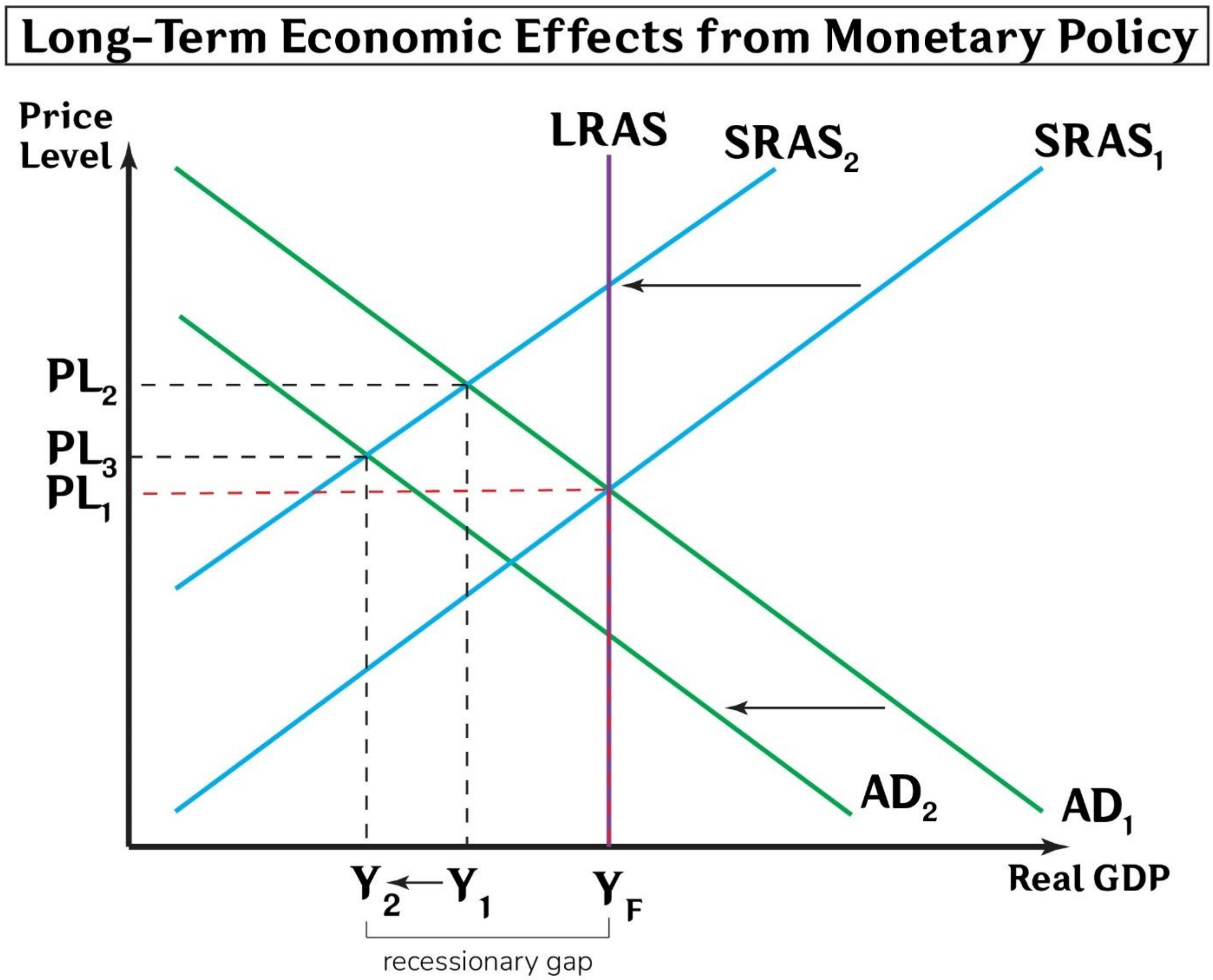
The diagram below illustrates the short-term economic effects of cost-push inflation currently experienced in Germany.



With energy prices rising "nearly 44% in September," prominently due to the Russia-Ukraine conflict, the cost of Factors of Production (FOPs) has increased, increasing the operating costs of firms, and thus lowering their production output as shown by shifting SRAS to the left ($SRAS_1$

to $SRAS_2$). Therefore, the cost of goods and services will increase, as evident by a 10.9% rise in inflation, and people will begin to lose their jobs as firms cut back on operating costs, indicative of cyclical unemployment. These conditions mean an economic recession is bound to happen.

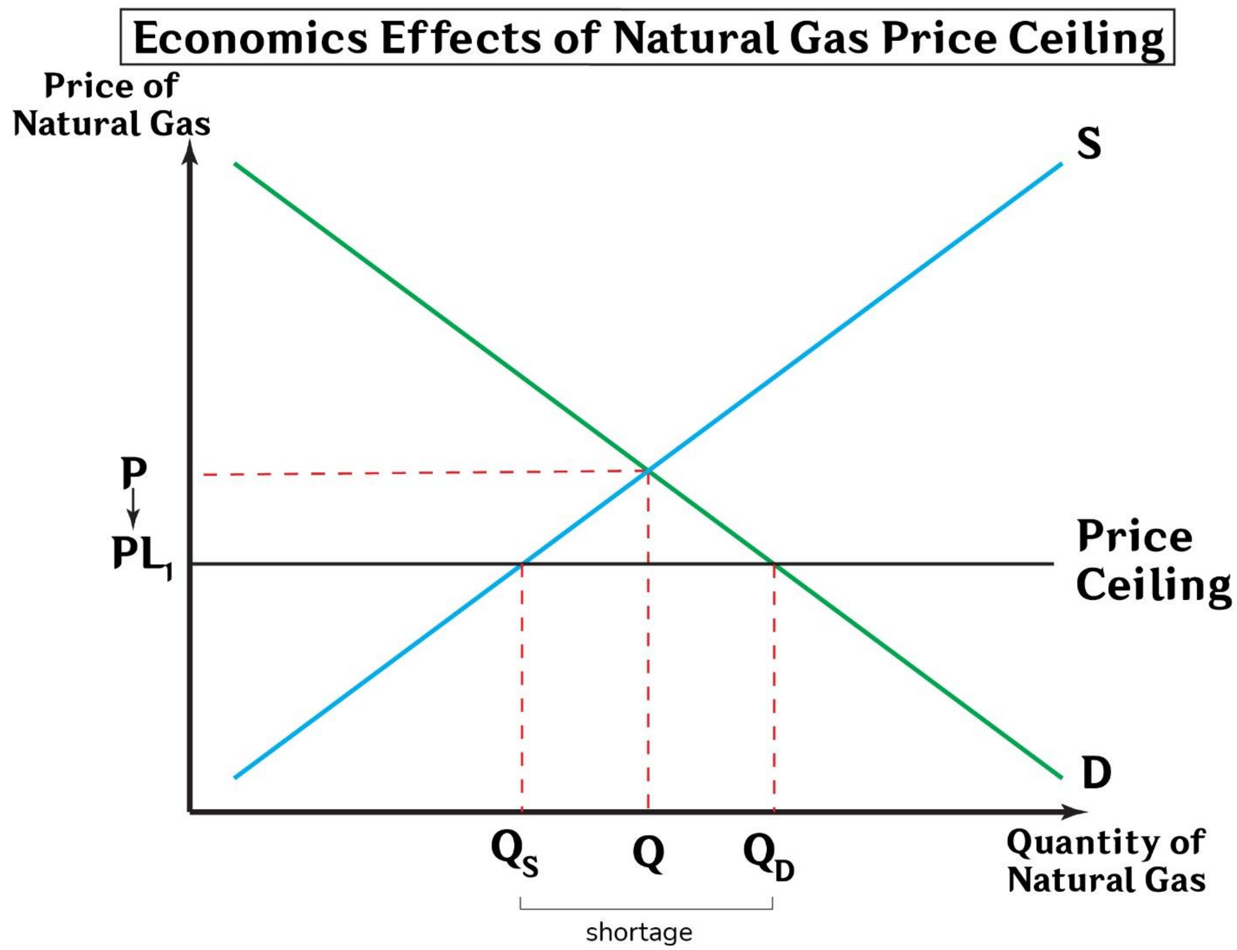
To combat this, both monetary and fiscal policies are utilized. Starting with monetary policy, a change to the supply of money, the European Central Bank (ECB) has "been raising interest rates aggressively to tame inflation" by "[increasing] its key rate by three-quarters of a percentage point." The long-term economic effects of this monetary policy are illustrated below.



Increasing the interest rate disincentivizes the borrowing of loans and creates economic uncertainty. This disincentivizes consumer expenditure and investment which ultimately reduces AD (from AD_1 to AD_2), slowing the rate of inflation (disinflation), as PL decreases from PL_2 to PL_3, and fewer jobs are available which decreases economic output as a recessionary gap is created (area between Y_2 and Y_F). In the long run, monetary policy will only increase this recessionary gap as it was previously from Y_1 to Y_F. From this, monetary policy alone can control inflation but brings the adverse effects of a shrinking economy and that other options such as fiscal policy should be explored.

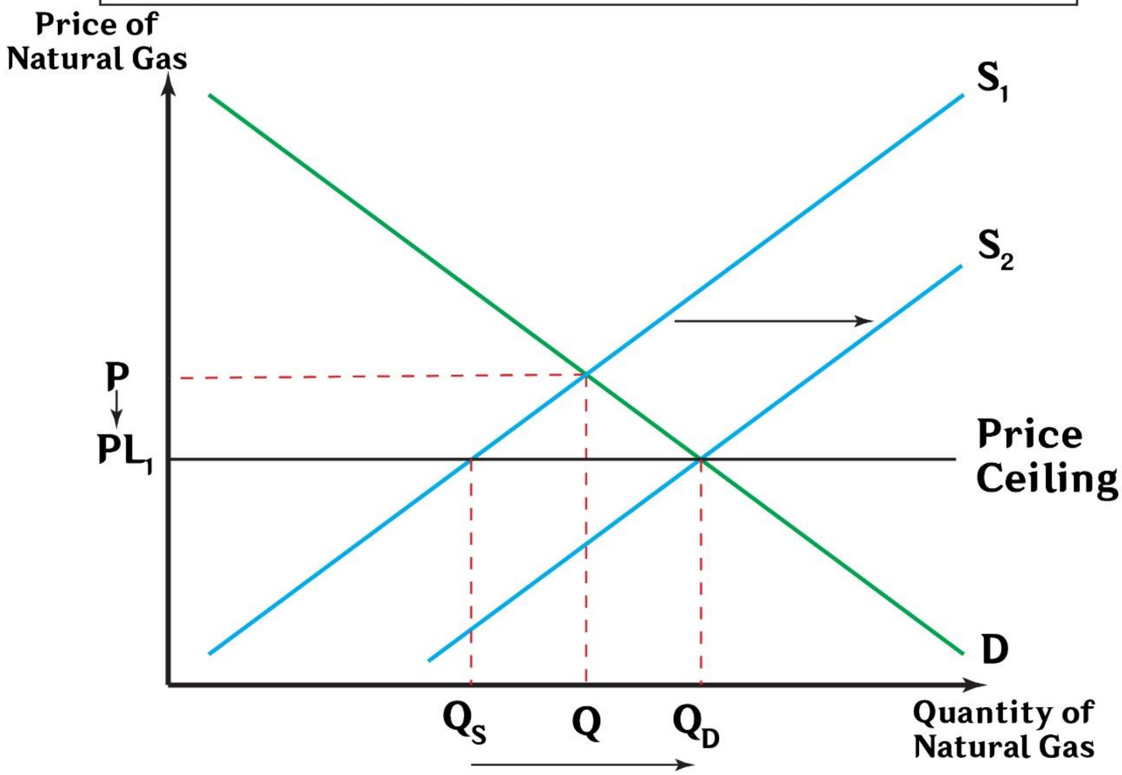
Food and fuel are necessities for human sustainability and are inelastic in demand. With winter approaching, Germans must continue to heat their homes and face the high energy prices, directly affecting their financial security and ability to meet basic needs which affects their **economic well-being**. According to the Keynesian economics theory, fiscal policy such as government spending is required to help bring economies out of recession. This is exactly what the German government plans to do as they have "announced a package of subsidies worth 200 billion euros" and "a limit on how much individuals and industrial users will have to pay for natural gas" with the goal that "prices have to come down."

As a price ceiling is being imposed, natural gas prices will decrease but a shortage will be created as the quantity demanded (Q_D) is greater than the quantity supplied (Q_S). This is illustrated below.

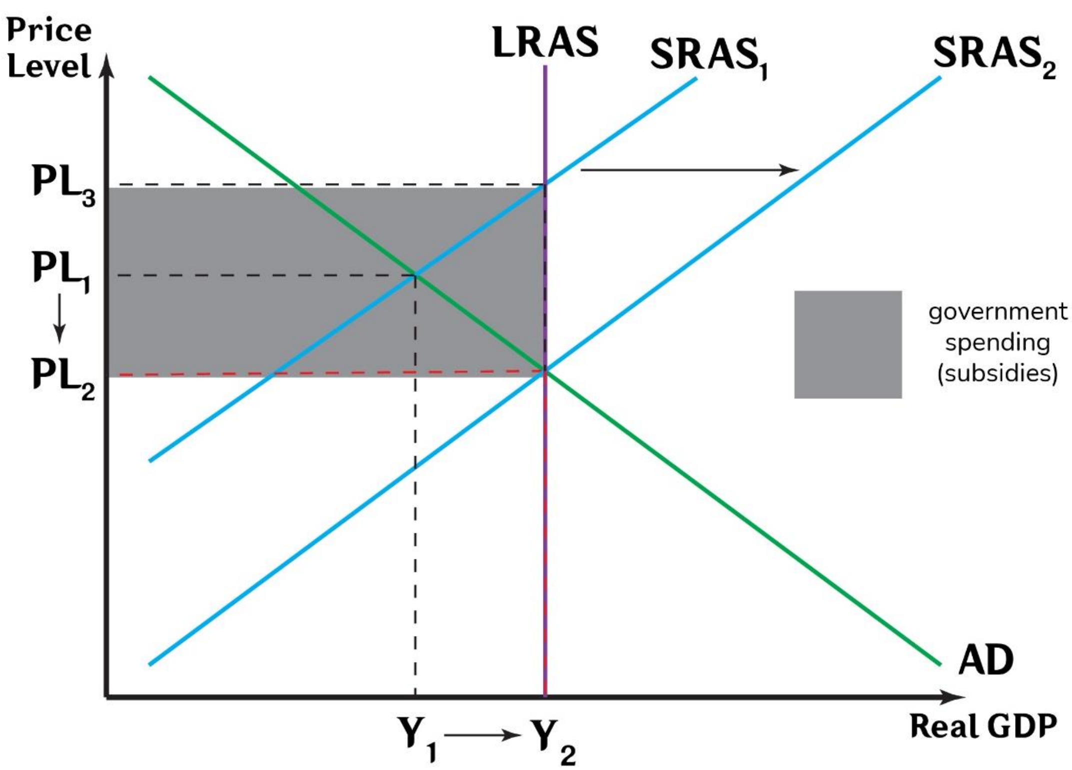


This shortage will be alleviated by government subsidies. The short-term economic effects of these subsidies are illustrated below.

Effects of Government Subsidies on Natural Gas



Economic Effects of Government Subsidies



The government subsidies aim to subsidize the production of natural gas, ultimately increasing the supply of natural gas from S_1 to S_2 and closing the shortage as Q_S is now equal to Q_D. Since the cost of FOPs (ex: transportation costs due to natural gas) decreases, SRAS will increase from $SRAS_1$ to $SRAS_2$, closing the recessionary gap and bringing the economy back to pre-recessionary levels. This is achieved by bringing unemployment back to the natural rate of unemployment (NRU), from Y_1 to Y_2, seen before the recession and lowering the price of natural gas which will bring down the prices of downstream industry products, like food, as PL decreases from PL_1 to PL_2. This price reduction is only possible due to the government subsidies (area shaded) as otherwise, prices would be at PL_3 instead of PL_2 at long-run equilibrium (LRAS) as SRAS would stay at $SRAS_1$. As Germans will have more disposable income, spending habits will return to pre-recessionary levels and the economy will begin to grow once again from demand-pull inflation. This will restore the **economic well-being** of the German economy and the living standards of Germans.

In conclusion, while monetary policy can control inflation, fiscal policy is required to recover an economy from recession. While there are time lags, fiscal policy proves to be the most effective in the long-term. The German government aims to subsidize the production of natural gas and control inflation amid the winter season fast approaching, improving the financial security of its citizens and firms.