# ECB watch: the Iran War Inflation Miracle

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## All is well on the inflation front

- **Remember the line from The Big Lebowski, when at the bowling alley Walter (played by John Goodman) screams at a hapless Smokey (played by Jimmie Dale Gilmore) "over the line"?** I would paraphrase Walter's line to *overpriced* when looking at ESTR pricing for the upcoming ECB meetings. Two quarter point hikes are priced for the next six months. That's one too many (not two too many if you get the other movie reference).
- **It turns out that the ECB's Iran war-induced inflation problem is much smaller than feared.** The dog that barked but didn't bite is an apt description. More on that later. Furthermore, the Eurozone economy is not exactly lighting the world on fire with GDP growth of barely a percent. More importantly, the labor market remains a sour spot. I know that I must come across like an overzealous Cassandra by complaining incessantly about the worsening Eurozone labor market. But it is the truth. Employment growth and wage growth are both slowing, vacancies are falling incessantly, and companies' hiring intentions are on balance slightly negative. That's why you don't even hear the hawkish ECB-speakers complain about the risk of second round effects (central banker jargon for price increases begetting wage increases and then further price increases). There is no such risk. Workers accept the real wage squeeze without much ado.
- **The point is that the ongoing real wage squeeze, while definitely unwanted as I can personally attest to, isn't that bad.** It's flesh wound territory, not a repeat of 2022. The 2022 real wage squeeze was akin to Monty Python's the Black Knight losing a limb. In 2022 headline inflation peaked at a lofty 10.6 percent. Depending on which measure you use, peak wage growth was as low as 4.0 percent or as high as 5.6 percent.
- **In the wake of the Iran war, headline inflation peaked at 3.2 percent in May.** That compares with the ECB wage tracker hovering around 2.6 percent over the course of the year while the most recent Eurostat figures have wage growth at 3.4 percent in Q1. Real wages are either falling slightly or increasing marginally.
- **Energy prices should have driven inflation somewhat higher based on past energy price spikes, which I have listed in the table below.** Notice how the current spike in oil futures prices closely matches the 2021-2022 episode while electricity and energy price increases were exponentially stronger.

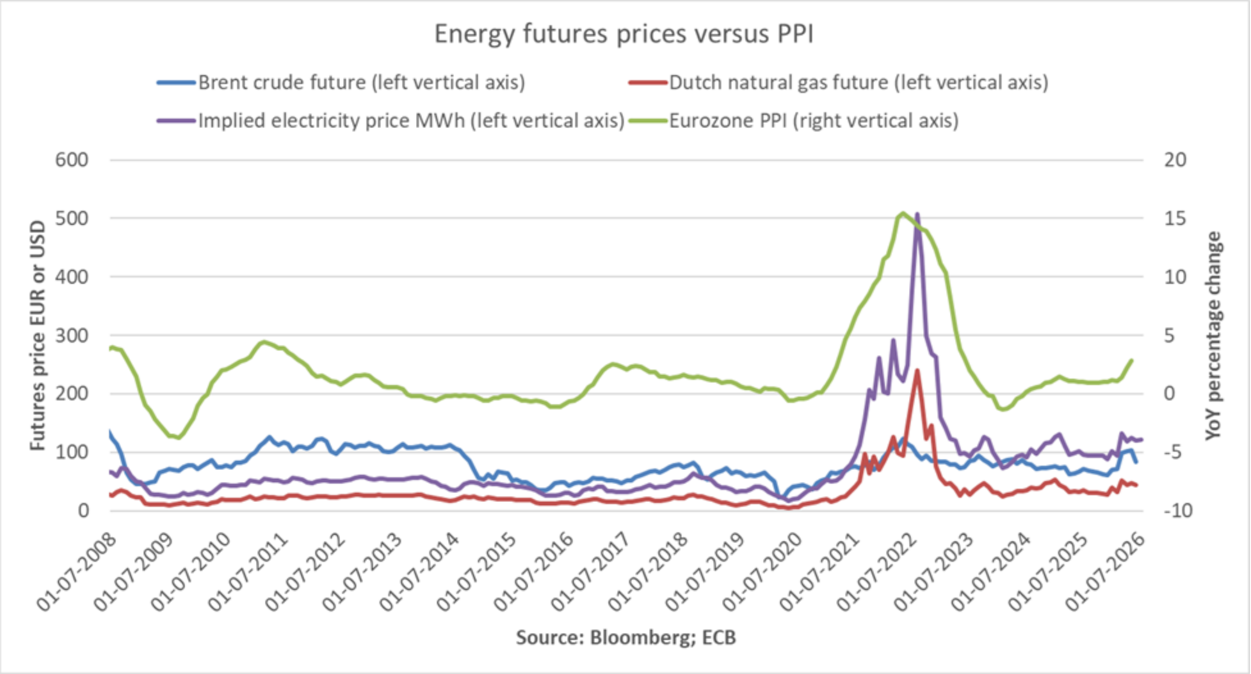
## Percentage increase in prices compared to *year-end

| | Crude oil | Natural gas | Electricity |
|---|---|---|---|
| **2007-2008** | 47 | -- | -- |
| **2010-2011** | 57 | -- | -- |
| **2021-2022** | 53 | 256 | 223 |
| **2025-2026** | 68 | 95 | 50 |

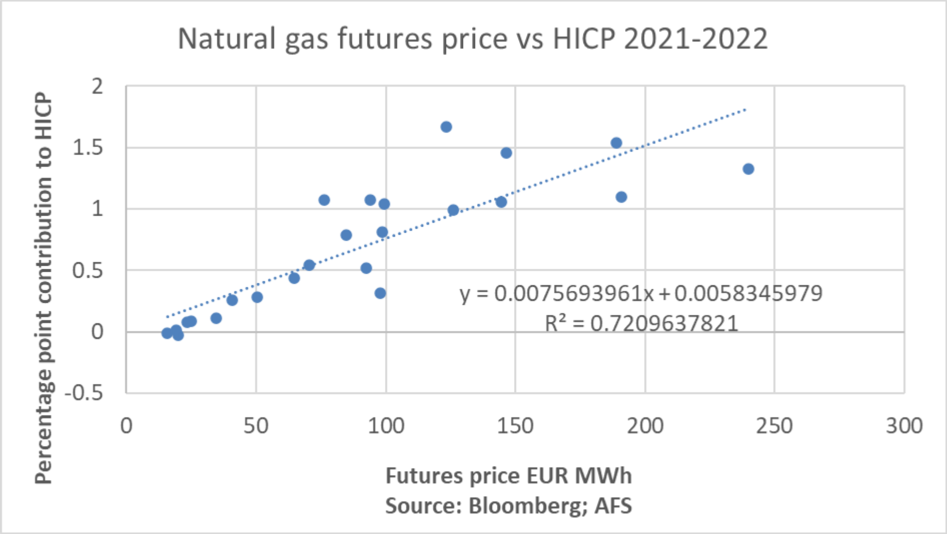
*September 2021 for 2021-2022

*Source: Bloomberg; AFS*

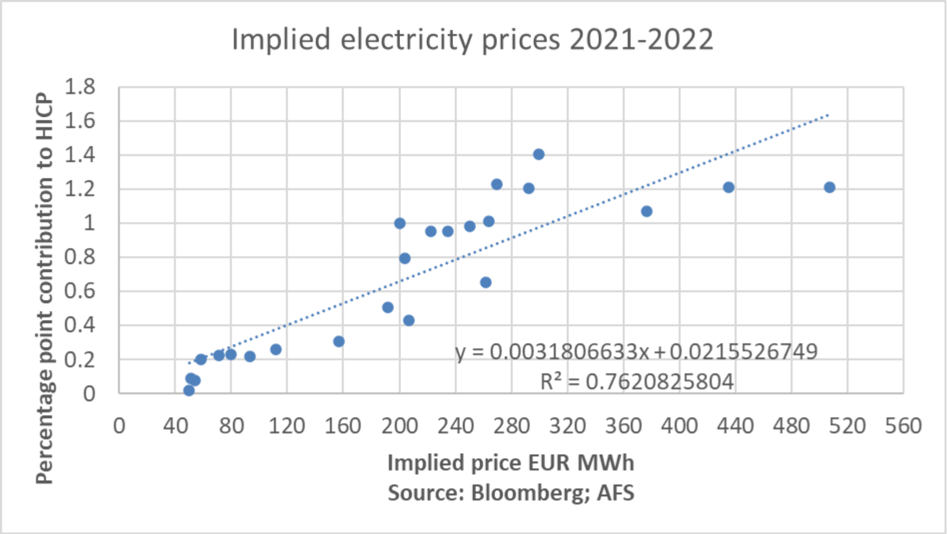
- **In the table I use monthly average futures prices because I want to estimate the effect of futures prices on consumer price inflation, which is measured monthly, of course.** I take the highest average monthly future price, then calculate the percentage difference with the pre-crisis base (incidentally December of the prior year except for 2021-2022, when I took September as the baseline). So, for example, during the 2022 crisis the highest average monthly increase in Dutch natural gas future prices was 256 percent compared to September 2021, when it had become unmistakable that price increases were unprecedented. Electricity prices, which were still closely linked to gas prices, showed a similar increase. Fortunately, nowadays the link between gas and electricity prices is much weaker.
- **Predictably, the futures price levels this year are also a fraction of what we witnessed four years ago.** The chart below shows Brent crude futures prices, Dutch natural gas futures prices, and implied electricity prices calculated as the sum of gas futures and EUA emission certificates. All on the left vertical axis. On the right vertical axis, I've plotted the annual percentage change in producer prices. Energy prices are through month-end July while PPI stops in June. Again, be aware that I use monthly averages for energy prices.



- **According to a simple regression, at the monthly average peak of 236 euros per MWh in 2022 (representing a 256 percent increase compared to the pre-crisis base), Dutch natural gas futures should have contributed about 1.7 percentage points to headline inflation.** For the record: the actual peak contribution to headline inflation was 1.7 percentage points.

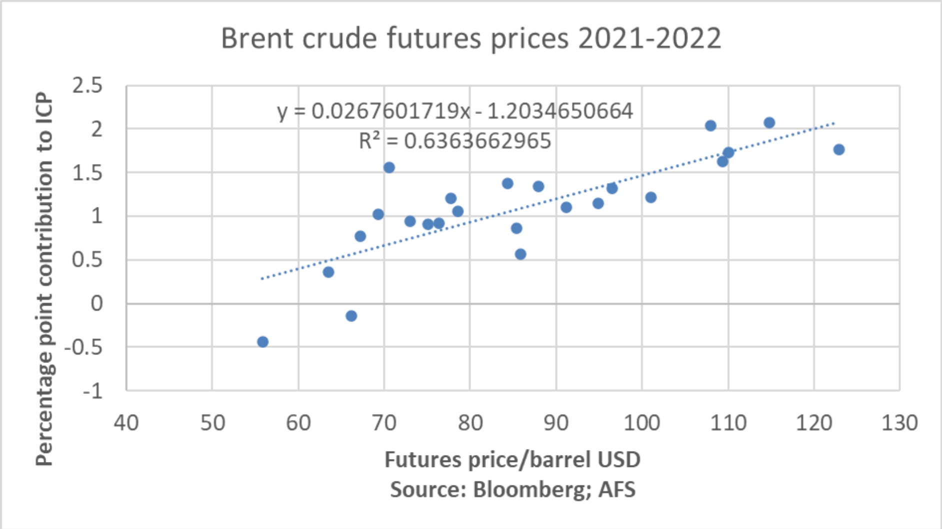



- **Since the outbreak of the Iran war, the highest average monthly natural gas futures price was 54 euros per MWh**. Which should have boosted headline inflation by 0.35 percentage points. But the actual percentage point contribution has not even exceeded a tenth of a percent (data through June).
- **It's the same story with electricity prices**. For the record, on a monthly average basis prices peaked at 507 euros per MWh in August of 2022 to be precise. The current highest average monthly price is 140 euros per MWh. Which should boost headline inflation by about half a percentage point:




However, the highest actual contribution to headline inflation was less than a tenth of a percentage point (data through June).

- **Only higher crude oil (futures) prices are actually significantly contributing to headline inflation.** In April and May, when prices peaked at a monthly average of slightly more than $100 a barrel, the contribution to headline inflation was a full percentage point. Which is in line with the oil price spikes of 2008, 2010-2011, and – albeit less so – 2022. It's also substantially lower than implied by the regression.




- **Bottom line: as of yet, only higher oil prices have meaningfully filtered through in consumer price inflation**. Whether or not natural gas and electricity prices will filter through in consumer prices at some point remains to be seen. Perhaps it will take time for electricity and gas household contract price increases to show up in the HICP basket. That could keep inflation higher for longer, albeit with lower peak increases. Then again, back in 2022 the peak contribution of gas and electricity prices was in October, only a few months after futures prices had peaked. Furthermore, both electricity and natural gas prices were already strongly contributing to headline inflation in late 2021, a few months after prices truly broke out. So, if 2021-2022 is any guide, we're unlikely to see electricity and gas prices boost headline inflation substantially further down the road. If it would happen, it would have happened by now. It looks like Europe has simply become more nimble and able to adapt to energy shocks.

## Sit back and relax, Madam Lagarde

- **Estimating the effects of higher energy prices on headline inflation is straightforward as I have shown above**. What about indirect effects on core inflation, which is my actual input for ECB forecasts? According to a widely cited Bank of Italy research paper on the 2022 inflation surge, for every ten percent increase in energy prices, through indirect effects core inflation rises by 0.45 percentage points. The pass-through to core is direct with a basically negligible lag. Two caveats. 2022 was a high pass-through scenario, where companies found it relatively straightforward to pass through higher energy prices without risking sales too much. We were dealing with the fiscally and monetarily stimulated pandemic demand overhang. Secondly, that 0.45ppt estimate is compressing the research paper to a single rule of thumb.
- **Between December 2025 and July 2026, the HICP energy price index rose nine percent**. Based on the elasticities of the 2022 shock, that should have boosted core inflation by 0.4ppt. Depending on which month one uses as the starting

point (December 2025 or February 2026), core inflation has increased by 0.1ppt or 0.2ppt to a peak of 2.55 percent in May. If we attribute the increase fully to the energy shock (big if!), the pass-through is much weaker than would have been expected based on the 2022 experience.

- **Now, of course, the conflict between the US and Iran is far from over.** At the time of writing, Brent crude futures prices remain elevated at close to $90 barrel. Dutch natural gas futures prices at nearly 60 euros per MWh are much closer to the March highs than crude is. The ECB is banking on core inflation rising further. Staff forecast of core inflation averaging 2.5 percent this year in the base case scenario requires core inflation to average 2.6 percent in the final five months of the year. Let's see about that. Producer price inflation and businesses' inflation expectations likely peaked in the early summer.
- **In the table below I show the annualized percentage change in producer prices (extrapolating the month-on-month increase to twelve months) and businesses' inflation expectations.** The latter are net percentages. When the number is positive, on balance a greater share of firms expects prices to increase.

| Month | Producer prices 3m/3m ^ | Producer prices excluding energy 3m/3m ^ | Selling price expectations industry net percent. | Selling price expectations services net percent. | Selling price expectations retail trade net percent. |
|---|---|---|---|---|---|
| 30-09-2025 | 0.10 | -0.33 | 7.9 | 12.4 | 17.1 |
| 31-10-2025 | -1.57 | 0.00 | 8.5 | 12.4 | 16.5 |
| 30-11-2025 | 3.37 | 0.34 | 10.8 | 13.8 | 18.8 |
| 31-12-2025 | 2.44 | 0.67 | 11.8 | 14.6 | 18.4 |
| 31-01-2026 | 5.12 | 3.10 | 11.1 | 14.4 | 17 |
| 28-02-2026 | -0.71 | 3.43 | 12.3 | 14.3 | 17.7 |
| 31-03-2026 | 16.80 | 4.80 | 19.6 | 14.9 | 20.3 |
| 30-04-2026 | 16.36 | 6.20 | 29.5 | 17.6 | 27.6 |
| 31-05-2026 | 19.76 | 8.25 | 26.5 | 16.6 | 26.9 |
| 30-06-2026 | 2.29 | 7.21 | 22.1 | 14.6 | 26.7 |
| 31-07-2026 | | | 17.7 | 13.5 | 22.4 |

Selling price expectations and producer price inflation clearly accelerated after the war broke out. However, both the PPI and the survey data suggest that we've already turned the corner.

- **So, to conclude, I think the ECB can sit back and relax a bit.** The Iran war shock isn't as bad as feared. Output is bottoming out (but nothing to write home about) while inflation and price pressures probably already peaked.
- **If I put 2.5 percent core inflation in my Taylor rule adjusted for high inertia[1], I arrive at a 2.5 percent deposit rate.** Without inertia, the highest estimate is a 3.00 percent deposit rate. Recent inflation developments show that the ECB need not to go that far.



[1] Adjusted for the current ECB policy rate. The weighting of the prior ECB rate is high because that gives the best historical fit.