# MARKET COMMENTARY

6 December 2022

## The German gas price brake – not much of an incentive to reduce gas consumption

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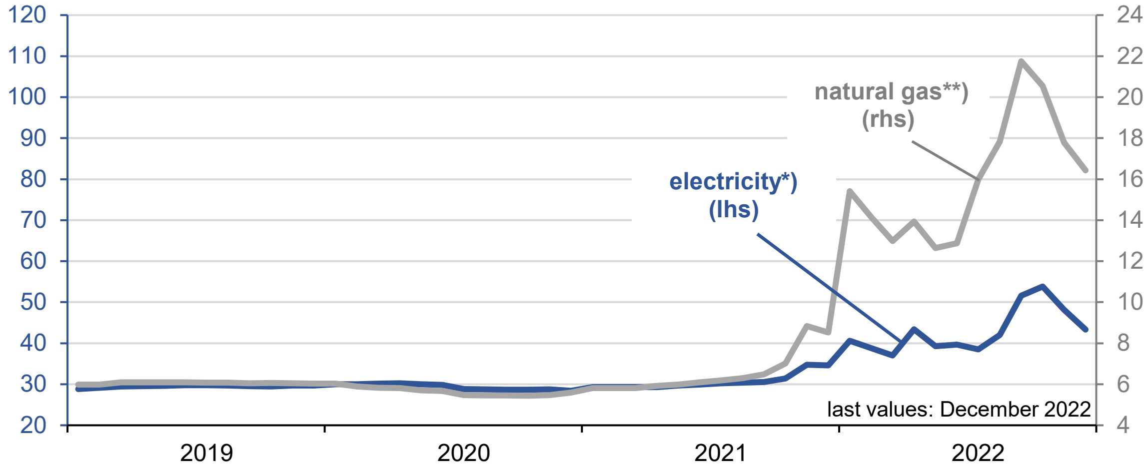
As gas prices – as well as electricity prices, which are driven by them – have exploded, causing a lot of hardship across the economy, politics has been faced with the alternative of subsidizing the income of households and businesses or introducing price controls and thus interfere with the market mechanism and the allocation of resources. Regrettably, the German government has opted for the second alternative.

**household electricity and gas prices in Germany**

*ct/kWh*




*) average electricity prices for an annual consumption of 4,000 kWh

**) average natural gas prices for new clients with an annual consumption of 20,000 kWh

source: Verivox; design & research: Uwe Richter

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The so-called gas price brake coming into force next year expires at the end of April 2024 and is thus intended to be a temporary measure. From January 2023 to April 2024, for private households the gas price is capped at 12 euro cents per kilowatt-hour for 80 per cent of last year's consumption; for the remainder they pay market prices. Industry pays just 7 cents per kWh on 70 per cent of 2021's consumption, and the full market price for anything beyond that. The difference between utilities' cost of gas inputs and the guaranteed price (cap) is borne by the federal government and is expected to be in the order of 56 billion euros. A similar approach is behind the electricity price brake – but in this case the major part of the expenditures is planned to be financed by skimming off windfall profits made by electricity providers. In total both measures will require expenses of 2 to 3 per cent of annual GDP. This is the core of the new program. In reality, it is very complicated as lawmakers have tried to take account of many special cases and contingencies. A bureaucratic monster.

The idea of subsidizing gas and electricity prices is to cushion the blow of the radical change of relative prices on the effective income distribution and the structure of the economy, especially with regard to defaults and unemployment. But from a macro point of view, it would be better to have let those extremely high energy prices do what they are supposed to do: reduce the demand for gas, ideally in a concerted OECD-action, and thus get their prices down this way. It would also have been good for the environment.

As it happened, to provide a guaranteed low price at the expense of the government/the taxpayer stimulates energy demand and slows the move away from fossil fuels. Technically speaking, the terms of trade for an energy importing country like Germany will not improve as much as would have been possible if politics had been more confident about the beneficial effects of market forces. An improvement of the terms of trade means that the aggregated real income rises. Using price support instead is a missed opportunity. Neither politicians nor the public seem to understand the terms of trade concept.

If everybody has to pay the full and unsubsidized world market price for energy, the pressure to adapt, ie, to rapidly cut the dependence on fossil fuels, would bring forward structural change and prepare the economy for its green future. Since many people would lose their jobs while lots of firms would go bankrupt, such a strategy would have severe negative effects on the economy. But since the government was prepared to spend about 3per cent of annual GDP on the two energy price brakes, it could also have directed this money toward the direct financial support of households and firms – subsidize income rather than the prices paid by energy consumers.

It is basically a social problem that has to be addressed. Those who are in need, who are hit hard by expensive energy, should get full government support, whereas the better-off should not. They can afford to pay more for energy, fly and drive less, turn down the heat of their homes and swimming pools and so on.

Such a strategy would stabilize household incomes and thus prevent a big decline of final demand and hopefully a recession, bring down gas prices, improve the terms of trade, cut the dependence on energy imports (by making green investments more attractive) and increase the population's real disposable income.

Let me point out that government revenues will suffer because of a possibly steep rise in defaults and unemployment in the near term, but they would, at the same time, benefit from higher inflation, as value added taxes increase significantly. The bottom line is that the inevitable structural change is accelerated while a deep recession is probably avoided, thanks to subsidizing incomes.

The sub-optimal decisions have been made by now, but next time around, post 2024, incomes should be subsidized, not prices. It is the much superior alternative.

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