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Energy prices: How big an economic shock is coming in Europe?

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Economic Monitor

Welcome to Economic Monitor – a quarterly publication where we explore the key themes shaping the global economy. In this issue we ask: how big an economic shock is coming to Europe?

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The energy shock is starting to take its toll on the European economy. Activity indicators already point to a contraction in activity in some of the region's major economies, with the services sector joining the manufacturing sector in contraction in August as inflation bites into household incomes. Unfortunately, the worst may be yet to come as energy usage increases over the winter months amid a tenfold increase in gas prices and the potential imposition of energy rationing.

Governments are now scrambling to secure supply and introduce measures that would reduce the impact on households and businesses. The policy prescriptions must be very different to those employed during the pandemic given the different inflationary backdrop and the threat of rising interest rates on government borrowing.

Heating up: Europe battles energy crisis

Ever since the Russian invasion of Ukraine, Europe has been facing a battle of politics, logistics, resources and time to try to replace Russian gas imports with alternative sources ahead of Winter 2022 and prior to a complete cessation of gas from Russia. Replacing 40% of the regions imports with other sources – mainly LNG – is a mammoth task. Russian President Putin of course knows this and has been using the threat as a weapon in its offensive against the West. The recent decision to halt deliveries from the Nord Stream I pipeline, while not surprising, is the biggest move yet by Russia to strangle the European economy in retaliation for its support for Ukraine.

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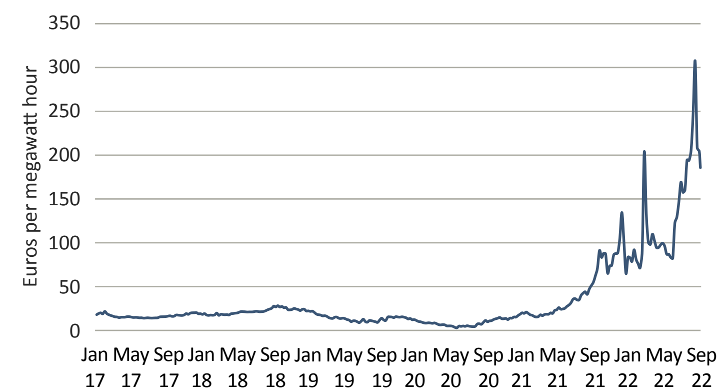
In anticipation of this move, European governments have been building up their storage gas storage levels over the course of 2022. As of last week, gas storage levels were 22% above 2021 levels. This is progress, but it is worth noting that storage levels last year were among the lowest in recent history, setting the stage for the most extraordinary price spike seen since the start of the Ukraine conflict (see figure 1). Storage alone is unlikely to be enough; demand reductions will be required. The extent of mandatory reductions in demand is impossible to predict, as it will depend on the availability of intermittent energy sources such as wind and solar over the winter period.

Figure 1. European gas prices spiked in August, but have fallen recently



Source: Bloomberg.

Preparing for the worst

European policymakers must prepare for the worst. They can do this in two ways. First, they must agree how they can capture some of the windfall gains that are being enjoyed by energy producers. Secondly, they must find ways to limit the economic impact of price rises already seen on households and businesses.

On the first issue, the outcome of the latest meeting of EU energy ministers shows how difficult this is to achieve in the context of the complexity and disparity of energy markets around Europe. At that meeting, ministers agreed that the price of gas should be capped but they were not able to agree how that cap was set. There was also a disagreement over how to cut energy demand and whether it would be mandatory.

> **€65bn**
> targeted suite of measures announced by Germany for the winter period

While discussions on energy supply must get approval at a European level, individual countries are coming up with their own solutions to ease the pain for households and consumers. Earlier in September, Germany announced a €65bn targeted suite of measures for the winter period, including increased housing allowances, benefits for students and pensioners and reductions in social security contributions. New UK Prime Minister Liz Truss took the "bazooka" out in announcing a freeze to energy bills for households over the next two winters as well as a six-month reprieve for businesses. The Irish government will announce its plans in Budget 2022 on Tuesday, 27 September.

> The ECB predicts that the euro area economy will expand by just **0.9%** in 2023 – more than one per cent lower than its June projections.

These fiscal packages will be important in limiting the economic hit due to high energy prices, but how bad might the hit be? The latest projections from this month's European Central Bank (ECB) meeting provide some guide (see figure 2). In its baseline scenario, the ECB predicts that the euro area economy will expand by just 0.9% in 2023, more than one per cent lower than its June projections. Its adverse scenario, which involves a complete shut-down of Russian gas, predicts a contraction of 0.9% in euro area GDP next year. This scenario incorporates energy prices that are 50% higher than its baseline forecast and tighter financing conditions. While some of the assumptions may appear extreme, ECB President Christine Lagarde effectively admitted that the ending of gas flows from Nord Stream I means that events are indeed moving closer to the adverse/recession scenario. Despite this admission, there seems little appetite to slow the rate of interest rate increases.

Figure 2. ECB projections for the euro area economy (%)

	Baseline forecast				Adverse scenario			
	Jun 22		Sep 22		Jun 22		Sep 22	
	2022	2023	2022	2023	2022	2023	2022	2023
GDP	2.8	2.1	3.1	0.9	1.3	-1.7	2.8	-0.9
Inflation	6.8	3.5	8.1	5.5	8	6.4	8.4	6.9

Source: Federal Reserve

Targeted response needed

It now appears unlikely that Europe can avoid a recession over the coming quarters given the combination of energy price hikes, core inflationary pressures and rising rates. Governments will be eager to ease the pain on households and businesses and may want to take a leaf out of the COVID-supports playbook. This is a very different time though, where higher energy prices are a necessary condition for reducing demand while inflation and interest rates are also very different. This requires a very different targeted response to the problem.

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