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CIO Viewpoint

Hitting the gas: avoiding a deeper European crisis

Investment Solutions

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Can Europe avoid severe energy rationing and power cuts this winter? A combination of alternatives to Russian gas imports and slowing demand mean that inventories are high. Yet the safety margin comes at a cost to governments and consumers, and is coupled with longer lifespans for coal plants and nuclear reactors. Much also depends on the severity of the continent's coldest season.

Europe faces some severe energy challenges. At the end of August, Russia halted gas deliveries through the Nord Stream 1 pipeline. European governments expect it to remain shut indefinitely. Russia stopped supplying gas through Poland in May, and another pipeline crossing Ukraine, 'Soyuz', is operating at only around 40% of capacity. Meanwhile, drought has undermined hydropower output this summer and maintenance problems with France's nuclear reactors have added to Europe's power woes.

Still, European energy policy has transformed since Russia invaded Ukraine. In 2021, the European Union imported around 155 bcm of natural gas, which supplied 24% of its energy needs, and around 40% of that was sourced from Russia. Today, the EU has nearly doubled its imports of liquefied natural gas (LNG) compared with a year ago, and has halved its dependence on Russia. It plans to cut Russian gas imports to zero by the end of 2022.

The EU now has stocks at more than 82% of capacity, equal to two months of consumption, and ahead of an 85% target for 1 November. This cushion has come at a price. The price of gas per MWh (megawatt hour) for forward contracts in Germany and France remains more than five times higher than one year ago (see chart 1).

Even if stocks prove sufficient to cover needs for this winter, the use of inventories will mean that reserves in 2023 / 2024 begin from lower levels, potentially pushing supply issues into the future. In an average winter, inventories account for as much as 30% of gas consumption in the region. Since 2014, and under better supply conditions than we can expect in the coming months, the EU has drawn down between 46 and 71 bcm of its gas in storage, the equivalent of between 18% and 54% of stocks. Avoiding the worst effects of rationing and shortages depends on warm weather, switching gas for other energies, and high prices to keep LNG imports flowing into European markets.

Stéphane Monier
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Key takeaways

- Europe has rushed to build gas inventories as supplies from Russia dwindle. Stocks stand at more than 80%, or around two-months of supply, ahead of seasonal targets
- This comes at a cost with prices at record levels. EU ministers have called for coordinated responses that will largely determine the eventual impact on GDP
- With slowing global activity, OPEC+ has trimmed oil output. We expect crude prices to remain between USD 90–100/barrel
- As high energy prices continue to fuel inflation, we see eurozone interest rates peaking at between 1.5% and 2% by end-2022.

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Preparing for the worst

Gazprom's suspension of gas flows through Nord Stream 1 is an additional shock to a euro area already facing tests as economies slow and consumers digest the impact of rising energy prices. Measures to save energy will have secondary effects on the economy by cutting industrial demand, further slowing aluminium smelting and fertilizer production, for example.

The European Commission, the EU's executive, has passed a regulation to reduce gas demand by 15% between now and March 2023 while price-sensitive European industries have already reduced demand by around 30%. Manufacturers are taking steps to save energy, and oil refineries have switched to using propane, which is derived from oil, rather than gas-generated hydrogen. The Dutch, German, French and Italian governments are working to hire floating LNG terminals that convert cargoes to gas that can be pumped through pipelines. Two such vessels moored in a Dutch port last week under a five-year contract, Bloomberg reported.

Even so, the efficiency of the EU's measures will depend on solidarity between member states and willingness to coordinate supplies. Discussions to share energy have not yet generated agreements. The German government has complained that neighbouring Belgium, Luxembourg, the Netherlands and Poland have declined to negotiate, according to news reports.

Counting costs

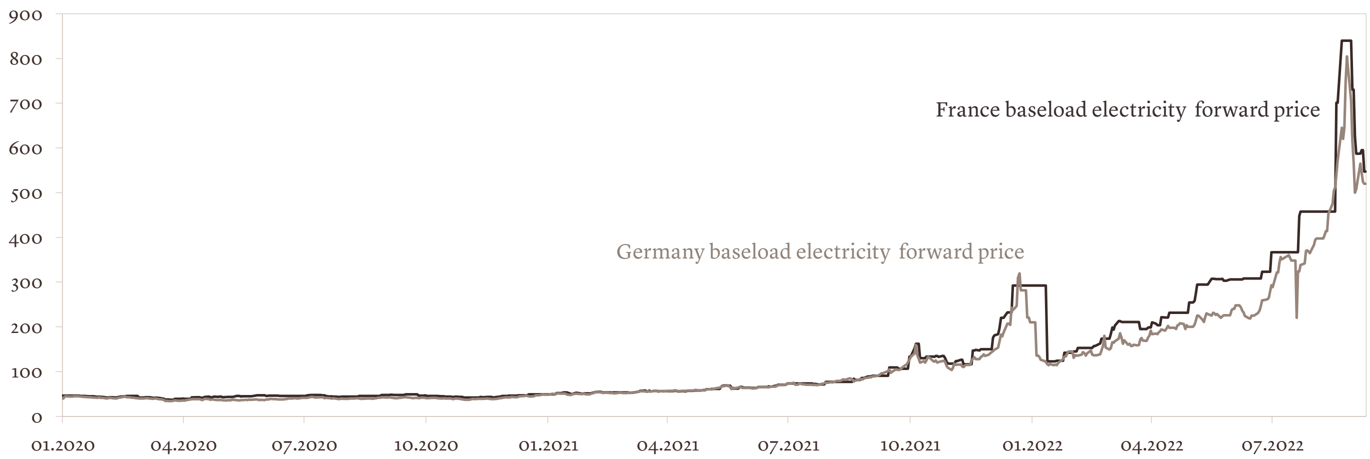
While Germany has pledged fiscal support equivalent to around 2.7% of GDP, a sizeable provision, it still pales in comparison to the 10% of GDP the country spent supporting its economy through the pandemic. The bloc's energy ministers have agreed in principle on the need to address the system of setting power prices across the region to better balance supply and demand without penalising cleaner sources. Their proposals include electricity savings, a cap on excess revenues and profits as well as state aid for utility firms.

As things stand, we anticipate a 1% decline in GDP for the eurozone in 2023, however, much depends on the severity of the winter ahead and how easy it will be to re-fill gas stocks. Some estimates suggest that a very cold winter could result in gas demand one-and-a half times higher than in than a mild season.

If the EU manages to coordinate LNG supplies, creating a cohesive approach to the market while offering households support, we estimate that the impact on GDP could vary from -1.1% in Hungary, to -0.2% in France. A fragmented approach and lack of fiscal support on the other hand could dramatically intensify the effects (see chart 2).

A further variable is the competition for LNG supplies with Asian markets, and China in particular. Unlike crude oil, the natural gas market is not global. Most of the infrastructure

1. France and Germany: baseload electricity power, one-year forward price
In EUR/MWh (Megawatt-hour)



Sources: Bloomberg, Lombard Odier calculations to deliver Russian gas still flows west, limiting the quantities that Russia can switch to deliver to China, and meaning that Asia and the EU continue to compete for shipments of LNG. Chinese natural gas imports have been rising by as much as 7 bcm per year since 2019.

Capping oil prices

Energy shocks are not limited to natural gas. In parallel with efforts to curb gas revenues paid to Russia, the G7 group of countries this month agreed to cap the price of Russian oil. The ban is designed to keep Russian oil flowing into global markets while limiting the Russian state's "ability to fund its war of aggression," according to the G7 statement.

As economies brace for the impact of recessions, as well as uncertainty over Chinese economic growth, the Organisation of Petroleum Exporting Countries, plus Russia (OPEC+) agreed last week to cut production by 100,000 barrels per day, or around 0.1% of global demand. The cartel is looking to retain some spare capacity and keep oil prices at around USD 90 to USD 100 per barrel, where we believe they are likely to stay until the end of the year, before falling in early 2023.

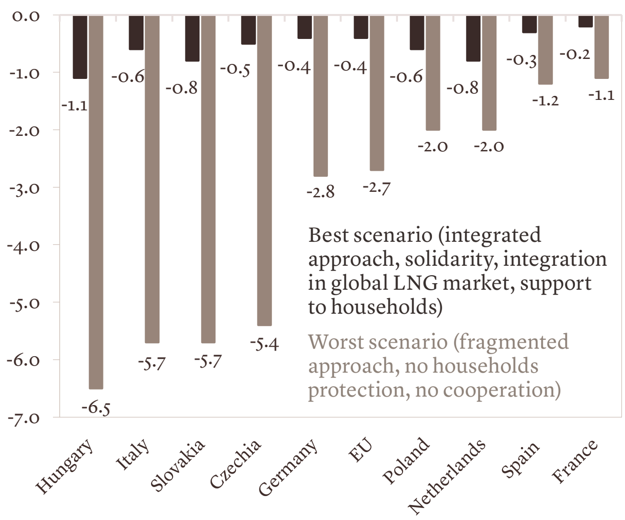
Monetary moves

Of course, higher imported energy costs are also driving inflation higher. Eurozone headline inflation rose 9.1% in August, compared with a year earlier and energy costs accounted for an estimated 38% of that increase, according to the European Commission. The euro's weakness against the US dollar is exacerbating the inflationary effect of imports. The common currency has declined nearly 18% against the dollar since January 2021.

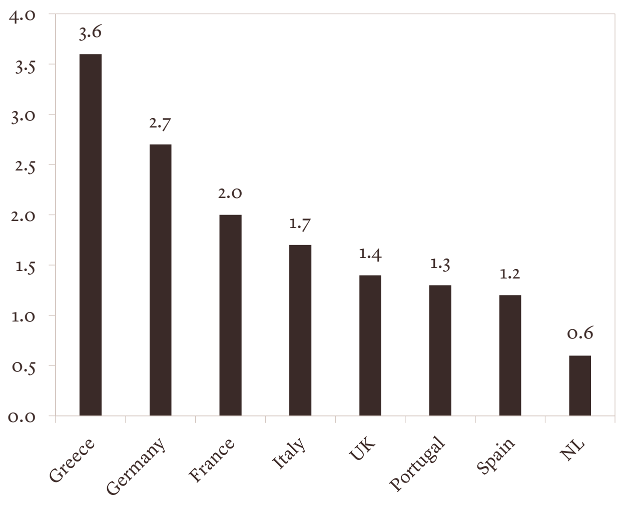
Last week the European Central Bank reacted by aggressively tightening its benchmark interest rates, by a record 75 basis points. It indicated that there will be further increases in the months ahead, although did not go as far as forecasting a recession. We see eurozone rates peaking at between 1.5% and 2% by the end of 2022 and remaining unchanged through 2023, when we expect the region's economy to expand by 0.4%.

2. The economic cost of a Russian gas freeze

GDP output losses 12 months after a theoretical Russian gas supply shut-off. By country, in %



Policy support in % 2022 GDP



Sources: International Monetary Fund, Lombard Odier calculations

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