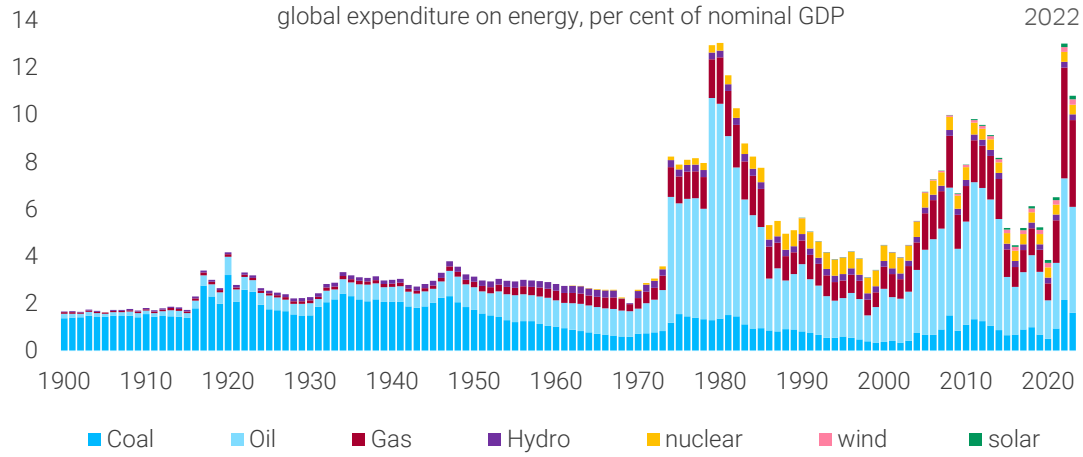
Macro Picture

THE EVERYBODY BAILOUT (2.0)

Dario Perkins

As energy costs surge, Europe faces a difficult winter – perhaps even a multi-year squeeze. Governments will intervene, through "price caps", fiscal transfers and liquidity support. Failure to act could unleash a recession like the one the authorities feared in 2020. But another economy-wide bailout could allow inflation to linger, raising terminal interest rates in Europe.

Chart 1: A global energy crisis – another eerie similarity with the 1970s



Source: Bloomberg

WINTER SQUEEZE

With Putin cutting the region's access to Russian gas, Europe is facing a difficult winter. Utility bills are set to soar, as energy providers raise their prices and seasonal demand increases. Outright shortages, power cuts and sectoral "lockdowns" are all possible. Even if there are sufficient supplies for the winter – which is uncertain – the energy squeeze could return in 2023.

ECONOMIC CRUNCH

Europe's economies are already flirting with recession, so governments are under enormous pressure to intervene. Price caps, liquidity support and big fiscal transfers seem inevitable. The authorities must support households and businesses or suffer a recession similar to the one they dodged during the pandemic. A COVID-sized crisis will bring COVID-sized policy interventions.

DOUBLE PIVOT

European central bankers have been worried about the inflationary consequences of rising energy prices, including the danger of second-round effects. Large-scale fiscal interventions could exacerbate their worries, forcing them to raise interest rates more aggressively. Europe's fiscal-monetary policy mix is shifting, with important implications – both domestic and international.

THE EVERYBODY BAILOUT (2.0)

Vladimir Putin's decision to "indefinitely" close the Nord Stream pipeline and cut off Europe's access to Russian natural gas has crystalized a major economic risk for the region, delivering what many investors have called the "doomsday scenario". While the move has not yet caused an additional surge in energy prices (from record levels), there are widespread doubts about whether Europe will have sufficient resources to make it through the winter without a serious crisis. The good news is that European governments have had time to prepare and have used the summer to stockpile inventories. LNG imports from China, the US and Qatar have helped. But there is no guarantee these resources will be sufficient, particularly if European citizens are unable to make sizeable efficiency gains – or if the weather turns especially cold. And even if the region makes it through the winter without a debilitating crunch, supply conditions will remain tight in 2023, causing a persistent (multi-year) problem. Economic pressures are building, and most European economies are already flirting with recession. As seasonal demand propels utility bills to their highest level since the 1970s, consumers and businesses must cut their discretionary spending.

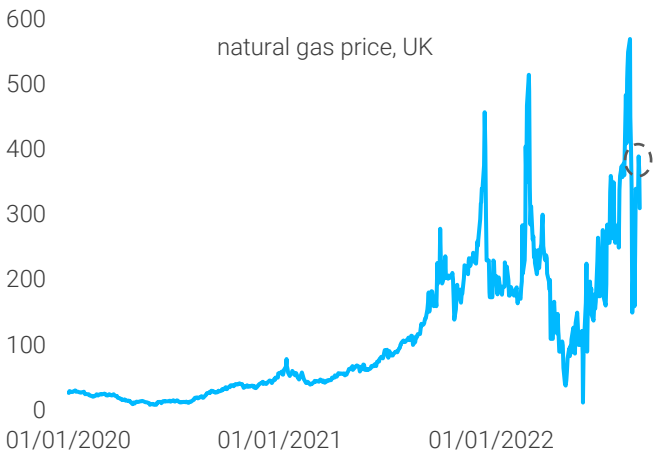
Inevitably, governments are under enormous pressure to support their economies through this difficult period. They have already announced various fiscal interventions, including liquidity provisions (for utilities companies facing extreme margin calls), income transfers, and even "price caps" on energy. The eventual bill for the public finances could be huge, with a successful intervention likely to cost at least 5% of GDP per annum (depending on what happens to energy prices). But Europe's politicians have no alternative, especially as – unlike central bankers – they will eventually be seeking re-election. Many low-income households are facing real poverty this winter, while rapidly rising input prices are set to destroy the profitability of European companies (especially the region's SMEs, which already operate on relatively thin margins). Unless governments act swiftly and decisively, they could find themselves facing an economic crisis similar to the one they successfully dodged during the pandemic: enormous strains on corporate balance sheets, which trigger a wave of bankruptcies and a sharp increase in unemployment. In short, another COVID-style economic crisis demands a COVID-sized policy response.

Europe is experiencing a classic "negative terms of trade shock": import prices are rising, currencies are weak, current-account positions are deteriorating, and real incomes are under enormous pressure. The region's central bankers are focused on the "nominal effects" of this adjustment, especially the threat of second-round effects from inflation expectations and wages. They have already raised interest rates more than most investors expected at the start of the year. The monetary authorities believe it is their job to prevent households and businesses from resisting an "inevitable" squeeze on their living standards. But governments clearly have other ideas, which means fiscal and monetary policy are now pulling in opposite directions. The net result will be a radically different policy mix compared with the pre-COVID era. Rather than engaging in a futile attempt to offset government austerity, central banks will now be battling persistent fiscal deficits and the threat of lingering inflation. Terminal interest rates will drift higher. There will also be knock-on effects from Europe's energy crisis to the rest of the world, particularly if supply shortages in Europe lead to further spikes in global food and commodity prices. Even if Europe avoids energy "lockdowns", other parts of the world – particularly poorer countries – may not be so lucky. Central banks everywhere are likely to maintain their hawkishness, at least through the winter, dashing market hopes for a "dovish monetary pivot".

1. WINTER SQUEEZE

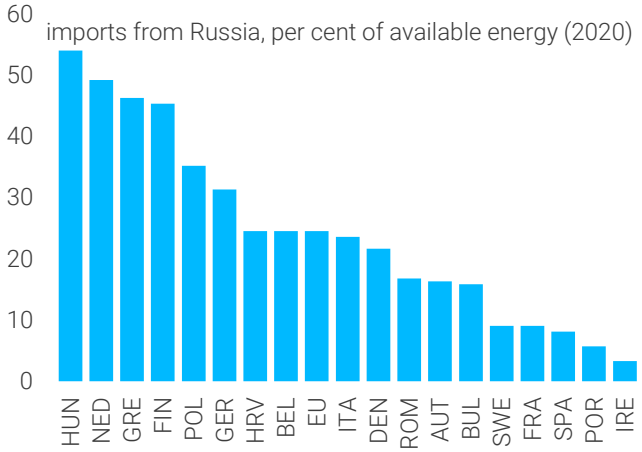
Every macro forecast for Europe – and, indeed, most recent projections for the wider global economy – has included some variant of the phrase "assuming Europe's energy crisis doesn't get materially worse". This assumption was crucial for maintaining even a mildly constructive view on the region because it meant Europe would be able to make it through the winter without a serious economic crisis. So, Vladimir Putin's decision to "indefinitely" close the Nord Stream pipeline, in effect cutting off the region's access to Russian natural gas, crystalizes a major economic risk. As a result, we have entered a situation which, six months ago, investors were calling the "doomsday scenario", a crisis that could bring sharply higher energy prices, winter blackouts/ energy rationing and a deep recession for the European economies. As Charts 4 and 5 show, Russia's (increasingly intermittent) flow of gas has now stopped almost completely.

Chart 2: New regime for energy prices



Source: Datastream

Chart 3: Europe was vulnerable

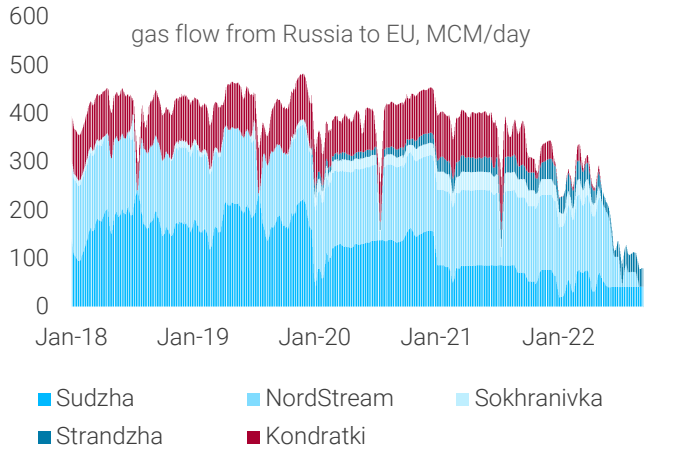


Sources: Eurostat, TS Lombard.

Energy shortages in Europe?

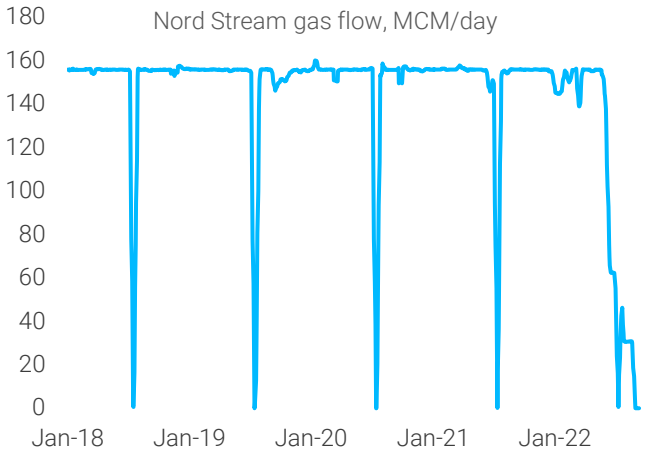
The good news is that Europe is in a better position today than it would have been six months ago to face the "doomsday scenario". After ratcheting up imports from elsewhere (namely LNG from China, Qatar and the US), governments have been stockpiling resources in preparation for a difficult winter. Charts 5 and 6 show inventories of natural gas have reached healthy levels, beyond the usual summer stockpiling. It is also reassuring that, despite the latest escalation in the energy-supply crisis, prices have not surged to fresh highs. But make no mistake, the situation in Europe remains extremely precarious. Supply conditions are tight, and wholesale prices remain at several multiples of 2019 levels (the equivalent of 400 $/bbl oil). Without Russian gas, Europe will need a reduction in energy demand of at least 15-20% based on average temperatures. If the weather turns colder than normal, further reductions will be necessary. It is worth noting that Europe's previous big energy crisis, which occurred during the 1970s, happened against the backdrop of particularly cold winters – another example of the horrible luck policymakers had during the Great Inflation. Recent winters have been mild, but this is hardly a source of comfort. And even if Europe avoids a genuine supply crunch, it will be difficult to rebuild inventories in 2023. It is possible that the current squeeze on the economy will part of a multi-year problem.

Chart 4: Putin turns off Russian gas



Sources: Bloomberg, TS Lombard.

Chart 5: Nord Stream supply has stopped



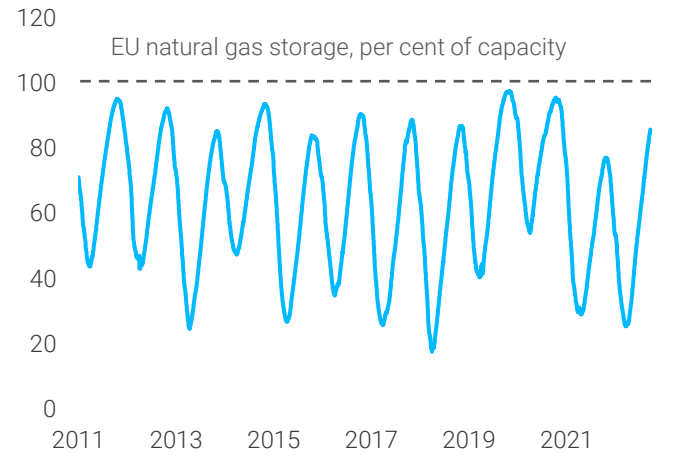
Sources: Bloomberg, TS Lombard.

Recessionary pressures build

The economic outlook in Europe was turning sour even before Putin's energy blockade. Leading indicators had deteriorated sharply, and parts of the region were already flirting with recession. While this is partly the result of a "fake" bullwhip recession in manufacturing – common to many other parts of the world – it also reflects a particularly powerful squeeze on real incomes. Inflation, largely imported from elsewhere, has comfortably outstripped modest nominal wage gains, which means the purchasing power of European citizens has rapidly dwindled. Of course, many other parts of the world are suffering from extreme levels of inflation, but in Europe – unlike in the US – it is hard to blame this on "excessive" spending or "overheating". There has been no domestic boom. Europe is sharing the inflationary hangover, without ever attending the party.

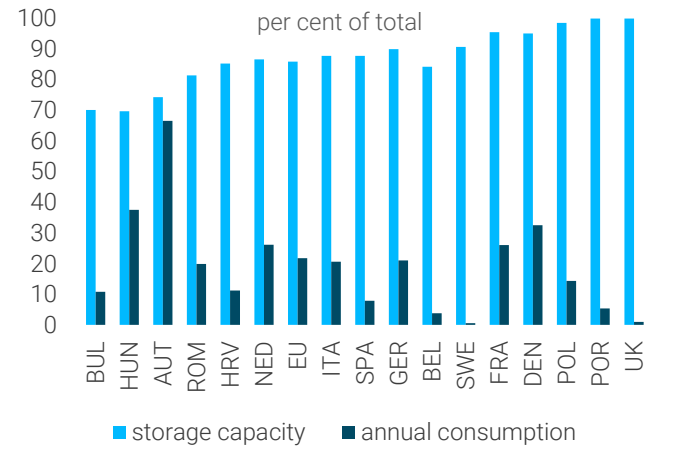
As we head into the winter, the squeeze on Europe's economies is likely to get materially worse. On some measures, such as the share of energy consumption in nominal GDP, the situation is already as bad as in the 1970s. Even if there is no further rise in energy prices, which remains highly uncertain, seasonal increases in demand will inevitably increase the economic burden of this crisis. The average household, for example, consumes around 80% of its total annual gas demand between October and March (Chart 8). And with temporary prices caps and fixed-term contracts in place in some jurisdictions, the 2022 spike in prices has yet been passed in full to

Chart 6: Europe has rebuilt inventories…



Source: Aggregated Gas Storage Inventory (AGSI database).

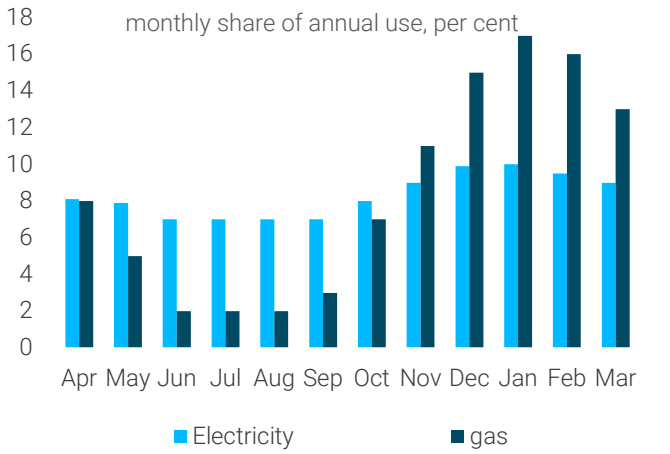
Chart 7: …but supply problems are likely to linger



Source: Aggregated Gas Storage Inventory (AGSI database).

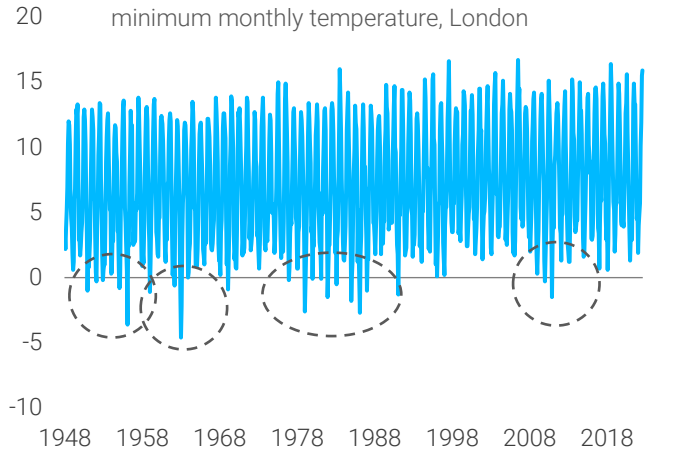
end users, which is another reason to think the pain will get worse. Many businesses and households are facing a doubling of their utility bills (if not more), which will naturally crowd out other forms of spending. This could trigger a broad economic contraction, even in the absence of government "lockdowns" of specific economic sectors and restrictions on energy use.

Chart 8: 80% of gas demand happens in winter



Source: Resolution Foundation.

Chart 9: The 1970s had harsh winters

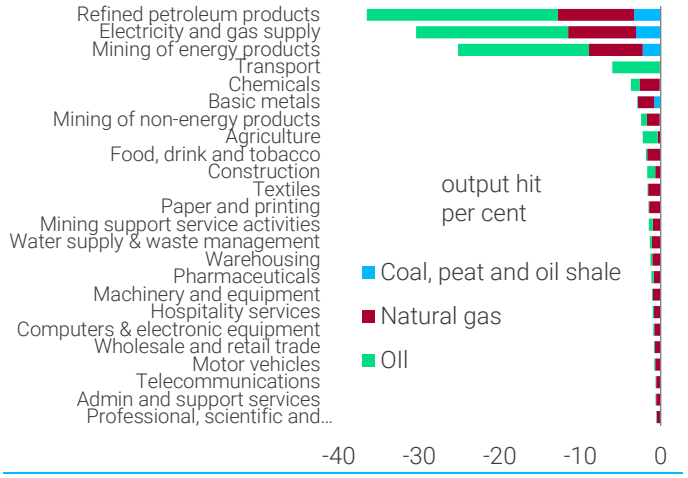


Source: UK Met Office, temperatures at Heathrow airport.

Energy 'lockdowns'

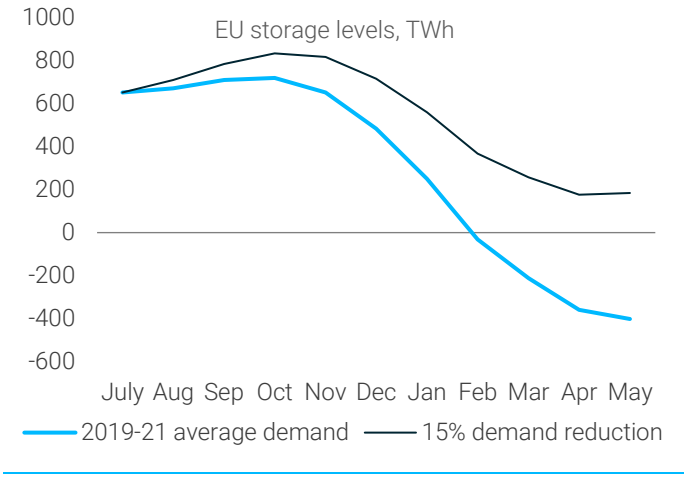
Naturally, in a situation where governments have to forcefully lockdown specific sectors of the economy or restrict energy use at certain times, the economic hit to the European economies will be even greater. The OECD used input-output tables, which track the interlinkages between different parts of the economy, to estimate a 3% decline in European output from the total loss of Russian natural gas and oil. Some sectors, such as mining, transport and chemicals production, are likely to suffer much larger declines (Chart 10). The OECD's study is now somewhat out of date as their economists published their findings in June; but those findings are broadly consistent with results from other sources, including the Bundesbank and the Bank of France.

Chart 10: Sectoral hit from total Russia embargo



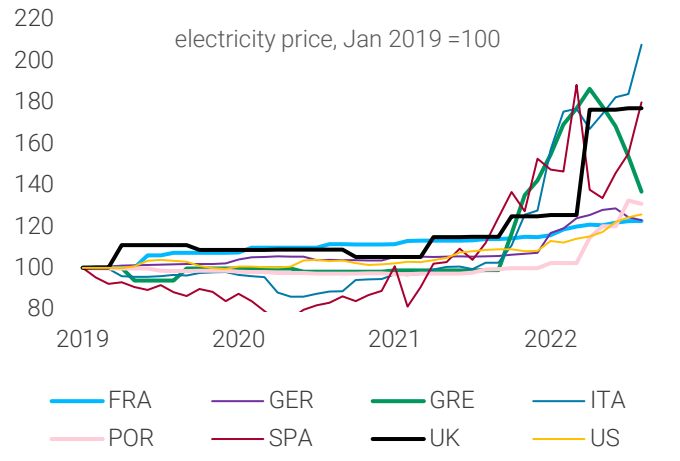
Source: OECD Economic Outlook, summer 2022.

Chart 11: Europe needs big demand reduction



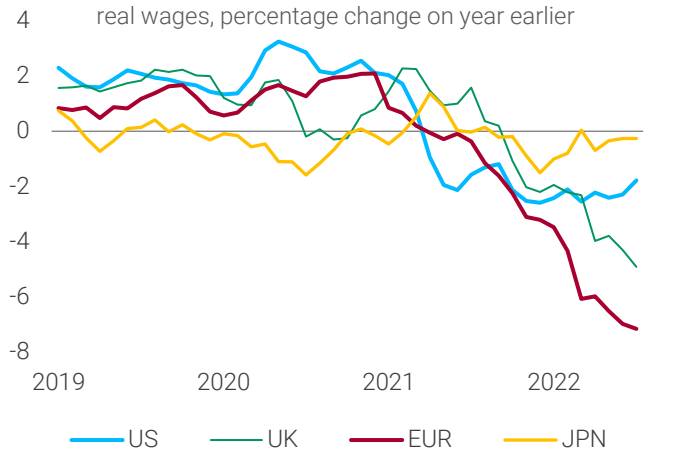
Source: Bruegel 2022 (link here).

Chart 12: The squeeze is set to continue



Source: Eurostat based on CPI data.

Chart 13: Full-blown cost of living crisis

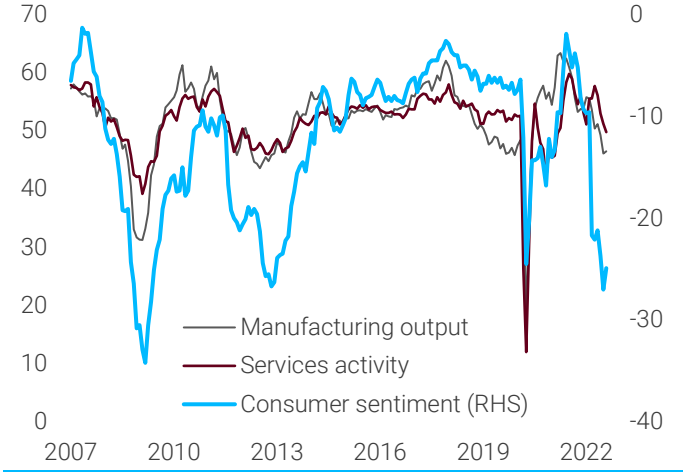


Source: TS Lombard estimates based on national data.

2. ECONOMIC CRUNCH

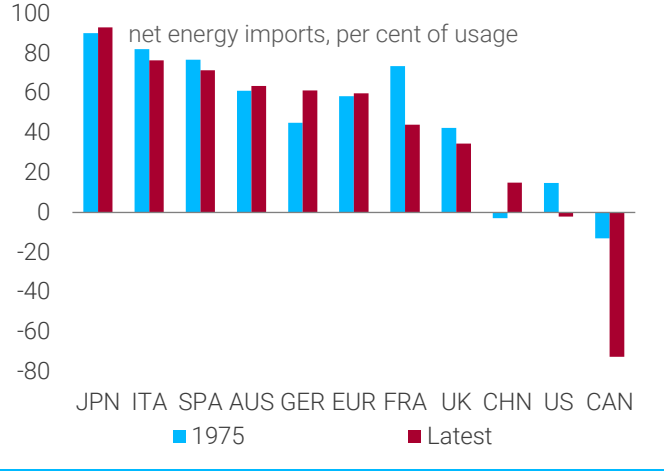
As the economic outlook darkens, governments across the continent are under enormous pressure to support their economies through what is likely to be a difficult winter. Some governments have already announced a range of fiscal measures, including liquidity support to utility providers, fiscal transfers to households and businesses, and even blanket "price caps" on the retail cost of electricity. Further action seems inevitable. Though the ultimate cost to the public finances could be considerable, politicians – who unlike central bankers will be seeking re-election – clearly feel they have no alternative. Indeed, a failure to act decisively could result in an economic crisis not unlike the one Europe managed to dodge during COVID-19. If policymakers allow widespread bankruptcies to occur, leading to sharply higher unemployment, they could find themselves facing a deep and protected economic slump – exactly what they feared in 2020.

Chart 14: Europe on the brink of recession



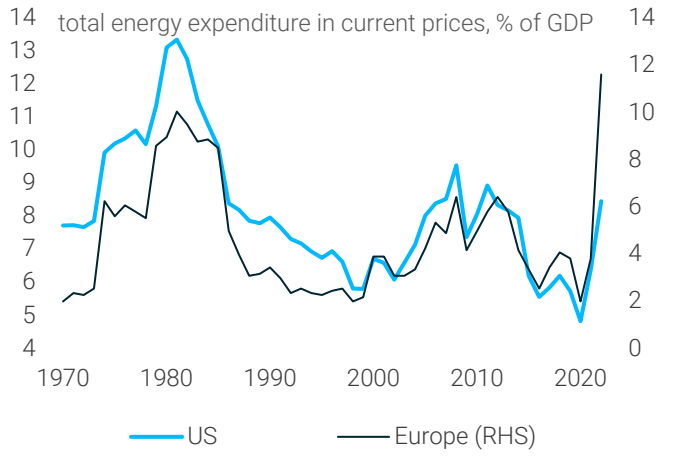
Sources: Markit, EC.

Chart 15: Energy importers will suffer most



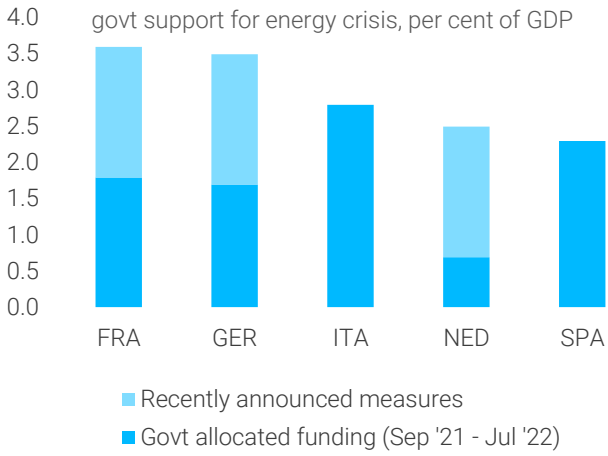
Sources: World Bank, TS Lombard.

Chart 16: Energy crisis as bad as the 1970s



Sources: EIA, BlackRock data for EU, TS Lombard.

Chart 17: Current support programmes not enough



Sources: Bruegel, TS Lombard.

The policy response

There is currently a lively debate about whether, and by what means, European governments should support their economies through the "cost of living crisis". Bruegel, the economic think tank, provides a helpful database covering most of the initiatives up to August; however, owing to the scale and pace of recent announcements, their analysis is already a little out of date. The total cost to the public finances is likely to balloon as the economic situation deteriorates and politicians become more desperate. In broad terms, there will be three forms of policy measure:

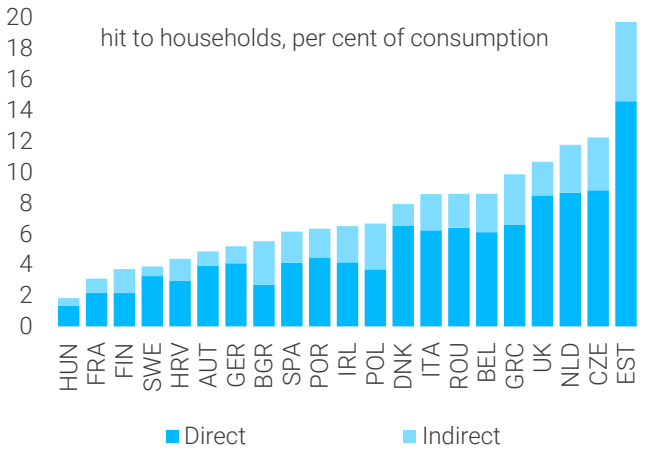
(i) Liquidity support for energy companies: Once again, there is a lot of chatter about a potential "Lehman moment" among European energy providers. Power generators usually hedge their sales to households and businesses by taking short positions in future markets before selling the physical electricity. In normal times, if electricity prices rise, the money they lose on their paper positions is offset by their gains in the physical market and vice versa. But the sheer scale of recent market moves means many of their hedges — often for electricity sold months or years in advance — are deep underwater, requiring them to post more and more cash to exchanges, even if the positions ultimately turn profitable once the electricity is sold. The worry is that utility companies will not have the liquidity to honour their margin calls, which could lead to bankruptcies and perhaps even financial instability – with risks to Europe's banking system. Policymakers are aware of this risk and will surely address it.

(ii) Price caps on energy costs: Many governments already impose restrictions on what energy companies can charge businesses and households. Usually, these caps are temporary, which means prices are set to ratchet higher during the winter. But the authorities in some countries – including the UK and France – have said they will extend these restrictions, at relatively low levels, in effect absorbing the difference between current wholesale and retail prices in their public finances. In principle, price caps could completely shield the economy from the impact of the energy squeeze, at least for a while. But they have major drawbacks, including the incentives they create and the extremely high cost to the public finances.

(iii) Fiscal transfers: Government price caps protect the private sector by blunting market forces and preventing the "price signal" from working. An alternative approach is to allow energy providers to raise their prices in full and then cushion the blow by

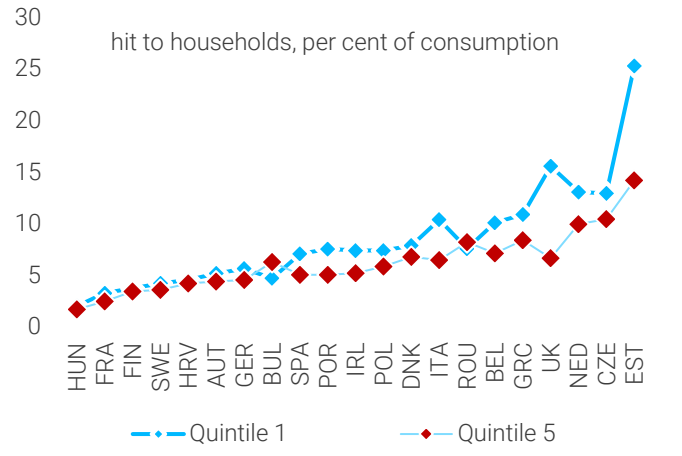
providing fiscal transfers (or loans) to those businesses and households that face acute financial difficulty as a result of their higher utility bills. The advantage of fiscal transfers is that they can be targeted at those parts of the economy that look most vulnerable, such as low-income earners, people on fixed incomes (such as pensioners) and SMEs (the companies most at risk of bankruptcy). As a result, the overall cost to the public finances will be much smaller than with a blanket price cap.

Chart 18: IMF estimates household hit



Source: IMF study, July 2022.

Chart 19: Energy impact is highly regressive



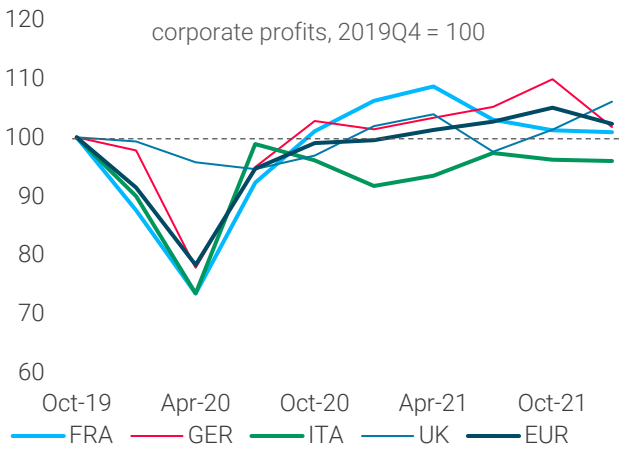
Source: IMF study, July 2022.

Energy transmission

To understand whether these measures will be effective – and to compare their relative impact – it is helpful to think through the "transmission mechanism" from higher energy costs. Let's start with a shock to global energy prices. In aggregate, countries that import their energy are at an immediate disadvantage compared with those that have their own domestic energy sources. The US, which is now a net energy exporter, will certainly experience an internal redistribution of income –for example, from households to energy providers – but there is no aggregate economic hit. Consumers spend more on their utility bills, while the domestic energy sector becomes more profitable (and may even recycle those resources back into the economy via capex and employment). In Europe, on the other hand, because most companies are large net importers of gas and oil, there is no escaping an overall deterioration in living standards. The only question is how to distribute the pain. (In fact, it is slightly more complicated in Europe because electricity prices are based on the most expensive marginal energy source – natural gas. As gas prices have risen, non-gas energy providers secured a revenue windfall, which governments are now planning to confiscate through higher taxes.)

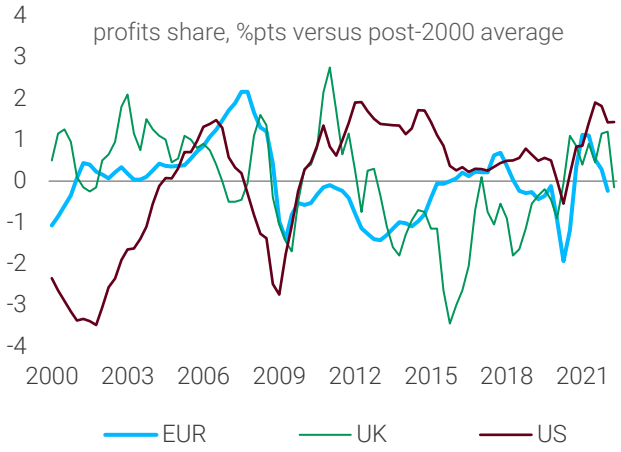
The basic point is that without government intervention, European utility providers have no choice but to raise their prices for consumers. And this will reduce the real incomes of businesses and households in two ways: (i) the "direct" effect of higher energy bills; and (ii) an "indirect" effect that comes from higher energy costs feeding through to all other goods and services that use energy as a component. It is difficult to say how large this squeeze will be, because it depends on both the evolution of prices and the amount of energy pass-through. But recent analysis from the IMF suggests the impact on household incomes will be large. Based on data until July, IMF staff estimated a large decline in household purchasing power, with significant variation across countries. The impact is also highly regressive, hitting low-income earners especially hard (Chart 19). In the UK, for example, the IMF's calculations show that bottom-quintile wage earners will experience a hit roughly double that of the top quintile.

Chart 20: No European profits boom



Sources: Eurostat, TS Lombard.

Chart 21: Margins under pressure already

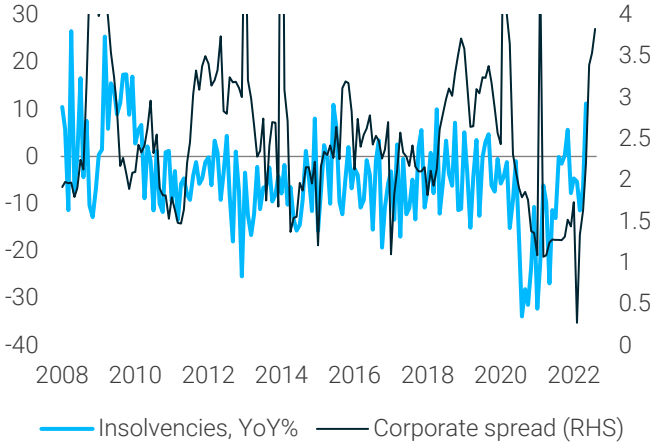


Sources: BEA, Eurostat, TS Lombard.

Stress in the corporate sector

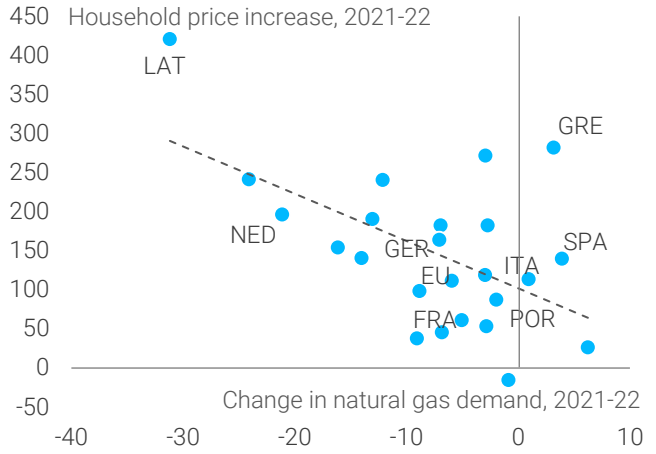
It is inevitable that most of the public debate has been about the pain the energy crisis will inflict on households, especially low-income earners. But the impact on the corporate sector could be devastating, too, particularly given the dominance of SMEs in Europe. European companies are facing a massive shock to their operating costs, which – unless they can pass this onto their customers – will destroy their profitability. Margins are already under pressure, another notable contrast with what has been happening in the US this year (Chart 21). The risk is that as profitability evaporates, the stress on corporate balance sheets will increase, leading to widespread bankruptcies and defaults. Unemployment would undoubtedly increase, perhaps markedly. Ultimately, Europe could end up with an economic crisis similar to the one the region faced – but successfully dodged – during the pandemic. Back in 2020, policymakers halted the credit cycle by "socializing" the corporate sector's main cost – its wage bill – through state furloughs. To halt the credit cycle this time around, governments will probably need to "socialize" Europe's enormous energy bill.

Chart 22: German bankruptcies set to rise?



Sources: Bundesbank, TS Lombard.

Chart 23: Price caps provide bad incentives?

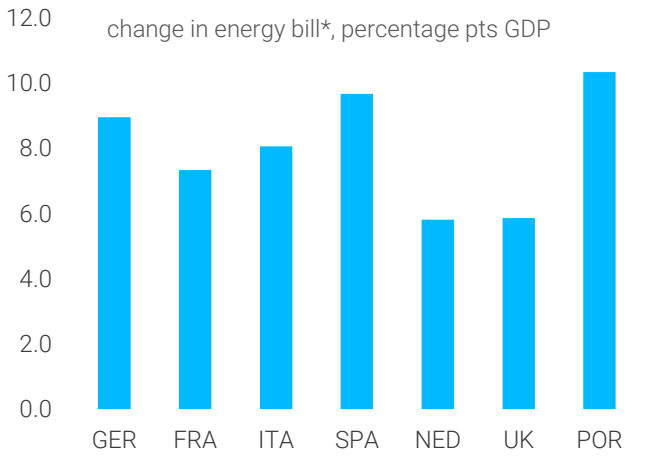


Source: Bruegel Institute.

Fiscal transfers vs price caps

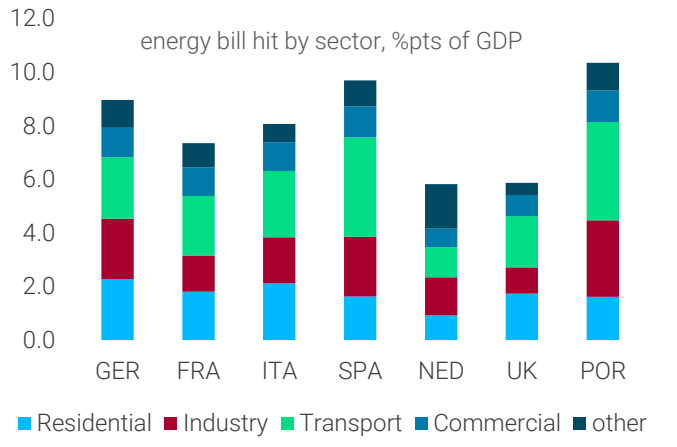
Given the risks associated with inaction, Europe's politicians have no choice but to intervene in the energy crisis. The only question is whether this intervention should take the form of fiscal transfers or blanket "price caps". At one extreme, the UK's new two-year price cap is obviously highly controversial. Some economists, such as Martin Wolf and Isabella Weber, have endorsed the scheme, pointing out that we are in an extreme "wartime" situation. Indeed, there are plenty of examples of similar interventions in the past, most notably during WW2. When a military conflict impairs supply and prices cannot reflect their "true fundamentals" (whatever that means), there is a strong case for government intervention. Yet, as we explained in a previous Macro Picture, the evidence on the effectiveness of these measures is often pretty underwhelming. And in the current situation, it is even possible that capping utility prices will backfire, especially if it dampens the incentive to reduce overall energy consumption. Chart 23 shows that those countries that have supressed utilities prices in 2022 have been the least successful in encouraging people to look for energy efficiencies – a result that is consistent with recent academic studies[1]. Since there is no guarantee that supply conditions will ever return to their pre-war norms, Europe may have to accept permanently higher energy costs. Trying to supress market forces would be extremely costly in the short term and might only delay the full inflationary consequences of this crisis – similar to what happened when President Nixon deployed strict price controls in the 1970s.

Chart 24: Energy bill without urgent govt action



Sources: IEA, Eurostat, TS Lombard, *assumes uniform 2.5x price hike.

Chart 25: All sectors will suffer this winter



Sources: IEA, Eurostat, TS Lombard, *assumes uniform 2.5x price hike.

3. NEW POLICY MIX

Europe is facing a difficult crisis and governments will be forced to do more – probably a lot more – to prevent a nasty economic slump. Yet the response from Europe's politicians seems radically at odds with the approach the region's central bankers have been taking. Where politicians see a "cost of living crisis", the monetary authorities see only extremely high inflation. And inflation at

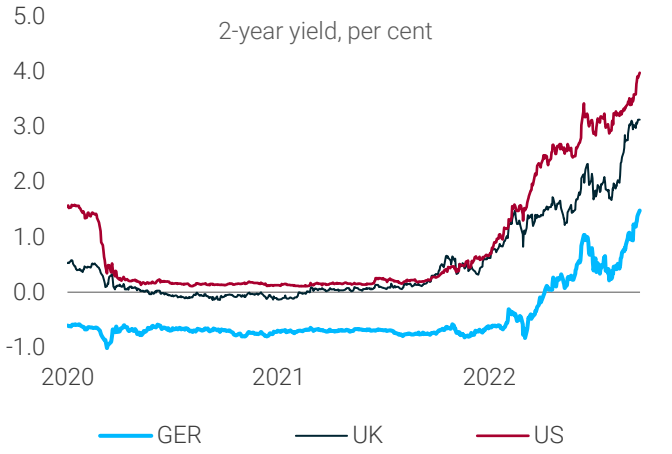
[1] The standard textbook view is that energy demand is famously "inelastic", that is, unresponsive to changes in prices. Yet recent evidence based on micro econometric analysis suggests this is not true. For example, one study that looked at daily credit-card transactions across US cities found that a 10% rise in petrol prices typically reduced fuel consumption by around 3%. Another found that a 10% hike in natural gas prices cut the energy consumption of households in California by around 2%, with larger effects (4%) during the winter.

these levels demands tighter monetary policy, which is why the region's central bankers have been raising interest rates rapidly, regardless of the additional pain they know this will inflict on many households and businesses. In the case of the Bank of England, officials clearly believe a recession is inevitable, perhaps even desirable. (ECB officials seem to be in denial about the true direction of the economy, or do not want to admit the scale of the crisis.) So, we have the start of a major "tug of war" between fiscal and monetary policy. And with both the two main levers of macro policy pivoting 180 degrees compared with the 2010s, this is a massive shift for investors.

The central banker view

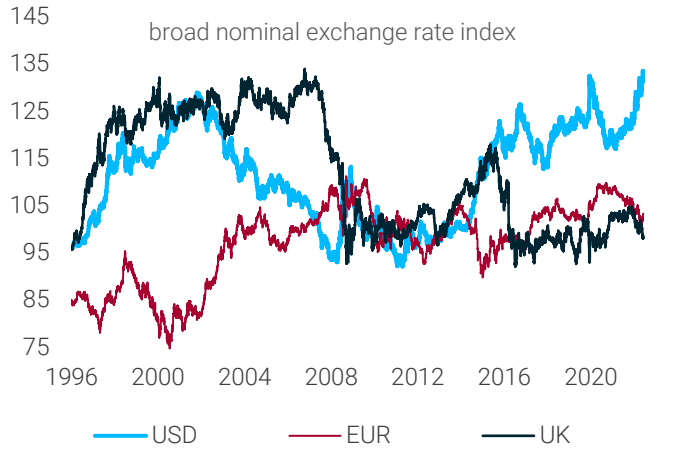
Central bankers in Europe have been surprisingly relaxed about the impact of the energy crisis on the region's economic growth. Sure, they expect some pain, but they seem to believe there is no way to avoid this squeeze. Europe, in their view, is experiencing a permanent "terms of trade shock", which will necessarily raise their import bill (worsening the current-account position), increase the price level and permanently reduce real incomes. In short, this is a "real" economic shock – a deterioration in potential output – and living standards must go down. Monetary policy cannot prevent these effects. In fact, the monetary authorities believe it is their job to ensure that households and businesses do not try to resist the adjustment. So, they want to avoid "second-round" effects, by preventing workers from securing higher wages or companies from protecting their margins. Europe's central banks are interested only in the inflationary consequences of the energy crisis, not its impact on GDP or unemployment. They are desperate to avoid a repeat of what happened in the 1970s, when a similar energy crisis triggered persistent wage-price spirals.

Chart 26: European rates chasing US rates higher



Source: Datastream.

Chart 27: Euro and sterling under pressure



Source: BIS exchange rates.

Policy tug of war

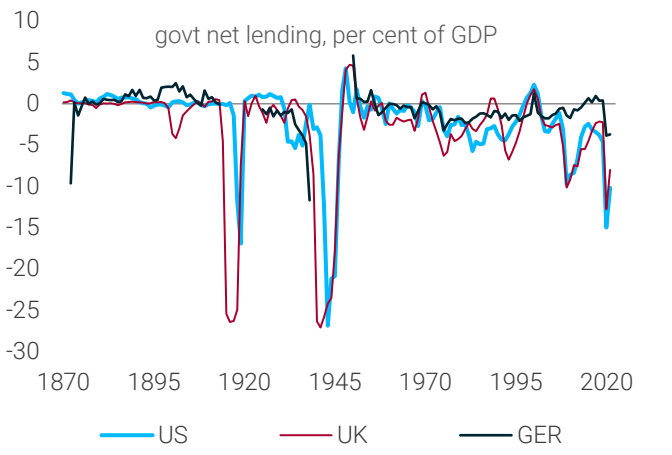
Naturally, a large fiscal expansion runs directly against the philosophy of Europe's monetary guardians. Governments are, in effect, trying to shield the economy from an adjustment that central banks say is inevitable. But is the public sector's response to the energy crunch necessarily inflationary? The answer depends on the persistence of the shock. If energy prices quickly return to their pre-2022 levels – or governments withdraw their support quickly – governments will have delivered a one-off increase in public debt, which is not likely to generate persistent inflation. Problems arise, however, if the energy crisis lingers. Wholesale energy prices could remain high in 2023 and possibly beyond, which would make it extremely hard for governments to reduce their support to households and businesses. Instead, the public sector would be under enormous pressure to continue to subsidize private living standards, leading to

large, persistent deficits and higher medium-term inflation. Throw in periodic energy blackouts and sectoral lockdowns and we could face another COVID-style dynamic, where governments are simultaneously supporting incomes and restricting supply. Central banks would not be happy, especially as the longer inflation stays high, the greater the risk of "de-anchoring" expectations.

Terminal rates higher

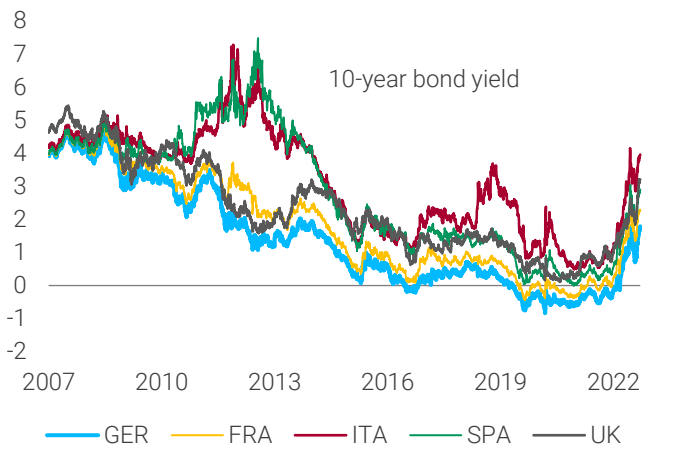
Back in the spring, we had serious doubts about how far Europe's central banks would get with their monetary tightening. By responding to an inflation problem that was largely imported from the rest of the world, it seemed the authorities were making "Trichet-style" policy errors. But with governments set to unleash a massive fiscal response, the odds of central banks having to immediately reverse course (back to ZIRP and QE) have now diminished. Europe's overall policy mix has shifted in a decisive way, which, in turn, should raise the "terminal rate" on interest rates. We are now in a situation that looks radically different from what happened after the global financial crisis, when central banks were engaged in a futile attempt to offset the effects of government austerity. Back then, the combination of tight fiscal policy and easy monetary policy was deeply disinflationary, a major contributor to global secular stagnation and one of the main reasons long-term interest rates eventually plunged to 800-year lows. By contrast, this new policy mix is likely to be inflationary and will contribute to a secular rise in bond yields during the 2020s. The basic task of monetary policy is changing, and a new "supercycle" is now taking shape.

Chart 28: Deficits to stay high in Europe



Sources: MacroHistory, OECD, TS Lombard.

Chart 29: Risk of a new euro crisis?

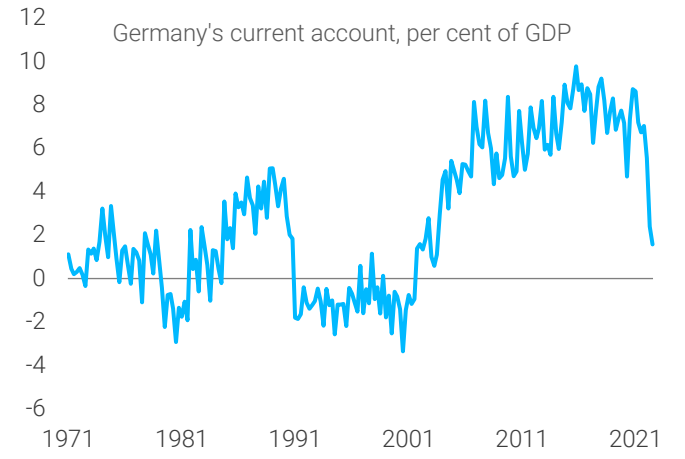


Source: Datastream.

Global spillovers

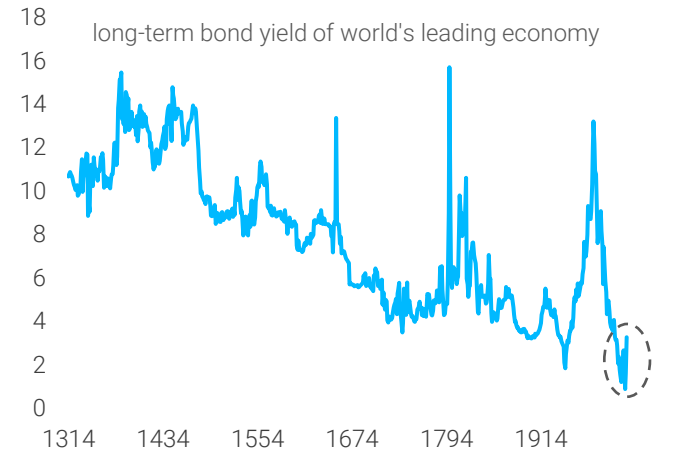
What does Europe's energy crisis mean for the rest of the world? As we have seen, countries with a strong degree of energy independence – such as the US – are less exposed to the direct consequences of the crisis. While the aggregate energy bill has increased in the US, it has clearly decoupled from the situation in Europe and remains well below the level seen in the 1970s (Chart 16). But big energy importers, particularly in the developing world, are in a far more precarious situation. The immediate risk is that shortages during the winter will force European suppliers to bid up the price of LNG and other energy resources in global markets, which would have serious knock-on effects elsewhere. Countries such as Pakistan are already struggling to secure supplies of NLG and others that subsidize energy consumption, such as Sri Lanka, are experiencing massive strains on the public finances, which have forced them to jack up prices for some of the world's poorest energy users. Even if Europe avoids energy rationing and blackouts this winter, other countries – especially in the developing world – may not be so fortunate.

Chart 30: Germany's terms of trade shock



Sources: Bundesbank, OECD, TS Lombard.

Chart 31: End of a deflationary policy mix



Sources: Bank of England, TS Lombard.

There is also a trickier question about what the energy crisis means for FX markets. European exchange rates have been under enormous pressure in 2022, which is a natural consequence of the terms of trade shock. If imported energy costs remain at these levels indefinitely, current-account positions in Europe will deteriorate. Germany's massive trade surplus has already evaporated (Chart 30). By raising terminal rates in Europe, governments' fiscal interventions could help central banks to contain the recent slide in their currencies (which – depending on China's response – could take some of the heat out of the US dollar). But the medium-term consequences are less obvious. The combination of larger fiscal deficits and higher interest rates is potentially bad news for the public finances; and in the case of the euro area – where ECB hawkishness is causing periphery spreads to widen – there are obvious question marks about the sustainability of these policies. Our next Macro Picture will look in more detail at DM public finances, an issue that is now returning as a source of concern among institutional investors.

Bottom line

Putin's blockade of Russian natural gas has crystalized a major risk for the European economies. Utility bills were always set to balloon during the winter, but now there is an additional threat posed by acute energy shortages. The seriousness of the situation will depend on forces largely outside policymakers' control – namely, winter temperatures and the ability of the private sector to reduce its energy consumption. Without Russian gas, Europe needs to consume 15-20% less energy. Unfortunately, even if Europe avoids blackouts and partial lockdowns, supply conditions are set to remain tight through 2023, producing a multi-year crunch. Governments are, of course, under enormous pressure to address the situation, which is why they are scrambling to provide liquidity to utility companies, send cash to households and businesses, and even cap retail energy costs. The cost to the public finances is likely to be huge (at least 5% of GDP per annum), several multiples of what governments have announced so far. Yet it is not clear the authorities can avoid these actions. Without a massive support programme, Europe faces an economic crisis as bad as the one the region successfully dodged in 2020, at the start of the COVID pandemic: households would slash their discretionary spending and many companies – particularly SMEs – would face bankruptcy. Inevitably, a large easing in fiscal policy complicates the task of central banks, which are focused on the inflationary consequences of the crisis. "Terminal rates" would drift higher, allowing the ECB and the BoE to continue raising interest rates to levels that seemed unthinkable less than six months ago. Europe's "policy mix" is shifting in a decisive way, which is another reason to think the long macro "supercycle" has reached a major inflection point.