Exchanges at Goldman Sachs

Europe's Energy Crisis: End in sight or far from over?

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Allison Nathan: Is the end of Europe's energy crisis in sight? Or is it far from over?

Samantha Dart: Our view is that Europe can get through without blackouts, without huge issues, again, because of how much storage was built. The problem is we get to the other side of this winter, and we have to do it all over again.

Allison Nathan: I'm Allison Nathan, and this is Exchanges at Goldman Sachs.

Plentiful natural gas supplies and warm weather across Europe are creating optimism that the continent may be able to avoid shortages and blackouts this winter. Is that optimism premature? Joining me today to discuss the state of Europe's energy crisis and its impact on the broader European economy are my colleges in Goldman Sachs Research, Samantha Dart, a senior energy strategist who focuses on the natural gas markets, and Jari Stehn, our chief European economist. Sam, Jari, welcome back to the program.

Samantha Dart: Thanks for having us.

Jari Stehn: Hi, Allison.

Allison Nathan: So let's start with the implementation of a price cap on Russian oil, which is set to begin in early December. Sam, what exactly is set to happen? And what effect will that have on global prices?

Samantha Dart: So at first, the price cap announcement sort of surprised us a bit because Europe had already decided that it would block all Russian product flow into Europe in the first place. So why would you cap a price of something you're not buying, right? But the price cap is actually to be imposed on third parties buying Russian oil and products. So the idea is that, for

European companies to offer financial services and insurance for those tankers full of Russian oil to be delivered elsewhere, it would need to be sold at a certain price cap or below. So that's the idea, to reduce Russian revenue in the volumes that they would sell elsewhere.

Now, we haven't really put a lot of weight on that price cap itself, the starting prices too much, because one of the issues that we see is that this measure is supposedly not going to be fully enforced. They only require an attestation that this is being followed. So it's not very clear how it's going to play out in practice. And not only that, there are some other suppliers of insurance, so part of that volume can be delivered anyways without the European insurance attached to it. So what we're most focused on is really the ban of Russian volumes to be sold in Europe.

I think the bottom line is that we're going to see a lot of Russian oil and products having to be diverted from Europe into Asia. And when that happens, you always have inefficiencies. You always lose volume. And that's the problem because, effectively, you're reducing the total of the ability of oil in the market. And that's one of the reasons why we expect brand prices to actually reach $115 a barrel by early next year versus a little over $90 right now.

Allison Nathan: But it wasn't that long ago that politicians, business leaders, people watching these markets closely were predicting a pretty devastating energy crisis that would push Europe into recession, deep recession. But so far it seems like Europe's getting a little bit of a reprieve. So tell us about how things have evolved recently that might take an edge off of some of that risk.

Samantha Dart: Sure. So I think what we need to remember is that, when you have a deficit in supply of this magnitude, right? I mean, normally Russia would cover for 20% of winter consumption of natural gas in Europe. So all of a sudden, you don't have that gas. What do you do? Well, you need to make sure that you fill enough storage in the summer so that you have that gas available in winter. So because of that, all of the price spikes we've seen take place in summer, all of the effort to, let's say, reduce demand and attract liquefied natural gas imports into Europe, all of that playing out in summer. And that has worked. So we're entering winter with a lot of storage in place so that Europe can actually withstand a bigger-than-normal deficit in winter. And this allows prices to move lower.

Now, on top of that -- and this should be mentioned -- we've not only had normal weather, but we've had mild weather. So this exacerbated this process, and it made the start of winter even easier for Europe because, not only is there a lot of storage in percale, but consumption for heating purposes is also a lot lower than normal because it's mild.

Allison Nathan: And so is it safe to say that we're out of the woods, and that Europe's energy crisis is at an end? Or what are the risks to your forecast heading into 2023?

Samantha Dart: No, I would not say that. So still, for this winter, yes, our view is that Europe can get through without blackouts, without huge issues, again, because of how much storage was built. The problem is we get to the other side of this winter, and we have to do it all over again. We have to rebuild storage, and this is going to take, again, price-driven demand destruction. And also, in terms of imports, to get all that liquefied natural gas, all that LNG, Europe had to price higher than everybody else in the world, so it's still a price-driven mechanism to solve the problem in summer. We think this is still going to play out next summer and even summer of 2024.

Allison Nathan: And what I'm hearing from you say is essentially this is not a temporary problem. That we don't expect supplies from Russia to return to the market anytime soon, if at all, so this is going to be an ongoing problem.

Samantha Dart: That's right. Which suggests that the only sustainable solution to this problem is when Europe can get its hands on additional global supply of natural gas. There are several projects being built as we speak that will supply liquefied natural gas globally. The problem is all of these projects, they are set to come online only from 2025 into 2026. So it's going to be a couple more years of pretty big challenges for Europe.

Allison Nathan: And so even with the sharp decline in natural gas prices in Europe, we're still euro area inflation supplies into the upside. Jari, how have falling gas prices affected overall inflation levels in Europe? And why are we still seeing high inflation?

Jari Stehn: Yeah, I think it's because you still have a lot of pent up pressures in the system here. And of course, gas prices have fallen, but gas prices are still much higher than they were before the war. And the increase in gas price is really the key reason why inflation is still so high in Europe, basically running around 10%. And almost half of that is due to high energy prices.

And the prop in gas prices that we've really seen hasn't really shown up yet in the inflation numbers because, first of all, there's typically a lag between wholesale gas prices and retail gas prices, contracts. There are also government stabilization policies. And then there's also usually a bit of measurement delay for consumer prices specifically. And the bottom line here is that we still think there's quite a bit of pent-up pressure in train, despite the drop in wholesale prices that we've seen. And as a result of that, we think headline inflation will actually still rise a bit further from here. So we have the peak at around 13% in January. And only after that in our forecast do the inflation numbers really start to come down.

Allison Nathan: And so as you said, still very high inflation. Europeans are still facing storing natural gas and power bills relative to what they're used to and just in general. So how does that affect disposable income from the consumer and the broader economy?

Jari Stehn: Yeah, it implies a big hit to consumer incomes, and that really is the key reason why we do think that the euro area is sliding into recession here, despite some of these easing in the gas market that Sam has described. So when you think about income, you are seeing that wage growth has picked up, so that's the positive. We're also seeing significant amounts of fiscal support to households. But inflation is so high that it more than offsets the combination of a pickup in wage growth and the physical support that we're getting. And so we do think that real disposable income -- so the inflation-adjusted take-home pay that households have -- will decline by about 3% in coming quarters, which of course implies a pretty big drag on consumer spend.

I think the big unknown in Europe that's actually similar in other places like the US is how households respond with their savings. So households still sit on a significant amount of pandemic saving, the money that they didn't spend during the pandemic, during lockdown. And that is probably going to provide some cushion to limit the effect this drop in income onto the consumer.

But at the same time, of course, you do have the war close by. We do think we're going into a recession. And of course, consumers typically in these situations are more cautious and tend to increase their saving rate. So I think the uncertainty around the saving rate is the big unknown of how this hit to income will translate into the consumer spending outlook.

Allison Nathan: And what about on the industrial side? Are we seeing a sizable hit to industrial activity, particularly in natural gas-intensive sectors?

Jari Stehn: Yeah. So far what's interesting is that we're seeing a big divide on the industrial data side. So the survey data has weakened very sharply, particularly in gas-intensive sectors. So if you take, for example, the EFO Survey [sp?], which is a German survey, and you weight firms' expectations by the gas intensity of the different industries, then that measure has fallen to an all-time low. They're basically lower than during COVID, lower than during the financial crisis, which shows you that, in the gas-intensive sectors, there's a lot of pessimism in the pipeline.

Now, at the same time, the hard data -- so when you look at industrial production -- has actually still held up reasonably well, including in Germany, which has been a key upside surprised, I would say, over the last few months. Now, I think part of that has to do with the time lag that the survey data is timelier than hard data. And also, of course, that other things have happened, for example, global bottlenecks in the goods sector have unwound. And so what you're seeing when you look more closely in Germany is that the gas-intensive sectors have started to cut production, but, for example, the chips-intensive sectors that were previously affected by the bottlenecks have actually started to ramp up production again. And so on net, this has so far been an offset. But when we look ahead, we do think that there's weakness in train in terms of production, particularly in the gas-intensive sectors.

Allison Nathan: And Sam, what are you seeing from your seat on the industrials side? Are you seeing less gas consumption that's essentially forced?

Samantha Dart: For sure. A lot of weakness, a lot of pain. So when we look, for example, at industrial plus generation demand for natural gas in Northwest Europe, for this month so far -- so we're in November, right? Mid-November -- that consumption is down about 35% relative to average. So it's an incredible cut in -- and it took a while for that to show up. If you look at the data over the course of this past summer, it wasn't there nearly to the same extent. And this is because a lot of buyers of natural gas, they either had price protection on or they had fixed price contracts or they were able to pass through that high cost to their customers. All of these protections are now rolling off, and those options are disappearing. So you end up with a bigger response in terms of natural gas demand versus what we saw earlier.

Going into next year, we actually expect that pain to continue, and the cut in consumption, if anything, to grow a little bit. Now, to be fair, not all of that is going to have to be price driven. Some of that, we hope, is just going to be substitution away from gas into other sources. For example, Germany has been working on bringing back some coal generation capacity from reserve to operational status. It's not fully done yet, so hopefully, as we bring more of that capacity on, your demand for gas can drop a little bit and that's not price driven.

If you have, for example, nuclear generation, which this year was a disaster because French nuclear generation in particular was facing heavy maintenance. So as we get over that, the nuclear generation again improves next year. Again, you need less natural gas in power generation. So some of the declines in consumption of gas that still need to happen next year we're hoping will come from substitution so that it's not all pain driven, not all price driven.

Allison Nathan: And so, Jari, you mentioned that the consumers are getting some support here. Are there also businesses getting support? What do these subsidization programs look like? And what impact are they really having?

Jari Stehn: Yeah, first of all, there's quite a big range across Europe when it comes to these measures. So countries have really tackled this on a national basis. So for example, France has capped consumer prices all along and has really limited the pass through from wholesale into retail prices. Germany is now moving into that direction. We are still waiting for some of the details here to be decided but is also moving towards price caps.

Whereas Italy and Spain have tended to be more tax focused, giving rebates and sort of household support. But overall, the amount of intervention here this has been more limited than, for example, France. So it's quite a heterogeneity across Europe as we look around.

Now, most of the measures have been aimed at households, so we've seen retail price caps, gas and electricity. We've seen rebates for petrol, for example. And there's been some measures for firms. So for example, tax rebates for gas-intensive firms, but that's generally been more limited. So I would say quite a lot of heterogeneity but most of the support aimed at households. And, as I said earlier, I think that is an important reason why we think the recession is going to be more limited in terms of depth because you are providing a lot of support here to households to cope with the winter months.

Now, of course that support is not going to be there forever. And at some point, as these measures are unwound, there is going to be a little bit of a fiscal [UNINTEL] effect and somewhat of a drag on growth as these measures are wound down sometime later in '23 and into '24.

Allison Nathan: And Sam, isn't there an aspect to these measures that's a bit counterproductive? Because of course it's helping support consumption at a time when we're concerned about the medium to longer supply outlook. So what's your take on these measures?

Samantha Dart: I think that's exactly right, Allison. It's interesting because all these measures announced by governments, it's really a matter of a price issue when, from a market perspective, we've really been facing a quantity issue. So the reason why prices have been so high is because there isn't enough of the ability of this commodity. And none of the measures implemented so far or announced by governments across Europe help reduce that commodity availability deficit. So it is a problem. Subsidizing consumption can actually make the deficit worse.

I'm less concerned with this winter in particular, not only because storage is very high, as we discussed earlier, but, for example, the energy cost cap that the UK has implemented for this winter still implies energy costs a lot higher than last winter. So year on year, yes, people are still going to face incentives to save.

In the case of Germany, what has been announced so far for residential users is also supposed to be implemented from March next year. So again, winter on winter, we're still seeing incentives for people to save in their consumption. So we have to monitor and see how those policies will evolve. But, yes, that is the risk that they end up making this deficit even worse.

Allison Nathan: And do we see the government intervening in other ways going forward? Jari, Sam, do you guys have a view on that?

Samantha Dart: So on the gas side, there have been a lot of conversations about potentially capping the gas price at the exchange. So at the wholesale level, which, from our perspective, would be a dangerous thing to do because you would be intervening with the price signal that balances the market. If you keep it artificially low, implicitly what you're doing is you are disincentivizing supply from coming to that location because prices are too low. So that was one of the concerns.

Another concern with a measure like that would be that this is already a market with very poor liquidity. So any news that takes place that gets announced makes prices jump quite a lot. If you then cap prices, you can make that liquidity even worse, creating even more volatility in the market and, again, creating an incentive for suppliers to refrain from selling into that market in the first place. So that has been discussed. It seems more recently that governments are moving away from that level of intervention. But again, things seem to have become a lot more unpredictable.

Jari Stehn: Yeah, I think from our side, the focus is less on new measures but more on sort of extended versions of the old measures. Price caps for longer. More subsidies. Utility bills and so on. So I think it's a little bit more the extent of a [UNINTEL] for support rather than innovative new measures.

Allison Nathan: Jari, you've mentioned a couple times we are expecting a recession in the euro area. What will that look like? How bad do you expect it to be generally?

Jari Stehn: So we do think that what we've discussed, the surge in energy prices, high inflation, is going to push us into recession both as firms cut back on production and as consumers need to tighten the belt given the hit incomes. So we do think that the euro area is entering recession right now in the fourth quarter. And we have a 3-quarter recession over the winter.

But at the same time, we think the recession is going to be fairly shallow, pretty moderate in terms of its depth, which is really related to the risk of rationing having fallen, given the rebalancing the gas market that we've seen, the additional fiscal support, and then also data that has held up relatively well so far. So we do think there's a recession that's coming, but we also think it's going to be a relatively mild one.

Allison Nathan: And so Sam, we've talked a lot about we may not be out of the woods but, in the near term, things are looking a little bit more well supplied in Europe. But what could change that at this point? Could anything? Are we still watching the weather? What risks are you most focused on over the near term and then potentially the medium term?

Samantha Dart: The number one risk to watch is weather. Still natural gas is a very seasonal commodity. Meaning, in the wintertime, its demand for heating purpose, it increases so much that it trumps everything else. So a colder turn of the weather can be very impactful for both balances and prices. So that's the number one thing to watch that is not in the forecast so far. We really can only trust forecasts that go two weeks ahead. Anything long range when it comes to weather, in our view, is not reliable. So that's number one.

Number two, I would say that the main risk ahead is China. China was the largest buyer of LNG last year, but this year, because its economic growth slowed significantly, its purchases of LNG, liquefied natural gas, also slowed. And because of that, there was a lot more supply left available for Europe. So if China rebounds into next year and grows faster and has stronger industrial activity, it's going to buy more LNG. If that happens, this is going to leave less supply available for Europe. It's something that we already expect for next year, but the extent to which it's going to play out is absolutely an important source of risk as well.

Allison Nathan: And Jari, you just said mild recession, but are the risks to your views due to the upside or the downside in terms of growth?

Jari Stehn: I think in the very near term, they're probably skewed a little bit to the upside, just given the momentum that we've seen in the data. During the winter, I would say that they still are skewed to the downside, along the lines of what Sam just described, because a colder winter, an increase in gas prices, possible rationing of gas could bring into play much more negative outcomes again for Europe. So we think that the risk of that has diminished, but it's not gone. And so I do think that, both for this winter and for next winter, that will continue to be a downside risk in the European outlook.

Allison Nathan: Jari, Sam, thank you both for joining us and sharing your insights.

Samantha Dart: Pleasure.

Jari Stehn: Thank you.

Allison Nathan: Thanks for joining us for this episode of Exchanges at Goldman Sachs, which was recorded on Monday, November 14th, 2022. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts.

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