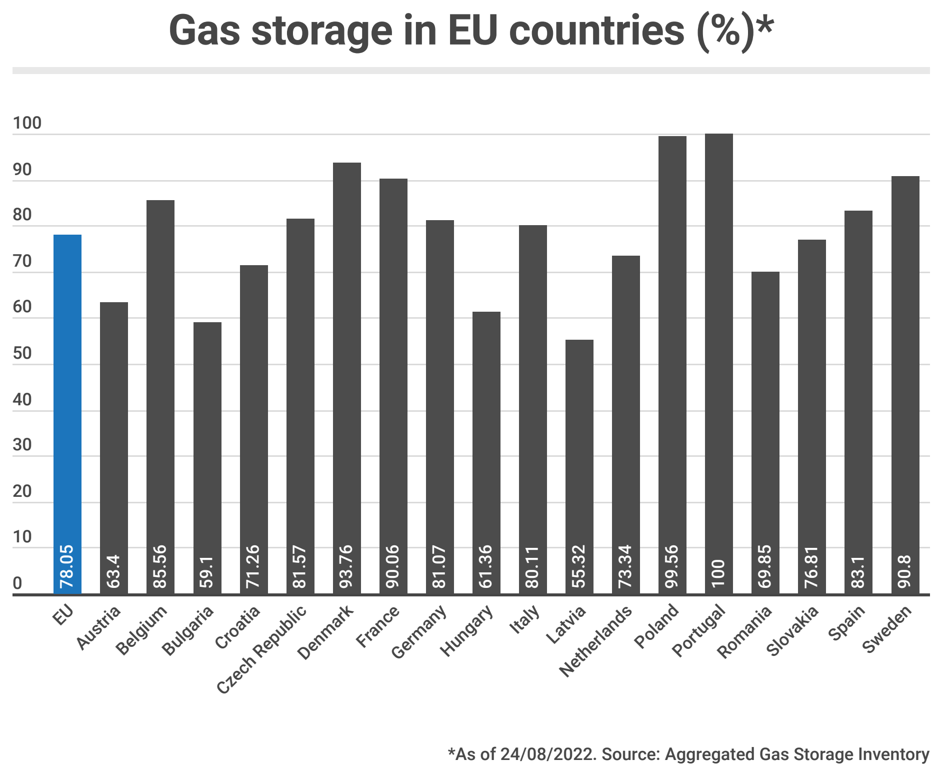
EU: Policy responses to energy crisis will likely remain reactive

- EU governments are doing their best to prepare for a winter of lower Russian gas supplies, but global price dynamics might strain European economies.
- National-level measures to protect consumers and firms will remain the default response, although their growing cost will increase the popularity of policy options such as windfall taxes and market interventions.
- Domestic politics will continue to complicate the response at the EU level, but the bigger the crisis becomes, the more it will force governments to confront structural problems.

European energy landscape

Europe has been relatively successful at replacing lost barrels and cubic meters of Russian oil and gas since the Ukraine invasion and the rollout of Russian sanctions. Particularly, gas storage tanks have reached 78% full, or just shy of the target in most European countries to fill storage to 80% capacity by end-October.



But prices tell a more ominous story, reflecting significant concern about further supply constraints driven by global LNG purchasing trends in the months ahead and the risk of steeper Russian gas pipeline supply disruptions to Europe. Even full storage tanks can only meet European demand for a couple of months if relied on exclusively. Ultimately, the severity of the situation rests with Russia. The new normal already assumes severely reduced supplies, but a total shutoff would be unprecedented and damaging given the lack of a European blueprint to mitigate impacts and enforce more widespread gas and power sharing. This will make it extremely difficult to move from the current voluntary 15% gas reduction plans to something mandatory.

The ensuing concern about gas supply volatility is impacting not only gas and power prices but also prices for alternative fuels from diesel to coal. Gas has reached new highs of roughly USD 80/mmbtu in recent days compared to a 12-month average of USD 30/mmbtu, and recent power prices in some European markets, such as Germany, have surpassed EUR 500/MWh. Futures prices suggest little relief from these trends for 2023.

There has already been a pronounced impact on industrial activity, with companies announcing production halts or curtailments to mitigate the impacts of soaring energy costs. As businesses reduce energy-intensive activities, industrial gas consumption in Europe has fallen as much as 25%. Lower industrial activity could impact supply chains and employment levels and generate a negative economic shock, the magnitude of which is hard to predict.

Fiscal policy remains king

European capitals initially tackled the impact of high prices by designing temporary ad-hoc measures to protect consumers. However, as inflation has continued to bite, they have been forced to extend support measures repeatedly. EU governments will likely continue to follow this reactive approach when responding to another substantial surge in power prices. This is especially the case considering the uncertain effect of public campaigns to save energy in countries such as Spain, France, and Finland. Moreover, with EU fiscal rules currently suspended, policymakers have an incentive to use this flexibility to cushion voters from high prices. That is, of course, in a scenario where the European Central Bank (ECB) can continue providing the necessary backstop for countries' sovereign debt.

At the same time, helping consumers does not mean governments are keen on letting budget deficits swell endlessly. Therefore, they will likely consider different ways to limit the potential bill. For instance, France is considering reforming its "tariff shield" from 2023 so that only poorer households are protected from a potential increase in power prices and measures to guarantee energy costs do not undermine the competitiveness of specific industries. Moreover, as anticipated, windfall taxes are becoming more popular, with Czechia being the latest EU state to consider imposing levies on the energy, banking, and refining sectors. While big countries such as France and Germany remain opposed, another substantial price surge would pressure European governments to consider taxing the "excessive" profits of certain sectors.

Another debate that will likely heat up is the one on capping energy prices at the EU level. Italy has continued to push for such a measure, even if Rome is now asking for an EU-wide cap on the price of gas imported from Russia. However, Germany and Brussels remain opposed to market interventions. The Czech government, which currently holds the presidency of the EU, is considering an emergency gathering of energy ministers in the coming days to discuss the idea of a cap on energy prices.

Different crisis, still hard politics

EU policymakers probably hope they can muddle through the next winter with marginal adjustments to the toolbox they have applied so far, combined with policies to accelerate the deployment of renewable energies (as shown by the recent announcements by the French and German governments). However, the latter changes are longer-term projects. The extent to which EU leaders will be forced to rethink their short-term crisis-management strategies will largely be determined by the magnitude of the economic shock generated by a potential recession.

In this regard, a world of stagflation would pose a significant risk to the settlement devised to stabilize the common currency about a decade ago. Back then, structural design issues were addressed only marginally, as German Chancellor Angela Merkel was unsure whether she would find the necessary political support at home. Instead, the main responsibility for saving the euro was outsourced to monetary policy. But a recessionary context with high inflation would put the ECB in a difficult bind. The obvious political signpost in this context is the markets' reaction to the Italian election in late September.

As ever, German domestic politics will continue to be key. Berlin is still envisaging a return to a balanced budget next year. However, being among the most exposed to the Russian gas crisis, it is unclear whether the government can stick to its plan amid the need for further support to companies and households. Another deviation from the "debt brake" could be politically costly for Chancellor Olaf Scholz's embattled coalition partners, the Liberals (FDP). In turn, this might constrain the room for equally painful compromises that could become necessary in a Eurozone crisis scenario.

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