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News Analysis

Gas Crisis Creates Recession Risk for Inflation-Hit Eurozone Economy

Recession Risks Loom

The eurozone is forecast to eke out growth fractionally above zero in the second quarter of 2022, but economists expect a steady deterioration in the bloc's economy over the next year as recession risks loom. Eurostat's first estimate of second-quarter gross domestic product is expected to show an expansion of 0.1% from the previous quarter, according to a poll by Reuters. That marks a sharp deterioration from 0.6% growth over the previous three months and would be the weakest performance since a surge in coronavirus infections and restrictions dragged the bloc into a short recession at the start of 2021. **(1)**

Similarly, the US economy shrank for a second straight quarter, placing the country in what is commonly but unofficially considered a recession. Gross domestic product fell at an annualized rate of 0.9% in the three months ended in June, the Commerce Department recently said, following a 1.6% contraction during the first quarter. While the labor market is the strongest it has been in about 70 years, with an unemployment rate of 3.6%, other areas of the economy are slowing in the face of high inflation and rising interest rates. **(2)**

Undoubtedly, Russia's invasion of Ukraine in February 2022 has sent energy and food prices soaring, eroding the spending power of consumers while threatening to unleash an energy crisis that leaves manufacturers and households short of gas over the coming winter. Political instability in Italy, UK and France adds to concerns about the bloc's outlook.

Russia and the EU

European gas prices jumped higher on July 27 after Russia followed through on its threat to further reduce supplies to the region, increasing the risk the continent could face shortages in the winter months. Gas prices rose as much as 13% on July 27 as flows on the Nord Stream 1 pipeline were cut to just a fifth of normal capacity. **(3)**

European politicians have accused Russia of weaponising gas supplies in retaliation for sanctions imposed following the invasion of Ukraine. The key Nord Stream 1 gas pipeline, which connects Russia with Germany, was first cut to 40% of capacity in June before Moscow threatened to make further cuts this week.

A prolonged reduction in Russian gas flows to Europe could leave the region unable to fill its storage facilities sufficiently before this winter's heating season, forcing supplies to be rationed for heavy industrial users. A complete cessation of flows "could force energy rationing, affecting major industrial sectors, and sharply reduce growth in the euro area in 2022 and 2023", the IMF warned on July 26 as it slashed its forecast for German growth next year by 1.9% to 0.8%, the biggest downgrade of any country. Without a shut-off, the fund expects the eurozone to grow by 2.6% this year and 1.2% next year (see more on IMF's forecasts later on).

Figure 1: European Gas Prices Climb Further

Sources: Refinitiv, Financial Times

The EU has set a target for most countries to cut gas usage by 15% **(4)**. The German government this week urged households and companies to save even more and Berlin plans to let energy companies pass on 90% of their higher costs to customers. "We are in a serious situation," said Robert Habeck, Germany's economy minister. "It's about time that everyone understood that." Government measures to cut fuel, electricity and public transport prices are likely to have kept a lid on inflation. But consumer prices are still expected to have risen to a new eurozone record of 8.7% in July, based on Eurostat's estimates.

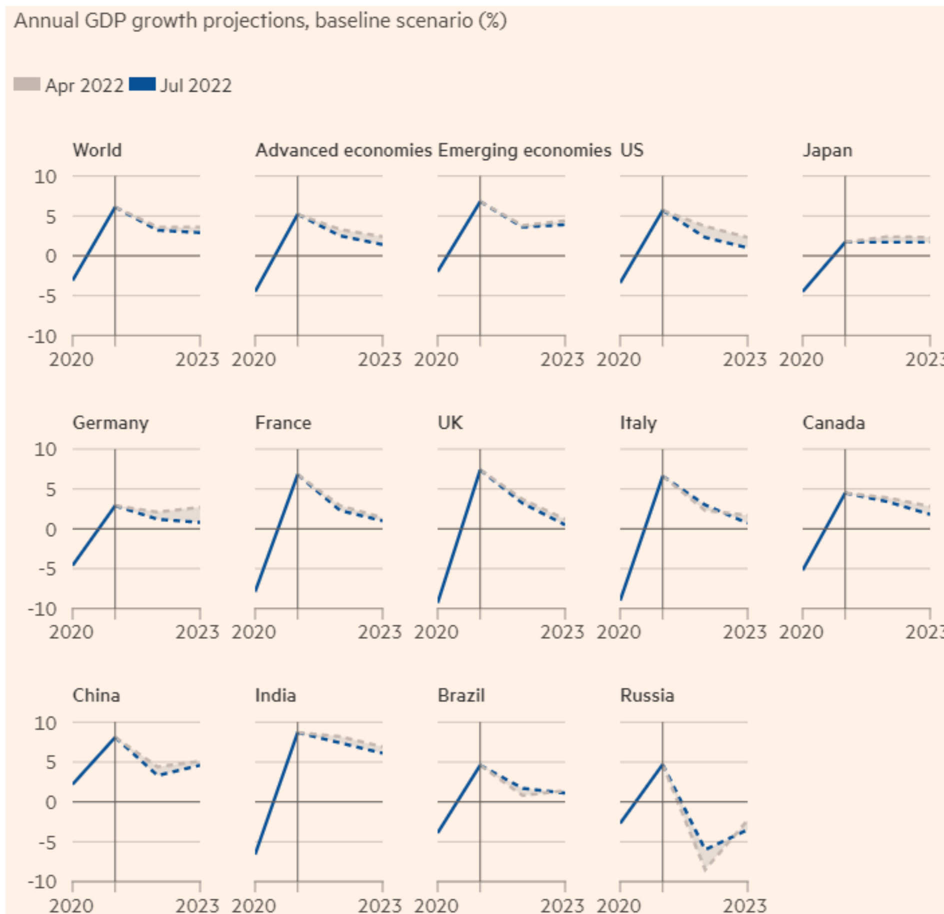
Ominous Economic Growth Forecasts and High Inflation Projections

The IMF has slashed its global growth forecasts and raised its projections for inflation, warning that the risks to the economic outlook are "overwhelmingly tilted to the downside". The downgraded estimates, released on July 26, come as the world grapples with the fallout from Russia's invasion of Ukraine, prolonged disruptions caused by the coronavirus pandemic and rapidly tightening financial conditions, with central banks seeking to contain soaring prices.

The fund now expects growth in gross domestic product to slow to 3.2% in 2022, down 0.4% from its April estimate and roughly half the pace of last year's expansion. In 2023, global growth is set to weaken further to 2.9%. Just three months ago, that estimate was 0.7% higher. Global inflation is likely to intensify, with the IMF raising its forecasts for this year and next by nearly a full percentage point to 8.3% and 5.7%, respectively. The multilateral

lender said the economic outlook had become much more gloomy and "extraordinarily uncertain", with inflation at historic peaks and challenges to growth increasing.

Figure 2: Global Slowdown Set to Intensify



Sources: IMF WEO, Financial Times

Pierre-Olivier Gourinchas, the IMF's top economist, warned in an interview it would also be an environment that tests the "mettle" of central banks around the world to continue raising interest rates in a bid to restore price stability even if the economy was slowing. "We are in a very critical moment here," he said. "It's easy to cool off the economy when the economy is running hot. It's much harder to reduce inflation when the economy is close to a recession." **(5)**

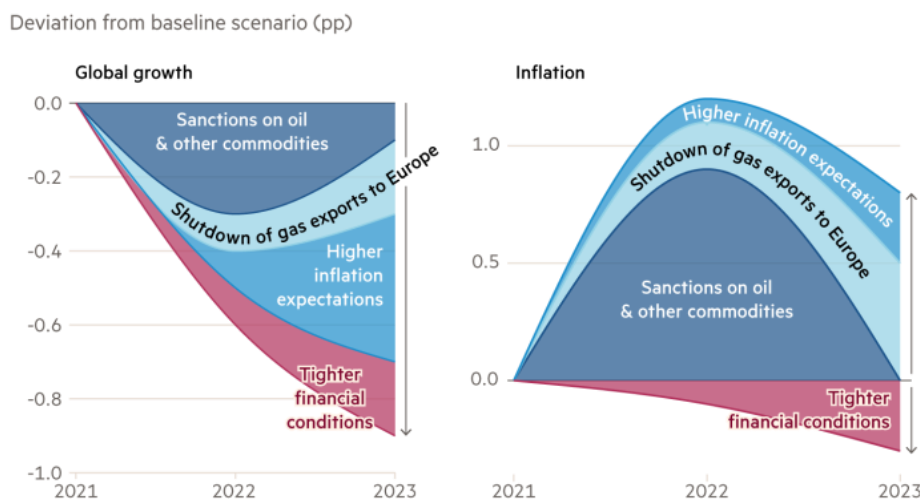
The risk of a recession appears "particularly prominent" for 2023, because by next year growth is expected to bottom out in several countries, stockpiles of savings amassed during the pandemic will have shrunk, and "even small shocks could cause economies to stall". One "plausible" scenario the fund mapped out is a sharp reduction in Russian energy exports, including a full cessation of the country's gas supply to Europe, which would further knock back growth and ignite new price pressures. The baseline outlook for Germany, the eurozone's largest economy and a country acutely exposed to a Russian gas cut off, is

already bleak, with the fund now expecting growth of 1.2% this year and just 0.8% in 2023 — a figure almost 2% lower than estimated back in April.

After a 3.2% expansion slated for 2022, the UK is projected to grow just 0.5% next year, the lowest rate across the G7. But Gourinchas stopped short of labelling the forthcoming economic environment as "stagflationary", akin to the 1970s, maintaining that central banks have much more credibility now than they did then. He said however that "the risk that we may have a global recession has gone up [and] inflation will remain more persistent than we anticipated".

Triggering the more pessimistic growth forecasts were downgrades across the world's largest economies. Hindered by extensive Covid-19 lockdowns, China's economy is set to expand just 3.3% this year, 1.1% less than anticipated in April and set to be the lowest growth in more than four decades, aside from the 2020 shock. For the US, last year's 5.7% expansion is forecast to more than halve to 2.3% in 2022, before dipping further the following year to just 1%, as soaring inflation eats away at households' ability to buy goods and services, consumption ebbs and the Federal Reserve's historically aggressive monetary tightening campaign begins to bite.

Figure 3: Economic Headwinds Strengthen Under the IMF's Alternative Scenario



Sources: IMF WEO, Financial Times

Compared with April's projections, the new estimates are each more than 1% lower. Once adjusted for inflation, "real" GDP growth in the US of only 0.6% on a year-over-year basis is expected in the fourth quarter of 2023. "It doesn't take much to knock the economy off into something that you might call a technical recession," Gourinchas said. He added that emerging markets had become a chief concern, as the Fed's tightening cycle pushed up borrowing costs globally. While "disorderly" financial market conditions had not yet taken root, he said, the big wild card was just how much additional pressure economies could withstand.

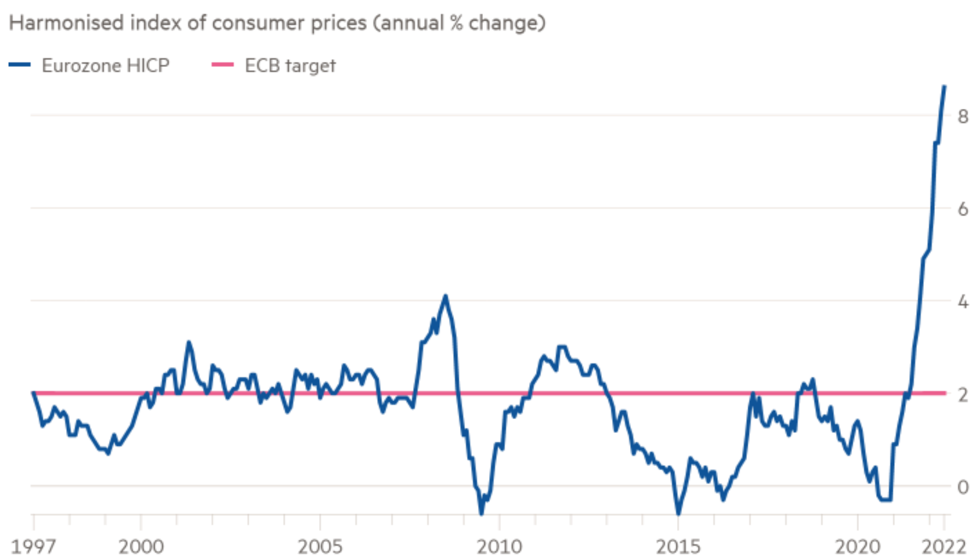
Emerging markets were likely to come under even more intense pressure should the fund's alternative scenario of a sharp drop in Russia's oil and gas exports come to pass, with inflation expectations mounting and central banks forced to tighten monetary policy even more aggressively. Under those circumstances, global growth is forecast to decline in 2022 and 2023 to just 2.6% and 2%, respectively. According to the fund, it has fallen below 2% just five times since the 1970s.

Dark clouds gather over the Eurozone

The euro area, already set for much lower growth this year than previously forecast, would also be disproportionately affected. The IMF has already revised lower its projections to a 2.6% expansion in 2022 and 1.2% in 2023.

A cessation of Russian gas exports could slash another 1.3% from euro areas' 2023 growth forecast, resulting in "near-zero regional growth". That is likely to create more problems for the European Central Bank, already facing challenges including how to raise interest rates to fight inflation without causing a new eurozone debt crisis. Gourinchas said a bond-buying tool unveiled by the ECB last week could potentially have a "very large soothing effect" on markets but added it would be a "delicate exercise" to pull off.

Figure 4: Inflation Has Hit a Record High in the Eurozone



Sources: European Central Bank, Eurostat

Higher energy prices have been blamed for a string of gloomy economic data. These include the first fall in eurozone business activity for 17 months, as indicated by S&P Global's latest survey of purchasing managers, and the drop in German business confidence to a two-year low, as measured by the Ifo think-tank's monthly survey.

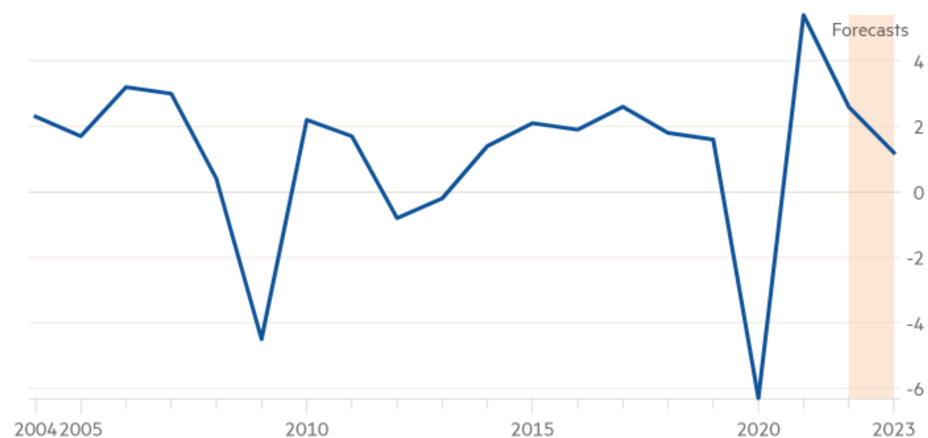
Meanwhile, consumer confidence fell to a record low this month, according to the European Commission's monthly survey. Banks are also squeezing the supply of loans to eurozone households and businesses — a trend that is likely to accelerate after the European Central Bank raised interest rates for the first time in over a decade last week.

The worsening outlook has already prompted investors to bet the ECB will stop raising rates much earlier than they expected only a few months ago. Germany's 10-year bond yield — a benchmark for eurozone interest rates —dropped on July 26 below 1% for the first time since May after falling from last month's eight-year peak of 1.77%. "The window of opportunity for the ECB to keep raising rates is closing as the economy is weakening," said Spyros Andreopoulos, senior European economist at French bank BNP Paribas. The nightmare scenario for the ECB and governments alike would be stagflation, with an interruption to Russian gas supplies sending the eurozone into recession while the energy crisis and a weaker euro continue driving prices even higher.

On July 27, Goldman Sachs downgraded its forecast for the euro area, saying a technical recession of two straight quarters of negative growth this year was now more likely to happen than not, even if Russia did not completely cut off energy supplies. A sharper downturn was likely "in the event of an even more severe disruption of gas flows, a renewed period of sovereign stress or a US recession".

Credit Suisse's Roharova predicted eurozone GDP would fall between 1% and 2% next year if Russian gas was cut off, while inflation would remain well above the ECB's 2% target for at least another year. "It is possible that inflation remains elevated or falls only gradually even as growth weakens," she said.

Figure 5: A Bumpy Ride: Eurozone Outlook Worsens Again



Sources: World Bank, IMF

Discussion

European gas prices have surged 30% in two days after Russia said it would slash gas deliveries in half from already reduced levels, and EU decided to impose 15% gas consumption cuts in all member states. Economists have warned that the continent's gas prices may remain elevated for years to come. Futures contracts for delivery next month tied to TTF, the European benchmark for wholesale gas price, jumped 20% on July 26 to exceed €210/MWh - more than 10 times higher than the average during 2010-2020. **(6)**

Benchmark electricity prices in Germany soared to a new record high of €370/MWh due to the rise in gas; prices rarely rose to more than €60/MWh before 2021. "We are now beyond the limits of affordability for many industrial users, and we might see recession alarms going off soon," Rystad analyst Kaushal Ramesh told Financial Times. "Given the constraints on securing natural gas from alternative suppliers, we expect Europe to struggle to meet its gas needs, which will keep the TTF price elevated for some time yet," said Jennifer McKeown at Capital Economics. "This has the potential to derail Europe's efforts to fill its storage to 80% of capacity by November (ahead of the winter-related surge in demand)".

While the potential gas shortage in Europe raises the likelihood of recessions in the region, Capital Economics said some of the world's biggest LNG exporters such as the US, Australia and Qatar may benefit from higher gas prices, but these countries cannot increase production quickly enough to ease global supply constraints or to fully profit from it.

In addition, European Union leaders are bracing for the shock of Russia turning off the gas taps and Brussels set a target for most countries to cut gas usage by 15% to prepare for such a blow. That should get Europe through next winter, even if Russian gas flows halt entirely and cost the euro-area economy about 0.4% of gross domestic product, according to Bloomberg Economics. If it's unusually cold and more cuts are needed, that could tip the region into recession and leave 2023 inflation lodged at 5%. **(7)**

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