4 October 2021

Research Euro Area

Looming energy crisis creates a perfect storm

- **Energy prices have risen globally, and while the base case remains for prices to reverse lower in 2022, risks of more persistent effects on euro area growth and inflation remain.**
- **The gas price surge has been a result of recovering industrial demand, high demand for heating and cooling, and limited supply of gas and renewable energy.**
- **Elevated energy prices combined with cost-push inflation from ongoing global supply issues pose challenges for manufacturing and real disposable income, which European governments have already tried to soften. Nevertheless, timing is unfortunate as the post-pandemic recovery is still vulnerable to setbacks.**

Severe gas shock expected to last through winter

As European gas futures hit 100EUR/MWH, market concerns of a looming energy crisis in Europe have risen. The rapid rise in European natural gas prices has been a result of a combination of factors. Demand has been driven up by both the very cold winter and the subsequent hot summer, which boosted households' heating and cooling needs. The reduced production of nuclear power has increased the relative importance of fossil fuels and renewable energy. The hot summer, however, also reduced electricity supply from both Northern European hydropower plants (Chart 1), as well as wind power.

The lack of alternative energy sources has increased demand for fossil fuels, and especially natural gas, and inventory levels have fallen below normal levels ahead of the high-demand heating season. The development can also be seen as a part of the more long-term European green transition challenge, where rising CO_2 prices encourage a shift towards renewables, yet the limited capacity leaves gas as a 'go-to' solution for more polluting fossil fuels.

The rise in energy demand is not Europe-specific, however. Cold weather and the post-pandemic recovery in industrial activity have increased demand also in Asia, which has already led to energy rationing in many Chinese provinces. From European perspective, this limits the global LNG supply, which could theoretically be shipped to Europe, as large share of the supply has already been tied to Asia with long contracts (Chart 3).

Market expects prices to moderate towards spring

Gas futures markets expect prices to remain high through the winter, before falling next spring (Chart 2). This largely reflects the cyclical nature of energy demand, and also highlights the uncertainty over the winter, as the upcoming weather is both important for prices yet highly unpredictable. We are now past the peak in the global recovery pace and approaching both fiscal and monetary tightening over the coming year. Moderating industrial growth should also limit upside in energy demand.

Yet, the rise in prices hits at an inopportune time, as the post-pandemic recovery is still vulnerable to setbacks. The higher prices come on top of the still ongoing global supply shortages, which continue to increase prices of inputs and raw material, and the power rationing in China could further delay easing of the situation. Labor shortages

Related publications

- *Research Global - Stagflation' risks on the rise*, 15 September
- *Global Research – Market implications in a global stagflation scenario*, 21 September
- *Global Inflation Watch - Electricity prices add new upside risks to euro inflation*, 22 September

Chart 1: Nordic renewables output has been lower than usual

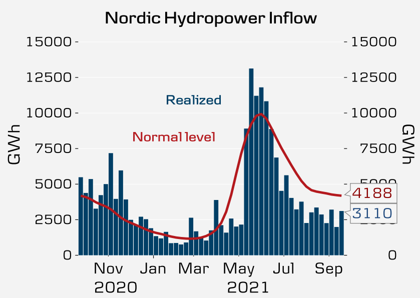
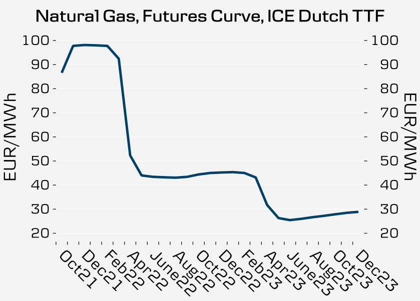


Chart 2: Market expects natural gas prices to drop by over 50% next spring



Sources: Macrobond, Refinitiv

Analyst
Antti Ilvonen
+358 445 180 297
antti.ilvonen@danskebank.co

Senior Euro Area Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.dk

continue to put upward pressure on wages especially in the US, but also in other parts of the world as we highlighted in *Research Global - Stagflation' risks on the rise*, 15 September.

Rising headwinds for European consumers

While the euro area HICP weights of gas (1.9%) and electricity (2.9%) are relatively small, a surge in gas and electricity price inflation to 30-40% could be on the cards in the coming months (Chart 4). This will be somewhat offset by the falling, but still positive contribution from changes in oil prices. Overall we expect the euro area energy price inflation to remain elevated for the remainder of this year as higher gas and electricity prices are countering falling inflation rates for transport fuels (see *Research Euro Area - Rising pipeline pressures for euro inflation*, 17 September).

The pass-through from higher gas prices to consumers will probably be highest in Italy, given that gas accounts for 38% of energy consumption (compared to 23% in Germany, 22% in Spain and 15% in France). With euro area negotiated wages growing by only 1.7% in Q2, inflation rates in excess of 3% for the remainder of this year point to an increasing erosion of purchasing power, which we expect to show up in a noticeable slowing in euro area private consumption growth to 1.0% q/q during Q4, after Q3's post-lockdown surge. However, the emerging European energy crisis will not only hit real incomes, but it could also lead to production outages in manufacturing which has already been seen in China.

European governments have become aware of the danger that elevated inflation pressures pose to the economy. Several countries have over the last weeks announced schemes to soften the blow on consumers, especially low-income households. Spain and Italy announced temporary VAT cuts, while France, Italy and Greece have planned subsidies for fuel payments. **So far the adverse impact of higher inflation on consumer sentiment has seemingly been limited.** Euro area consumer confidence rose marginally during September, remaining above pre-pandemic levels and high frequency indicators point to a continued high willingness to spend despite rising prices (Chart 5). Furthermore, according to *ECB estimates*, households in the euro area have amassed more than EUR 500bn in extra savings, over and above the normal saving rate, that also compensate for the real income losses on top of government compensation measures. With inflation rates expected to fall back again in 2022, we also expect adaptive consumer inflation expectations to come down again. That said, should elevated inflation persist for longer than expected in H1 22, it could raise the spectre of higher inflation expectations feeding into the upcoming wage negotiations during 2022, posing a challenge to ECB's transitory inflation narrative.

In conclusion, while the base case remains for energy prices to moderate towards 2022, risks of more persistent effects remain. The key risks include power outages weighing on industrial growth, lower real household income dampening private consumption and higher long-term inflation expectations posing risks to ECB's current view on inflation. Even if the period of higher inflation proves temporary, the currently observed rise in prices could spark higher wage demands and thus more persisting inflation, which has already contributed to a rise in market's long-term inflation expectations (Chart 6).

Chart 3: China is the largest LNG consumer in the world

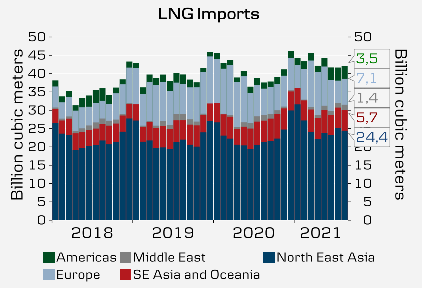


Chart 4: Gas and electricity inflation to rise steeply in coming months

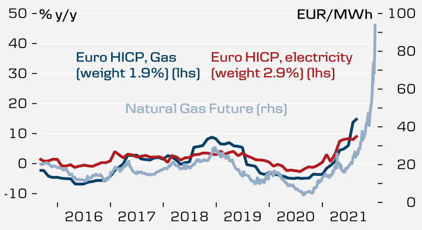


Chart 5: Consumer confidence not yet affected by rising prices

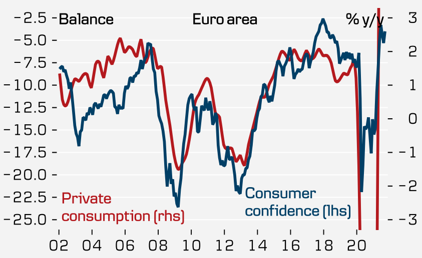
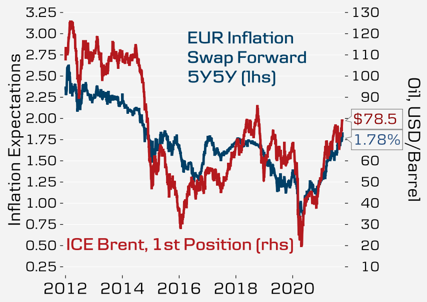


Chart 6: Energy prices tend to affect longer-term inflation expectations as well



Sources: Macrobond, Bloomberg

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Antti Ilvonen, Analyst and Aila Mihr, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc.

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 1 October 2021, 16:00 CET

Report first disseminated: 4 October 2021, 06:00 CET