ODDO BHF

MACROECONOMIC *view*

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European outlook, one year after the "Putin shock"

Key highlights:

- The energy crisis, which is partly due to the war in Ukraine, is costing the euro area 2 to 3 GDP points
- Europe has avoided a severe recession but is going through a phase of quasi-stagnation
- Initially of energy origin, inflation continues to spread to food and services
- The ECB is not signalling any pause in its monetary tightening

What would have been the level of growth in Europe today, had Russia not invaded Ukraine on February 24, 2022? What about inflation and interest rate levels? We will never know for sure, but it is clear that this geopolitical event has profoundly changed the energy markets and subsequently, the economic and financial outlook.

Let's briefly remind ourselves of the situation on the eve of the invasion. At that time, the last restrictions on mobility had been lifted, which boded a catch up in spending in many areas (leisure, travel). Business climate was higher than normal, with companies having healthy order books. Inflation had been accelerating for several months, due to various global shortages and the speed of the post-lockdown recovery. The ECB signalled its desire to make its monetary policy less accommodative.

Then suddenly, Europe was hit by a new supply shock, just as unexpected as the pandemic, and causing a chain reaction in the same way: soaring uncertainty, supply disruptions, higher production costs, eroded household purchasing power, etc. The main transmission channel of this shock to the real economy is energy. Almost everything stems from there. At the start of the conflict, Russia supplied about 40% of the gas consumed in Europe, almost a quarter of the oil, half of the coal, not to mention a significant share of other industrial and agricultural raw materials.

What's the situation like one year later? Escalating sanctions and counter-sanctions between Europe and Russia have completely reshaped the energy landscape. The EU has banned coal, crude oil and refined products purchases from Russia. It has found alternatives to Russian gas, whose share has fallen to around 10%. Furthermore, efficiency gains and energy-saving efforts have led to a sharp drop in energy demand. While these adjustments were materialising, energy prices soared, reaching eye-watering records in the summer of 2022 (x20 the historical average price for gas), before falling back.

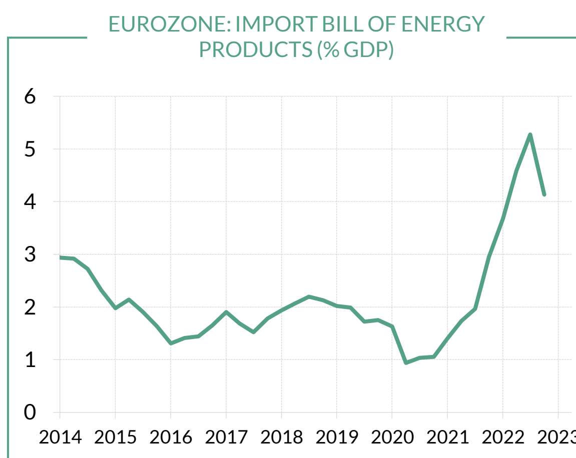
In the euro area, the trade balance in energy products represented around 2% of GDP in pre-pandemic years, compared with 4 and 5% of GDP now (graph). **The energy crisis has drained 2 to 3 GDP points from European resources to the benefit of exporting countries.** While the US and Qatar, which are major LNG producers, may be preferable to Russia in geopolitical terms, the fact remains that the bill has considerably increased.

This changes the outlook for growth, inflation and monetary policy.

It is rare that economic conditions are changed by a single event. However, in the case of the "Putin shock", as with the pandemic, there can be no doubt. Household and business confidence plummeted immediately as energy prices rose and the risk of a winter shortage loomed. This extreme scenario did not materialise. As a result, climate indices have recovered in recent months but remain weak. **Europe has avoided a severe recession but instead, a quasi-stagnation has set in at the end of 2022. Some sectors, more energy-intensive than others, are going through a deep crisis and there are fears that bankruptcies will increase.** In total, over the course of one year, growth prospects have been cut by about 2 points in the eurozone, and even by 3 points for Germany, a country more exposed to the shock because of its energy mix and the weight of its industry.

Moreover, the inflation situation hasn't stabilised. Last year, most European governments adopted subsidies or price cap measures to mitigate the impact on households, but this "shield" is short-lived. **Today, even if the energy crisis is less intense, the shock continues to spread to other expenditures, from food to transport services. This is fuelling demand for higher wages, with the risk of prolonging price pressures.** For the past year, the inflationary impact of the war in Ukraine has been steadily revised upwards. At the start of 2022, when inflation in the eurozone was around 5%, no one would have predicted that it would double in a few months. Since peaking at 10.7% in October 2022, inflation has come down (8.5% in February) but the decline is too slow and modest to satisfy the ECB.

Although the ECB's restrictive turn was in the offing before the invasion of Ukraine, it was difficult to imagine that it would be of such a magnitude. Since July 2022, the key rate has been raised by 350 basis points. This is a regime change after eight years of negative rates. **There is no pause looming in the tightening process as the rate hike is not biting into inflation, at least not yet. Nevertheless, credit conditions are becoming increasingly tight, which will no doubt weigh on capital expenditure and construction.** The ECB would rather have too much tightening than too little, even if it means risking a miscalibration of monetary policy.



Source : Thomson Reuters, ODDO BHF

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