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Written by: Harry Colvin, CFA, Director & Senior Market Strategist

Can Eurozone Households Absorb an Energy Shock?

Summary Extract:

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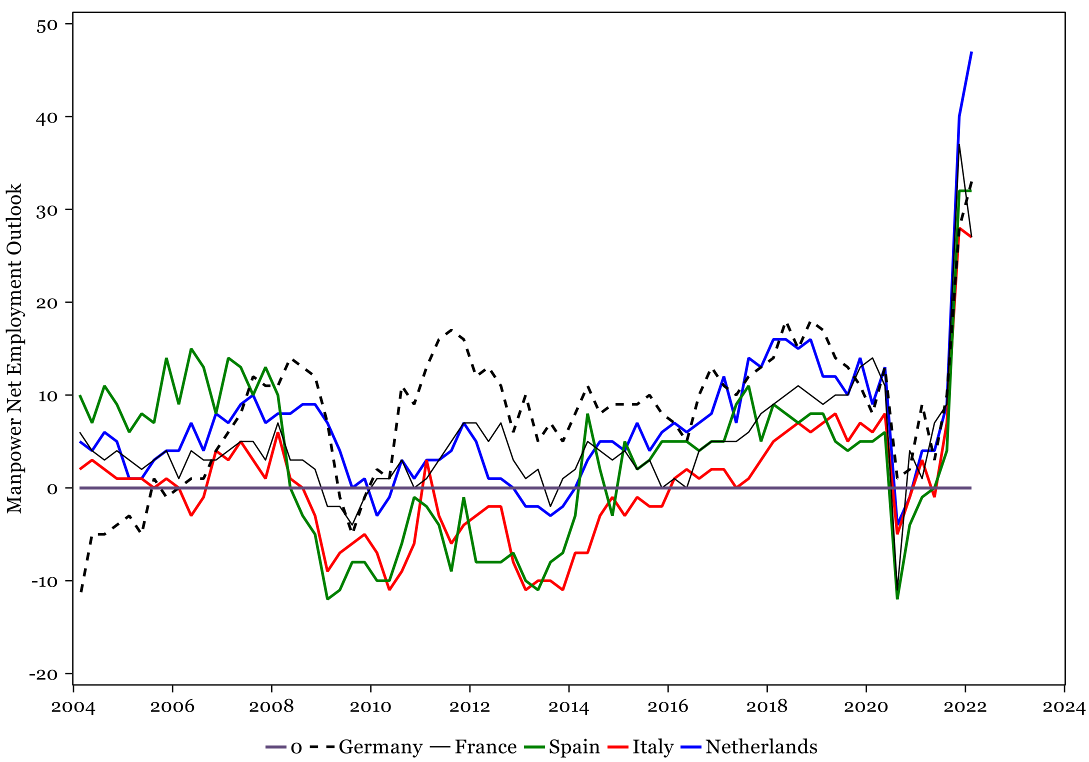
Can Eurozone Households Absorb an Energy Shock?

Harry Colvin, CFA, Director & Senior Market Strategist, Longview Economics
Email: harry@longvieweconomics.com; Direct Line: +44 (0) 207 062 8803

Summary & Conclusion

While risks are elevated (and examined in detail below), **the cyclical outlook for the Eurozone economy remains strong**. In particular, the corporate sector is throwing off record levels of 'spare cash' (fig 5), business confidence is high and companies are starting to put their spare cash to work. That's illustrated, most notably, by the sharp increase in hiring intentions in recent months (fig 1). Added to which, companies have begun to rebuild inventories (from low levels) while new orders have picked up (which typically leads capex activity). The corporate sector, therefore, appears increasingly likely to drive robust economic growth in the Eurozone, at least over the next 1 – 2 years.

Fig 1: Manpower Net Employment Outlook (various Eurozone economies)



Source: Longview Economics, Macrobond

Added to which, **households are in strong shape:** Consumption has fully recovered from the pandemic; the consumer is cash rich; employment growth is rapid; and house prices (and net household wealth) are growing at multi-year/fast levels. Reflecting all of that, as well as the elevated inflation backdrop, monetary policy is likely to normalise and the outlook for the euro is reasonably strong (for detail see Recommended Global Macro Trade 8th February 2022: "Play higher EZ rates and stronger EUR-USD").

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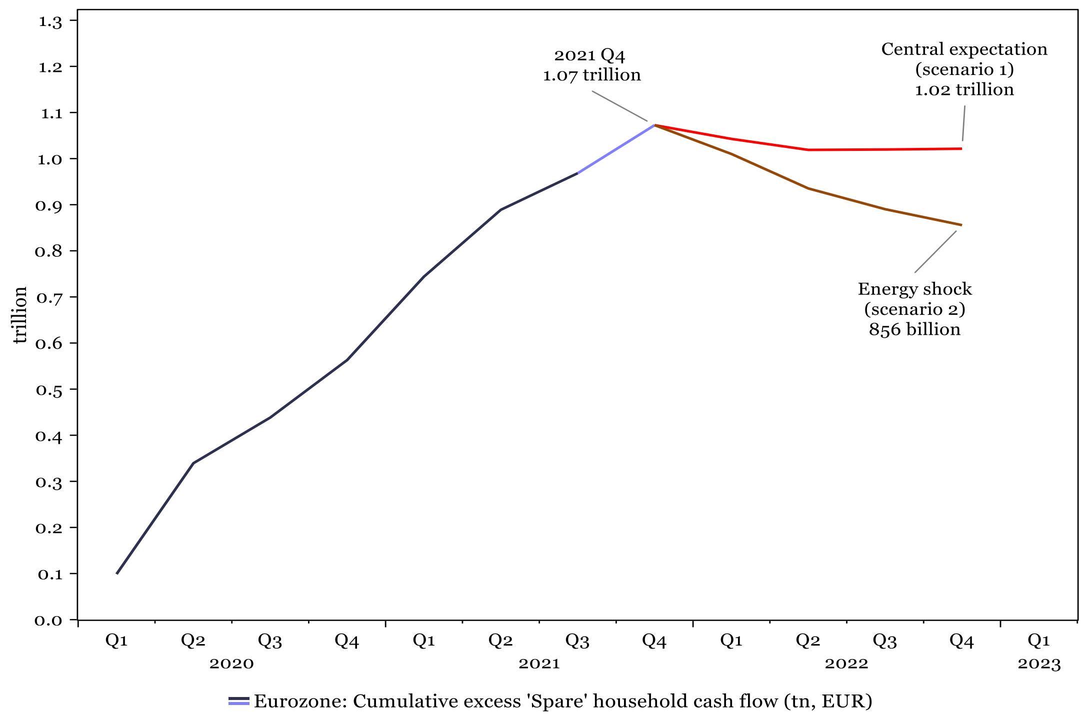
The **key risk** to that outlook is a **potentially marked deterioration in the Russia situation**. In particular, it's possible that an invasion of Ukraine is followed by (i) a Western policy response/sanctions; followed by (ii) a Russian reprisal which includes the weaponization of Russia's energy production.

Our analysis shows that Europe is (mostly) unable to switch its energy dependence away from Russia (for detail see 16th February 2022 Commodity Fundamentals Report: "Energy as a Weapon"). The key question, therefore, assuming that energy supplies are not completely cut off[1], is: How resilient is the Eurozone economy to an energy price shock (in the event, for example, that Russia curtails *some* energy exports)? Could households withstand a significant spike higher in energy prices? Or, with oil/natural gas prices *already* notably higher in the past 6 – 9 months, is the Eurozone economy closer to the brink of recession than we think (i.e. than our overview on page 2 suggests)?

Below we answer those questions by **'stress testing' household balance sheets & levels of 'spare cash flow'**. We focus on two plausible scenarios: **(i)** broadly undisrupted energy flows from Russia (this is scenario 1, our central expectation); and **(ii)** a curtailing of *some* energy exports (scenario 2). In the second scenario, we assume that Europe is able to somewhat substitute away from Russian supply (towards other suppliers), but that it suffers from an energy price shock. These scenarios are summarised below (pages 4 & 5) and examined in detail in Appendix 1.

Fig 2: Households' cumulative extra savings since the start of the pandemic



Source: Longview Economics, Macrobond

[1] In which case, there would not only be a major price spike, but also major power outages (as yesterday's research shows) and, with that, a likely recession.

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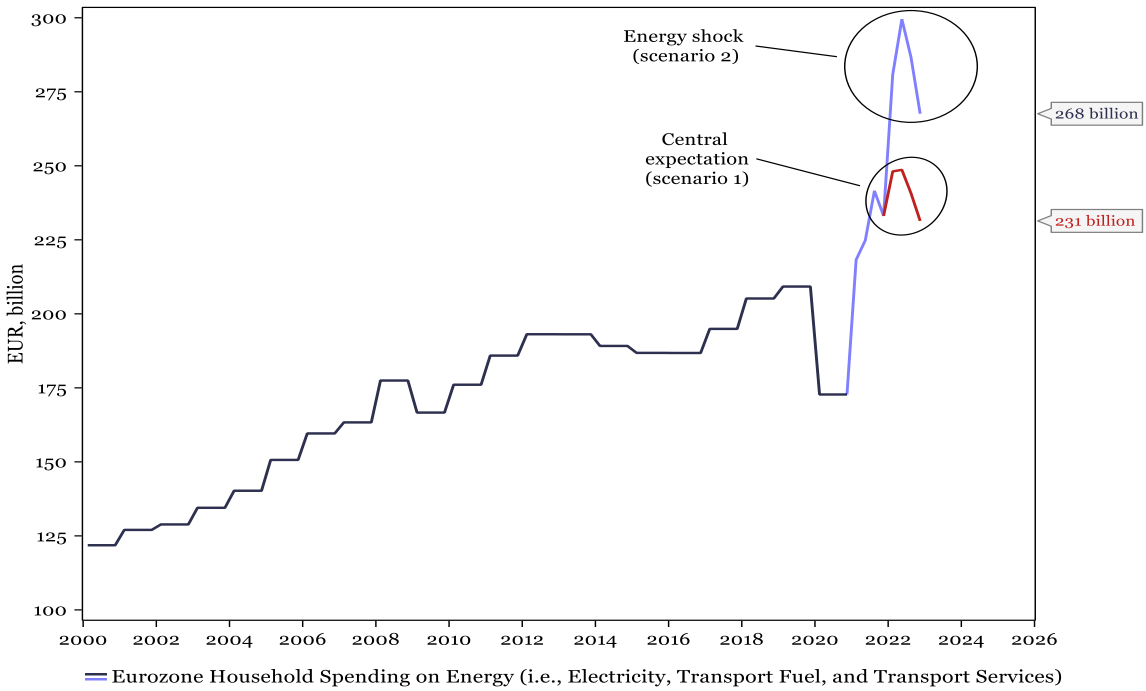
The Key Scenarios

Overall, European households are currently in a structurally strong cash position. Since the start of the pandemic they have built up a large, €1.07 trillion 'spare cash' buffer (i.e. a measure of the stock/amount of extra cash in household bank accounts, shown in fig 2 above). In addition, their savings rate is high (with spare cashflow averaging ~€135 billion per quarter more than normal, see fig 6), i.e. a key flow measure of cash savings, for detailed analysis please see 10th December 2021 Quarterly AA Extract "Eurozone: Strong Growth Underpinnings".

In our **central scenario**, household spending on energy this year grows by 5.0% vs. 2021 (i.e. an increase of +€51bn). That reflects our expectation that energy prices remain elevated in Q1 and then ease somewhat later this year as the Russia situation de-escalates. The impact on cashflow and cash levels is relatively marginal (e.g. see fig 2).

In an **'energy shock'** (scenario 2), oil and natural gas prices average $110/barrel & €95/MWh for 2022 (i.e. up by 57% and 90% compared to average levels in 2021). Given the usual relationship between those prices and total energy spending, we would expect that to result in extra household spending on energy of €217 billion (compared to last year), i.e. a 24% increase vs. 2021. That's a significant increase (equivalent to ~1.8% of Eurozone GDP). **It's in the context, though, of an especially large savings buffer**[2] of €1.07 trillion. As such, it would be comfortably absorbed by high levels of spare cash (fig 2).

Fig 3: Eurozone household energy spending (two key scenarios), EUR, bn



Source: Longview Economics, Macrobond

[2] For the purposes of this analysis, we have held the level of accumulated 'spare cash' constant at end-2021 levels in order to isolate the impact of extra spending on energy.

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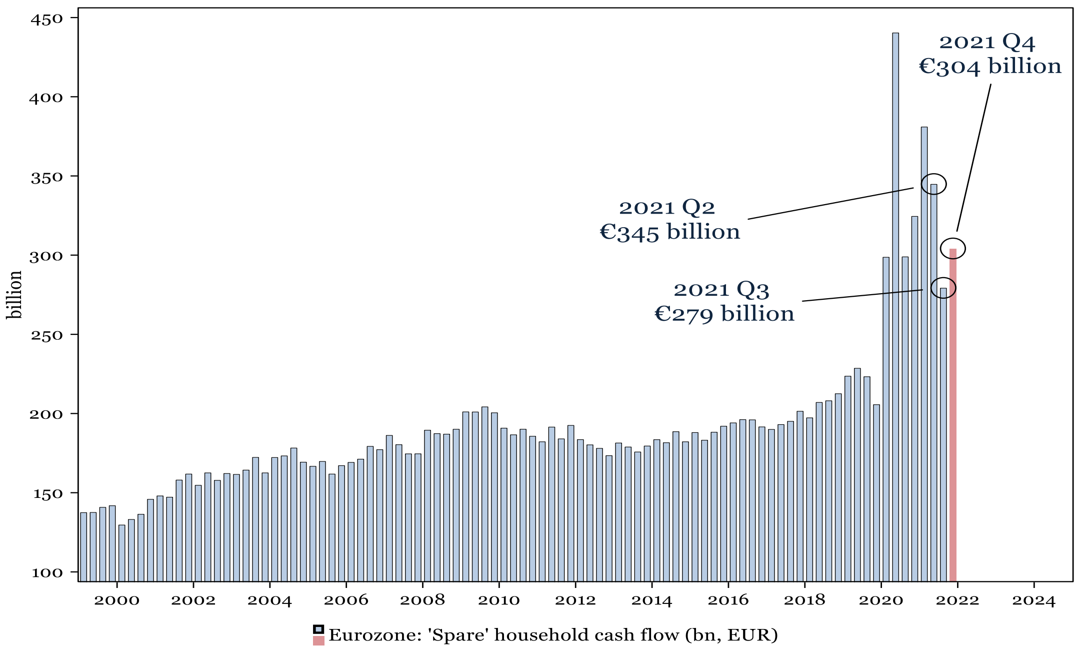
Or, thought about another way, households likely generated ~€300bn in spare cash flow last quarter (see fig 4), and more than that in recent quarters (fig 6). That is about €100bn more than normal/pre-pandemic cash flow generation (each quarter). Higher energy costs of €217bn in 2022 would therefore be absorbed quite rapidly (by approximately two quarters of 'spare cash flow').

Fig 4: Eurozone household spare cash flow (billion, EUR)



Source: Longview Economics, Macrobond

Naturally, an extra €217 billion of spending on energy would detract from other spending and somewhat dampen Eurozone economic growth in 2022. In the absence of a significant cut in Russian energy exports (and power outages), though, European households remain 'cash rich' and well placed to absorb higher energy costs (with recession risk therefore remaining relatively low).

Indeed, on our analysis, oil and natural gas prices would have to trade at significantly higher levels for a prolonged period of time before spare household cash buffers were used up. By way of example, the oil price would need to average $220/barrel and the natural gas price €150/MWh (i.e. 215% & 200% above average 2021 levels), for household cash to be fully exhausted. While that way of thinking is somewhat simple on many fronts (and even problematic), it **illustrates the size of the European household cash buffer**.

Overall, though, and as highlighted above, our central view is that Russia does not shut off its energy supply to Europe (which is not in the interests of Russia or Europe). Of note in that respect, most major (Russia-related) geopolitical events have not resulted in energy supply shutdowns (including the cold war, the collapse of the Soviet Union, the annexation of Crimea, and so on[3]).

[3] There are, though, some exceptions, including a brief disruption to the flow of gas supply through Ukraine in 2009.

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Appendix 1: Two Key scenarios

In our **central scenario**, we assume that energy prices remain relatively elevated for the first half of the year, to reflect the possibility that Russia could reduce/stop exports. In other words, we assume that the geopolitical risk premium remains in place (at least in Q1 and Q2, before easing later this year). This scenario therefore considers recent upside moves in energy prices to be reasonably advanced. In our model, we assume an average oil price of $95/barrel and a natural gas price of €55/MWh.

If correct, then the overall impact on household cash flow is limited. We estimate Eurozone household spending on energy to have been €918 billion in 2021 (and ~13% of total spending, see table 2 for a detailed breakdown). In this scenario, assuming no further/significant price increases, spending on energy will likely be €969 billion in 2022. That is €51 billion above 2021 levels and €173 billion above the average level of 2016 – 2019.

In this scenario, the current increase in energy prices, even if it's maintained, is unlikely to materially impact the cash position of Eurozone households.

Table 1: Eurozone household spending by category (billion, EUR)

Non-energy spending by category	**2016**	**2017**	**2018**	**2019**	**2020**	**% of total (2016-2020)**
	in EUR billion					
Maintenance & Repair of the Dwelling	50.1	51.1	52.3	54.1	52.3	0.9
Education	54.4	55.9	57.0	58.2	55.3	0.9
Water Supply & Misc. Services Relating to the Dwelling	111.7	114.6	116.4	118.7	118.8	1.9
Communications	142.2	144.7	145.5	145.9	145.6	2.4
Purchase of Vehicles	208.1	220.1	230.7	239.4	212.7	3.7
Clothing & Footwear	280.7	286.9	286.4	287.5	234.0	4.6
Alcoholic Beverages, Tobacco & Narcotics	223.0	226.2	231.9	236.8	242.4	3.9
Health	250.6	259.3	267.6	275.4	261.5	4.4
Actual Rentals for Housing	269.2	276.7	284.6	293.3	297.6	4.7
Furnishings, Household Equipment & Household Maintenance	327.3	335.4	337.6	346.5	342.4	5.6
Restaurants & Hotels	497.5	528.4	551.8	576.5	359.0	8.4
Recreation & Culture	495.2	514.6	528.1	542.1	445.2	8.4
Miscellaneous Goods & Services	662.4	679.7	705.5	716.2	681.8	11.5
Imputed Rentals for Housing	728.5	743.2	762.4	781.2	798.0	12.7
Food & Non-Alcoholic Beverages	728.3	747.0	767.0	786.6	830.0	12.9
Sub-total	**5,029**	**5,184**	**5,325**	**5,458**	**5,076**	**87.1**
Energy spending by top level catergory						
Electricity, Gas & Other Fuels	225.9	229.3	237.4	243.0	234.5	3.9
Transport Fuel	392.5	415.4	441.9	448.8	373.5	6.9
Transport Services	128.7	135.0	141.4	145.1	83.1	2.1
Sub-total	**747**	**780**	**821**	**837**	**691**	**12.9**
Total	**5,776**	**5,963**	**6,145**	**6,295**	**5,768**	**100**

Source: *Longview Economics, Eurostat*

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In the **'energy shock' scenario**, we make the following assumptions about Brent oil and European natural gas prices:

i. The oil price rallies sharply to a high of $150/barrel by June 2022. Then, after the initial shock of higher oil prices, we assume they move lower and finish the year at ~$100/barrel. Overall, the oil price averages $110/barrel in 2022 (from $70/barrel in 2021). While it's possible that the oil price would spike to (and average) higher levels this year, we are also cognizant that OPEC spare capacity is large (approx. 5 mbpd) and governments would likely release oil from their strategic reserves. We infer European gasoline prices based on their tight relationship with the Brent oil price.

ii. European gas prices would initially move sharply higher on the news of a cut in Russian exports (i.e. likely above the major spike to €175/MWh in December last year). This scenario anticipates the price then reverting back to lower levels (probably relatively quickly and once alternative gas sources are secured). Overall we model an average natural gas price of €95/MWh for the year (from an average of €50/MWh in 2021).

In the table below, we break down Eurozone household spending on energy by the three main types (table 2). In the energy shock scenario, household spending rises by 24% in 2022. While this does not seem particularly large, a key assumption is that the spike in energy prices is relatively brief (albeit significant), as major energy price spikes often are (e.g. see the oil price spikes of 2008 & 1990). That therefore makes the average increase in the cost of energy in 2022 (vs. 2021) somewhat less dramatic.

Table 2: Eurozone household spending on energy with key scenarios (EUR, bn)

Energy spending by top level catergory	2018	2019	2020	2021	2022	
	in EUR billion					
					Scenario 1	Scenario 2
Electricity, Gas & Other Fuels	237.4	243.0	234.5	285.1	288.7	349.6
Transport Fuel	441.9	448.8	373.5	487.9	528.7	623.7
Transport Services	141.4	145.1	83.1	144.7	151.4	161.2
Total	**821**	**837**	**691**	**918**	**969**	**1,135**

Source: *Longview Economics*

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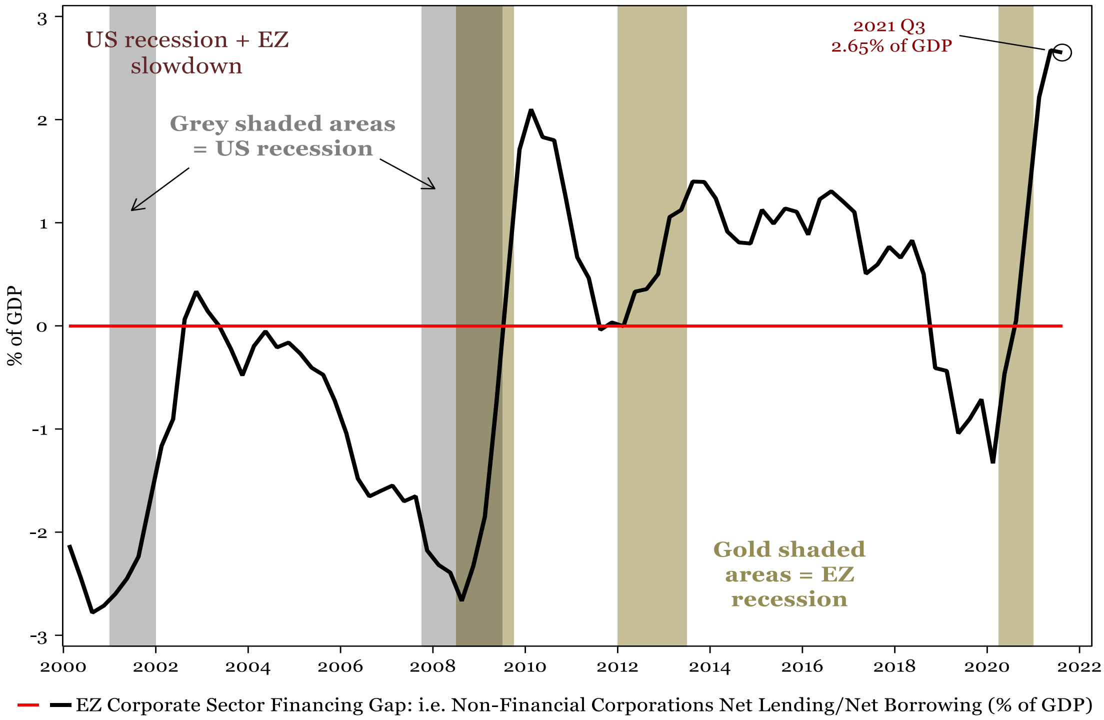
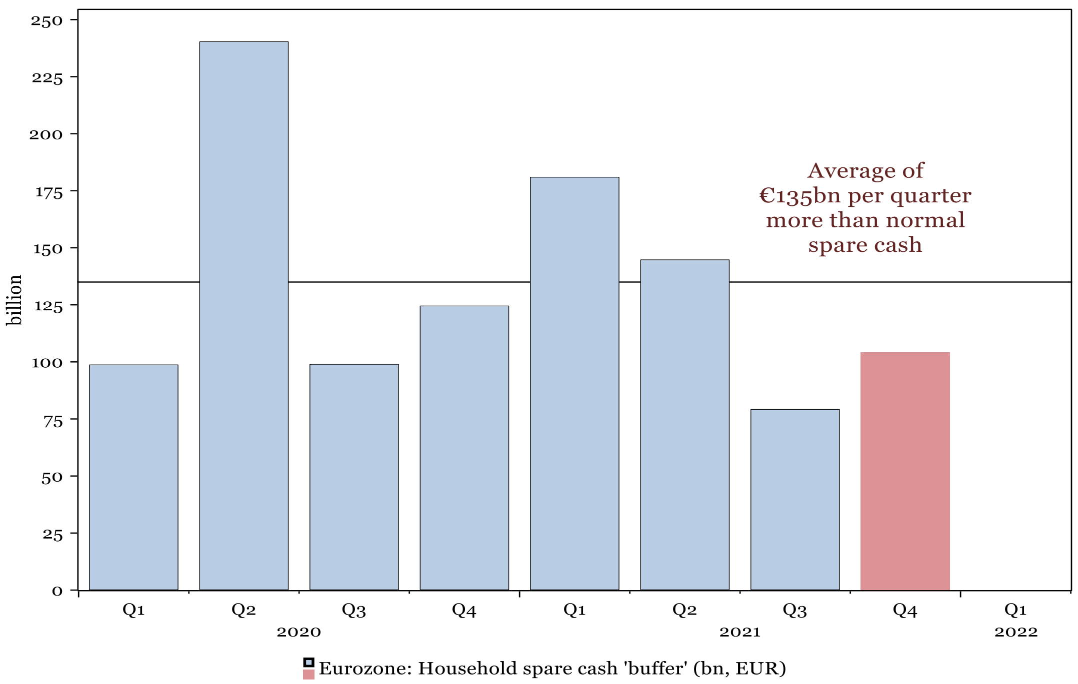
Key charts

Fig 5: Eurozone corporate sector lending/borrowing (% of GDP)



Source: Longview Economics, Macrobond

Fig 6: Eurozone household spare cash 'buffer' (bn, EUR)



Source: Longview Economics, Macrobond

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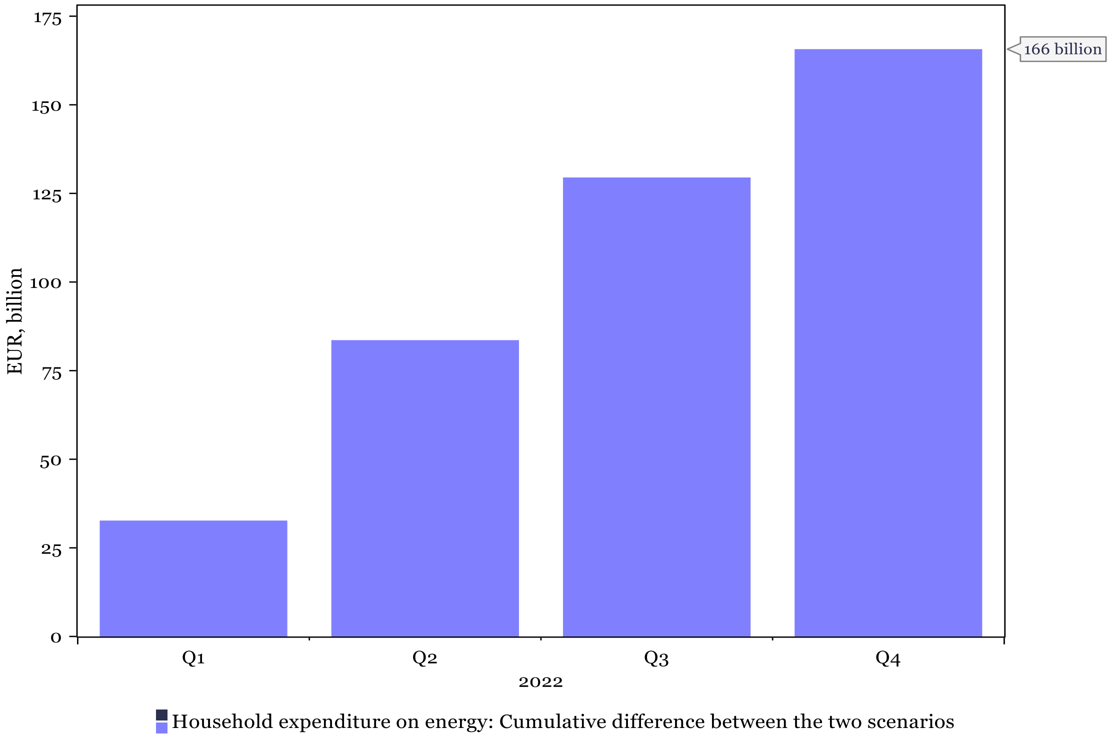
Fig 7: Eurozone household expenditure on energy: Cumulative difference between the two scenarios (bn, EUR)



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