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Economic insights

The energy crisis: adding fuel to the fire in Europe

Key takeaways

- Europe is in the eye of a global energy price storm as tight supply coincides with a post-COVID-19 demand surge.
- Natural gas futures in Europe almost doubled in September alone to reach record highs.
- "Fuel poverty" risks fueling social tensions as low-income households are disproportionately affected.
- The crisis is in part an unintended consequence of a global push to reduce reliance on fossil fuels.
- Much more development and investment into reliable renewable energy supplies are needed.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

A global shortage of energy is fueling soaring prices and raising the spectre of stagflation in Europe. Governments are acting to relieve households' immediate financial pressure, but we see a risk of "fuel poverty" reviving social tensions if the crisis persists. This underlines the urgent need for orderly climate change transition plans that invest more into renewables to meet the Paris targets.

Energy prices have skyrocketed in recent weeks. From renewables to fossil fuels, shortfalls in supply have coincided with a surge in demand for energy to power the global economic reopening after COVID-19. The most extreme movements are in natural gas (TTF) prices in Europe, which rose by 94% in one month to reach an all-time high of EUR 97.80/MWh on 30 September (see Figure 1, left). Oil prices are also up, albeit less (Brent crude +7.6% in September). Winter is likely to intensify the crisis. This will weigh on the near-term economic outlook. First, it will add to inflation pressure. Last week's Euro area headline CPI print was the highest in 13 years (+3.4% y-o-y), in part due to higher energy costs. Risks are most acute in the UK where we expect headline CPI to near 4% y-o-y in Q4. We have revised up our UK headline CPI forecast to 2.3% (+0.2pp) for 2021 and 2.7% (+0.4pp) for 2022. We also see upside risks to our Euro area CPI forecasts. Second, it will drag on already slowing economic activity. For example, China's efforts to burn less coal have caused power rationing and outages that have cut industrial production.[1] Third, higher energy bills will create negative second-order effects, such as lower disposable incomes and disappointing corporate profits.[2] Governments and central banks alike are seeking ways to end the crisis.

Central banks have limited ability to resolve this shock and are likely torn between whether to address rising inflation or slowing growth. Key to watch will be how this energy crisis impacts long-term inflation expectations. An adverse scenario would be if it triggers a disorderly rise in long-term inflation expections, which could push central banks to normalise interest rates faster. This risk is more acute in the UK and US, where long-term inflation expectations are already above central bank targets, unlike in the Euro area.

Governments face a delicate balancing act to prevent rising energy prices from heightening social tensions. Demand for household energy and petrol is inelastic – it responds little to changes in price. Rising costs act as a "tax" on consumers, eating disproportionately into the disposable incomes of low-income households, just as COVID-19 support measures are withdrawn. This coincident timing risks sparking social unrest, with longstanding frustrations over "fuel poverty" erupting as recently as this summer in Spanish cities. Recognising the need to avoid a resurgence in demonstrations like France's

[1] China's official manufacturing PMI fell into contractionary territory in September for the first time since March 2020 amid production cuts caused by energy outages.
[2] The Eurozone Producer Price Index is at an all-time high of 12.1% y-o-y.

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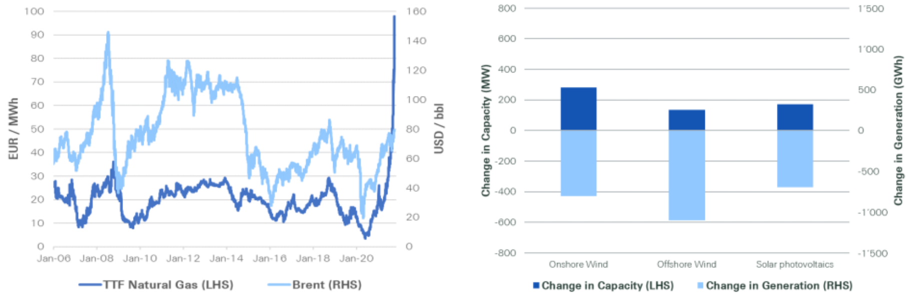
"yellow vest" protests in 2018, governments have stepped in with quick fixes to shield the vulnerable from high energy bills. These range from proposed subsidies (eg, in France) to tax cuts on energy (eg, in Spain).[2] The UK has fired up old coal plants, but this is clashing with both its green targets and activists.

Figure 1

Left: Brent crude oil and European TTF natural gas futures contract prices
Right: UK renewable energy generation and capacity, 2Q20-2Q21



Source: LHS: Bloomberg, Swiss Re Institute; RHS: UK Department for Business, Energy & Industrial Strategy

What does this crisis teach us? The energy crisis doesn't call the need for more climate actions into question, but it shows that the transition can be very painful and is complex. Today's energy shortfalls are in part an unintended consequence of the multi-year global push to reduce reliance on fossil fuels, while renewable energy capacities have not been ramped up fast enough and are still vulnerable to volatility. For example, below-average wind speeds in the North Sea in Europe contributed to wind power shortfalls that have exacerbated this energy crisis (see Figure 1, right).[3] Dwindling water reservoirs in the Nordics have also hampered hydroelectric power generation.[4] Much more investment in renewable energy supplies is needed as the world reduces its reliance on fossil fuels. This will add pressure for more concrete actions to be decided at COP26, the annual UN climate change conference.

The insurance industry, as a provider of risk transfer capacity, risk knowledge and long-term investment, can help to facilitate the transition to a low-carbon economy. The development of green technologies and construction of new energy infrastructure, including carbon capture and storage, will create new insurance and investment opportunities. More broadly, a commitment to a "net zero" asset and underwriting portfolio, and PPPs with sustainability criteria at their core, can help to nudge global stakeholders towards a greener future.

[2] "France to boost energy vouchers as consumer bills rise", Reuters, 15 September 2021; "Spain moves to reduce rising electric bills.", New York Times, 14 September 2021.
[3] In Germany, wind power generation was 50% below its five-year average in the first two weeks of September. In the UK, wind power usually provides over 20% of the UK's power, but recently the share has been below 10%. Natural-gas prices are spiking around the world | The Economist
[4] "Europe's Power Crisis moves North as Water Shortage Persists", Yahoo Finance, 4 October 2021

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