

'Whatever it takes' reloaded?

Europe's fiscal response to the energy crisis

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EXECUTIVE SUMMARY

- We estimate that current (median) fiscal support amounts to about 3% of GDP in Europe (more than EUR475bn, on top of the EUR170bn pre-conflict). Unsurprisingly, the fiscal response is somewhat higher in countries with a larger energy-intensive industry and/or greater gas dependence. In most countries, the total measures (e.g. price caps, energy tax cuts, liquidity and equity injections, state-guaranteed loans, and furlough schemes) amount to around half of the Covid-19 packages. With the energy crisis – and in turn the inflation hit to the private sector – not yet past the peak, we expect EU governments to increase spending further. However, the big fiscal leaps are behind us as the room for maneuver is much more constrained amid rising interest rates.
- Available fiscal support will reduce the impact of higher energy prices on real disposable incomes and soften the blow on demand but can also slow down the reduction in inflation rates overall. We estimate that current measures directly reduce inflation rates by lowering energy prices most in the UK (-3.7pp in 2023), followed by more than -2pp in Germany, France, Italy and Spain. By doing so, however, they “free” 1.7% of GDP of domestic demand on average, as the decline of household disposable incomes in 2023 will be more than halved from -4.3pp to -1.7pp on average (more than EUR1,300 per household). Based on the current trend of real government expenditures (above pre-pandemic levels in Spain, the UK and to a lower extent Germany, and back to pre-pandemic in France and Italy) and current fiscal plans, limiting the fall in aggregate demand will delay the pullback in inflation. However, a rise in the savings rate could mitigate the inflationary effects of these fiscal measures. We expect Eurozone and UK inflation to come in at 5.6% and 7.5%, respectively, in 2023 – still way above the historical average.
- Fiscal support measures should help limit the number of vulnerable firms becoming insolvent over the next four years. At current levels, energy prices would virtually wipe out the profits of most non-financial corporates as pricing power is diminishing amid slowing demand. If firms can pass one quarter of energy-price increases to customers, they can withstand a price increase of below +50% and +40% in Germany and France, respectively. Given the nature of the current crisis, governments chose to use more cash-based measures to offset the war-induced rise in energy prices. Indeed, for both political and economic reasons (high corporate leverage amid an environment of rising interest rates), promoting corporate leverage to face the crisis could prove to be a policy mistake. Thus, even weaker firms can survive: The share of fragile firms in the UK, France and Germany is stabilized at respectively 17% of total, 13% and 6%, or close to 42,000 firms in the UK, 28,400 in Germany and more than 18,700 in France. This means that on average governments will “save” more than 4,500 SMEs. However, as measures only offset much stronger rises in costs, they will not provide any additional boost to corporate profitability.
- The optimal policy response to the energy crisis would have been a swift structural overhaul of the European energy market. Since precious time was lost, the EU and

national governments now need to resort to second-best options based on an EU Commission menu of policy options. Some key considerations are: 1) Fiscal support measures at the national level should not fuel EU divergence, including by distorting intra-European competition. 2) In cases where fiscal space is limited, joint borrowing could and should allow all EU member states to formulate an adequate fiscal response without putting additional strain on national budgets. However, fiscal support needs to be temporary and targeted. 3) Sustained energy-demand reduction will be inevitable in what shapes up to be a more persistent energy-supply crisis. Countries need to find a way to reduce gas consumption beyond near-term savings (which currently stand at only 10%). Retaining the signaling function of market-based prices plays a crucial role in sustainable self-rationing while facilitating efficient reallocation of energy demand.

Current measures - so far so good?

Governments have significantly scaled up their response to the energy crisis over recent months to mitigate the impact on vulnerable households and firms. Initially, support measures largely came in the form of limited needs-based government transfers (e.g. energy vouchers) and lower (energy) taxes in most countries, with the exception of France, and later on Spain, which imposed general price caps on electricity and gas, respectively (Figure 1). Most governments roughly doubled their support since the summer as energy prices continued to increase amid escalating sanctions on Russian energy exports and dwindling gas supply through Germany's North Stream 1 pipeline (Figure 2). We estimate the median fiscal shield at about 3% of Western Europe GDP (more than EUR475bn on top of the EUR170bn pre-conflict), which includes both revenue and below-the-line measures, including public debt guarantees and credit lines to energy utilities. With the energy crisis – and in turn the inflation hit to the private sector – not yet past the peak, we expect EU governments to increase spending further. However, the big fiscal leaps are behind us as the room for maneuver is much more constrained amid rising interest rates.

The most significant national measure so far has been Germany's massive EUR200bn economic "shield" to support industry and households amid the energy crisis. On 29 September, the German government unveiled plans for a "protective shield" for which up to EUR 200bn (5.6% of GDP) have been earmarked to subsidize above all a "basic amount" of electricity and gas¹ and to reduce the VAT on gas and district heating to 7% until spring 2024. While the exact cost will depend on specifications that still need to be decided over the coming weeks, the total cost of the gas price subsidy amounts to EUR96bn (2.7% of GDP). In addition, the government decided to abandon controversial plans for a levy on household gas bills, which was supposed to start in October to partly fund the bailout of some utility companies as the government is in the process of nationalizing several of the most hit utilities. These costs will now have to be borne fully by the government.

One day later, the EU energy ministers reached a political agreement on the following measures to mitigate high electricity prices:

- *Electricity demand reduction.* A voluntary target of 10% of gross electricity consumption and a mandatory reduction target of 5% of electricity consumption in peak hours.
- *Revenue cap for inframarginal technologies.* A cap of market revenues set at EUR180/MWh for renewables, nuclear and lignite electricity generators. The choice of

¹ A one-off full reimbursement in December will be followed in spring with a more differentiated subsidy scheme that reduces the gas price to 12 cents from March through to the end of April 2024 on 80% of usage. For large industrial customers, a price brake of 7 cents will apply to the procurement price from January 2023.

measures is at the discretion of member states, as well as the decision to set a lower cap for some technologies. The revenues gathered will be redirected towards final customers.

- *Solidarity contribution for the fossil fuel sector.* A mandatory temporary levy for businesses active in the crude petroleum, natural gas, coal and refinery sectors set at 33% on taxable profits in the 2022 and/or 2023 fiscal year.
- *Support measures for small-and medium-sized enterprises (SMEs).* Member states may temporarily set a price for the supply of electricity to SMEs to alleviate the pressure from the high costs of energy.

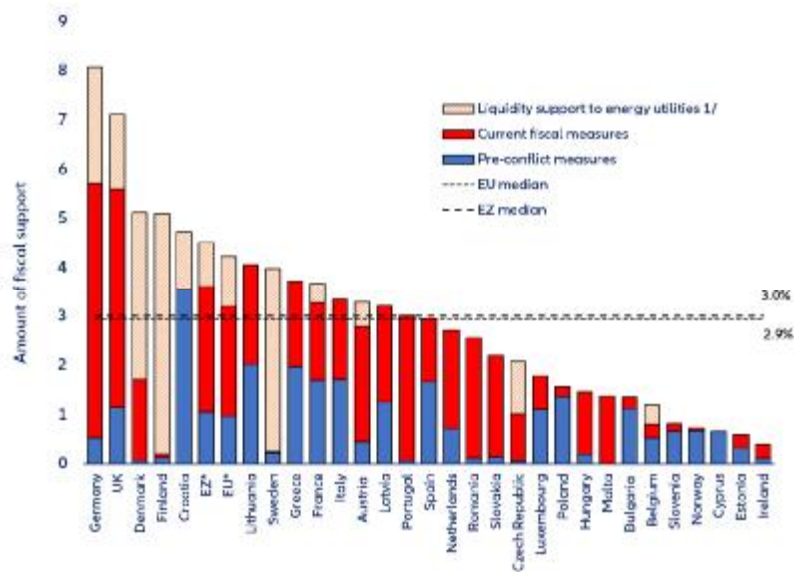
As expected, no agreement was found on the issue of a price cap for gas imports, although ministers discussed the matter extensively. While at least 15 member states are in favor of the measure, there are still plenty of technical differences in the proposed approaches. Notably, whether the cap will cover all pipeline gas imports or just those from Russia, and whether a fixed or a flexible cap should be imposed. The main concern is that a price cap could end up in less gas supply for Europe – aggravating the energy crisis.

Figure 1 – Europe: Overview matrix of fiscal measures

Impact	What	How	Corporates						Households					
			EU	DE	FR	ES	IT	UK	EU	DE	FR	ES	IT	UK
Revenue measures	Energy price cap/subsidy	Electricity price cap/subsidy	✓	✓	✓	o	o	✓	✓	✓	✓	o	o	✓
		Gas price cap/subsidy	o	✓	✓	✓	o	✓	o	✓	✓	o	✓	
	Windfall profits	Levy on windfall profits	✓	✓	✓	o	✓	✓	-	-	-	-	-	-
	Transfers	Grants	-	✓	o	o	o	o	-	✓	✓	✓	✓	✓
		Fuel subsidy	-	✓	✓	✓	✗	✗	-	✓	✓	✓	✗	✗
	Taxes	(Energy) tax cuts	-	✓	✓	✓	✓	✓	-	✓	✓	✓	✓	✓
		Tax deferrals	-	o	o	o	o	✗	-	o	o	o	o	✗
Furlough	Easier access conditions	-	✓	o	o	✓	✗	-	✓	o	o	✓	✗	
Below-the-line measures	Loans	Debt guarantees and loans	o	✓	o	✓	✓	✗	-	-	-	-	-	-
	Equity injections	for energy utilities	-	✓	✓	o	o	✓	-	-	-	-	-	-
	Nationalization	of energy utilities	-	✓	✓	o	o	✓	-	-	-	-	-	-
Structural measures	Insolvencies	Temporary suspension of insolvency law	-	o	o	✗	✗	✗	-	o	o	o	o	✗
	Debt moratoria		-	o	o	o	o	✗	-	o	o	o	o	✗

Note: ✓ = announced/in place, o = likely to be announced, ✗ = unlikely to be announced, - = does not apply.
Sources: Allianz Research.

Figure 2 – Europe: Scale of fiscal measures to address the impact of the energy and cost-of-living crisis (% of GDP)



Sources: National authorities, Bruegel, Allianz Research. Note: pre-conflict=measures taken prior the war in Ukraine; fiscal measures cover budgetary spending, below-the-line measures as well as contingent liabilities (e.g., public debt guarantees) and include both energy-related transfer payments, price caps and reductions of energy surcharges as well as other support measures aimed at vulnerable households and firms. The measures are taken at gross values, assuming accrued accounting (given the cross-country differences in timing and implementation of measures). 1/ includes public sector debt guarantees, credit lines and asset purchases/nationalization; */ GDP-weighted average of member countries; Spain's fiscal expenditures assumes an energy subsidy of EUR150 for 11.5mn (lower-income) households.

While fiscal support is critical to mitigate the impact of higher energy prices on real disposable income, it can also delay the decline in core inflation, which would work against the restrictive monetary stance. Considering the inflation-dampening impact of government measures and the share of regulated/non-regulated prices, we calculate the effective rise in electricity and gas prices that consumers will face in key European economies. We find price increases to the tune of +45% in France, +42% in Germany, +39% in Spain, +30% in Italy and +27% in the UK, against rises of more than +80% – or even +100% in the case of the UK – without state support. Hence, the reduction in the inflation rates is highest in the UK (-3.7pp in 2023), followed by Germany, France, Italy and Spain with more than -2pp, see Figure 3. At the same time, these measures will bring down the average loss of -4pp in households' purchasing power in 2023 (the equivalent of more than EUR1300 per household), to -1.7pp on average (see Figure 4).

Figure 3 – Impact of fiscal support measures on inflation

	Avg. expected increase in electricity/gas prices (2023)		Electricity & gas share in CPI inflation	Impact on CPI inflation		Estimated inflation reduction (pp)
	<u>without</u> public sector support	<u>with</u> public sector support*		<u>without</u> public sector support (pp)	<u>with</u> public sector support (pp)	
	(1)	(2)		(1) x (3)	(2) x (3)	
Germany	88%	42%	5.10%	4.5	2.1	2.3
France	90%	45%	5.10%	4.6	2.3	2.3
Italy	80%	30%	4.70%	3.8	1.4	2.4
Spain	80%	39%	5.60%	4.5	2.2	2.3
UK	100%	27%	5.00%	5	1.4	3.7

Sources: national sources, Allianz Research. Note: the expected increase of energy prices in Germany without public support has been calibrated to those in France in the absence of any government statement; *we look into regulated and non-regulated prices when relevant.

Figure 4 – Impact of state support measures on households' disposable income

Loss in HH disposable income (pp)	2022	2023 pre-measures	2023 post-measures	Purchasing power saved by the government (pp)	EUR bn	% of GDP	EUR/household
Germany	-1.4	-3.7	-1.7	1.9	42.8	1.2%	1056
Spain	-1.7	-4.0	-2.0	2.1	16.3	1.3%	866
France	-0.5	-3.1	-1.6	1.6	25.2	1.0%	832
Italy	-1.9	-4.5	-1.7	2.8	34.0	1.9%	1304
UK	-2.1	-6.2	-1.7	4.5	78.8	3.0%	2676

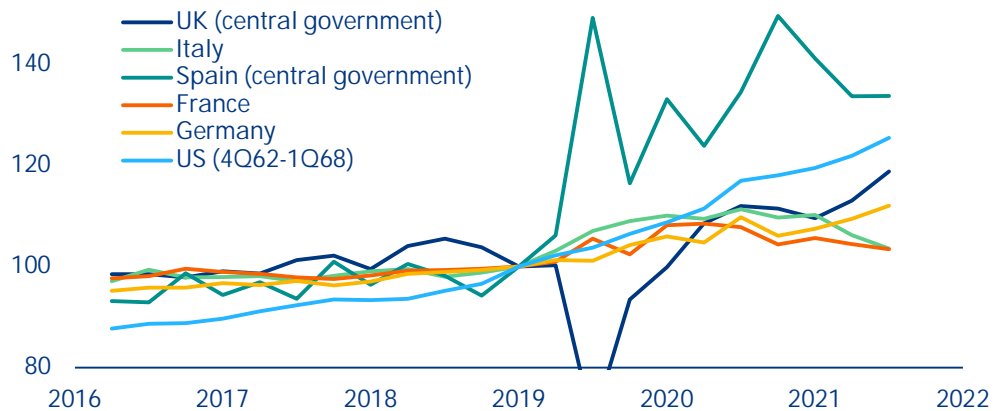
Sources: National sources, Allianz Research

But can these measures make inflation rates stickier? The UK and Germany are most at risk given current fiscal spending plans. The fiscal policy-induced effect on inflation in the wake of the pandemic was large in 2021. According to a paper by the Fed², the expansionary policy of Eurozone governments boosted inflation by nearly +2pp. Historical episodes also highlight the key role of expansionary fiscal policy in fueling inflation. For instance, the spike in US real government spending in the late 1960s (see Figure 5) – to fund the Vietnam war and the 'Great Society' initiatives of the Johnson administration – greatly contributed to the subsequent pick-up in inflation during the 1970s. An important lesson from this time is that if large government spending hikes are not reversed in due course, inflation is likely to become entrenched and get out of control.

In the current backdrop of already elevated inflation, the large amount of spending (and, to a lesser extent, tax cuts) rolled out by several European governments has stoked legitimate concerns that fiscal policy will fuel inflationary pressures further. For instance, while price caps directly reduce energy inflation (by -2.6pp on average for largest European countries, see Figure 3), they also limit the amount of aggregate demand destruction (on average 1.7% of GDP, see Figure 2), potentially fueling higher prices on non-energy items. Ultimately, headline inflation will be higher than in the absence of fiscal measures.

² [The Fed - Fiscal policy and excess inflation during Covid-19: a cross-country view \(federalreserve.gov\)](https://www.federalreserve.gov/econres/br/brown/20210801.html)

Figure 5 - Real (cash-basis) government expenditures (Europe: Q4 19 = 100, US: Q3 65 = 100)



Sources: National sources, Allianz Research

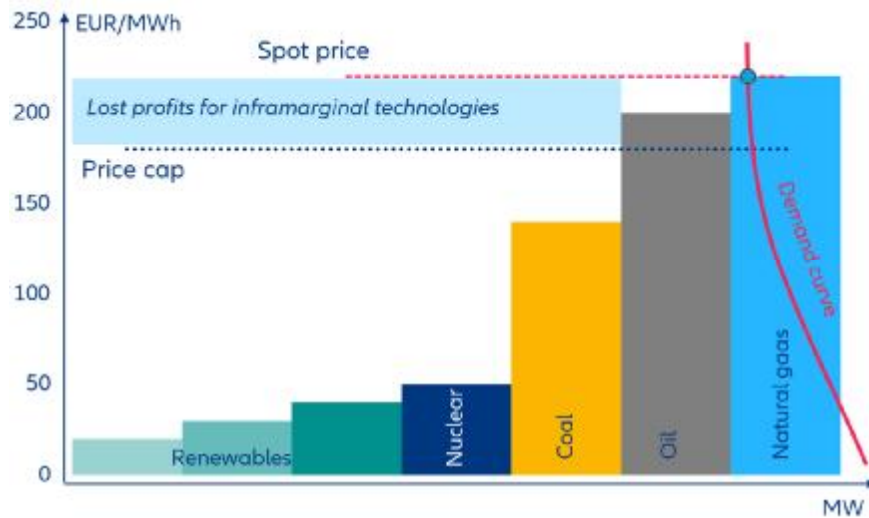
The latest data on real government spending show that in some countries fiscal policy is still very loose. Up to Q2 2022, real government expenditures (cash-basis) are indeed well above their pre-pandemic trend in Spain and, to a lesser extent, in the UK (see Figure 5 again). In contrast, in France and Italy, real spending is back to its pre-pandemic trend as the French and Italian governments have unwound most of the pandemic support measures. Germany is somewhat in the middle of the pack.

More worrying, however, are the fiscal plans for the next months and years. Germany's very large fiscal announcements represent a material upside risk to the inflation outlook, given its outsized economic weight in the Eurozone. In the UK, the government also intends to loosen fiscal policy further on a substantial scale. In Italy, the newly elected coalition set out plans to loosen the purse strings during the election trail. However, against this backdrop, adverse financial market reactions to large debt-funded fiscal announcements – as highlighted in the UK recently – constrain the ability of governments to follow up on their ambitious pledges. Furthermore, households could save part of the fiscal transfers they receive, which would mitigate the inflationary effects of fiscal policy. In all, the speed at which European governments unwind these large fiscal support packages will be crucial to watch for the inflation outlook, as well as financial stability prospects.

Gas price cap still a debated measure, power market reform unlikely

In order to protect consumers and to redistribute the power sector's surplus revenues, the EU recently agreed to a cap of EUR180/MWh for electricity generated through renewables and nuclear (i.e. inframarginal power generation). This cap will be introduced on 01 December 2022 and will apply at least until 30 June 2023. EU member states agreed to use tailor-made measures to collect and redirect these revenues towards final electricity customers. Some flexibilities can apply based on national circumstances, including the possibility to set a higher or lower revenue cap, differentiate between technologies etc. The move has been criticized by some actors in the market for not incentivizing the energy transition by hampering returns for renewable energy. However, many renewable energy projects that were initiated before 2021 were made under business plans assuming power prices four or five times lower than the EU cap.

Figure 6 - EU price cap mechanism



Source: Allianz Research

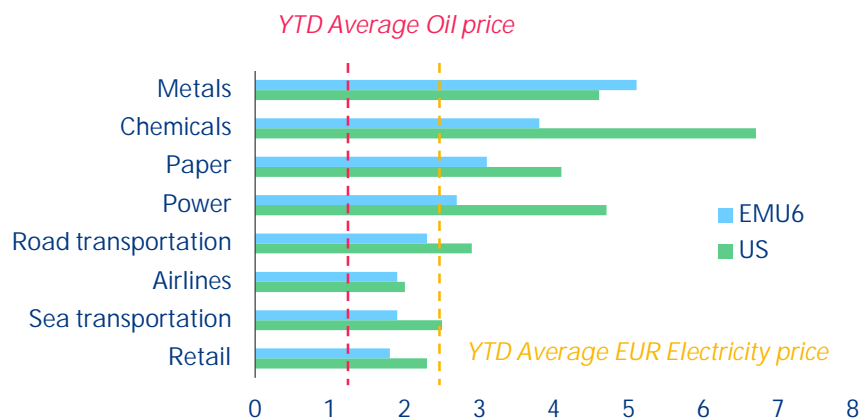
However, a price cap on gas remains a matter of controversy among EU member states. Italy, Greece, Poland and Belgium proposed recently to establish a trading range of say 5% or 10% around an agreed gas price cap. At this stage, such proposals seem unlikely. Indeed, most countries do not agree on whether firms generating power with gas should be compensated or whether the burden should rest solely on suppliers. For instance, Norway, which currently provides a quarter of Europe's gas, has already voiced its opposition to a cap that would apply to suppliers. Meanwhile, energy producers have hinted that they could halt or reduce production if they need to pay above the price cap to source natural gas on the market without being compensated. Overall, the fears of worsening either the energy supply or fiscal deficits are leading to the current standstill. Regarding the broader electricity market, there have been calls for large reforms, mostly from southern European countries (e.g. moving to regionalized prices for instance) but other countries such as Germany or the Netherlands are still supporting current market structures and are only willing to consider slight adjustments such as circuit breakers or emergency interventions. This also means that episodes of high volatility and high prices could repeat for corporates in the future, which is fostering questions around the affordability and availability of energy in Europe, especially for energy-intensive sectors (metals, chemicals, and paper).

Support measures to shield corporates but will not provide any boost

At current levels, non-financial corporates wouldn't have been able to avoid losses as the rise in energy prices would have pushed their intermediate consumption up by more than +70%, notably as their pricing power is diminishing with demand slowing down fast. We calculate that the maximum rise that firms in Germany and France could sustain without EBITDA losses, if they can pass around one fourth of the rise in energy prices to the final customer, is +50% and +40%, respectively. Hence, a price cap was needed to avoid a strong wave of insolvencies. Note that there is heterogeneity among sectors and that European firms were already more vulnerable than US competition. For instance, a doubling of the energy bill for Eurozone airlines or retail firms from 2021 levels would wipe out all profits – if not compensated by an increase in revenues (see Figure 7). Such a situation could be particularly worrying in the absence of policy support

as spot electricity prices in Europe have been multiplied by 2.5 compared to the 2021 average (see Figure 8).

Figure 7 - Energy bill increase that could wipe-out all profits by sector (multiple of 2021 prices)



Sources: Refinitiv, Allianz Research. Note: we only consider sectors in which energy costs >5% opex / EMU6 = Germany, France, Italy, Spain, Netherlands, Belgium

Figure 8 - Evolution of energy-related commodity prices

	Unit	Latest 07.10.2022	Average 2021	Average 2022 YTD	Multiple 2022/2021
Brent	(USD/bbl)	97.9	70.9	102.3	x1.4
WTI	(USD/bbl)	93.1	68.1	98.8	x1.5
TTF Gas	(EUR/MWh)	155.0	47.3	136.1	x2.9
Henry Hub Gas	(USD/MBTU)	6.8	3.7	6.7	x1.8
Electricity JPM	(USD/MWh)	56.3	47.8	76.6	x1.6
Electricity APX	(EUR/MWh)	147.5	108.9	273.4	x2.5

Sources: Refinitiv, Allianz Research

Furthermore, European governments have propped up the power sector over the recent months. For instance, Germany and France announced the full nationalization of key players in the sector. Many other countries also set up liquidity facilities as firms are facing huge margin calls on electricity markets. Beyond the power sector, most countries will also support firms in broader sectors. To understand the impact of such support we simulate the financial performances of SMEs using our proprietary database of over 5mn companies. Based on GDP growth figures for France, Germany and the UK, as well as energy-price changes including support measures, we compute profitability, liquidity and capitalization ratios for each SME in our base. To properly impact each firm's financials, we consider the share of energy expenses in total expenses by sector. We inflate the energy bill from 20% to 50% depending on the energy mix (fuels, electricity, gas) and the relevant price dynamics. Our estimates show that the fiscal measures do not lead to a boost in profitability for SMEs, which is consistent with the nature of the measures. However, we do notice that they lead to a stabilization in the number of fragile SMEs from 2021³ at 17% of the total in Germany, 13% in the UK and 6% in France, or close to

³ See our report "[Three indicators can reveal SME insolvency risk up to four years in advance](#)" for details on indicators and the respective thresholds for each country

42,000, 28,400 and more than 18,700, respectively now . This means that on average the fiscal support – which along with energy subsidies includes generous furlough schemes, state-guaranteed loans and in some countries direct grants – will “save” more than 4,500 SMEs.

Figure 9 - Share of fragile SMEs in selected countries (% of total)

	Share of fragile SME ...in %		...in number		Number of SMEs “saved” by the government
	<u>without</u> support	<u>with</u> support	<u>without</u> support	<u>with</u> support	
UK	20	17	49,240	41,854	7,386
France	14	13	20,105	18,669	1,436
Germany	7	6	33,072	28,348	4,725

Source: Allianz Research

Policy considerations

The optimal policy response to the energy crisis would have been a swift structural overhaul of the European energy market at a time when disruptions in gas supply from Russia became exceedingly likely. Key challenges relate to the design of market mechanisms (such as the merit order model in the presence of quasi-permanent price pressures on gas-fired power plants as marginal price setters for electricity at large) and the compatibility of different infrastructure (e.g. delivering gas from Spain, where imports outstrip consumption) to other parts of Europe. Scaling up investment in renewable energy infrastructure and viable alternatives to pipeline gas, such as LNG terminals in ports, is also essential, but needs early strategic commitment and additional fiscal support to create predictability for businesses. The current crisis underscores the urgency of a *bona fide* energy union that ensures energy security while preserving the green transition of the European economy to net zero emissions.

As meaningful reform will likely require some time, the EU and national governments need to resort to second-best options. Effectively mitigating the impact of the energy crisis will require a coordinated fiscal policy response in the meantime, based on recommendations to be provided by the EU Commission. In this context, key considerations are:

- 1) Current fiscal support at the national level should not increase divergence in Europe. Fiscal support in countries with more energy-intensive industries and/or a high share of gas in energy consumption (Germany, Italy and many Eastern European countries) that suffer disproportionately from the current crisis will need to be higher. However, there is a risk that the EU Temporary State Aid framework allows countries with more fiscal space to provide disproportionately more support to their own firms, which could distort intra-European competition. Furthermore, support measures, if longer lasting, would need to be more targeted to avoid creating inflationary pressures and increasing moral hazard, notably if most of the measures concern direct cash support to compensate for losses from high energy prices.
- 2) To underline European solidarity, joint borrowing would allow all EU member states to formulate an adequate and aligned fiscal response to the energy crisis without putting debt sustainability at risk. While a repeat of the Next Generation EU (NGEU) framework seems unlikely, we see two main options: (1) repurposing the more than EUR200bn of funds still remaining in the current NGEU and/or (2) setting up a new crisis fund at the European Commission, using SURE as a blueprint (backed by government guarantees) In both cases, support would come in the form of loans rather than grants, which remain an attractive option for countries that face higher interest costs. While overall a pan-EU fiscal policy

response should cushion the economic blow to the region and reassure investors, it will hardly clear the path for an unlimited fiscal response. After all, it could incite the ECB to opt for even more rapid policy tightening, including by bringing forward quantitative tightening.

- 3) A sustained energy demand reduction will be necessary in what shapes up to become a more persistent energy supply crisis. While current fiscal support can mitigate the income shock to households and firms, the EU and national authorities need to find a way to enhance energy efficiency and stabilize gas consumption beyond near term savings (which currently stands at only 10%). Retaining the signaling function of market-based prices plays a crucial role in sustainable self-rationing while facilitating efficient reallocation of energy demand. Otherwise, unmitigated demand for natural gas over the longer run is likely to push gas prices even higher while requiring large-scale subsidies, which could complicate the necessary fiscal consolidation.

These assessments are, as always, subject to the disclaimer provided below.

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