ING Monthly: bracing for a tough winter

As the global economy slides into a winter recession, Europe is in the eye of the storm. High energy costs caused by the war in Ukraine and rising interest rates have sent a cold chill through the region, which is only set to get worse. And as ING's Carsten Brzeski explains, there is no easy way out

More economic drama for Europe amid global shockwaves

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The global economy has clearly not turned for the better in recent weeks. On the contrary, our earlier fears of a looming recession seem to have become a reality. All sentiment indicators point to a slowing of the global economy; the only question is how severe this slowdown will be. The deceleration in activity is being driven by high energy and commodity prices but increasingly also by higher interest rates. Let's not forget that over the last 70 years, the most common trigger for a global recession has indeed been too aggressive monetary policy tightening.

It is no surprise that Europe remains in the eye of the storm. The war in Ukraine continues to rage on and the risk of further escalation seems higher than a peace deal being reached any time soon. High energy prices have increasingly found their way into the real economy, denting private consumption, industrial production and shrinking profit margins. The silver lining of filled national gas reserves has recently become clouded again by the stoppage of the Nordstream 1 pipeline and the cold September weather. The risk of energy supply disruptions is back again. Even worse, there is an increasing awareness that high energy prices will not only be a problem for this winter but also for next.

While everyone is still assessing the depth of a potential winter recession, another risk has not yet received sufficient attention; the eurozone may be witnessing the end of the business cycle as we knew it. Energy prices are very likely to remain high – very high – in the coming years. This will be a structural, not just cyclical burden on companies' cost competitiveness and households' purchasing power. It is a structural shift that could be compared with the deleveraging many eurozone countries saw after the financial crisis and which led to subdued growth for many years. Consequently, the risk is high that the eurozone economy will not experience a V-shaped or U-shaped recovery but rather, a J-shaped recovery.

This distinction between a rather traditional cyclical recession and a recession at the start of a structural change is important as it has implications for the right policy answer. Currently, many governments have started to support the demand side of the economy with large fiscal stimulus packages. It is a recipe that worked well during the pandemic. However, the history of previous crises or downturns in the eurozone shows that such fiscal stimulus only works in the absence of structural issues. In the case of highly needed structural change and transition, fiscal stimulus aimed at the demand side of the economy rather runs the risk of delaying change at the cost of surging government debt.

It is not easy to be a European policymaker these days. The potential economic fallout of the looming recession could be painful and in a worst-case scenario runs the risk of destroying production capacity for good. At the same time, the European economy is facing a structural energy shock which actually requires a policy answer aimed at the supply side of the economy. Currently, however, most efforts are aimed at the demand side, and monetary and fiscal policy are clearly not in sync. While the European Central Bank is hiking interest rates to fight inflation and inflation expectations, implicitly accepting a weakening of the demand side, governments are actually supporting the demand side. Delivering fiscal stimulus that is both aimed at the supply and demand side of the economy is possible in theory, but in practice, there are clear limits to such stimulus in the form of too high government debt, as the recent market reaction to the UK government's fiscal stimulus plans showed.

An uncomfortable truth is that the current crisis in Europe cannot be quickly and easily resolved. Indeed, it increasingly appears that it cannot be resolved without accepting economic damage. We are bracing for a tough winter.

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