How rate hikes slow the German economy

Dr Ralph Solveen

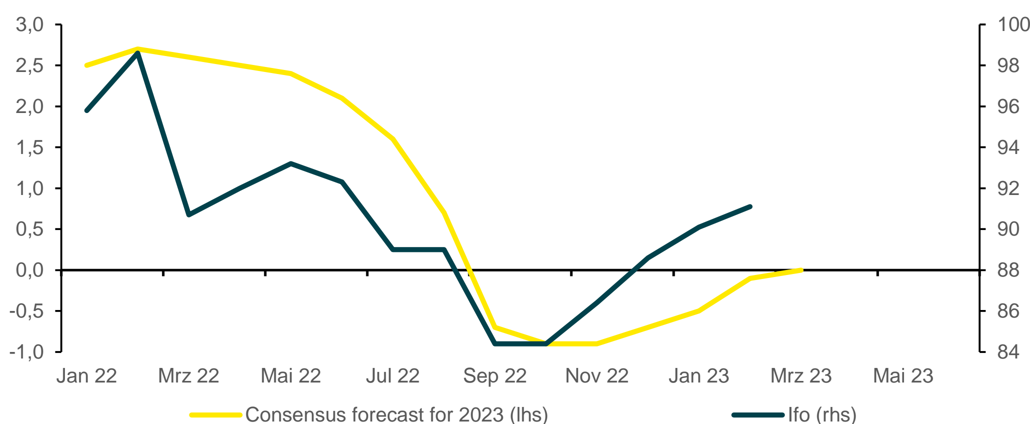
The global key rate hikes of the past twelve months have contributed to the recent problems in the banking sector. However, monetary tightening is also likely to weigh on the real economy. In Germany, for example, every rate hike cycle over the past 50 years has been followed by a recession. This argues against the economic recovery expected by many economists in the further course of the year. Instead, we expect a temporary decline in GDP for Germany and the euro area, although we do not anticipate a deep recession due to the stable labor market and the resilience of companies.

Hope for a better second half of the year ...

Although the German economy contracted by 0.4% in the fourth quarter - which hardly anyone had expected - many economists have revised their growth forecasts upward in recent weeks (Chart 1). They expect growth to accelerate in the course of this year. The arguments cited for this are mostly the easing of supply bottlenecks and a lighter burden from energy prices. Improved business sentiment is also frequently cited as evidence of the brighter outlook. After all, the Ifo business climate has recovered noticeably from its crash in recent months.

Chart 1 - Firms and analysts in better mood

Consensus forecast for growth rate of the German economy in 2023, in percent; Ifo business climate, 2015=100



Source: Consensus Economics, IHS, Commerzbank Research

... despite strong tightening of monetary policy?

Somewhat surprisingly, the fact that many central banks around the world have raised their interest rates sharply is hardly a factor in these outlooks. At the ECB, the cumulative amount of rate hikes now comes to 350 basis points, while other central banks such as the Fed have tightened even more.

Over the past 50 years, such rate hikes have not left the German economy unscathed. Rather, they have always been followed with a certain delay by a recession (front page chart). One exception might be seen in the Bundesbank's rate hikes between the summer of 1988 and the fall of 1989, which were initially followed by a boom and not a recession. At that time, however, fiscal policy pursued an extremely expansionary course because of reunification, which obviously neutralized the tighter stance of monetary policy for a time. When the degree of expansion of fiscal policy declined again and the Bundesbank raised interest rates further, the seemingly inevitable recession followed.

Monetary policy argues for weaker economic ...

This experience with previous rate hike cycles shows that it is easy to justify that the economy is expected to remain weak for the rest of the year in view of the significant tightening of monetary policy. This is all the more true given that interest rates have been raised much faster so far this time than in most other cycles (table 1).[1]

Table 1 - Fastest rates hikes in almost 50 years

Figures in quarters (distance and length) or percentage points (extent and pace); figures for current rate hike cycle up to and including 2023Q1.

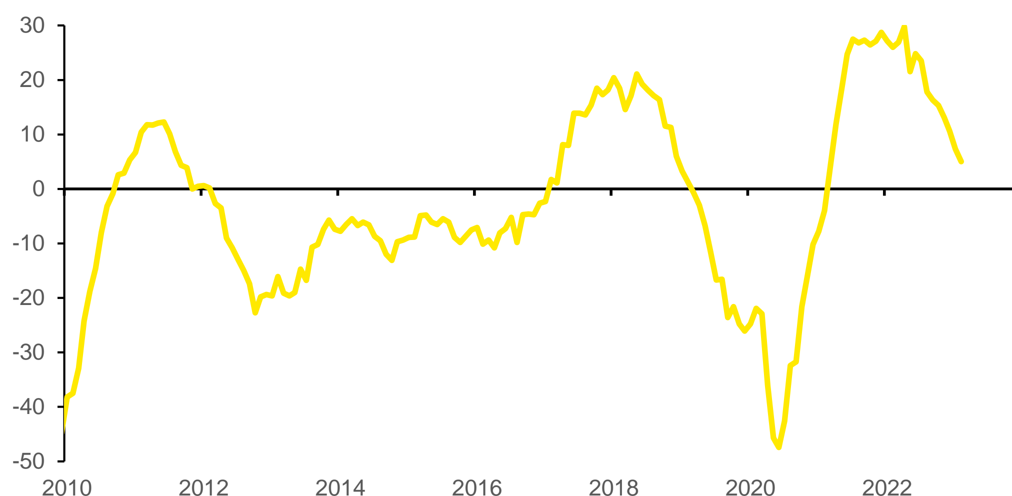
Start rate hikes	Start recession	Lag	Total rate hikes (until start of recession)	Extent of rate hikes (until recession)	Pace (rate hikes per quarter)
1972Q4	1974Q2	6	4,0	3	1,3
1979Q1	1980Q2	5	4,0	5	0,8
1988Q3	1992Q2	15	5,5	14	0,4
1999Q4	2000Q3	3	1,8	3	0,6
1999Q4	2001Q2	6	2,3	5	0,5
2005Q4	2008Q2	10	2,0	7	0,3
2011Q2	2012Q4	6	0,5	2	0,3
2022Q3	???	???	3,5	3	1,2

Source: Bundesbank, destatis, Commerzbank Research

Instead, very good arguments are needed to back the expectation of a sustained revival of the economy. The relief in energy prices is unlikely to be sufficient to neutralize the effect of the interest rate hikes (see our **Economic Insight**). The repeatedly cited easing of supply bottlenecks may well support manufacturing activity in the first few months of this year. However, the various indicators are giving different signals as to how big this back-log really is. In the Ifo survey, for example, only a slight majority of industrial companies still rate their order backlogs as unusually large. Consequently, it is at least doubtful that this effect will still be felt in the second half of the year.

Chart 2 - Back-log of orders has shrunk

Manufacturing, assessment of order backlog in Ifo survey, diffusion index, seasonally adjusted monthly figures



Source: IHS, Commerzbank Research

…. in the second half of the year

Therefore, the question is probably less whether the tighter monetary policy will ultimately lead to a recession of some kind, but when this will be the case. A look at previous interest rate cycles shows that some time passed after the first rate hike before the recession began. In most cases, the delay was 3 to 6 quarters. It took considerably longer – for the reasons described – around reunification. The same applies to the run-up to the financial crisis, where the economy slumped particularly sharply – because of the uncertainty shock following the bankruptcy of Lehman Brothers.

This makes it fairly certain that the contraction of the economy in the fourth quarter was not due to the tighter monetary policy, but primarily to the significant loss of purchasing power among consumers as a result of inflation. For otherwise, monetary policy would have taken effect for the first time with virtually no delay. Instead, the negative effect of tighter monetary conditions is likely to be felt in the second half of this year at the earliest, with the risk certainly being an even longer delay. Thus, one should not be lulled into a sense of security if the economy picks up again somewhat in the first and in the second quarter. After all, in view of the experience of previous interest rate cycles, this would probably not be the start of a sustained recovery, but merely a postponement of the recession due after such a tightening of monetary policy.

However, the recession is likely to be rather mild. On the one hand, the above-mentioned positive factors – i.e. the relief in energy prices and the decreasing problems in the supply chains – will stabilize the economy. On the other hand, companies are likely to be much more resilient in a recession than in the past because of their more solid balance sheets. As a result, they are also likely to be much more cautious when it comes to job cuts, especially as many of them have recently suffered from a shortage of labor.

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[1] The starting point of the recession shortly after the turn of the millennium cannot be clearly timed. After two quarters with a slight decline in real GDP in the second half of 2000, there was a quarter with a significant increase, followed by several more quarters of negative growth. Depending on whether one places the start of the recession in the summer of 2000 or in the spring of 2001, different values are obtained for the lag between the first interest rate increase and the recession, as well as for the extent of the interest rate increases up to the start of the recession. This is why this cycle is shown twice in the table. (back to text)

What's next after the price slump on the oil market?

Carsten Fritsch

At the beginning of the week, crude oil was cheaper than it was last 15 months ago. The market turmoil contributed to this, but the fundamental outlook has also deteriorated, at least in the short term. For example, the IEA expects higher oversupply in the first half of the year, and inventories in OECD countries have risen significantly. We have therefore lowered our oil price forecast. However, we still expect the oil price to rise in the course of this year. After all, the oil market is likely to be significantly undersupplied in the second half of the year due to a strong increase in demand, particularly in China, and stagnating supply.

Oil prices have recently been under significant pressure due to the market turmoil. The price of a barrel of Brent crude fell to USD 70 per barrel at the beginning of the week, hitting its lowest level since December 2021 (Chart 1). This was driven by concerns that demand would weaken as a result of the recent market jitters, although there is no evidence of this yet. Another factor weighing on prices was the strong appreciation of the US dollar in the meantime, which benefited from its role as a safe haven.

At the same time, however, the fundamental situation has deteriorated. The IEA now expects a higher global supply surplus of just under 1 million barrels per day for the first quarter and also a slight oversupply for the second quarter. This is because, contrary to expectations, oil supply from Russia in January and February was only slightly lower than a year earlier, despite the Western oil sanctions. In addition, inventories have risen significantly as a result of the oversupply.For example, the IEA reports that oil inventories in the OECD countries rose four times as much as usual in January. As a result, inventories are again broadly in line with their 5-year average (Chart 2).

Even if the market turmoil subsides, the higher risk aversion sparked by it is likely to ease only gradually. Together with the fundamental data, which are unlikely to be as supportive, this suggests that the oil price will be lower in the months ahead than we have previously expected. On the other hand, OPEC+ is unlikely to stand by and watch a further decline in the oil price, but rather reduce supply if necessary, which argues against a further decline in the oil price. We are therefore lowering our oil price forecast for mid-year to USD 80 per barrel (previously USD 95), which would still be higher than current levels.

We are sticking to our general view that the price of oil will rise. If the market stabilizes, the US government can be expected to buy oil to replenish its strategic reserves. After all, the WTI price is now at the lower end of the corridor that the US government referred to for reserve purchases last autumn. In addition, the oil market is likely to be significantly undersupplied in the second half of the year due to a strong increase in demand, especially in China, and stagnating supply. For example, the IEA expects a daily supply deficit of around 1.5 million barrels in the second half of the year if OPEC keeps oil production stable until the end of the year and Russian oil production declines as expected. The deficit will also increase in the course of the year. We therefore expect that the oil price will rise to USD 90 per barrel by the end of the year (previously USD 100).

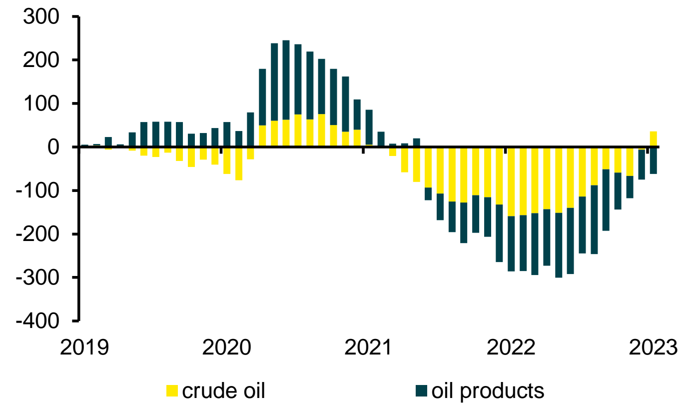
Chart 1 - Oil price has fallen to 15-month low

Brent in USD per barrel

Source: Bloomberg, Commerzbank-Research

Chart 2 - Industrial oil stocks in the OECD no longer tight

Deviation from 5-year average in million barrels



Source: IEA, Commerzbank-Research

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