



MARKET *view*

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“AT NIGHT, I THINK OF GERMANY”: RECESSION WORRIES AND EMBARGO OF RUSSIAN GAS



KEY HIGHLIGHTS

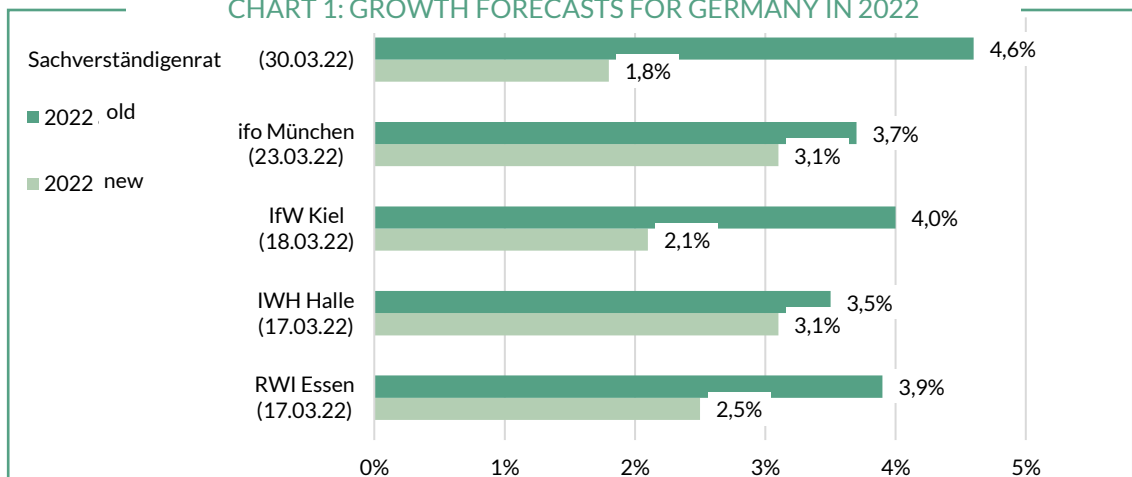
- In response to the war in Ukraine and increased uncertainty, the German Council of Economic Experts and leading research institutes have already significantly lowered their growth forecasts for Germany. The German Council of Economic Experts expects the German economy to grow by a meager 1.8% in 2022.
- In an initial study, prominent German economists estimate that a gas embargo will lead to a 0.5% to 3% decline in Germany's gross domestic product. In fact, however, the loss of growth could be much higher.
- A supply freeze of Russian gas would not only lead to energy rationing and production losses, but also to a significant demand shock. If there were a gas embargo in Germany, we would further reduce the risk in our portfolios.



The latest economic data from Germany are not very encouraging. Chart 1 shows that the major German research institutes and the German Council of Economic Experts have significantly downgraded their 2022 growth forecasts for Germany. Russia's invasion of Ukraine in violation

of international law and the resulting uncertainty are the main reasons why the German Council of Economic Experts now only expects the largest economy in the eurozone to grow by a meagre 1.8% in 2022.

CHART 1: GROWTH FORECASTS FOR GERMANY IN 2022



Sources: Press release Sachverständigenrat 30.03.2022; ifo Schnelldienst digital, 2022, 3, No. 1, 1-15; Kieler Konjunkturbericht, No. 89 (2022 | Q1); IWH Konjunktur aktuell, No. 1, 2022; RWI Konjunkturbericht, Vol. 73 (2022), Issue 1.



Highly regarded leading indicators such as the ZEW indicator and the IFO business climate index suggest that the economic situation in Germany could deteriorate even further. In March 2022, the ZEW Indicator of Economic Sentiment fell more than at any time since the survey began in December 1991. And the IFO business climate index, which measures sentiment in the German economy, also plunged more in March 2022 than at the outbreak of the Coronavirus pandemic two years ago. At the same time, Eurostat has reported that inflation in Germany rose to 7.6% in March 2022, a level not seen since the 1980s.

Meanwhile, experts in Germany are arguing about the effects a ban on Russian energy imports could have on the German economy. According to Bachmann et al. (2022), a halt to Russian energy imports would cause a decline in gross domestic product of "only" 0.5% to 3%. The study by the nine economists has caused a stir. When asked about it on the well-known political talk show *Anne Will*, German Chancellor Olaf Scholz sharply criticised it. The Chancellor and his Ministers of Economics and Finance - Robert Habeck and Christian Lindner - believe that serious consequences for the German economy are possible if Russian gas supplies were to be suspended in the short-term.

And indeed, as a result of the Ukraine conflict, Germany has had to make two 180-degree U-turns. In foreign and security policy, Chancellor Scholz recently announced investments of 100 billion euros in the German armed forces and, in a departure from earlier positions, agreed to arms deliveries to Ukraine. In energy policy, the task now is to reduce the self-inflicted dependence on Russia. Germany obtained from Russia 55% of its natural gas in 2020, and 34% of its oil and 26% of its coal in 2021.

So who's right? The nine economists who consider a short-term halt of Russian natural gas supplies to be "manageable" or the policy makers who warn of severe economic losses as a result of a gas embargo? The study by Bachmann et al. (2022) is to be welcomed in principle, as it takes into detailed account the trade relations of many countries and the input-output structure at the sector level when estimating the effects of a gas embargo on the German economy. However, despite the high level of uncertainty, the authors refrain from showing the limitations of their estimates and thus, the high forecast inaccuracy of their study in the central table summarizing the results.

It is also questionable whether the model really allows for a realistic approximation of the situation on the ground. In Germany, industry is a major consumer of natural gas, which is used to manufacture chemicals, metals, glass, paper, food and many other products. Martin Brudermüller, BASF's CEO, believes, like E.ON's CEO Leonhard Birnbaum, that Russian gas can only be replaced over a longer period of several years. Moreover, at BASF's largest site in Ludwigshafen, a reduction or discontinuation of production could not be ruled out if Russian gas failed to be delivered. Chemical industry products are used as basic materials in the manufacturing of plastics, adhesives, pharmaceutical products and many other goods, which themselves often serve as basic inputs in a closely interlinked value chain. Therefore, many companies are warning of a collapse of entire supply chains as a result of a gas embargo. It is striking that the warnings from business and political experts are considerably gloomier than the model considerations of Bachmann et al. (2022). Under the auspices of the Federal Network Agency, politicians and businesses are now considering which companies would have to be taken off the grid in an emergency if Russia stopped supplying natural gas. At the end of March 2022, Economics Minister Habeck activated the early warning stage of the "Gas Emergency Plan".

In addition, Bachmann et al. (2022) underestimate the interdependencies of a supply shock. Rising prices for natural gas, oil and coal can lead to a sudden increase in inflation. The rise in inflation, in turn, acts like an "oil tax": those who spend more at the pump have less money available to buy other goods and services. High inflation also leads to rising interest rates and thus, to lower investment and a slowdown in growth. Furthermore, as a result of a supply shock, uncertainty in the economy increases, for example due to sharply rising input costs, supply chain problems, credit defaults or even a wage-price spiral. Bachmann et al. (2022) are not very realistic in assuming that demand effects are fully compensated by government action and that second-round effects do not occur. Realistic scenario analyses of how a jump in prices could affect demand behaviour are omitted. Nevertheless, policy makers are well advised to keep all options open. Even very high growth losses can quickly lose significance if politicians hope that a gas embargo can contribute to a faster end to a war that is causing so much human suffering and misery in Ukraine.



It's always good to think in scenarios. So far, based on the above forecasts from the research institutes and the Council of Economic Experts, we consider a brief technical recession in Germany to be likely if there is no halt to the supply of Russian energy. With a freeze on the supply of energy from Russia, however, rationing, production downtime, supply chain problems, soaring energy prices and falling demand could no longer be ruled out. A short-term halt to the supply of Russian energy would probably

lead to a longer recession and significantly higher unemployment in Germany. Such a scenario would cause us to be significantly more cautious in our investment decisions. On the other hand, a much desired peace agreement in Ukraine would also make us more optimistic in our investment decisions. Uncertainty remains high in the context of increased recessionary risks and the possibility of a gas embargo.

Sources:

1./ Bachmann, Rüdiger et al. (2022): *What if? The Economic Effects for Germany of a Stop of Energy Imports from Russia*, ECONtribute Policy Brief No. 028. 2./ Blinder Alan S. / Rudd, Jeremy B. (2008): *The Supply-Shock Explanation of the Great Stagflation Revisited*, NBER Working Paper 14563 3./ Hans Böckler Foundation (2022): *Economists warn of economic crisis, issue 05/2022*. 4./ Krebs, Thomas (2022): *How not to calculate the effects of a gas embargo*, Macronome, 30 March 2022. 5./ Leopoldina, National Academy of Sciences (2022): *How Russian natural gas can be replaced in German and European energy supply, ad hoc statement of 8 March 2022*.

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