

| The current economic situation in Germany

Overview

First signs of recovery after historic slump in economic activity

Huge declines in economic output in large parts of the world

Within the space of just a few weeks in the first half of 2020, the coronavirus pandemic brought economic output to its knees in almost all parts of the world, throttling activity to a far greater extent even than the financial and economic crisis of 2008-09. Downturns were particularly severe in countries whose governments had felt impelled to take very far-reaching measures to contain the infection or had kept the restrictions in place for a protracted period. This was true of the United Kingdom, in particular. Contractions were somewhat less pronounced in the euro area, in the United States and probably also in Japan. Most emerging market economies suffered substantial declines as well. One bright spot was the Chinese economy, which in the second quarter had already recouped the heavy losses from the beginning of the year.

But lowest point of crisis probably already over

Starting at the end of April, the relaxation of containment measures ushered in a certain degree of normalisation in many countries. Both advanced and emerging market economies saw many people return to the workplace. Consumption of goods in a number of countries even returned to pre-crisis levels at the end of the second quarter. So far, industry and world trade have recovered more slowly. Services sectors continued to lag far behind, as continued social distancing requirements are resulting in greater restrictions.

Business surveys indicate that the incipient recovery will continue. Given the depth of the slump, however, a return to normal activity levels is still a long way off. There is also a high risk of setbacks, especially with regard to the further course of the pandemic.

The economic repercussions of the coronavirus pandemic and the extensive support measures taken to contain it also dominated events in global financial markets in the spring and summer of 2020. Market participants' assessment of global economic developments was closely linked to the latest updates on infection figures and medical research results as well as reports on containment measures. Uncertainty lingered at high levels over the entire period. At the same time, monetary and fiscal policy support measures on both sides of the Atlantic stabilised expectations. Faced with a lower inflation forecast, the Governing Council of the ECB announced at the beginning of June, amongst other things, that the envelope for the pandemic emergency purchase programme (PEPP) would be increased by €600 billion. In addition, at the end of July, the EU Heads of State or Government agreed on a €750 billion recovery fund to deal with the economic impact of the coronavirus pandemic (see the box on pp. 83 ff.). In the United States, the Federal Reserve reaffirmed its expansionary monetary policy stance and the continuation of its market stabilisation programmes, but refrained from taking additional monetary policy measures. With the above factors at play, government bond yields fluctuated markedly. In various euro area countries with tight public finances, they decreased significantly on balance. Furthermore, interest spreads between corporate bonds and benchmark bonds narrowed. Equity markets saw a continuation of the recovery observed since the end of March, even though uncertainty about future stock market developments remains heightened compared with previous years. An overall resurgence in investors' risk appetite was the main factor driving the recovery in stocks. Foreign exchange markets once again saw marked shifts in exchange rates between individual currencies, which partly reflected the differing infection rates in the respective economies. Measured as a weighted average against the currencies of 19

Uncertainty about economic fallout of pandemic hangs over financial markets

major trading partners, the euro appreciated by around 2½% on balance compared with the end of the first quarter of 2020.

Monetary policy: PEPP increased and extended

In view of a significant downward revision to the expected path of inflation, the Governing Council of the ECB decided not only to increase the total volume of the PEPP but also to extend the horizon for net purchases under the programme to at least the end of June 2021. It also decided to reinvest the maturing principal payments from securities purchased under this programme until at least the end of 2022. The Governing Council left the asset purchase programme (APP) and the Eurosystem's key interest rates unchanged, however. Therefore, the main refinancing rate remains at 0%, while the interest rates on the marginal lending facility and the deposit facility are 0.25% and -0.5%, respectively.

TLTRO-III sees very strong demand

On 24 June 2020, the fourth operation of the third series of targeted longer-term refinancing operations (TLTRO-III) was settled, and saw banks take up a total of €1,308.4 billion. The extremely favourable interest rate of up to -1% between June 2020 and June 2021, which is below the Eurosystem's deposit facility rate, is likely to have been a key reason for the very strong demand.

Monetary developments shaped by coronavirus pandemic: strong increase in overnight deposits and ...

Monetary developments in the second quarter of 2020 were also largely shaped by the coronavirus pandemic and the measures taken to contain it. There was strong growth in overnight deposits, in particular, which meant that the steep increase in the broad monetary aggregate M3 observed in the previous quarter continued into the reporting period. By the end of June, the annual growth rate of M3 had risen to 9.2%, a level last seen in the summer of 2008.

... brisk growth in loans, particularly to non-financial corporations and government

As for the counterparts, monetary growth in the second quarter was driven almost exclusively by loans to residents. The largest contribution was made by loans to the private sector, followed by securitised lending to government.

The increases in these two positions were also closely linked to the effects of the coronavirus pandemic. The significantly expanded PEPP led to higher purchases of government bonds by the Eurosystem, and commercial banks, too, added substantially to their holdings of government bonds in the second quarter on balance. The strong growth in lending was mainly attributable to loans to non-financial corporations, which are likely to have been stimulated by the various government support programmes and emergency measures taken by governments to prop up the corporate sector during the crisis. In contrast to this, loans to households, which until early 2020 had been on a stable upward path, weakened significantly, particularly in the countries that were especially affected by the pandemic.

In Germany, too, the coronavirus pandemic caused a historic decline in economic output. The Federal Statistical Office's flash estimate indicated that real gross domestic product (GDP) in the second quarter of 2020 was just over one-tenth (-10.1%) down, after seasonal and calendar adjustment, on what had already been a significantly depressed previous quarter. The decline in economic activity was unprecedented not just in terms of its depth, but also for the speed at which it unfolded. May, however, saw an economic recovery set in after the first steps were taken to relax the general social distancing requirements.

The coronavirus crisis took its toll on large parts of the German economy. Second-quarter real value added is once again expected to have contracted more strongly in the manufacturing sector than it did in the services sector as a whole. That said, the picture was probably rather mixed in the individual services sectors. Retail sales, for one, moved more or less sideways overall, benefiting in part from the uptick in household spending on food as considerable restrictions were applied to food and beverage service activities. By contrast, economic activity shrank dramatically in accommodation services, which bore the brunt of the general

German economy sees historic slump in Q2

Coronavirus crisis affects large parts of German economy

social distancing requirements. Other consumption-related services such as travel agency activities, other recreational and cultural activities and passenger transport continued to be severely affected by the crisis as well. Consequently, private consumption contracted sharply on the demand side. The economic fallout of the pandemic outside Germany also took its toll on exports. Industrial investment in machinery and equipment probably saw an even steeper decline amidst uncertainty surrounding global infection rates and the subdued outlook for growth. Construction investment, on the other hand, held up fairly well, contracting by less than the average rate overall. Government consumption expanded as extensive measures were rolled out to combat the pandemic, thereby boosting economic activity.

This is primarily because of the large-scale reductions made to the working hours of people still in employment. Widespread take-up of short-time work schemes brought stability to both employment levels and incomes. Initial estimates by the Federal Employment Agency indicate that the number of people who had enrolled in short-time work schemes for economic reasons in May was 6.7 million. This equates to one in five employees subject to social security contributions – an unprecedented figure in the history of the Federal Republic of Germany. As activity began to recover in May, however, the rise in unemployment and drop in employment eased significantly towards the end of the reporting period. The labour market still has not made a full recovery, though. Negotiated wage growth in the second quarter was again weaker than in the previous quarter, largely because of the social partners' response to the ongoing pandemic and its impact on the economy.

Fresh uptick in German banks' loans to domestic private sector

German banks' lending to the domestic private sector, which had been remarkably strong in the previous quarter, given the onset of the coronavirus crisis, did not continue at the same pace in the second quarter of 2020. Net lending, however, increased at roughly pre-outbreak rates. The largest contribution once again came from loans to households for house purchase, which expanded at a pace that was slightly higher still overall, despite showing signs of flagging towards the end of the quarter. Loans to non-financial corporations likewise saw strong inflows in the quarter under review on the back of extensive assistance loans from the Federal Government as well as additional financial support from state governments, which enterprises could apply for via their house banks. Respondents to the Bank Lending Survey (BLS) reported that credit standards and credit conditions were tightened across all segments on balance.

In June, the Minimum Wage Commission unanimously recommended that the Federal Government significantly increase the statutory general minimum wage, raising it in four steps between January 2021 and July 2022 by a total of €1.10, or 11.8%, to €10.45 per hour. The large number of steps and the size of the increases deviate from the Commission's former calculation method, which was very much guided by collective wage developments. It remains to be seen how the significant increase will impact on future wage negotiations and the employment situation for low-skilled workers, particularly in eastern Germany, where the higher minimum wage will affect a much larger proportion of employees than in western Germany.

Minimum wage to increase gradually to €10.45 per hour in July 2022

Significant adverse effects spill over to labour market

The coronavirus crisis took a huge toll on the labour market in the spring, eating into employment over the course of the reporting quarter and causing unemployment to balloon. Measured against the depth of the economic slump, though, these adjustments were fairly

The inflation rate was dampened in the second quarter mainly by falling energy prices. In seasonally adjusted terms, consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) remained more or less unchanged after rising by 0.3% in the first quarter of 2020. Developments by category of goods

Inflation rate dampened in Q2 mainly by energy

exhibited two divergent trends. On the one hand, energy prices declined significantly amidst a sharp drop in crude oil prices in the second quarter. Inflation for non-energy industrial goods also tailed off somewhat. On the other hand, there was another considerable increase in food prices, while services prices also rebounded distinctly. The latter had been hit particularly hard by the measures taken to contain the pandemic. Numerous services even had to be suspended temporarily, meaning that in some cases, particularly for these consumption segments, prices had to be estimated. However, according to the Federal Statistical Office, the quality of the HICP data was assured overall. Quarter-on-quarter inflation slowed to 0.7%, down from 1.5% at the beginning of the year. By contrast, core inflation excluding food and energy declined only slightly, from 1.3% to 1.1%.

July inflation rate significantly depressed by VAT cut

The temporary cut in VAT rates was clearly reflected in consumer prices in July. Core inflation shrank from 1.1% to 0.7%, while the headline rate decreased even more sharply, dropping from the previous month's 0.8% to 0.0%. Softening energy prices also played a role in this decline. The temporary VAT cut will probably push inflation rates into negative territory as the second half of 2020 progresses. VAT rates are scheduled to be reinstated at their previous levels in January 2021, however, which will return inflation rates to (clearly) positive ground.

German economy may be on the road to recovery in Q3, but economic slack is still significant

The significant slump in the first half-year will probably give way to very strong growth in the German economy in the third quarter. From today's perspective, the clear and broad-based recovery in aggregate output that began right after the slump bottomed out in April looks set to continue. The recovery in industrial activity will probably stimulate industrial investment in machinery and equipment. Private consumption is likewise expected to contribute robustly to the overall recovery, primarily because the pandemic-related restrictions have been eased considerably and infection rates appear to be largely under control. Not just that: the situ-

ation in the labour market has also stabilised somewhat recently. An added boost will be provided by fiscal policy measures, in particular the temporary VAT cut adopted as part of the recent economic stimulus package, which will buoy consumers' mood for spending as well as their incomes. However, although the economy is making up ground, activity levels will remain well short of pre-crisis levels in the third quarter and beyond, not least because the pandemic still has not been contained in many countries around the world, which is hurting German exports. Another factor to consider is the acute uncertainty surrounding infection rates, which is dampening the willingness of enterprises in Germany and abroad to invest. This is likely to impede a full-blown recovery in demand for German industrial products. Economic activity will also remain constrained in a number of domestic services sectors until effective medical treatment such as a vaccine becomes available.

German public finances have been making a significant contribution to stabilising the economy during the coronavirus crisis. Discretionary fiscal policy measures have been taken, and automatic stabilisers have been implemented via the existing social security and transfer system without any active involvement on the part of fiscal policymakers. Tax revenue has fallen, whilst expenditure has not only continued, but has been pushed significantly higher in some cases – such as with the unemployment insurance scheme – by the crisis. In addition, Germany is heavily involved in the EU's assistance and development programmes.

Public finances stabilising the economy significantly ...

This contribution to stabilising the economy is leaving its mark on public finances. For one thing, the previous surplus for this year will switch to a heavy deficit. As things stand currently, this could be somewhere in the region of 7% of GDP. The expansionary fiscal stance, especially the measures prompted by the pandemic, is responsible for around two-thirds of the rise in the deficit, while the rest can be attributed to the automatic stabilisers. This year

... while producing a high deficit and sharply rising debt

will probably see the debt ratio heading towards 75%. Besides the deficit, this is also due to the loans and capital assistance granted to enterprises as well as falling nominal GDP growth (in the ratio's denominator).

Public finances to remain supportive in 2021, too

Next year will probably see the deficit shrink again as a large number of stabilisation measures are currently expected to come to an end. That said, public finances will continue to provide considerable support for economic activity and incomes. The solidarity surcharge is set to be lowered, for example, and child benefit is scheduled to rise. Compared with the current year, economic activity is likely to ease the burden on public finances only slightly (through the automatic stabilisers). Wages and private consumption, for instance, are expected to recover only slowly.

Federal budget in crisis mode

The second supplementary budget to the Federal budget had already been approved in June, and the escape clause invoked for a second time. The revised Federal budget will see net borrowing rise sharply to almost €220 billion, in what represents an even more substantial breach of the standard threshold under the debt brake by a revised amount of almost €120 billion in total. Note that while the escape clause allows the standard threshold to be exceeded for a time, the amount exceeding that threshold needs to be repaid at some point in the future. In general, the debt brake enables additional cyclical or crisis-related debt to be raised. However, provisions such as the control account and the repayment obligations are designed to prevent such excessive levels of debt from becoming entrenched.

Further fiscal stabilisation appropriate for the time being

It is appropriate for the fiscal policy stance to be highly expansionary in the current crisis. Mounting deficits and debt are warranted for combatting the pandemic and its fallout and countering any lasting damage to the economy. This is why the EU fiscal rules, like the debt brake, permit the automatic stabilisers to

take effect and deliver a major stabilising fiscal stimulus. The economic costs associated with the pandemic and the need for countermeasures are likely to persist beyond 2020, so it would seem premature to return to the standard rules as early as next year and attempt to comply with the limits they set. On the contrary: it might actually make sense to roll out further stabilisation measures if the economic situation shows no major signs of improving over time. If new measures are introduced, though, these would need to be of a temporary nature, since this would ensure that the resulting deficits are also temporary and that (much like the automatic stabilisers) they will recede automatically over time.

Mounting general government debt in Germany is manageable from today's perspective, but it is important not to lose sight of the risks and future challenges. Fiscal policy has been sound in recent years, not least thanks to the debt brake. This is why public finances are not in a critical position and enjoy a high level of confidence, despite the extensive burdens which the crisis has placed on the budget, as seen not least in interest rates for German debt, which are negative all the way up to long maturities. Nonetheless, fiscal policymakers should not count on interest rates being this low indefinitely, nor can it be ruled out that the pandemic will push the economy onto a lower growth path. This would also place a structural strain on public finances. Demographic change is likely to pose challenges as well, and it is also important to keep an eye on and service the joint debt that has now been agreed upon at the European level. If the economic recovery does take hold, it will therefore be crucial to restore a sound fiscal position. The standard budgetary rules would then need to be reinstated, not least in order to uphold confidence in public finances. This applies not just to Germany, but to other euro area Member States as well.

Return to standard budget rules if recovery takes hold