The German economy

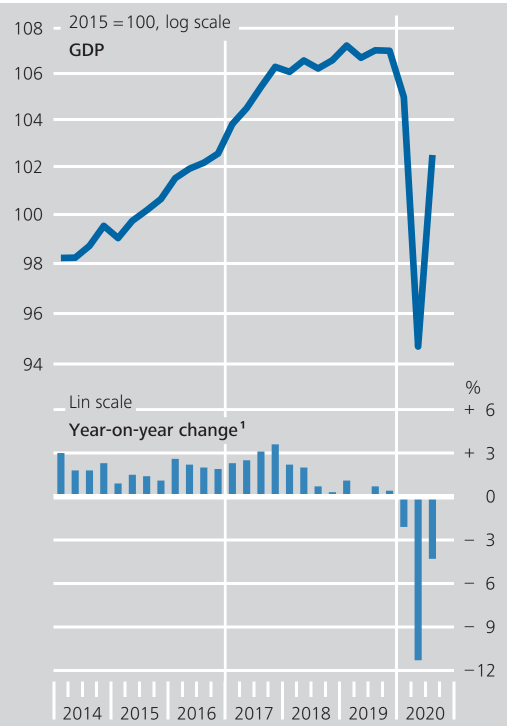
Macroeconomic situation

Very strong growth in German economy in Q3

The German economy picked up strongly in the summer months following its steep decline resulting from the coronavirus pandemic. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) in the third quarter of 2020 expanded very strongly (+8.2%) on the severely depressed figure for the preceding quarter. The fact that activity was already starting to recover strongly in the second quarter played a key role in the scale of the countermovement. After infection rates had been brought back under control and the strict containment measures had been relaxed, the economy picked up again considerably from May onwards. This meant that economic activity at the beginning of the third quarter was already far above the average of the second quarter. The recovery continued during the summer months, albeit at a significantly more moderate pace. Irrespective of this strong growth, aggregate output in the third quarter was still more than 4% down on the pre-crisis level of the final quarter of 2019. This catch-up movement is not likely to continue over the near term in the final quarter of 2020. The key reasons for this are the recent resurgence of the pandemic in Germany and its neighbouring countries in Europe as well as the additional containment measures adopted for November. The latter are impeding economic life as a whole much less than in March and April, however. From the current perspective, this means that it is not very likely that economic output will slump to a similarly depressed level as in the second quarter.

Overall output

Price and seasonally adjusted



Source of unadjusted figures: Federal Statistical Office. **1** Price and calendar adjusted.

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Broadly based economic recovery

The recovery in the German economy in the third quarter was broadly based. On the supply side, real value added experienced considerable growth in both manufacturing and services. The services sector as a whole nevertheless presented rather a mixed picture. While retail sales figures were already clearly up on their pre-crisis level, turnover in the hotel and restaurant sector was still quite substantially down on the average of the fourth quarter of 2019. This was due to the continuing restrictions owing to the coronavirus pandemic, which affected some branches of the services sector significantly more than others. Construction output is likely to have contracted slightly. This sector has been experiencing a boom of its own for some time now, however, and has weathered the coronavirus crisis without significant problems so far. On the demand side, strong rebound effects in all the previously depressed components provided a powerful impetus. Households used the consumption opportunities that became available again and probably made a number of purchases that had previously been put on hold. Given that global trade was picking up again, exports also made a strong contribution. Moreover, enterprises are likely to have expanded their investment in machinery again on a quite considerable scale. Besides the temporary brightening of the business outlook at home and abroad, catch-up effects may have been a factor in this context, too.

Strong counter-movement in exports

German exports of goods in the third quarter of 2020 saw an increase of around one-fifth in price-adjusted terms. This meant that they had already offset two-thirds of the pandemic-induced slump in the first half of the year. This was due chiefly to the broad-based pick-up in world trade following the easing of the containment measures in a large number of countries. The increase in German firms' exports of goods to other euro area countries was somewhat stronger than the increase in goods exported to countries outside the euro area. Broken down by category – data for which are available up to August – the volume of exported capital goods saw an especially sharp rise. The main part in this had been played by motor vehicle exports, which had been hit harder than most goods by the pandemic-related slump. German exports of intermediate and consumer goods also enjoyed considerable growth, however.

Very sharp rise in private consumption overall …

Private consumption is likely to have undergone a very strong increase in the third quarter of 2020. Households massively reduced their consumption and strongly expanded their saving in the second quarter. Key reasons for this were the unavailability or only partial availability of a number of consumption options and the fact that some consumers did not make use of them owing to the risk of infection. The fear of future job loss and loss of income may also have contributed to the record high level in saving. With the easing of the containment measures, the pandemic abating and the stabilisation in the labour market, the savings ratio is likely to have gone back down considerably in the third quarter, boosting private consumption.

Some of the areas of consumption that had suffered very heavily under the restrictions on

Foreign trade

Seasonally adjusted, quarterly data

Source of unadjusted figures: Federal Statistical Office. **1** Adjusted using the price indices for foreign trade.
Deutsche Bundesbank

… but quite differing developments depending on sector

social contact in March and April, showed the highest growth rates. Although real turnover in the hotel and restaurant industry during the summer months was one-quarter down on its pre-crisis level in the final quarter of 2019, the increase on the depressed second quarter was around nine-tenths. The catch-up movement in the automotive trade is likely to have been similarly strong. This can be seen from private owners' new passenger car registrations, which likewise almost doubled compared with the average of the second quarter. This meant that they were, in fact, well up on their level before the crisis. There was also a considerable expansion in retail sales, although developments across the subsectors were very mixed. Some areas that particularly suffered under the restrictions in spring – such as the retail sale of textiles, clothing and footwear – recovered very strongly, although they were still down on their pre-crisis levels. Sales of information and communication technology (ICT) equipment, household appliances as well as furniture likewise suffered under the crisis. Even so, their slump in the second quarter was less severe and, in the reporting quarter, sales were already back up again on their pre-crisis levels. In some areas, such as e-commerce and mail order as well as trade in food products, the crisis in fact brought an increase in sales. Sales figures returned to something like normal in this sector, but were still higher than before the crisis. In addition to catch-up effects and temporarily lower rates of value added tax, the overall rapid pace of growth in retail sales could also be due to substitution effects. In view of the fact that the containment measures remained in place, consumers cut back massively on their spending on travel, and the food retail sector is likely to have benefited from the restrictions applying to the hospitality industry. Given the continuing high rates of infection, use of leisure and cultural services likewise probably remained heavily subdued. As a result, there is likely to have been an expansion of the scope for expenditure in other areas of consumption.

Commercial investment in machinery and equipment likely to have shown a sharp increase

Commercial investment in machinery and equipment can be expected to have risen sharply in the third quarter of 2020. The key reason for this was a rapid improvement in the business outlook for many industrial firms following the pandemic-related downturn. This may have induced firms to execute investment plans that had been put on hold in view of the dramatically increased uncertainty. This picture is confirmed by the economic indicators. There was a sharp increase in nominal sales of capital goods in Germany – even without taking the automotive sector into consideration, which had suffered disproportionately from the pandemic-related downturn. This is also true of the value of capital goods imports. New purchases of passenger cars are likely to have made a particularly strong contribution to the overall increase in investment expenditure. While the registration figures for commercial vehicles increased by just under half in the third quarter, the corresponding figures for commercial passenger vehicles were up by four-fifths.

Marked decline in construction investment

Construction investment is likely to have undergone a marked decline in the third quarter of 2020. The coronavirus crisis affected the construction sector no more than marginally in the second quarter. In the third quarter, investment was therefore not subject to the same catch-up momentum. Nominal turnover in the main construction sector – data for which are available up to August – indicate that it was mainly the corporate sector that perceptibly cut back its investment in commercial buildings. Housing construction investment is likely to have seen only a slight fall, however.

Goods imports up by just under one-tenth

In real terms, German exports expanded by just under one-tenth in the third quarter of 2020. The increase in the volume of imports from other euro area countries was, however, clearly larger than that of imports from non-euro area countries. This discrepancy was due in part to imports from China, the value of which declined quite considerably. To a quite significant extent, this was due to declining imports of medical personal protective equipment, which were still being stepped up on a massive scale at the height of the pandemic in spring. A breakdown of imports by category of goods shows that the largest increase was in the volume of capital goods. This was primarily connected to the massive rise in motor vehicle imports, where there was a particularly strong countermovement following the sharp downturn in spring. While there was a similarly sharp rise in imports of intermediate goods in real terms, demand for imported consumer goods eased somewhat, with demand admittedly having been very robust previously.

Sectoral trends

Industrial output caught up strongly in Q3

German industrial output increased very strongly in the third quarter of 2020. Compared with the average of the second quarter, it rose by 14¾% in seasonally adjusted terms. Despite the marked recovery following the pandemic-related downturn, industrial output was still slightly less than one-tenth below its pre-crisis level in the final quarter of 2019. Producers of capital goods showed the largest decline. Production of intermediate and consumer goods was notably less down on pre-crisis levels.

Further increase in capacity utilisation

According to the ifo Institute, capacity utilisation of tangible fixed assets in manufacturing in October showed a further clear increase on the last survey in July. It was nevertheless still markedly lower than its end-2019 level, and down more than average in the case of capital and intermediate goods producers.

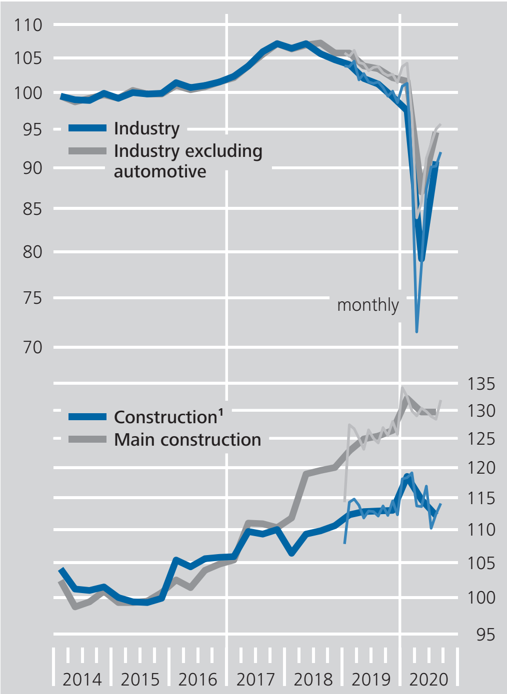
Marked fall in construction output

The construction sector did not follow the general catch-up movement in the German economy in the third quarter of 2020. This industry-specific development is due to the fact that the sector – thanks also to exemptions from the general rules on social contact – was left relatively unscathed by the coronavirus crisis and, looking at the whole picture, did not suffer any significant losses of output. On an average of the third quarter, construction output was markedly down on the quarter in seasonally adjusted terms (-2¼%). This was due mainly to the sharp decline in activity in the finishing trades. Activity in the main construction sector, by contrast, remained unchanged on the quarter. The overall decline in output should not, however, be interpreted as a sign that the construction boom has run its course. Activity in this sector remains at a very high level. This is indicated by ifo Institute data on equipment utilisation and the reach of orders in the construction industry during the summer months.

The services sector is likely to have recovered quite strongly on the whole in the third quarter

Output in industry and in construction

2015 = 100, seasonally adjusted, quarterly data, log scale



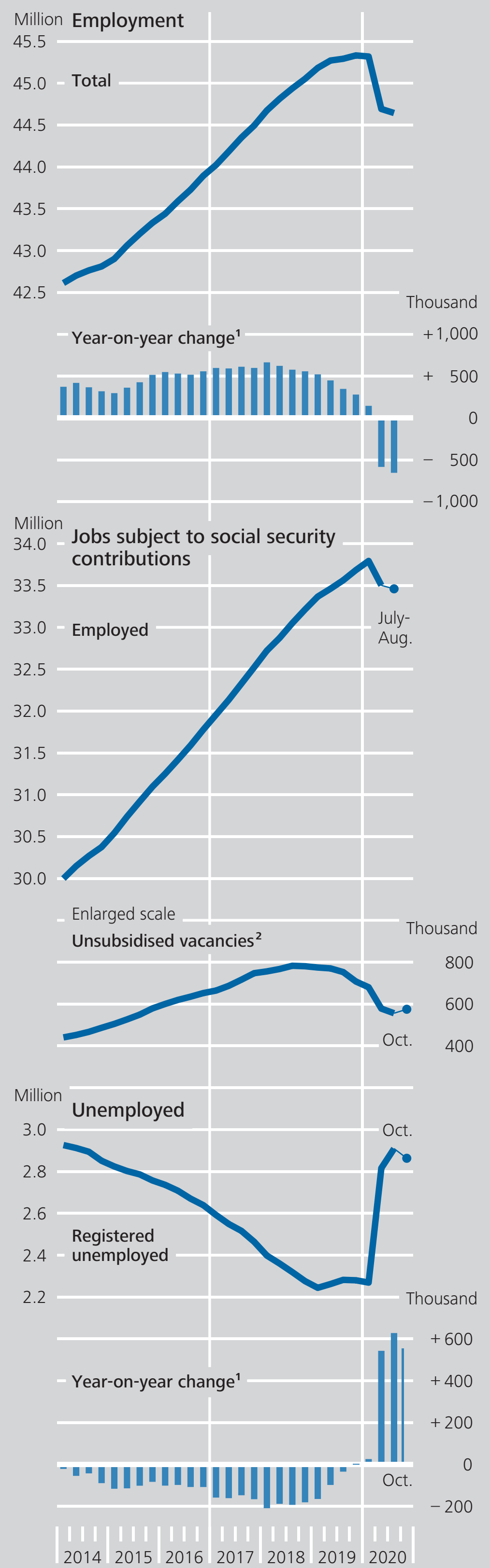
Source of unadjusted figures: Federal Statistical Office. **1** Main construction sector and finishing trades.
Deutsche Bundesbank

of 2020. The progress of the catch-up movement was extremely mixed, however, when looking at the individual services subsectors. Real retail sales were well up on their pre-crisis level, for example. The volume of wholesale sales – where the relevant statistical data are available only for the months of July and August – likewise underwent a strong expansion and was no more than marginally down on the average of the final quarter of 2019. The automotive sector is also likely to have made good most of the second-quarter downturn. This is indicated by new passenger car registrations, which were up very strongly on an average of the summer months. By contrast, real sales in the hotel and restaurant sector, which was hit very severely by the coronavirus crisis, were still far below their pre-crisis level despite a massive increase. This is also likely to be true of a number of other consumer and business-related areas of the services sector, whose business activity has remained subdued owing to the pandemic-associated restrictions.

Recovery in the services sector mixed

Labour market

Seasonally adjusted, quarterly data



Sources of unadjusted figures: Federal Statistical Office and Federal Employment Agency. **1** Not seasonally adjusted. **2** Excluding seasonal jobs and jobs located abroad.
Deutsche Bundesbank

Labour market

Labour market picks up slightly in Q3

The labour market in Germany shifted onto a mild path of recovery at the beginning of the third quarter. Employment levels rose somewhat during the quarter after declining considerably. Unemployment peaked temporarily in June and has since fallen slightly. The deployment of short-time working has in fact declined heavily since its high point in April but it is still in wide use. The renewed restrictions on economic life in November are likely to interrupt the recovery in the labour market, too.

Employment up somewhat, but still well below its pre-crisis level

Employment recovered slowly during the third quarter of 2020 from the low reached in June. This stabilisation is remarkable given the downturn in the second quarter. The increase was small, however. In September, employment was up on its level three months previously by just 54,000 persons, or 0.1%. This was still 1.5% down on the level prior to the pandemic. Furthermore, the recovery does not yet cover all sectors and forms of employment. Even before the pandemic, self-employment was showing a clearly negative trend, which has now increased slightly. The development in employment subject to social security contributions, at +0.2% over the last three months, was somewhat better than total employment and was just 1.0% down on its level in February 2020. The number of persons in low-paid part-time employment recovered somewhat more rapidly in fact, although the preceding decline was admittedly relatively sharp in this area.

Stabilisation or recovery in most services subsectors, but not in manufacturing

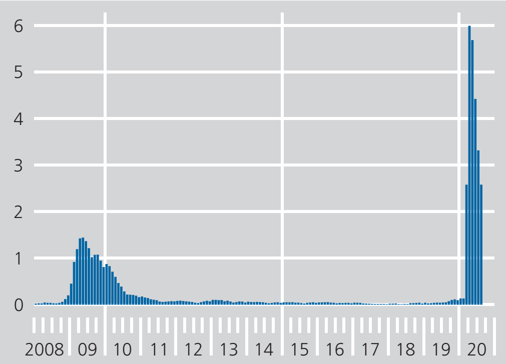
In most areas of the services sector, employment subject to social security contributions stabilised in line with the provisional sectoral estimates, which are available up to August. The biggest increase in absolute terms in the last three months was recorded by the health and social care sector, whose level of employment had barely fallen previously. The education sector developed along generally similar lines. Recruitment was also relatively strong in the hotel and restaurant sector. This industry was hit especially hard by the restrictions introduced in spring, however. Nearly one in ten jobs subject to social security contributions was shed in this sector. The construction sector, which was relatively unencumbered by restrictions in the second quarter, also continued to hire staff. The development in the export-dependent manufacturing sector is noticeably negative.

Short-time working substantially reduced since high point in April, but still being widely used

With the economy picking up strongly in the reporting quarter, it was mainly working hours that increased again following their sharp decline. This was due mainly to a substantial reduction in short-time working, which was at an all-time high in the second quarter. Various special arrangements had been made beforehand to make the use of short-time working easier and more attractive for firms. Six million persons were in economically induced short-time work in April, 18% of all employees subject to social security contributions. According to the initial estimate by the Federal Employment Agency, their number had fallen by nearly three-fifths to 2.58 million in August. As there was also a decline in the number of lost working hours per short-time worker, the volume of labour lost through short-time work fell by more than two-thirds over the last four months. Even so, the use of this instrument is still at an extremely high level compared with earlier crisis situations. The Federal Employment Agency's provisional estimates up to July show that there was a reduction in short-time work especially in the sectors affected by the enforced closures in the second quarter, such as in the hotel and restaurant sector as well as the wholesale and retail trade. In the manufacturing sector, working time accounts and overtime were run down initially and short-time working did not peak until May and has been scaled back comparatively little so far. This is especially true of the metals and technology sector, including the manufacture of fabricated metal products, manufacture of machinery and equipment and automotive manufacturing. Nearly one in four persons employed in these sectors was in short-time work in July.

Persons in short-time work for economic reasons*

Millions, monthly data



Source: Federal Employment Agency. * Number of short-time workers whose entitlement is based on Section 96 SGB III, unadjusted figures. From May 2020, provisional figures.
Deutsche Bundesbank

Unemployment down slightly since June

There has been a slight decline in registered unemployment since June, with the number of unemployed people falling by 76,000 up to October and the unemployment rate down by 0.2 percentage point to 6.2%. However, the number of job seekers receiving unemployment benefits under the statutory unemployment scheme, which is more strongly affected by economic developments, did not decrease until October. The number of unemployed receiving the basic welfare allowance was down somewhat more strongly. This area had seen a rise in unemployment in the second quarter, partly because many labour market policy measures had to be interrupted owing to contact restrictions.[1] The recommencement is likely to have reduced unemployment, even if the resumption of active labour market policy is far from being complete.

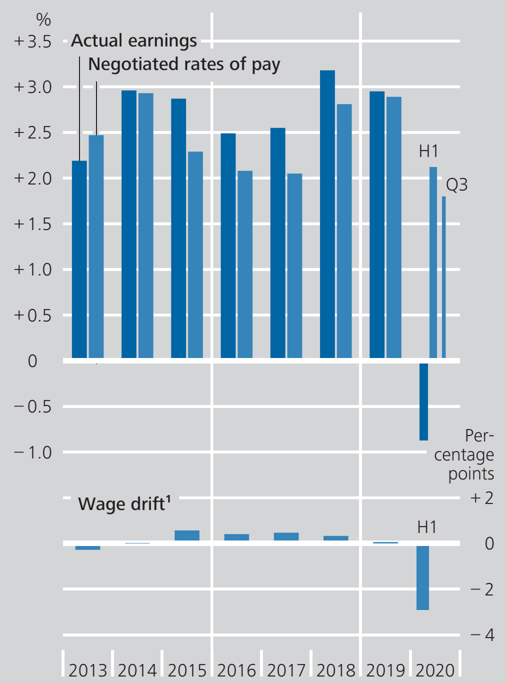
Leading indicators still reflect the situation before latest containment measures

The massive increase in the number of infections since mid-October and the restrictions on economic life that were initially set for November are not yet adequately reflected in the current leading indicators, as many surveys or evaluations were conducted beforehand. Short-time work is expected to have continued to decline markedly in September and October. In November, however, it could potentially rise again in the

1 Participants in such measures are generally not counted as unemployed, as by making use of the measure they do not meet the criterion of availability for taking up a job. The suspension/interruption of many measures therefore led to the persons affected being made unemployed.

Rates of pay and wage drift

Year-on-year percentage change, on monthly basis



Sources: Federal Statistical Office (actual earnings) and Deutsche Bundesbank (negotiated rates of pay). **1** The wage drift is calculated as the annual change in the ratio of actual earnings to negotiated rates of pay.

Deutsche Bundesbank

short term beyond the level reached in August. There could be a renewed increase in the number of lay-offs through the final quarter of 2020 and the first quarter of 2021, which would represent a setback to the recovery process in terms of employment and unemployment. By contrast, leading indicators were still suggesting that the recovery is continuing. The number of vacancies rose again distinctly in the course of the third quarter. This related to both positions reported to the Federal Employment Agency as well as the jobs on offer in the economy as a whole as determined by the Institute for Employment Research survey. The number of vacant jobs subject to social security contributions reported to the Federal Employment Agency grew in all sectors of the economy, including manufacturing.

Wages and prices

The pandemic is leaving its mark on employees' earnings. The rise in negotiated wages remained moderate in the third quarter. The social partners settled on mainly low wage agreements or delayed negotiations of collective agreements due to expire. The annual growth rate of actual earnings may also have declined in the third quarter, although probably not as strongly as in the second quarter. This is mainly due to short-time work, which pushed down hours worked and thus wages. The volume of short-time work, which had reached a record level in the spring, was also still high in the third quarter.

Pandemic leads to moderate increase in negotiated pay and a decline in actual earnings

In the most recent pay negotiations, the social partners often focused on protecting employment – by ruling out redundancies and through sector-specific regulations on short-time work, for example – at the expense of significant wage increases. The rise in negotiated wages was therefore markedly lower than last year. Several months without wage increases were often agreed upon at the start of contracts. Even in sectors not as hard-hit by the crisis, such as the main construction sector, annualised wage increases were modest, at around 2%. The pay settlement in the central and local government areas of the public sector provides for a moderate 1½% increase in wages based on a notional duration of 12 months.[2] Not only in the construction and public sector, but also in a number of other sectors, the social partners agreed on one-off special coronavirus payments, which are exempt from tax and social security contributions for employees.[3]

2020 pay round: lower wage increases than in the previous year, often special coronavirus payments

2 This figure is calculated on the basis of a central government employee receiving the agreed basic pay rate subject to the wage agreement for the public sector (TVöD), who benefits disproportionately from the increase in the low and middle remuneration bands through staggered coronavirus special payments. Employees in the healthcare and long-term care sectors, in particular, received further marked financial improvements as a result of the wage agreement.
3 According to Section 3 No 11a of the Income Tax Act *(Einkommensteuergesetz)*, employers can pay their employees special payments up to an amount of €1,500 exempt from tax and social security payments up to 31 December 2020. This is conditional on the special payment being made in order to cushion the additional strain caused by the coronavirus crisis and being provided in addition to the wage that is due in any case.

Federal Cabinet to raise minimum wage in stages from January 2021

On 28 October 2020, the German government decided to raise the general statutory minimum wage in four stages by a total of €1.10 or 11.8% from the current €9.35 per hour to €10.45 per hour from 1 July 2022, in line with recommendations from the Minimum Wage Commission at the end of June 2020. While the first two phased rises in 2021 are very small in order to take account of the current crisis situation, the further improvements in the minimum wage in 2022 provide for significantly higher wage increases.

Temporary VAT cut led to broadly based price drops in Q3 …

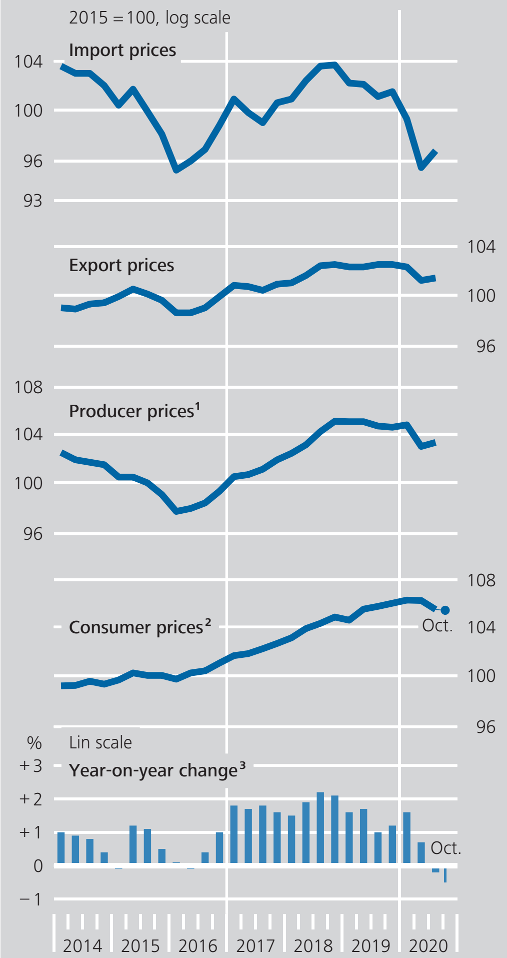
Consumer prices fell significantly in the third quarter against the backdrop of the temporary VAT cut (see the box on pp. 56 ff.). The Harmonised Index of Consumer Prices (HICP) averaged over the July to September period was down by a seasonally adjusted 0.7% from the second quarter, in which prices had remained virtually constant. The steep fall in prices in the wake of the VAT cut was felt in almost all categories of goods. The temporary tax measure, which entered into force on 1 July 2020, was also very evident in year-on-year terms. Consumer prices were down by a total of 0.2% on the year, following an increase of 0.7% in the previous quarter. Core inflation excluding energy and food dropped from 1.1% to 0.5% over the same period, but remained in positive territory.

… and also still dampened the year-on-year rate significantly in October

In October, consumer prices remained below their previous year's level on account of the temporary VAT cut. The inflation rate fell to -0.5% from a level of -0.4% in the previous month.[4] The rate for energy remained clearly negative, partly because crude oil prices were low. The same goes for industrial goods excluding energy, which, against the backdrop of the VAT cut, were distinctly cheaper than in the previous year. The rate of inflation for services almost halved in October in spite of the fact that prices were still up on the year. A steep decline in prices for package holidays[5] and one-off effects due to lower dental and insurance fees played a role in this. By contrast, unprocessed food, in particular, has risen more sharply again recently. Excluding energy and food, the overall inflation rate fell further in October from 0.3% to 0.1%.

Import, export, producer and consumer prices

Seasonally adjusted, quarterly



Source of unadjusted figures: Federal Statistical Office. **1** Producer price index for industrial products in domestic sales. **2** Harmonised Index of Consumer Prices. **3** Not seasonally adjusted.

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4 The annual rate of consumer inflation according to the national Consumer Price Index (CPI) was -0.2% in October, as it had been in the previous month. The comparatively large difference between CPI and HICP rates is due to the recent increase in fees for gambling, which are only captured in the CPI.

5 Owing to the travel warnings issued by the Federal Foreign Office, the prices for international package holidays had to be largely estimated (imputed), especially in September and October, and are therefore less meaningful. Overall, however, compared with the second quarter, nonavailability of price representatives owing to pandemic-related restrictions, as measured by their share of the HICP basket of goods, played almost no role in the third quarter. See Federal Statistical Office (2020b).

Impact of the temporary reduction in VAT on consumer prices

On 29 June 2020, the Bundestag and the Bundesrat adopted an economic stimulus package to support the economy, the key points of which had previously been agreed by the coalition committee on 3 June. A key component of this package is the temporary reduction in VAT: with effect from 1 July 2020, the standard rate of VAT for goods and services was reduced from 19% to 16% and the reduced rate of VAT for goods was lowered from 7% to 5% on a temporary basis until 31 December 2020. This temporary VAT cut was the first of its kind in Germany.[1] Its aim was to boost private consumption through lower prices in the face of weak demand. Whether and to what extent the VAT cut is actually passed on to consumers depends on enterprises' pricing strategy. If enterprises do not pass the VAT reduction on to consumers, they could, for example, use it to strengthen their margins.

If enterprises had passed the VAT cut through immediately and in full to their prices, these would have fallen by 2.5% for goods and services subject to the standard rate of VAT and by 1.9% for goods and services subject to the reduced rate. The standard rate of VAT only applies to slightly less than two-thirds of the basket of goods on which the Harmonised Index of Consumer Prices (HICP) is based. The standard rate of VAT applies to all energy products, most non-energy industrial goods, almost one-half of services and around one-third of food products.[2] The lion's share of food products, by contrast, are subject to the reduced rate of VAT. Together with certain industrial goods (e.g. books or the water supply) and some services (e.g. local public transport), which are also taxed at the reduced rate of VAT, they account for around 15% of the HICP basket of goods. Only services, including rents, which constitute one-tenth of the total HICP basket of goods, are exempt from VAT. All in all, around one-half of services, i.e. around one-quarter of the HICP, are not subject to VAT. Taking into account these shares in the basket of goods, the HICP rate would have been 1.8 percentage points lower in each case in the months from July to December 2020 if the VAT cut had been passed through immediately and in full.[3] Core inflation excluding energy and food would have fallen almost equally as sharply. Looking at 2020 as a whole, the impact of the reduction in VAT would have been only half as great since it would have affected only six months.

However, initial analyses suggest that the pass-through of the reduction in VAT to consumer prices was actually significantly lower: the annual HICP rate was down markedly in July, but only fell from 0.8% to zero, which is less than half of what mechanical calculations predicted. Food price inflation, in particular, recorded a sharp decline, and the inflation rate for industrial goods excluding energy also fell distinctly by 1½ percentage points. By contrast, the inflation rate for services remained more or less unchanged, both overall and also for those services subject to VAT. However, movements in the annual growth rate provide only a rough indication of the pass-through of the VAT cut, as other factors also influenced prices in July. For example, it is not surprising that the inflation rate for

1 However, there was a temporary reduction in VAT in the United Kingdom, for example, in 2008-09.
2 The standard rate of VAT applies to beverages and tobacco.
3 The Federal Statistical Office (2020a) has reached a similar conclusion, reporting an effect of -1.6 percentage points for the national consumer price index (CPI). The slight deviation from the figure for the HICP can be explained by the fact that the share of goods subject to VAT is lower in the CPI than in the HICP. This is because owner-occupied housing is excluded from the HICP, which means that the share of rents exempt from VAT is twice as high in the CPI as it is in the HICP.

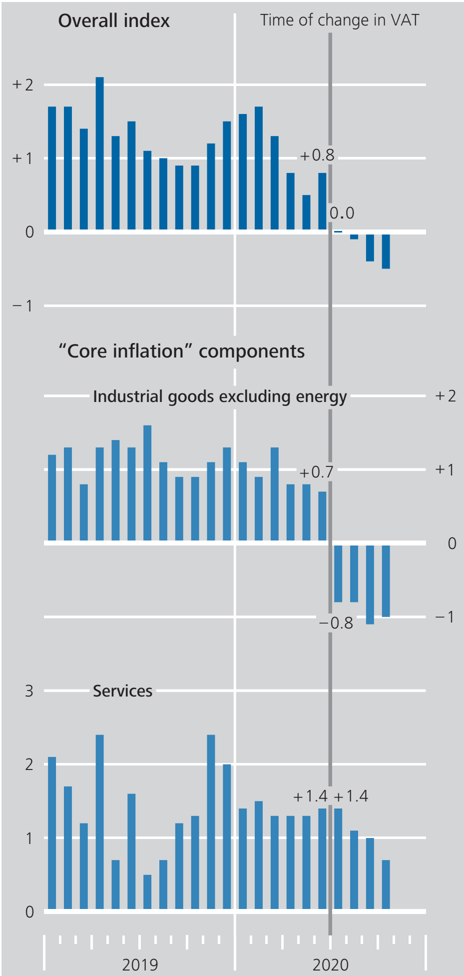
energy barely fell in July despite the VAT cut, since oil prices, which usually have a significant and rapid impact on consumer prices, rose markedly at the same time.[4] Besides this, many service providers are likely to have retained most of the VAT cut because the measures needed to contain the spread of the coronavirus have both severely dampened turnover and caused additional costs, such as the installation of partition walls.

If other factors are then included in the analysis of the HICP rate since July,[5] the VAT cut appears to have been passed through in full for most food products and industrial goods excluding energy.[6] In addition, in these two categories of goods, price declines are evident in some cases which go well beyond the VAT effect. This was probably partly because some retailers had announced in advance that they would not be cutting prices across their entire product range as a result of the change to the tax rate, but would instead be offering very large discounts on selected products.[7] Looking at services, by contrast, just one-third of the lower tax rate appears to have been passed on. Only a few areas, such as telecommunications, which were not adversely affected by the containment measures and the prices of which are relatively easy to adjust, saw price reductions in the full amount of the change in VAT. In terms of headline HICP inflation, the change in VAT may have been passed on by just over 60%. For core inflation excluding energy and food, this figure would be just under 50%. Most of the prices were changed in July. In the months that followed, prices are only likely to have been changed in very isolated cases, probably owing to the fact that the VAT reduction was announced at short notice and not all prices could be adjusted on time.

In other countries which temporarily cut VAT rates, prices were frequently raised to their original level before tax rates were put back up again.[8] So far, however, there have

HICP in Germany

Year-on-year percentage change

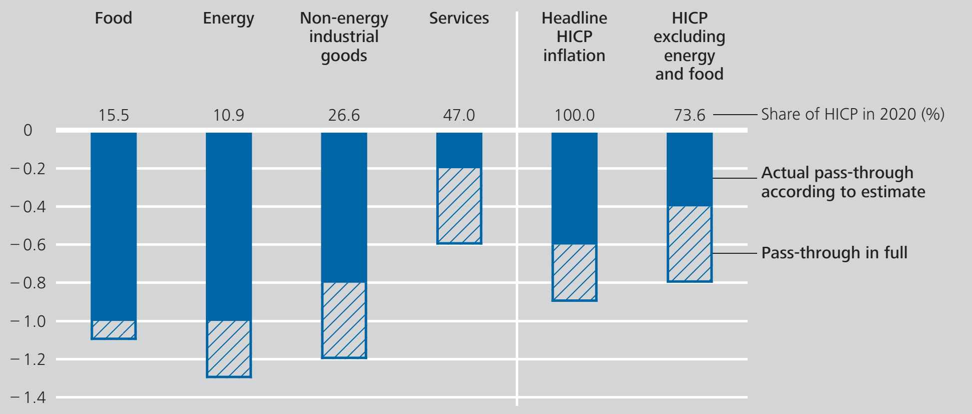


Source: Federal Statistical Office.
Deutsche Bundesbank

4 In addition, suppliers of refined petroleum products increased their margins in July, as separate data show.
5 For this purpose, a regression equation which explains the price change not only by the change in VAT but also by a cost factor of importance to the respective product or service, such as a sectoral producer price or negotiated wage, was estimated at the smallest possible level of aggregation for each category of goods or services subject to VAT included in the HICP. This allows the impact of the change in VAT to be separated from the impact of other cost factors.
6 The ifo Institute (2020) has reached a very similar conclusion for food products.
7 For example, one larger clothing retailer announced that it would cut the prices of a different range of items every week by 30%.
8 See, for example, Office for National Statistics (2009) for the temporary reduction in VAT in the United Kingdom.

Contributions of the VAT reduction to the inflation rate in 2020

Percentage points



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been no indications of a similar early reversal in Germany. It is likely, then, that prices will only be raised again once the temporary change in VAT has expired in January 2021. Assuming a symmetrical price rebound such as this, the inflation rate should then once again take on significantly positive values. In the second half of 2021, the inflation rate might even be quite high for a while because prices were dampened by the VAT cut one year earlier.

Higher inflation rates expected again when value added tax raised from beginning of 2021

Measurement uncertainty in the HICP is expected to intensify again in November against the backdrop of renewed restrictions in the services sector and the associated non-availability of price representatives. However, negative inflation rates are still expected up to the end of the year owing to the temporary VAT cut. Thereafter, the return to the higher VAT rates planned for January 2021 is likely to lead to inflation rates entering clearly positive territory again.[6]

Order books and outlook

German economic recovery probably interrupted for time being, …

The recent significant acceleration in infection rates and the measures adopted restricting social and economic life, for November to begin with, are initially likely to interrupt the recovery of the German economy in the final quarter of 2020. After the very strong growth seen in the third quarter, aggregate output could stagnate or even decline at the end of the year. In addition, there is a risk that further restrictions will be imposed at a later stage if it is not possible to reduce the infection rates significantly and sustainably. However, from the current perspective, it seems unlikely that there will be a repeat of the situation in the second quarter which saw a dramatic slump in economic output. This is largely because the imposed restrictions, which chiefly affect the hotel and restaurant sector as well as other leisure and cultural services, are much more targeted than the measures applied in March and April. Retail and motor vehicle trade are able to continue operations, for example. In addition, despite the very high number of new infections in almost all European countries and the resulting restrictions, there has so far been no further disruption to international production chains. This means that losses could be limited in sectors of the economy not directly affected by restrictions.

6 See Deutsche Bundesbank (2020).

… although manufacturing could provide support

Against this backdrop, the manufacturing sector, in particular, could provide support in the fourth quarter, with value added in October likely to have been well above the average of the previous quarter. Industrial orders had improved significantly towards the end of the period under review, and, according to the ifo Institute, the rise in capacity utilisation between July and October was roughly the same as that between April and July. However, the recovery in the predominantly export-oriented industry is also being hampered by the resurgence of the pandemic in Europe. Although it is also mainly contact-intensive services that are likely to suffer in other European countries, demand for goods from Germany's export range, such as investment in machinery and equipment, will also probably be dampened, with exports to these countries losing considerable momentum.

Sentiment in the German economy deteriorated again somewhat

Sentiment in the German economy became much gloomier again of late. After five consecutive improvements, the ifo Business Climate Index declined slightly in October. This is likely to have been due to the rapid increase in the number of new COVID-19 infections in Germany and in neighbouring European countries, which apparently fuelled enterprises' fears of a setback on the back of tighter containment measures. It should be noted that these survey results were collected before the recent decisions to significantly tighten the epidemic containment measures became public in November.[7] The deterioration in sentiment was primarily due to business expectations, which declined to a similar extent across all sectors of the economy. Short-term industrial output and export expectations also saw a marked deterioration.

Orders situation in industry largely recovered

The orders situation in German industry largely recovered following the dramatic decline in March and April. For example, the inflow of

Demand for industrial goods and construction services

Volumes, 2015 = 100, seasonally adjusted, quarterly data

Source of the unadjusted figures: Federal Statistical Office. **1** Only calendar-adjusted.

Deutsche Bundesbank

7 By contrast, the earlier than anticipated wide availability of a vaccination represents an upside risk for medium-term developments.

orders in the third quarter of 2020 rose by just under one-third on the quarter and was thus only marginally down on the pre-crisis level in the last quarter of 2019. The pre-crisis volume of orders in the automotive sector was even exceeded in the third quarter, while the mechanical engineering sector was still clearly lagging behind. Broken down by region, new orders from non-euro area countries were down on the pre-crisis level to a slightly smaller extent than incoming orders from Germany and the euro area. According to the ifo Institute's survey results, the assessment of the stock of orders still being processed also improved significantly recently, slightly exceeding the pre-crisis level.

Construction activity likely to continue to be brisk at year-end

The German construction industry is expected to flourish towards the end of 2020. The sector is not affected by the recent tightening of contact restrictions due to the resurgence of the COVID-19 pandemic. Furthermore, in July and August – the most recent months for which statistics are available – incoming orders in the main construction sector saw a steep seasonally adjusted rise compared with the previous quarter, with the inflow of orders in housing construction increasing particularly sharply. The number of building permits in this sector of the construction industry likewise remained at a very high level. The more timely survey indicators show a similarly positive economic picture for the sector as a whole. According to surveys by the ifo Institute in October, equipment utilisation in the main construction industry remained well above its long-term average. The reach of order books, which has so far also been stable during the coronavirus crisis, even expanded slightly of late from a very high level.

Distinct setback in private consumption towards end of year

By contrast, private consumption is likely to decline markedly in the final quarter of 2020. Following the steep catch-up movement in the third quarter, this setback is mainly due to the recent decisions by central and local governments to tighten contact restrictions significantly for at least one month from 2 November in the light of rising coronavirus infection rates. This mainly affects hotels and restaurants, as well as leisure and cultural services sectors. Business activity in these branches is set to plummet dramatically, at least in November. Moreover, households' travel expenditure abroad is expected to decline again. This is due mainly to the growing incidence of infection in EU Member States as well as in many non-EU countries. By contrast, the fact that retail trade is not affected by recent government decisions could have a stabilising effect. On the one hand, the pandemic is likely to have a slight dampening impact on customer numbers but, on the other, business activity in this area continues to benefit from the temporary reduction in the VAT rate. Moreover, the renewed tightening of contact restrictions could lead to certain substitution effects, as the widespread closure of catering establishments increases retail demand for food, for instance.

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