The current economic situation in Germany

Overview

Resurgence of pandemic is slowing economic recovery worldwide

Global economic recovery lost momentum in Q4

The exceptionally rapid global economic recovery, which had allowed a sizeable part of the severe downturn caused by the pandemic to already be recouped over the summer months, lost considerable momentum in the fourth quarter. This was due mainly to new waves of infections across much of the world. The containment measures were tightened again in Europe, in particular, which placed a marked strain on the region's economies. Economic output in the euro area fell by 0.6% on the quarter in the fourth quarter of 2020. In the United States, growth in real gross domestic product (GDP) dropped off significantly. In China, meanwhile, which has not yet experienced a new wave of the pandemic, growth remained brisk. China also made a significant contribution to the ongoing global industrial recovery, with industry visibly decoupling from developments in the services sector.

Economic developments in 2021 depend on how the pandemic unfolds

With infection rates still high and containment measures having been further tightened in many places, the global economy looks set to get off to a weak start to 2021. However, the rapid development of vaccines at least means that vaccination campaigns are now under way in many countries. There are consequently hopes that it will be possible to ease restrictions noticeably over the next few months. However, there are also potential risks if new strains of the virus spread. Nonetheless, other factors have brought about a marked brightening of the risk assessment as of late. A trade deal was struck between the European Union and the United Kingdom. Moreover, a number of countries look set to introduce additional, large-scale fiscal stimulus measures, which could further fuel global economic activity. Nonetheless, a sustainable global economic recovery can still only be achieved if the pandemic is combatted successfully. Efforts to accelerate the production and distribution of vaccines around the world are therefore particularly important, and not merely for humanitarian reasons.

Optimistic view starting to assert itself in the financial markets

The international financial markets were shaped by a bifurcation during the final quarter of 2020 and first quarter of 2021: while the availability of vaccines strengthened market participants' optimism, the renewed rise in infections and containment measures were perceived as a drag on growth. Within the euro area, the Governing Council of the ECB responded to the second wave of infections with a decision to increase the envelope of the pandemic emergency purchase programme (PEPP) and to extend the horizon for net purchases under the programme. This helped bring down the yields on sovereign bonds of euro area countries with relatively low credit ratings. Average yields on euro area corporate bonds also continued to decline, hitting new lows in January. By contrast, yields on highly rated European sovereign bonds picked up, mainly due to the interest rate linkage with the United States, where yields on US Treasuries rose sharply. Market participants now see a greater likelihood of the incoming US administration undertaking substantial deficit spending. An increase in market-based measures of long-term inflation expectations, which was observed in numerous countries, was also particularly pronounced in the United States. The combined impact of the aforementioned developments sent global equity markets sharply higher. Financial market participants upgraded their earnings outlook, particularly for US enterprises. In foreign exchange markets, hopes that the vaccinations would help global activity bounce back far more quickly than previously expected dampened demand for currencies regarded as relatively safe havens. This meant that the US dollar and yen lost value in effective terms. The

euro also depreciated slightly on a weighted average.

Monetary policy: ECB Governing Council recalibrates monetary policy measures

At its December 2020 monetary policy meeting, the ECB Governing Council recalibrated its monetary policy measures in view of the economic consequences of the resurgence in coronavirus infections. In particular, it increased the envelope for the PEPP by €500 billion to a total of €1,850 billion. If favourable financing conditions can be maintained with overall lower purchase volumes, the decision states that the envelope need not be used in full. At the same time, the Governing Council extended the horizon for net purchases under the PEPP to at least the end of March 2022. In addition, it recalibrated the conditions of the third series of targeted longer-term refinancing operations (TLTRO-III) again and will offer three additional operations in 2021. It will, moreover, offer four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021. The Governing Council said that it would continue conducting regular lending operations as fixed rate tender procedures with full allotment at the prevailing conditions for as long as necessary. In addition, it extended the collateral easing measures up until June 2022 and the Eurosystem repo facility for central banks (EUREP) and all temporary swap and repo lines with non-euro area central banks until March 2022.

Monetary dynamics still highly accelerated due to coronavirus pandemic

In the final quarter of the year, monetary growth was also shaped by the impact of the coronavirus pandemic and economic policy action taken in response to it. The annual growth rate of the broad monetary aggregate M3 climbed to 12.3% by end-December, more than double its rate at the end of the previous year. Given the persistently high level of uncertainty about how the pandemic will unfold, precautionary considerations still dominated for households and enterprises, with highly liquid overnight deposits, in particular, recording substantial net growth. On the counterparts side, this development was driven by three factors in particular. First, the Eurosystem's ongoing asset purchases again fostered monetary growth. Second, the commercial banks significantly stepped up their securitised lending to private issuers. Third, loans to the domestic private sector saw major growth overall, even though non-financial corporations sought fewer loans than in the preceding quarter. The banks participating in the Bank Lending Survey (BLS) also reported a drop in demand for loans to enterprises. At the same time, though, they reported tightening their credit standards in all loan categories surveyed, particularly on account of elevated risk related to the pandemic.

Second wave of pandemic thwarted Germany's economic recovery at end of 2020

The economic recovery in Germany was brought to a standstill in the final quarter of 2020. According to the Federal Statistical Office's flash estimate, real GDP was up by a marginal 0.1% after seasonal and calendar adjustment. This means that economic activity was still almost 4% down on the pre-crisis level of the fourth quarter of 2019. The catch-up was halted by the resurgent infection rates and the associated gradual tightening of containment measures. These measures primarily targeted contact-intensive areas such as recreational and cultural services, hotel and restaurant services, and bricks-and-mortar retail outlets, leading them to report considerable losses in some cases. By contrast, many sectors that were not directly affected by the measures continued to recover. The industrial sector, in particular, stepped up production substantially.

Sectors hit by containment measures to varying degrees

The construction sector also increased its value added. It has so far remained largely unscathed by the pandemic. On the expenditure side, the tightened restrictions had a noticeable effect on household consumption especially, which is likely to have shrunk considerably despite the strong increase in car purchases. Exports remained on an upward trajectory, by contrast. Economic indicators are also signalling that enterprises are likely to have increased their investment in machinery and equipment as well.

These developments are also feeding through to bank lending, which was more dynamic

Fresh uptick in German banks' loans to domestic private sector

overall than it had been in the preceding quarter. Loans to households once again made the largest contribution to growth; demand for loans to households for house purchase continued to rise. Loans to non-financial corporations also saw distinct growth in the fourth quarter. Heightened uncertainty about future economic developments and the resultant reluctance to invest did, in and of themselves, dampen German enterprises' demand for bank loans. However, not all economic sectors were equally affected by this; in particular, financing needs remained high among enterprises in the loan-intensive construction and real estate sectors. In addition, the enterprises affected by the lockdown again saw an increasing need for funds, partly because of delays in the payment of government bridging aid. Respondents to the BLS tightened their credit standards and credit conditions on balance for loans to enterprises.

Labour market robust

The labour market proved relatively robust in the face of tightened measures taken during the fourth quarter to contain the pandemic. Based on the data available so far, the level of employment remained more or less constant compared with the third quarter. However, this may mask a significant bifurcation depending on the form of employment and economic sector. This heterogeneity also applies to take-up of short-time working arrangements. Overall, the number of people in short-time work rose again at last report, but on the other hand, unemployment fell fairly significantly up to January, despite the restrictions caused by the pandemic. The expanded contact restriction measures in place since mid-December dampened expectations and the outlook for the next few months, however.

Negotiated pay rose moderately in Q4, and actual earnings hardly, owing to pandemic

The pandemic is continuing to shape wage developments. Negotiated wages rose moderately in the fourth quarter as well. The latest wage agreements provide for low wage increases following several zero months at the start of the contractual term. Having decreased in the third quarter, actual earnings may have increased again in the fourth quarter owing to a decline in short-time work. Even so, wage drift (i.e. the difference between the growth rates of negotiated and actual wages) is likely to have been distinctly negative, as in the two preceding quarters. The wage demands of the trade unions in this year's major wage round currently amount to 4% to 6% for a period of 12 months and continue to reflect the ongoing strains of the pandemic.

Inflation in Q4 2020 clearly dampened by temporary VAT cut and energy prices, but up strongly in January

In the final quarter of 2020, consumer prices (HICP) remained constant on the quarter in seasonally adjusted terms after falling markedly in the third quarter owing to the temporary reduction in value added tax (VAT). The temporary VAT cut and energy prices continued to have a significant dampening effect year on year. At -0.6%, inflation in the final quarter of 2020 was even slightly lower than in the previous quarter (-0.2%). The inflation rate excluding energy and food was likewise in slightly negative territory (-0.1%, after 0.5%). In January 2021, consumer prices surged upwards. Inflation rose exceptionally sharply, from -0.7% in December to 1.6%. The core rate also picked up significantly (from -0.1% to 2.0%). The increase was thus even stronger than had been expected as a result of the reintroduction of the regular VAT rates and the implementation of the measures contained in the climate package. This is likely to be explained by extensive updates to the expenditure weights underlying the HICP.

German economic output likely to contract markedly in Q1 2021 but return to significantly higher level from Q2

The increased burdens caused by the strict containment measures in place until at least early March are likely to hamper aggregate output in the first quarter of 2021. However, there is no reason to fear that economic activity will sink to the lows recorded during the lockdown in the second quarter of 2020. First of all, this is because many sectors that are hardly directly affected by the measures, such as industry, have continued to recover so far. Second, enterprises in the sectors strongly affected by the containment measures, such as retail trade and the accommodation and food services sector,

are likely to be increasingly adapting to the conditions of the pandemic. According to the ifo Institute, enterprises from the retail and accommodation and food services sectors, for example, were distinctly more optimistic about their business situation in January than in April 2020. However, industry could encounter headwinds from growing supply bottlenecks for a number of intermediate products owing, for example, to border closures or stricter border controls. On the demand side, private consumption is likely to suffer owing not only to the closure of consumption opportunities during the pandemic but also to the restoration of VAT rates to their original levels. As infection figures decline, vaccines become more widely available and the containment measures are gradually eased, the current drags on growth should slowly recede, however. Economic output is therefore likely to return to a significantly higher level from the second quarter and continue its recovery. However, the future outlook remains closely linked to developments in the pandemic, with the risk of further setbacks stemming from mutations of the virus, in particular.

Government's significant contribution to stabilising the coronavirus crisis reflected by high deficit and clear rise in debt

The coronavirus crisis also shaped German fiscal policy last year. Starting from the first wave of infections in March, extensive measures were taken to support the healthcare system, enterprises, and households. General government investment continued to grow at a dynamic pace. Moreover, the tax and social security system had an automatic stabilising effect during the economic downturn, with tax and social security contributions decreasing in line with corporate earnings, wage income and private consumption, and wage income losses being offset to some extent by social benefits. As a result, a large general government deficit was recorded in 2020. Initial reports in January put it at almost 5% of GDP, following a surplus of 1½% of GDP a year earlier. The debt ratio could have risen by roughly 10 percentage points to around 70% by the end of 2020.

Deficit and debt ratio expected to stay at similar levels in 2021

The outlook for this year remains uncertain. As things stand, both the deficit and the debt ratio could move more or less sideways. Because parts of the economy will remain severely impaired by the containment measures at first, many support measures will stay in place or be adapted. In addition, the solidarity surcharge has been partially abolished and child benefits significantly raised. However, the upturn should gradually pick up speed over the course of the year, also increasingly easing the burden on public finances.

2021 central government budget contains buffers for further crisis support

Although the deficit recorded by the central government budget was very large at the end of 2020, it was nonetheless considerably smaller than planned. The standard limits imposed by the debt brake were exceed by only around €40 billion rather than by around €120 billion. In line with this, the annual repayments, which are due from 2023 onwards, will run at just €2 billion instead of €6 billion. A very large volume of net borrowing is expected again this year. However, this will contain generous buffers which can be used fairly flexibly during the crisis. Some of these buffers have already been earmarked as part of the most recent government decisions – for example, for a second child bonus or additional spending on vaccines. Nonetheless, a great deal of leeway remains to allow the funding of additional measures if required by the crisis. Setting a time limit on these measures will prevent strain on future budgets.

Public finances will recover as pandemic subsides, but expenditure set to rise regardless of the coronavirus crisis

The general government deficit is likely to fall significantly in 2022. To wit, the economic recovery is set to firm once the coronavirus pandemic has died down, and support measures may be discontinued. Many of the projections published since the autumn indicate a structural deficit of around 2% of GDP. Rising social insurance contribution rates have probably already been factored in here, as was the case in the Bundesbank's December projection, for example. For the most part, this is not a direct consequence of the coronavirus crisis, but instead reflects additional spending on educa-

tion, climate policy and digitalisation, for example. Moreover, expenditure on pensions, healthcare and long-term care is growing rapidly in the wake of political decisions and as a result of demographic change. While interest expenditure declines, growth in other expenditure (primary expenditure) is therefore likely to remain dynamic. It could thus reach a new peak as a share of GDP. The tax and social contributions ratio is also expected to reach a relatively high level in historical terms.

Remain focused on managing the crisis, then return finances to sound footing

Overall, it is appropriate for fiscal policy to remain focused on stabilisation at first in order to deal with the crisis as effectively as possible. Once the pandemic subsides, it will be time to return public finances to a sound footing. A good way to anchor a multitiered policy of this sort consists of fiscal rules that provide fiscal leeway in a crisis while at the same time ensuring a solid outlook for public finances. This could take various forms. Both the European fiscal rules and the German debt brake cater to this two-pronged objective.

Fiscal rules ultimately mean that receipts and expenditure need to be matched and that priorities need to be set. Given the high levels of uncertainty at present, it is difficult to reliably gauge exactly how much need there will be to adjust German public finances in the future. Although there will probably not be sufficient room for additional spending, or for tax cuts, the need for consolidation at all levels of government does not appear exceptionally great overall from today's perspective. Moreover, the rules allow adjustments to be spread out over a period of time. Central government can thus use its generous reserves, which amount to almost €50 billion. No specific decisions will be made until the central government budget for 2022 is adopted after the general election.

Adjustment needs are limited from today's perspective and should be spread over several years

Social security funds under financing pressure

Regardless of the coronavirus crisis, social security funds will require considerable structural adjustment in the future. This is mainly the result of demographic change, but also of the extensive benefit increases adopted over the last few years. Contribution rates are therefore expected to rise sharply – first for health insurance and then for pension and long-term care insurance schemes. It will be key here to set out a roadmap for social security contribution rates, central government funds and the level of benefits going forward. Without further adjustment, the central government budget is unlikely to have the capacity to take on additional structural burdens here.