

| The current economic situation in Germany

Overview

Light at the end of the tunnel

Subdued start to year for global economy

The pandemic maintained a firm grip on the global economy in the first quarter of 2021 as well. In many places, new waves of infections and tighter containment measures set the recovery back. Services were once again particularly affected. Towards the end of the reporting period, supply shortages were a drag on industry, which had initially experienced a lively expansion. This also drove industrial producer prices up. On the whole, the global economy continued its recovery in the first quarter, yet at a distinctly reduced pace. In the euro area, gross domestic product (GDP) was even down by 0.6% from an already weak preceding quarter. Japan and the United Kingdom likewise experienced a marked drop in activity. By contrast, the economic recovery took off again in the United States, where many restrictions were already lifted over the course of the first quarter and extensive stimulus packages gave the economy an additional boost. In China, where the pandemic has already been under control for quite some time now, the economy continued to recover, whereas some other emerging market economies suffered from the economic fallout caused by new waves of infections.

Supply-side bottlenecks a drag on global industrial upturn

The industrial sector was one of the main reasons why the global economy remained on a path of expansion in the final quarter of 2020 and first quarter of 2021, despite new waves of infections. It benefited considerably from the pandemic-induced shifts in demand. Since its drastic slump in the spring of last year, global industrial production had already grown substantially, surpassing its pre-crisis level in December 2020. At last report, however, the upturn in manufacturing was running into supply-side bottlenecks. Purchasing managers the world over complained about rising delivery times. In addition, the strong demand for in-

dustrial goods caused commodity prices to increase considerably, and transport costs rose steeply. This cost surge most recently affected industrial producer prices perceptibly and will probably have an impact on consumer prices, too.

In the meantime, vaccination campaigns have taken off in many places, and in a great number of advanced economies infection rates have flattened markedly. It appears that, as from the third quarter if not beforehand, it will be possible to open the economy in those places on a broad scale, which would lend significant momentum to the global economic recovery.

The international financial markets reflected this outlook for an economic recovery. Market participants' confidence was boosted by progress in vaccinations, positive business cycle signals and an accommodative monetary policy stance. Given simultaneous fiscal policy stimulus – particularly in the United States – yields on benchmark government bonds rose worldwide, at times distinctly, via the interest rate linkage with the United States. This rise in yields occurred in a setting of calm markets and high liquidity. A key factor behind the increase in risk-free interest rates was mounting inflation expectations, which continued to pick up from their low in March 2020 on both sides of the Atlantic. Real interest rates therefore rose less strongly, on the whole, than nominal government bond yields. In January 2021, yields on euro area corporate bonds initially hit all-time lows before then rebounding as well. They nonetheless continued to reflect very favourable financing conditions as this report went to press. The upbeat setting led to strong price gains in the equity markets. Alongside the aforementioned factors, this also reflected enterprises' higher profit expectations and investors' high risk appetite, which dampened demand in the foreign exchange markets for

Vaccination progress holds out hope for opening

Financial markets reflecting more favourable economic outlook

some currencies regarded as relatively safe. Consequently, the yen and Swiss franc lost value in effective terms. The euro also depreciated on a weighted average, though its losses were small by comparison. Given rising yields on US Treasuries, the effective exchange rate of the US dollar, which also often depreciates when risk appetites rise, remained virtually unchanged. By contrast, the pound sterling benefited from the trade and cooperation agreement with the EU reached at the end of 2020 and the United Kingdom's successes in its vaccination campaign.

the persistently low level of interest rates encouraged these sectors to continue to accumulate, in particular, highly liquid overnight deposits. On the counterparts side, the Eurosystem's continued asset purchases boosted monetary growth. Moreover, banks' lending to the domestic private sector once again registered significant inflows on balance. It was particularly loans to non-financial corporations which picked up substantially in some Member States during the quarter under review; households' demand for loans for house purchase also remained lively. At the same time, the banks participating in the Bank Lending Survey (BLS) reported mostly tightening their credit standards due to elevated risk related to the pandemic.

Monetary policy: ECB Governing Council expecting higher monthly PEPP purchases in Q2

Following its March and April monetary policy meetings, the Governing Council of the European Central Bank (ECB) expected purchases under the pandemic emergency purchase programme (PEPP) over the second quarter to be conducted at a significantly higher pace than during the first few months of the year. This position was based on an assessment of developments in financing conditions since the beginning of the year, especially of the rise in market rates over this period. At the same time, the Governing Council reaffirmed its decision taken in December 2020 to continue to conduct net purchases under the PEPP with a total envelope of €1,850 billion until at least the end of March 2022 and, in any case, until it judges that the coronavirus crisis phase is over. If favourable financing conditions can be maintained with smaller asset purchase flows overall, the envelope of €1,850 billion need not be used in full. Equally, the envelope can also be increased if required.

Aggregate output in Germany fell strongly in the first quarter of 2021. According to the Federal Statistical Office's flash estimate, real GDP was 1.7% down on the quarter after seasonal and calendar adjustment. This meant that economic activity again fell short of the pre-crisis level of the fourth quarter of 2019 by almost 5%. The setback can be attributed in large part to the stricter and more prolonged measures to protect against coronavirus compared with the preceding quarter. In particular, this hit a number of services sectors hard. Moreover, industrial output stagnated, and construction output even declined, after both sectors had provided considerable support to the economy in the previous quarter. Various factors were at work here. In the construction sector, the return of the VAT rates to their higher levels at the start of the year and the unfavourable weather conditions in January and February had a dampening effect. In industry, bottlenecks in the supply of intermediate goods led to the recovery stalling, despite a further increase in demand. The automotive sector experienced delays in production owing to a lack of semiconductors.

German economic output down strongly in Q1 2021

Monetary dynamics still strong on account of coronavirus pandemic

In the first quarter of 2021, the broad monetary aggregate M3 once again went up steeply on account of the impact of the coronavirus pandemic and the economic policy responses. Although monetary dynamics slowed down considerably compared with the situation at the outbreak of the coronavirus crisis a year ago, the annual growth rate of the broad monetary aggregate M3, at 10.1% at the end of March, remained high. Precautionary considerations on the part of households and enterprises and

On the demand side, it was probably, above all, private consumption which declined strongly in the first quarter. A host of opportunities for consumption of services were either partially or entirely unavailable owing to the coronavirus

Strong signs of slowdown, mainly in private consumption

mitigation measures. In addition, the return of VAT rates to their higher level dampened demand for consumer durables such as motor vehicles. Purchases of such goods had been brought forward to the second half of the previous year. Businesses probably reduced investment in new machinery and equipment in the first quarter as well, albeit on a much smaller scale. On the other hand, German enterprises continued to benefit from dynamic foreign demand and significantly increased their exports.

Fresh uptick in German banks' loans to domestic private sector

The depressed level of private consumer expenditure also dampened demand for consumer credit. Nonetheless, the lending business of banks in Germany grew dynamically on the whole, for two reasons. One was that household demand for loans for house purchase remained consistently strong. The other was that loans to non-financial corporations gained significant momentum compared with the two preceding quarters. This was caused by a growing need for funding on the part of those enterprises not directly impacted negatively by the coronavirus crisis, such as enterprises in the construction and real estate sectors and service providers operating in the field of digitalisation and research and development activities. The upswing in global industry has also acted to stimulate investment by export-oriented sectors. In addition, some banks had a heightened interest in lending business as well. They were still trying to reach, by the end-March reference date, their lending performance threshold set as the condition for the particularly attractive interest rate on TLTRO-III operations. On the whole, however, respondents to the BLS once again somewhat tightened their credit standards for loans to enterprises in the first quarter.

Labour market robust

The labour market responded robustly to the prolonged mitigation measures in the first quarter. Both employment and unemployment held nearly steady at the level of the fourth quarter of last year. The effects of the lower economic output were largely cushioned by short-time work, which was again taken up on a much larger scale after the decline in the

second half of 2020. As the mitigation measures first began to be eased in March and progress on vaccinations advanced, the labour market also saw a return of confidence in developments over the next few months.

Negotiated wages recorded only a moderate rise in the first three months of 2021. Including additional benefits, they were up by just 1.4% on the year in the first quarter. The increase in the fourth quarter of 2020 had still stood at 2.6%. The most recently concluded new agreements were a key factor behind this weakening. They initially provide for pay freezes of several months at the start of the contracts, followed by low wage increases only around one year into the contracts. In addition, one-off coronavirus special payments had been made in a number of sectors in the fourth quarter of last year. Wage bargainers restricted agreed wage increases in order to protect jobs. With short-time work having gone back up in the first quarter, actual earnings may even have fallen. As in the previous three quarters, wage drift is likely to have been clearly negative.

Negotiated wages up only moderately due to pandemic; actual earnings probably even down

Consumer prices as measured by the Harmonised Index of Consumer Prices (HICP) rose exceptionally strongly at the beginning of the year. On average for the months of January to March 2021, they increased by a seasonally adjusted 2.1% on the quarter, after having previously stagnated. The main reasons for this were the reversal on 1 January of the temporary VAT cut, but also measures contained in the climate package and the higher oil price. Overall, prices for all the main components of the HICP basket rose strongly, with the higher VAT rates in January 2021 being passed on in a more or less inverse manner to their reduction in July 2020. While the inflationary pressures for food, non-energy industrial goods and services normalised again by March, energy prices continued to rise significantly, tracking crude oil prices.

Due primarily to return of higher VAT rates, consumer prices at start of year up sharply on the quarter ...

The return to the higher VAT rates also had a clear impact on the annual increase in the HICP, with inflation up from -0.6% in the fourth quar-

... and on the year

ter of 2020 to 1.7% in the first quarter of 2021. Excluding energy and food, inflation increased from -0.1% to 1.8%. A statistical effect in connection with the more extensive pandemic-related updates to the expenditure weights underlying the HICP, particularly in the case of package holiday prices, also played a role here.

Inflation rate in April up further due to energy and food

The annual rate of inflation rose again slightly in April to 2.1%, compared with 2.0% in March. Energy inflation in particular increased sharply of late, but food inflation also picked up significantly. By contrast, the core inflation rate excluding energy and food fell from 1.6% in March to 1.1%. However, a decisive factor here was the reduced contribution of the statistical effect for package holidays, which had pushed up the HICP rate significantly in the previous months.

Inflation rate set to rise further and could temporarily reach 4% at end of year

In the coming months the rate of inflation is likely to continue on a slow upward trajectory at first. While the recent strong rise in the prices of non-energy commodities and transport costs is already having a very significant impact on input prices at the producer level, this development is not feeding through directly to consumer prices. Consumer prices are correlated more closely to producer prices for non-food consumer goods, which have thus far risen rather moderately. Furthermore, distribution costs and margins are also major determinants of consumer prices. The upward pressure on prices in the earlier input stages is therefore likely to have merely a weakened and delayed impact on consumer prices. As far as headline HICP inflation is concerned, a significant factor is that the base effect resulting from the temporary VAT cut will raise the annual rate as of July. However, this is likely to be almost completely obscured at first due to the statistical effect for package holidays simultaneously having a dampening impact for several months. At the end of the current year, however, this one-off effect will once again intensify inflationary pressures. As a result, the inflation rate could temporarily rise to 4%.

German economic output is likely to grow again significantly in the second quarter of 2021. The extent of this growth will depend largely on how heavily the containment measures weigh on the economy in comparison to the first quarter. As soon as the measures to protect against the coronavirus are successively loosened, activity in the affected services sectors should pick up again considerably. The industrial sector is benefiting from strong demand, with industrial orders recently seeing a further strong rise from their already elevated levels. Manufacturing firms have recently assessed the business situation as having improved again and have once more raised their production and export expectations. However, industrial output will probably continue to be subdued in the near future owing to bottlenecks in the supply of intermediate goods. Output in the construction sector is likely to rebound once dampening one-off effects cease to apply. Business expectations brightened on a broad cross-sectoral basis. Rapid progress in the vaccination campaign opens the prospect of a considerable loosening of containment measures in the coming months. GDP could then grow strongly in the third quarter and exceed its pre-crisis level as early as the fourth quarter.

Economic output likely to grow considerably in second quarter

To date, the fiscal policy response in Germany has been flexible and, overall, targeted to the difficult crisis situation. Although, in some cases, the specific design and implementation of individual measures are less than convincing, it should be borne in mind that action sometimes had to be taken fairly swiftly and subsequently fine-tuned as the pandemic unfolded, for example.

Targeted fiscal policy for the most part

Public finances have continued to significantly support the economy in 2021. The dedicated coronavirus assistance measures and the regular social systems are continuing to mitigate the economic fallout from the coronavirus crisis. To combat the pandemic, sizeable funds are being channelled into healthcare, for example for vaccinations and tests. Above and beyond that,

Public finances again providing strong support to the economy in 2021

various structural measures are providing relief for households in particular; for example, the solidarity surcharge has been partially abolished and child benefits have been raised significantly.

Deficit likely to continue rising in 2021

Germany's general government deficit could therefore approach around 6% of GDP this year, up from just over 4% in 2020. The bulk of the fiscal burdens presented by the crisis are being borne at the central government level. As things currently stand, however, it seems that the buffers in the Federal budget are very ample and far from being exhausted. Net borrowing by central government in 2021 would therefore again be considerably lower than the very high budgeted figure.

Deficit expected to shrink considerably in 2022

As long as the pandemic-related restrictions continue, targeted fiscal assistance will remain important. However, it is currently anticipated that the restrictions will increasingly be lifted as the year progresses. In 2022 it is likely that the deficit will then shrink considerably. The burden on public sector budgets will be relieved by the ongoing recovery in the German economy and the fact that numerous support measures will no longer be necessary and will be phased out; the fiscal policy stance is in this respect not restrictive.

Decision on necessity of escape clause in 2022 should wait until later this year

With regard to the fiscal rules, there is much to be said for putting off a decision on whether the escape clauses should also remain activated in 2022 until later in the year. This applies in equal measure to the EU rules and the debt brake. This is because as the year progresses it will become much easier to assess whether the

given escape clause is still necessary to overcome the crisis. Due to the German general election, the 2022 Federal budget probably will not be adopted until next year in any case. Besides, even without the exemptions, the fiscal rules provide scope for reducing deficits in a cyclically appropriate manner. For example, under the debt brake reserves can be used to comply with the ceilings. Under EU rules, expiring assistance measures will be deemed to constitute consolidation. It should therefore be possible for other Member States to meet the standard requirements as well. At least on the basis of the European Commission's most recent projection, use of the escape clause in 2022 does not seem convincing.

The debt brake is sometimes criticised for having excessively restricted government activities and spending in recent years. However, this is belied by the dynamic expenditure growth under the debt brake regime. For the coming years it even appears that non-interest expenditure as a share of GDP will reach new structural highs. The fiscal rules are not in any case designed to limit government spending. Rather, the rules are meant to keep the government budget in an agreed state of balance or to revert it to such a state. This means matching revenue and expenditure and setting priorities. If funds for important future tasks are considered to be insufficient, various courses of action are available. If the fiscal burden is not to be increased, say due to negative impacts on growth, the political priorities or adopted spending programmes would have to be re-adjusted.

Fiscal rules do not prevent additional spending for future tasks