German economy stuck in stop-go situation

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The coronavirus pandemic continues to determine world economic events. A powerful recovery lasting from summer to late fall 2020 followed the drastic slump in economic output in the first half of the year. Thereafter, the new coronavirus case numbers in many countries increased considerably, which led to renewed, partly wide-reaching restrictions on social life. Among the countries most affected were those of the European Union and the United States. Overall, global economic outlook declined by 2.7 percent in 2020. Advanced economies, including Germany, dealt with a significantly larger decline of 4.8 percent.

The second coronavirus wave in winter 2020/21 and the third wave now emerging have interrupted recovery in many countries. The service sectors above all are being dampened by consumer reticence and lockdown-related closures of retail and the cultural sector. Compared to the first coronavirus wave in spring 2020, the manufacturing industry has adjusted better to the pandemic worldwide; therefore, industrial production is robust. Global trade in particular is also in a better situation compared to spring 2020. The German economy, whose export goods are in demand despite the rampant pandemic, benefits from this as well. Business in Asia and the US is supporting exports, while the second coronavirus wave stopped recovery in the European Union. Unlike in the US or the United Kingdom, the EU's vaccination campaign is proceeding sluggishly and dampening prospects of a quick recovery.

Despite the continuing high case numbers, many countries decided to lift restrictions. Germany adopted a multi-phase plan at the beginning of March 2021, making regional differences in new case numbers the basis for opening up retail, gastronomy, and many other services. According to this plan, regions with a seven-day incidence of fewer than 50 new cases per 100,000 residents may implement expansive re-opening measures within one week. There are more restrictive rules for the public in areas with an incidence between 50 and 100. In the case that the incidence increases to over 100, new closures are planned.

This plan is likely to lead to a stop-go situation for value added, especially for services, as re-opening while an increasing share of coronavirus mutations are spreading faster than the original variant is expected to lead to a significant increase in case numbers. It is assumed in the calculated scenario that numerous districts and urban municipalities will again have to noticeably restrict activities in retail, gastronomy, and other service sectors. Following re-openings, a similar development is expected for early summer 2021. Overall, the multi-phase plan is likely to enable more economic activity in the service sectors in the second quarter of 2021 compared to the first, but recovery will be sluggish and a permanent return to normal business will not be possible until early summer as vaccinations continue and additional test opportunities improve.

In light of the robust industrial activity and foreign business's continued recovery, DIW Berlin is forecasting that German economic output will increase by around 3.0 percent in 2021 and that the recovery will continue with an increase of 3.8 percent in 2022. This recovery is progressing significantly slower than was expected at the end of 2020. The underlying scenario assumes a stop-go situation in Germany and Europe, while in other parts of the world—especially in Asia and the US—the pandemic is being combated more effectively, primarily due to a quicker vaccine rollout and no need for renewed, expansive lockdowns.

As before, the risks for this scenario are considerable. For example, politicians have changed their stance on corona-

DOI: https://doi.org/10.18723/diw_dwr:2021-11-1

virus policies more than once, which creates uncertainty for economic actors on its own. In addition, insolvencies are being obscured by the suspension of duty for companies to file for insolvency. Many firms exhausted their equity buffer in 2020; this applies to small businesses in the service sectors especially, who are less crisis-resilient and have fewer opportunities to prepare themselves for serious economic crises. Even before the coronavirus pandemic, these companies had a lower equity position, as surveys from the KfW, for example, show. In many cases, they are dependent on state aid to avoid insolvency, but it is often delayed or stopped entirely due to fraud. In 2020, however, there were fewer corporate insolvencies; thus, they could increase significantly in 2021 alone, putting additional pressure on the labor market. Therefore, there is a significant risk that a larger number of companies will go bankrupt. This could also lead to negative consequences for many creditors, especially the banking sector. Moreover, aid granted in the form of loans worsens the creditworthiness of the surviving companies, whose margin for maneuver, especially for investments, will be restricted in the aftermath of the crisis.

Nevertheless, the emergency aid for companies, the fiscal stimuli, and an expansionary monetary policy are likely to have reduced negative economic consequences of the crisis significantly. Larger parts of income losses and declines in demand were absorbed with instruments such as short-time work and the stimulus package from summer 2020. Although the damage to the labor market is considerable, it is still relatively minor in view of the economic slump. This is likely to be primarily due to the flexible use of short-time worker rules. The unemployment rate is likely to have reached its highest level at more than six percent in 2020 and will be 5.8 percent on average in 2021. That Germany's government debt ratio up until now has only increased to 69 percent compared to GDP is also due to the fact that parts of the aid provided have not yet been requested or were not required. Nevertheless, the debt-to-GDP ratio is likely to further increase to 71 percent in 2021, but it remains markedly lower compared to in the immediate aftermath of the global financial crisis.

A discussion about a rapid return to the debt break is already underway. However, due to the economic situation and its uncertainties, it seems too early to aim for an almost balanced budget. Particularly the fiscal stimulus in Germany and in the euro area has been significantly smaller than that of other major economic areas, such as the US or Japan. In the US, it is around 13 percent of GDP and in Japan, around six percent. In contrast, overall fiscal aid in response to the coronavirus crisis was only about four percent compared to GDP in Germany. In the coming months and years, Germany also plans to spend significantly less than, for example, the United States, where around four times the current output gap is being spent on crisis management. In Germany, around six percent of economic output is intended for fiscal aid and measures supporting the economy for 2020 to 2022, which is only 1.2 times the output gap in 2020.

Germany and the euro area will unquestionably profit in the short-term from the stimuli in the rest of the world. Nevertheless, important modernization projects are being advanced in other economies more quickly. Therefore, a speedier pace would be important in Germany. Particularly during a time of negative interest rates, the moment seems favorable for investment measures, as these pay off double in the current economic situation. The economic capacities are underutilized, uncertainty about future development is high, and interest rates are incredibly low. Simultaneously, there is a consensus regarding the necessity of expansive state investments in decarbonization, digitalization, research and development, and education, but also in existing infrastructure. Model estimates show that one euro of this public investment will cumulatively add about 1.60 euros to GDP by 2024. As a result, real economic output would be around 0.4 percent higher on an annual average by 2024 than it would have been without the investments under the stimulus program. Especially in an environment of low interest rates, which eliminates the financing costs of issuing government debt or may even turn them into real profits, the additional growth should also make a tangible contribution to reducing public debt in the medium term.

As production potential increases, public and private capacity expand and production processes become more efficient, for example through digitalized schools and public administrations or better childcare. Short- and medium-term demand bottlenecks, which could lead to rising prices as a result of the effective fiscal stimulus, would also be mitigated by the fact that an investment program also increases production capacities permanently.

This means that in the long term there is no trade-off between a reduction in the government debt ratio and more public investment expenditure if this investment increases potential growth, thereby strengthening tax revenues and easing the burden on social systems. Currently, Germany has a great need for such investments and should seize the opportunity to modernize its economy in a sustainable manner while overcoming the crisis at the same time.

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Mohrenstraße 58, 10117 Berlin
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Phone: +49 30 897 89–0 Fax: –200
Volume 11 March 19, 2021

Sale and distribution
DIW Berlin Leserservice, Postfach 74, 77649 Offenburg
leserservice@diw.de
Phone: +49 1806 14 00 50 25 (20 cents per phone call)

Layout
Roman Wilhelm, DIW Berlin

Cover design
© imageBROKER / Steffen Diemer

Composition
Satz-Rechen-Zentrum Hartmann + Heenemann GmbH & Co. KG, Berlin

ISSN 2568-7697