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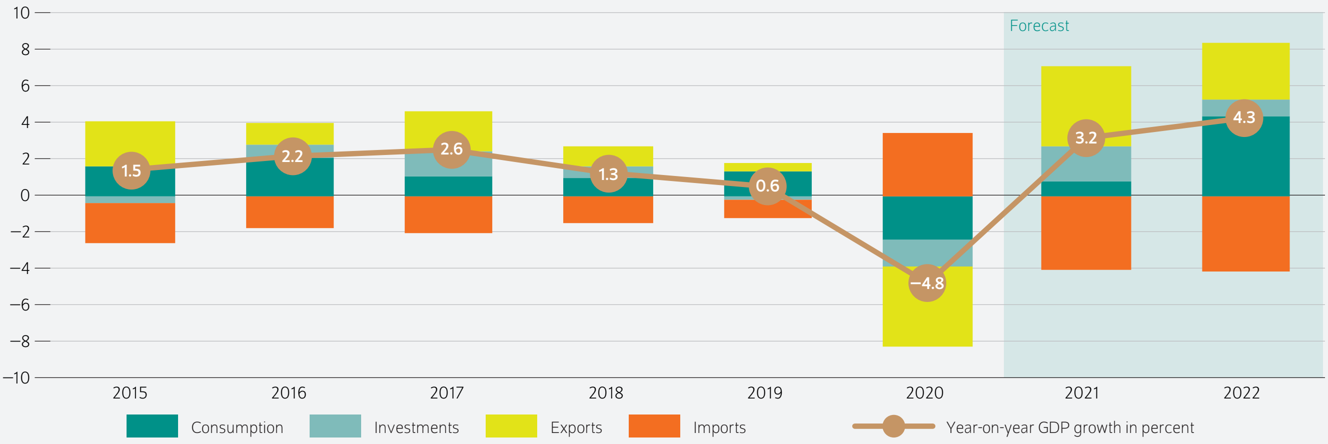
AT A GLANCE

German economy with delayed recovery; industry in a tight spot

By Claus Michelsen et al.

- DIW Berlin is slightly increasing its growth forecast for the German economy to 3.2 percent for 2021 and to 4.3 percent for 2022
- However, the consequences of the pandemic are far from over and setbacks are feared; increasing raw material shortages are weighing on industry, risk of insolvencies is rising
- German exports are benefiting from global economic growth; boom in the USA is compensating for the weak recovery in some emerging economies
- In Germany, overall economic loss due to the pandemic should be around 350 billion euros, around ten percent of GDP
- Returning to a balanced budget too early would cause damage—without investments and innovation, structural changes such as the demographic shift cannot be handled

German economy growing faster than expected in spring 2021; consumption to primarily drive growth in 2022
Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Economic Outlook Summer 2021.

FROM THE AUTHORS

"Service sectors in particular are benefiting from the easing of the lockdown measures. However, incidences could rise again as re-openings begin. We will only see a sustained upswing once the vaccination rate is high enough to approach herd immunity."
— Claus Michelsen, DIW Berlin Chief Economic Forecaster —

MEDIA

Audio Interview with C. Michelsen (in German)
www.diw.de/mediathek

German economy with delayed recovery; industry in a tight spot

By Claus Michelsen, Guido Baldi, Marius Clemens, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Max Hanisch, Simon Junker, Laura Pagenhardt, and Sandra Pasch

The coronavirus pandemic will continue to determine economic development worldwide in early summer 2021. The vaccination campaigns have gained momentum, especially in developed economies, and many countries, including Germany, are gradually easing restrictions on social life. The effects of the pandemic are determining the recovery process, but nevertheless, many service sectors—above all the hospitality sector and retail industries—have already been able to achieve significant sales gains in recent months and thus participate in the progress made in combating the pandemic.

The manufacturing sector, in contrast, is being significantly hampered by raw material shortages and other important advance services. Despite a return to well-filled order books, industry and the construction sector cannot meet demand fully. The prices of important advance services have increased significantly recently and a large number of businesses are reporting that the missing advance services are hindering production. Consequences of the pandemic not directly related to the spread of the virus or to preventative measures are now coming into the foreground: For example, the extraction and production of important raw materials were shut down during the pandemic and now the rapidly growing demand cannot be met immediately. Additionally, demand has shifted, in some cases drastically. In particular, the shift to digitalization has created skyrocketing demand for semicondutors in the electrical industry, which has resulted in a shortage for automotive manufacturing. Such shortages show that containing the pandemic is a necessary but insufficient precondition for a quick and smooth economic recovery.

Despite these developments, the outlook for the German economy is somewhat more positive than expected in spring 2021. For 2021, DIW Berlin is now forecasting growth of 3.2 percent compared to 2020. Strong recovery is expected to continue into 2022 with growth of 4.3 percent. However, this should not obscure the fact that the road to fully overcoming the impact of the pandemic is long and setbacks must always be expected. It is estimated that the pre-crisis growth level will be achieved by the final quarter of 2021. The cumulative, pandemic-related loss of value added in Germany is around 230 billion euros. Without the pandemic, economic output would have increased by around 2.5 percent. Overall losses due to the coronavirus pandemic from 2020 and 2021 are 350 billion euros, around ten percent of GDP. These losses also impact production potential, which will not reach its pre-crisis level in the medium term: In 2025, value added is likely to still be lower than projected before the crisis. Thus, it would be counterproductive to end the current economic stabilization measures too early. Rather, additional fiscal stimuli would be helpful to strengthen production potential in order for it to return to its pre-crisis growth path sooner.

In the short-term, the German economy will benefit from the global recovery: Important imports from the mechanical engineering and automotive sectors are in demand worldwide. Demand from the euro area and the USA in particular is better than forecast in spring 2021. In contrast, economic growth in the emerging markets is less positive than expected in spring 2021, as brutal waves of the coronavirus have led to tragic conditions in the hospitals in these countries. Moreover, the Chinese economy has lost some momentum as well. Nevertheless, despite the raw material shortage and temporary blockades of important sea trade routes, the global economy is on a recovery course overall.

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In this forecast, it is assumed this shortage is temporary and the advanced economies will be able to lift restrictions on social life on a sustained basis due to the progress in their vaccination programs. The situation is different for emerging economies, however, where there are not enough vaccine doses to comprehensively cover the population. As a result, recovery in these countries will be repeatedly hindered and a high risk of further virus mutations remains. If the current vaccines do not protect from the new variants, recovery in Europe, the USA, and other parts of the world will also be at risk.

In Germany, the phased plan to determine the re-openings and closings of businesses based on the seven-day-incidence that was adopted by the federal and state governments still applies. According to the plan, many activities may be carried out largely without restrictions when there are fewer than 50 new infections per 100,000 inhabitants within one week, or with additional restrictions at 100 new infections. Accordingly, many districts and urban municipalities were able to ease restrictions and as a result, business activity, primarily in the service sectors, is increasing and currently driving the recovery in Germany. However, it is also to be expected that infections will increase as social activities resume. The race to vaccinate against the spread of further virus mutations has not yet been won. Therefore, it is assumed in this forecast that regional restrictions will be necessary in the summer months to keep the spread of infection under control. This is likely to lead to a stop-go situation for recovery in the service sectors, at least in districts currently experiencing higher incidences.

However, the recovery is likely to be held back considerably more by the obstacles faced by industry and the construction sector, which are not expected to be overcome until fall 2021. Many raw material prices have increased significantly within a short period of time and there is low availability of important primary products. On the one hand, this reflects the global economy's robust recovery; on the other, it is also a result of raw material extraction and production shutdowns during the peaks of the pandemic. However, there is much to suggest that this development will only have a temporary impact on value added and that no new supercycle in demand for raw materials is forming. Accordingly, the worries of permanently high inflation rates on the consumer level are likely to be unfounded.

Nevertheless, the higher raw material prices are causing concern in other areas: Many industrial and construction sector orders are placed many months in advance without anticipating corresponding price developments. Small and medium-sized business as well as many tradespeople may have been unexpectedly affected by the latest developments without having agreed upon corresponding hedges against such price increases. This can lead to orders having to be carried out with losses or with delays and corresponding contractual penalties due to the delivery difficulties, particularly in the skilled trades. Depending on volume, this may cause economic hardship for smaller businesses and hides the risk of insolvencies despite high demand. In any case, an increase in insolvencies and business closures is expected over the coming months. In 2020, the requirement to report insolvency was suspended and the number of cases opened was accordingly low; the number of business deregistrations was also comparably low. This is atypical for recessions and likely means many businesses must head to the district court.

An increasing number of corporate insolvencies could entail negative effects on the labor market. Insolvencies are expected to rise in the scenario assumed here but a major wave of insolvencies beyond a normalization of insolvency activity is not expected. Accordingly, employment subject to social security should increase strongly and the unemployment rate is likely to decrease to five percent in 2022. Thus, the negative effects of the crisis would be overcome quickly, partly due to the expansive claims of short-time work allowances on the labor market. However, it is already clear that the results are unequally distributed over economic sectors and types of employment. The number of the self-employed has decreased significantly and the number of the marginally employed will probably no longer reach its pre-crisis level. Employment growth is not being driven by industry, the core sector of the German economy. Instead, the number of workers is increasing in some service sectors, the public sector especially. If a major wave of insolvencies occurs, it is likely to cost jobs and slow economic recovery overall.

The development of advance services and product prices is also putting pressure on profit margins and thus on the ability to build up necessary equity for investments. In this way, the increasing raw material prices could significantly hinder the global investment cycle and thus weigh on domestic and foreign demand for machines and installations.

Both equity items and the debt of many companies have already worsened noticeably during the crisis. This is reflected in the volume of emergency aid and loans granted, which secures the survival of many companies but also worsens their balance sheets. The KfW, a German business development bank, has issued around 50 billion euros in loans to the business sector. Subsidies and aid were significantly greater; these burdens on public debts are noticeable in the government debt ratio, which has expanded to over 70 percent.

In the run-up to the German federal election in September 2021, calls are now being made for a faster return to a balanced budget. However, such a return would be too early: On the one hand, the crisis has not yet been overcome. The aftereffects are showing up repeatedly in unexpected developments, as is now the case on the commodity markets. On the other hand, there are considerable structural changes ahead, especially the demographic change, that will weigh on the growth potential of the German economy. These changes should be countered with government stimuli: It will only be possible to get out of debt if Germany's locational qualities do not fall behind in international comparison and, above all, if its innovative power is strengthened. Its innovative power is likely to have suffered during the crisis, as start-ups and thus the potential for new, innovative business models were missing in large numbers in 2020. Moreover, businesses may have stopped cost-intensive, high-risk innovative projects or not begun them in the first place. Such a development is often met with an expansive industrial policy agenda and public investments, especially in the United States. Corresponding stimuli for private activities in research and development, state support for innovative start-ups, and public investments in research and education would be important in boosting Germany's growth path. The steps adopted as part of the German government's future package provide a tangible impetus in this regard, but are only a first step in light of the scale of the challenges.

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