GERMANY

BUMPY RECOVERY DESPITE STRONG FISCAL STIMULUS

With the gradual easing of the lockdown restrictions, economic activity has shown signs of rebounding. The government stimulus plan might give further impetus to growth and also contribute to lower carbon emissions. The prospect of an EU stimulus is good news for Germany's export-oriented manufacturing sector. However, in the absence of a Covid vaccine or better treatments the recovery is likely to be bumpy. GDP is unlikely to return to its pre-Covid level before 2022.

EASING OF RESTRICTIONS LIFTS EXPECTATIONS

The economic climate has substantially deteriorated during the past three months because of the lockdown measures in order to stop the Covid-19 pandemic. However, there were some remarkable differences between sectors. In May, in the industry sector, manufacturing output was 23.7% lower from a year earlier. By contrast, construction was among the least affected activities, and production was even slightly above the level in May 2019. In the retail sector, clothing stores were particular hit, reporting a fall in turnover by 23.1% in May from last year after more than 70% in the preceding month. Nevertheless, the sector had also some clear winners. As bars and restaurants were closed, food stores reported an increase in sales of more than 10% in May, and online sales even rose by more than 30% from last year.

The trough is likely behind us. Following the decline in new Covid-19 cases, all German states have been gradually lifting lockdown restrictions since the end of April, although each at its own speed. The progressive opening of businesses has certainly contributed to the improvement in economic sentiment. Consumer confidence strengthened both in May and June and a further improvement is anticipated for July. Also the ifo climate index improved in June for the second consecutive month on the back of a rebound in expectations (chart 2). Nevertheless, in the manufacturing sector, the assessment of actual conditions continued to decline.

PREPARING FOR THE AFTER-COVID WORLD

As the country went into lockdown in March, the federal government launched a substantial emergency package worth EUR 750 bn largely aimed at protecting jobs and income. A key element was the short-time working scheme (*Kurzarbeit*), under which the Federal Employment Agency (FEA) pays 60-67% of the forgone wages of workers whose hours are being cut. The scheme was very successful in protecting jobs during the great recession in 2008-09. The emergency package also provided liquidity assistance and loan guarantees for businesses. *

On top of that, the government unveiled a stimulus programme, worth EUR130 bn, in early June. The Bundesbank estimate that the programme can boost growth by 1 percentage point in 2020 and 0.5 pp in 2021. In the first place, the programme intends to boost household spending. A key measure is a temporary VAT cut from 19% to 16% for the standard rate, and from 7% to 5% for the reduced rate between 1 July and 31 December. Other measures to bolster spending power are a EUR 300 one-off payment for every child and a reduction in electricity costs by a reduction in the renewable energy levy.

The package also includes substantial transfers to businesses through a EUR 25 bn loan support programme for small firms that have seen their sales drop by more than 60% for June to August. In particular firms in the hospitality sector are likely to benefit from this programme. Furthermore, the maximum amount for tax loss carry backs shall be increased temporarily for losses in 2020 and 2021 from EUR 1 mn to EUR 5 mn.

GROWTH AND INFLATION (%)

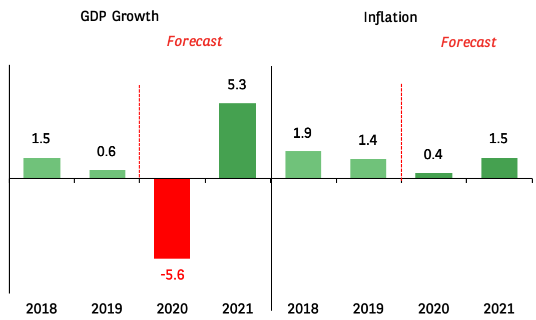

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

ENTREPRISES NOTE AN IMPROVEMENT IN CURRENT CONDITIONS

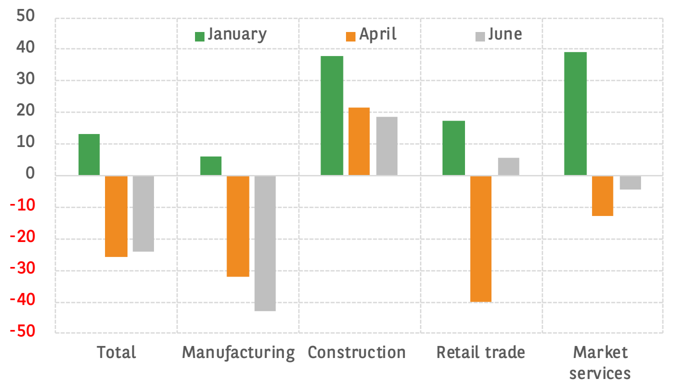

CHART 2 SOURCE: IFO SURVEY - ACTUAL CONDITIONS

At the same time, the government wants to use the package as an environmental policy instrument. EUR 50 bn is set aside to fund research into promising technologies such as hydrogen. Moreover, it wants to stimulate the use of electric vehicles (EV) by increasing the number of EV charging station. In addition, buyers of full-electric cars with a net list price of up to EUR 40,000 will be eligible for a grant of 9,000 euros, including 6,000 euros from the government and 3,000 euros from car manufacturers. However, the government refused to extend this bonus to petrol and diesel cars.

However, the government is well aware that Germany's export-oriented manufacturing industry cannot recover as long as the recovery in the neighbouring countries lags behind. Hence, the Chancellor's strong support for the European Commission's proposal to put in place a EUR 750 billion stimulus package. In that respect, it is a good thing that Germany has taken over the rolling presidency of the European Council for the second half of 2020.

RECOVERY TO REMAIN BUMPY

Even though the economy is showing clear signs of rebounding, the recovery is likely to remain slow and bumpy at times, at least until there is a Covid vaccine or better treatments. In their absence, substantial restrictions will remain in place, which will to continue to weigh directly on productivity growth. As the fear for the virus is likely to stifle spending on capital and research & development, the potential growth is likely to be negatively impacted.

On the demand side of the economy, the current boom in retail spending is likely to fizzle out quickly when consumers remain wary about the virus. Moreover, the deterioration of the employment outlook is likely to lead to an increase in precautionary savings. Hence the saving ratio might remain at a relatively high level.

Labour market conditions have considerably deteriorated. In May, employment was 1% lower than a year earlier and the unemployment rate had risen to 4.4% compared with 3% in May 2019. Moreover, the number of hours worked has dramatically fallen due to the massive use of short-term work schemes. Applications for more than one-third of all employees had been submitted by the end of May (see chart 3). A part of these might eventually become fully unemployed. Unemployment is expected only to peak next year.

Compensation per employee is likely to decline in 2020 because of the large fall in hours worked. However, this is largely compensated for by an increase in short-time work benefits. It could rise again in 2021, as short-time work is diminishing. Nevertheless, wage growth is likely to remain subdued as the growing number of unemployed will limit the trade-unions negotiation power.

Profit margins are likely to be squeezed in 2020, as sluggish demand conditions make it had for companies to recuperate the Covid-19 related costs in sales prices. Inflation is set to drop sharply in 2020, due to the decline in energy prices and the VAT cut. Inflation should rise again in 2021, as energy prices and the VAT rate return to their previous levels.

After a surplus amounting to 1.4% of GDP in 2019, the government will run a large deficit, around 6% of GDP, in 2020, due to the emergency spending and stimulus plan. In addition, tax receipts will disappoint and social security spending rise. However, as the economy slowly recovers, the deficit is projected to be limited to 3% of GDP in 2021. The debt GDP ratio, which had gradually declined in previous years to 60%, could reach 80% be end 2021.

The risks to our scenario are balanced. Upside risks include the possibility of a discovery of an effective treatment and/or a vaccine, which could give a boost to final demand. On the downside, a second wave of contagion might plunge the economy in recession again. However, a new generalised lockdown is unlikely. In addition, geopolitical tensions could intensify, in particular in the run-up to the US presidential election and the finalising of Brexit. This could be very damaging for Germany's large manufacturing sector.

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MORE THAN 7 MILLION IN SHORT-TIME WORK SCHEMES IN MAY

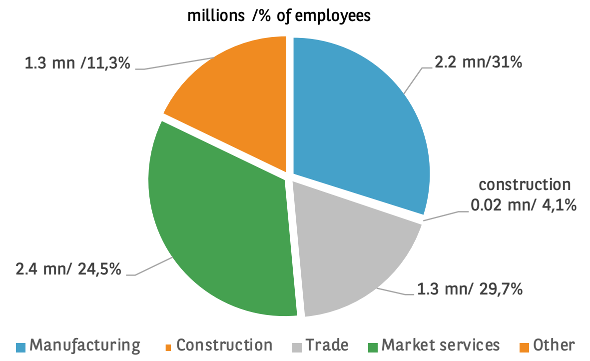

CHART 3

SOURCE: IFO