GERMANY

CHANGE IN CLIMATE

After a sharp contraction in Q1 2020, the economic climate improved significantly in Q2, as the domestic economy gradually opens up. In 2020, the government was very successful in limiting the impact of the coronavirus crisis for households and businesses. In 2021, the fiscal policy stance will remain very accommodative, and covid-19 support measures could amount to 3% of GDP. As the federal election takes place on 26 September, the budget for 2022 will be determined by the incoming government. Opinion polls point to a coalition between the CDU/CSU and the Greens, which should propel climate change to the top of the agenda. The economy is projected to grow robustly in 2021 and 2022. On the domestic side, the main engine of support is private consumption. The manufacturing sector should benefit from the EU's Next Generation programme. The rapid recovery could rekindle inflationary pressures and the ECB's monetary stance might become too loose for Germany.

CHANGE IN THE ECONOMIC CLIMATE

The German economy started the year in a bad way. Economic activity contracted by 1.8%, partly due to the tightening of Covid-19 related restrictions, such as shop closures from mid-December onwards. Moreover, construction activity had been brought forward to Q4, ahead of the expiration of the temporary VAT reduction on 1 January 2021. In addition, construction was also negatively affected by the exceptionally cold weather in early 2021.

In Q2, the economic climate improved drastically, as the fall in the infection rate allowed the gradual re-opening of the domestic economy. The ifo climate indicator for June even reached a highest since April 2018. Activity in the manufacturing sector had already started to strengthen in Q1, partly driven by strong demand from China (Chart 2). In the latest months, sentiment improved strongly in services and retail. Even though activity remains well below levels seen before the outbreak of the pandemic, production bottlenecks have become apparent due to lack of essential intermediate goods in manufacturing and construction. In addition, in the hospitality sector, enterprises have recruiting difficulties.

As the economy is opening up, the unemployment rate is inching down. In May, it stood at 4.4%, which is still 1.2 percentage points higher than in Q4 2019. Also, the number of employees on furlough (*Kurzarbeit*) is declining. In May, still 2.3 million, or 7% of the labour force were on furlough, of which more than half in services.

Inflation has been on a rising trend since the beginning of the year. In May, the harmonised index was 2.4% higher from last year. This is only due to the sharp increase in energy prices (9.5% y/y). By contrast, core inflation remained modest at only 1.6%.

FORCEFUL RESPONSE TO THE PANDEMIC

The government's rapid and forceful response to the pandemic has limited the economic consequences of the pandemic. In 2020, corona support measures amounted to about 2.8% of GDP, of which almost half in the form of subsidies and liquidity assistance for enterprises. The envelope for guaranteed loans and capital injections - the latter are only recorded in the debt level - amounted to even close to 30% of GDP. The fiscal balance (as a percentage of GDP) deteriorated sharply from +1.5% in 2019 to -4.2% in 2020 and the debt-to-GDP ratio rose by 10 percentage points to 70%.

The Covid-19 support measures were quite successful. Around 44% of German enterprises have called on at least one of the schemes. Even though GDP contracted by 4.8% in 2020, the unemployment rate has only increased by 0.7 percentage point to 3.8%. Household disposable

GROWTH AND INFLATION (%)

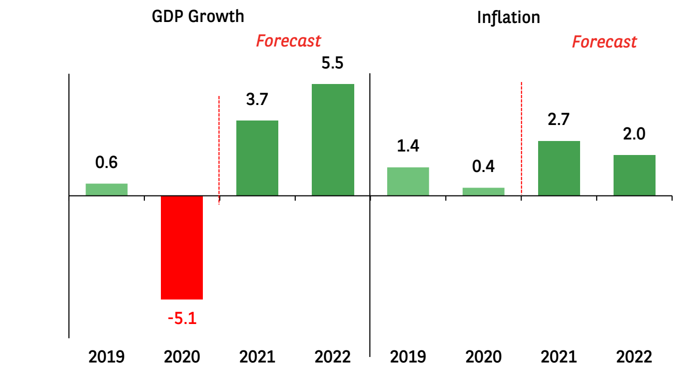

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

QUICK REBOUND OF MANUFACTORING PRODUCTION

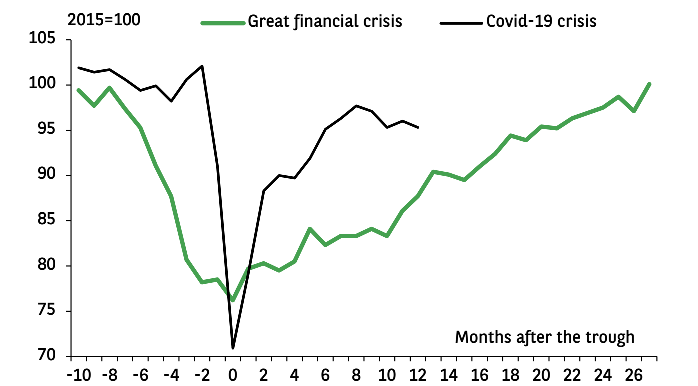

CHART 2 SOURCE: DEUTSHE BUNDESBANK, BNP PARIBAS

income even increased by 0.7% and bankruptcies fell to a historically low level. As a percentage of GDP, the deterioration in the government budget balance was mirrored by a substantial improvement of the financial balances for household and businesses, as the current account surplus hardly changed (Chart 3).

In 2021, the fiscal policy stance will remain very accommodative, and the Covid-19 support measures could amount to 3% of GDP. The short-time work scheme will remain in place until the end of the year. Health care spending will be stepped up to finance the vaccination campaign. Other fiscal measures include the abolition for most taxpayers of the solidarity surcharge, introduced in 1991 mainly to finance the German re-unification, and the adjustment of the income tax scales to eliminate the so-called "bracket creep".

Additional revenues will be raised from the new carbon pricing system for transport and buildings, which generally are not subjected to the European emission trading system. Up to 2025, the price of CO_2 certificates is fixed at EUR 25 per tonne of CO2. After 2025, the price is set by the market. The budget deficit is likely to increase to around 4.5% of GDP.

In the coming years, the federal government will step up investment spending to achieve its ambition of slashing emissions 65% from 1990 levels by the end of the decade and hit climate neutrality by 2045. This will be partly financed by EU's New Generation Plan (NGEU). The government has set aside around EUR 52 bn between 2022 and 2025. Before the crisis, the federal investment programme amounted to only EUR 38 bn.

The budget for 2022 will be ultimately determined by the new government that will be formed after the federal election on 26 September. The opinion polls show that the parties of the outgoing coalition of CDU/CSU (Christian Democrats) and SPD (social democrats) could each lose around 5% of the votes compared to the previous election in 2017. By contrast, the Greens could become the country's second largest party with around 20% of the vote, making a coalition between the CDU/CSU and the Greens the most likely outcome. In that case, climate change will become a major theme for the government agenda. On fiscal policy, the new coalition is likely to remain committed to returning to the European fiscal rules and the debt brake.

ROBUST RECOVERY AND RISK OF OVERHEATING

The economy is projected to grow robustly in 2021 and 2022. On the domestic side, private consumption will become the main engine of growth. Despite the coronavirus crisis, household disposable income has improved, shored up by extensive government aid. Nevertheless, households restricted spending as consumption possibilities were limited and on worries about contracting the virus[1]. Consequently, the savings ratio increased from 10.9% in 2019 to 16.2% in 2020. As the domestic economy is opening up, consumer spending is likely to normalise. The savings ratio could even temporarily drop below levels seen before the crisis, as households reduce the wealth accumulated during the crisis.

German manufacturers are likely to profit from the sharp rise in global demand. The sector is likely to profit from the implementation of the NGEU not only in Germany, but also in the other European countries. Moreover, the supply disruptions such as for semiconductors may abate in the coming quarters.

FINANCIAL SURPLUS (% OF GDP)

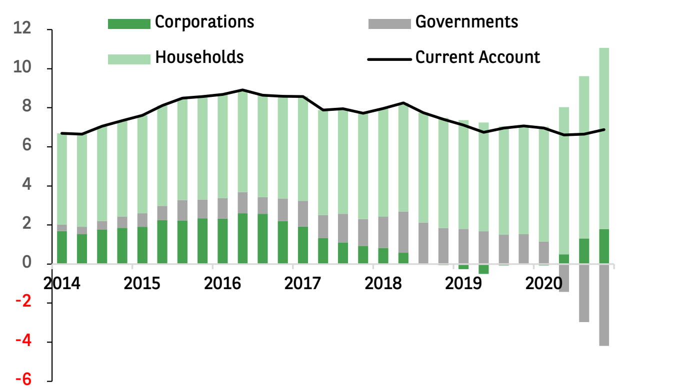

CHART 3

SOURCE: EUROSTAT

The renewed dynamism of the economy will boost the demand for labour, and skill shortages that existed before the pandemic are likely to return soon. This could result in higher wage settlements and a turn up in inflation. As the ECB policy stance is set with regard to inflationary pressures in the whole eurozone, it is not excluded that Germany will be soon confronted with too loose monetary conditions.

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1 According to the Bundesbank Online Panel Household Survey, only 7% of households stated to have reduced spending because of fear of income losses.