GERMANY

INCOME UNCERTAINTY BOOSTS PRECAUTIONARY SAVINGS

The second lockdown interrupted an already stalling recovery. However, the business climate is likely to improve soon on the expectation that several vaccines might soon be available. Inflation is currently in negative territory because of the VAT cut, but will soon turn positive again once the measure expires on 1 January 2021. Because of the second lockdown, the 2021 budget will show a larger deficit than assumed in September, EUR180 bn or 5.2% of GDP. In Q2, the household savings rate rose to 20.1%, a new historical high. Once the pandemic is over, the savings rate could drop considerably if consumers catch up on postponed purchases.

LOCKDOWN INTERRUPTS RECOVERY

After a historical contraction of 9.1% in Q2, GDP rebounded vigorously in Q3 by 8.5%, which was slightly better than expected. Nevertheless, activity was still 3% lower than a year earlier. The rebound was partly due to the progressive lifting of the lockdown measures from end of April onwards. Moreover, activity was also boosted by the government stimulus programme launched in June. Nonetheless, in the course of Q3, business cycle indicators signalled that the recovery was losing momentum. The ifo climate indicator peaked in September well below the pre-crisis level. Moreover, despite an impressive rebound, GfK consumer confidence index remained in negative territory, as the propensity to buy stalled owing to fears about a second wave of infections.

Following the sharp rise in infections, new restrictions were necessary. However, the government initially did not want to decree full lockdown, as it would make one of its key measures – the cut in the VAT rate from 1 July – ineffective. Only bars, restaurants and theatres wear closed but non-essential shops stayed open. As infections remained at a very high level, at mid-December the authorities decided finally also to close non-essential shops, schools and nurseries. In addition, employers were asked either to close their companies for holidays or to enable working from home.

End November, the ifo climate index lost 2.5 points, due to considerably more pessimistic expectations, in particular in services. Also the GfK consumer confidence index plunged deeper into negative territory. However, even though the actual business situation has deteriorated, it is possible that expectations in have improved in December, amid reports that several vaccines might soon become available, one of which from the German firm BioNTech together with the US firm Pfizer. The government is preparing a vaccination campaign, but it might take up until 2022 before the whole population has been vaccinated.

TEMPORARY VAT CUT RESULTS IN LOWER PRICES

Even though wages have not progressed much, purchasing power of employees improved considerably in the second half of the year as consumer prices declined following the temporary cut in the VAT rate. With effect as from 1 July, the standard rate was cut from 19% to 16% and the reduced rate from 7% to 5%. If enterprises had fully passed on the VAT cut to consumers, HICP inflation would have been lowered by 1.8 percentage points. This has not been the case. In October, consumer prices were 0.5% lower from a year earlier. According to the Bundesbank, the VAT cut appears to have been passed on fully for most food products and industrial goods excluding energy. In some cases, the price declines went even well beyond the VAT effect. By contrast, in services only one third of the lower tax rate appears to have been passed on. Only in a few areas such as telecommunications, prices were reduced. The VAT cut will expire on 1 January 2021, and inflation should return to significantly positive values. In 2021, inflation could reach 1.3 compared with 0.4 in 2020.

GROWTH AND INFLATION (%)

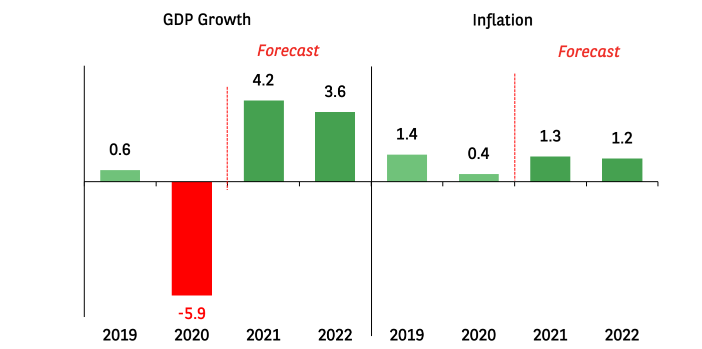

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

LIGHT LOCKDOWN HAS FAILED TO CURB COVID-19 INFECTIONS

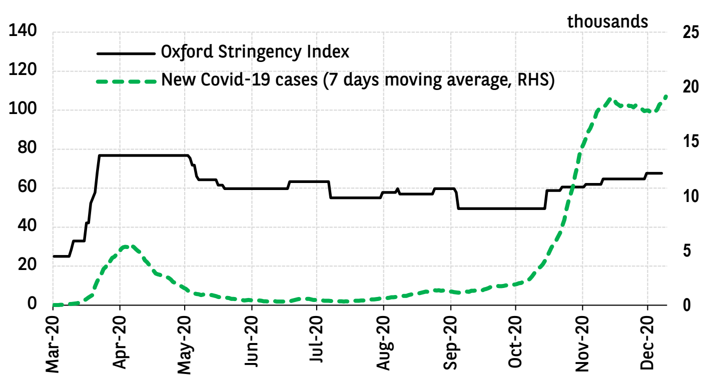

CHART 2 SOURCE: ECDC, UNIVERSITY OF OXFORD

2021 BUDGET DEEPER INTO THE RED

As the economic consequences of the coronavirus pandemic will continue to be felt next year, fiscal policy will be very accommodating in 2021. The escape clause of the federal government's debt brake and the EU budget rules are to remain active. End November, the Parliamentary Budget Committee reached agreement with the government on a revised budget for 2021, foreseeing EUR 180 bn (5.2% of GDP) in new debt compared with EUR 218 bn in 2020. This is substantially higher than the EUR 96 bn finance minister Olaf Scholz presented in his original draft budget in September.

Federal spending will be close to EUR 500 bn, about the same level as in 2020. Compared to the original draft, expenditure will be increased by EUR 85 bn to cover the additional costs related to the new lockdown and the vaccination. By contrast, tax receipts should be slightly higher, as the economy is doing better (EUR 293 bn compared with EUR 265 in 2020). Much is done to reduce the tax burden for household. From 2021 onward, many citizens do not longer pay the solidarity levy. Moreover, families will receive more child support: EUR 15 per month and per child. For all households, the basic tax-free allowance will be increased. A major question is when parliament will reactivate the debt brake mechanism. As the general election will be held in autumn 2021, that will be for the next parliament to decide.

HOUSEHOLD SPENDING DURING THE PANDEMIC

The lockdown measures and distancing rules have resulted in significant income losses for the household sector. In Q2 and Q3, net wages and salaries contracted by 3.8% and 0.5%, respectively. This implies that the average employee lost around EUR 130 a month in Q2. Thanks to increased social security spending, the annual change in disposable household income amounted to -0.8% in Q2 and +0.7% in Q3. At the same time, household consumption sharply declined due to the closure of non-essential shops, bars, restaurants etc. Moreover, as income uncertainty increased, consumers became more reluctant to spend. As a result, the savings ratio has risen to 20.1 in Q2, a highest since the start of the series in 1991, and eased down to 13.5 in Q3. The latter was still well above the long-term average (10.8). It is expected that consumption could rebound and the saving ratio could return to close to its long term average once the pandemic is over and public life has returned to normal. The savings rate could even drop considerably below its long-term average if consumers catch up on postponed purchases.

In May, the Bundesbank has conducted a survey on how household budgets have been affected by Covid191. It found out that on average, more than 40% of respondents incurred income or other financial losses due to the pandemic or the policy measures addressing it. Not surprisingly, the number is much higher for people in the labour market (46%) than the rest of the population, mainly pensioners (28%). On average, the Bundesbank panel expects their monthly net income to fall, on average, by EUR 64 per month over the following twelve months. Compared to the previous survey in May 2019, spending intentions were lowered driven by income losses and higher inflation expectations. The latter is surprising as in standard economic theory spending on durables would increase if one expects inflation to be higher. The loss in income only had a limited effect on the marginal propensity to consume.

Using the Bundesbank household expectations survey, a different group of researchers at the Bundesbank have studied how households react to policy announcements2. The panel was divided in four groups, three of them receiving relevant information about actual announcements and the fourth one receiving irrelevant information, a so-called placebo treatment. All the three policy measures were expansionary and should have boosted household confidence. However, the research showed

PROBABILITY DISTRIBUTION OF EXPECTED INDIVIDUAL MONTHLY INCOME CHANGES

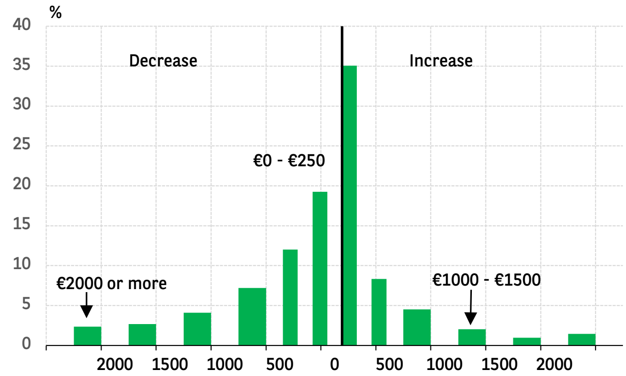

CHART 3

SOURCE: DEUTSCHE BUNDESBANK ONLINE PANEL HOUSEHOLDS (BOP-HH)

that it did not have any significant impact on expectations about income. Moreover, individuals who received information on stimulus packages actually provided a lower estimate on GDP growth. A possible reason is that the policy announcements signalled to households that the economy was in a weaker state than they had assumed. The researchers found that credit-constrained households became more optimistic after having received news about the policy announcements. These households are probably already aware of the economy being in dire straits. Any announcement of an expansionary policy, might lead to an upward revision of their expectations. By contrast, credit unconstrained households became more pessimistic, suggesting that in their case the signalling effect dominated.

It would be wrong to conclude from this research that stimulus packages do not affect household spending. By their effect on employment and income expectations, they can have an important impact once implemented. The Bundesbank research brief demonstrates primarily the importance of carefully announcing these programmes to prevent households reacting negatively to them.

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Raymond Van der Putten
raymond.vanderputten@bnpparibas.com

1 René Bernard, Panagiota Tzamourani, Michael Weber, *How are households' consumption plans affected by the COVID-19 pandemic?*, Research Brief | 35th edition, November 2020
2 Olga Goldfayn-Frank, Georgi Kocharkov, Michael Weber, *Households' Expectations and Unintended Consequences of Policy Announcements*"Research Brief | 34th edition, November 2020