# GERMANY



## STRONG RECOVERY FROM MID-2021

**After a difficult start of the year, business cycle indicators improved markedly in March on the hope that the worst of the Covid-19 crisis is behind us. GDP is projected to reach the pre-Covid-19 level by the end of 2022. Many of the government support measures will remain in place this year. Fiscal policy for 2022 will depend on the outcome of the general election in September. After a significant weakening of the Christian-Democrats in the polls, a coalition between Greens, social-democrats, and liberals cannot be excluded. The business sector has been severely weakened during the crisis, but this is unlikely to have long-term consequences.**

### THE FIRST GREEN SHOOTS IN MARCH

The increase in corona cases in Q4 2020 forced the authorities to impose a second lockdown from the beginning of November. In particular, services that involved intensive social contacts, such as bars, restaurants and theatres were closed. By mid-December, non-essential shops had also to lower their shutters. As a result, GDP grew by only 0.3% compared with 8.5% in Q3. This was the result of two opposing forces. On the one hand, activity in manufacturing and construction increased by more than 5%, while activity in market services (trade, communication and hospitality) contracted by around 4.4%.

This dichotomy between manufacturing and services was also observed in early 2021. Activity in the manufacturing sector continued to expand, despite the disruption in the car industry caused by shortages of semiconductors. By contrast, construction activity was severely affected by adverse weather conditions in January and February, while services remained subjected to lockdown restrictions. In March, the economic climate improved considerably. The IFO climate indicator rose to 92.7, a highest since September 2020. In particular, business optimism about the coming months rose sharply on the back of expectations of the easing of lockdown restrictions as infections were set to decline due to the ongoing vaccination campaign.

Despite the sharp fall in activity in 2020 (-4.9% and -5.3% adjusted for calendar effects), the unemployment rate rose only to 4.6% compared with 3.4% in early 2020. This is largely due to government measures to ease the impact of the crisis, and, in particular, the furlough scheme (Kurzarbeit). The Ifo Institute estimates that 2.8 million or 8.5% of employees made use of this scheme in February (chart 2). In accommodation and food services, more than 50% of employees were on furlough.

### FISCAL POLICY REMAINS ACCOMMODATIVE

The Federal government was quick to respond to the corona crisis and ease its impact on activity. In March, a comprehensive support package for employees and enterprises worth EUR 750 bn (22% of GDP of 2019) was deployed. As a large part of the package consisted of guarantees, loans and tax deferrals, public spending rose by EUR 127 billion, of which €50bn was made available to support small businesses and self-employed persons. In June, the government presented a second support package worth EUR 130 bn. The measures focused on boosting demand through a temporary cut in the VAT - from 19% to 16% between July and December 2020, providing families with an additional EUR 300 per child and doubling a government-supported rebate on electric car. It also contained a €50 billion fund for addressing climate change, innovation and digitalisation. In November and December, further measures were introduced to support the most affected businesses during the renewed lockdown. As a result of these packages

GROWTH AND INFLATION (%)

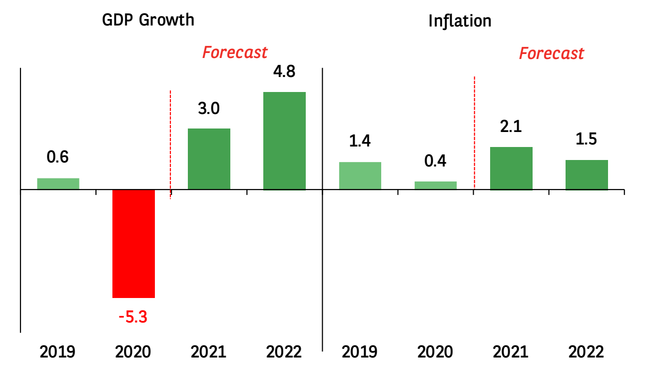


CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

MANY EMPLOYEES STILL ON FURLOUGH

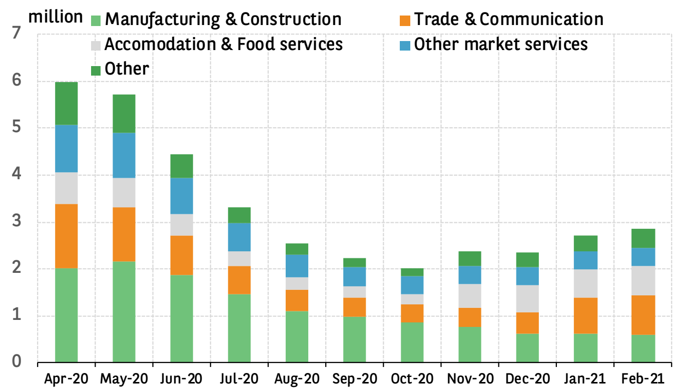


CHART 2 SOURCE: IFO, BNP PARIBAS

and the disappointing tax receipts, the financial deficit of the general government increased to 4.2% of GDP, a highest since 2009. Public sector debt amounted to 70% of GDP by the end of the year. For 2021, the deficit is likely to move sideways and the debt ratio could further increase to 75%. However, this is substantially lower than during the financial crisis, when the debt ratio reached 82.4% in 2010. In 2022, the government budget is expected to improve sensibly as stimulus measures expire and tax receipts will rise because of the economic upswing. The deficit could fall below 2% of GDP.

The 2022 budget will depend on the next government. The current coalition between the Christian-Democratic parties (CDU/CSU) and the Social Democratic Party (SDP) is unlikely to be continued after the next general election, to be held on 26 September. The CDU/CSU, recently weakened by scandals, is likely to remain the largest block in the Bundestag. It might seek to form a coalition with the liberals (FDP) and the Greens, the so-called Jamaica coalition. On paper, it could reckon on a large majority in parliament. However, the programmatic differences might be hard to bridge. Since the weakening of CDU/CSU in the polls, a coalition of Greens, SDP and FDP, the so-called traffic light coalition, could become possible. At the moment, the combination stands to gain close to 50% of the seats. It might be very attractive for the Greens, as the leader of the party would become Chancellor for the first time.

## HIGH ENTERPRISE DEBT, BUT NO LONG-TERM ECONOMIC DAMAGE

The outlook for 2021 depends largely on the course of the pandemic and the progress in the vaccination process. In our scenario, we assume that the decline in infection rates will allow a gradual easing of the lockdown measures eased from mid-April onwards. In that case, services could join manufacturing as a driving force behind the recovery. GDP is projected to grow by 3% in 2021 and 4.8% in 2022. By end 2022, GDP would have reached pre-Covid-19 level.

A major question is what will happen to enterprises if the government support measures are gradually withdrawn. In the past year, these measures have been very effective in keeping unemployment down and avoid bankruptcies. Despite economic activity contracting by around 5% in 2020, the number of bankruptcies actually declined by 15.5% compared to 2019. This is not only due to the suspension of the obligation for insolvent firms to file for bankruptcy, but also because of loans and grants that companies have received. Many fear that the state's generosity could increase the number of zombie firms, thus weakening the structure of the economy[1]. In a recent survey of the Ifo Institute and Frankfurter Allgemeine Zeitung among a panel of economists, 86% of them believed that the number of zombie firms had "increased" or "strongly increased" in Germany since March 2020.

It is likely that the lifting of the support measures will lead to an increase in bankruptcies. Even though for most firms, it will be business-as-usual, many of them may face high debts and some firms with a viable business model might even need to be restructured.

Indebtedness of the non-financial sector has reached a record level, which could weigh down on investment and productivity (Chart 2). The reassuring news is that research by a group of German and US economists shows that a boom in business loans is not likely to damage the economy in the long-term[2]. A possible explanation is that firms may switch to other internal sources of financing, i.e. equity instead of debt. Moreover, firm liabilities are ultimately limited by firm assets.

STEEP INCREASE IN BUSINESS INDEBTEDNESS

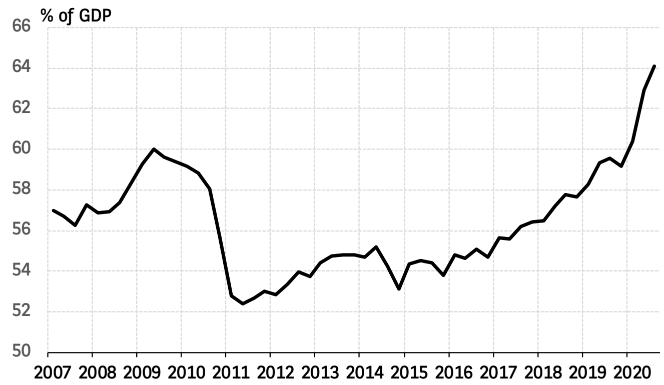


CHART 3 SOURCE: DEUTSCHE BUNDESBANK, BNP PARIBAS

If the going concern value drops below the market value, liquidation of the firm will ensue, the excess debt will be erased and the assets freed up for other productive ends. The smoothness of the liquidation depends on the efficiency of the insolvency process. In that respect, Germany is well placed. It has one of the most efficient insolvency regimes in the world[3]. On average, the length of the procedure is just over a year, with a recovery rate of almost 80% and the costs amount to only 8% of the estate.

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1 Baudchon, H., Boisset, L., Derrien, G., Van der Putten, R. (2021). *European Union: Europe: the shock of Covid-19 and the fear of accelerated zombification*, BNP Paribas Conjoncture, January.
2 Jordà, Ò., Kornejew, M., Schularick, M., & Taylor, A. M. (2020). *Zombies at large? Corporate debt overhang and the macroeconomy* (No. w28197). National Bureau of Economic Research.
3 The World Bank Group, Doing Business 2020