GERMANY

AFTER THE VIRUS, THE THREAT OF ZOMBIES

A strong rebound is expected in Q3 (7.2%) following the progressive lifting of restrictions. Nevertheless, the recovery is likely to remain slow and bumpy at times, at least until there is a Covid-19 vaccine or a better treatment. Thanks to the widespread use of furlough, the labour market has held up reasonably well. However, the scheme may also have been delaying a necessary restructuring, which could weigh on the long-term performance of the economy. The huge increase in public spending to ease the economic consequences of the virus have forced the authorities to activate the debt brake exemption clause. The excess debt will be repaid over 20 years starting in 2023.

A REBOUND, BUT NOT IN ALL SECTORS

The lockdown measures to contain the coronavirus resulted in a sharp drop in activity in Q2 in Europe. In Germany, GDP contracted by 9.7%, which compared reasonably well with the rest of the Eurozone (-12.6%). An important reason for this was that the lockdown measures were less strict in Germany, as the authorities succeeded in limiting the spreading of the virus by widespread testing.

Starting at the end of April, lockdown measures have been progressively lifted resulting in a rebound in activity. After having reached a trough in April (74.4), the ifo business climate index gradually improved in the following months and reached 93.4 in September (2015=100). Nevertheless, activity has remained well below pre-crisis levels. In July, manufacturing production strengthened by 0.3% on the previous month, the third consecutive improvement, but was 12% lower from a year.

The sector most affected by the pandemic was services, as social distancing requirements made it difficult to resume activity. Retail sales rebounded strongly after April. In July, sales were 5.6% higher than a year ago. By contrast, the hospitality sector continued to suffer. Despite the strong rebound in turnover in accommodation and food in July (22% from a month earlier), it was still 27% lower compared to last year. Overall, the economy is likely to have rebounded strongly in Q3, by 7.2% (to be announced end October).

FURLOUGH MAY DELAY RESTRUCTURING

Despite the collapse in output in Q2, the labour market held up reasonably well. The unemployment rate (ILO definition) inched up to 4.4% in July compared with 3.8% in March. The main reason for this subdued reaction is the widespread use of furlough (*Kurzarbeit*). Ifo estimates that in August, the number of *Kurzarbeiter* fell by one million to 4.6 mn, i.e. 14% of socially insured employment. The decline was mainly due to the trade and the hospitality sectors. Nevertheless, in the hospitality sector still 34% of the employees are on furlough.

The advantage of *Kurzarbeit* is that firms would not lose skills during the crisis. Once demand picks up, staff is available again immediately. However, this argument sounds less convincing the longer the crisis lasts. Moreover, *Kurzarbeit* does not only benefit dynamic sectors that are only suffering a temporary decline in activity. It also benefits sectors such as the embattled car and metal industries, and postpones their necessary restructuring. Furthermore, *Kurzarbeit* is also widely used in the hospitality sector. In this case, the scheme is not aimed at protecting skilled labour and technologically advanced firms but serves a social objective.

Recently, the government decided to keep *Kurzarbeit* in place at least until the end of 2021. The decision was probably politically motivated, as the general election is to take place in autumn 2021. In the same vein, the coalition parties CDU/CSU and SPD have agreed to extend a freeze on insolvency rules put in place to avoid a wave of corporate bankruptcies due to the coronavirus crisis. The freeze would have been ended in September. A new date to end the scheme has not been set yet. The danger is that the very low interest rate environment in combination with these policies could create conditions, which are very conducive to the creation of zombie companies[1]. Zombies can weigh on the economic performance because they are less productive and their presence lowers investment and employment at more productive firms.

GROWTH AND INFLATION (%)

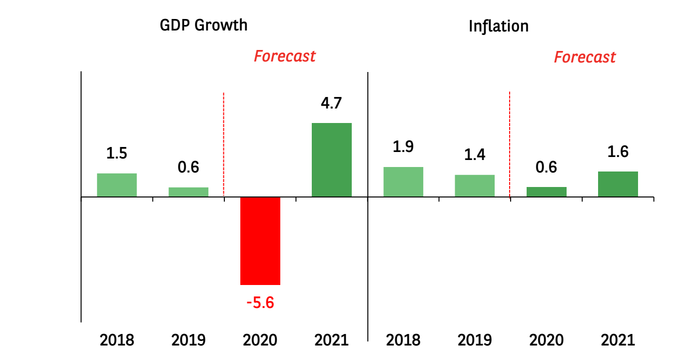

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

IFO CLIMATE INDEX SIGNALS UPTURN

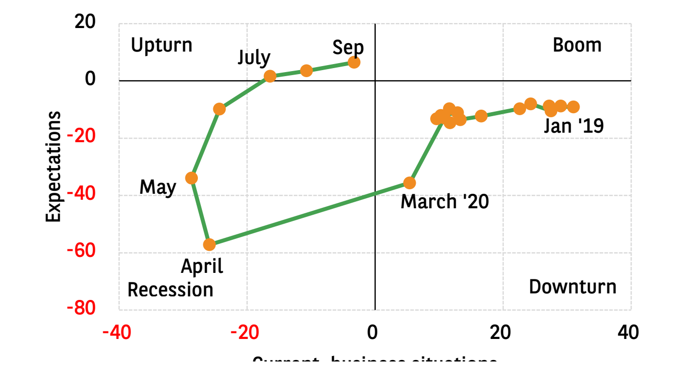

CHART 2

SOURCE: IFO, BNP PARIBAS

1 Zombie companies are firms that are unable to cover debt servicing from current profits over an extended period.

DEBT BRAKE TEMPORARY OUT OF ORDER

The pandemic has not only led to a historic output slump, but also to a record budget deficit, which could reach 7% of GDP in 2020. One third of the deficit is related to the automatic stabilisers, such as disappointing tax receipts and higher social expenditure due to the shrinking of the economy. The rest is due to two special packages introduced by the government in March and June.

The first package, worth EUR 750 billion, included fiscal measures to support the healthcare system and mitigate the economic impact of the lockdown measures on enterprises and households. This was followed in June by a comprehensive stimulus programme worth EUR 130 billion that did not only have demand measures, but also included measures to strengthen future growth and sustainability. These packages in total will increase the deficit by 5% of GDP.

The debt ratio is set to climb from 60% end 2019 to 75% end 2020. The exceptional circumstance forced the authorities to activate the debt brake exemption clause. The excess debt will be repaid over 20 years starting in 2023.

THE FALL IN THE OPERATING SURPLUS WILL WEIGH ON INVESTMENT

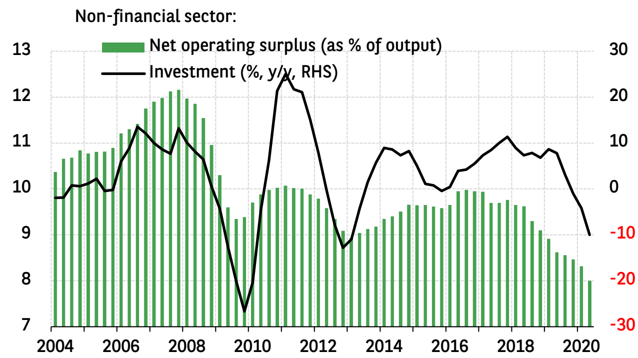

CHART 3

4-QUARTER MOVING AVERAGE
SOURCE: DESTATIS, BNP PARIBAS

A BUMPY RECOVERY

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-19 vaccine or better treatments. GDP is projected to rebound by 4.7% next year after the 5.6% contraction in 2020.

On the demand side of the economy, the current boom in retail spending is likely to fizzle out quickly if 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. Finally, consumers might bring forward their purchases before the end of December ahead of the end of the temporary VAT cut. In addition, investment could remain sluggish due to squeezed profit margins, as companies may find it difficult to recuperate the Covid-19 related costs in sales prices.

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