2. GERMANY

Germany's economy is in for an historic recession in 2020 but this should be followed by a rebound in 2021 and 2022, as capacity utilisation and activity recover. Though the downturn this year now looks likely to be less severe than previously expected, the outlook remains uncertain given the resurgence in COVID-19 cases and the structural challenges facing manufacturing. Large policy support is expected to remain in place and should help avert massive job losses and insolvencies. The budgetary costs of the crisis will continue accumulating, but the fiscal deficit is expected to narrow in 2021 and 2022.

An historic recession in the first half of 2020

Due to the COVID-19 pandemic and the containment measures it has necessitated, the German economy experienced the sharpest contraction on record in the first half of the year. Demand for hospitality and leisure services was particularly constrained by distancing measures and health concerns. While manufacturing was not subject to restrictions, major factories chose to shut for weeks due to lost demand and the disruption of supply chains as a result of the global spread of COVID-19. The resilience of the services sector, which helped the economy through earlier episodes of weak growth, was compromised by the pandemic. As a result, the economy contracted by 2% in the first quarter and by an unprecedented 10% in the second quarter of this year.

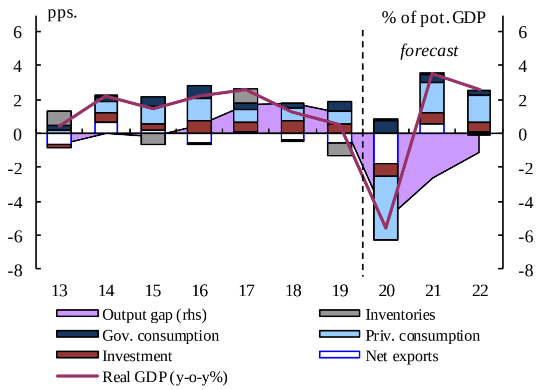
An upswing in the making

According to the latest data, activity in the hospitality sector had by July recovered about 70% of its February level, up from just 25% in April. In August, manufacturing production had risen to 88% of its February level, up from 70% in April. After losing just 8% between February and April, retail trade recovered swiftly, exceeding the February level by between 3 and 5% in May-August and despite significant losses in clothing retail. These data suggest that in the third quarter the economy may have rebounded somewhat more strongly than expected.

In mid-October, following a clear resurgence of new daily COVID-19 cases, authorities issued restrictions to travel, accommodation, restaurant and social activities. It can be expected that many services will again curtail operations, hindering the recovery in consumption and putting a drag on investment. On the other hand, despite the structural changes afflicting the automotive cluster, manufacturing and exports should continue to recover, provided supply chains remain functional. Net exports are expected to contribute positively to growth next year, as import-rich investment and outbound travel remain weak. As a result, the current account surplus is expected to rise above 6% again, but stay below the level of 2019.

The further, if slowing, recoveries in private consumption and exports are expected to drive growth in 2021-2022. Investment should remain solid, thanks to housing and public investment, while business investment may remain subdued. GDP is set to contract by 5½% in 2020, i.e. less than projected earlier thanks to the strength of growth in the third quarter. Still, the second wave of infections is expected to dampen the rebound next year to 3½%. Assuming there is no permanent damage to productive capacity, Germany's economy is projected to continue to grow above potential in 2022 at 2½% and complete its recovery to pre-crisis levels.

Graph II.2.1: **Germany - Real GDP growth and contributions, output gap**



Maintained policy support

Unemployment rose 0.8 pps. between February and July and was up 1.4 pps. compared to the all-time low reached in mid-2019. Thanks to the expansion of subsidised short-time work schemes it has stayed relatively low at 4.4% in July and August. Employment began increasing again in August and the number of workers tapping the short-time work scheme has started to come down from its peak of six million in April-May, even though the availability of the scheme has been prolonged until the end of 2021. With household incomes remaining relatively stable and consumption restrained by health concerns and uncertainty, the saving rate has increased and is expected to remain higher than before the pandemic over 2020-2022. Thanks to generally sound balance sheets and the large public support measures, Germany is expected to avoid a massive wave of corporate insolvencies. The second wave of infections, however, could threaten many small businesses in the most affected sectors.

Inflation to stay low

Consumer price inflation is expected to turn out low at just under 1% in 2020 due to cheaper energy and the decrease in VAT that took effect in the second half of the year. In subsequent years, HICP inflation is expected to increase somewhat but remain subdued at less than 1.5% due to excess capacity in the services sector and muted demand.

Strong crisis response leads to a swelling deficit

The government adopted measures of historic size to fight the COVID-19 pandemic and stabilise the economy. The volume of these measures amounts to 4.7% of GDP in 2020 and 2.1% in 2021. They include financial support for small- and medium-sized companies and the self-employed, easier access to the short-time work scheme to avoid lay-offs, as well as additional health spending. In addition, about 38% of GDP (€1½ tr) was provided for liquidity support in the form of public guarantees for loans. Overall, after a surplus of 1.5% of GDP in 2019, the government balance is projected to turn to a deficit of around 6% of GDP, before narrowing to 4% in 2021 and 2½% in 2022, based on unchanged policies. This forecast does not yet include measures funded by grants of the Recovery and Resilience Facility, which are expected to further support growth.

Government debt fell in 2019 below 60% for the first time since 2002, but is projected to resurge to 71% of GDP in 2020, before resuming the decline next year and falling to 69% of GDP in 2022. The increase in public debt is explained by automatic stabilisers and the fiscal measures adopted, but is also influenced by the provision of loans and equity investment in rail- and air transport.

Table II.2.1:

Main features of country forecast - GERMANY

	2019			Annual percentage change						
	bn EUR	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP		3449.1	100.0	1.2	2.6	1.3	0.6	**-5.6**	**3.5**	**2.6**
Private Consumption		1806.9	52.4	0.8	1.5	1.5	1.6	**-7.2**	**3.6**	**3.1**
Public Consumption		704.5	20.4	1.6	1.6	1.2	2.7	**3.5**	**2.0**	**1.5**
Gross fixed capital formation		748.0	21.7	0.7	2.5	3.5	2.5	**-3.8**	**2.8**	**2.7**
of which: equipment		240.1	7.0	1.4	4.2	4.4	0.5	**-15.7**	**7.1**	**4.1**
Exports (goods and services)		1617.4	46.9	4.7	4.7	2.3	1.0	**-9.7**	**6.2**	**4.2**
Imports (goods and services)		1417.4	41.1	3.9	5.3	3.6	2.6	**-6.8**	**5.5**	**4.5**
GNI (GDP deflator)		3542.8	102.7	1.4	2.5	1.6	0.6	**-5.7**	**3.6**	**2.5**
Contribution to GDP growth:		Domestic demand		0.9	1.6	1.8	1.9	**-3.9**	**2.9**	**2.5**
		Inventories		-0.1	0.8	-0.1	-0.7	**0.0**	**0.0**	**0.0**
		Net exports		0.5	0.1	-0.4	-0.6	**-1.7**	**0.6**	**0.1**
Employment				0.6	1.4	1.4	0.9	**-1.0**	**0.2**	**0.6**
Unemployment rate (a)				7.5	3.8	3.4	3.1	**4.0**	**4.0**	**3.8**
Compensation of employees / head				1.8	2.6	2.9	3.0	**-0.8**	**2.8**	**2.7**
Unit labour costs whole economy				1.1	1.4	3.0	3.3	**4.0**	**-0.4**	**0.8**
Real unit labour cost				-0.2	0.0	1.3	1.1	**1.4**	**-1.9**	**-0.7**
Saving rate of households (b)				17.0	17.9	18.3	18.4	**23.6**	**20.9**	**19.4**
GDP deflator				1.3	1.4	1.7	2.2	**2.6**	**1.4**	**1.5**
Harmonised index of consumer prices				1.5	1.7	1.9	1.4	**0.4**	**1.4**	**1.3**
Terms of trade goods				0.5	-1.6	-1.0	1.1	**3.0**	**-0.3**	**0.4**
Trade balance (goods) (c)				6.8	7.7	6.7	6.4	**5.3**	**5.7**	**5.8**
Current-account balance (c)				5.5	8.0	7.6	7.3	**6.2**	**6.6**	**6.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				5.4	7.7	7.4	7.1	**6.0**	**6.3**	**6.3**
General government balance (c)				-1.5	1.4	1.8	1.5	**-6.0**	**-4.0**	**-2.5**
Cyclically-adjusted budget balance (d)				-1.4	0.5	1.0	0.9	**-3.4**	**-2.7**	**-1.9**
Structural budget balance (d)				-	0.7	1.1	0.9	**-3.4**	**-2.7**	**-1.9**
General government gross debt (c)				70.1	65.1	61.8	59.6	**71.2**	**70.1**	**69.0**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.