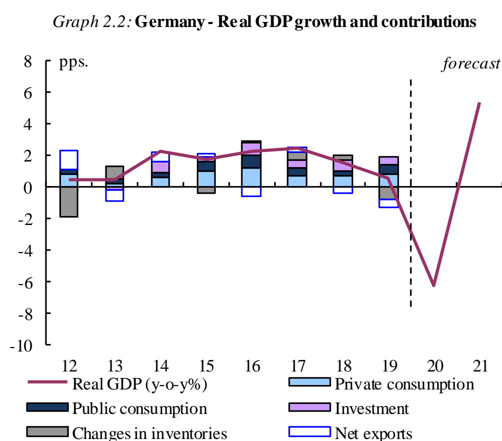
2.2. GERMANY

Germany's real GDP contracted by 2.2% in the first quarter of 2020. This was the second consecutive decline after -0.1% in the last quarter of 2019, indicating a technical recession. In January and February, the ailing manufacturing sector seemed to be bottoming out, hinting at a possible revival of growth. Over the course of March, the COVID-19 pandemic reached Germany and the imposition of confinement measures paralysed numerous activities, particularly in the services sector. In addition, manufacturing increasingly felt the disruption of value chains and a demand slump in key markets.

Mandatory and voluntary shutdowns in the second half of March led to a sharp decline in private consumption and exports in the first quarter (-3 % for both). Investment fell slightly overall, masking the differing fortunes of construction activity, which remained robust, and equipment spending which fell significantly.

Although a relatively benign epidemiological situation allowed Germany to be among the first EU countries to start relaxing confinement measures, with significant easing beginning in mid-May, economic activity in the second quarter is still expected to show an unprecedented decline. In April, industrial production was down by 22% compared to March and by 30% compared to February. Similarly, monthly exports were 24% less than in March and 32% less than in February. Retail turnover shrank 7% in April (after declining by only 3% in March), with food, medicines and toiletries staying resilient, while store sales of non-food items were sinking further after the collapse in March. The unemployment rate is still close to historical lows (3.5% in March and in April) but this conceals an unprecedented surge in short-time work, which according to the IFO institute involved an estimated 6.7 million employees or 15% of the workforce in June.

Graph 2.2: **Germany - Real GDP growth and contributions**



Since spring, the German government took further sizeable measures to stabilise the economy in the wake of the outbreak of the pandemic. The initial response in March included vast liquidity support for companies in the form of public guarantees for loans, tax deferrals, grants for small businesses and extended and simplified access to short-time work schemes. In total, the deficit-relevant measures amounted to 4.7% of GDP in 2020, while guarantees amounted to some 40% of GDP. On top, in early June the government announced a fiscal stimulus package of about EUR 130 bn (3.8% of GDP) for the years 2020 and 2021 to support the economic recovery. It includes measures to boost consumption (notably lower VAT rates in the second half of this year) and investment, alleviate the balance sheet impact of company losses and maintain the investment capacity of local governments. The package also provides incentives for future-oriented investments aimed at helping the green and digital transition.

Despite weaker-than-expected growth in the first quarter and a deterioration in the external outlook, real GDP is forecast to decline in 2020 largely in line with the spring forecast by 6¼%. The massive fiscal stimulus is expected to boost demand, provide needed liquidity support and avert a surge in unemployment. It is therefore expected to pave the way for a relatively swift recovery, starting in the second half of this year. GDP is expected to grow by 5¼% in 2021.

Risks are tilted to the downside and relate to a possibly more protracted international fallout and depressed export demand. Given the strong export orientation of Germany, this would take a larger toll on industrial

activity and may slow down the recovery. Domestically, consumer demand could take longer to recover if sanitary concerns linger, income uncertainty persists and the effects of the consumption stimuli prove weaker.

The currently weak inflationary pressures will be further attenuated by the low energy prices. The VAT cut from July till December 2020, is expected to be at least partly passed on to consumers and slow inflation even further later this year. Next year would see a strong base effect, as the VAT rates are restored in January, but inflation is set to remain moderate overall. Accordingly, HICP inflation is expected to ease to 0.4% this year and return to about 1.5% in 2021.