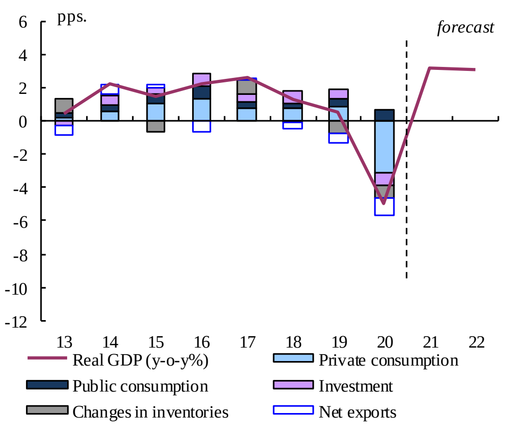
2.2. GERMANY

After 10 years of expansion, Germany's economy contracted in 2020 by 5% due to the COVID-19 pandemic and the measures taken to contain it. Manufacturing activity declined by 10.4%, mainly due to supply chain disruptions. Sanitary restrictions and health concerns led to a strong decline in non-food stationary retail, hospitality and other contact-intensive services, and foreign travel. Overall, gross fixed capital formation also declined by 3.5% as the fall in private investment outweighed the continued strong growth in public investment. For the first time since 2009, exports and imports of goods and services decreased in 2020, by 9.9% and 8.6%, respectively.

The extended regulations on short-time work helped prevent dismissals on a larger scale and employment decreased by just 1.1% in 2020. Wage growth came to a standstill (-0.4%) after 2.9% the year before. Nevertheless, the net saving rate of households rose from 10.9% to an unprecedented 16.3% as consumption declined strongly (6%) despite a slight increase in disposable income due to the employment and income support measures put in place.

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



Economic activity experienced large swings over the course of 2020. The fallout from the pandemic was already apparent in the first quarter when GDP declined by 2.0%. The brunt of the impact fell in the second quarter when GDP dropped by 9.7%, its sharpest quarterly decline on record. In the third quarter, by contrast, GDP rebounded by 8.5%, as a relaxation of confinement measures and the revival of foreign trade led to a partial resumption of activity in both industry and services. In the fourth quarter, the number of new infections soared and restrictions were re-imposed on a number of sectors. GDP, however, avoided another contraction as industry posted robust growth and some consumer spending was redirected from services to goods.

With sanitary restrictions in place, consumption is expected to remain depressed in early 2021, particularly for services. In addition, exports are expected to suffer from weak demand in key European trading partners and some temporary supply disruptions. As a result, economic activity is expected to dip again in the first quarter of this year. With more vaccinations taking place and infection rates subsiding, some relaxation of restrictions is assumed in subsequent quarters. A number of other factors should also favour a resumption of the economic rebound. Strong industrial order books suggest that exports are likely to grow again and sentiment in industry is high. Government support for businesses is expected to avert a large wave of insolvencies and employment growth should resume. Accumulated savings should spur a recovery in consumer spending, which should benefit the repair of contact-intensive service sectors. In anticipation of all that, investment is expected to start recovering.

Overall, real GDP is forecast to rebound by 3.2% in 2021, returning to its pre-crisis level at the turn of the year. In 2022, it should continue growing by 3.1% on the back of the momentum gained in the second half of this year and as the repair of the economy advances. Those projects related to the Recovery and Resilience Facility that were included in the 2021 budget have been taken into account in this forecast.

HICP inflation fell from 1.4% in 2019 to 0.4% in 2020 amid weak demand, cheaper energy and reflecting a reduction of VAT rates in the second half of the year. The flash estimate for January 2021 HICP inflation came in relatively strong at 1.6% y-o-y. This could be due to a combination of economic and statistical factors. The reinstatement of almost all of the regular VAT rates seems to have been passed through to a larger extent than the reduction in July 2020. Energy prices inflation will be spurred by an upward adjustment of CO2 taxation. In addition, shifts in the consumer basket could also be driving the inflation rate up. Combined with the expected recovery in consumer demand, these factors should push inflation to 2.3% in 2021. With the base effects dissipating and energy prices again exerting a disinflationary effect, inflation is expected to ease to 1.3% in 2022.