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**Article**

## German economy in recession: Bridging pinch points, building confidence, boosting demand

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## AT A GLANCE

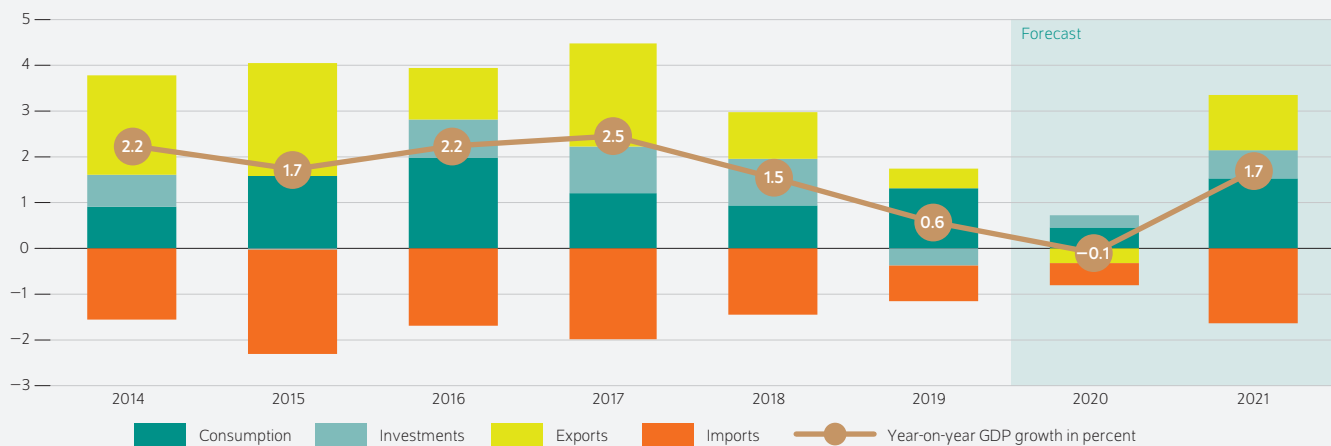
# German Economy in Recession: Bridging Pinch Points, Building Confidence, Boosting Demand

By Claus Michelsen et al.

- Coronavirus pandemic hitting the global economy hard in spring 2020; exact consequences currently difficult to determine
- V-shaped recovery scenario assumes a course similar to previous epidemics with a quick return to normal economic activity, resulting in a slightly decreased economic output in Germany for 2020 overall
- L-shaped scenario, or not quickly returning to normal economic activity, would result in a deep and persistent recession
- A large-scale range of measures at a German and European level necessary; first steps in the right direction have been taken
- Most importantly, small businesses must be helped quickly and without bureaucratic red tape; demand stimulus for consumption and investments should be prepared

### German economy shrinking in 2020 – consumption and exports will drive the economy again in 2021

Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Spring Economic Outlook 2020.

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## FROM THE AUTHORS

“Currently, it is difficult to make a forecast. We have little official data that already reflect the effects of the Coronavirus pandemic. Our models are based on the past; it is possible that they do not adequately reflect the current situation, seeing as it is unprecedented. Moreover, it is unclear how governments will react over the course of the pandemic.”

— Claus Michelsen, DIW Berlin Chief Economic Forecaster —

# German Economy in Recession: Bridging Pinch Points, Building Confidence, Boosting Demand

By Claus Michelsen, Guido Baldi, Marius Clemens, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Max Hanisch, Simon Junker, Konstantin Kholodilin, Malte Rieth, and Thore Schlaak

The coronavirus hit the German economy hard in spring 2020. Economic output is expected to shrink this year. Germany is likely to experience a recession in spring and summer. This has been triggered by a number of factors.

The spread of the coronavirus is having a negative impact on production output: First, there were severe restrictions on mobility and the production of important intermediate goods in China. Since then, far-reaching quarantine and precautionary measures have been put in place in various other countries, some of which are having a dramatic impact on manufacturing processes and everyday life. As a result, not only are production and supply chains disrupted, but consumption opportunities are also significantly reduced. In addition, the measures taken, media coverage of developments, and reactions from the international financial centers have resulted in uncertainty among households and companies. Both are exercising restraint; purchases of consumer goods are being put on the back burner, as are investments in machinery and equipment. Overall, the global economy is experiencing supply- and demand-side shocks, which, in the short term, will result in a substantial loss of economic momentum.

DIW Berlin is lowering its forecast for Germany by 1.3 percentage points compared to its winter outlook, according to which the German economy was expected to gradually recover. Economic output is expected to shrink by one-tenth of one percent this year. Global economic momentum will also be nearly one percentage point weaker due to the effects of the corona pandemic.

This forecast is based on a scenario that assumes the course of an epidemic will resemble previous events such as swine flu, SARS, or bird flu: Following a significant increase in the number of infections in the coming weeks, the virus will

then be contained by quarantine measures. The negative economic consequences will mainly be felt in the first half of 2020 with a recovery expected in the second half of the year (V-scenario).

In the light of the current developments, this scenario appears more and more optimistic. There is considerable uncertainty surrounding the scenario described. The virus could spread over greater distances and more rapidly, forcing other regions and countries to place even more restrictions on daily life, just as Italy, France, Austria, Germany, and Spain have done recently. If this happens, it will significantly accelerate the downward momentum further and delay a recovery. The reactions on the financial markets also indicate a great deal of nervousness—important leading indices have fallen by historic proportions in recent days. The loss of confidence among both consumers and businesses may be even higher than might be expected based on the actual circumstances. The narrative of a severe crisis alone drastically reduces people's willingness to consume and invest. There is also the risk that the financial and debt crisis in the euro area will flare up again. If the risk premiums of individual countries rise significantly as a result of the distortions—as was recently the case for Italy—the question of debt sustainability arises again. In addition, there is a real likelihood that many companies in the euro area will go bankrupt, putting considerable pressure on commercial banks. The longer the crisis continues and the more severe its impact becomes, the greater the likelihood of a deep and persistent recession. Instead of a rapid V-shaped recovery, there would then be the danger of the economy not being able to make up the lost output, but instead moving to an L-shaped, i.e., a lower and slower growth path.

The consequences of the corona pandemic have affected different parts of the world to varying degrees. Many countries have taken measures to halt the spread of the virus and limit the economic impact. China, South Korea, and Japan, for example, have taken extensive steps to stabilize their economies and Italy has also adopted an initial package of measures costing around ten billion euros. In the US, the Federal Reserve Bank cut its key interest rate by a total of 1.5 basis points in two successive steps. Although the European Central Bank left its key interest rate for the euro area unchanged, it has announced it will increase bond purchases by 120 billion euros by the end of the year and simplify liquidity and financing conditions for banks, with the aim of improving lending, particularly to small and medium-sized enterprises. Additionally, the ECB decided to increase the volume of asset purchases to 750 billion euros until the end of this year. On balance, the sharp fall in oil prices as a result of the conflict between Russia and the other OPEC countries is also likely to cushion the blow.

Economies with a high degree of openness, such as Germany, are likely to experience disproportionately high losses. Private consumption and investment activity, which has so far been quite strong, are likely to be cut back considerably. There are also likely to be significant repercussions for exports. Given the uncertainty and weak profits, companies will be buying significantly fewer new machines, equipment, and vehicles this year. Only the construction industry is likely to continue to benefit from the exceptional boom in residential construction and significantly larger public investment budgets. Consumption will lose at some of its ability to cushion the economy. Households will shift their spending away from durable consumer goods to everyday consumer goods. As a consequence of the now weaker employment growth and considerably more short-time work, the development of household income will be weaker in the scenario assumed here and the savings rate will increase. Furthermore, wage replacement benefits for people in quarantine are paid by the health authorities of the respective federal states, in accordance with Germany's Infection Protection Act (*Infektionsschutzgesetz*). All this spending will make a dent on public budgets, and reserves built up in recent years in unemployment insurance and in other public budgets are likely to dwindle rapidly.

However, this is no reason to initiate additional austerity measures in order to maintain a balanced budget. On the contrary, now is the time to take targeted measures, or at least make credible announcements should the crisis intensify, in order to prevent it turning into an even greater economic crisis. It is important to provide support to companies whose existence, through no fault of their owners, is threatened by a lack of demand or production disruptions. Consideration should also be given to stimulating weak demand through government spending. This financial aid should first and foremost prevent insolvencies and employee layoffs, and counteract any decreased demand or loss of confidence. Ideally, there would be a coordinated launch of such a package among the Member States in the euro area. Monetary policymakers have already responded and, in some cases, taken bold steps. Most recently, the German government followed suit and announced unlimited liquidity for companies in difficulty as a result of the corona crisis.

First, it is right to tackle friction on the supply side. If, as a result of interrupted supply chains, lower freight volumes, quarantine measures, or other difficulties in the production process, companies find themselves in a situation where their solvency is no longer assured in the short term, it seems sensible to provide the necessary liquidity in the form of guarantees and default loans in order to ensure those companies can continue trading. The announced deferral of advance tax payments is also to be welcomed as this prevents government tax demands from creating additional shortfalls in company finances. Another plausible step would be to increase the maximum loss carryback. This would also give small businesses and the self-employed the opportunity to claim for potential lost earnings and obtain additional liquidity. The liquidity provided would ensure that, at least initially, these companies could continue trading. However, for many small companies in particular, the issue is how to repay such loans if they cannot make up for the lost turnover—this is especially true for the solo self-employed. The quarantine measures might also lead to financial difficulties for some employees, for example, if they have to take unpaid leave. An unbureaucratic solution might be for the tax office to offer them tax credits.

In previous crises, extending the short-time working allowance and the group of companies entitled to it has also

proved an effective measure. This ought to help prevent redundancies and support household purchasing power. Smaller restaurants, tradespeople with small businesses and service companies, in particular, are likely to be hit hard by the lack of demand. Their reserves are likely to be used up quickly. Appropriate liquidity support should also be made available to these inherently healthy enterprises. Subsidies for small enterprises in sectors that cannot make up for lost demand could also be considered. With all of this, the major issue is whether to go for the least bureaucratic option of providing everyone with this financial assistance or whether to go down the path of needs assessment. Ultimately, there is much to be said for broad and universal support in the current situation because, like the virus itself, increased company bankruptcies in an economy with a strong international division of labor could also have disruptive effects on production.

Second, the government should move to prevent a profound crisis of confidence among companies. The resulting reluctance to invest might also be countered, initially with a credible announcement of fiscal policy interventions and, in the event of a self-perpetuating economic crisis, by implementing concrete measures. Possible options include changing the depreciation rules on capital goods. Full depreciation could be granted for a limited period in the first year that new equipment is purchased. This would be a strong incentive for companies to bring forward investment projects that were already being planned, thus boosting demand. A long-term public investment program could also have a similar effect, provided that a credible signal was sent to companies that conditions in Germany were improving sustainably. This is necessary in any case, because this crisis also shows how quickly public infrastructure can reach the limits of its capacity. The considerable need to modernize the public infrastructure, for example in the area of digitization, and the lack of human resource capacities in the health sector, daycare

centers, and schools are likely to have made crisis management in politics and public administration considerably more difficult. This all applies under the proviso that there are no significant supply-side restrictions at this point in time.

Third, the government could strengthen household demand when the immediate quarantine measures come to an end. The government is also considering abolishing the solidarity surcharge ahead of schedule. However, there is a risk that anxious households would use the additional financial scope to boost their savings. One possible means of stimulating consumption directly would be to temporarily reduce sales tax (*Mehrwertsteuer*, MwSt). A reduction of one percentage point would create around 13 billion euros in additional leeway for households and this step would also benefit households with low incomes and a higher propensity to consume. Placing a time limit on the reduction would provide a strong incentive for households to bring forward their purchases of durable consumer goods, in particular. However, such benefits must not be allowed to thwart any health protection measures adopted. This is especially true when the population is encouraged to practice social distancing wherever possible.

The monetary and fiscal policy measures already adopted are all pointing in the right direction and are bold. The promise of unlimited liquidity, in particular, sends a strong signal to companies. However, liquidity will not help them if demand is permanently disrupted. Policymakers are not only called upon to relieve pinch points, but also to strengthen the confidence of economic actors and, if necessary, take steps to boost domestic demand. Monetary policy now has virtually no room for maneuver—fiscal policy is therefore all the more important. Without further clear and coordinated interventions, this public health crisis threatens to develop into an even more far-reaching economic crisis.

## EDITORIAL

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