

Michelsen, Claus et al.

Article

Germany hit hard by the global recession as uncertainty weighs heavy

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AT A GLANCE

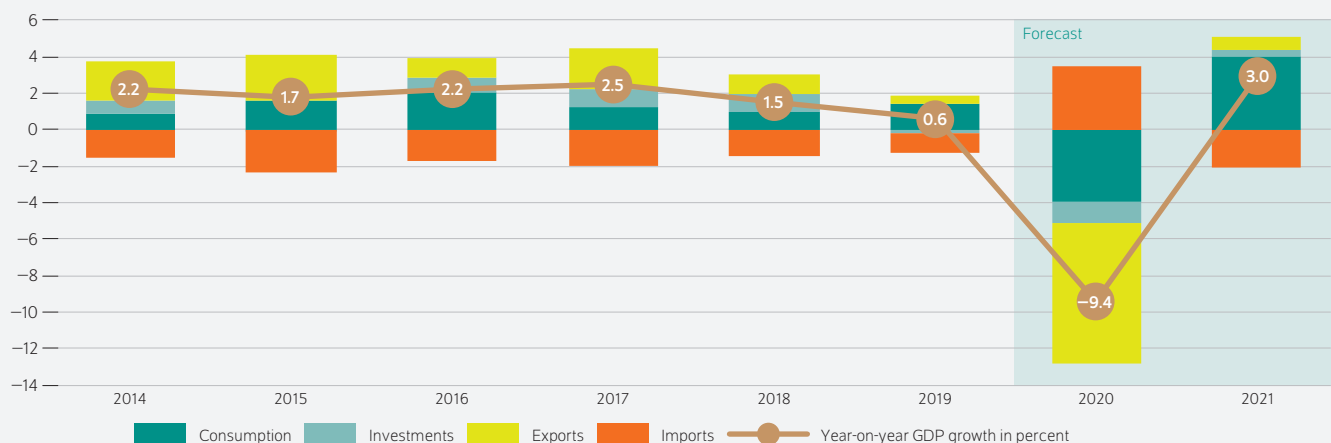
Germany Hit Hard by the Global Recession as Uncertainty Weighs Heavy

By Claus Michelsen et al.

- Economic output in Germany is likely to plummet drastically by over nine percent in 2020; the global economy also shrinking significantly
- A U-shaped recovery is currently the most likely scenario for Germany: the intense slump will be followed by a period of poor growth before gradually picking up again
- Uncertainties are weighing heavily on firms and private households, making them reluctant to purchase capital and major consumer goods
- The German Federal Government's economic program is helping, will increase economic output in 2020 and 2021 by 1.3 percentage points
- More broadly, DIW Berlin proposes an investment program to counter the crisis and strengthen the economy's growth potential

German economy plummets drastically: pre-crisis level by the end of 2021 remains far off

Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Economic Outlook Summer 2020.

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FROM THE AUTHORS

“The German economy needs a stimulus which will stimulate demand while addressing future problems at the same time. We have been discussing decarbonization, digitalization, and education issues for some time. Now is our opportunity to address these obvious weaknesses and strengthen the growth potential of the economy.”

— Claus Michelsen, DIW Berlin Chief Economic Forecaster —

MEDIA



Audio Interview with C. Michelsen (in German)
www.diw.de/mediathek

Germany Hit Hard by the Global Recession as Uncertainty Weighs Heavy

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

The coronavirus pandemic is plunging the global economy into a deep recession. Economic output declined in many economies in the first quarter of 2020. However, this decline is likely only the beginning, as the majority of the coronavirus containment measures were implemented in the second quarter of 2020. The coronavirus has also spread to emerging economies, where it has significantly affected daily life. The German economy is being hit hard by the crisis and is likely to experience the deepest recession in post-World War II history as a result.

The recession has been caused by the uncontrolled spread of the novel coronavirus. Most governments took drastic measures to contain the virus in response, but these measures massively restrict social life and economic activity. Moreover, production shutdowns resulted in disruptions of international supply chains. Short-time work and layoffs are lowering the purchasing power of private households and thus their demand, and massive sales shortfalls and increasing debt are restricting firms' scope of investment.

In addition, serious uncertainty from both firms and private households regarding the economy and the further course of the pandemic results in a significant reluctance to invest and to purchase expensive, durable consumer goods, such as cars, which deepens the recession. The export-based German economy was hit particularly hard, as it specializes in producing high-quality machines, devices, and cars, and foreign demand for these goods has fallen. Despite the fact that many countries have now eased containment measures, foreign demand is likely to recover only slowly; it is additionally dampened by uncertainty from private households and firms.

Therefore, DIW Berlin is expecting a significant decline in economic output and is lowering its forecast for the German

economy for 2020 to -9.4 percent. The global economy is likely to decline by 4.9 percent and only recover very gradually. Due to the high degree of uncertainty, massive income losses, and the containment measures remaining partially in place—and despite the expansionary monetary and fiscal policy reactions—DIW Berlin predicts a U-shaped recovery as the most likely course of the crisis. Thus, economic activities are bound to recover only slowly. For 2021, the German economy is predicted to grow by 3.0 percent and the global economy is predicted to grow by 5.5 percent. The economic consequences of the pandemic will be nowhere close to offset during the forecast period.

This forecast depends on many assumptions. For example, a more rapid (V-shaped) recovery is also possible, provided that the consequences of the pandemic are quickly overcome and, in particular, uncertainty is markedly reduced. If economic activities are revived worldwide during summer 2020 and the monetary and fiscal policy measures have a broad impact, optimism can return. Renewed optimism would move firms to invest and hire new employees. However, there is also the risk of an even deeper, more long-lasting economic slump, especially if the pandemic cannot be contained and one or more coronavirus waves follow. This would force a large number of firms into bankruptcy and have even more drastic consequences on the labor markets. This “L-shaped scenario” could lead to crises in the banking sector and a loss of trust in the credit standing of many emerging economies and some more developed economies such as Italy or Spain. One of the main goals of forming economic policies during this crisis is to avoid this scenario.

Therefore, many governments reacted swiftly to the economic crisis with various measures, attempting to prevent corporate insolvencies with subsidies, loans, and guarantees.

Private household incomes were also stabilized via instruments such as short-time allowances, subsidies, or one-time payments. Germany's measures alone, including all guarantees, amount to around 1.5 trillion euros; in the United States, around three trillion dollars in aid has been distributed. Worldwide, central banks have reacted by lowering interest rates, expanding asset purchase programs, and providing extensive liquidity to commercial banks to support their lending to firms.

Despite these measures, the economic crisis will strongly negatively affect almost every economic variable in Germany. Private consumption as well as investment activity will decline significantly. Foreign demand is also likely to markedly decline, which will put pressure on export activity. Even the construction industry, which has had extraordinarily good business over the past few years, will probably have to deal with a significant drop in sales, primarily due to lower demand from companies and municipalities. This impacts the labor market: for example, in May 2020, firms declared interest in short-time work allowances for (a maximum of) 11 million people. However, despite the possibility of short-time work, personnel are being made redundant or not replaced and the unemployment rate will increase to 6.0 percent. This development is noticeably impacting public budgets, as the German Federal Government is being forced to partially spend its reserves. For example, some of the reserves built up in recent years in unemployment insurance and other areas of public budgets, such as statutory health insurance and pension insurance, will probably be used up by the end of 2020. The reserves in unemployment insurance are likely to drop from 26 billion euros to minus five billion euros overall. According to current estimates, German federal debt alone will increase by 156 billion euros. When the new debt of regional and local authorities is added, in addition to direct loans and investments in firms, the national debt ratio will rise from below 60 to about 77 percent.

Although measures were quickly implemented to stabilize the economy, a rapid recovery and a continuation of the economic growth of the 2010s cannot be expected without further action. The coronavirus recession will leave deep marks on economic output and result in lower levels of prosperity for some time to come. Following the financial crisis of 2007–2008, Germany experienced a decade of

strong growth and thus reductions in public and private debt ratios. Economic policies going forward should do everything so that this development repeats itself. Decisive for this is that the German economy improves its competitiveness in next-generation businesses and remains attractive as a production location for firms. Therefore, economic stimuli that both increase purchasing power and stimulate investments to increase production potential are necessary to combat the acute crisis. An economic and growth package that stimulates economic activity for a specific period of time in the short-term in a targeted manner is needed. This package should also strengthen transformation processes that meet the needs of a sustainable, inclusive, and digitalization-oriented economy.

Such a program has now been passed by the German Federal Government. Around 130 billion euros are to be invested primarily in short-term measures to stimulate demand, and a significant amount of the instruments will stimulate consumption. Overall, the package covers more than 50 points, including temporarily decreasing the value-added tax, granting a children bonus, and providing aid to municipalities. This aid intends to compensate for the commercial tax losses and provide relief for social security contributions in addition to stabilizing public gross fixed capital formation in construction. Further elements address climate policy, digitalization, and education. Overall, many prudent steps have been decided upon, which will noticeably stabilize economic output in 2020 and 2021 with a stimulus of 1.3 percentage points in each of these two years.

However, a stronger focus on investments would be wise as a supplement to the measures, or even partially in place of them, as this would have greater effects on the potential growth rate. DIW Berlin recommends such a program in the amount of around 192 billion euros. This would speed up economic recovery and actively contribute to making the economy sustainable and digitalized. The growth potential of 2021 and beyond could thus be increased significantly, by an average of 0.5 percentage points annually, while at the same time meeting the goals of decarbonization and creating more equal living conditions through improved educational opportunities. In this way, the program would largely finance itself through increased growth.

EDITORIAL

Claus Michelsen is head of the Forecasting and Economic Policy Department at DIW Berlin | cmichelsen@diw.de

Guido Baldi is a guest researcher in the Forecasting and Economic Policy Department at DIW Berlin | gbaldi@diw.de

Marius Clemens is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | mclemens@diw.de

Geraldine Dany-Knedlik is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | gdanyknedlik@diw.de

Hella Engerer is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | hengerer@diw.de

Marcel Fratzscher is President of DIW Berlin | mfratzscher@diw.de

Stefan Gebauer is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | sgebauer@diw.de

Max Hanisch is a guest researcher in the Forecasting and Economic Policy Department at DIW Berlin | mhanisch@diw.de

Simon Junker is deputy head of the Forecasting and Economic Policy Department at DIW Berlin | sjunker@diw.de

Konstantin Kholodilin is a research associate in the the Forecasting and Economic Policy Department at DIW Berlin | kkholodilin@diw.de

Laura Pagenhardt is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | lpagenhardt@diw.de

Malte Rieth is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | mrieth@diw.de

Thore Schlaak is a research associate in the Forecasting and Economic Policy Department at DIW Berlin | tschlaak@diw.de

LEGAL AND EDITORIAL DETAILS



DIW Berlin — Deutsches Institut für Wirtschaftsforschung e.V.

Mohrenstraße 58, 10117 Berlin

www.diw.de

Phone: +49 30 897 89-0 Fax: -200

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Publishers

Prof. Dr. Pio Baake; Prof. Dr. Tomaso Duso; Prof. Marcel Fratzscher, Ph.D.;
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Sale and distribution

DIW Berlin Leserservice, Postfach 74, 77649 Offenburg

leserservice@diw.de

Phone: +49 1806 14 00 50 25 (20 cents per phone call)

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