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Article

Economic outlook better than expected despite pandemic

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AT A GLANCE

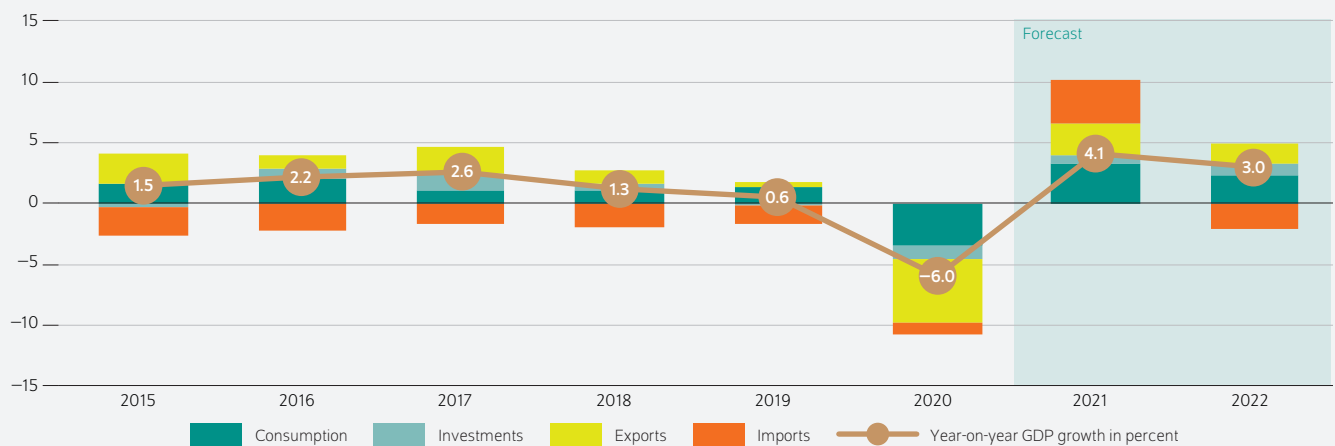
Economic Outlook Better than Expected Despite Pandemic

By Claus Michelsen et al.

- German economy weathering the crisis better than expected, but still too soon to declare it over
- GDP likely to sink by around six percent in 2020 as long as no new pandemic-related restrictions are implemented; autumn forecast more optimistic than summer forecast
- Private consumption increasing over the course of the year; short-term work declining gradually, disposable incomes increasing
- Comparably rapid economic recovery in China is a positive sign for German export economy; economies and labor markets of many other trade partners were more negatively impacted
- German Federal Government should maintain stabilization policies and increase investments for future development, primarily in education, digitalization, infrastructure, and R&D

German economy's slump was weaker than expected, but the crisis is long from over

Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Economic Outlook Autumn 2020.

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FROM THE AUTHORS

“The German economy has weathered the crisis better than expected, but it is too soon to relax. Many important trade partners have been hit hard, which leaves the export economy facing an uncertain future. Even here in Germany, many negative economic effects will only gradually make themselves visible.”

— Claus Michelsen, DIW Berlin Chief Economic Forecaster —

MEDIA



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

Economic Outlook Better than Expected Despite Pandemic

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

The coronavirus pandemic triggered drastic economic slumps worldwide over the course of 2020. In many countries, gross value added declined by over ten percent in the second quarter, an unprecedented drop for some. In particular, developed economies experienced significant losses.

The German economy declined by 9.7 percent in the second quarter, shrinking more than it ever has before. Nevertheless, companies and households have weathered the crisis better than expected, significantly in part due to the government's monetary and fiscal policy stabilization measures. Economic activity picking up again from a standstill should lead to strong GDP growth in the summer of 2020. However, this should not give the impression that the economic crisis has been solved quickly. The uncertainties facing households and firms are too great: Although their moods have improved, there is still the fear that the pandemic could worsen again and significant limitations could be reimposed. In addition, the pandemic's effects on business accounts and the development of the labor market are not yet completely clear. The enormous decrease in equity capital and lower disposable incomes are likely to dampen demand for capital goods and durable consumer goods for some time to come, slowing down economic recovery. However, China provides a glimmer of hope, as their economic activity significantly increased again in the second quarter and is also supporting domestic export activity.

The German Federal Government took decisive action to combat the crisis and implemented countless measures to secure firms and jobs as well as to stabilize overall economic demand, including decreasing the value-added tax and extensive increases in investment spending. In many sectors, the liquidity support and equity injections provided may have ensured firms' survival. For example, the short-

time work allowance and easier access to housing benefits and a guaranteed minimum pension significantly stabilized private household income. Although these fell significantly in the second quarter, the decline of around one percent in disposable income is far less than the decline in gross value added. In many cases, income is not spent, but rather saved. The savings rate doubled in the second quarter of 2020 and, as of September 2020, is above 20 percent. This also reflects consumers' considerable uncertainty. In contrast, corporate and investment income has been much more resilient and is likely to have considerably weakened many firms' equity position. This weighs on investment activity, which slumped by an unprecedented 20 percent in the second quarter.

Therefore, DIW Berlin expects a significant decline in economic output for 2020. Nevertheless, the outlook has improved somewhat. The economic situation is more positive than expected as was in summer 2020, in part due to the political response to the pandemic. As long as massive restrictions to public life are not reintroduced, DIW Berlin is calculating a decline of 6.0 percent in German economic output in 2020. The global economy is likely to shrink by four percent. Unlike as forecast in the summer, recovery is occurring more dynamically. Therefore, DIW Berlin is also raising its forecast for 2021 to 4.1 percent GDP growth.

However, despite the positive outlook, the coronavirus recession will not be handled within a few months. Rather, the recovery is likely to drag on until late into 2021 and is fraught with considerable risks. There is still no cure for the coronavirus and there is a significant risk that more coronavirus waves could lead to renewed economic slumps. Even if Germany can prevent an increase in the rate of new infections, further waves in important sales markets could lead to a dramatic decrease in demand, such as for machinery

and equipment, Germany's main exports. It is also possible that some sectors of the economy will not regain their former strength and firms will go bankrupt. A wave of insolvencies would also negatively impact the labor market. So far, the short-time work allowance has stabilized the workforce. If demand for certain goods and services remains weak for a longer period of time, unemployment figures would also be expected to rise significantly. A U-shaped recovery, a scenario with significantly more time spent at the bottom of the recession, is therefore still conceivable, as is an L-shaped recovery, where the deep recession is not followed by a correspondingly strong period of recovery. If more uncontrolled waves occur, then a W-shaped recovery is possible, a cycle of recession and recovery.

If the positive development forecast occurs, the macroeconomic impact is nevertheless likely to be deep and have a longer lasting effect. Investment activity will probably suffer considerably and the lack of expansion and modernization of the capital stock will reduce the German economy's growth potential. The same applies to foreign business, as its growth depends largely on investment activity in the German sales markets. Private households, saving considerably in 2020, are slowly reducing their high saving rate, which is dampening consumption. Short-time work is also likely to be reduced only gradually and wage trends are likely to remain relatively

weak. Overall, the state will accumulate considerable deficits until at least 2023. In 2020 alone, there is likely to be a deficit of around 215 billion euros.

However, due to the pandemic, it is not prudent to end fiscal policy support too early or to attempt to comply with the new debt limits of the debt brake in the short term, or even in 2021. Rather, it is important for the confidence of firms and households that the aid packages continue to be available as insurance. However, it does not mean the financial measures are not ineffective if the funds are not used up entirely. It is a good sign that funds from the emergency aid measures are still available to a considerable extent, as that indicates firms have weathered the crisis better than feared.

Regardless of the current crisis, there is still a considerable need for investments in Germany. From 2021 onward, the issue must be addressed and Germany must be further developed as an investment location in important areas such as digitization, education, infrastructure, and research and development. It is well known that the leverage effect of such expenditures is particularly high in times of underutilization. Extending the short-term stabilization policy by creating a future program that addresses long-term investment needs would be an important signal to market participants and would significantly brighten medium-term growth prospects.

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