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**Article**

## Second coronavirus wave affecting German economy and halting recovery

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## AT A GLANCE

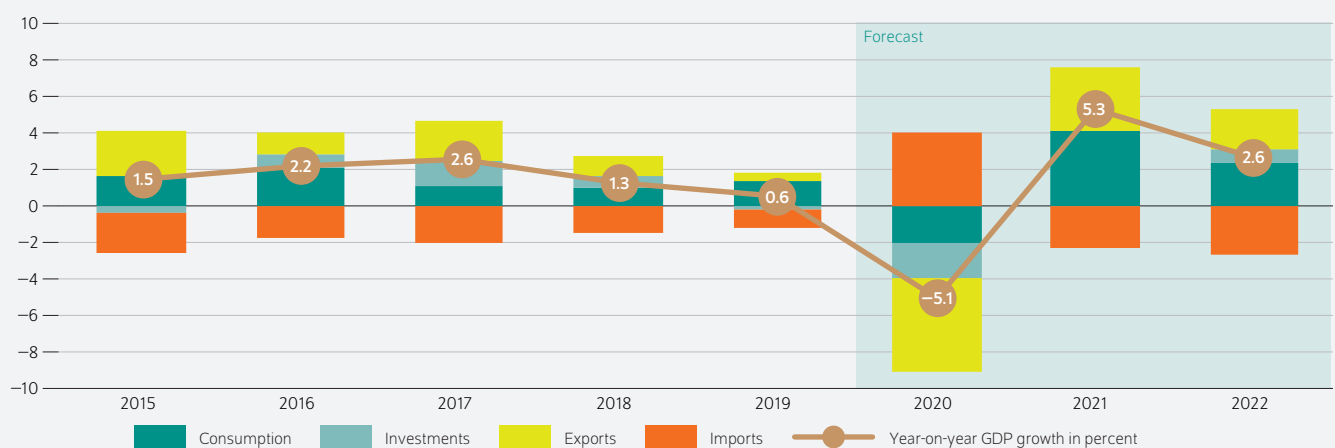
# Second coronavirus wave affecting German economy and halting recovery

By Claus Michelsen et al.

- The German economy is still on a roller coaster: after an unexpected strong recovery in summer 2020, GDP is shrinking as 2020 ends
- Economic output expected to fall by 5.1 percent in 2020; DIW Berlin forecasts growth of 5.3 percent in 2021 and 2.6 percent in 2022
- Pre-crisis level would be reached by the end of 2021 if the pandemic can be successfully controlled over winter 2020/2021, but significant risks remain
- Many of Germany's important trade partners remain in difficult situations; only the USA, China, and Japan offer glimmers of hope for foreign business
- Public budgets in 2020 have a record deficit of 186 billion euros; despite this, the investment path decided upon should be consistently pursued

### German economy could significantly recover in 2020, but risks remain

Individual GDP components' contribution to growth in percentage points



Source: DIW Berlin Economic Outlook Winter 2020.

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## FROM THE AUTHORS

*"Despite the record deficit in the public budgets, it will most likely be cheaper in the end to fight the recession with fiscal policy measures now than to save up against it to avoid a national debt crisis, as that risk is not on the horizon."*

— Claus Michelsen, DIW Berlin Chief Economic Forecaster —

## MEDIA



**Audio Interview** with Claus Michelsen (in German)  
[www.diw.de/mediathek](http://www.diw.de/mediathek)

# Second coronavirus wave affecting German economy and halting recovery

**By Claus Michelsen, Paul Berenberg-Gossler, Marius Clemens, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Max Hanisch, Simon Junker, Laura Pagenhardt, and Sandra Pasch**

The coronavirus pandemic continues to weigh on global development. Although the situation improved over summer 2020—as the German economy experienced a strong recovery in the first half of 2020, in part due to financial aid packages, after a combined decrease of almost 12 percent—this improvement did not last long. In fall 2020, the second wave arrived, negatively impacting the German economy and putting an abrupt end to the recovery process. As a result, Germany, like many other countries, re-implemented containment measures, although they are less expansive compared to spring 2020. However, significant risks for companies, their solvency, and labor market development remain. The declining equity base of many companies and the decreased disposable income of private households is likely to again dampen demand for capital and durable goods. Important trade partners, especially those in the euro area, have also been severely affected by the pandemic and are likely to have lower demand for German goods, at least temporarily. However, the development of the Chinese, American, and Japanese economies are providing rays of hope for foreign business.

In light of the surprisingly strong recovery process in summer 2020, DIW Berlin is now forecasting that Germany's economic output will only sink by around 5.1 percent in 2020. A powerful recovery in 2021 will lead to growth of 5.3 percent that year and 2.6 percent in 2022. In the underlying scenario, it is assumed that the measures will lower the infection rate and successfully bring it under control in winter 2020/2021 and that COVID-19 vaccines will be widespread soon. As herd immunity grows, the German economy could experience another powerful recovery in spring 2021. It is also assumed that corporate insolvencies, loan defaults, and significant increases in unemployment can be avoided by economic aid packages and that the crisis will not reach

the financial sector. If the sector were hit, this would pose the danger that banks could experience difficulties, ultimately leading to a public debt crisis in countries with high debt ratios.

These assumptions also represent the main risks of the forecast: It is entirely possible that one or more of the risks mentioned will actually occur. Primarily, it is questionable whether the infection rate can be controlled despite vaccine breakthroughs. If the rate cannot be controlled and containment measures last until spring 2021, economic output in 2021 is likely to be 1.7 percent lower. In Germany, it would likely be 1.5 percent.

These risks have been avoided successfully in part due to extremely expansive monetary and financial policies worldwide, which have compensated for a large portion of lost income. The German Federal Government passed an expansive economic stimulus package in summer 2020, which is likely to support the economy by around 1.3 percent in 2020 and 1.5 percent in 2021. In addition to this stimulus package, the November aid should compensate for a large part of the losses in the sectors affected by the renewed lockdown. Short-time allowance and interim aid that stabilizes the corporate sector were extended as well. This impacts Germany's debt-to-GDP ratio, which should be around 69 percent at the end of 2020.

The resolutions also contain numerous positions on strengthening public and private investment activities. Private investment activities are likely to decline especially steeply during the crisis, as sales prospects have clouded, capacities are underutilized, and the capital buffers necessary for modernizing capital stock have shrunk significantly. With regard to debt sustainability, it is important to increase Germany's growth rate, thus reducing the debt burden. Studies show that during

economic crises and in an environment of low interest rates, public investment activity entails considerable private investment. In particular, public research and development, expenditure in the education sector, and infrastructure will generate strong growth impulses in the medium term. As many areas of public infrastructure are experiencing high demand, it is prudent to support them and to expand public investment activity in a sustainable manner. Additionally, there is considerable additional need for public investment that financial planning does not yet reflect, as was discussed before the crisis. Such additional public investment includes investment expenditure for research and development, education, decarbonization and digitalization, and infrastructure. Until 2030, a further 220 billion euros would be necessary for this in addition to the measures already passed. Therefore, an economic policy that focuses on strengthening and transforming Germany as a business location makes sense for reasons beyond long-term crisis management.

Discussions on the fiscal consolidation strategy have already begun and will likely shape political discourse in 2021. It is in no way clear that the debt brake in its current form will simultaneously reduce public debt and enable Germany to modernize as a business location. Rather, rapidly returning to the debt brake regulations would result in a substantial reduction in the loans taken out. Such a consolidation path would significantly narrow the leeway for necessary investment activity and halt the modernization process. For investment purposes, net borrowing is justified as long as the return on the projects exceeds the cost of capital. In the current environment of low interest rates and underutilized capacities, this is often the case. Numerous proposals for a reform of the debt rule exist, ranging from focusing on the interest burden to considering symmetrical investment rules to implementing a nominal spending rule. These proposals should now be discussed in depth in order to create the space for the necessary modernization investments.

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