

| The current economic situation in Germany

Overview

Pandemic plunges world economy into severe crisis

World economy in deep recession

Within just a few weeks, the rapid spread of the novel coronavirus has sent the world economy into a deep recession. In particular, the far-reaching measures to contain the spread of the virus have weighed heavily on economic activity in many places. In China, where the pandemic originated, economic life largely came to a standstill in the first half of February 2020. Similar developments are becoming evident elsewhere, with a certain time lag. In the euro area, real gross domestic product (GDP) was already down substantially in the first quarter. In March, three major Member States – Italy, Spain and France – felt impelled to take drastic measures due to rapidly rising case numbers. Beyond the services sector, some industrial firms whose output was considered non-essential were also closed in those countries. In the United Kingdom and the United States, too, aggregate output fell considerably in the first quarter. However, the main impact of the containment measures is unlikely to be reflected in the GDP figures until the second quarter almost everywhere – with the exception of China, where the economy is already recovering after material restrictions were lifted. The same will hold for most emerging market economies. Some are suffering from the additional burden of worsened financing terms and the steep drop in commodity prices.

First restrictions eased, but swift normalisation unlikely

Since the end of April, the first restrictions have been relaxed in Europe, but also the United States, meaning that economic activity could be gradually restarted in some areas. Other countries are likely to follow. The world economy's path to recovery will largely depend on the pace at which rules are relaxed and on how the pandemic develops, making it highly uncertain. It is to be expected that at least some economic activities will remain subject to significant restrictions for a long time yet. Cautionary

consumer restraint, as can be observed in China, is also likely to impede a swift return to normal. Finally, there is the risk that, despite broad government assistance, the recovery process will extend over a longer period due in part to weak corporate finances and rigidities on the labour market.

Developments in international financial markets over the past few weeks have been dominated by the assessment of the economic and financial fallout from the coronavirus pandemic. The stock markets saw a surge in volatility and strong price drops. At the same time, bonds with high credit quality (safe haven assets) were heavily in demand, in spite of intermittent tensions even in these highly liquid markets. Federal securities (Bunds) were delivering historically low yields in the first half of March. Announcements of fiscal and monetary policy support measures stabilised the markets in mid-March: the central banks of major currency areas loosened their monetary policy stance, in some cases using new monetary policy instruments. At the same time, additional issuance of government bonds took shape, which is intended to finance the fiscal burden posed by the coronavirus pandemic. All in all, these measures have transferred some of the pandemic's costs and risks from the private to the public sector. In the stock markets, this was evidenced by subsiding volatility and significant price recovery. Government bond market yields saw mixed developments, however. In the euro area, they picked up somewhat after reaching their lows. Yield spreads between ten-year Bunds and government bonds with the same maturity issued by other euro area countries initially widened, but then narrowed again slightly under the influence of the new pandemic emergency purchase programme. Given the elevated level of uncertainty, participants in the foreign exchange markets increasingly sought currencies that are considered to be relatively safe. In effective terms, the US dollar,

Financial markets influenced by the coronavirus pandemic and its fallout

the euro, the yen and the Swiss franc appreciated. By contrast, mainly the currencies of commodity exporters as well as of emerging market economies and former transition countries fell across the board. In keeping with this, extensive outflows from investment funds which invest in emerging markets were observed in March.

Monetary policy: far-reaching measures in face of coronavirus crisis

In response to the severe deterioration in the outlook for growth and inflation in the euro area – in the face of the spread of COVID-19 – the Governing Council of the ECB adopted a series of measures in March and in April. These include adding a temporary envelope of additional net asset purchases of €120 billion to the existing asset purchase programme (APP), and a new pandemic emergency purchase programme (PEPP) coming to €750 billion. As for refinancing operations, the Governing Council twice eased the terms of the third series of targeted longer-term refinancing operations (TLTRO-III). In addition, in March it adopted a series of additional unconditional refinancing operations in order to bridge the period until the fourth TLTRO-III in June. In April it adopted a further series of unconditional operations, the pandemic emergency longer-term refinancing operations (PELTROs). Above and beyond that, the Governing Council decided to temporarily ease the Eurosystem's collateral framework and announced the Eurosystem's participation in a coordinated action to enhance the provision of US dollar liquidity to the banking system. The Eurosystem's key interest rates and the associated forward guidance were left unchanged by the Governing Council of the ECB at all monetary policy meetings during the reporting period. Therefore, the main refinancing rate remains at 0%, while the rate of the marginal lending facility stands at 0.25% and the deposit facility rate at -0.5%.

Rapid acceleration in lending growth due to coronavirus crisis

Given the much gloomier economic outlook and the feared risks to price stability, the adopted measures are intended to increase the degree of monetary policy accommodation. They also aim to prevent the pandemic's nega-

tive effects on the real economy from spilling over to the banking system. This would amplify the risk of the real economy and the financial system getting caught in a mutually reinforcing downward spiral. One of the key aspects in this connection is preventing disruptions in bank lending. In this respect, a surge in loans to the private sector was observed in the first quarter. In March, in particular, businesses took out credit lines and new loans on a large scale to compensate for lost earnings and to avoid future liquidity shortages. This increased borrowing was supported by various assistance programmes for business loans which national governments had created as first responses to the crisis. In contrast to this, lending to households, which until then had been on a stable upward path, weakened significantly, particularly in the countries that were especially affected by the pandemic. Amidst this strong credit growth, the broad monetary aggregate M3 likewise grew exceptionally strongly in the first quarter of 2020.

On 5 May, Germany's Federal Constitutional Court delivered its verdict on the Eurosystem's public sector purchase programme (PSPP), which forms part of the APP. It found that the Court of Justice of the European Union's ruling on this matter in December 2018 and the PSPP decisions of the Governing Council of the ECB were "ultra vires" acts by the Court and the ECB Governing Council, meaning that both parties exceeded their powers; in the first case, this was due to an insufficient assessment of proportionality, and in the second, an insufficiently substantiated and documented assessment of proportionality. The Federal Constitutional Court found no evidence as to whether the Governing Council of the ECB, in its assessment of proportionality, had sufficiently weighed and balanced the expected benefits for achieving the monetary policy objective against the economic policy effects arising from the PSPP. The court ruled that the Bundesbank's continued full participation in the PSPP is contingent on the Governing Council of the ECB presenting its considerations on the pro-

Federal Constitutional Court delivers verdict on PSPP

portionality of the programme within three months.

German economy in deep recession

German economic output experienced a huge decline in the first quarter of 2020 owing to the COVID-19 pandemic and the measures taken to contain it. According to the Federal Statistical Office's flash estimate, real GDP decreased by 2.2% from the previous quarter after seasonal and calendar adjustment. The exceptionally steep drop in GDP in the first quarter is all the more notable as economic output had probably still seen broad-based growth in the first two months of that quarter, meaning that the drop was confined to the month of March.

Economic slump on a broad front

The pandemic and the measures taken to contain it in Germany and abroad have impaired economic activity in Germany on a broad front. On the one hand, many consumer-related service sectors have been affected, some of which had to interrupt their business activities for some time or severely restrict them. These include the hotel and restaurant sector, large parts of the bricks and mortar retail sector, travel service providers, other leisure and cultural services and passenger transport. Consumer spending is therefore likely to have declined considerably. Domestic restrictions have also affected output and sales in the manufacturing sector. The decline in demand from abroad and disruptions to global supply and value chains have caused additional downward pressure here, with exports of goods falling by more than one-tenth in March alone. Furthermore, the abrupt change in the economic environment and the exceptionally high level of uncertainty are likely to have had a dampening effect on private investment in machinery and equipment. By contrast, the construction sector remained on an expansionary path, partly because construction activity continued to a large extent.

Credit developments and credit standards

Banks in Germany likewise substantially expanded their lending to the domestic private sector in the first quarter of 2020. This was

attributable mainly to loans to non-financial corporations, which rose exceptionally sharply in March in the wake of the COVID-19 crisis. The loans primarily served to strengthen liquidity reserves and thus mainly covered the short-term maturity segment. This was supported by extensive assistance loans from the Federal Government as well as additional financial support from the state governments, for which applications could be submitted as of March. According to the latest round of the Bank Lending Survey (BLS), banks expect enterprises' demand for loans to further accelerate in the second quarter. Loans to households for house purchase, which recorded high inflows in Germany, especially before the outbreak of the coronavirus epidemic, also had a supporting effect. However, on balance, credit standards and credit conditions were tightened across all segments by the banks participating in the survey, with tightening particularly pronounced in corporate lending.

The measures to contain the pandemic are having a considerable impact on the labour market. The most important adjustment tool is the short-time work scheme (*Kurzarbeit*), which is currently playing a much greater role than in the Great Recession of 2008-09, when just under 1½ million people received this wage substitute at its peak. From the beginning of March to 26 April, the Federal Employment Agency processed applications for short-time work covering 10 million people. However, the number of notifications is a ceiling, as the prior notification of short-time work is a necessary condition for enterprises to subsequently claim short-time working benefits. Assuming that current registration patterns mirror those in the past, around 6 million people may have been in short-time work in April. In the same month, seasonally adjusted registered unemployment rose sharply by 373,000 on the month to 2.64 million, with the unemployment rate increasing by 0.8 percentage point to 5.8%. The severe recession is also gradually making its mark on agreements in the current wage round. Instead of signifi-

Labour market considerably impacted by the effects of the pandemic measures

cant pay improvements, the focus is now on protecting jobs.

No significant impact of the pandemic on inflation trend to date

Up to and including March, the pandemic and the containment measures affected consumer price inflation mainly through lower energy prices. By contrast, there was no observable change in the general price trend. This is likely to do with the containment measures' large number of partially conflicting price effects. By March there had also still not yet been any significant constraints in the collection of prices, as this took place around the middle of the month and thus in some cases before the severe restrictions were imposed across Germany. It was not until April that there were mounting reports of difficulties in the on-site collection of prices and of the non-availability of individual price representatives. This mainly affected the services sector (e.g. hair salon visits) and travel (e.g. package holidays or hotel accommodation).

Inflation rate in April markedly lower due to energy

Against this backdrop, inflation declined from 1.3% in March to 0.8% in April, reflecting a further sharp fall in energy prices. By contrast, food prices rose significantly. The core rate, i.e. the annual inflation rate excluding energy and food, weakened from 1.3% to 1.0%.

German economy in accelerated tailspin in Q2 2020

The German economy will remain firmly in the grip of the COVID-19 pandemic in the second quarter. Economic output is likely to be significantly lower still than the average of the already depressed first quarter. This is mainly due to the fact that the containment measures will have an impact for a considerably longer period than in the first quarter, when they mainly only affected the second half of March. Despite the easing that has been initiated, social and economic life in Germany is still very far from a situation that would previously have been regarded as normal. The available economic indicators show a correspondingly gloomy picture. For instance, sentiment among enterprises and consumers recently fell to the lowest level ever recorded since observations began in the Federal Republic of Germany. Timely high-

frequency indicators also indicate that economic activity in the second quarter has remained strongly subdued thus far. This applies both to the services sector, in which business activity was massively restricted on a temporary basis by the containment measures implemented, and to industry, which has to cope with a slump in incoming orders from Germany and abroad. By contrast, the construction sector appears to be comparatively robust. In addition, fiscal policy is providing positive stimuli.

There is currently much to suggest that macro-economic developments will pick up again over the course of the second quarter as a result of the easing of measures and that a recovery will ensue. However, there is a very high degree of uncertainty about economic developments going forward. These will depend, amongst other things, on the further global spread of the virus and the measures to contain it, but also on the resultant changes in consumption and investment behaviour.

This crisis situation shows how important sound public finances are. They enable central government to take on extensive costs and risks without sacrificing confidence in its ability to act. German public finances have been placed on a sound footing in recent years. In 2019, the general government budget recorded a structural surplus and the debt ratio fell below 60%. Since March, however, German fiscal policy has been dominated by the COVID-19 epidemic. Extensive fiscal policy measures have been implemented to support the health system and limit economic damage. In addition, public finances are to some extent automatically stabilising economic developments. Taxes, in particular, are falling sharply and expenditure on short-time workers' benefits and unemployment benefits is growing strongly. The latest tax estimate is therefore not a surprise and confirmed expectations. In addition, enterprises can receive extensive credit guarantees and in some cases government capital injections are also being envisaged. Such assistance will increase the Maastricht debt level. Overall,

Recovery foreseeable, but scale and speed uncertain

Public finances have stabilising effect in the coronavirus crisis

a high deficit and a sharp rise in the debt ratio are only a matter of time, though the actual extent remains very uncertain. However, Germany is likely to be able to cope well with these challenges because it built up considerable leeway before the crisis.

Supportive fiscal policy in the crisis important and right

It was important and right that fiscal policy makers quickly set up a broad rescue package in the face of the abrupt deterioration in the macroeconomic situation. The aim was, and still is, to avoid overwhelming the healthcare system and to limit the economic fallout of the containment measures. The objective of fiscal measures to support economic activity is to limit income losses, unemployment and corporate insolvencies as much as possible. As the duration, scale and economic impact of the course of the pandemic and the resulting constraints are difficult to estimate reliably, adjustments may become necessary. For example, the longer economic activity is restricted as a result of the pandemic, the more squeezed enterprises will be. If insolvencies and subsequent unemployment are to be avoided in the event of prolonged restrictions, it would be logical to retool government assistance from liquidity support to solvency protection.

Economic stimulus programme as and when needed going forward

The Federal Government is preparing measures to stimulate economic activity going forward. This means that it will be possible to additionally counteract weak demand following the severe restrictions. An economic stimulus programme should be targeted and mainly temporary and could incorporate other government objectives such as climate protection or digitalisation. When the fiscal stabilisation measures are phased out and the economy picks up, public finances will then improve again automatically, at least to a large extent. Owing to the favourable starting position, fiscal policy is likely to still have sufficient scope for a strong temporary stimulus if necessary. The budgetary rules, with their exemption clauses, offer sufficient flexibility to deliver the appropriate fiscal response to the current crisis. At the same time, they will ensure a reduction in the

temporarily required deficits and higher debt ratio going forward. Given the high level of uncertainty, it is not yet possible to reliably assess the extent to which a subsequent consolidation will be necessary. In this respect, it is logical to focus on stabilising economic activity for the time being and to not yet address potential consolidation measures. There is therefore also ample justification for initially continuing to monitor and assess developments as well as basing the Federal Government's budget plans, for example, on better information in the third quarter.

In the other euro area countries, public finances are likewise making a strong contribution to stability. The European Commission and the European Council have activated the general escape clause of the Stability and Growth Pact; the usual rules are therefore no longer in force until further notice. The case for this measure is quite strong in the light of the exceptional crisis. Owing to extensive measures taken in all countries and due to the severe economic slump, the European Commission has most recently forecast a euro area deficit ratio of over 8%. The debt ratio is set to rise past 100%. However, the Commission is expecting a visible reversal to occur in 2021: given a rebounding economy and the phase-out of support measures, the deficit ratio will then go back down to 3½%. Going forward, the aim will once again be to reduce the high debt ratios in an orderly manner commensurate with the fiscal rules.

Public finances throughout euro area making strong contribution to stability

It is also in the euro area where the important role of sound public finances in crisis resolution is being witnessed. Some individual countries currently have only limited leeway as they are being squeezed by rising financing costs. Action to address this situation is being taken at the European level. The idea is to shield countries in part from the consequences of a loss of confidence so that important and sound measures are not rejected out of fears of negative market reactions. This is why the European Council has approved a raft of joint fiscal meas-

Protection against loss of confidence in public finances

ures ensuring favourable financing conditions and thus facilitating efforts to combat the crisis. Further joint assistance is in the pipeline.

*Further
European-level
measures
planned*

All in all, fiscal policy is in a position to make an essential contribution to resolving the COVID-19 crisis. This is primarily a national task. However, the European level is likewise capable of making an important contribution in the spirit of solidarity. Assistance loans at favourable interest rates can take pressure of those Member States which are having – or are afraid of encountering – temporary difficulties accessing the capital markets. This is what the ESM is for,

in principle. Transfers can also be made in order to support those Member States hit especially hard by the crisis. The EU budget would be a suitable tool for this purpose and could also be expanded considerably depending on the political consensus reached. As has usually been the case, the measures can be transparently and directly funded by contributions from Member States. In order to maintain a balance between liability and responsibility, a new extensive and, in particular, more permanent debt instrument at the European level should logically be accompanied by more comprehensive integration steps.