The current economic situation in Germany
Overview

Strong recovery may be followed by a temporary setback

In the third quarter, the global economy continued to recover from the slump in March and April 2020 caused by the coronavirus pandemic, albeit at a somewhat slower pace. Global gross domestic product (GDP) rose sharply on the quarter, not least owing to the strong countermovement already seen in May and June, yet fell short of its pre-crisis level. This was the case for all major advanced economies as well. In the United States and the euro area, economic output rebounded significantly in the third quarter, returning to, respectively, 97% and just under 96% of its pre-crisis level. In the United Kingdom, real GDP increased even more strongly after a particularly sharp decline in the first half of the year, but remained nearly 10% below its level in the final quarter of 2019. The recovery in Japan and some emerging market economies is likely to have been somewhat more subdued. China’s economy, on the other hand, had already practically returned to its pre-crisis path, partly thanks to the country’s success in containing the pandemic so far.

As the number of infections has started to rise again, new restriction measures have been introduced in recent months, especially in Europe. At first, these mainly applied only to individual, contact-intensive services, and were regionally targeted. Recently, however, high levels of infection have prompted many governments to take wider-reaching measures again. It remains to be seen how quickly these steps will halt the current wave of infections. The economic recovery in the affected countries will probably suffer a setback in the final quarter as a result of greater cautiousness among the general public as well as of the new restrictions. Ensuring that measures effectively contain the pandemic whilst also minimising constraints on public life – and thus also the economy – will remain a challenge. Recent progress in the development of an effective vaccine is sparking hope that it may soon become easier to master this challenge.

The strong economic recovery also shaped the international financial markets in the third quarter of 2020. In the United States, above all, but also in Europe, (expected) monetary and fiscal policy support measures and favourable economic signals fuelled optimism among financial market participants. However, significant growth in the number of infections and the concomitant imposition of restrictions led to a clear correction, especially in Europe. Equity markets in the euro area came under marked pressure in October as market participants flocked towards safe havens. Towards the end of the reporting period, however, hopes that a vaccine might soon be available effected a resurgence in confidence. On balance, equity prices have risen since the end of June, while the average yield on long-term government bonds in the euro area has declined.

By contrast, the US financial markets remained comparatively robust in the face of the pandemic. Buoyed by predominantly good quarterly results and improved corporate earnings expectations, US equity prices rose significantly overall, even reaching an all-time high at one point. The Fed’s new strategy of average inflation targeting is likely to have boosted yields on US Treasuries by increasing term premiums. Market participants’ expectations that US fiscal policy could become even more expansionary as infection numbers increase also had a positive impact on yields, which had risen significantly on balance. Changes in infection rates and the ensuing responses by policymakers were also partly reflected in the foreign exchange markets. The euro appreciated slightly on balance.
At its monetary policy meetings in September and October 2020, the Governing Council of the ECB left both key interest rates and asset purchases under its purchase programmes unchanged. Given the renewed rise in the number of infections, the Governing Council identified significant downside risks at its October meeting. Based on new projections in December, the Governing Council will recalibrate its instruments to respond to the situation and to ensure that financing conditions remain favourable.

Monetary developments were influenced by the coronavirus pandemic in the third quarter, too. The annual growth rate of the broad monetary aggregate M3 accelerated further to 10.4% at the end of September, thus doubling in comparison to the end of 2019. These strong dynamics were driven by three factors. First, households and non-financial corporations continued to increase their precautionary holdings of highly liquid bank deposits. Second, monetary growth was fuelled by the Eurosystem’s asset purchase programmes (especially the large-scale government bond purchases), which were expanded during the crisis. Third, commercial banks’ lending to the domestic private sector once again played a substantial role. Non-financial corporations’ demand for loans declined in comparison to the preceding two very strong quarters as the substantial economic recovery reduced enterprises’ acute liquidity needs. However, households’ demand for housing and consumer loans picked up at the same time. In addition, commercial banks significantly increased their holdings of corporate bonds on balance.

In the third quarter, the German economy recovered strongly from its slump in the quarter before. According to the Federal Statistical Office’s flash estimate, in the third quarter of 2020, real GDP expanded by more than 8% on the severely depressed figure for the preceding three-month period. The onset of the strong recovery already took place in May, which played a key role in the size of the counter-movement. Economic activity at the beginning of the third quarter was thus already far above the average of the second quarter. The recovery continued as the quarter progressed, albeit at a considerably subdued pace. Irrespective of this strong growth, aggregate output in the third quarter was still down by more than 4% from the pre-crisis level of the final quarter of 2019.

The German economy underwent a broad-based recovery in the third quarter. On the supply side, both manufacturing and services witnessed considerable growth in real value added. Nevertheless, the services sector as a whole continued to present rather a mixed picture. While retail sales figures were clearly up on their pre-crisis level, seasonally adjusted turnover in the hotel and restaurant sector was still quite substantially below the average figure for the fourth quarter of 2019. This was due to the continuing restrictions in the wake of the coronavirus pandemic, which affected some branches of the services sector significantly more than others. Construction output is likely to have contracted slightly. However, this sector has been experiencing a boom of its own for some time now and has weathered the coronavirus crisis without significant problems so far. Demand for loans for house purchase remained very high, for instance.

On the demand side, all those components which had previously been depressed rebounded strongly. Households used the consumption opportunities that became available again and probably made a number of purchases that had previously been put on hold. They also showed renewed interest in consumer credit, for instance. Given the pick-up in global trade, exports also made a strong contribution. Moreover, enterprises are likely to have expanded their investment in machinery again on a quite considerable scale. Besides the temporary brightening of the business outlook at home and abroad, catch-up effects may have been a factor here, too. By contrast, loans to non-financial corporations declined slightly on
balance in the quarter under review. However, this is not at odds with brisk investment activity as, in the second quarter, enterprises had taken on large volumes of debt and built up generous liquidity reserves. They were then able to use these funds, together with the resurgent income, to pay back short-term loans and finance investment.

The labour market in Germany shifted onto a path of slight recovery at the beginning of the third quarter. Employment levels rose slightly over the course of the quarter following a considerable decline. Unemployment temporarily peaked in June and has since fallen slightly. The uptake of short-time work has dropped from its high point in April but has remained widespread. As the number of hours worked per short-time worker has simultaneously increased, the volume of labour lost through short-time work has decreased by more than two-thirds over the past four months.

In the most recent pay negotiations, the social partners often focused on protecting employment – by ruling out redundancies and sector-specific regulations on short-time work, for example – at the expense of significant wage increases. The rise in negotiated wages was therefore markedly lower than last year. Several months without wage increases were often agreed upon at the start of employment contracts. Even in sectors not hit as hard by the crisis, such as the main construction sector, pay rises were modest. The pay settlement in the central and local government areas of the public sector also provides for restrained increases in earnings.

Consumer prices fell significantly in the third quarter against the backdrop of the temporary VAT cut. The Harmonised Index of Consumer Prices (HICP) averaged over the July to September period was down by a seasonally adjusted 0.7% from the second quarter, in which prices had remained virtually constant. Consumer prices declined by 0.2% year-on-year following an increase of 0.7% in the preceding quarter.

Core inflation excluding energy and food dropped from 1.1% to 0.5% over the same period, but remained in positive territory. In October, consumer prices remained stuck below their previous year’s level on account of the temporary VAT cut. The inflation rate fell to -0.5% from a level of -0.4% in the previous month.

The catch-up momentum is unlikely to continue into the final quarter of 2020. After the very strong growth seen in the third quarter, aggregate output could stagnate or even decline. This is due mainly to the recent resurgence of the pandemic in Germany and its European neighbours as well as the additional containment measures adopted for November. The imposed restrictions, which chiefly affect the hotel and restaurant sector as well as other leisure and cultural services, are nowhere near as extensive as the measures applied in March and April. However, an additional compounding factor is that recovery in the predominantly export-oriented industry is also being hampered by the resurgence of the pandemic in Europe. On balance, short-time work, which is likely to have continued to fall markedly in September and October, could, in November, temporarily go back over the level reached in August. Overall, from the current perspective, a slump in economic output to a similarly subdued level as in the second quarter is not very likely.

German fiscal policy is still geared towards tackling the consequences of the coronavirus pandemic, entailing a high deficit and a sharp rise in debt this year. The economic slump is weighing on taxes and social contributions, whilst at the same time, short-time working benefits and unemployment benefits are rising. The fiscal stabilisation measures taken since March are having an even greater impact than these automatic stabilisers. However, public finances will gradually recover as the crisis abates and fiscal stabilisation through public finances gradually comes to an end. From the current perspective, this means that the deficit
will go back down to a degree over the course of next year and decline more significantly in 2022. However, the outlook here remains highly uncertain. This applies both to economic developments and to any potential additional stabilisation measures.

Central government is responsible for the bulk of fiscal policy stabilisation. To this end, it has borrowed on an extensive scale. Here, the deficit for 2020 is likely to remain well below the budgeted figure of almost €220 billion. As things currently stand, a figure in the area of €150 billion seems plausible. Although the deficit is expected to decline next year, it is still projected to be very high; the Federal Government’s draft budget envisages a figure of almost €100 billion. This means that central government will be expected to continue making a considerable contribution to macroeconomic stabilisation. According to the plans, the debt brake will be adhered to again from 2022. To achieve this, the Federal Government’s medium-term financial plan envisages, first, dissolving reserves. In addition, a need for action was identified which is set to require funds rising from €10 billion in 2022 to €16 billion in 2024. It is not clear how this has been calculated in the planning. Given the uncertain economic outlook, it is difficult to predict the actual need for action that will ultimately be identified. Nonetheless, the challenges currently expected should be disclosed transparently. That said, given the very high level of uncertainty, it is understandable that no concrete consolidation measures have been approved yet.

As the crisis will continue beyond the current year, a stabilising fiscal policy will also be important in the year to come. Invoking the debt brake escape clauses once again in 2021 in order to increase scope for borrowing is therefore the right course of action. Germany had achieved sound public finances before the crisis and has headroom to significantly expand government stabilisation if necessary. However, new measures should be temporary in nature in order to avoid placing a permanent strain on public finances. In addition to the anticipated need for structural adjustment in the wake of the coronavirus crisis, further fiscal challenges are already in store for the medium term. These include demographic change and the associated foreseeable pressure on social security funds, for example. Once the crisis abates and the normal budgetary rules apply again, it is important that public finances be restored to a sound footing within a reasonable period of time. This will ultimately be the prerequisite for maintaining confidence in the public finances of both Germany and the other euro area Member States alike. Borrowing on a large scale will in future occur at the European level for transfers to Member States, amongst other things. However, fiscal scope cannot be expanded permanently by shifting debts to the European level. Rather, EU debts will also have to be serviced by the taxpayers in these Member States.