# A strong recovery so far but headwinds are increasing

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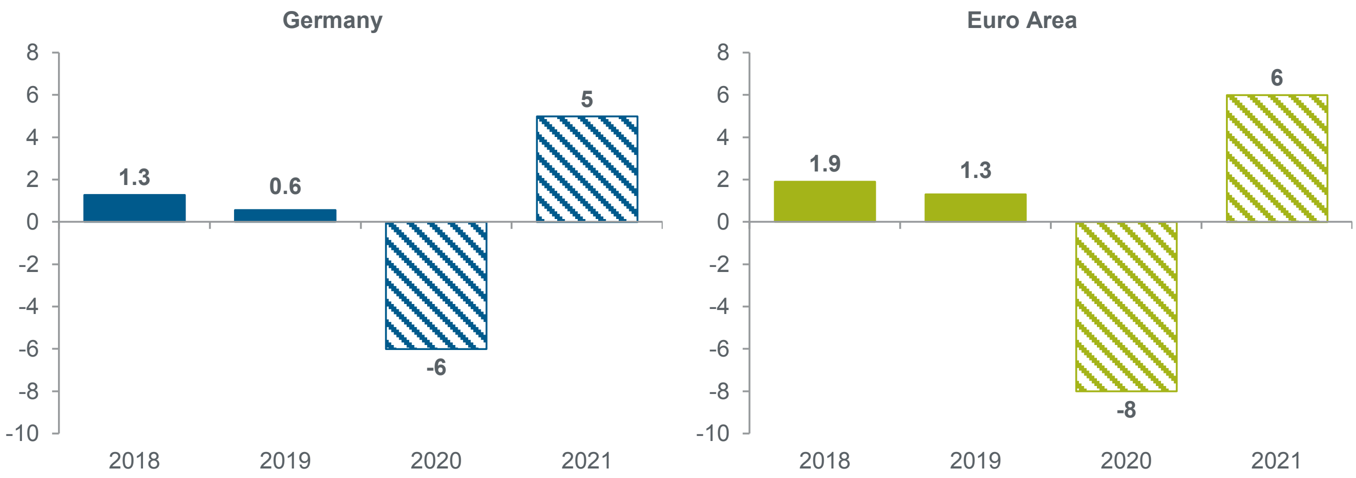
- The coronavirus pandemic has led to an economic slump of unprecedented scale in Germany and the euro area. The low point, however, was passed back in April. It was followed by a vigorous catch-up movement that translates into very high growth in the present quarter. But headwinds are gathering strength.
- KfW Research stands by its forecast that Germany's gross domestic product will contract by around 6% in 2020, before growing again by 5% in the coming year. The pre-crisis level will probably be achieved again by the end of 2021.
- Gross domestic product in the euro area will likely contract by around 8% overall. Catch-up growth of around 6% can be expected for 2021.
- Monetary and fiscal policy measures are mitigating the impact of the crisis. A second wave of infections remains the highest risk, although new restrictions would likely end up being more targeted than in spring.

**Figure 1: Gross domestic product of Germany and the euro area**
Variation on previous year in per cent, adjusted for prices




Source: KfW Research, Destatis

### Historic slump in second quarter

As expected, Germany recorded a drop of historic proportions in gross national product in the second quarter. The 9.7% plunge was more than double the previous record slide during the height of the financial crisis in winter of 2009. The particularly steep fall in the course of the coronavirus crisis was also due to the sharp drop in private consumption that added to the decline of the usual cyclical components such as fixed capital formation in machinery and equipment and exports. Containing the first wave of infections in spring required a previously inconceivable shutdown of many economic activities in Germany and numerous other countries.

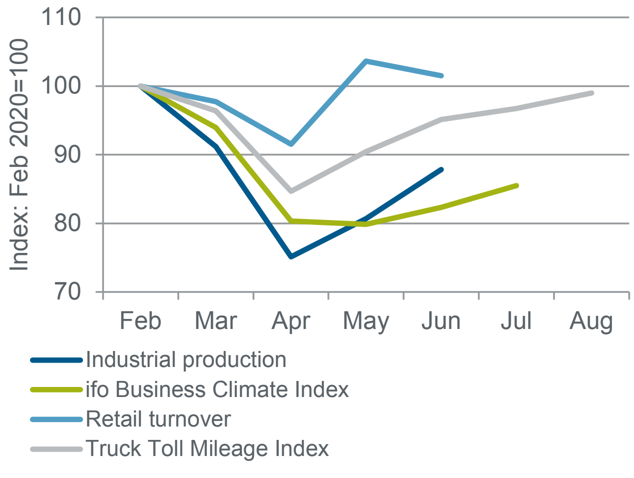
During the weeks of the hard lockdown from 23 March to 19 April, economic activity in Germany was probably around 20% below pre-crisis levels. Many retail operations and some service sectors were directly affected by officially mandated business closures. Some manufacturing came to a standstill because supply chains were disrupted by even stricter lockdown measures adopted by important trading partners. Industrial production in April was 25% below February levels, while retail turnover remained surprisingly steady, down only around 9%.

### The recovery is off to a vigorous start ...

The pace of the initial rebound, however, which set in from May after the first wave of infections was successfully contained, almost matched that of the contraction. The gradual lifting of restrictions in Germany and abroad enabled business activity to ramp up again in many sectors. Industrial output increased by 17% overall by June but remains around 12% below the pre-crisis level (Figure 2). Retail turnover, which had already returned to the pre-crisis level in May, recovered even more significantly before dipping marginally in June before the value-added tax reduction. According to sentiment indicators such as the ifo Business Climate Index, the catch-up movement is likely to have continued at a high pace at the start of the present quarter as well. However, the surveyed businesses' current situation assessments are still far below pre-crisis levels. Nonetheless, the catch-up movement seen up to June alone has generated the potential for the record slump to be followed by record growth in the summer quarter. This is also thanks to the government's stabilisation measures, which have so far enabled the survival of many businesses and jobs, thus preventing the crisis from deepening. Furthermore, with its temporary value-added tax reduction, the economic stimulus package which was adopted in June will generate a short-term surge in demand in the second half but otherwise has a rather medium-term effect.

### Figure 2: Slump and rebound of major indicators

Monthly indicators up to the currently available margin.




Note: Truck toll index in August taken from median of available days.

Sources: Destatis, ifo Institute, KfW Research

### ... but headwinds are building at the moment

The initial high pace of the recovery, however, is already set to slow considerably. After the relatively mechanical recovery enabled by the lifting of many containment measures, the remaining gap to normal economic activity is becoming increasingly difficult to close. Export-oriented manufacturers in particular expect to face increasing headwinds from the demand side. Uncertainty remains extremely high amid rapidly rising global infection rates. In addition, crisis-induced higher debt levels are putting the brakes on businesses' domestic and international capital expenditure activities. Moreover, unemployment in Europe will likely continue to grow for the time being and this is set to have second-round effects on consumption and, in particular, on the sale of durable goods such as automobiles. A more moderate rise in the truck toll index from July is a first sign of a slowing catch-up rate in the manufacturing sector (Figure 1). With case numbers rising again in Germany as well, certain service areas, such as the hospitality and event sector, must be expected to face a tightening of existing restrictions rather than a relaxation.

### Hope for a vaccine in the coming year

We therefore expect catch-up growth to remain slow in the autumn and winter quarters. But as the development of vaccines is progressing quickly, with six different vaccines already in phase-three clinical trials in mid-August, it is realistic to assume that wealthy economies such as the euro area member states will be able to start mass immunisations from spring 2021. As this will lead to a further lifting of restrictions and, in particular, boost confidence, the forecast presupposes temporary growth acceleration from early summer. GDP should return to pre-crisis levels by the end of 2021.

### Annual forecasts for Germany remain at -6 and +5%

Overall, we expect average annual GDP to contract by around 6% in 2020 and grow again by 5% in the coming year. It is true that the past quarter turned out slightly better than expected in the previous forecast. But the annual forecasts remain unchanged, along with the slightly more pessimistic outlook on the near future. Overall, the coronavirus crisis will probably lead to a loss of around EUR 340 billion in economic output compared with potential growth in 2020 and 2021. Uncertainty about the future remains extraordinarily high. In order to avoid making our growth forecasts seem more accurate than they are, we will continue to dispense with the usual decimals behind the comma.

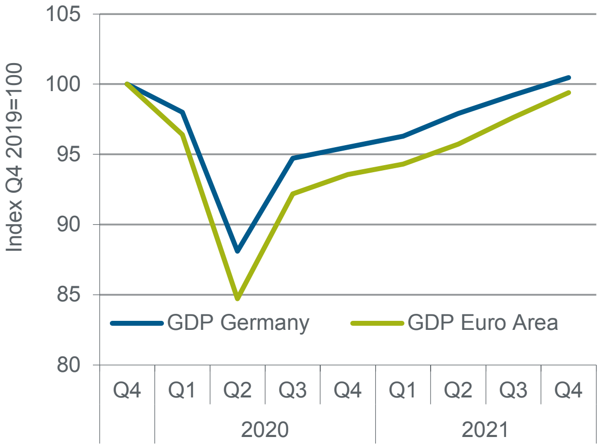
### Second wave and other risks

Starting from a low level, many European countries as well as Germany have reported rising daily new infections again since mid-July. The growth momentum is not as fast as during the first wave of infections in March, however, although differences in testing frequency and strategy make comparisons difficult. The reproduction rate estimated by the Robert Koch Institute has averaged 1.15 since mid-July, indicating that the pandemic is spreading in Germany. However, the R-value has so far remained relatively constant and is significantly lower than in the first half of March (2.26–3.41). We expect a base scenario in which the rise in new infections can be stopped with more effective tracing of infection chains and economically relatively innocuous measures such as stricter mask-wearing requirements, restrictions on private gatherings and a more consistent enforcement of distancing rules already in place. A pronounced second wave of infections in Germany and in Europe as a whole, however, remains a significant downward risk. In that case, it is true that knowledge acquired in the meantime will enable more targeted and regional containment measures than in spring. But second-round effects such as business insolvencies would probably increase considerably. As a risk scenario with local lockdowns in autumn and winter, we believe it is plausible to assume that Germany's economic output would contract by almost 8% in 2020 and grow by just +3% in the next year. In the euro area, financial markets' confidence in member states such as Italy might also come under stress if there is a pronounced second wave of infections. Even without a second wave, a surprisingly sharp rise in business insolvencies would be a downside risk for 2021. Failure to reach a trade agreement with the United Kingdom and an escalation of the trade and geopolitical conflict between the US and China are further risks, although their short-term negative impact on Germany would be relatively moderate.

**Euro area will contract by around 8%**

Economic output in the other major euro countries Italy (-17.8%), France (-19.7%) and, in particular, Spain (-23.7%) contracted much more sharply in the first half of the year than in Germany (-11.5%). As they were hit harder by the pandemic, they adopted more drastic containment measures on the one hand. On the other hand, the particularly hard-hit sectors such as tourism are very important, especially in Italy and Spain. However, a strong catch-up movement already began across the entire euro area in May. But infection rates are picking up very fast again, above all in Spain, threatening to overwhelm the healthcare system yet again in some regions. Spain's economic output must therefore be expected to dive by a good 13% this year. We expect Italy's GDP to contract by -11%, while France is likely to get through the year with a drop of only 9% thanks to the particularly strong catch-up movement seen so far. In the euro area as a whole, we expect gross domestic product to decline by 8% on average this year. In the coming year, economic output is likely to grow by just under 6%, boosted by a vaccine and the rebound that has already begun.

**Figure 3: Basic scenarios KfW Research**




Sources: Eurostat, KfW Research