Hoping for a strong recovery after a difficult winter

24 November 2020

Author: Dr Klaus Borger, phone +49 69 7431-2455, klaus.borger@kfw.de
Press contact: Christine Volk, phone +49 69 7431-3867, christine.volk@kfw.de

– In the summer months Germany and the euro area were able to offset a large part of the previous economic contraction. Gross domestic product in both economic areas has returned to 96% of the level recorded before the coronavirus pandemic.

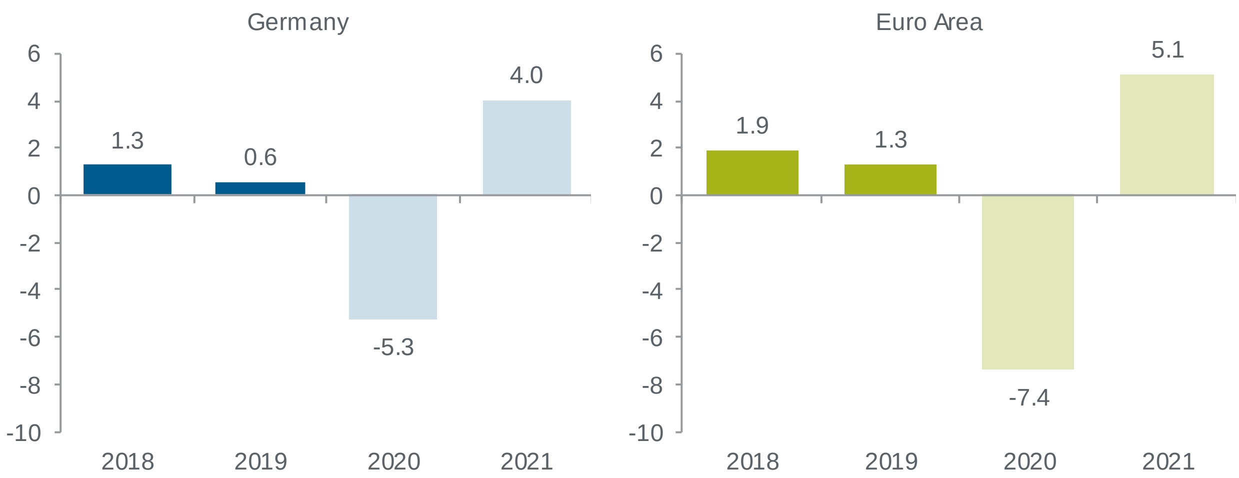
– However, as a result of the recent sharp rise in the number of new infections and the restrictions that became necessary, the recovery will stagnate temporarily. An overall decline in economic output is to be expected for the winter half-year of 2020/2021.

– Based on the encouraging perspective that effective vaccines will soon be available, KfW Research forecasts that the return to public life and social activities will lead to a surge in growth from next spring.

– On balance, KfW Research expects price-adjusted gross domestic product to grow by 4.0% in 2021, after contracting by 5.3% this year. On a quarterly basis, the pre-crisis level should be restored at the end of 2021.

– The euro area's price-adjusted gross domestic product will likely grow by 5.1% in 2021 on the back of vigorous catch-up growth after contracting by an expected 7.4% in 2020. However, the euro area as a whole will still fall short of the pre-crisis level in 2021.

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 quarterly growth over the summer

Adjusted for price, seasonal and calendar variations, Germany's third-quarter 2020 gross domestic product (GDP) grew by an historic 8.5% on the previous quarter, much more strongly than in any other quarter since 1970, the beginning of the time series. It was boosted by the large government rescue packages aimed at stabilising the economy during the COVID-19 pandemic and by the considerable easing of restrictions on public life from May after the successful containment of the first wave of infections. The crisis-induced contraction of GDP by a cumulative 11.5% in the first half of 2020 could thus be offset again in large over the summer, with Germany's GDP now standing at 96% of the pre-crisis level recorded in the final quarter of 2019.

Euro area has also returned to 96% of pre-crisis level

Economic output in the euro area also returned to 96% of its pre-crisis level in the third quarter, although with significantly sharper downward swings (a cumulative -15.1% in the first and second quarter) and upward swings (+12.6% in the third quarter). This rollercoaster ride was much more pronounced than in Germany. For one thing, it was driven by the much tighter coronavirus restrictions at the time in important European countries such as Italy, France and Spain, some of which included shutting down all non-essential businesses. For another, the relatively larger economic weight of services that necessarily require social contact such as hospitality, the most important sector for tourism, played a role as well.

Recovery is set to stop temporarily in the winter half-year

Contact-intensive service industries are now confronted yet again with the consequences of a new partial lockdown, which went into effect at the beginning of November with the aim of putting the brakes on the renewed sharp increase in COVID-19 infections since the start of autumn. It was initially planned to last until the end of November. On 23 November the seven-day incidence continued at 143, which was significantly above the 50 mark officially set as barely controllable given the health authorities' contact tracing capacities. The country will therefore have to prepare to endure significant restrictions on public life even beyond the end of November. Against this background we expect GDP to shrink again in the fourth quarter of 2020, although the contraction will likely be much less dramatic than in the spring, at -1% on the previous quarter. With tight restrictions still in place and what will likely continue to be a rather cautious approach to spending on the part of private households and businesses in the face of uncertainty, we expect the countermovement in real growth to remain incomplete and amount to around ½% in the first quarter of 2021.

Manufacturing partly offsets decline in service industries

We expect the overall damage to the economy this time to be much less serious than in the spring. One reason is that retail outlets, schools and child daycare centres will generally remain open. Keeping schools and child daycare facilities in operation is relevant for parents' employment in the short term and for the children's future prospects in the long term. However, it is uncertain whether this decision from late October can be maintained without restrictions for the period that lies ahead. Another, even stronger reason for our prediction is the robust recovery of the manufacturing sector, which can be inferred from both the soft and the hard indicators. Thus, the KfW ifo Business Climate Indicator for this sector took a giant leap upward in the last three months (SMEs: +16.7 balance points; large enterprises: +26.4 balance points; each based on the average for the months of August to October compared with the preceding three-month period). Unlike in the spring, there are no significant disruptions to value chains at present and, above all, international demand for German manufacturing products is also picking up strongly (total orders received were +29.2%, with +15.5% from within Germany and +40.6% from abroad, each in the third quarter compared with the previous quarter). The stock of orders was 0.9% higher in September than in February, the month preceding the outbreak of the pandemic. Arithmetically, it is sufficient to fully utilise factory production capacity for 6.4 months; on average for the year 2019 the order stock was just enough for nearly 5.7 months. Thus, the upward trend in industrial output will make up for a major portion of the inevitable losses in turnover in sectors directly affected by the partial lockdown – hospitality, entertainment, culture, sport and most personal services – and significantly cushion the contraction in GDP. In the affected service sectors themselves, turnover losses will again be substantial, as they were in the spring but these sectors combined account for only a modest share of 3.7% of GDP. Besides, some activities that generate turnover there are still allowed (such as restaurant food delivery services), so that their share in GDP even overestimates the actual loss.

Growth spurt from next spring

The most recent announcements of vaccine efficacy by Pfizer/BioNTech and Moderna mean there is a good chance that effective mass immunisation campaigns can be launched from next spring. The real prospect of being able to return to public and social life and the foreseeable end to the COVID-19 pandemic are set to give business and the society an enormous confidence boost that should ensure a very strong temporary growth spurt. Businesses already proved this summer that they have the ability to do this – also thanks to the comprehensive coronavirus shield that was deployed to preserve economic potential. On the expenditure side, those GDP components that had suffered the deepest plunge as a result of the crisis are then likely to rebound particularly strongly. Apart from the usual cyclical components such as fixed capital formation in machinery and equipment and exports, this will also include private consumption this time. During the period of the pandemic, private households saved a much larger portion of their disposable income than usual (21.1% in the second quarter of 2020 compared with 10.2% on average between 2010 and 2019), which can be mobilised for demand. This also puts into perspective the dampening effect of the expiration of the temporary reduction in value added tax at the end of the year, as does the scrapping of the solidarity surcharge for the bulk of taxpayers from next year.

Germany's GDP is set to grow by 4.0% in 2021

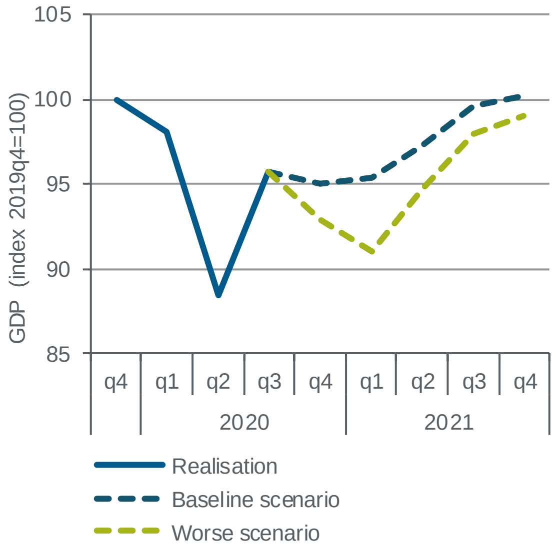
On balance, KfW Research expects price-adjusted GDP to grow by 4.0% in 2021 (price and calendar-adjusted: +4.0%), after contracting by 5.3% this year (price and calendar-adjusted: -5.6%). On a quarterly basis, the pre-crisis GDP of the final quarter of 2019 would thus be restored after two years, at the end of 2021. In the year as a whole, however, GDP in 2021 would still lag around 1.5% behind its 2019 level. Compared with our previous forecast from August, our new prediction means a slight upgrade for 2020 and a somewhat sharper downgrade for 2021, with the revision for

2021 primarily due to the difficult economic situation in the winter half-year and the resulting unfavourable start to the year 2021.[1]

In the short term, the pandemic will remain the greatest risk

The main long-term economic risks of the past years, such as the tensions in global trade relations and Brexit, have lately faded considerably with the election of Joe Biden to the US presidency and rumours circulating at the time of this publication on the EU and the United Kingdom making progress on the shape of their long-term relations. Unexpected setbacks in the fight against the COVID-19 pandemic therefore remain by far the greatest threat to the business cycle, even if trade and geopolitical tensions as well as possible renewed conflict between the EU and the United Kingdom in the year 2021 and beyond are risks that generally cannot be ruled out. This is especially true in the short term until an effective vaccine is actually available.

Figure 2: Business cycle scenarios for Germany



Source: KfW Research, Destatis

A more negative development of the business cycle than predicted by us in the base scenario is possible particularly if the current measures in Germany and other countries to contain the unacceptably high numbers of new infections are insufficient, or if a renewed flare-up of infections occurs in the first months of 2021 after a brief respite in December. In that case, the country would have to prepare to reintroduce, extend or possibly even tighten lockdown measures. The dampening effect on the economy would be all the more pronounced the more countries in Europe and around the world were affected by such a development, as the recovery in manufacturing would then also come to an end. Second-round effects such as a surprisingly high number of business insolvencies with negative consequences for the banking system's lending capacity could even increase this effect. In such a worse scenario, a pronounced W-shaped economic recovery with a significant second slump in the winter half-year of 2020/2021 would have to be expected, as illustrated in Figure 2. This worse scenario would result in only around 2% economic growth in Germany in 2021, after a contraction of around 6% this year.

Many arrows still left in the economic policy quiver

Even so, in that case it is reassuring to know that enough arrows are still left in the economic policy quiver to effectively combat any unexpected cyclical deterioration. By our calculations, only a good 11% of the EUR 1.4 trillion made available under the coronavirus shield and the economic stimulus programme has actually had to be used so far. The national budget can easily handle the financial burden. According to the European Commission's recently published autumn forecast, Germany's expected general government gross debt ratio of 71% of GDP in the year 2020 will be not just significantly lower than after the financial crisis (2010: 82%) but also much lower than other countries' typical levels (US 128%, Japan 266%, UK 104%, EU 94%). Sustainable government finances ultimately mean that interest expenditure remains manageable in relation to revenues. Whereas Germany still had to employ 7.7% of government revenue for interest payments after reunification (1995) and 5.6% after the financial crisis (2010), it will presumably be little more than 1% on average from 2020 to 2022 despite the coronavirus crisis.

Sharper swings in the euro area business cycle

The business cycle profile of the euro area as a whole should be similar to that of Germany, although with greater swings, as was the case in the spring. We expect the euro area's price-adjusted gross domestic product to grow by 5.1% in 2021 on the back of vigorous catch-up growth after likely contracting by 7.4% in 2020. It will thus still fall short of the pre-crisis level next year, both on a quarterly basis (final quarter 2021: 99% of the final quarter of 2019) and on an annual basis (2021: 97% of the year 2019).

[1] In our August forecast we deliberately dispensed with the usual decimal places because of the massively increased uncertainty from the COVID-19 pandemic, as we had done in the spring, and predicted a GDP contraction of around 6% for 2020 and growth of approx. 5% for 2021. The methodology used therefore limits the comparability of our forecast to the previous one, particularly since we deliberately discounted in August the very high calendar effect of nearly 0.4 percentage points in 2020 (growth contribution of around four more working days than in 2019).