Germany and the euro area: Recovery merely paused by second wave

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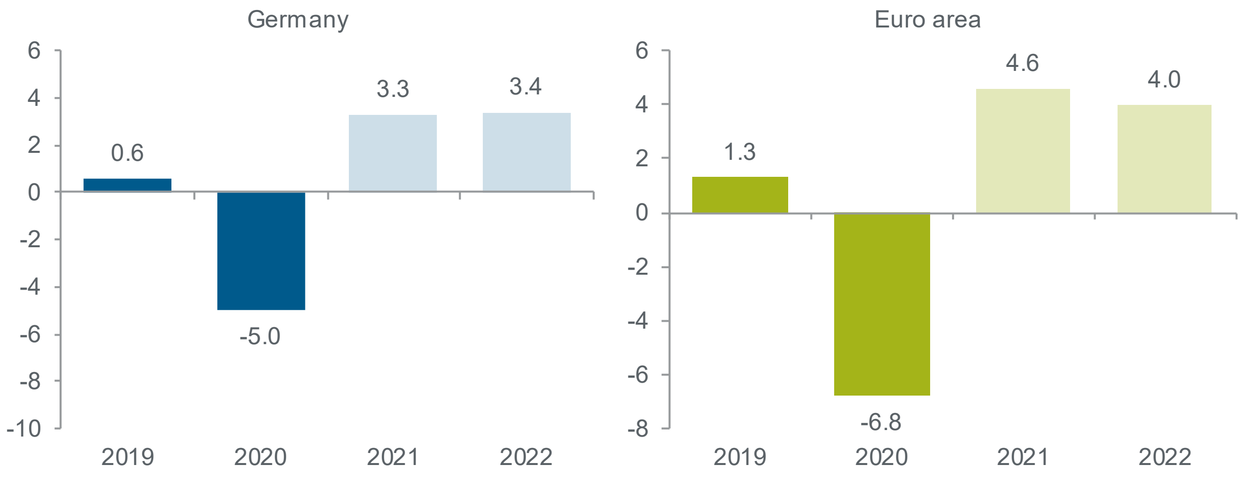
– Germany ended the year 2020 on a stable note despite the second coronavirus wave and renewed lockdown: GDP grew by 0.3% in the final quarter on the back of a sustained recovery in manufacturing. The drop in euro area GDP was very moderate.
– Continued high infection rates, the risk of more contagious virus mutations and related extended restrictions, however, will now cause Germany's first-quarter 2021 GDP to contract noticeably by 1.5 to 3%.
– With progress made in the rollout of vaccines and restrictions being eased cautiously and then more broadly as the virus is controlled and a third wave is avoided, KfW Research expects a recovery in the spring and a growth spurt in the summer.
– Overall, KfW Research forecasts a 3.3% increase in real GDP for Germany in 2021 (previous forecast in November: +4.0%) and growth of 3.4% for 2022 (initial forecast). The pre-crisis level will presumably be reached again in the fourth quarter of 2021.
– Driven by vigorous catch-up growth, real GDP in the euro area is set to grow 4.6% in 2021 (previous forecast November: +5.1%) and 4.0% in 2022 (initial forecast). But the euro area as a whole will not return to 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

German economy steady despite second coronavirus wave

After last summer's historic catch-up process, Germany's economy closed the year on a steady course. Despite the second coronavirus wave with restrictions imposed at the beginning of November and tightened in mid-December 2020, final-quarter gross domestic product (GDP) – adjusted for price, seasonal and calendar variations – grew by 0.3% on the previous quarter. The strong 6.7% output growth in manufacturing offset the foreseeable declines in the restricted service industries. Manufacturing benefited from the recovery of external trade, as illustrated by the significant 4.5% growth in exports.

Moderate drop in euro area GDP

Euro area GDP contracted by 0.6% in the final quarter of 2020. The decline was very moderate considering the challenges presented by the strong rise in new infections everywhere and the hard lockdowns imposed in some countries, especially France. Thus, at the end of the crisis year of 2020, overall economic output in real terms was at 95.0% of the pre-crisis level of the final quarter of 2019 in the euro area, compared with 96.4% in Germany. In our view, the extremely moderate drop in the euro area – compared with the experiences of the first coronavirus wave in the spring of last year – and the steady trend in Germany, along with the currently supportive performance of manufacturing, suggest that the affected businesses have now adapted somewhat better to the pandemic conditions. Retailers, entertainment and cultural sectors, for example, can now provide online options and restaurants can offer deliveries as a way to generate at least some turnover.

A difficult start to the year 2021 ...

Irrespective of these positive signs, the economy is off to a difficult start to the year 2021. We expect many contact-intensive service industries to remain closed until the end of the first quarter. To be sure, new COVID-19 infections have fallen continuously since mid-January. But the decline recently came to a standstill and new infections as at 24 February were 59.3, above the case rate threshold of 50 cases per 100,000 persons over a seven-day period. In addition to continuing high infection rates, the vaccine rollout has been sluggish and significantly more contagious virus mutations present a new risk. The growing spread of the UK variant B.1.1.7 is presumed to be the cause of the current stagnation in case numbers and, in the worst of cases, may even trigger a third wave. All of this warrants a cautious lockdown relaxation strategy. Although the current restrictions in contact-intensive services industries are not any tighter than during the first lockdown, they remain in effect for a much longer period. This time, non-essential retail, for example, must remain closed from mid-December into the month of March, twice as long as in the spring of 2020. The expiry of the temporary VAT reduction at the end of the year is also having a negative impact.

... leads to a sharp drop in quarterly GDP

At the same time, the still very strong momentum in the manufacturing sector is likely to level off, making it a weaker counterweight to the renewed significant turnover losses in the sectors directly affected by the lockdown: retail, hospitality, entertainment, arts and culture, sport and most personal services. Orders received in the manufacturing sector in December 2020 fell for the first time in eight months (-1.9% on November) and a semiconductor shortage is temporarily slowing production in the automotive industry. The closure of borders with Austria and the Czech Republic that was imposed in mid-February may also temporarily disrupt industrial value chains. On balance we expect GDP to contract noticeably in the first quarter of 2021, even though the presumed drop of -1.5 to -3% will not be nearly as steep as during the first lockdown in the second quarter of 2020 (-9.7%), when manufacturing nosedived together with services.

Recovery in the spring, growth spurt in summer

The outlook will brighten noticeably in the spring and summer. We expect the rollout of vaccines to be greatly accelerated, first for high-risk groups and then for further groups, and restrictions potentially to be lifted gradually, for example in hospitality, as case numbers stabilise. The recovery from the low level will enable strong growth in the second quarter. From the third quarter, progress in vaccinations will probably make it significantly more difficult for the virus to spread, which may ultimately allow all economically relevant restrictions (except mask wearing and similar hygiene requirements) to be largely lifted. This will provide further growth impetus in the summer.

Germany’s economy will likely grow by 3.3% in 2021

We expect price-adjusted GDP in Germany to rise by 3.3% in 2021 (previous forecast from November 2020: +4.0%). As 2021 has practically the same number of working days as 2020, the calendar effect this year is negligible so that our forecast is for price and calendar-adjusted GDP growth of 3.3% as well. The downgrade from our previous forecast is mainly driven by our much more negative outlook on the first quarter of 2021. On the other hand, since the final quarter of 2020 was better than expected in our previous forecast, the slightly lower growth now predicted in the course of 2021 will be sufficient for GDP to return to the pre-crisis level of the final quarter of 2019 after two years, meaning the end of 2021. Our current and previous forecasts are therefore materially closer than it may seem based on the downgrade of 0.7 percentage points.

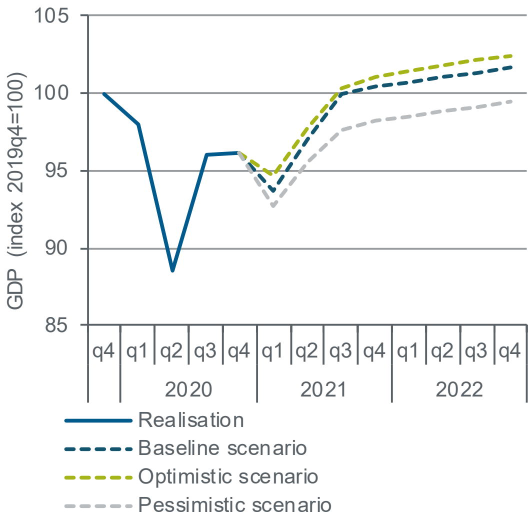
GDP growth rate of 3.4% in 2022 similar to 2021

Our initial forecast for 2022 is for price-adjusted GDP growth of 3.4% (price and calendar-adjusted: +3.5%), a similar rate as for the current year. The high annual growth rate will again benefit from an extremely favourable starting level resulting from the strong momentum built up over the course of 2021 (statistical overhang: +2.7%), while quarterly growth is likely to level off again to the trend rate of around 0.3% in the course of the coming year. A return to trend growth after reaching the pre-crisis level appears to us to be the most solid assumption given high forecast uncertainty and opposing influencing factors. In the medium term, for example, increased corporate debt and the beginning consolidation of the national budget may weigh on growth, contrasting with persistent catching-up effects in consumption for which private households can draw on the significantly above-average savings they have built up during the lockdown. Private households saved about 50% more money overall in 2020 than in 2019. Their saving rate of 16.2% is by far the highest ever recorded.

Pandemic remains greatest risk to the economy for now

The highly dynamic development of the pandemic means forecast risks on both sides, particularly as a function of vaccine progress, vaccine efficacy (protection from disease for vaccinated people only, or protection of others from non-contagious vaccinated people), the constant possibility of virus mutations, related adjustments to restrictions (towards tightening or easing) and specific impacts on the economy (as businesses adapt to changing conditions). Assuming an otherwise nearly identical quarterly profile, a possible smaller dip in GDP in the first quarter of 2021 would already drive annual growth in 2021 up to a rate of 4.0% (see optimistic scenario in Figure 2). With the 0.3% increase in the final quarter of 2020, GDP outperformed the forecasts, the vast majority of which expected a decline, underscoring the possibility of positive surprises in an exemplary way. Furthermore, risks have faded since the EU and the United Kingdom have agreed on a trade and cooperation agreement and since the election of the new US president Biden has raised the prospect of more multilateralism in global trade relations.

Figure 2: Business cycle scenarios for Germany



Source: KfW Research, Destatis

As infection rates remain high and the risk of a third wave remains difficult to assess given the emergence of virus mutations, however, less favourable scenarios are possible with a noteworthy probability. In such a pessimistic scenario, we expect annual growth of only 1.5% in 2021. A downward risk will arise particularly if manufacturing is also hampered by restrictions or disruptions to value chains and the hitherto stabilising recovery of the industrial sector slows more abruptly than expected. 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. Second-round effects such as an unexpectedly high number of business insolvencies with negative consequences for the banking system's lending capacity could even increase this effect. A protracted delay in the vaccination campaign could also slow the recovery. We currently believe that the downside risks are generally higher than the upside risks of the forecast, which is expressed in the asymmetrical corridor of the marginal scenarios around the GDP path in the base scenario in Figure 2.

Euro area back to pre-crisis level later

We expect the cyclical profile in the euro area to be similar to that in Germany in qualitative terms. But after the much steeper drop in the past year (Germany 2020: -4.9%; euro area: -6.8%), a stronger upward countermovement is now to be expected for this year and the next. Specifically, we expect price-adjusted GDP in the euro area to grow by 4.6% in 2021 (previous forecast from November 2020: +5.1%) and by a further 4.0% in 2022, especially on the back of the momentum built up in the course of the previous year (initial forecast). The large euro countries Spain and Italy, however, will not return to their pre-crisis levels until the second half of 2022 owing to the relatively high importance of the tourism sector, which has taken a particularly hard hit from the coronavirus pandemic. By contrast, France will presumably return to its pre-crisis level in the first quarter of 2022, one quarter after Germany, as will the euro area as a whole. At European level as well, the rapid spread of more contagious virus mutations is likely to be the economic risk that needs to be monitored most carefully. The spread of mutations could mean that another exponential rise in case numbers may occur again in a matter of weeks even with measures that recently led to a slight drop in infection rates. The possibility therefore exists that tighter restrictions will be imposed yet again and reduce economic activity. However, the experience of the United Kingdom shows that even with the B.1.1.7 mutation spreading it is possible to quickly reduce infection rates without shutting down manufacturing and construction.