Germany and the euro area: at the end of the tunnel?

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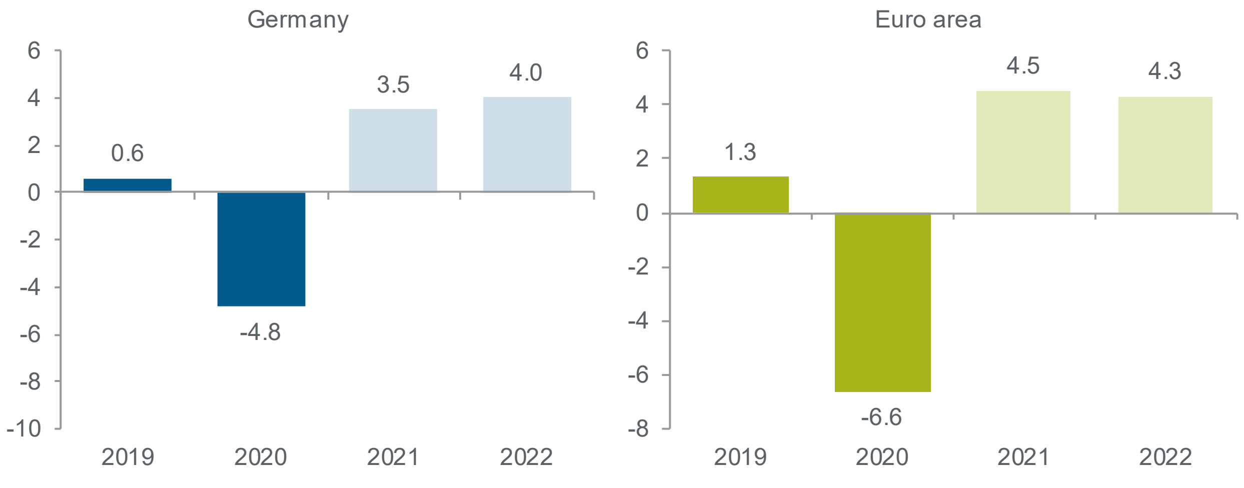
- The pandemic and the long lockdown at the start of the year left a deep mark on Germany's gross domestic product, causing it to shrink by 1.8% in the first quarter. The euro area fared slightly better, contracting by 0.6%.
- Vaccination progress has since picked up and the third infection wave has been contained. With the first steps towards a reopening, Germany's GDP is likely to grow by 1 to 2% in the current quarter. A strong surge is expected to follow in the summer.
- KfW Research expects Germany's GDP to rise by 3.5% on a price-adjusted basis in 2021 as a whole (previous forecast in February: +3.3%). Because of a considerable statistical overhang from the current year, we predict 4.0% growth for 2022 (previous forecast: 3.5%).
- On the back of vigorous catch-up growth, euro area GDP is set to expand by 4.5% in 2021 (previous forecast: +4.6%) and by 4.3% in 2022 (previous forecast: 4.0%).
- The pandemic continues to pose particular downside risks to this forecast. However, should the supply bottlenecks in the manufacturing sector be resolved quickly, growth might even surprise in a positive way.

Figure 1: Gross domestic product of Germany and the Euro area
Change on previous year in percent, adjusted for prices



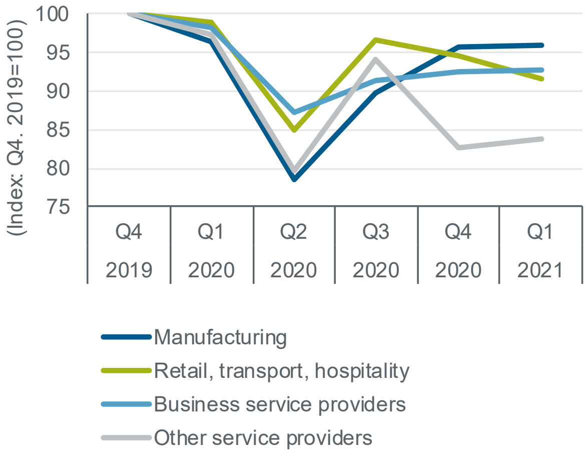
Source: KfW Research, Destatis

Germany's GDP shrank in the coronavirus winter

The second wave of infections and the long lockdown led to a sharp decline in Germany's economic output at the start of the year. In the first quarter, gross domestic product adjusted for price, seasonal and calendar effects decreased by 1.8% on the previous quarter. Gross value added in the retail, transport and hospitality sector, which was hit particularly hard by the restrictions, even contracted by 3.2%. Unlike in the previous quarter, the manufacturing sector hardly cushioned this decline. Hampered by a shortage of inputs, value added in manufacturing rose by a mere 0.4%. The construction sector even recorded a distinctive quarterly drop of 4.9% which was partly due to periods of unusually cold weather combined with pull-forward effects resulting from the expiry of the temporary value-added tax reduction. On the expenditure side, private consumption in particular contributed to the negative quarterly result, dropping by 5.4%.

Figure 2: Development of gross value added

In manufacturing and in the services segments hit particularly hard by the pandemic, adjusted for price, seasonal and calendar effects.



Source: KfW Research, Destatis

Moderate drop in euro area GDP

The monetary union also started the year 2021 with shrinking economic output. However, the differences in the timing of alternating restrictions and relaxations meant that the 0.6% drop in GDP turned out slightly more moderate than in Germany. France, in particular, had already contained its second wave of infections with a lockdown in autumn and then primarily focused on relatively business-friendly evening curfews, enabling modest growth of 0.4% in the first quarter. In Italy and Spain, gross domestic product shrank slightly by 0.4 and 0.5%, respectively, with somewhat milder restrictions imposed on average across the quarter than in Germany but with stricter interventions than in France.

Hope for services businesses

Even if the pandemic with its wavelike progression has led to repeated disappointments, the end of the tunnel now appears to be near even for the services segments that were hit hard by restrictions. After all, vaccination progress in Germany and throughout the EU has ramped up quickly since the beginning of the second quarter thanks to a significantly increased supply of vaccines. By the end of June, a good half of the German population will have received at least their first dose, which already provides high protection against severe disease progression. Furthermore, new infections have been on the decline since the end of April, so that increasingly more federal states and districts are currently falling below the threshold at which gradual openings in retail, hospitality, personal services and some recreational and cultural businesses are admissible under the 'federal emergency brake' that only went into effect on 23 April. If new infection rates continue to decline despite relaxations and pandemic fatigue, the critical services segments should also grow again on a quarterly average for the first time since the summer of 2020. But it will probably not be until the next quarter that the re-openings will be sufficient for a strong recovery and, hence, a considerable GDP growth surge. Activity in most high-contact service segments will then likely move closer to pre-crisis levels again in the course of next year.

Producing sector still has a spanner in the works

The manufacturing and construction industries, by contrast, already decoupled from the pandemic-induced slump since autumn. Thanks to strong demand from buyers outside Europe, but also due to vigorous domestic demand for industrial goods, manufacturing orders have recovered rapidly and in March already exceeded the level of early 2020 by 6%. But supply bottlenecks mean that manufacturers are having difficulty working through their well-filled order books. As a result, industrial production continues to hover around 5% below pre-crisis levels. Shortages currently affect a wide range of inputs and materials from semiconductors to timber, disrupting production both in important industrial sectors such as automotives and in the construction industry. But as companies are expecting very high levels of business and production operations despite the known supply problems, ultimately this is likely to be a temporary issue. Rising prices will encourage an expansion in the production of inputs, so that a strong boost from the production sector can be expected again, especially in the second half of the year.

Germany's economy will likely grow by 3.5% in 2021

Germany's GDP is likely to grow again in the current quarter, offsetting most of the decline of the previous quarter. The summer will likely bring a strong growth rebound and aggregate economic output will probably exceed the pre-crisis level in autumn. On average for the year, we expect a price-adjusted GDP growth rate of 3.5%. As the calendar effect is negligible this year, this forecast is for price and calendar-adjusted GDP growth of 3.5% as well. The slight upgrade from our previous forecast of February (2021: +3.3%) mainly results from a revision of data in the previous year. The growth rate in the third and fourth quarter and the average growth rate for the year 2020 (now -4.8% instead of -4.9%) were marginally upgraded by the Federal Statistical Office, raising the statistical overhang from the previous year by a good 0.2 percentage points. The contraction of -1.8% in the first quarter of 2021 turned out slightly more moderate than feared in February but part of the recovery process expected for the current quarter is being pushed back, so this hardly changes our forecast for the year 2021 as a whole.

GDP growth in 2022: 4.0% will do more than it looks

The weak start to the year and the expected strong growth in the second half of 2021 will result in an exceptionally large statistical overhang for 2022 (+3.1%). This momentum from the previous year is the main reason that we expect price-adjusted GDP to grow by an unusually high rate of 4.0% in 2022 (also adjusted for price and calendar variations). But we expect only average quarterly growth rates throughout the next year as positive and negative factors will roughly offset one another. The increased corporate debt resulting from losses during the crisis and the beginning consolidation of the national budget are among the factors weighing on growth. On the positive side, demand from abroad will likely be strong, particularly from the US economy, which is being bolstered by stimulus packages, but also from Europe, where significant additional expenditure is scheduled under the EU Recovery Fund. Besides, excess savings accumulated by private households during the lockdowns – amounting to around 4% of GDP from 2020 alone – provide potential for vigorous domestic demand.

Euro area: +4.5% in 2021 and +4.3% in 2022

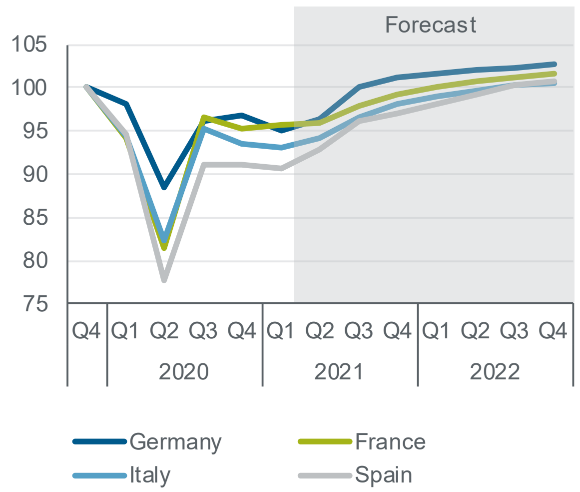
The same economic drivers are currently present everywhere across the euro area, with comparable vaccination progress made possible by joint vaccine procurement and strong global demand for industrial goods. We therefore expect a similar quarterly profile for the euro area as a whole and for the four large euro countries Germany, France, Italy and Spain this year, with a strong growth surge in the summer quarter. However, given the still uncertain pandemic situation and the numerous virus mutations, the recovery of international tourism is likely to be delayed even more into the next year than was expected in February, so we have slightly downgraded our forecasts for 2021 for Italy and Spain in particular, whose economies depend more strongly on tourism. This results in a minimal downside revision this year and a slightly more positive picture for 2022 in the euro area as a whole. Specifically, we expect price-adjusted GDP in the euro area to grow by 4.5% in 2021 (previous forecast from February: +4.6%) and by a further 4.3% in 2022, also on the back of the momentum built up in the course of 2021 (previous forecast: 4.0%). Growth will thus not exceed the pre-crisis level until the first quarter of 2022. We expect the same for France. Italy and Spain, however, will not return to pre-crisis levels until the summer of 2022.

Upside and downside risks

The light at the end of the pandemic tunnel is becoming increasingly brighter and the gap between the manufacturing sector and the critical services segments is beginning to close. Still, the pandemic continues to pose significant risks. The spread of vaccine-resistant mutations would be a serious threat. But even without such mutations, significant waves of infections can re-surge after restrictions are lifted prematurely even if the majority of the population has been immunised. The purely economic uncertainties include rising insolvencies of businesses that have received government support and a stronger than expected increase in unemployment. To be sure, as opposed to the years following the global financial crisis, the likelihood of monetary and fiscal policy support in the euro area winding down prematurely is now slim thanks to favourable financing conditions. But should the US economy overheat, or in the unlikely event of a prolonged phase of increased inflation in the euro area, the macroeconomic environment could change abruptly. Conversely, the generally high optimism about the US economy also offers potential for disappointment given the slowing pace of vaccination in the US. Germany and the euro area can grow faster than predicted particularly if the supply shortages in the manufacturing sector are resolved quickly, or if the funds spent under the EU Recovery Fund come with considerable multiplier effects.

Figure 3: Growth projections for the euro-4 countries

GDP indexed: Q4 2019=100, adjusted for price, seasonal and calendar variations.



Price-adjusted GDP growth on an annual basis

	DE	FR	IT	ES
2020	-4.8	-8.2	-8.9	-11.0
2021	3.5	5.8	4.6	6.2
2022	4.0	3.8	4.5	5.8

Source: KfW Research, Eurostat