

## »»» Where to from here? The crucial next steps in the coronavirus crisis

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### Motivation

The economic crisis from the coronavirus shock is unprecedented in the speed of its spread, its depth and global scale. As the shock originated outside the economy, a quick restart of economic activity is possible in principle. However, continuing high uncertainty makes a broad economic recovery particularly difficult. Overcoming three immediate challenges is therefore crucial for the speed and nature of this recovery:

1. Business debt and its ramifications,
2. Seizing opportunities from an acceleration of digitalisation and
3. Maintaining a focus on and working to transition towards a carbon-neutral economy.

The following position paper aims to describe these challenges and provide impetus for their solutions.

### 1. Crisis and crisis responses

**Germany has weathered the coronavirus pandemic relatively well so far but its economy will not return to pre-crisis levels before the end of 2021.** Germany and the world have been abruptly plunged into a deep economic pit. We probably passed the low point in April but the road back to pre-crisis levels is rocky and long. The pandemic is not over yet and the current rapid recovery rate will probably slow significantly soon. We expect GDP to plummet by around 6% in 2020, followed by catch-of growth of approx. 5% in 2021.

**Continuing enormous uncertainty and pressure on company balance sheets resulting from losses in turnover are leading to investment restraint around the globe.** Besides 'problem children', such as hospitality and aviation, it is above all the manufacturing industry with its cyclical focus on capital goods and inputs and closer integration into the global economy that will remain under pressure for longer.

**The coronavirus crisis is quite unlike other economic crises.** The pandemic-induced shutdown of entire economies was the necessary response to an exogenous shock. This means that, in contrast to the financial crisis of 2008 and 2009, there is no need to correct any debt excesses or misguided structural developments of the past. Thus, the recovery can be quicker in principle. However, the economic slump has been exceptionally fast and deep and, in particular, global.

**In our view, this poses three main direct challenges for Germany and meeting them is crucial for the speed and nature of the recovery: 1. Business debt and its ramifications, 2. The opportunities from speeding up digitalisation 3. Maintaining a focus on and working to transition towards a carbon-neutral economy.** Failure to address these challenges can jeopardise the recovery. Debt burdens in what has been a well-funded business ecosystem are weighing on necessary investment and, in an extreme case, could lead to a wave of insolvencies, with every conceivable consequence for employers, employees and banks. Doubts exist whether opportunities which the crisis undoubtedly also holds, such as speeding up the trend towards digitalisation, are being harnessed with determination. And there is also the danger that important long-term issues, particularly achieving climate neutrality, are being neglected in the current drive to rein in the crisis. How well we master these challenges will be crucial for the speed and quality of the recovery.

**The government's response to the crisis is right:** Preserve economic capacities, stimulate economic activity and frame the economic transformation. The support package rolled out quickly and comprehensively has shielded the economy and society from acute damage and preserved the economy's productive potential. The economic and sustainability packages aim to chart pathways out of the crisis and then engineer the structural transformation for a better future. The fiscal measures are being accompanied by substantial contributions from the European Central Bank to the functioning of financial markets.

**Renewed faith is one of the most important keys to a sustainable upturn.** The coronavirus crisis and the broad range of new experiences it has brought can become a catalyst for necessary transformation. Economic policy can build on enhanced faith in the government's problem-solving skills and a high willingness on the part of the population to embrace flexibility. Fiscal stabilisation policy and monetary policy are buying time over the short term. In the medium term, the economy must succeed in mostly standing on its own two feet again. That requires consumers and businesses to have faith in the economy's future viability.

## **2. Coronavirus trends – challenges during and after the crisis**

**The three immediate challenges are closely interwoven and overlap with medium and long-term fields of action in which the course must be plotted for a sustainable recovery.** The fields of action identified by KfW Research are the following: Making the economy more resilient to crises, fostering the transition towards a carbon-neutral economy, translating inventiveness and reduced mistrust in digitalisation into productivity increases, continuing to use the advantages of international integration and avoiding a nationalisation of value chains, as well as strengthening Europe.<sup>1</sup> While the challenge of indebtedness is also closely tied to crisis resilience, it has taken on a prominent role because of the speed of the spread and the enormity of the coronavirus crisis. With respect to the second challenge of digitalisation and innovation, the impulse from the crisis must be translated into more profound transformations and, thus, competitiveness. The danger that the immediate economic crisis overshadows the urgency of the long-term climate crisis requires a special, direct focus on the third challenge as well. If reasonable efforts are undertaken and sufficient funds are invested, both a digitalisation and innovation surge and the transformation towards a climate-neutral economy can contribute to the recovery. How this can be accomplished quickly and effectively in light of the current indebtedness situation is the key question that guides the following considerations.

### **2.1 Debt and liquidity position of companies and the situation of banks**

**The pandemic-induced losses in turnover have put great pressure on companies' liquidity and caused payment difficulties for many.** In order to bridge the liquidity gap, businesses have received emergency assistance and bridging funds under government subsidy programmes and drawn on existing credit lines as well as taken up new loans. Accordingly, the momentum of new lending to businesses has been strong in the first half of 2020. After the pace of growth already doubled in the first quarter to 7.3%, new lending commitments in the second quarter were only marginally lower. Loans are being used mainly to keep businesses operating, while the financing of capital expenditure has slipped into the background. As lending has expanded and pressure on the equity base has been increasing as a result of losses, debt to equity ratios in the business sector can be expected to be on the rise. At the beginning of June, 45% of SMEs were expecting their equity ratio for the current business year to remain steady, while 29% were anticipating a deterioration.

**The risk of overindebtedness across the business sector is low, however, although differences exist between sectors.** Whereas turnovers in the hospitality sector in June were still almost 30% below the February level, retail turnovers now exceed pre-crisis levels again significantly. Turnovers of vehicles and vehicle parts still need to rise by 20% to match February levels, mechanical engineering by 10%. Businesses in Germany generally had a solid basis to start from. On average, equity ratios were on a high level (2018: SMEs 31.2%; businesses overall 31%). The high level of equity helps enterprises to absorb losses in their balance sheets over an extended period of time, preserves their liquidity and strengthens their credit rating, which helps keep access to credit open. Corporate debt in Germany has been moderate lately: the bank debt ratio was a mere 22% in 2017 (1997: 37%).

**Overall, however, many companies will be facing a target conflict after the coronavirus crisis which, in the absence of a vigorous response, will most likely come at the expense of investment.** Forced to choose between strengthening their financial viability and increasing their financial resilience, many companies will lower their sights in growing their productivity and competitiveness through investment, innovation and digitalisation, which also require funds. In sectors that are facing major structural upheavals, such as the automotive industry, the consequences could be fatal. This danger has not been eliminated, especially because of the continuing high uncertainty over global infection spread but also with regard to a second wave of infections in Germany and, thus,

<sup>1</sup> Köhler-Geib et al. (2020): 'Die Krise als Katalysator für nachhaltigeres Wirtschaften' (*Crisis as a catalyst for a more sustainable economy*), position paper, KfW Group, 18 May 2020 (in German only).

a renewed (local) lockdown.

**The banking sector is an important partner for the implementation of companies' investment projects but its income situation is under pressure.** Before the coronavirus crisis, around 15% of small and medium-sized enterprises took on bank loans to finance investment projects every year. Furthermore, the increased debt level of the business sector and the resulting possibility of rising credit default risk pose a challenge for the banking sector.

**A massive banking crisis in Germany because of the coronavirus crisis is unlikely.** The severe pandemic-induced recession will leave deep marks in bank balance sheets because of rising costs of risks and loan defaults which will take time to clear away. After the financial crisis, banks had significantly bolstered their equity and liquidity positions, which is why credit institutions will likely be capable of absorbing the losses. The comprehensive economic-policy measures, which include expansionary monetary policy, the economic stimulus programme and, in particular, state risk guarantees for loans, also contribute decisively to limiting the risk of losses. Banks were therefore able to expand their credit supply in the acute phase of the crisis while only moderately tightening their lending criteria.

**However, there is reason to fear that banks may not be able to adequately support the economic recovery phase.** Rising loan defaults threaten to erode their capital positions, which they cannot compensate on their own in the short term because of weak profitability. The rolling back of state support is therefore likely to cause banks to tighten the supply of credit.

**The strong lending momentum in the first months of the crisis is likely to reverse with the turn of the year 2020/2021.** Businesses will attempt to reduce the debt they incurred to close liquidity gaps, leading to an incomplete recovery in investment activity and related financing requirements. New lending to businesses can therefore be expected to fall, perhaps significantly.

**The coronavirus crisis will tend to exacerbate the major structural challenges for the banking sector, above all the pressure to digitalise operations.** Competition from large tech companies is growing, the negative interest rate environment is consolidating and banks are being called upon to take responsibility for sustainable economic management. The increased urgency to act, however, also comes with an opportunity for faster changes. Physical distancing requirements are speeding up digitalisation, new forms of collaboration with platform companies are emerging and the trend towards branch closures and consolidation is being strengthened. However, both banks and the business sector face the target conflict between financial crisis resilience and medium-term profitability.

## 2.2 Transforming the digitalisation push from the coronavirus crisis into long-term competitiveness

**At first glance, we see a digitalisation push triggered by the coronavirus crisis but investment in larger projects and innovation is falling by the wayside.** For many businesses, measures aimed at increasing innovation and digitalisation constitute a key building block in their crisis management strategy. As a result, innovation and digitalisation projects expanded significantly during the crisis. Businesses that have been hit heavily by the crisis are particularly active in innovating (and tackling digitalisation projects). However, these are usually measures that can be implemented quickly and require little development work.

**Instead, longer-term, more complex and thus more in-depth innovation and digitalisation projects are more often being spread over a longer period or deferred.** The reason is that the financial constraints are making it difficult to mobilise funds – which typically come from internal resources. This 'innovation gap' in more in-depth projects will weigh on the affected enterprises' competitiveness when the crisis is over.

**Capital expenditure has also likely collapsed during the crisis, with consequences for the aggregate economy and Germany as a business location:** Businesses have probably deferred replacement investment in response to pressure on liquidity. The collapse in demand, for its part, has negatively impacted on the need for expansion investment. Furthermore, strengthened protectionist trends can weigh on the export-driven German economy for the longer term beyond the immediate consequences of the coronavirus crisis. What is unclear is whether German enterprises will be able to benefit in the medium term from trade diversion (in a US-China trade war) and from shortened value chains (resulting from increased use of robotics/Industry 4.0). However, it is

already clear that holding off innovation and digitalisation projects as well as reducing capital expenditure could have an adverse impact on Germany as a business location in the medium to long term.

### **2.3 Carbon neutrality: Financial constraints and lower prices of fossil fuels are making it difficult to mobilise necessary investment**

**The public is currently focusing less on climate action than before the coronavirus crisis, with the risk that the issue may fade into the background** (exemplified by a drop in Google searches in this area since March, according to Google Trends). The German goal of achieving carbon neutrality by 2050, however, continues to demand structural change in all areas of the economy through swift and decisive action.

**The necessary structural transformation requires extensive investment, for example in renewable energy, the manufacturing sector and the modernisation of energy systems in buildings.** According to a study conducted by the Federation of German Industries, reducing greenhouse gas emissions by 95% compared with 1990 levels alone will require investment totalling EUR 2.3 trillion over the next 30 years. Financial constraints faced by the relevant actors as a result of the coronavirus crisis are new barriers for mobilising these funds. In addition, lower fossil fuel prices resulting from the crisis make climate-friendly technologies relatively less cost-effective. Against this backdrop, the risk exists that businesses, private and public households defer or abandon necessary capital expenditure altogether.

**Given the economic and social risks of unchecked global temperature increase, economic recovery in the course of the pandemic and action on climate change must go hand-in-hand.** An ambitious climate action policy with corresponding incentives for private investment, public-sector investment and necessary changes to the underlying conditions will open up new markets, contribute to modernising the economy and thus make it fit for the future.

### **3. Impact of the coronavirus crisis on employment**

**The sharp drop in corporate earnings and the need for physical distancing at the workplace have triggered two critical developments in the labour market:** The number of short-time workers jumped to 6.8 million by April and the number of unemployed was 2.9 million in June, up more than 600,000 than in April of the previous year. It will likely rise to just over 3 million in the coming months before the economic recovery leads to a labour market turnaround as well towards the end of the year. Should a second lockdown become necessary, however, a further wave of dismissals may also follow. Furthermore, many companies are aiming to reduce their costs in the long term because of ongoing loss of revenue. This may still result in layoffs next year as well.

**Furthermore, companies are hiring and training fewer workers because of the crisis, so that considerations on measures aimed at bolstering the labour market and start-ups are gaining importance.** The number of job vacancies dropped further after the lockdown to 570,000 in June, more than 200,000 fewer than in the same month last year. Unemployment has increased mainly among workers without qualifications and youths. In the coming months it will be important to prevent unemployment from becoming permanent and leading to lasting disadvantages. The conditions for this have become more difficult because businesses will remain reluctant to fill training places and conduct in-house training as long as the risk of contagion persists. Financial assistance and incentives for creating training places, hiring new young professionals and general training and retraining may be helpful, for example by promoting the creation of digital training opportunities. Expanding start-up promotion could also help to make use of free capacity for implementing new business ideas and models. Given that start-up activity will likely increase as a result of rising unemployment, now would also be a propitious time for reviewing laws and regulations and make them more favourable towards start-ups and self-employed persons.

**The high number of short-time workers shows that companies are keen to keep workers on their payroll.** This is due to the growing skills shortage resulting from falling productivity growth and demographic change. Despite the sharp drop in labour demand, skills shortages are also becoming evident in the crisis. Among others, this applies to providers of digitalisation services but also to the construction sector and the care and health sector. The skills shortage will generally worsen again once the crisis has been overcome. That is another reason that education, further training and retraining become financially very important in the crisis and deserve to be supported.

**Advances in digitalisation and new environmental technologies will create jobs that help to reduce unemployment again but with a time lag.** Besides, new jobs will only be created if businesses invest and innovate in these areas. Placing the focus of the Federal Government's and the EU's economic and sustainability packages on investment in digitalisation as well as climate and environmental technologies is therefore also the right approach for quickly creating jobs that are fit for the future.

#### 4. Overcoming the crisis and providing inputs for solutions

##### 4.1 Be mindful of debt without dramatising it

**As they incur higher debt from the coronavirus crisis, in the medium term many businesses will be facing the target conflict of strengthening their financial resilience (liquidity reserves, equity) at the expense of capital expenditure, innovation and digitalisation – and thus future competitiveness.** What will be decisive for their decision for or against financial resilience will be how they perceive uncertainty over the further economic recovery. In addition, the expectation of a second wave of infections in Germany with a renewed lockdown and palpable consequences for their liquidity is likely to significantly influence this decision. It is therefore of fundamental importance to send a clear signal that swift measures aimed at bolstering businesses' liquidity in the form of unbureaucratic loans on favourable terms in combination with grants will continue to be offered. From the government's point of view it is important to stabilise enterprises, also with a view to stopping the downward spiral of supply chains, for example, while at the same time weighing the profitability of business models to avoid supporting what are known as 'zombie enterprises'.

**Moreover, strengthening opportunities to finance investment, innovation and digitalisation projects that ease pressure on businesses' capital structure appears to be beneficial.** Leasing and mezzanine finance should be taken into consideration in this regard. For the financing of innovation, the increased combination of loans and grants could represent useful support.

**In general, however, it also needs to be emphasised that an increase in the debt level of enterprises is not per se a negative development.** Used wisely, debt capital can also have a positive effect on a company's profitability ratios (leverage effect). Raising the equity ratio and reducing debts should thus not become an end in itself but be part of a sustainable and balanced financing strategy. Borrowing to finance capital expenditure, innovation and digitalisation projects that promise future profits is an essential component of the dynamics for economic growth.

##### 4.2 Transform the impetus from the coronavirus crisis for digitalisation and innovation into new momentum, take measures against falling investment

**A large proportion of affected businesses have responded to the coronavirus crisis by innovating and digitalising, although most of the response was in the form of quickly implementable measures.** In order to build on this impetus and transform it into more substantial momentum, it is important to adopt short-term measures. Here it would be useful to expand the content of existing support measures to innovation and digitalisation activities. This will also include lending-based support instruments. Recent findings on the ERP Digitalisation and Innovation Loan, for example, show that extensive borrowing for digitalisation and innovation projects does not adversely impact on businesses' credit rating because the competitiveness gains offset the increased debt.

**In the medium term, the shortage of skills and expertise in companies needs to be addressed for both innovation and digitalisation.** This requires increased training and continuing education but also support for businesses' innovation management in order to harness relevant in-house potential (for example, through targeted employee training). In digitalisation, expanding broadband connectivity remains an important approach as well. Over the medium term it would also be important to develop additional low-threshold promotional instruments that make it easier for businesses that are yet not innovating or digitalising to initiate such activities.

**In general, it is important to expand investment promotion and targeted public investment in order to avoid investment weakness after the coronavirus crisis.** At the same time, however, care must be taken to avoid one-sided facilitation of investment without equally promoting innovation and digitalisation activity. The result might otherwise be an unwanted redirection of business activity towards physical investment and, hence, a further weakening of technological progress. Uncertainty regarding further technological development also plays a role for the reduced propensity of small businesses, in particular, to invest in further innovation and digitalisation projects.

An area in which the government can invest therefore involves large projects such as data infrastructure (cloud technology) in order to support more complex projects in the field of artificial intelligence with a platform also for SMEs and start-ups.

#### **4.3 Carbon neutrality: Necessary structural transformation calls for swift and consistent action**

**Even before the coronavirus crisis, in October 2019 the Federal Government presented its Climate Action Programme 2030, a comprehensive package of measures aimed at reducing greenhouse gas emissions by 55% by 2030 compared with the 1990 baseline.** In addition, around one quarter of the funds budgeted in the recently adopted economic and sustainability package is earmarked for climate action. The agreed measures must now be consistently and swiftly implemented. However, it is already foreseeable that further measures must follow in order to achieve the goal, for example by expanding promotion and the regulatory framework. This applies all the more given the currently debated increase in the EU-wide 2030 greenhouse gas reduction target, which would also involve a more ambitious target for Germany.

**The energy transition can become an important engine of growth and innovation in Germany and Europe by providing strong incentives for far-reaching investment.** Relevant areas include expanding renewable energy and electricity grids, modernising the energy systems of buildings, promoting sustainable mobility including virtual substitutes (such as video conferencing) and developing a hydrogen economy to decarbonise the industrial sector.

**In order for the economic transformation towards climate neutrality to succeed, investors need planning certainty.** Apart from the continuous promotion of innovation and investment, a reliable and rising CO<sub>2</sub> pricing signal in all economic sectors is an essential factor for climate-friendly technologies to prevail cost-effectively over fossil alternatives that damage the climate in the long term. That is why Germany's approach of putting a price on CO<sub>2</sub> from heating and transport is of great importance and requires consistent continuation and further development of the EU emissions trading scheme. Compensation mechanisms for socially disadvantaged households and businesses competing internationally ('carbon leakage') are vital to ensure acceptance of the transformation. Until there is a globally harmonised CO<sub>2</sub> price and so long as the levels of ambition for climate action outside the EU differ considerably, further instruments will be necessary, particularly for industry, in order to offset possible competitive disadvantages from more ambitious climate action and thereby create investment certainty. Instruments that can be implemented in the short term would be, in particular, 'carbon contracts for difference' (state contributions to operating costs to offset higher CO<sub>2</sub> avoidance costs) and demand quotas for basic materials extracted without releasing CO<sub>2</sub> (such as minimum quotas for green steel or electricity-based synthetic fuels in aviation).