Germany in 2021: The U-turn

From austerity champion to big spender, the German government's complete U-turn on fiscal policy is the most remarkable feature of the crisis and should help steer the necessary structural transition in 2021

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Getting through better than most

At the start of the pandemic, the verdict seemed clear and straight-forward: the German economy would be one of the first and one of the strongest to come out of the crisis. A good health sector (which for a couple of years was deemed by many experts to be far too expensive), the German government's well-considered crisis management, and the unprecedented huge fiscal stimulus made a strong case for this argument. More than half a year later, this verdict has become more nuanced.

Germany is still managing to get through the crisis better than many other countries. However, it has not jumped ahead of the rest. In fact, while the slump in the second quarter was less severe than in most other eurozone countries, the rebound in the third quarter was also less pronounced. A reason behind this development is the fact that up to now, large parts of the fiscal stimulus package haven't actually been used. Many of the funds made available, be it in the form of grants or guarantees and loans, have simply not been taken up, at least not yet.

Short-term outlook

Looking ahead, the outlook for the German economy will be affected by cyclical and structural considerations. As for the cyclical part, the second lockdown will push services and consumption into contraction in the fourth quarter of 2020. Involuntary savings by consumers are likely to become precautionary savings. Also, the second lockdown is hurting sectors which had not recovered fully from the first lockdown, such as leisure, travel, culture, restaurants and hotels. These are sectors which employ around 10% of total German employment.

The risk of increasing structural damage in the form of higher unemployment and bankruptcies has clearly risen. Interestingly, there is currently a new divergence between weakening services and a still strong manufacturing sector. The positive momentum in the manufacturing sector is, in our view, driven by the delayed rebound after the first lifting of lockdown measures in the spring and a better-than-expected recovery in China. However, the ongoing structural changes in the manufacturing industry suggest that it could still take a while before industry returns to pre-crisis levels.

Covid-19: The accelerator of structural change

The Covid-19 crisis has accelerated several structural trends in the German economy that had already been brewing under the surface in recent years. The most important ones are the U-turn on fiscal policy, digitalisation and the transition of manufacturing.

The most remarkable development of 2020 is, without doubt, the transformation of the German government from austerity champion to big spender. The government was swift, and certainly not thrifty, in its reaction to the economic impact from the lockdowns. At least at face value, Germany has had the largest fiscal stimulus package of all European countries, with more than 30% of GDP put on the table to support the economy. While the largest part of these measures are guarantees, the government also led the way for other European governments with a stimulus package that aims to use the current crisis to steer structural changes. The latest €130 billion stimulus package not only included a temporary VAT reduction but up to €60 billion was dedicated to investment in sustainability, innovation, digitalisation and tackling climate change. Interestingly, this change of heart had already been in the making in 2019, with the first tentative investment packages, but it gained enormous momentum due to the crisis.

> *Covid-19 will not be a wasted crisis*

Driven by the crisis, home-schooling, online learning and working from home have once again highlighted the urgent need for more and better digitalisation in Germany. While this is not new, the awareness and the pressure to act, together with the agreed fiscal stimulus, support our view that at least regarding investment in digitalisation, Covid-19 will not be a wasted crisis for Germany.

On a more negative note, the crisis seems to have aggravated the need for structural change in the manufacturing sector. The sector had been on a downward trend already since mid-2018. Trade tensions, increased competition from Asia and a general shift of the global economy towards services will continue to put pressure on industry. Several announcements of restructuring and job shedding are another illustration of this structural change.

The final structural change will be political. Elections in autumn next year will mark the end of Chancellor Angela Merkel's term in office. Probably. Even though Merkel remains by far the most popular German politician - a popularity which actually increased during the crisis - she has ruled out another term on several occasions. The leadership race in her own party is still going on and will only be decided in early 2021. While it is too early to predict the outcome of the elections, it is clear that any new chancellor will not be able to fill Merkel's shoes immediately.

The German economy in a nutshell

	2019	2020F	2021F	2022F
GDP (%)	0.6	-5.6	3.4	3.2
Private consumption (%)	1.5	-5.3	3.8	3.8
Investment (%)	2.7	-4.2	3.0	3.1
Government consumption (%)	2.1	3.8	3.1	2.9
Net trade contribution (%)	-0.4	-2.1	0.4	0.5
Headline CPI (%)	1.4	0.1	1.4	1.8
Unemployment rate (%)	3.2	3.8	4.4	4.0
Budget balance as % of GDP	1.8	-8.0	-4.0	-2.0
Government debt as % of GDP	58.0	76.0	77.0	73.0

Source: Thomson Reuters, all forecasts ING estimates

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