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Reflections on COVID-19 – Views From Germany

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In a series of blogs, we will be reflecting on how the coronavirus disease 2019 (COVID-19) has affected local economies and businesses considering the impact of lockdown, how businesses have fared during the pandemic, whether support from the government has helped protect against business failure, which sectors have been hardest hit by the pandemic and which have prospered, as well as considering the impact of a second wave and what the future might hold.

In this first blog, we focus on the impact of COVID-19 on Germany.

How Has COVID-19 Impacted the German Economy?

The COVID-19 pandemic caused a historic decline in economic output in Germany. At the end of July, the Federal Statistical Office recorded an unprecedented drop of 10.1% in gross domestic product (GDP) during the second quarter. Economic output fell, and even slumped in some cases, in virtually all areas of the economy apart from the construction sector.

Nevertheless, an economic recovery began in May after the first easing of containment measures. Expansionary monetary and fiscal policy measures, such as the economic stimulus package adopted by the German federal government of €130 billon, provided additional support to the economy. The industrial sector was able to expand its production and sales in May and June. However, its production level in June was only just over 87% of that of Q4 2019, i.e. prior to the outbreak of the pandemic. The service sector is also seeing economic recovery and in view of this rather more favorable situation, experts see in the third quarter a powerful rise in GDP. However, the future development of the German economy will very much depend on how the COVID-19 pandemic shapes up both in Germany and abroad.

Have Businesses Managed to Weather the First Wave Storm?

Germany's economy has maneuvered through the first stage of the COVID-19 pandemic, thanks in part to the unprecedented €130 billion aid package that sought to prevent insolvencies, mass layoffs and a rise in poverty.

Low-interest loans to companies, an expansion of wage subsidies for furloughed workers and state aid for large corporates have all lessened the financial outcome caused by the pandemic. The sentiment among German business leaders is continuing to improve. There is perhaps more optimism among companies for the future than expected, but there is still a certain level of pessimism.

Order books are filling once more. The service sector expects the situation to improve in the coming six months and while trade has seen the upward trend in the business climate noticeably flattened, it has not declined. In manufacturing, the business climate has improved considerably and in construction, the business climate continues to improve. Construction companies were also happier with their current situation.

Nevertheless, many industrial companies still consider their current business to be poor and wholesale has seen a downturn.

Overall, expectations are still pessimistic but improved from last month.

Has Government Support Helped Protect German Businesses From Failure?

The German government has taken decisive, vigorous and targeted action to protect the country. The government deployed the largest assistance package in history of the Federal Republic for 130 billion euros. In this was, it was building a protective shield for employees, self-employed and businesses, including:

- multiple measures to safeguard the provision of healthcare in times of crisis
- fast and very extensive support for small businesses, self-employed individuals and freelancers
- comprehensive measures to support the real economy – protecting businesses, employees and jobs; and
- tax related assistance that is available to companies of all sizes in order to strengthen their liquidty

In particular, the furlough scheme, known as *Kurzarbeit* (short work), means the German government pays around 60% of a worker's salary – more if they have children – if they were sent home or work reduced hours. From the fourth month of payment, the amount increases to 70% (or 77% for employees with at least one child), and from the seventh month to 80% (or 87% for employees with at least one child). The months in which short-time work benefits are paid will be taken into account from March 1, 2020. The German government recently agreed to extend the scheme by an extra year, until December 2021, to help companies avoid layoffs and enable them to keep their staff on standby until things pick up again. The number of companies participating in the German government's furlough scheme is slowly falling. According to the German Ifo economic institute in Munich, 37% of all companies surveyed still had their workers on short-time hours in August, down from 42% in July.

However, more than half of industrial companies surveyed are still reliant on the program, and within the industrial sector, some 80% of metal producers were still on short-time hours, and 65% in the automotive industry. A collapse in global demand for new cars, one of Germany's most important exports, is threatening jobs in the car industry. The German Automotive Industry Association warned in June that around 100,000 jobs are at risk in the sector due to enduring low demand. The travel industry in Germany remains devastated by the COVID-19 pandemic, with 88% of travel and tour operators on *Kurzarbeit*, as well as 71% of hotels. In the service industry, 33% of companies were still availing themselves of the furlough scheme, down from 39% in July.

Which Sectors Have Been Hardest Hit or Seen an Uptick in Profitability?

At the center of restructuring efforts are two of Germany's key industries – the automotive sector and machinery and plant engineering. In addition, the aviation industry and the tourism sector generally have been hit hard.

For the automotive and engineering industries, the generally tense situation of recent years resulting from the effects of the diesel crisis and the lack of a coherent and sustainable electric mobility strategy is now aggravated by the COVID-19 crisis: to contain the pandemic, many manufacturers and suppliers have had to close down their plants at least partially and stop their supply chains. The long-term effects of these measures are unpredictable, but the vast majority of experts expect particularly high defaults in corporate loans in the coming months. The willingness of banks to provide new loans for restructuring cases is also likely to decline further, and a higher default rate is feared. The overall restructuring landscape shows a significant increase in financial corporate crises. The numbers will increase even further over the course of the year. The prospects of a successful implementation of restructuring measures are also expected to decline, which will most likely result in more insolvencies.

Has There Been, or Is There Expected to Be, an Increase in Insolvencies?

To mitigate the estimated 29,000 corporate insolvencies expected as a consequence of the economic fallout of the COVID-19 pandemic, Germany made a number of changes to its insolvency law, including suspending the obligation to file for insolvency (currently in place until September 30, 2020, although this will probably be extended) and relaxing legal provisions banning certain payments amid bankruptcy procedures, giving managers more leeway to maintain business operations or implement a restructuring, without triggering personal liability. In addition to the financial support available, it is hoped that these measures will avoid significant insolvencies, but not all companies have taken advantage of these measures and once the deadline expires (currently September 30), we expect the amount of insolvency filings will increase again.

Reduced Working Hours for How Long?

Germany's reduced-hours working scheme has helped many companies stay afloat. Although the program is recognized as the gold standard of labor market instruments in times of crisis, it comes at a huge cost to the public purse. Predictions of a severe second wave make uncomfortable reading for many Germans, who have got quickly used to their government stepping in to protect them from the worst effects of the health crisis. However, even Europe's largest economy cannot mitigate all the negative effects of the COVID-19 pandemic.

How Will the German Economy and Business Respond to a Second Wave?

Various scientists are predicting a potential second wave of infections. If it comes, it will likely arrive in the fall or winter, just as many German economic programs are due to run out. The second wave could also hit amid a new round of protectionism against Europe from Washington DC, depending on the result of the US presidential election, and as the UK exits its Brexit transition period, potentially without an EU trade deal.

The scale of the German government's initial intervention has raised questions about what stimulus measures are still available if there is a resurgence in COVID-19 cases or whether all its possibilities were used up in the first wave. In many cases, corporate loans will have been spent without the necessary return on investment, and may still not have increased the company's finances. Based on the €130 billion stimulus program launched as the lockdown was eased in May, Germans have built up more than €100 billion in additional savings, which can be used for consumption. The most fragile part of the economy, however – the corporate sector – might need stronger stabilization measures in the form of state subsidies, as well as loans.

What Does the Future Hold?

The current global economic crisis is unique in its kind because the crisis consists of at least two kinds of economic problems: a reduction to production due to the disrupted global supply chains and an unprecedented demand shortfall as a result of the lockdowns. For most small businesses, this reduced demand resulted in a sudden dry-up of cash flows and liquidity shortages. The German government directly responded to support SMEs with direct subsidies and short-term work compensations, but also substantial expansions of guarantee programs. Common proposed changes are an expansion of the maximum guarantee amount, a higher guarantee coverage, wider eligibility and better terms and conditions.

One reason for a slow recovery of the German economy is that some important export destinations are economically more affected by the COVID-19 pandemic than Germany, so that exports are only gradually picking up again. Moreover, companies will remain reluctant to invest for some time to come, as uncertainty will remain high and the equity basis of many companies is being negatively affected by the reduction in sales. Private consumer spending is likely to recover somewhat faster, partly because the savings ratio, which rose sharply during the lockdown, is likely to decline again with the easing measures. As a result, the purchasing power will stimulate demand. However, the recovery in private consumption is also exposed to other issues, as some private households are suffering income losses and larger purchases are being postponed in view of the increased job insecurity. Overall, experts see a decline of the GDP to be around 6.2% in the current year, followed by an increase of 6.3% in the coming year. Further, the number of people in employment is falling sharply, and the unemployment rate might rise from 5% in 2019 to 6.1% in 2021. The budget deficit might increase to about 6% of GDP in the current year, and might remain at around 3% next year, when revenues have stabilized and many of the stimulus packages have expired. The debt-to-GDP ratio stays above 70% in both years, after 60% in 2019.

Finally, in August, Germany experienced a surge in infections not seen since April 2020. While there are currently no plans to return to the nationwide lockdowns of March and April, the government has ramped up virus testing and mandatory quarantine for those returning from some 160 countries designated as high risk.

Lessons Learned?

In the EU, the shape of the recovery, as well as its distributive impact, will depend on the ambition and effectiveness of the policy response at the national and EU levels. An ambitious policy reaction would change these centrifugal forces and safeguard the integrity of the single market and the economic and political viability of the EU project.

The EU has adopted a recovery fund of €750 billion – €390 billion as grants and the remaining amount as loans – over the period 2021-26 to be financed via issuing common debt. Next Generation EU would complement the measures agreed by the Eurogroup for a total of €540 billion in support of healthcare spending, unemployment and short-time work, and credit to the private sector. The centerpiece of the EU recovery package is the Recovery and Resilience Facility (RRF), which amounts to €560 billion between grants and loans to support investment and reforms, with an emphasis on favoring the green and digital transition. In addition to the recovery fund, the EU said its next budget, which will fund initiatives between 2021 and 2027, will total €1.074 trillion. The two combined bring upcoming investments to the level of €1.824 trillion.

The EU handling of the COVID-19 crisis can so far been characterized by a largely consensual view of the nature and effects of the crisis and the need to complement the monetary policy response by a centralized fiscal action. The risk of fractured global governance also pushes the EU to devise a response to the crisis that relies more on its inner strengths. As a result, there has been a resurgence of the community method compared to the mainly intergovernmental approach during the financial crisis. Hence, the crises created a chance for the EU to adopt an ambitious response to the COVID-19 pandemic, and this might also lead to finalize long-lasting open institutional issues such as Banking Union and Capital Markets Union.

This would be the best chance to devise an effective response to the COVID-19 crisis and boost European sovereignty domestically and abroad.

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