Finanzgruppe
Deutscher Sparkassen-
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STANDPUNKTE
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The Corona Shock: Economic policy requirement

The coronavirus is hitting the German economy dramatically. The Chief Economists of the Savings Banks Finance Group emphasise that, given the current crisis developments, everything possible must be done to support the economy in a stabilising manner now. The task now is to overcome the shut-down of the economies and limit negative second-round effects. For this reason, the foundations for a revival of the German and European economies must be kept in view even now:

- The corona pandemic has severe economic dimensions. With the measures announced on 13 March 2020, the German government has created necessary conditions to support companies effectively in this challenging time. In addition, it is now a matter of finding sector-specific solutions to help cushion companies in the period of shut-down - the standstill of normal economic activities. Relief for banks must also follow. Closures of stock exchanges must be examined, too.

- To limit the adverse economic effects as far as possible, the package of measures of the Federal Government must be implemented as quickly as possible. In the case of indemnifications, KfW should take over the risk assessments of the house banks. Furthermore, as an immediate measure, KfW should grant suspensions of repayments for the next instalments at the request of the principal bank. Additionally, if there is a risk of insolvency, the loans could also be converted into a grant. If these measures are not sufficient, targeted, strictly limited government grants could also be considered.

- It must be possible to return the economy to a robust situation as quickly as possible after the pandemic. The capital stock and labour force potential must be maintained during the crisis. They form the basis for the economy's recovery and the necessary further modernisation of the capital stock. Increasing digital and knowledge-based investment requires special attention.

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Authors
Uwe Burkert - LBBW
Uwe Dürkop - Berliner Sparkasse
Jochen Intelmann - Haspa
Dr. Ulrich Kater - DekaBank
Christian Lips - NORD/LB
Dr. Jürgen Michels - BayernLB
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann
 - Kreissparkasse Köln

Coordinators
Dr. Reinhold Rickes
Reinhold.Rickes@dsgv.de
Dr. Sonja Scheffler
Sonja.Scheffler@dsgv.de

The Corona Shock: Economic policy requirements

German economy faces fundamental reorientation

The pandemic leads to a new global economic crisis. Everywhere, the next quarters will show dark red figures. In addition to supply-side restrictions - such as disruptive global supply chains - there will be a massive drop in demand, which is unavoidable due to the necessary health precautions. However, depending on how the pandemic is overcome, catch-up effects could stimulate the economy again. However, negative two-round effects should not be neglected, as they can further reduce consumption and investment as a result of lost confidence.

Deep global economic crisis

It is becoming increasingly clear that Germany will initially face strong recessionary tendencies in 2020. Further downward spirals must be broken as best they can. The spring of 2020 must therefore first be used in economic policy to cushion a deep economic slump. At the same time, the foundations for a possible upswing must be laid. Fiscal policies must now deliver their „whatever it takes". Then the course will also be set for limiting negative second-round effects. Germany and Europe have developed the first essential activities in this regard. However, the task now is to support citizens and companies as well as banks and savings banks even more strongly with measures that will help them overcome this dramatic crisis phase.

...now „whatever it takes" fiscal policy

Although Germany has had robust SME and foreign trade figures before the crisis accelerated, sales are now coming to a complete standstill in many areas. With short-time working allowances and the first credit assistance programmes, essential foundations have been laid. It is now vital, however, to provide some sectors with even more targeted assistance, possibly also in the form of subsidies, to compensate for the complete loss of revenue and, as part of this, to take over fixed costs from the state. This will help employees and companies on both sides and is also an expression of solidarity in practice. At the same time, however, the risks of improper use must be avoided in the procedure.

Taking the reins of action: Now…

The Corona pandemic has severe economic dimensions. With its measures announced on 13 March 2020, the German government has created necessary preconditions for effectively supporting companies in this challenging time.

These include, among other things, making the short-time working allowance more flexible, tax deferrals for companies and bridging loans for all sizes of SMEs. At present, small and medium-sized enterprises form the core of the Federal Government's announced package of measures. The short-time work regulation makes it easier for companies to retain their employees even in a difficult economic situation. Tax deferrals avoid outflows of funds by companies and unlimited KfW loans for companies help to prevent insolvencies. The decisive factor for short-term assistance is that KfW takes over the risk assessment of the company's major banks. The consequences of state aid law should not play a role at the national and European level. Loan-financed losses can cause companies to slip into under capitalisation. Under certain conditions, the loans could then be converted into a lost grant.

There is no doubt that some service sectors, in particular, are facing a blatant slump in demand in the short term, which is due to the population's careful handling of the crisis on the one hand and the necessary administrative intervention to stem the spread of the coronavirus on the other.

However, there are also considerable acute disruptions on the supply side, which make liquidity contributions and aid from the federal government indispensable for sectors whose supply chains have broken apart due to the spread of the virus or which have been completely shut down due to the ordered stoppage of demand (e.g. gastronomy). This creates trust, supports companies in securing their existence and ensures employment and income for the people concerned. The more successful this is, the less need there will be for stabilisation of overall economic demand, which is subject to significant question marks as to its targeted effectiveness. This could create the basis for compensating adverse losses of confidence and setting the course for an upswing after the pandemic.

Fully support for small and medium-sized enterprises

Besides, the German government has already revitalised national value chains in the health care system (breathing apparatus for intensive care). This is to be welcomed unreservedly and, in our opinion, will lead to the revitalisation of European, national and local value chains having to be more strongly discussed in economic policy discourse again after the crisis. A renaissance of the local therefore remains a lesson from the disaster.

„Renaissance of the local ?“

Locally anchored institutions have a crucial stabilising function in times of crisis. This is particularly true of locally rooted banks and savings banks, which, with their infrastructure, contact management and continuous lending, help small and medium-sized enterprises to overcome liquidity bottlenecks, stabilise the present and invest in the future. For this to succeed, everything possible should be done in regulatory and macroprudential terms to maintain the liquidity and credit supply. It is therefore not the right time to put further macroprudential tightening on the economic policy agenda, as called for in the European Commission's Germany country report at the end of February 2020. Instead, relief is now needed.

... also with a view to the banking world

Central banks have acted globally, bringing financing conditions close to zero, especially in those currency areas where they were above zero before the crisis. Now the monetary policy must accompany the higher national debt associated with the fiscal policy measures through the monetary sphere. Large government bond purchases should, therefore, be made possible for a limited period during the pandemic.

No interest rate cuts...

It is not the time to stick to apodictic demarcations between fiscal and monetary policy. At the same time, monetary policy should not be overstretched in this situation. In this way, it should be avoided to lead the money and capital markets conditions even further into deep negative territory. Although no one knows precisely where a negative interest rate lies, that accelerates the current crisis (the so-called reversal rate) - a further worsening of the crisis via such a development should be avoided at all costs. For this reason, the ECB has reacted appropriately in its first step and, like the other central banks, now remains challenged to ensure that the real economy is supplied via the banking system. Also, the supervisory and financial stability mechanisms now remain called upon to ensure stability.

... Government bond purchases

For example, it would be a precise stabilisation and support signal if the announced increase in the countercyclical capital buffer were to be suspended on 1 July 2020. The Financial Stability Committee should now act quickly after the ECB had already called for this last week in its function in the European Systemic Risk Board. In addition, it should be examined to what extent other macro-prudential instruments are also being interpreted differently, at least temporarily. For example, the definition of non-performing loans could be extended further to react to supply bottlenecks and to ensure the supply of liquidity and credit. Also, with a view to data collection to safeguard financial stability, the burden on credit

institutions should now be reduced with a sense of proportion.
To further reduce the potential risk of a credit crunch, further relief in terms of capital adequacy requirements for SME lending and the infrastructure factor would seem appropriate.

The SME factor is currently structured in two stages: The share of receivables up to EUR 2.5 million is multiplied by 0.7619 (= 8% / 10.5%), and the amount exceeding this is multiplied by a factor of 0.85. This two-tier structure increases complexity and is also inconclusive from a risk perspective. Furthermore, the politically desired support for lending to SMEs would be promoted by applying the SME factor at the level of the individual subsidiary (and not, as is currently the case for the entire group of affiliated companies). This would increase the savings effect, so that the capital burden on banks would be reduced, thereby supporting lending. Concerning the infrastructure factor, we think it would be worth considering whether a reduction of the factor of 0.75 might not be appropriate or whether the strict requirements for applying the support factor should be relaxed to increase its effectiveness. This is because, in practice, examining whether the specific conditions set out in CRR II can be met at all is likely to be a significant challenge, given the large amount of information required for this purpose. This reduces the effectiveness of the infrastructure factor and thus, its intention to promote the financing of similar investment projects.

Anchoring equity relief quickly for banks

As a third point to reduce the risk of a credit crunch, we would also like to point out the effectiveness of the IFRS9 accounting standard for the recognition of loan loss provisions, which will very probably already be reflected in the figures for the first quarter in the form of falling profits and downward pressure on banks' equity ratios. In the current situation, we need to emphasise that financial institutions have made excellent progress in recent years in terms of asset quality and capitalisation and are not primarily affected by the current crisis. Nevertheless, the IFRS9 bi-financial mechanism could intensify the rapid, cross-sectoral turmoil in the real economy. A more flexible handling of the standard and the regulatory definition of default, therefore also seems appropriate in the current exceptional situation. In this context, it is only logical if the banking supervisory authority also interprets any dismantling of the SREP component of the Pillar 2 Recommendation („Pillar 2 Guidance") flexibly and does not automatically impose sanctions on affected institutions. Prudential measures that in the current situation would lead to unnecessarily higher capital.

Regulatory pause

Last but not least, all planned additional new supervisory and regulatory measures should now also be set to shut down and further activities should only be resumed after the pandemic has been overcome (this includes the planned stress tests). It also remains to be examined whether, in view of the continuing decline of stock markets worldwide, these should also be closed for the duration of the pandemic. Together with the supervisory authorities, savings banks and banks must now make every effort to maintain the infrastructure with regard to monetary functions in the near future. This includes in particular the classical functions of money as a means of transaction and as a store of value.

Stock exchange close ?

Building confidence in the future through investment

If we look beyond the current crisis, we can see that Germany is lagging behind in investment. In the long term, underinvestment is a threat to growth: the less capital there is, the lower the production level and growth rates.

Higher investment is the best way to ensure a healthy economy once the pandemic is over. The expansion of the German health care system, with billions of euros in investment initiated by the corona crisis, is now also making a direct contribution to this. They will also help to reduce current account surpluses, to better cope with the upcoming demographic challenges and to make our economy more sustainable overall. Last year's climate package for sustainable economic activity provided significant investment impetus. To overcome the corona shock, therefore, further public and private green investments must also be made.Combined with more capital expenditure and more considerable efforts in research and development, higher investments are an imperative for today, tomorrow and the day after tomorrow. It will not be enough to maintain the current capital stock. If possible, it should be expanded and continuously modernised.

Investments in health sector are important!

Knowledge and the world of tomorrow

Knowledge is also capital. A study recently published by DIW Berlin shows that, in an international comparison, Germany can only be placed in the middle of the field when it comes to the use of knowledge capital. Besides, the knowledge capital stock of German companies also appears relatively outdated. Germany's lower level of modernity in comparison to its competitors and the fact that its intellectual capital stock is only in the midfield jeopardise Germany's claim to be one of the leading nations in technology and Germany's future competitiveness as a business location.

German companies must, therefore, invest more in knowledge capital to keep up with the international comparison in terms of quantity and quality of knowledge-based capital (KBC). The characteristics of intangible assets offer excellent incentives to do so. For example, the aspects of non-rivalry

Further strengthen digitalisation

and synergy effects mean that investments in knowledge capital, especially in combination with complementary investments intangible assets, can lead to an increase in production efficiency. Economic policy should, therefore, support companies in increasing investment in all relevant elements of knowledge capital.

There are also indications that the increasing importance of intangible assets could at least partly contribute to explain persistently low-interest rates and low GDP growth rates. For example, the cautious investment activity observed since the financial crisis could be explained at least in part by the fact that the national accounts do not or not sufficiently take into account investments in intangible capital.

From a macroeconomic perspective, the generation of positive spill-overs is also of great interest. For example, investments in knowledge capital by a single company can benefit the economy as a whole. Policymakers should, therefore, create favourable conditions for investment in KBC. This includes, among other things, the provision of a modern digital infrastructure with a corresponding expansion of fibre optic and mobile networks.

Germany remains an innovative location in itself. There is no sign of a shortage of gifted minds or declining research intensity. According to the EU Commission, Germany ranks third among the EU countries with R&D spending of 3.13% of GDP. Around 1.68% of the workforce is engaged in R&D, compared with 1.36% of the EU average. In 2018, one in three of the 55,000 or so patents filed by Germany (companies and public research institutions) with the European Patent Office in 2018 is based in Munich, which is not by chance. Around two-thirds of R&D expenditure is borne by companies. Their share is also the third-highest in the EU at 2.18% of GDP.

It would be desirable to reintroduce the option of declining-balance depreciation under section 7 of the German Income Tax Act (EStG), as has been possible in the past, for example, from 2006 to 2007 and 2009 to 2010. It can provide immediate help, especially now in times of corona shock. Unlike straight-line depreciation, declining-balance depreciation distributes the costs of investment more effectively over different phases of use. Besides, rapid reduction regains the company‘s liquidity scope for new investments. Given the short product life cycles for knowledge-based capital, this is an advantage that should not be underestimated. Similarly, a shorter depreciation period for KBC assets and, if necessary, special depreciation for assets with a useful life of fewer than five years at the beginning of the useful life could be helpful. The fact that investments in knowledge capital are of particular importance for the German economy is currently also evident in the health sector. The healthy balance between centralisation and decentralised institutions creates resilience. It is based on trust, the willingness to coordinate and quick joint decisions. The additional investments in the health sector currently announced by the Federal Government are therefore to be expressly welcomed.

Further improve depreciation terms

Disclaimer

The present position paper of the Chief Economists does not necessarily reflect the position of DekaBank or the position of the respective Landesbanken and savings banks.

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Editor
Deutscher Sparkassen- und Giroverband
Abteilung Volkswirtschaft, Finanzmärkte
und Wirtschaftspolitik
Charlottenstraße 47
10117 Berlin
Telefon: 030 20225-5303
DSGV-Volkswirtschaft@DSGV.de
www.DSGV.de

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Responsible
Pia Jankowski – DSGV
Director
Head of Economics, Financial Markets
and Economic Policy
Pia.Jankowski@DSGV.DE

Dr. Reinhold Rickes – DSGV
Director of Department
Head of Economics
Reinhold.Rickes@DSGV.DE

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