Finanzgruppe
Deutscher Sparkassen – und Giroverband

STATEMENT BY THE CHIEF ECONOMISTS OF THE SPARKASSEN-FINANZGRUPPE

Light at the end of the tunnel!? The pandemic economy

The coronavirus pandemic has caused the worst global economic slump since World War II. In Germany, real gross domestic product plummeted by as much as 5.0 percent in 2020.
The duration of the pandemic and the extent of the economic fallout are still difficult to estimate. The vaccination rollout is raising high hopes, but new virus mutations are causing concern.

- The Chief Economists of the Sparkassen-Finanzgruppe expect a strong economic recovery from spring onwards. German GDP is forecast to grow by 3.5 percent in 2021.
- The most important prerequisite for this is a single-minded and swift response to the pandemic. Risks threatening the success of the vaccination campaign (mutants, willingness to vaccinate) must be minimised, the constraint here being that the burden on the economy as a whole should be kept as light as possible. This has implications for the measures taken to contain the second wave now sweeping over us.
- Restrictions on economic activity must be carefully weighed up and, should they prove unavoidable, need to be further compensated for by monetary and economic-policy measures. Further crisis measures should be geared above all to avoiding hysteresis lags and second-round effects.

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The Covid-19 crisis caused a dramatic economic slump in 2020

The coronavirus pandemic caused a historic slump in global economic activity in 2020

The coronavirus pandemic has left deep scars on the trend in the real economy. In response to the first wave of infections, which originated in China and spread to almost all countries in the world, many nations temporarily implemented massive containment measures, literally shock-freezing large swathes of social and economic activity. Due to the absence of sufficient time for preparation, this also led to disruptions in global trade and international value chains, which resulted in supply bottlenecks, at least intermittently.

The consequence of these combined supply-side and demand-side shocks was an unprecedented slump in macroeconomic activity in the first half of last year, albeit followed, in some phases, by an equally rapid catch-up process. Global aggregate economic output is likely to have slumped by around four percentage points in real terms in 2020 as a whole. In terms of its depth at least, this crisis thus represents the most severe economic burden since the Second World War. Europe in general, including Germany, likewise witnessed a significant decline in economic output. For the last three months of the year, a - thankfully, comparatively mild - contraction is emerging for the euro area as a result of the second wave of infections, resulting in an annual rate of change of around -7 percent for real GDP in 2020 as a whole, and thus a record negative growth rate. According to the Federal Statistical Office's flash estimate, Germany's GDP shrank by 5.0 percent. Among the major European economies, the Federal Republic has thus come through the crisis year best from an economic perspective. France's and Italy's economic output is likely to have contracted by slightly more than three percentage points more than in Germany’s case. Spain has probably even racked up a double-digit contraction rate in 2020.

To date, the German economy has weathered the crisis better than many other European countries

Several factors are likely to have contributed to the fact that Germany has so far weathered the crisis better than most countries in Europe. For one thing, the crisis waves first washed up on the shore in neighbouring countries, enabling the Federal Republic to take advantage of a certain advance-warning period. In addition, the German healthcare system has proved to be more efficient. The lockdowns have also crimped a smaller share of German value added in terms of sectoral weights. The first lockdown was also significantly shorter than in many other European countries. From the perspective of economic structure, the country’s lower dependence on tourism is worth mentioning. Industry - still a heavyweight in Germany with a share in value added of over 20 percent - has been comparatively little affected by contact restrictions. Together with the construction sector, manufacturing was even able to function as the growth engine in Germany at the end of 2020. Last but not least, Germany's decidedly healthy public finances pave the way for greater support from economic and fiscal policy. This fiscal solidity has certainly also played a part in bringing about the relatively swift brightening of sentiment in Germany.

The pandemic remains the determining factor

The current pandemic differs from previous economic crises

The coronavirus crisis differs from previous economic crises in several respects. First, this pandemic is a global crisis, the overcoming of which requires the most coordinated action possible by the international community. Second, it is a public-health crisis, that can most readily be compared to a natural disaster. For the current pandemic, there are hardly any comparative parameters that would permit an advance assessment of its trajectory and, in particular, of its economic consequences. Despite major differences in the pathogens involved and despite considerable data problems, it is nevertheless possible to draw some conclusions from the last major pandemic, the Spanish flu which struck from 1918 to 1920.[1] Because of the specific characteristics of the coronavirus, the pandemic is unfolding in waves, partly due to weather conditions, but mainly depending on the extent of social contacts and opportunities for infection. This makes it necessary to restrict physical contact, at least until the infection rate has been brought under control for the long term or unless sufficient vaccination coverage of the population (“herd immunity”) has been achieved. Many examples of the interactions between contact restrictions/relaxations and the wave-like dynamics of infection have been documented for the Spanish flu epidemic, and these call for caution.

The second wave has Germany, and Europe in general, firmly in its grip

The pandemic still has Germany, and Europe in general, firmly in its grip. The second wave, which has been rolling across Europe since the beginning of autumn, is significantly higher than the first wave of infections. Containment measures have been tightened several times since October. The Stringency Index[2] indicates that, following successive tightenings, relatively robust restrictions, even by international standards, are now in place in Germany to prevent the proliferation of

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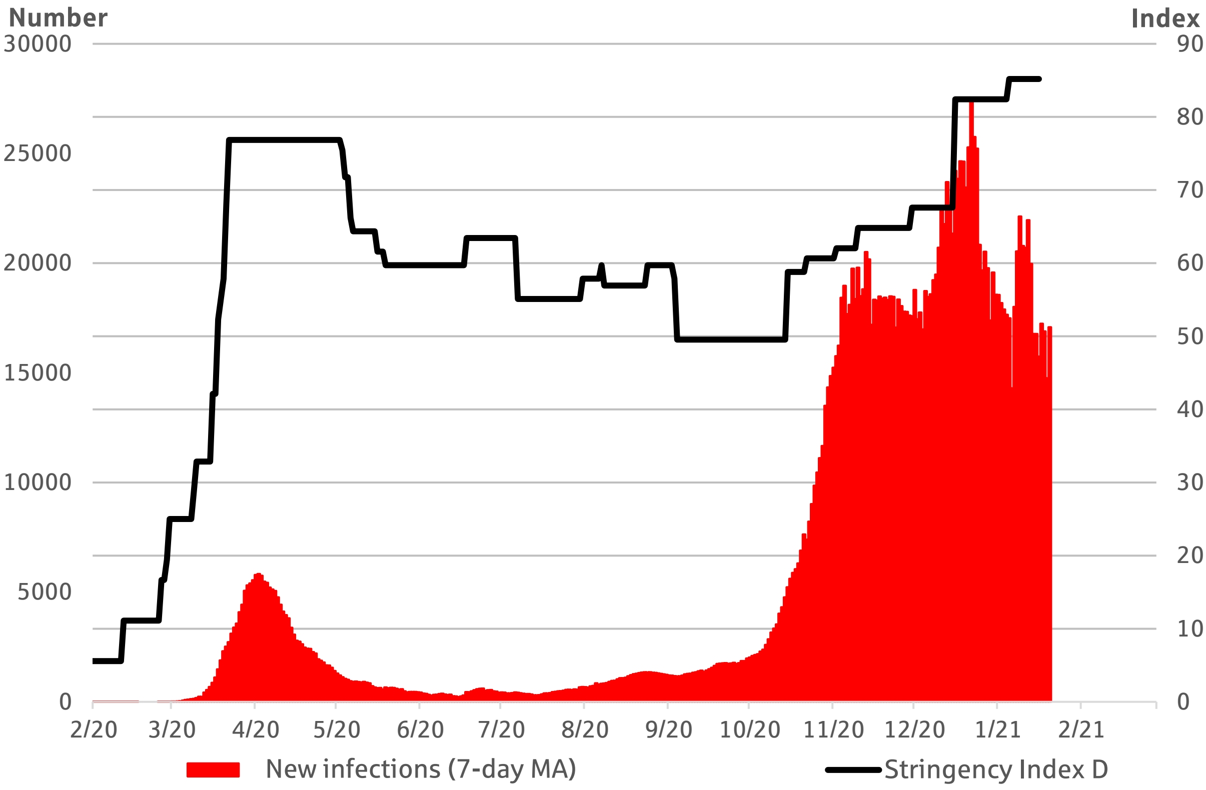
[1] Cf. DSGV Newsletter (30.10.2020): *Corona ... the second wave: Act with caution on the economic-policy and monetary-policy front!*

[2] An index modelled by Oxford University, composed of nine indicators encompassing measures such as school and workplace closures, travel bans and curfews. Intensity measurement scaled to 0-100; the methodology should not be interpreted as “scoring” the appropriateness or effectiveness of a country’s response. See Hale, T. et al. (2020): Oxford COVID-19 Government Response Tracker, Blavatnik School of Government.

infections. It should be noted that this time series does not yet include the latest lockdown resolutions.

Figure 1: Germany: New infections and Stringency Index



Source: RKI; Hale, T. et al. (2020); Bloomberg; NORD/LB Macro Research.

The second wave is proving relatively stubborn despite the containment measures taken

Nevertheless, unlike during the first wave, the measures taken so far do not seem to have led to a sustained reduction in the incidence of infections even after two-and-a-half months.[3] That said, it is not yet possible to assess the latest tightening measures in terms of effectiveness and efficiency. The goal of significantly reducing incidence in order to once again ensure nationwide contact tracing by health authorities is still a long way off. In the light of the new, apparently more aggressive and more infectious virus mutations that have appeared for the first time in Great Britain, Brazil and South Africa, it is all the more urgent to materially reduce the tally of infections.[4]

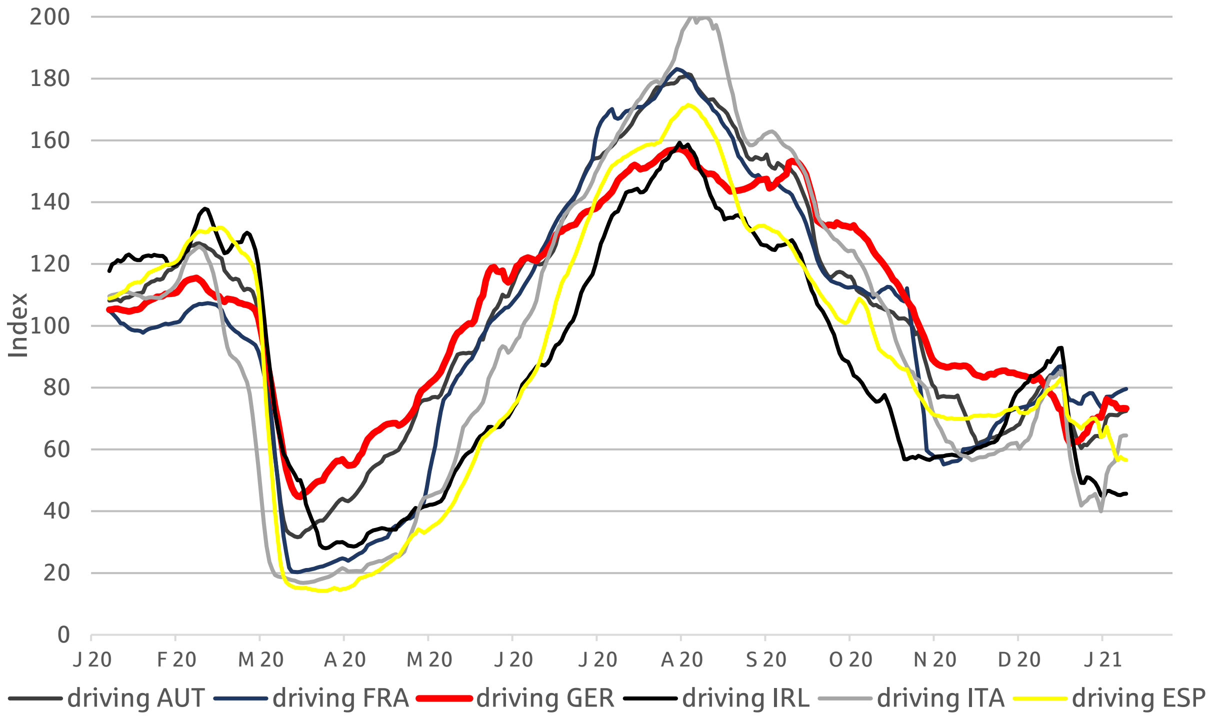
[3] It should be noted that the data around the turn of the year are difficult to interpret, as many doctors' offices were closed for the holidays, the volume of tests was lower, and presumably many people only sought treatment if they had more severe symptoms. More reliable data - whose dynamics are still difficult to interpret due to distortions over time - have been available again since mid-January.

[4] To reduce the risk of further mutations, a containment strategy is of course necessary, if possible on a global scale. At least in the USA, under the new US President Joe Biden, a more scientifically sound approach to the pandemic and a greater willingness to adopt internationally coordinated procedures can be expected.

Mobility diminished with the start of the lockdown in November, but to a somewhat lesser extent than in the spring of last year. However, there was a significant additional reduction in mobility over Christmas and New Year's Eve. This was not a seasonal effect, but apparently a very deliberate reaction of a large part of the population to the pandemic situation, in that above all distinctly fewer longer trips to visit relatives or to go on vacation were undertaken than in the previous year. [5]

Significantly reduced mobility during the Christmas vacation

Figure 2: Mobility during the first and second waves



Source: Apple Mobility Data (Covid-19); NORD/LB Macro Research.

Assessment of the latest decisions regarding pandemic containment

Ultimately, government containment measures can only have an indirect effect; the behaviour of a country's citizens is the factor which has a crucial bearing on the success of the measures. Against the backdrop of the still tense pandemic situation, the German Chancellor and the heads of government of the German federal states decided on January 19 to extend and deepen the lockdown until mid-February. The main decisions are as follows:

Germany's containment measures have been extended until mid-February

- First, a tightening of the mask-wearing requirement, according to which medical masks (FFP/2 or surgical masks) must be worn in public transport and stores;

[5] Cf. Destatis (2021): *Corona pandemic: sharp drop in mobility on Christmas and New Year's Eve 2020*. Press release No. 13/2021.

- Second, a home-office ordinance at the federal level, according to which home office work should be put on offer wherever this is possible and wherever operational concerns do not conflict with this;
- Third, schools are to remain closed in principle until February 14, but emergency care will continue to be provided.

Negative cyclical effects will increase in the first quarter but may nonetheless be coped with

The Economists of the Sparkassen-Finanzgruppe support this resolution in principle from an economic-policy perspective. The more far-reaching measures envisaged in the resolution are not expected to additionally slow down economic activity in the German economy to any appreciable extent. The apparent contradiction between the extent of infection control and overall economic activity seems at least less clear-cut in view of the vigorous development in the fourth quarter than was the case last spring - thanks, of course, to currently vital demand from China and to intact supply chains. It always depends on the individual measures chosen in each case. From an economic vantage point, it is particularly welcome that neither a closure of the public transport system nor a complete lockdown for manufacturing companies has been agreed on. However, it is becoming increasingly apparent that the period of severe restrictions on contacts could endure right through to Easter. There is still room for improvement with regard to the testing strategy (including the use of rapid tests), the fields of application and effectiveness of the Corona Warning App, or short-term increases in staff at health authorities mobilising temporary personnel from the sectors severely affected by the lockdown.

The education and childcare situation is causing increasing concern

The education and care situation of children and adolescents is a major concern. It is true that recent studies indicate that infections occur in schools as well; however, if schools and childcare facilities are closed for a longer period of time, considerable negative consequences are to be feared in the long term from the point of view of education, social policy and the macroeconomic development. Children from educationally disadvantaged backgrounds are particularly negatively affected by distance learning, and there is a risk that they will be “left behind” as a result. This is all the truer if schools are not equipped with notebooks, which is obviously the situation on the ground in most cases. But even in the short term, the negative effects are amplified in line with the duration of the closure, among other things wth respect to the labour supply, especially for parents with children aged 0 to 12. In the long run, the demands of home schooling are not compatible with parents working full time (even in home office). In 5.7 million families with children under 13, at least one parent is employed, and in 3.6 million families, both parents are in the active work process.[6] In addition, there are 730,000 working single parents with children aged 0 to 12, 310,000 of whom are in full-time employment. In view of the considerable macroeconomic costs caused by school closures, measures and investments must be urgently examined that will make safe face-to-face teaching possible again.

Thanks to the vaccines that have been developed and authorised, the decisive instrument for overcoming the pandemic in the long term is now available. Vaccinations are also the basic prerequisite for economic recovery. The success of the vaccination rollout must not therefore be jeopardised. There is no way around single-minded containment of the second wave, as vaccination coverage is unlikely to be sufficiently high before the middle of the second half of 2021. The population's approval of vaccination has already increased significantly after just a few weeks, and this trend should be further buttressed with incentives and clarification. In parallel, production and administration of the vaccines must run at full speed. Government support for this should be stepped up. Every day counts when more people can be vaccinated.

Global economic environment: Hoping for a game changer

Hopes are resting on vaccines as a game changer

The Chief Economists of the Sparkassen-Finanzgruppe expect the situation on the pandemic front to gradually improve. In particular, the development and production of vaccines is progressing promisingly and could morph into a game changer in 2021. We are also seeing initial promising approaches to the development of potential drugs to treat Covid-19. Despite the very difficult situation prevailing in most developed economies during this winter half-year, the global economy is set to recover significantly from the coronavirus shock. We expect an extraordinarily dynamic catch-up process for the global economy from spring onwards, which will continue into 2022. The unprecedented support provided by monetary and fiscal policy will continue during 2021, and the major central banks are even likely, in principle, to maintain an accommodative monetary-policy stance for a longer period - at least until the pandemic has been overcome in a sustainable fashion.

The global economy will have tailwinds at its back during 2021

For the current year, most professional forecasters and institutes expect a high pace of growth for the global economy, and global trade should also continue its recovery. The Chinese economy was the first to return to the recovery path, already surpassing the previous-year level in the third quarter of 2020 and reporting a 6.5 percent increase in aggregate

[6] Cf. Destatis (2021), data for 2019.

economic output in the last three months of the year compared with the fourth quarter of 2019, albeit at the price of a further spike in government and corporate debt. In the USA, the Fed provided massive support for the recovery in 2020. Thanks in part to a still highly expansionary fiscal-policy stance, the US economy stands to recover swiftly in 2021 from its previous-year slump. An important determinant of the global economic trend is the emerging shift in US policy under the new US President, Joe Biden, especially as the Democrats have managed to secure a de facto majority in both chambers of Congress for the first two years of his term. In the foreign and trade-policy arenas, some conflicts with the USA remain, but Europe in particular can justifiably hope for a return to a more cooperative - and, above all, more reliable - transatlantic relationship. The rivalry with China, on the other hand, is not going to fade away even under Joe Biden and will certainly have a major impact on the global economy over the course of the present decade. The prospect of a fundamental paradigm shift in US policy under Joe Biden, the resolution of the uncertainties surrounding the Brexit endgame and, of course, high hopes for vaccines have recently had a favourable impact on sentiment on the markets and among companies and financial-market experts.

Downside risks are mainly pandemic-related

There are, of course, downside risks to the baseline scenario presented here. Above all, a less favourable pandemic trajectory should be mentioned in this context, for example due to disappointments regarding vaccine production, insufficient vaccination readiness, or further viral mutations. At present, however, there is much to suggest that the pandemic will become progressively more manageable in 2021 after another tough period this winter, and that a return to a post-pandemic “new normal” is a realistic prospect.

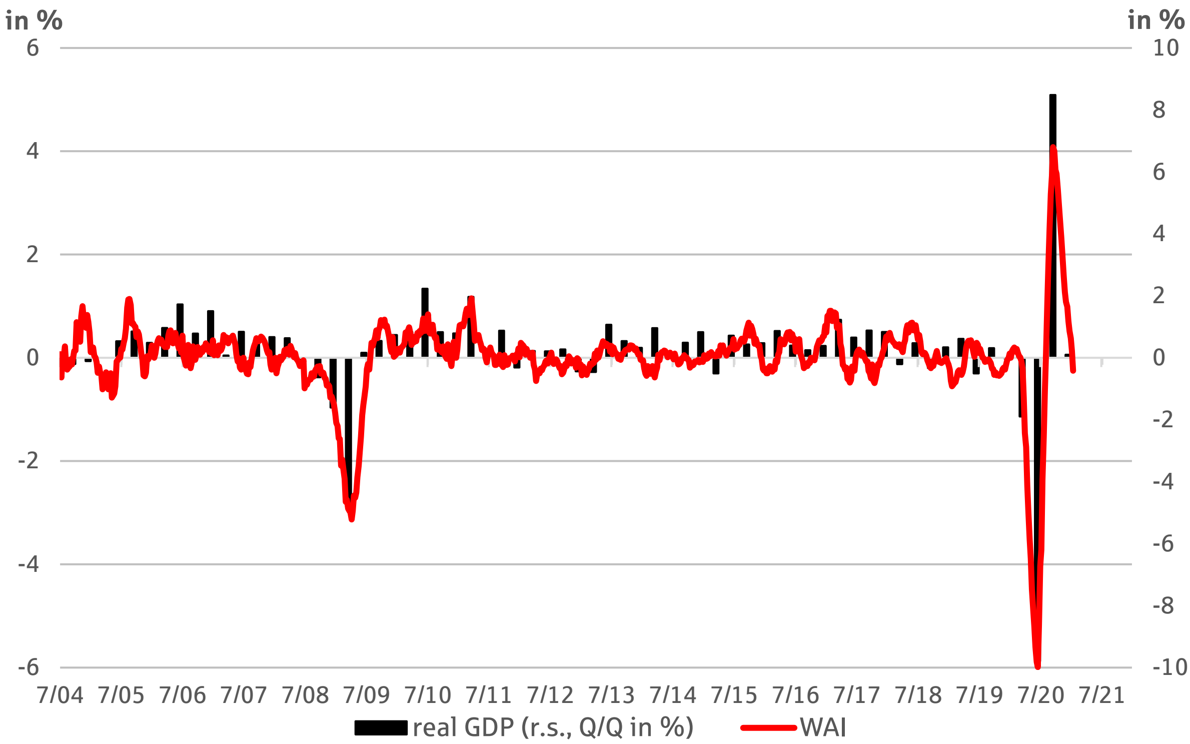
Short-term outlook: The second wave will weigh on the economic development during the winter months

The macroeconomic burdens in the winter half-year should prove much lighter than during the first wave

The impact of the second wave of infections and of the containment measures has, at least so far, proved significantly less marked than during the first lockdown. It is true that individual sectors and companies have seen their economic activity particularly severely restricted in some cases. Economic sectors that rely on pronounced social contacts are being particularly affected. This applies to large swathes of the services sector, and to the hotel and restaurant industry, as well as to offline retailing. However, the share of value added in the directly affected sectors is comparatively low, so that the continued recovery in industry, along with a very robust performance by retailing, at least until the end of November, has largely made up for these losses.

Most companies are also likely to have been better prepared for the second wave; in contrast to the situation during the first wave of infections, there were no disruptions to supply chains and foreign demand also provided noticeable support. Probably the most decisive difference from the first lockdown is that manufacturing industry has been able to continue its recovery, thanks in part to strong export demand and to the absence of supply-side constraints deriving from supply-chain disruptions. Intra-European traffic is not being as much impeded as in the spring either. The Federal Statistical Office (Destatis) is forecasting a near-stagnation scenario for the final quarter, which springs a positive surprise given the more negative signals flashed by recent real-time-activity indicators. The point is that most of the latter are still calibrated on the basis of experiences from the first lockdown and now appear to significantly overstate the extent of the negative macroeconomic effects.

Figure 3: The weekly activity index is a good guide to the trend in GDP

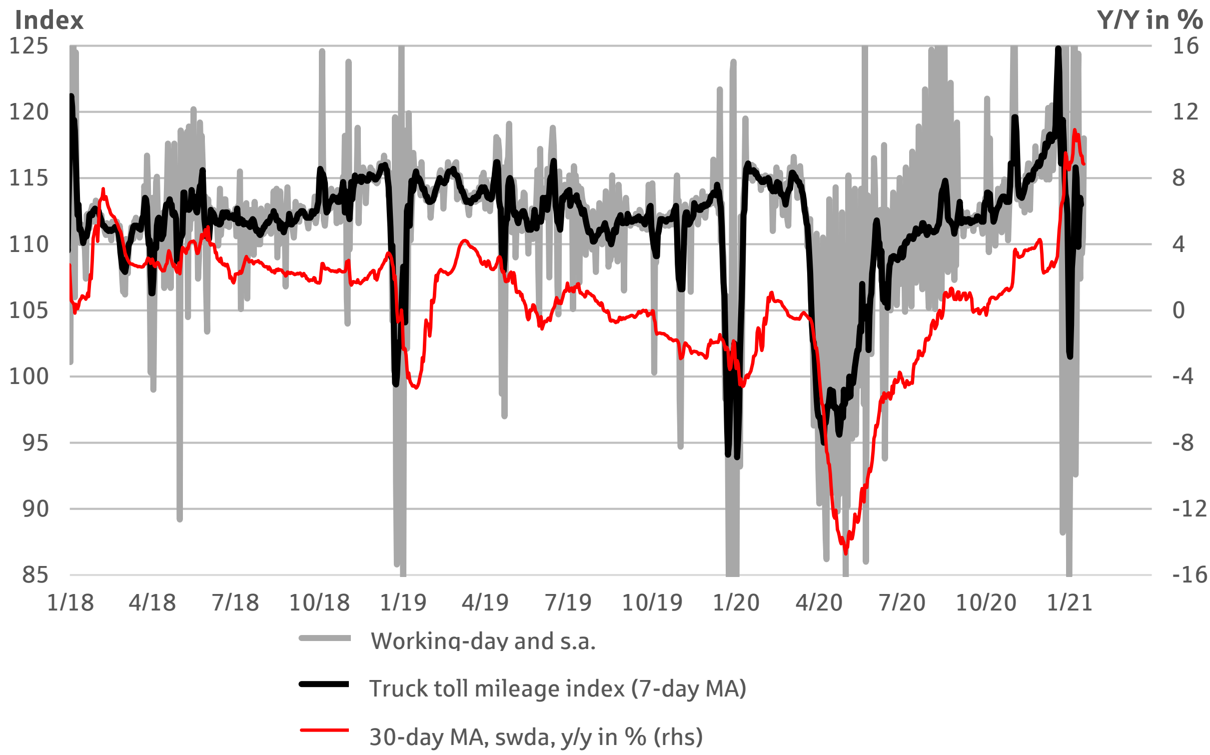


Source: Deutsche Bundesbank; Destatis; Feri; NORD/LB Macro Research.

Recent indicator readings reveal the stabilising effect emanating from the relative strength of industry

By contrast, a more reliable signal has emerged this time from the weekly activity index calculated by Deutsche Bundesbank. This gauge has continued to decline right up to the time of writing, and a subdued start to 2021 is certainly to be expected with the lockdown now scheduled to remain in force for some time to come. For the manufacturing sector, however, both the truck toll mileage index and the incoming-orders metric, which is already well above its previous-year level, point to industry continuing to show relative strength. Major negative consequences from possible anticipatory effects resulting from the reversion to normal VAT rates, or from more pronounced inventory accumulation ahead of the uncertain outcome of the EU-UK negotiations, are relatively unlikely.

Figure 4: The truck toll mileage index indicates sustained high momentum in the industrial sector



Source: Destatis; NORD/LB Macro Research.

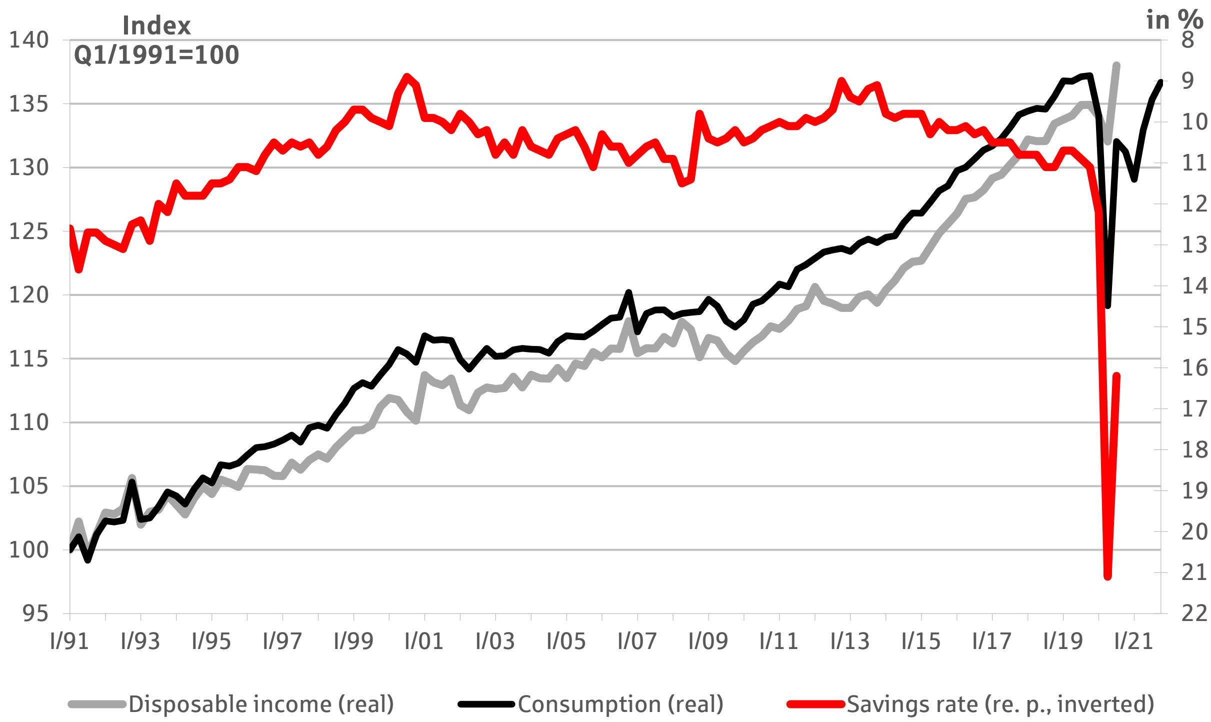
Forecast for 2021/22: Germany looks to be on the brink of a strong recovery

A strong recovery should kick in again from spring onwards

In the wake of this dent in economic activity, however, the Chief Economists of the Sparkassen-Finanzgruppe expect the recovery to get back on track. Simply because the weather conditions will be more favourable again, a strong increase in economic activity can be expected from the spring onwards - provided that there are no setbacks on the vaccination front. Despite the second wave of infections which is in motion, the mood of companies and financial-market experts has recently improved, in some cases significantly, particularly the expectations component. Such brighter sentiment has definitely been sparked by the increasingly concrete reports on vaccine breakthroughs coming in since the beginning of November. Confidence will certainly tend to rise further still as the vaccination coverage of the population increases.

Nevertheless, consumers are still comparatively sceptical about the future, and fears about their own jobs in particular remain rampant. For the first time since 2009, consumers are therefore bracing for incomes to fall slightly on average. As a result, many have increased their provisioning to adjust for anticipated, or at least feared, negative effects of the crisis on disposable income. Savings ratios have increased - the last time that this effect was so pronounced was immediately after the attacks on the World Trade Center in 2001. This trend in savings may partly be explained by precautionary motives. However, the main reason is the massive slump in private consumption to the tune of -6.0 percent, which was mainly attributable to the loss of various consumption opportunities. The flipside of reduced scope for consumption has been a climb in the savings rate from 10.9 percent (2019) to no lower than 16.3 percent in 2020, although this parameter already back came off its spring peak in the third quarter, normalising significantly. This trend is likely to continue going forward.

Figure 5: Private consumption, disposable income and the savings rate



Source: Destatis; Feri; NORD/LB Macro Research.

The savings rate will gradually return to normal - catch-up effects for private-consumption expenditure

By setting aside an unusually high pile of savings during the crisis, private households have built up a cushion which, at least in part due to pent-up consumer wishes, is likely to translate into tangible demand once the pandemic is over. According to the joint forecast by our Chief Economists, private consumption will therefore turn out to be a mainstay of the economic recovery in the current as well as in the coming year. For

2021, the Chief Economists expect GDP growth of around 3.5 percent on average. The static pre-crisis level (note: not the old trend!) is likely to be reached again as early as around the turn of the year 2021/22. For 2022, aggregate economic output is expected to expand at a similar magnitude. The picture for the eurozone is similar in terms of the course and extent of the economic recovery.

Table 1: Key data from the joint forecast by the Chief Economists of the Savings Banks Finance Group and Landesbanken

Germany	Available readings for 2020	Forecasts for 2021	Forecasts for 2022
Gross domestic product [1)]	-5,0	+3,5	+3,1
Private consumption expenditure	-6,0	+3,4	+3,4
Government consumption expenditure	+3,4	+2,8	+1,1
Construction investment	+1,5	+1,7	+2,7
Equipment investment	-12,5	+8,5	+5,8
Exports	-9,9	+9,5	+5,3
Imports	-8,6	+8,7	+5,8
Employed persons [2)]	44.800	44.800	45.200
Unemployment rate [3)]	5,9	6,2	5,6
Consumer prices (HICP) [4)]	+0,4	+1,4	+1,7
Core inflation rate (excluding energy, food, alcohol, tobacco) [4)]	n.d.	+1,2	+1,4
Savings rate [5)]	16,3	13,1	11,0

Fiscal policy: Avoidance of second-round effects is crucial

Avoidance of hysteresis lags and second-round effects is of crucial importance

How dynamically the economic recovery proceeds in parallel with progress in surmounting the coronavirus pandemic also hinges on whether the labour market can be largely shielded from (lasting) effects of the coronavirus crisis over the coming months. The short-time work instrument and a wide range of fiscal-policy support measures for companies have prevented worse knock-on effects in the form of a major wave of layoffs. The seasonally-adjusted unemployment rate climbed only briefly to 6.4 percent in the summer of 2020. At times, however, around six million people were in short-time working mode. Nevertheless, the number of people in employment fell for the first time in 14 years, by almost 500,000 (-1.1 percent yoy). In addition, hours worked per employee declined by almost 4 percent. Since then, the labour market has continued to improve: even in the lockdown months of November and December, the number of those registered as unemployed decreased significantly. Admittedly, it would appear that greater use has once again been made of the instrument of short-time work. This makes it clear that the current regulations need to be extended until the end of 2021, especially against the background of the recurring stresses and strains recurring in waves as a consequence of the coronavirus crisis.

The support measures for the economy have been both extended and adjusted. Replacing the November/December aid, Bridging Aid III has been in effect since mid-December 2020. Unless it is rendered unnecessary by positive developments in the intervening months, this scheme is to apply until summer 2021, entailing monthly burdens for the federal government amounting to EUR 11 billion. This is intended to avoid overcompensation - an important principle in order to give companies not only support but also the signal to adapt to changed framework conditions with entrepreneurial innovations, thus helping to actively shape them. It should be possible for companies to determine the key benchmarks (sales and fixed costs) for receiving the support and the improved terms of depreciation and amortisation without additional bureaucratic effort. Simplifications have now been agreed on in this regard, which will help to improve the situation over the next few weeks.

Monetary-policy and economic-policy flanking measures are needed to fight the pandemic

Reliable monetary-policy and economic-policy support remains necessary for the time being. Further crisis measures should focus primarily on avoiding hysteresis lags and second-round effects, whereas traditional economic-stimulus (“pump priming”) programmes would not appear to make much sense at the present juncture. The results of last year’s cut in VAT are also mixed.[7] In view of the specific configuration of the pandemic, requiring contacts to be reduced as much as possible, classic stimulus measures to pump up demand may even have undesirable counterproductive effects. The VAT measure was designed

[7] Fuest, Clemens / Neumeier, Florian / Peichl, Andreas (2021): Has the VAT Cut Boosted Consumption? In: *ifo Schnelldienst digital*, 2021, 2, no. 1.

from the outset to be temporary. The decision to allow the VAT reduction to expire at the end of 2020 is therefore to be welcomed.

Medium-term development prospects

Not only has the coronavirus outbreak affected almost all areas of life; structural shifts are also foreseeable as a result of the pandemic - from sustainable changes in consumption and demand behavior to an acceleration of digitalisation to an increased focus on a greener and more ecologically correct economy.[8] The latter is also being promoted by political influence. In any case, one of the already foreseeable results of the coronavirus crisis is the greater influence of politics on economic issues. In addition, fiscal policy has experienced a veritable renaissance as a result of the crisis and has made an important contribution to stabilisation in the short term, while at the same time leaving behind significantly increased debt in its wake as a burden for the future.

The possible consequences of the unconventional crisis-related monetary and fiscal-policy measures

Along with the sharp crisis-related rise in public debt, some economists see the danger of a sustained rise in inflation being spawned by the measures taken by central banks. In the short term, such a surge in inflation can largely be ruled out due to the massive negative output gap resulting from the crisis. The gradual uptick in the inflation rate this year is mainly due to certain special factors such as the reversion to the previous VAT-rate levels or higher CO2 pricing. Baseline effects emanating from the higher oil price will also ensure a higher inflation trajectory in 2021.

The coronavirus crisis could well increase the risk of fiscal dominance over monetary policy

Once the pandemic is overcome, overall economic demand could indeed pick up significantly. Even after the accelerated catch-up process envisaged for 2021/22, the Chief Economists still see annual growth rates averaging 1.5% for Germany and the wider euro area in the medium term. Should there be a stronger inflationary impulse, monetary policymakers may not be able to respond to higher inflation, or at least not adequately, due to the very high debt levels in member countries and due to the way their instruments have been pre-calibrated. The risk of the pandemic leading to fiscal dominance over monetary policy certainly cannot be dismissed out of hand. Yet public budgets will, in all likelihood, be consolidated after the crisis and government deficits will be scaled back. How successful fiscal policy will be here remains to be seen. According to the Chief Economists, it will take some time for public-debt ratios to return to pre-crisis levels: on average, this is not

[8] The Chief Economists will be taking an in-depth look at this topic in a separate issue of "Statement" later this year.

expected to happen until 2030 for Germany, and distinctly later still for the euro area.

Post-pandemic, crisis measures need to be scaled back and side effects limited

A massive and sustained post-pandemic demand stimulus entailing strong inflation potential is not currently the Chief Economists' baseline scenario. In the medium term, however, average inflation is expected to be hovering in the region of 1.8% (Germany) and 1.6% (euro area). The premise on this score is that monetary policymakers scale back their extraordinary crisis measures once the pandemic has been overcome. In the current acute phase of the crisis, monetary-policy support is as justified as it is helpful - though it also has some undesirable side effects from a crisis-policy perspective. The sharp increase in excess liquidity, which is set to continue in future, should lead to an increase/recalibration of the tiering factor to prevent unnecessary additional burdens on the banking sector during the crisis and thus to make a further contribution towards ensuring a satisfactory credit supply for the economy.

Disclaimer

This position paper by the Chief Economists of the German Savings Banks Finance Group does not necessarily reflect the stance of DekaBank or the position of the respective Landesbanken and savings banks.

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