IWH Halle Institute for Economic Research
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Global economy under the spell of the coronavirus epidemic

The epidemic is obstructing the economic recovery in Germany. Foreign demand is falling, private households forgo domestic consumption if it comes with infection risk, and investments are postponed. Assuming that the spread of the disease can be contained in short time, GDP growth in 2020 is expected to be 0.6% according to IWH spring economic forecast. Growth in East Germany is expected to be 0.9% and thus higher than in West Germany. If the number of new infections cannot be decreased in short time, we expect a recession in Germany.

Forecast for Germany: Key Economic Indicators[a] for Germany, 2018–2021

	2018	2019	2020	2021
	percentage change over previous year (price adjusted)			
Germany	1,5	0,6	0,6	2,0
East Germany[a]	1,9	1,0	0,9	1,8
	percentage change over previous year in %			
hours worked	1,3	0,6	0,7	0,7
hourly union wages	2,9	3,2	2,2	2,2
hourly actual wages	3,0	3,2	2,1	2,6
unit labour costs[b]	2,5	3,4	2,2	1,3
consumer price index	1,8	1,4	1,2	1,4
	1 000 persons			
employment (domestic)	44 854	45 251	45 474	45 754
unemployment[c]	2 340	2 267	2 249	2 197
	in %			
unemployment rate[d]	5,0	4,8	4,7	4,6
East Germany[a]	6,8	6,4	6,2	6,1
	in % of nominal GDP			
general government overall balance	1,9	1,4	0,7	–0,1
current account balance	7,4	7,7	7,4	7,2

[a] East Germany including Berlin. – [b] Per hour (IWH calculations). – [c] Federal Employment Agency (BA) concept.– [d] Unemployment in % of civilian labour force (Federal Employment Agency (BA) concept).
Sources: Federal Statistical Office; 2020-2021: IWH forecast (as of March 12, 2020).

Since the end of January 2020, the coronavirus epidemic has affected the global economy. Production and demand in China probably declined in the first quarter. Although economic life in China gradually returns to normal amid a significant decline in new cases, the number of confirmed cases steeply rises elsewhere. For many advanced economies, the economic consequences are likely to be similar to those for China. The significant interest rate cut by the US Federal Reserve at the beginning of March was unable to prevent severe price slumps on the stock and commodity markets. However, the current forecast assumes that the spread of the epidemic in advanced economies will be contained in the second half of the year as it is already the case in China. Under this assumption, the global economy is likely to remain weak in the first half of 2020, but will recover from summer onwards.

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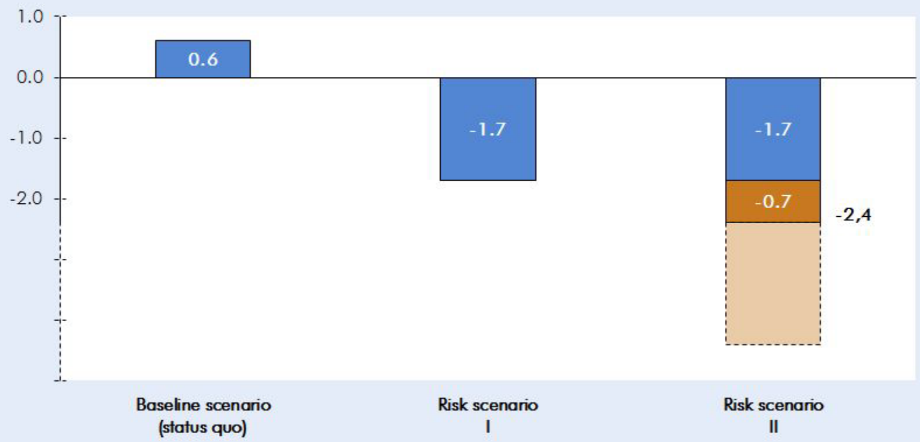
The epidemic hit the German economy at a time when a prolonged period of economic weakness seemed to come to end. World trade, however, is now expected to slump in the first half of 2020. In addition, the uncertainty associated with the epidemic should also dampen economic activity in Germany. Production is expected to decline slightly in the second quarter of 2020. Under the assumption that the epidemic in Germany and abroad tails off in the second half of the year, the economy should pick up quite strongly during next winter. According to this forecast, production is expected to grow by 0.6% in 2020 and in 2021 by 2.0%. Around one third of the increase is attributed to a higher number of working days. The temporary decline in production is unlikely to have a significant impact on employment, not least because recent employment growth has mainly taken place in sectors that are hardly or not at all affected by the current economic downturn. At 1.0%, the economy in Eastern Germany is expanding markedly faster than the overall German economy this year, mainly because consumer goods, for which demand is likely to remain fairly stable, are an important part of East German production. "A major risk for the German economy poses the potential restriction of the labour supply if many people get sick at the same time. Even in the case of mostly mild courses, this could temporarily lead to a significant decrease of labour input for specific quarters", says Oliver Holtemöller, head of the Department Macroeconomics and vice president at the Halle Institute for Economic Research (IWH). He considers that measures to contain the spread of the disease and increasing uncertainty could then also dampen domestic demand even further.

Figure

Corona-Scenarios for economic activity in Germany

Price-adjusted GDP growth for Germany in 2020



Baseline scenario: epidemic will soon be contained. Risk scenario I: demand sharply falls in advanced economies. Risk scenario II: in addition, labor supply is constrained markedly in Germany due to increasing infection cases.
Source: Statistisches Bundesamt; IWH calculation and presentation.

Economic implications of the coronavirus crisis

Economic policy measures that stimulate aggregate demand are currently not appropriate. The necessary measures to contain the infections lead to short-term losses, which must be accepted in order to prevent even greater damage in the future. The top priority is to slow down the spread of the virus. Next policy actions should aim at preventing an excessive increase in corporate insolvencies. A multi-stage system is suitable for this. Short-time work regulations have already been extended. The first partner for firms in the event of liquidity bottlenecks are banks.

These must therefore remain operational and should be supported by liquidity measures where necessary. If the risks in individual firms are so high that banks refuse to lend, then state guarantees, while maintaining a certain level of risk for the banks themselves, are the next step. Deferments of government claims (such as taxes and social security contributions) may be an additional measure, although they might not be targeted. If all this is not sufficient to avert major damage, financial transfers to individual firms may be considered. Although preparations should now be made for this and a public signal should be given that this instrument would be used if necessary, it is too early to take concrete decisions on direct financial transfers to firms. This requires a better empirical basis. Measures to stimulate aggregate demand would only make sense if private demand does not catch up after new infections have slowed down.

The full version of the forecast contains three boxes:

Box 1: Assumptions and forecasts regarding the general conditions

Box 2: Estimation of potential output

Box 3: The Corona epidemic as a risk for the German economy

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