
18 Economic implications of the COVID-19 crisis for Germany and economic policy measures

Peter Bofinger, Sebastian Dullien, Gabriel Felbermayr, Clemens Fuest, Michael Hüther, Jens Südekum and Beatrice Weder di Mauro

Würzburg University; HTW Berlin; Kiel Institute for the World Economy; ifo Institute and Ludwig Maximilian University; German Economic Institute; Heinrich-Heine-University Düsseldorf; Graduate Institute, Geneva and CEPR

Coronavirus: A China-induced but now global supply and demand shock

The coronavirus crisis started in China, where it caused massive damage to public health and economic growth. In the meantime, high and rapidly growing numbers of cases of COVID-19 have also been recorded in Japan, Korea, the US, Germany, the UK, France and above all Italy, where the number of infected per inhabitant is already six times as high as in China. The main difficulty of an efficient and effective economic policy reaction to the crisis is that it is triggering a simultaneous supply and demand shock. The massive slump on the stock markets and the flight to safe investments is a reaction to these shocks. It may trigger further shocks and intensify the downward dynamic in the real economy.

The extent of these shocks is strongly dependent on **expectations** and **beliefs**, which can be very volatile in the face of a crisis. Economic policy measures must take account of this. Therefore, the timing and communication of measures are of crucial importance. Economic policy must contain the economic effects of the health crisis in such a way that it does not turn into a systemic economic crisis with long-lasting effects on the labour market, banks and financial markets.

The coronavirus as a supply shock

In highly integrated value chains, production losses due to a lack of inputs spread rapidly worldwide. Many companies today rely on **just-in-time production** with low inventories. The components supplied are often highly specialised and tailored to the needs of the next step in the value chain. As a result, there are often no alternative suppliers who can deliver quickly and at acceptable prices for companies.

The peak of these production losses has not yet fully hit the German economy. The plant closures in China peaked at the beginning of February, but production is now slowly starting up again. Due to delays in transport, the full impact in Germany will not be felt until April. Quarantine measures in Italy, in other EU countries and in Germany itself will cause additional disturbances.

An additional supply shock occurs when employees are absent due to illness or quarantine measures. The closure of schools and pre-school facilities leads to an indirect loss of employees, as can illnesses in the family. In principle, this supply shock can be mitigated by **teleworking and working from home**. While these options are being increasingly used, they are not practicable for personal services and production occupations.

The maintenance of production chains is made more difficult by the **disruption of transport infrastructure networks** when air connections and travel in general are severely restricted.

Quarantine measures can have very sizeable economic effects: one week during which a country runs at 50% of capacity amounts to a loss of yearly GDP of up to one percent.

The coronavirus as a demand shock

China and other economies severely affected by the coronavirus will reduce their demand for German intermediate products, capital and consumer goods and tourism services in the foreseeable future. The full extent of these global effects depends on the further course of the global spread of the virus. The OECD has presented initial model-based estimates and forecasts on this (Boone 2020).

Their optimistic scenario, in which the spread of the virus remains essentially concentrated in China, is already outdated.

In the less optimistic but now more realistic scenario, the virus spreads rapidly outside China. The economic impact will then be felt not only through the decline in Chinese demand, but also directly in the countries affected. In this scenario, global GDP growth falls by 1.5 percentage points in 2020 and the volume of world trade by 3.75 percentage points.

Germany is particularly affected by these developments due to its high dependence on exports and industry. Already before the crisis, the GDP forecast for Germany in 2020 was very low.

Direct negative effects from the growing security measures will massively restrict ‘**social consumption**’ (restaurant visits, domestic tourism, trade fairs). Prominent events (the Hanover Fair, the Leipzig Book Fair) have been cancelled and all German sports leagues have now ceased operations until April. The whole of public life in Germany has now come to a standstill.

This drop in demand is unlikely to be fully offset by a **catch-up effect** after the end of the crisis. If supply chains are interrupted, purchases and sales can be made up for. Social consumption (for example, restaurant visits or private trips) that is cancelled now will not necessarily be made up later.

This will have a strong negative impact on private consumption, which has so far proved to be a pillar of economic support for Germany. A consumption recession in the first half of 2020 has become very likely, in addition to the industrial recession that has been observed for some time anyway.

Other demand segments may also be negatively affected. The prospect of a longer quarantine has already led to **stockpiling** of certain goods. Insecure consumers could, however, shy away from buying consumer durables. Many will reduce spending on other types of consumption to build up precautionary savings.

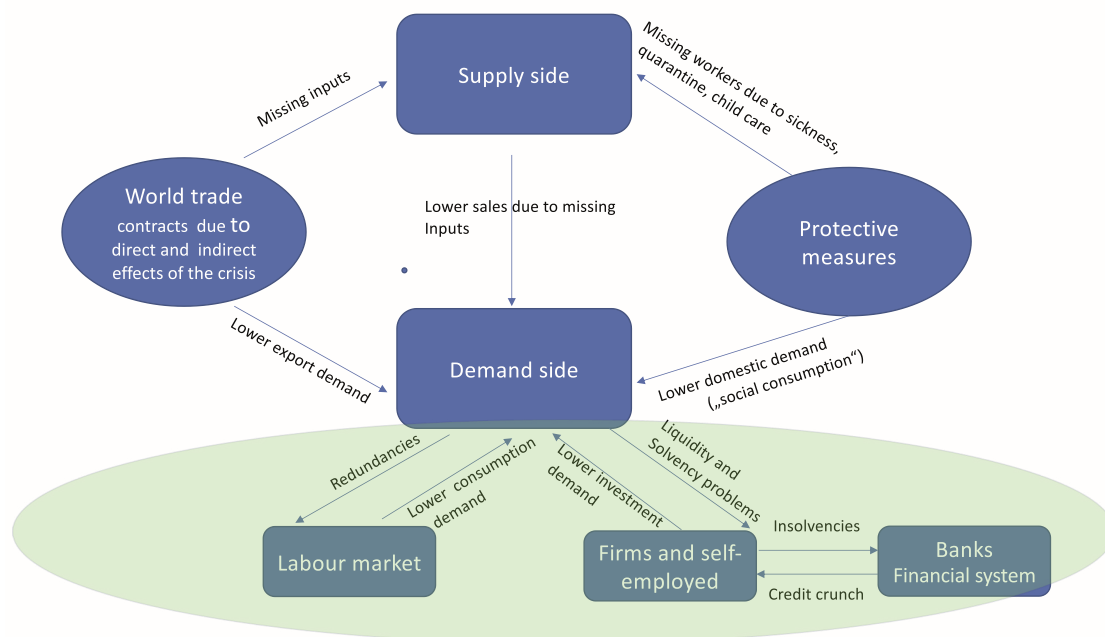
In addition, a demand contraction may be triggered by reactions in the **financial sector**. Banks may need to reduce the supply of credit if they make losses on outstanding loans to companies strongly affected by the crisis. In addition, many companies will fully use their credit lines to build up cash reserves for the crisis. This credit expansion may crowd out the bank financing of private investment and other credits.

The difference from the Global Financial Crisis

The financial crisis uncovered an imbalance in the real estate markets that had been built up over many years, with significant and long-lasting negative effects on the financial system and on labour markets. However, there was no supply shock in the context of this crisis. Policymakers were therefore able to focus on stabilising the financial system and on the consumer and investment demand.

In the case of COVID-19, the situation is more complex. It is simultaneously a supply and demand shock, and the collapse in demand for ‘social consumption’ for medical reasons should not – and probably cannot – be compensated for by state support for demand. In the event of supply shortfalls, government support for demand is counterproductive (Figure 1).

Figure 1



The prospects for economic recovery are better than in the Global Financial Crisis in so far as normal operations can be resumed quickly after the end of the epidemic and positive catch-up effects would support the recovery. However, this presupposes that the epidemic will soon be brought under control and that its effects on the labour market, the liquidity and solvency of companies and the banking system will be contained to the sectors directly affected.

An important parallel is that, even in the COVID-19 crisis, it is important to counteract a loss of confidence among companies in the real economy and in the financial sector in the solidity and solvency of business partners.

Functionality of medical care as a top priority

The priority for all (economic) policy measures must be to ensure the functionality of the health system and medical care.

Overcrowded or even closed doctors' practices and clinics, overtaxed health authorities, and a lack of medicines and testing facilities would lead to panic in the population, especially if this is accompanied by a further increase in the number of cases of infection. Such a dynamic must be avoided at all costs, even if this requires a targeted renunciation of 'social consumption' (such as the cancellation of major events). This is exactly what almost all governments worldwide are trying to achieve through drastic measures limiting international travel, closing borders and even requiring citizens not to leave their homes.

In the short term, one could argue that there is a conflict between medical and economic goals. Cancelling an event or closing schools slows down the spread of the virus.¹ On the other hand, these measures generate immediate economic costs – for example, when restaurants are closed, employees are not allowed to work or are tied up in childcare.

At present, however, there are many indications that **containment of the virus must be a priority**. As the course of the infection develops exponentially and the health care system reaches the limits of its capacity, a lax containment policy would lead to much more drastic quarantine measures and thus to the threat of higher economic costs in the future. In the long term, the economic impact of overly lax containment would be much worse.

Due to resource constraints (availability of medical staff and hospital beds), a credible state guarantee of universal health care is not easy to give. However, the state must do everything in its power to maintain the functionality of the health system and to provide the necessary financial resources without limit.

1 The effectiveness of targeted mitigation measures appears to be quite high (WHO 2020).

Unconventional measures should also be considered if bottlenecks occur and they are already implemented in some countries:

- The reactivation of **retired medical staff** (as in the UK) or holiday bans
- Financial incentives for part-time doctors in private practice to **temporarily extend their working hours**
- In the event of the closure of schools and kindergartens, **special care should be provided for the children of medical staff**
- The state can persuade companies whose production is at a standstill anyway to **switch their product ranges to urgently needed medical goods** (e.g. respiratory masks)
- **Employees in the public sector** who are unable to carry out their regular work due to protective measures can be **deployed in the health sector** (e.g. in health offices at citizen telephones).

Economic policy measures

In the short term, the main aim is to compensate for negative effects on **corporate liquidity** and thus also on the stability of the banking system. In the event of **longer-lasting disruption**, the focus must increasingly be on additionally stabilising the earnings situation of companies and the self-employed. Above all, negative effects on the labour market must be avoided. In view of the increasing spread of the crisis, both measures may now be necessary.

Demands for an economic stimulus package – i.e. the usual measures of stimulating the economy through monetary and fiscal policy – cannot do justice to the specifics of this crisis:

- The **stimulation of economic activity** must not lead to a further spread of the epidemic. ‘Social consumption’, which brings people together physically, should not be stimulated.
- The **time delay in a classical investment programme** would be far too long to make an effective contribution to mitigating the economic consequences of the corona crisis.

Once the health crisis is contained, a stimulus package in form of tax cuts or higher public investment can be sensible to move the economy as fast as possible back to its pre-crisis trend.

The role of the ECB

The ECB has an important role to play in stabilising the financial system:

- In the event of a general crisis of confidence in the stability of the financial system, which would lead to a bank run, the ECB must stand ready as a ‘lender of last resort’ without restrictions.
- The ECB has the necessary refinancing instruments (e.g. LTRO) to deal with liquidity bottlenecks at banks.
- The ECB has very little scope left for further reducing the interest burden of companies; interest rates on the capital market and money market are already at historic lows and in the negative terrain.
- It would be possible to increase the purchases of corporate bonds (for example, from airlines). However, such a step would not be unproblematic because many small and medium-sized enterprises would not benefit from it.
- Given the massive losses on global stock markets, one might consider the purchase of shares, as operated by the Japanese central bank, to stabilise the confidence not only of the markets but also of the whole population. However, previous experience with stock market slumps has shown that the effects on the economy as a whole are limited.
- The model of helicopter money would be technically difficult to implement, not to mention the lack of targeting. Here, direct payments from the government, as operated in Hong Kong, are the better solution.

With a very low debt ratio by international standards, German fiscal policy has huge potential to stabilise the economy during the crisis. It is now important to make use of this room for manoeuvre. It would be irresponsible to stick to the ‘black zero’.

Fiscal policy action is needed, and Germany has the necessary leeway

The principle of ‘**timely, targeted and temporary**’ should apply to all fiscal policy measures (Gaspar and Mauro 2020). The COVID-19 crisis is therefore not in itself a reason for permanent tax cuts or a permanent increase in government spending. Neither the ‘black zero’ nor the debt brake limit the scope for action. In any case, there is no legal basis for the ‘black zero’. The debt brake has an explicit exception for crisis situations (natural disasters, extraordinary events beyond the control of the state) in

Article 115 of the German constitution. The European **Stability and Growth Pact** also provides for **temporary fiscal leeway** in crisis situations, i.e. extraordinary events beyond the control of the member states.

With a very low debt ratio by international standards, German fiscal policy has huge potential to stabilise the economy during the crisis. It is now important to make use of this room for manoeuvre. It would be irresponsible to stick to the ‘black zero’. The German Chancellor and the Federal Minister of Finance have already made it clear that they are clearly giving priority to combating the crisis over fiscal principles.

German government willing to provide unlimited liquidity support

The measures required to contain the epidemic are directly causing a liquidity problem for many companies and the self-employed. While their revenues come to a halt, payments for current obligations (especially for wages, rent, interest and down-payment obligations, rental and leasing obligations) must still be made. In terms of economic policy, the aim must therefore be to ensure that the crisis does not lead to a wave of insolvencies in the German economy. This requires comprehensive liquidity assistance as quickly and unbureaucratically as possible. The German government has taken this into account with the **package of measures** entitled “A protective shield for employees and companies” of 13 March 2020.² The finance minister, Olaf Scholz called this package a “bazooka”.

- The possibilities for **liquidity support from the state-owned bank Kreditanstalt für Wiederaufbau (KfW)** are being significantly expanded, especially for larger companies. The KfW provides companies with long-term, low-interest loans that are channelled through banks or savings banks.
- In addition, a broadly based, **interest-free deferral of tax payments due** (advance payments and back payments) for income tax, corporate income tax and sales tax was agreed.

An important contribution to stabilising firms’ liquidity is made by the **short-time working allowance**. This instrument enables companies to temporarily reduce the working hours of their employees, with 60% (single) and 67% (married) of the resulting loss of earnings being borne by the Federal Employment Agency. During the Great Recession, this instrument helped to largely cushion the effects on the labour market.

² See https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finzen/2020-03-13-Schutzschild-Beschaefigte-Unternehmen.html

In response to the crisis, the federal government has, in a very short time, already made the conditions for the use of short-time work compensation more flexible and increased the benefits granted. As this instrument reduces companies' wage costs, it contributes to improving both liquidity and solvency.

In our paper (Bofinger et al. 2020), we have proposed in particular a generous expansion of the depreciation possibilities for investments as further measures to improve liquidity.

Solvency aid is additionally required

The crisis not only affects corporate liquidity, it also has serious effects on the earnings situation of many companies and self-employed. As these are mainly caused by restrictions imposed to protect the health of the population, they can be regarded as negative external effects for which companies must in principle be compensated. Apart from the short-time working allowance, which plays an important role here, the German government has not yet taken any major steps in this direction.

In Bofinger et al. (2020), we propose various tax policy measures:

- A **temporary reduction in income and corporation tax** (§ 51 (3) EStG and § 23 (2) KStG), as provided for in the Stability and Growth Act. However, this would only benefit companies that can still make a profit this year.
- For companies with losses, the **tax loss carryback** instrument is therefore the better solution (§ 10d EstG). So far, the loss carryback is limited to €1 million; this amount would have to be increased significantly. It would also be conceivable to carry back the profits of 2018 and 2019.
- **Bringing forward the partial abolition of the solidarity surcharge** to 1 July 2020 as a measure mainly limited to private households. This measure is to be considered mainly for psychological reasons.
- A reduction in VAT rates does not seem to make much sense in the short term. This measure is not very well targeted as it would also benefit sectors that have only been affected by the crisis to a limited extent, such as the construction industry or the consumer goods industry. It would also promote social consumption, which is not desirable in the short term.

What is now missing above all are measures to stabilise the liquidity and earnings situation of the **self-employed and owners of smaller companies**. For these people there is no automatic stabilisation mechanism available, such as unemployment benefit or short-time work. What is needed here is short-term and administratively simple aid, which should be provided either in the form of direct transfers or loans with very long maturities and, if possible, free of interest.

Corporate rescue fund as ‘ultima ratio’?

If it is not possible to stem the spread of economic shock waves and there is a greater incidence of corporate insolvency, the last resort would be to consider measures under which the state would invest equity in companies. This would be analogous to the rescue of banks under the SoFFin3 bank protection umbrella from the crisis of 2008/09. However, compared to the banking system, there is a much larger number of small and medium-sized enterprises in the real economy, so that the implementation of such measures on a broad scale would involve enormous administrative effort. From a competition policy perspective, too, such a solution does not appear unproblematic. However, in the case of large companies, especially in the transport sector, such measures will become unavoidable.

The European dimension

In this chapter we have focused on measures that can and should be implemented specifically by the German government for the German economy. We are, however, fully aware that national measures alone cannot overcome the crisis. It is a common challenge for all member states and can therefore only be successfully tackled with the help of a common and solidary European strategy. This applies both to the health policy dimension and to economic policy.

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3 *Sonderfonds Finanzmarktstabilisierung*, or Special Financial Market Stabilization Funds.

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About the authors

Peter Bofinger is Professor of Monetary Policy and International Economics at the University of Wuerzburg and a former member of the German Council of Economic Experts.

Sebastian Dullien is Professor for International Economics at HTW Berlin - University of Applied Sciences.

Gabriel Felbermayr is President of the Kiel Institute for the World Economy.

Clemens Fuest is President of the ifo Institute and Professor for Economics and Public Finance at the Ludwig Maximilian University of Munich.

Michael Hüther is Director of the the German Economic Institute.

Jens Südekum is Professor of Economics at Heinrich-Heine-University Düsseldorf.

Beatrice Weder di Mauro is Professor of International Economics at the Graduate Institute of Geneva and President of CEPR.