

Economics Standard Level

Commentary 2 – Macroeconomics

Title of article: Merkel Seals \$145 Billion Stimulus to Lift Battered Economy

Source of article: Bloomberg

Date article published: 04/06/2020

Date commentary written: 09/10/2020

Word count: 745

Merkel Seals \$145 Billion Stimulus to Lift Battered Economy

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4 June 2020, 03:56

Link- <https://www.bloomberg.com/news/articles/2020-06-03/merkel-s-coalition-reaches-deal-on-german-stimulus-package>

Chancellor Angela Merkel's coalition agreed on a sweeping 130 billion-euro (\$145 billion) stimulus package designed to spur short-term consumer spending and get businesses investing again.

The wide-ranging plan to lift Germany out of the crisis unleashed by the coronavirus exceeded the top end of expectations by 30%. Alongside an immediate jolt from a temporary reduction in value-added tax, coalition officials allocated money to build out 5G data networks, improve railways and double incentives for electric vehicles.

In one of the most contentious issues in the talks, the auto industry fell short of its goal of getting direct government support for purchases of conventional cars, as Merkel sent a signal that she intends to take a longer term view in fostering a recovery of Europe's largest economy.

"We couldn't just set out a stimulus package that was done in the traditional sense," Merkel told reporters late Wednesday in Berlin. "It had to be a package of measures that contained a view to the future. And this is precisely what we have emphasized."

Following an initial shot of stimulus in March, Merkel's administration vowed to spend whatever it takes to get the country growing again. Including programs to guarantee company liquidity, Germany has made more than 1.3 trillion euros available -- the most in the European Union by far. Still, the efforts couldn't prevent unemployment rising in May to the highest level since late 2015.

“It’s big, it’s bold, but let’s face it, that’s what’s needed,” Simon Wells, HSBC’s chief European economist, said in an interview with Bloomberg Television. Christian Schulz, an economist at Citigroup Inc. in Frankfurt, said the tax cut in particular was “a big and welcome surprise to us.”

“The idea is that households bring forward some spending on discretionary items, which then sets off a virtuous cycle of rising demand feeding on itself,” Schulz wrote in a note to clients.

After tense negotiations over two days, the chancellor overcame an impasse in the governing parties to broker a deal, which covers programs running through 2021.

The euro briefly extended its advance after Bloomberg first reported the agreement Wednesday, reaching an almost 12-week high of \$1.1257, before paring its gains.

Bunds extended their decline Thursday, taking the rise in yield on 10-year bonds this week to about 10 basis points. Not only are they headed for their biggest five-day drop since March, they’re also on course to stretch their weekly losses to the longest run since 2018.

Highlights of New Stimulus Plan

- Value-added tax cut to 16% from 19% through the end of 2020 at a cost of 20 billion euros
- Bridge financing for small and medium-sized businesses of as much as 25 billion euros
- Accelerate 10 billion euros in investment in digital, security and defense projects
- Tax incentives for corporate investment, impacting government revenue 6 billion euros
- 5.9 billion euros in aid for municipalities
- Bonus of 300 euros per child, totaling 4.3 billion euros

Rescue Package (agreed in March)

- 156 billion euros in new borrowing to finance higher social spending and a 50 billion-euro liquidity fund for self-employed people
- 600 billion-euro rescue fund, including: 100 billion euros to buy stakes in stricken companies, loans through state-run development bank KfW and 400 billion euros in guarantees
- KfW has extra 500 billion euros available to boost liquidity of German companies

Commentary:

This article outlines the recent **\$145 billion dollar stimulus package** in the German economy, as the sweeping effects of the Covid-19 pandemic hit the nation.

An economic stimulus, is **directed government deficit spending**, in key sectors of an economy, with the intention of producing a strong, **positive multiplier**, that would lead to an increase in private sector consumption and investment spending. It is reported that the overall stimulus package involves a “temporary reduction in value-added tax”, and a **long-term approach** “to build out 5G data networks, improve railways and double incentives for electric vehicles”. The pandemic has caused unemployment levels in the nation to be at the “highest level since 2015”, which reinforces the clear **reduction in aggregate demand**, as household disposable incomes fall. The stimulus package aims at producing an immediate response to energise the economy, but also sustaining the growth in the long term.

We can first evaluate the short-term effects of the stimulus. As stated, the value added tax rate has been cut from 19% to 16%, and an instrument of the **expansionary fiscal policy**. Such a reduction in the indirect tax rate would correspond to a reduction in the price levels of consumer goods and services in the economy. Indirect taxes tend to be inflationary, and thus a reduction would help **lower their inflationary effects**, and lead to a rise in aggregate demand. The government faces a loss of \$20 billion in fiscal revenue due to the cuts, indicating that effectively consumers now hold a \$20 billion **increase in purchasing power**. Moreover, a rise in AD would contribute to an increase in **derived demand for labor**. Such short-term shifts in demand would begin to address the issue of growing unemployment during the pandemic, as firms are likely to employ more workers as aggregate demand for goods and services rises. This establishes the **positive Keynesian multiplier effect**, which is the main aim of the stimulus package.

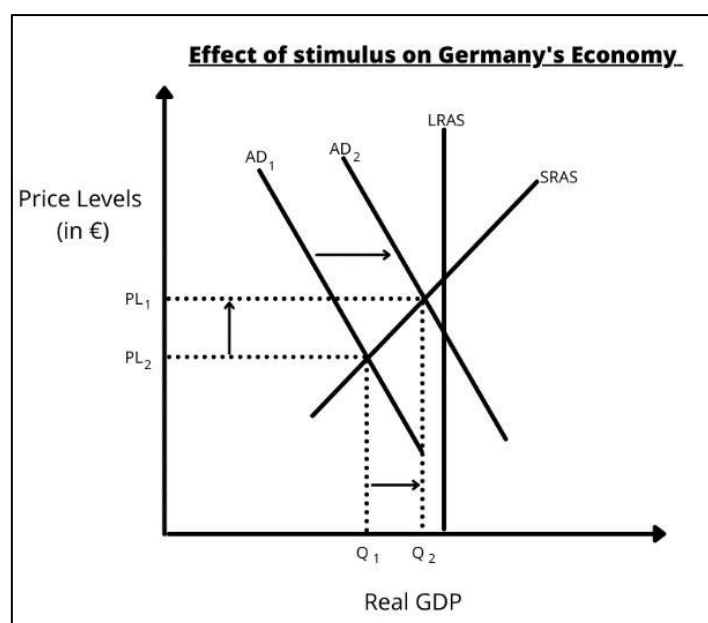


Fig. 1

AD is determined by the formula $= C + I + G + (x-m)$, and as the Consumption of Households (C) increases, the AD shifts to the right, from Q_1 to Q_2 , as seen in Fig. 1. Consequently, the greater revenue of firms due to increased expenditure will promote investment spending (I), and further influence a positive growth in the AD of the economy, representing a growth in real GDP, achieving economic growth.

However, since the increase in AD is dependent on the consumer response, if **the MPS of the population is higher than the MPC**, the greater disposable income (Y_d) may prove ineffective in stimulating consumption, as **consumers would rather save than spend**, which may be due to the uncertainty created by the pandemic.

Furthermore, the package aims at providing 25 billion euros in “bridge financing for small and medium-sized businesses”. Bridge financing is a form of temporary financing aimed at helping companies cover short term expenses, until funding for the long term is secured. Such funds would be vital in **preventing business from closing down**, and offer **greater security for those employed in them, in terms of income**.

Secondly, we can evaluate the long-term aspects of the package. As aforementioned the package has allocated funds into the developments of 5G data networks and railways. Such projects fall under the **supply side aspect of the stimulus package**, and have greater **long-term significance**. As the package aims to “accelerate 10 billion euros in investment in digital

security and defense projects”, it helps further address the key issue of unemployment. It can be determined that the two main forms of unemployment faced by the economy are those of structural, and cyclical unemployment. The investment is pivotal in job creation, and will help **relieve the issue of unemployment immediately**, providing workers with the required skills for the proposed projects. Moreover, government spending will directly influence AD, as G rises, and **initiates another multiplier**, as by providing jobs for unemployed workers, their disposable incomes rise, and it acts as another avenue to stimulate spending, and thus growth in the economy.

Lastly, the investment in infrastructure is a pivotal supply side policy, in ensuring sustained growth. The development in technology and communication will result in an **outwards shift in the LRAS** over time, and results in economic growth. This indicates a rise in the production capacity of the nation.

In conclusion, the package put into action by Germany has all the hallmarks of proving successful in stimulating the economy, however, considering the consumer response is in favor of increased consumption.