With or without the debt brake, fiscal stimulus will have to come to Germany

'Schuldenbremse' is currently the most known German word in financial markets. It contributed to the collapse of the government and will be a key element in any next government's plans to overhaul and modernise the economy. Either with full legal changes or new flexibility, we expect the next German government to agree on additional fiscal stimulus

There are not many German words that have found their way into international usage. Kindergarten is probably the most prominent one. In recent months, however, ‘Schadenfreude’ and ‘Schuldenbremse’ were clearly added to the list – at least in the financial community.

‘Schadenfreude’ or maybe also ‘cringe’ when looking at the German economy and the major protagonists. It is struggling with first recognising the structural changes and weaknesses of the economy and then with finding solutions. The economy has been in a de facto stagnation for more than four years, industrial production is still some 10% below its pre-pandemic level, international competitiveness has deteriorated, and the growing investment gap of the last decade has become visible in many parts of the economy.

There is no single reason for the collapse of the German government almost two weeks ago, but it is clear that the 'Schuldenbremse' played a prominent role, next to growing personal tensions between the leaders of the coalition partners, dropping support in regional elections and opinion polls as well as different views on how tackle the weak economy.

Looking ahead and beyond the upcoming elections in February, the main economic question the next government will have to answer is as simple as it is complicated: how will Germany restore international competitiveness and growth? And the solution, which is as simple as it is complicated, is: Germany will have to go either the Southern European way with structural reforms and (forced) austerity or with structural reforms, investments and somewhat looser fiscal policy.

A reminder – what is the German debt brake?

The German fiscal debt brake, or "Schuldenbremse," was a political reaction to the financial crisis in 2008 and surging government debt. It was agreed in 2009, when German government debt stood at around 70% of GDP, and became effective in 2010, when government debt was at 80% of GDP. The arguments behind the fiscal debt brake were to anchor sustainable public finances in the Constitution and prevent politicians from engaging in irresponsible fiscal spending. Changes need a two-thirds majority in parliament.

The debt brake restricts structural annual budget deficits to 0.35% of GDP and commits regional state governments to balanced budgets since 2020. Remember that the recently revised European fiscal rules no longer prescribe a certain fiscal deficit when a country has a debt ratio of below 60% of GDP but will instead focus on a sustainable path for public expenditures. Back to the German debt brake, there are provisions for exceptions in cases of natural disasters or severe economic crises, allowing for a temporary suspension of the debt brake, as in the European rules. The war in Ukraine and the pandemic have been valid reasons for exemptions but for the 2025 budget not everyone in the government wanted to opt for another year of special circumstances.

Current state of German public finances

When reading about the current political debate on public finances in Germany, one could get the impression that Germany is close to bankruptcy. The opposite is true. According to the latest forecasts by the European Commission, German government debt has stabilised slightly above 60% of GDP and is expected to stay there until 2026. Germany has by far the lowest government debt ratio of the larger eurozone countries. For example, France currently runs a government debt ratio of 115% of GDP. The expenditure ratio in Germany is currently at 49% of GDP, in France it is at 57% of GDP.

Admittedly, German public finances will be facing more stress over the longer term as a result of demographics. Just think of ageing having a negative impact of government revenues as less people will be at work and at the same time higher government expenditures, for example for pensions and health care. According to European Commission estimates, ageing-related public expenditures in Germany will rise by 2 percentage points over the next decades. However, in the IMF's estimates of government net debt, Germany's position will improve over the next five years and is one of the lowest in the eurozone. Debt sustainability is currently not an issue.

No overhaul of the economy without an overhaul of the debt brake?

The government collapsed over personal tensions, disappointing results in the opinion polls and different views on how to get the economy out of its current stagnation and structural weakness. The different economic policy ideas will therefore very likely play an important role at the upcoming elections on 23 February 2025. Differences will mainly occur on how and where to cut expenditures and how to finance or incentivise investments.

Reaching the debt brake during the economic good times of the 2010s was achieved via low interest rate payments and reduced investments. As a result, the economy has fallen behind in important fields like infrastructure, digitalisation and education – often traditional public goods. Of course, it is not only about public investment, as private investment plays a far bigger role. But without public goods and public incentives, there won't be private sector investments. Currently, the investment gap in Germany is estimated to be some 600bn euro, or some 15% of GDP. Also, add to this another 30bn euro per year, which would be needed to bring German defence spending to the 2% of GDP target. The closing of such a gap will never be achieved by only cutting expenditures. Consequently, any serious effort to fundamentally reform and improve the German economy will have to come with fiscal stimulus. Stimulus that would also benefit the debt-to-GDP ratio as in the German debate very often the denominator is overlooked. Debt ratios can also come down when GDP growth picks up.

Any serious efforts to fundamentally reform and improve the German economy will have to come with fiscal stimulus

---

Whether the debt brake will be officially changed after the elections remains unclear at present. Interestingly, the CDU has started to make some moves, in our view paving the way for investment-related fiscal stimulus after the elections. As official changes can only be made with a two-thirds majority in parliament, everything will depend on the results for the AfD and the FDP, probably the only two parties left with a very rigid opposition against changes to the debt brake. According to current polls, the two parties together could get some 25% of the votes, with the FDP still at risk of not making it into parliament at all.

In any case, whether there are official changes to the debt brake, following proposals like a golden rule for (defence) investments, a higher structural deficit or a longer exemption period for the sake of infrastructure investments, or whether any new government would opt for other tools, doesn't matter. Fiscal stimulus is here to come. Other financing tools could still include the so-called Sondervermögen (special purpose vehicles). Contrary to public belief, the Constitutional Court didn't prohibit these vehicles but only ruled against shifting money from one to the other. A special purpose vehicle to finance an infrastructure and digitalisation modernisation programme could be possible.

Taking the 600bn euro investment gap as a starting point, this would mean more than 1.5% GDP additional fiscal stimulus over the next ten years.

When any next government has to decide on the future path for the economy, there are simply two options: structural reforms and investment via austerity or structural reforms via investment and looser fiscal policies. In all honesty, it's not a difficult choice. And with looser fiscal policy and a reform and investment agenda, it could be time for Europe to dust off another German word often used: Leitmotiv.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de