# Research Germany

## Fiscal policy to boost growth but also inflation concerns

The coming German government managed to pass its' large fiscal package through parliament with support from The Green party, leaving the German economy set to receive the largest fiscal boost in at least three decades. The package must also be passed in the Bundesrat on Friday, which is it likely to be. The three pillars of the package are:

1. An infrastructure fund of EUR 500 billion (12% of GDP) outside the ordinary budget. The fund is to run over 10 years and be used for *additional* investments in transport infrastructure, electricity grids, public housing, and digitalisation, of which EUR 100 bn are earmarked a fund for green initiatives.
2. A change to the "debt brake" that exempts both defence expenditures exceeding 1% of GDP (€ 45 billion) and support for Ukraine from the debt brake limits. Thereby setting no upper limit on defence spending, but which is expected to be around EUR 400 bn (10% of GDP) the coming 10 years.
3. A relaxation of the states' budget requirement "black zero" from a requirement of 0% deficit to 0.35% of GDP in deficit.

As lawmaker's has had less than one month to negotiate the package there are no further details on what exactly the money will be spent on. When a new government is formed, which will likely take around one month, we will get to know more.

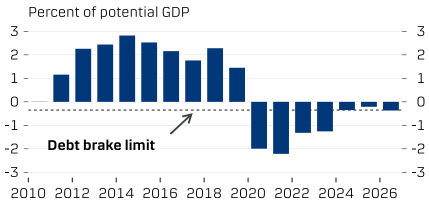
### Significant boost to growth is expected

We expect the package to have a positive effect on Germany's economy, as the lack of public investments has been one of the main arguments for weak productivity and structural growth. The infrastructure fund is expected to be the part of the package that has the greatest impact on the economy, as the easing of regional states' budget is minor and since defence equipment is mainly produced outside of Germany. Public investments in infrastructure are the part of fiscal policy that has the greatest impact on growth, and the German central bank assumes the fiscal multiplier to be around 1.0 in the first year in their forecasting model. This means that if investments equivalent to 1% of GDP are made, for example, in 2027, real GDP growth will also increase by 1% in 2027. In the longer term, investments in infrastructure can increase private sector productivity e.g. due to faster internet and better roads, leaving GDP to rise significantly more than 1 euro for each euro spent (see table to the right).

At the same time, public investments take time to impact growth, as large infrastructure projects must first be planned and approved by the authorities. The *average* permitting time for onshore wind energy projects are four to five years in Germany. Therefore, we do not expect to see an economic impact on growth in 2025, but from 2026 and especially in 2027-2030 we expect to see increased activity. As the government will likely front-load some of the spending, we expect German GDP growth to rise by 1-2 percentage points in 2027, but the exact timing is uncertain before we have details on the actual projects that will be made.

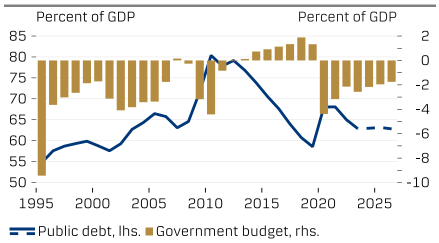
**Fiscal policy has previously been very tight...**

**Germany structural budget**




*Source: European Commission, Macrobond Financial*

**.. which has lowered public debt significantly since the debt brake was introduced in 2009**




*Source: European Commission, Macrobond Financial*

**Public investments are the most potent part of fiscal policy**

**Present-value fiscal multipliers in Germany**

| | Impact | Long run |
|---|---|---|
| Consumption | 1.03 | 0.24 |
| Investments | 0.98 | 3.56 |
| Transfers | 0.59 | -0.29 |
| Labour tax | -0.43 | -0.27 |

*Note: Table shows the deviation of real GDP in % from an 1% of GDP increase in the public sector variable in the first column.*
*Source: Impact: Bundesbank's macro-econometric model (Haertel, Hamburg, Kusing (2022)). Long-run: Bundesbank discussion paper (Gadatsch, Hauzenberger, Stähler (2015))*

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Expectations for future investments can, however, create increased sentiment in the private business sector, which may result in an earlier positive effect. German business sentiment has been depressed in the previous year's due to a mix of structural and cyclical factors, and this package could be a silver lining for business optimism. Such an effect would likely be visible in labour hording, which could increase private consumption in the short-term, but we expect this effect to be limited to certain businesses in the construction sector, which has a relatively small part of German employment.

## Lack of labour increases inflation risks

The German economy currently has spare capacity in the construction sector and manufacturing due to the recent years' dire performance. Companies report that capacity utilization is significantly below the historical averages (see chart to the right), so production could rise without it leading to significantly inflationary pressures. Yet, as we expect growth to rise in the economy even without the fiscal easing, an important question in the coming years will be whether there is still spare capacity when the investments begin.

Employment has declined slightly in the construction and manufacturing sector and hours worked is also lower due to the use of short-term working schemes. Hence, there previous years' weak performance in the German industry is now giving some availability of workers with the skills required. Yet, the employment levels remain close to historical highs and, more importantly, the labour is force estimated to shrink by 6% the coming 10 years. Hence, there is a significant risk that the package will fuel wage growth and thus inflation due to a lack of available workers, which is also a key concern for the ECB.

## ECB could cut less due to the fiscal package

The ECB has communicated that they see upside risks to inflation and growth from the fiscal package in Germany, and that a more active fiscal policy could increase the neutral policy rate. Hence, the package supports the hawk camp in the ECB and thereby a slower pace of rate cuts compared to our current ECB profile. Especially the upside risks to inflation from the package given the demographic projections in Germany is important for monetary policy.

At the same time, financial conditions in the euro area have tightened due to the announcement of the fiscal package, both from a rise in longer-term yields and a strengthening of the euro. This creates a headwind to growth in the euro area before the positive effect of the German fiscal package comes in the coming years, which increases the risks of monetary policy becoming too tight in the near-term

## Defence industry is a very small part of the economy

The increased defence spending is expected to have a smaller impact on growth in the short term compared to the infrastructure package. Currently, the EU countries import 78% of all defence equipment from outside the Union. The coming Chancellor Merz has said that defence spending should prioritise European companies and the Commission aims to buy 65% of all defence equipment from within the EU and Ukraine. Yet currently the German defence industry is a very small part of the economy. In 2020, around 55.000 employees where directly employed and up to 300,000 (0.6% of total employment) indirectly in the sector. The numbers have since 2020 risen with e.g. Rheinmetall employing 10,000 more compared to 2020, but overall, the sector remains small, and sales in the entire defence industry are less than 1% of German GDP.

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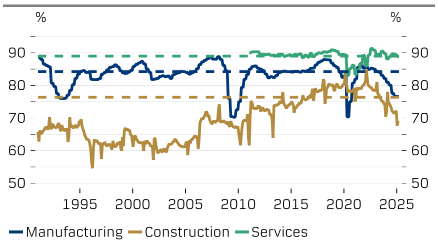
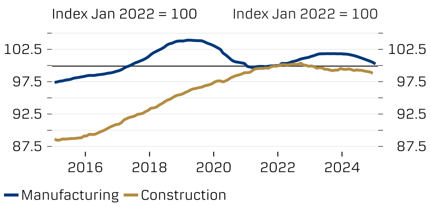
**Capacity utilization is currently low in the industry, leaving room for increased production**




*Note: Dotted lines are historical averages*
*Source: Ifo, Macrobond Financial*

**Employment has fallen slightly in the industry but remains high**

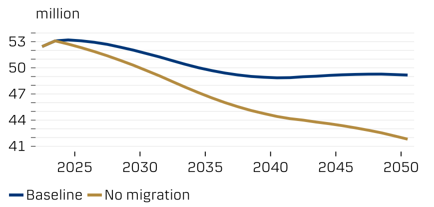
German employment




*Source: Statistisches Bundesamt*

**German labour force is set to shrink, giving upside risks to inflation from the fiscal package**

Population projection 20-67 year




*Source: Eurostat*

**Financial conditions have tightened on the back of the fiscal package**

Euro area Financial Conditions Index


*Source: Goldman Sachs*

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