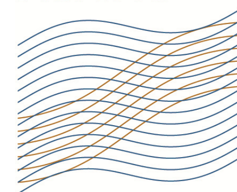

REPORT ON THE ECONOMIC SITUATION

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Germany on the way into a debt republic

Exclusive report for ACATIS Investment: Prof. Dr. Dr. h.c. Lars P. Feld, University Freiburg and Walter Eucken Institute

Germany voted and got the government it wanted - a coalition that was previously known as the "Great Coalition". In view of the geopolitical events, CDU/CSU and SPD wasted no time and only took two weeks to set out the main goalposts for the upcoming legislative period. These initiatives will continue to have an effect long after this period ends.

The main item of the coalition talks - a new financial policy direction. The old debt brake (Schuldenbremse) is history. The plan is to have the old Bundestag (with its two-thirds majority of CDU/CSU, SPD and Greens) approve an infrastructure fund for EUR 500 billion, an exception for defence expenditures (which exceed one percent of the gross domestic product) in the debt brake, and more leeway for the structural deficits of the federal states (+0.35 percentage points). Because the Linke party and the AfD will have a blocking minority for Basic Law amendments in the new Bundestag, these measures have to be approved before 23 March. Another exception for government investments in the debt brake, which the coalition partners want to approve by the end of 2025, would therefore require the votes of these two parties - regardless of firewalls and incompatibility resolutions.

The new government wants to use the new financing leeway for election goodies - expanded mothers' pensions, reducing the value-added tax rate for the hospitality sector, re-introduction of the agricultural diesel subsidy, subsidies for energy-intensive companies, eMobility and automotive suppliers, extending the rental price brake, EUR 15 minimum wage etc. The consultation paper is quiet with regard to market economy reforms, as only vague references are made to income and corporate tax reform and reducing the size of government.

One would be right to be sceptical that such a government programme will actually strengthen the growth forces in the country to produce innovation-driven and self-sustained growth. It seems that the planned additional expenditures will be wasted on consumption and transfers. In this context, higher defence expenditures could be used for a technology push - the US has been doing that since WWII. The infrastructure fund could be targeted towards research and strengthening transportation networks. However, the aforementioned examples indicate that these growth opportunities will not be utilised.

In return, the country will become even more indebted. For example, just opening up the debt brake for defence expenditures, which are over one percent of GDP, will create additional leeway of EUR 8 billion in the current year. Based on a nominal GDP growth rate of 2.5% and defence expenditures of 3% of GDP, defence expenditures would probably accumulate to EUR 950 billion over ten years (or EUR 85 - 110 billion per year). The infrastructure fund would probably create a debt of approximately EUR 50 billion a year in the same time period. Together, the federal states contribute EUR 170 billion (i.e. EUR 15 - 19 billion a year) to the higher debt, with the same amount coming from the federal government. All in all, the total figure would be EUR 1.8 trillion (or EUR 165 - 200 billion per year) over a period of ten years. With an assumed nominal growth of 2.5%, the debt ratio would increase by 33 percentage points, i.e. to approximately 95% of GDP. If the yield for 10-year government bonds remained at 2.5% over this ten-year time period, the federal government alone would incur interest expenses of EUR 250 billion. At a yield of 4%, this figure grows to toughly EUR 400 billion.

Last week, the yield for 10-year federal government bonds already increased from 2.5% on 4 March 2025 to 2.8% on 5 March 2025, with another ten basis point increase at the end of the week. This development is probably due to the expectation that the government will flood the market with bonds and therefore will have to offer higher yields. On the other hand, some view the accompanying exchange rate trend and the increasing share prices in the DAX as an indication of a positive growth effect on interest rates. Standard & Poor's quickly confirmed this view with the statement that the package strengthens the AAA rating. Only time will tell.

But that does not matter. Because higher German interest rates pull up the interest rate level in the Eurozone. The yield of 10-year Italian government bonds is now 3.9%. If the situation remains dynamic, bond markets will become nervous and there will be pressure on Germany with regard to new joint debt in the EU.

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