German fiscal big bang, tariffs and our forecasts

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The CDU/CSU and SPD have agreed on a huge fiscal package, and the likelihood of tariffs against the EU has increased significantly. We are adjusting our forecasts. We expect somewhat less growth for Germany this year (0.0% instead of 0.2%) due to tariffs and more growth (1.5% instead of 1.0%) in 2026 due to increased government spending. We have adjusted our yield forecasts upwards due to a massive increase in government debt.

Trade conflict between EU and US more likely, ...

Two important inputs for our forecasts, US tariff policy and German fiscal policy, have developed differently than we had previously assumed. The Trump administration's aggressive approach against Canada and Mexico (even if some measures have been partly postponed) has increased the risk of a severe trade conflict between the US and the EU. We now consider it the most likely scenario that the US will impose significant tariffs of 25% on at least some key industries such as the automotive and pharmaceutical industries.

... but German fiscal policy will be significantly more expansionary

In addition, the CDU/CSU and SPD – who will in all likelihood form the next German government – agreed this week on a significantly more expansionary fiscal policy than we had previously assumed. For example, most of the defense spending will no longer be counted towards the constitutional debt brake. In addition, 500 billion euros are to be raised over the next ten years via an extra-budgetary fund ("special fund") for infrastructure investments, with these debts also not to be counted towards the debt brake. Finally, the debt brake is to be relaxed for the federal states. We assume that the necessary amendment of the constitution will ultimately receive a two-thirds majority in both the Bundestag and the Bundesrat, although this is not entirely certain.

Germany: 2025 less and 2026 more growth,...

This results in two opposing effects for the German economy. On the one hand, the US tariffs will make it noticeably more difficult for the affected companies to access the US market. Consequently, German exports to the US are likely to decline markedly. We estimate that this alone will reduce German GDP by a total of about ½% this year and next.

On the other hand, the additional public demand will give the economy a noticeable boost. The 500 billion euros for infrastructure are to be invested over the next ten years, which, in purely mathematical terms, will result in additional demand of 50 billion euros per year, currently equivalent to just over one percent of GDP. Added to this is the additional investment for defense. Assuming that Germany will spend 3.5% of its GDP on defense in the future, this would result in additional demand of about 1.5% of GDP in the coming years. Together with the potential additional spending on infrastructure, this would result in a very strong fiscal impulse of 2.25% of GDP.

However, it is uncertain how quickly this stimulus will take effect. Experience with the first Bundeswehr (German armed forces) special fund shows that domestic industry can only deliver military goods that have been ordered after a considerable delay. The additional infrastructure investments must also first be planned and then approved, not to mention the fact that capacities in the relevant construction sectors are already fully utilized due to the investments that have been made in recent years. For these reasons, the funds earmarked in the budget for investment have not been fully spent in recent years. We therefore assume that the changes to the debt brake will have little impact on the economy this year and will not boost it nearly as much next year as the figures described above might suggest.

This year, therefore, the negative effect of the expected US tariffs is likely to dominate from the point of view of the German economy. We are therefore lowering our growth forecast for this year from 0.2% to 0.0%. Next year, the positive effect of higher government spending and additional investment should gradually unfold and more than offset the negative effect of the tariffs. We are therefore raising our German growth forecast for 2026 from 1.0% to 1.5%.

In the long term, stronger government demand, which is meeting an economy that is already operating at quite high capacity, is also likely to push up prices more sharply. However, this effect is likely to take some time to materialize, i.e. towards the end of next year at the earliest. We have therefore not changed our inflation forecast for this year and next and continue to expect an inflation rate of 2.5% for both years.

… which also applies to a lesser extent to the eurozone

With regard to the eurozone, loose fiscal policy and the tariffs have a similar effect – albeit to a lesser extent. On the one hand, US exports are not quite as important for the average eurozone country (8% of total exports) as they are for Germany (10%). On the other hand, the budget deficit in the other euro area countries is not rising as sharply as in Germany because most of them are already heavily indebted and have less leeway than Germany. All in all, we are lowering our 2025 growth forecast for the euro area by only 0.1 percentage points to 0.7% and raising the 2026 forecast from 1.0% to 1.3%.

As in Germany, higher demand in the euro area should lead to faster price increases at the end of next year. But at the beginning of next year, the weakness of the economy in 2025 will still be felt. We are therefore leaving inflation for 2026 at 2.4%.

Looking further ahead, we continue to expect inflation to settle above the ECB's 2% target due to structural inflation drivers such as de-globalization, demographics, de-carbonization and defense.

On the whole, the macroeconomic changes are unlikely to have much impact on ECB policy in the coming months. Trump's tariffs are dampening economic growth in 2025. But the loosening of fiscal policy increases the risk of inflation in the long term. We continue to expect the ECB to cut its deposit rate to 2.0% by mid-year after yesterday's cut to 2.5%. It would then be at the lower end of the range in which most ECB council members see the neutral interest rate, which neither boosts nor dampens the economy and ensures the long-term target inflation rate of 2%.

USA: Less growth and more inflation

Donald Trump wants to use higher tariffs to persuade foreign companies to relocate their production to the USA. This may well happen in the longer term. But regarding this year, the risks for the US economy outweigh the benefits. This is because the tariffs create enormous uncertainty for US companies. Just think of the US automakers who, believing in the North American Free Trade Area, have organized their production on both sides of the US-Mexican border. Their production system is being thrown into disarray by tariffs on Mexican imports, which is also likely to lead to massive write-offs on factories. All in all, we have lowered our US growth forecast for 2025 from 2.3 to 2.0%. We confirm the growth forecast for 2026 at 2.0%.

Because the US tariffs are coming earlier than previously assumed, we have raised our US inflation forecast for this year from 3.0% to 3.5%; we are not changing the forecast for 2026.

As far as the Federal Reserve is concerned, the effects of lower growth and higher inflation roughly cancel each other out. Unlike the futures markets, we continue to expect the next interest rate cut (from 4.50% to 4.25%) only at the end of the year, followed by a further reduction to 4.00% after the turn of the year.

Rising government debt, higher yields

The fiscal package agreed by the CDU/CSU and SPD in Germany is of great importance for the bond markets. This is because German government debt relative to GDP is not expected to continue to fluctuate around the 60% mark (2024: 63.6%), but to rise rapidly in the coming years. The shadow budget ("special fund") for infrastructure, for example, which amounts to 500 billion euros, will increase the sovereign debt ratio by around 10 percentage points. If defense spending were to rise to 3.5% of GDP, the debt ratio would increase by an additional 2.5 percentage points each year; calculated over ten years, the debt-to-GDP ratio would rise by a further 25 percentage points. All in all, the debt ratio could rise to 90 - 100% of GDP in ten years, although this also depends on inflation.

Due to the de facto abolition of the debt brake and the prospect of rapidly rising government debt ratios, the yield on the ten-year Bund rose unusually sharply by 20 basis points on the morning after the fiscal package was announced. In the coming weeks, the government bond markets will remain on edge as more and more information about rising budget deficits will be leaked not only in Germany but also in the euro area. With a view to the end of the year, the yield on 10-year Bunds should tend to be higher. We remain cautious about the debt policy of the states and expect that the yields have not yet seen the peak.

Dollar ultimately suffers under Trump

When it became increasingly clear in autumn that Donald Trump would win the election, the dollar began to appreciate significantly against the euro for two reasons. Firstly, many investors expect Trump to create better growth conditions for US companies through tax cuts and deregulation. On the other hand, many assume that the Fed will take decisive action against higher inflation caused by tariffs, in the sense that its key interest rates will rise more than inflation, which will increase the real interest rate and thus strengthen the dollar.

Recently, the dollar has lost some of its strength because the risks of Trump's tariff policy for US companies have also come more into focus. The dollar should recover somewhat by the summer (point forecast EUR-USD at the end of Q2: 1.05). Finally, the Fed is not expected to lower its key interest rate twice in the summer and fall, contrary to expectations on the futures markets; these interest rate cut expectations should therefore be priced out.

However, if it becomes clear later in the year that Donald Trump does not want the appreciation of the dollar to partially offset the effects of his tariff increases, he is likely to publicly pressure the US Federal Reserve, especially since he is already taking aggressive action against federal agencies. In this environment, investors are likely to increasingly doubt the Fed's resolve, which would weigh on the dollar again. Looking ahead to the end of the year, EUR-USD should rise again (year-end forecast: 1.08).

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