Will Germany's fiscal Big Bertha boost growth or inflation?

The financial package of more than €1,200 billion agreed this week represents a huge fiscal impulse. We analyze whether the debt-financed increase in demand will encounter an economy with plenty of spare capacity or one with not much. In the end, a considerable portion of the package is likely to evaporate in higher prices.

Dr. Jörg Krämer [AC]

A huge fiscal impulse

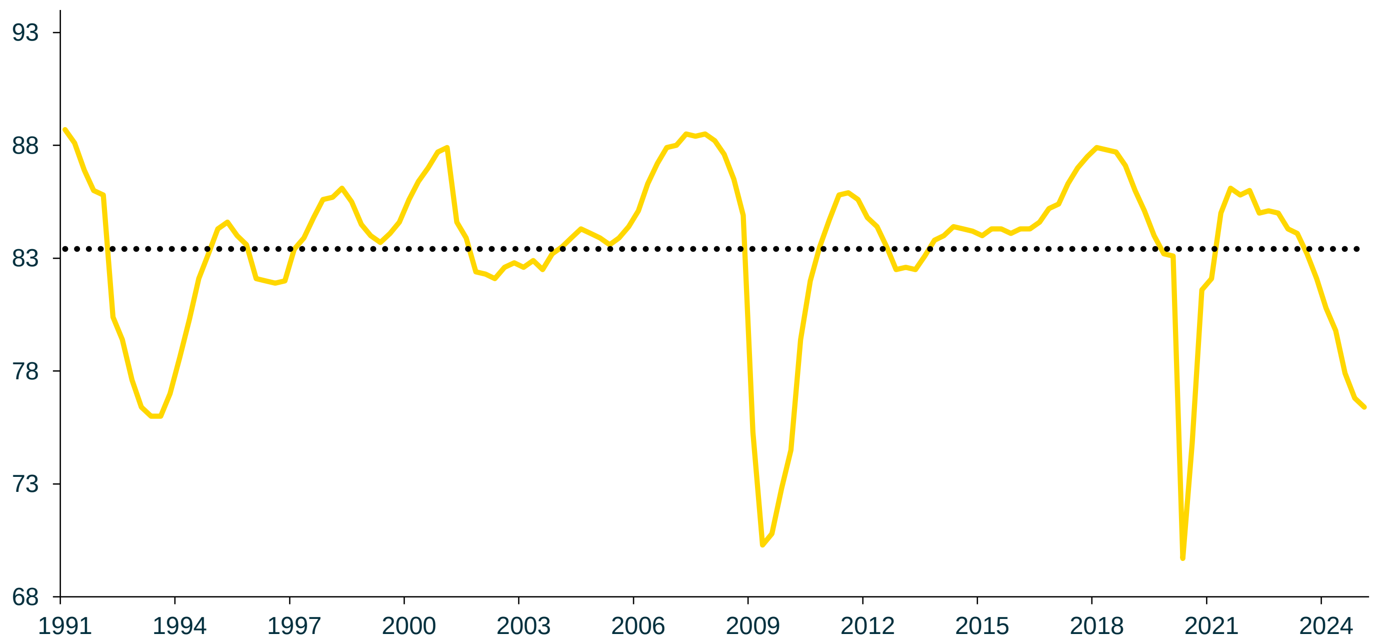
The financial package agreed this week provides for an additional 500 billion euros in infrastructure spending over the next twelve years, with 100 billion going to the climate and transformation fund and 100 billion to the federal states. In addition, the changes to the debt brake are likely to lead to a medium-term increase in defense spending from the current 2% of GDP to 3.5%, which, at today's prices over twelve years, would lead to additional spending totaling 750 billion euros. All in all, depending on inflation, we are talking about significantly more than €1,200 billion, which corresponds to around $2^1/_4$% of GDP per year. This is therefore a huge fiscal stimulus.

Low capacity utilization...

Whether the massively expansionary fiscal policy boosts the economy in the coming years or fizzles out in higher prices depends, first of all, on whether the debt-financed increase in aggregate demand is met with an economy with plenty of spare capacity or one with little. At first glance, the capacity utilization in the German manufacturing sector is well below the average of the past 30 years, according to the relevant surveys conducted by the Ifo Institute (Chart 1).

Chart 1 - Manufacturing apparently suffers from low capacity utilization

Survey results among German manufacturing companies regarding the question of their capacity utilization



Source: European Commission, Commerzbank-Research

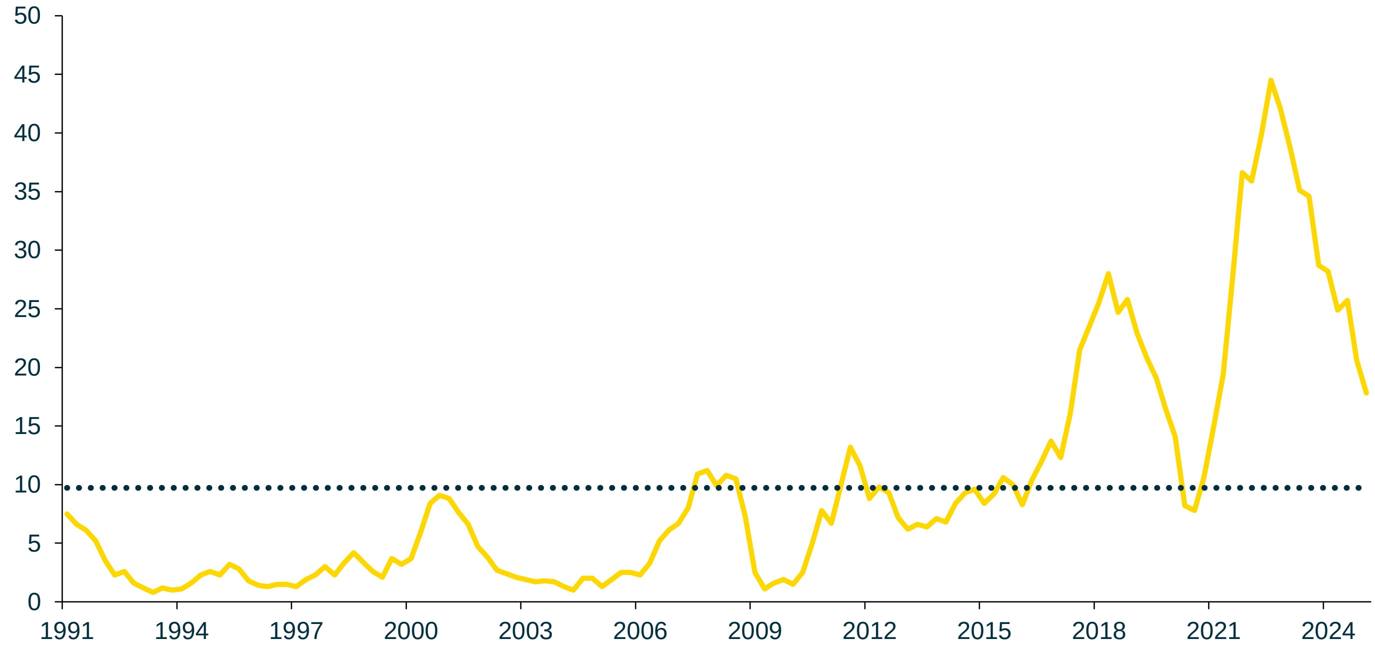
... but there is still a shortage of skilled workers...

However, business surveys show that companies are still suffering from a shortage of skilled workers. Although the proportion of companies in the manufacturing sector that see their business affected by a shortage of skilled workers has fallen significantly, the proportion is still well above the long-term average. (Chart 2). This also explains why many of the medium-sized firms in our client base still complain about a shortage of skilled labor in discussions.

In civil engineering, which is likely to receive many additional government contracts in the future, almost a third of companies have complained of a labor shortage in the past twelve months (Chart 3). That is almost as many as at the peak in 2022 and significantly more than over most of the past 30 years.

Chart 2 - Skilled worker shortage is above the long term average

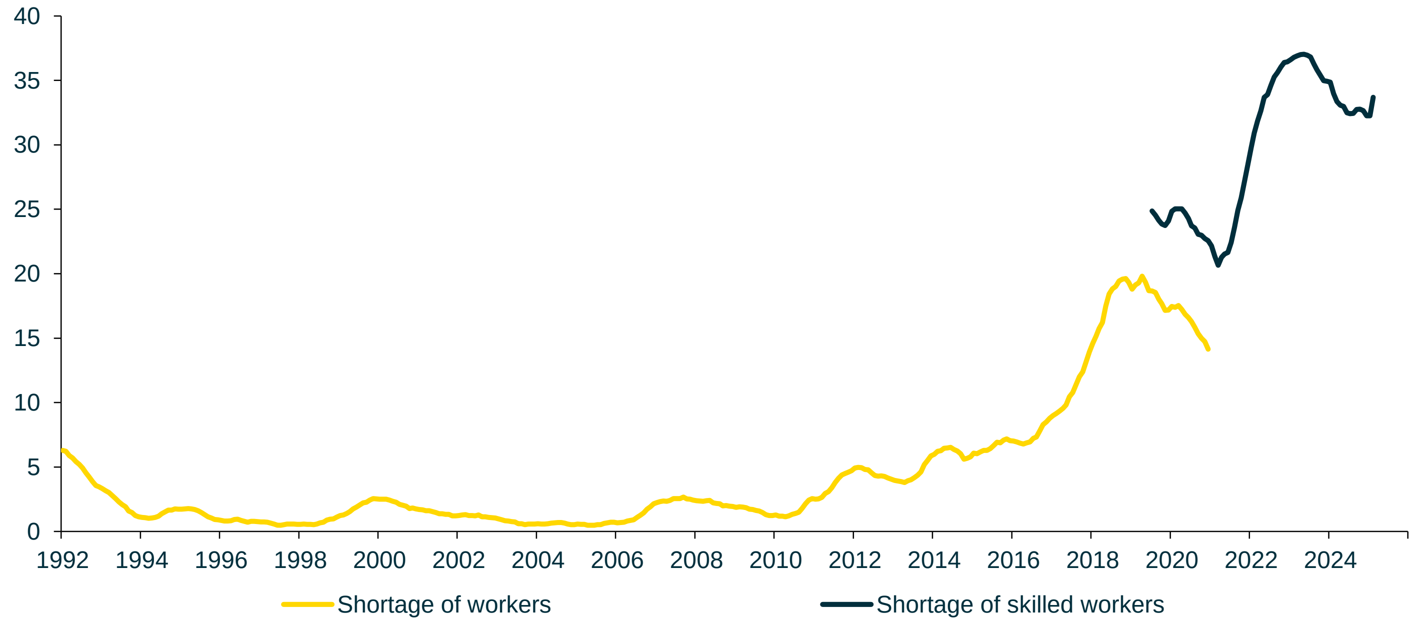
Share of companies affected by skilled worker shortage in manufacturing in Germany, dotted line is average since 1991, in %



Source: ifo Institute, Commerzbank-Research

Chart 3 - Many firms in civil engineering looking for additional skilled workers

Civil engineering, percentage of civil engineering companies affected by a shortage of skilled workers/workers at all, monthly figures, average of the last 12 months



Source: Ifo, Commerzbank Research

… which will intensify in the coming years

In addition, the above-mentioned surveys relate to the here and now. But demand for more armaments and infrastructure will not increase this year, but only from next year on:

- In the defense sector, experience shows that it takes a long time for armaments to be ordered, produced and delivered. For example, the special budget ("special fund") created in 2022 for the German armed forces created, amounting to 100 billion euros, has so far only taken on 23.6 billion euros in debt. Only this sum, at most, has thus been paid out to defense companies in the form of advance payments and installments **(Chart 4)**.

- In the area of infrastructure in the narrower sense (bridges, roads, railways, buildings), it often takes several years before the necessary approvals have been issued. A law streamlining and accelerating this process – as had happened with the rapid build-up of LNG terminals after Russia's invasion of Ukraine – is not in sight.

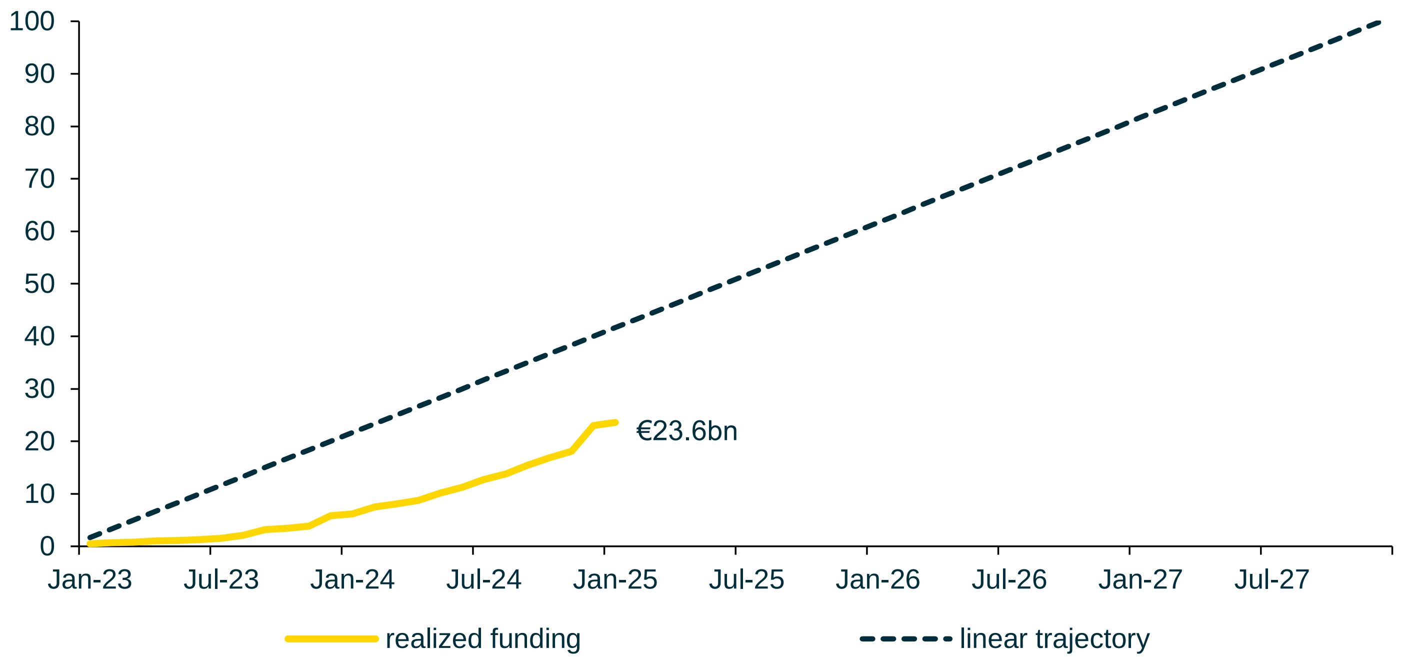
If demand only picks up from next year onwards, the shortage of skilled labor is likely to have worsened for two reasons:

- The fact that less companies have been complaining about a shortage of skilled workers recently is also due to the fact that the past massive rate hikes by the ECB and other western central banks have dampened growth. This cyclical burden is likely to ease in the coming quarters due to the key interest rate cuts, which should also cause demand for skilled workers to rise again.

- According to a projection by the Federal Statistical Office, the number of people of working age in Germany will fall by more than 300,000 or 0.5% annually by 2030 despite immigration.

Chart 4 - Slow rearmament

Realised funding for military fund (Sondervermögen Bundeswehr) vs. linear trajectory since inception, in €bn



Source: DFA, Commerzbank Research

A fresh start for economic policy?

All in all, from next year onwards, the demand fueled by debt will meet an economy with a shortage of skilled workers. One might object that the financial package and the intended economic policy decisions will improve framework conditions and thus increase productivity growth, which would reduce the labor shortage. In the following, we analyze whether this will happen:

- Infrastructure: It is good that a lot of money will be made available for infrastructure in the future, even if it will not flow exclusively into roads, bridges, railways and buildings. Unfortunately, however, the **exploratory paper** of the CDU/CSU and SPD does not say a word about a law to speed up the painfully slow approval procedures for infrastructure projects and to increase the understaffed authorities tasked with planning these projects. The situation will probably only improve slowly.

- Corporate taxes: The exploratory paper only mentions an “entry point” for corporate tax reform in the coming legislative period. It is clear that this project is not a high priority, although it is important for companies' competitiveness.
- Energy policy: According to the exploratory paper, more energy-intensive companies are to benefit from the subsidized industrial electricity price in the future. Electricity tax and grid fees are to be lowered for all companies. This is a positive step in itself, although energy in Germany will remain expensive.
- Non-wage labor costs: Companies' social security contributions are likely to rise significantly in the coming years because the future coalition partners do not want to raise the retirement age despite increasing life expectancy and rule out a reduction in the pension level. Furthermore, early retirement will continue to be subsidized.
- Bureaucracy: The exploratory paper contains only declarations of intent in this area, but little that is specific.

All in all, there may be some improvements to infrastructure in the coming years. But we do not expect a broad-based economic policy reboot. Productivity growth remains low, and skilled workers tend to remain in short supply.

Conclusion: the economy will only benefit moderately

The credit-financed massive increase in demand for armaments and infrastructure will meet an economy with a shortage of skilled labor from next year on. A considerable part of the additional spending of a good 2% of GDP annually will therefore evaporate in higher prices. The price-adjusted GDP is likely to rise much less than the additional spending would suggest. As a result, two weeks ago we raised our German growth forecast for the coming year only moderately, from 1.0% to 1.5%.

What will the markets make of it?

Many investors, especially from the English-speaking world, have reacted enthusiastically to the de facto suspension of the debt brake. They say Germany has freed itself from fiscal shackles. Now, not only individual sectors such as armaments or civil engineering could take off (a justifiable assumption), but the entire German economy, which we do not expect for the reasons mentioned above. But it may well take more than a year for investors' enthusiasm to fade.

As for the bond markets, the yield on ten-year German government bonds had risen more in the week the fiscal package was announced than at any time since the early 1990s. On the one hand, bond investors have very positive expectations regarding the fiscal package's impact on the economy, which is why they now expect somewhat fewer interest rate cuts by the ECB. On the other hand, the ratio of government debt to nominal GDP is likely to rise from 63% recently towards 90% over the next twelve years, so investors are demanding higher risk premiums. But after the recent sell-off, bond markets should initially calm down in the coming months and yields should fall again somewhat. After all, the German federal government is not likely to issue many more bonds this year. But over the longer term (12 months and more), we definitely see higher bond yields. After all, partisan political differences in other eurozone countries are also likely to be papered over with more debt. In addition, inflation in the eurozone will probably end up above 2%.

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