5 September 2019

Research Germany

Loosening the brake

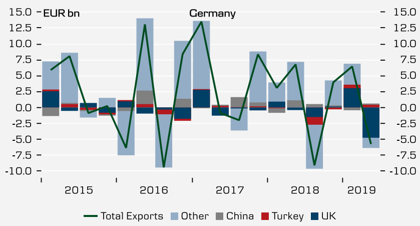
- **Fiscal space under the debt brake is limited to some extra EUR5bn (0.14% of GDP) in 2020. In this light, we see the probability of a significant stimulus package beyond automatic stabilisers as low at the current stage.**
- **Should the current economic downturn, against our expectations, develop into a deeper recession, a more relaxed stance towards the balanced budget policy and exceptions for green investments could be a first step towards looser fiscal policy.**
- **An important bellwether for the timing, size and scope of fiscal measures will be developments in the German labour market.**
- **In our view, softer fiscal policy will not 'rock the boat' for funding and issuance until 2021.**

As the German economy continues to be caught in the maelstrom of the trade war, calls for fiscal stimulus are growing louder. Still, the idea remains a contentious one, not only in policy circles but also among economists and the uncertainty centres mainly on whether the current slump is severe enough to warrant additional fiscal spending (see *interview* with Bundesbank President Jens Weidmann).

Without a doubt in our minds, the German economy is showing further signs of slowdown. Although the weak growth performance in Q2 was largely due to a slump in net exports related to Brexit stockpiling (see Chart 1), signs are also growing that domestic demand is feeling the pinch. Investment growth declined by 0.1% q/q in Q2 and, although private consumption held up, the big decline in retail sales in July by -2.2% m/m does not point to a strong rebound in Q3. With growth in key export markets such as China and the US slowing and uncertainty on the global political stage remaining prominent, **we think it will be difficult for the German economy to avoid falling into a technical recession in Q3** (see *here*). In this light, we expect GDP growth in 2019 and 2020 to arrive at a meagre 0.5% and 0.7%, respectively – significantly below potential growth. Downside risks remain prominent, not least if US President Donald Trump makes true on his threat to impose car tariffs and Britain leaves the EU without a deal (see *Brexit Monitor*). **As the ECB readies another stimulus package, we expect the effect of another rate cut plus QE restart to be miniscule in terms of real economy effects.** What currently ails the Germany economy is mainly a lack of demand rather than too tight financial conditions and borrowing constraints for companies (see Chart 2). In this light, the uncertainty about the effectiveness and scope of fiscal stimulus bears closer inspection.

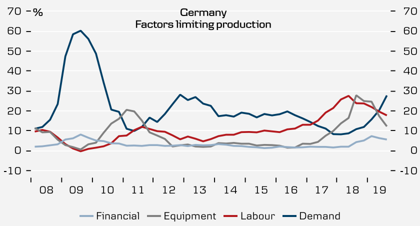
Looking back in history, the German government has shown a willingness to loosen its purse strings when faced with a significant economic downturn, as was the case during the Global Financial Crisis (GFC). In 2008 and 2009, the German government launched two fiscal stimulus packages ('Konjunkurpakete') totalling some EUR73bn. Although the packages helped to counter the economic downturn, they also left sizable holes in state coffers, causing the debt to GDP ratio to jump to 81% in 2010 (part of the jump was due to significant bail-out packages for German banks such as Hypo Real Estate, Depfa and WestLB, which were funded by issuance of government bonds).

Chart 1: German export growth on a rollercoaster thanks to Brexit



Source: Eurostat, Macrobond Financial, Danske Bank

Chart 2: Lack of demand ails German industry



Source: European Commission, Macrobond Financial, Danske Bank

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To reverse this development and bring public debt back on a downward trend, the so-called ‘debt brake’ was written into the constitution and came into force in 2011. Additionally, since 2014, the government has also subscribed to the ‘Schwarze Null’ (black zero) policy, which stipulates balanced budgets and rules out any new net borrowing.

With the advent of the constitutional debt brake, the scope for additional fiscal spending in Germany has been significantly limited. The rule limits the structural deficit of the federal government to 0.35% of GDP and is thereby even stricter than the EU rules of the Fiscal Compact, which allows a structural deficit up to 1.0% of GDP for countries with a debt-to-GDP ratio below the 60% limit (which Germany is likely to achieve in 2019). So far, German Länder have been excluded from the debt brake but, from 2020 onwards, the constraint will also become binding at the state level.

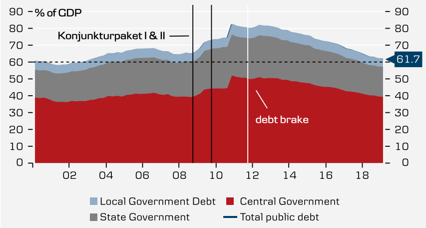
Debt brake ties the government’s hands

Even without an additional stimulus package, fiscal policy will remain expansionary in 2020. In its *2020 budget draft* from June, the government envisions a further increase in expenditure by 1% (EUR3.5bn) compared with the 2019 budget, particularly focused on pensions, families and defence spending, but also includes some EUR40bn of investment in infrastructure, housing and education. Taking into account various shadow budget items, which are excluded from the headline budget balance but count towards the structural one, the 2020 budget in its current form would be likely to leave only around EUR5bn (or 0.14% of GDP) of extra fiscal room before the constraint of the debt brake becomes binding (see Table 1). **This means that even if the government were to loosen its stance on the (voluntary) balanced budget rule, the constitutional constraint of the debt brake remains a key impediment for a big fiscal stimulus package.**

In the event of natural catastrophes or ‘exceptional emergencies’ that materially affect public finances and are beyond the state’s control, a majority in the Bundestag can vote to abrogate the debt brake temporarily. However, we see the political hurdles to such a decision as high, not least because it is difficult to categorise the current slowdown as either a natural catastrophe or an exceptional emergency and, not least, because a conservative fiscal approach still has public backing. However, **should – against our expectations - an economic crisis with similar dimensions as in 2008/09 start to unravel, we think the likelihood of a ‘loosening of the brake’ would increase.**

An easier way to loosen the purse strings would be to abandon the self-imposed policy to abstain from new net borrowing. With the economic downturn, the government has already revised its revenue estimates down from the original 2020 budget draft and plans to plug the gap by using reserves from the refugee fund (‘Flüchtlingsrücklage’).

Chart 3: Debt brake is a legacy of the Global Financial Crisis



Source: Destatis, Macrobond Financial, Danske Bank

Table 1: Fiscal room under debt brake is limited to EUR5bn in 2020

EUR bn	2018	2019 (Proj.)	2020 (Proj.)
Expenditures	336.7	356.4	359.8
Revenues	347.6	350.6	350.3
Net borrowing	-	-	-
Reserves	-11.2	5.5	9.2
Cyclical component	6.7	0.7	1.3
Net financial transactions	0.7	0.7	0.7
Shadow budgets*	4.0	-3.5	-4.9
Energy and Climate Fund	2.9	-0.7	-2.5
Aufbauhilfefonds (Flood 2013)	-0.6	-0.7	-0.5
Local Authority Investment Promotion Fund	-0.7	-1.9	-2.0
Digital Infrastructure Fund	2.4	-0.2	-0.9
Primary School Care Fund	-	-	1
Structural deficit	-3.7	-5.2	-7.2
Debt brake threshold	-11.4	-11.5	-11.9
Fiscal room under debt brake	**-7.7**	**-6.3**	**-4.7**

** Shadow budgets are special funds that are not accounted for in the main budget but are included in the calculation of the structural deficit relevant for the debt brake. These funds include the Energy and Climate Fund, a fund to promote investment by local authorities, a special relief fund established to remedy the damage caused by the June 2013 floods in Germany and a special fund for digital infrastructure.*

Source: Bundesbank

Figure 1: Germany’s fiscal space for 2020 under different fiscal rules

	Black zero	Debt brake	Fiscal compact	Maastricht criteria
Criteria	Balanced budget (no new net borrowing)	Structural deficit max. 0.35% of GDP	Structural deficit up to 1.0% of GDP	Budget deficit 3% of GDP, 60% public debt
Fiscal space	-	≈ EUR5bn	≈ EUR27bn	≈ EUR93bn
	German fiscal rules		EU fiscal rules	

Note: ‘Black zero’ is a voluntary rule, while all other fiscal rules are stipulated by either German or EU law

Source: Bundesbank, Danske Bank

However, in Berlin's corridors voices are also growing louder to abandon the 'black zero' altogether in favour of achieving the green zero, i.e. a cut in greenhouse gas emissions by 95% by 2050. The government plans to unveil its initiatives in a big climate package on 20 September, with some *media* putting the cost as high as EUR37bn. To finance part of these measures, the issuance of green bonds is also under discussion (see *FT article*).

Fiscal gradualism remains the guiding principle

In our view, readers should see the debate about additional fiscal stimulus in the context of the current political climate. Pressure is rising for government parties to respond to the public's demands for 'greener policies' amid growing tension in the grand coalition following the EU elections and the SPD's refusal to support Ursula von der Leyen's bid for EU Commission President. A government crisis before the SPD leadership contest on 6-8 December remains unlikely but **we see heightened risk of political upheaval in Germany in 2020, which could further impede timely fiscal policy action in response to a deepening economic downturn.**

At the current stage, a wait-and-see attitude seems to prevail in Berlin, as fiscal policy is already becoming more expansionary than in past years and Germany has strong automatic stabilisers (see charts 4-5). Still, **should the current economic downturn, against our expectations, develop into a deeper recession, we would be surprised to see politicians sitting on their hands. A first step in this process could entail a more relaxed stance from the government on the balanced budget policy and exceptions for green investments.**

Labour market holds the key for fiscal stimulus

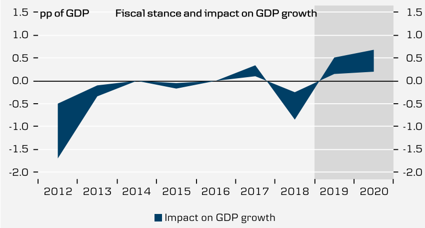
An important bellwether for the timing, size and scope of fiscal measures will be developments in the German labour market. Sentiment indicators point to a clear risk that unemployment could start to rise in H2 19 (see Chart 6), mainly in the manufacturing sector (which accounts for c.27% of total employment). A deteriorating employment situation would also leave its mark on consumer confidence and spending power, raising the risk of adverse spillovers to domestic demand and the so-far robust service sector.

In our view, an important early warning indictor to watch is claims made to the Federal Employment Agency (Bundesagentur für Arbeit) for short-time working arrangements (Kurzarbeit). Traditionally, German companies have shied away from shedding skilled labour in downturns to avoid hiring bottlenecks and skills shortages in times of high capacity utilisation. In a forthcoming law, the Federal Labour Ministry plans to loosen restrictions for companies to access government compensation for workers' earnings losses due to reduced working hours. A similar scheme enacted during the Global Financial Crisis proved a forceful measure to stem a rise in unemployment and could again play an important part in shielding the German labour market from the worst (see Chart 7).

Fiscal policy could counter the downturn but not insulate the economy from external shocks

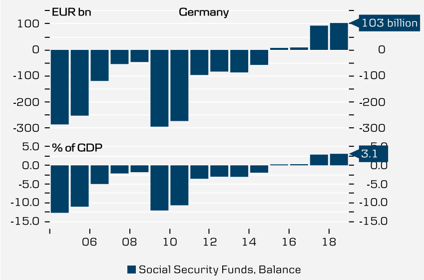
To sum up, in exceptional circumstances Germany has the scope to counter a downturn with additional fiscal measures and the key trigger for such a move would be a significant deterioration in the labour market situation and the wider domestic economy. However, what concrete fiscal measures could such a package entail and will they help to alleviate the downturn?

Chart 4: Fiscal headwind is already turning into a tailwind



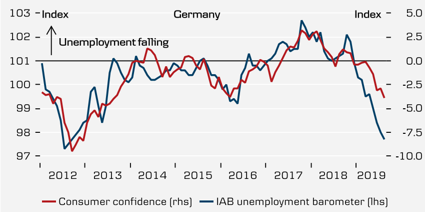
Source: Danske Bank, European Commission

Chart 5: German social security system has ample reserves to weather economic downturn



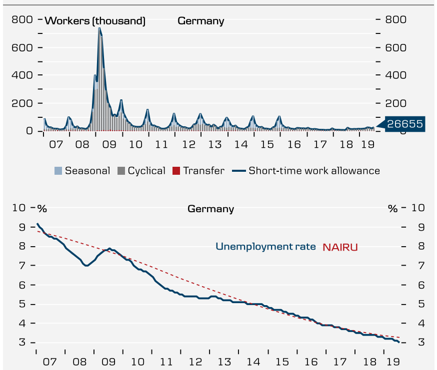
Source: Destatis, Macrobond Financial, Danske Bank

Chart 6: Labour market deterioration set to leave its mark on consumer spending



Source: IAB, Macrobond Financial, Danske Bank

Chart 7: Short-time working arrangements could soften a blow to employment



Source: Federal Employment Agency, Macrobond Financial, Danske Bank

As mentioned above a green investment package and additional labour market policies are already part of the current political discussions. Furthermore, we would expect politicians to draw inspiration from the previous fiscal stimulus package in 2008/09. Initiatives such as tax cuts (for both households and companies) increased subsidies for families and an infamous car scrappage bonus ('Abwrackprämie'), which proved very successful in boosting domestic car sales (see Chart 8), could again be part of the toolbox.

Black zero vs green zero? A range of policy measures is currently being discussed

Climate	Labour market	Infrastructure	Social welfare	Industry
• CO2 tax on fossil fuels according to CO2 content • Lower prices on train tickets and raise prices on plane tickets • Climate-related development aid • Programme of reforestation • Improve energy efficiency of homes	• Additional funding for short-time work • Additional funding for employee training during short-time work	• Helping indebted municipalities to invest • Modernising and extending rail tracks	• Universal basic pension • Rise in child and pension benefits	• Support SMEs trough tax cuts and lower social security contributions • Scrappage scheme to encourage new car purchases/e-mobility

Source: Danske Bank

Overall, we think fiscal measures would be a much more powerful tool than monetary policy to counter the German downturn, especially in an environment where interest rates are already very low, which enhances the effect of the fiscal multiplier. However, it is also important to stress that while a fiscal stimulus package could go a long way to propping up the domestic side of the economy, there will be implementation lags (especially on investments) and it cannot do much to reverse the weakness in external demand, which is currently causing such broad-based weakness in German industry (see Chart 9). As long as the German economy does not wean itself off its export dependency, we believe it will continue to suffer from collateral damage in an increasingly hostile global trade environment.

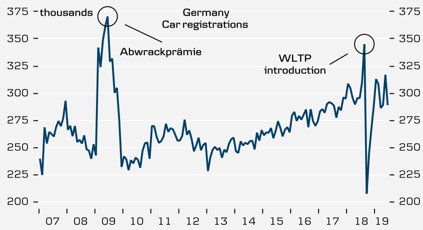
Softer fiscal policy unlikely to 'rock the boat' for funding and issuance until 2021

Given the potential easing of fiscal policy, the main questions for the market will be the following.

1. **How much will gross funding increase in coming years?**
2. **Which segments of the curve will the German Debt Agency target in the event there is an increase in the funding need in coming years?**

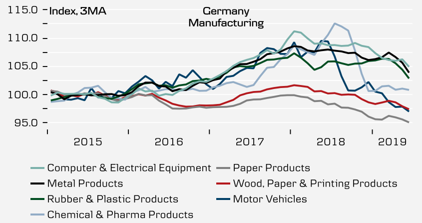
The recent budget from the German Ministry of Finance increased the gross financing need from EUR185bn in 2019 to EUR234bn in 2020. On top of this, there is funding for FMS Wertmanagement. This is EUR20bn in 2019 and we expect it to be EUR10bn in 2020. If we look ahead to 2021, then redemptions from German government bonds and bills are some EUR170bn. If we add EUR10bn funding for the FMS Wertmanagement and a financing gap of EUR20bn to take account of the financing gap (this is twice as much as in 2019), the gross financing need for 2021 is EUR200bn as shown in Chart 10. This is a solid decline from 2020 but driven mainly by much lower redemptions in 2021. We expect redemptions of German government bonds to amount to EUR130bn in 2021 relative to EUR147bn in 2020. Furthermore, we expect redemptions in T-bills to decline from EUR66bn in 2020 to EUR45bn in 2021.

Chart 8: 'Abwrackprämie' helped boost German car sales in 2009



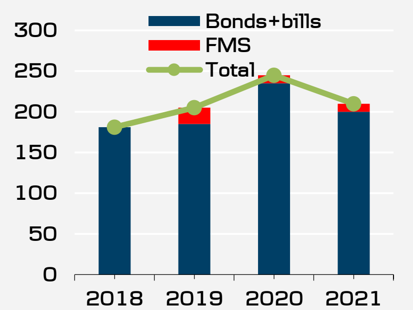
Source: ECB, Macrobond Financial, Danske Bank

Chart 9: Broad-based weakness in German industry



Source: Destatis, Macrobond Financial, Danske Bank

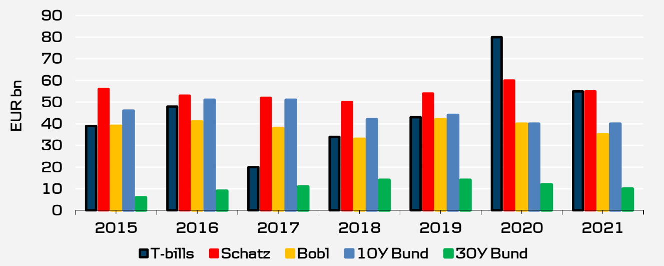
Chart 10. German gross financing need in 2018-21 (EURbn)



Source: German Ministry of Finance, Danske Bank

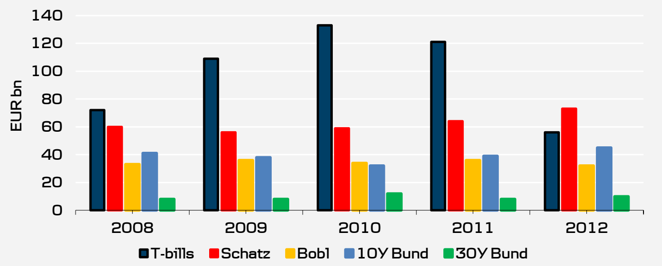
Hence, the answer to the first question is that the gross funding need for Germany will rise only modestly in 2020 but decline in 2021, even if we include a higher funding gap in 2021. Furthermore, this is financed mainly through an increase in T-bills rather than through bonds (Schatz, Bobl, Bunds and linkers). Here we expect the German Debt Agency to follow the same pattern as it followed for many years, with the issuance of bonds not varying much and additional issuance being done mainly through T-bills (Bubills), as shown in Chart 11 below, which illustrates how the gross issuance is financed through T-bills, Schatz, Bobl and Bunds.

Chart 11. Gross issuance of German government bonds and T-bills (EURbn)



Source: German Debt Agency, Danske Bank

Chart 12. How did Germany finance the budget in the aftermath of the financial crisis



Source: German Debt Agency, Danske Bank

Hence, the answer to question two is that the German Debt Agency will follow the pattern from previous years and there will not be a significant increase in issuance at the long end of the German yield curve. In our view, the German Debt Agency will do most of the additional issuance in 2019 and 2020 through T-bills and Schatz. This was also the case in the aftermath of the financial crisis from 2009-11, when the German Debt Agency increased the sale of T-bills and Schatz significantly as shown in Chart 12 below.

Overall, the market impact of a potentially softer fiscal policy is likely to have modest impact on the German government bonds for the following reasons:

- The net issuance of German government bonds remains low as the financing 'gap' is still very small.
- Most of the increase in issuance is done through T-bills.
- Issuance at the long end of the German curve is unchanged relative to previous years.

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Aila Mihr (Senior Analyst), Jens Peter Sørensen (Chief Analyst) and Piet P. H. Christiansen (Senior Analyst).

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