GENERALI ASSET MANAGEMENT

FOCAL POINT

Germany at the crossroads

Martin Wolburg

November 26, 2024

Our Focal Point series explores topical issues on macro, markets and investment

- **The next year will be decisive for Germany: Federal elections on Feb. 23, the threat of an US-induced trade war, ongoing restructuring in the manufacturing sector amid restrictive public finances are headwinds to the struggling economy.**
- **Polls suggest that the election will result in a change of power. A tail risk is that the extremes (AfD & BSW) gain one third to the seats so that they could block any constitutional changes, e.g. related to the debt brake.**
- **The new government will likely take office in April/May. Uncertainty related to the working of the minority government, the passing of the supplementary 2024 budget and the 2025 budget remains high.**
- **In any case, fiscal policy will remain restrictive in 2025. We expect pragmatic solutions about acute issues like defence spending to circumvent the debt brake but do not expect any quick reform.**
- **Manufacturing restructuring will continue and weigh on activity. US import tariffs could reduce exports by up to 2%, adding to these headwinds.**
- **In 2025 we look for an only meagre growth of 0.3% for Germany, well below the current consensus of 0.7%. It will drag on the euro area growth and contribute to a more dovish ECB.**

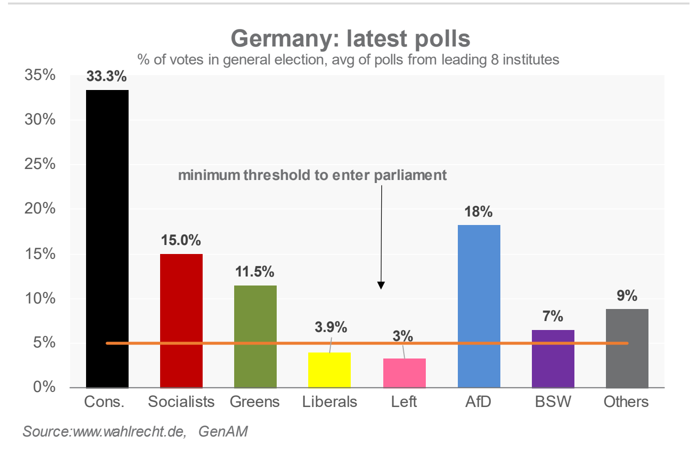
Germany lost its economic shine. After the GFC until the start of the pandemic German GDP advanced by 14%, clearly outperforming the euro area growth of 9%. Since then, the picture reversed. German output stagnated as of Q3/2024 while the euro area one expanded by 4 ½%. **While the past decade had largely been impacted by structural adjustment needs of the Southern European economies it is now Germany coming under pressure.** It's export-driven growth model no longer works and on top of that it currently undergoes a political crisis. **2025 will be a decisive year** for the euro area's largest economy as it will become clear whether and how the political stalemate will be solved, the growth-limiting effects of the national debt brake can be overcome and how much additional global headwind will come from US tariffs.

Uncertainty: Snap election and new government

On November 6 the three-party coalition consisting of socialists (SPD), greens and liberals (FDP) broke down. A key trigger for Chancellor Scholz to dismiss his liberal Finance Minister was disagreement of how to fix the 2024 supplementary budget. The liberals wanted to finance it via savings while the Chancellor wanted to declare exceptional circumstance to temporarily exempt the debt brake. The road

towards snap elections is now clear: On December 16 the Chancellor will go for a vote of confidence in parliament that he is prepared to lose, and the President will then formally call for **elections on February 23**. Thereafter a new government will need to be formed which realistically only will take office in April/May. Hence the country will for about half a year be governed by a minority government. We see no problem to pass undisputed issues like growth-enhancing remaining measures agreed in spring (the so called *Wachstums-chancengesetz*). But there is disagreement with the largest opposition party (conservatives, CDU/CSU) in most fields.

How will the next government look like? According to polls the conservatives will become strongest and gather about one third of the votes, followed by the extreme right (AfD). However, there is broad agreement (a so-called firewall) among parties to not cooperate with the AfD. Likewise, the extreme left (BSW) and its insisting on a more Russia friendly policy makes a coalition with centre-parties very difficult. And as it stands now liberals (FDP) and Left will not enter parliament again. **Hence there remain two realistic coalitions: Conservatives either with socialists or the greens. A conservatives and socialist so-called grand coalition is our base case**. It already worked before (from 2017 to 2021) and the differences in programmes are smaller than with the greens.



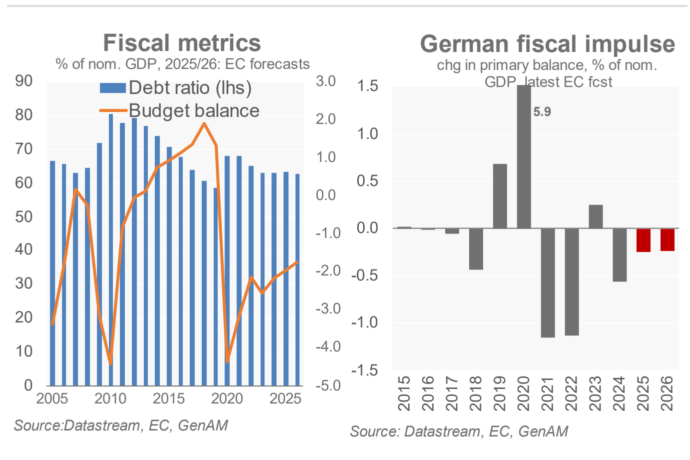
Source:www.wahlrecht.de, GenAM

However, the election campaign has just started, and the polls might not only be very fluid but also wrong. A key **risk scenario would be AfD and BSW jointly holding 1/3 of the seats**. They could block any constitutional changes, e.g., related to the debt brake, to push through some extreme positions. As the centre-parties would most likely not give in political stalemate would follow. If the liberals would re-enter parliament (in some recent polls they are back to the 5% threshold) a coalition with the conservatives and the greens might become viable. But we hardly see any appetite for another three-party coalition and see this only as a tail scenario. Not excluded but with low probability is a conservatives-liberal coalition which would be most market-friendly.

Fiscal policy to stay restrictive

The government breakdown came at a delicate time of the year when a **supplementary budget for 2024** and the one for 2025 need to be passed. According to the government € 11.8 bn are needed for 2024. However, **even if not passed no budget freeze would be needed**. More problematic is the 2025 budget. As it stands now there will be **no parliamentary agreement on next year's budget**. In this case a provisional budget based on expenditures in 2024 (each month the government is allowed to spend 1/12 of the previous year's budget) would be in place and the next government would need to pass it. This could extend into summer or even beyond depending on how fast the new government is to find a consensus.

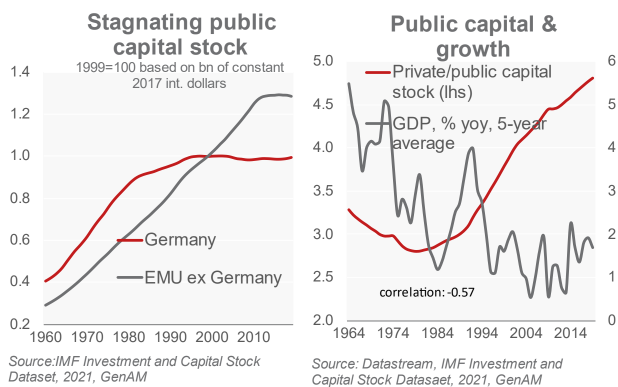
The previous government's budget plan for 2025 foresees slightly lower expenditures than in 2024 so that the macroeconomic effect would not be significant. That said, the government **budget plan submitted to the European Commission** assumes a 2025 growth rate of 1.0% and a fall in the unemployment rate by 0.2 pp (to 2.8%). We deem this scenario **much too optimistic**. While still rising wages as well as the phase-out of the tax-free bonus to compensate households for the high inflation of the last years will support revenues, we see considerably less growth and hence revenues. Moreover, we see upside risks to social and defence spending. Based on the budget plan the fiscal impulse (or change in the primary balance) is set to become less restrictive. However, given the overly optimistic macro assumptions the **next government will probably need to increase the degree of restrictiveness for 2025**. Bottom line, fiscal headwinds and uncertainty related to fiscal policy measures will drag on German activity in 2025.



Lack of infrastructure an obstacle to growth

Apart from the headwind of a restrictive budgetary stance on activity, Germany suffers from insufficient infrastructure. In a recent joint study the employer-affiliated Institute of the German Economy (IW) and the union-owned Institute for

Macroeconomics and Business Cycle Research (IMK) identified a **public investment gap of almost € 600 bn**. This gap increased from € 460 bn some years ago considering additional green goals and higher input prices. Indeed, the German public capital stock broadly stagnated since the mid-1990s. As a result, the private-to-public capital ratio (PPCR) rose from 3 just before reunification to 4.8 by 2019. Behind this stands a poor endowment of roads, rail networks, schools but also digital infrastructure. According to the IW **80% of firms report a negative effect of infrastructure issues on their business**. It is obvious that lacking infrastructure is an impediment to growth. German public underinvestment started well before the debt break became constitutional in 2009 and is also related to bureaucratic obstacles.



Source:IMF Investment and Capital Stock Dataset, 2021, GenAM

Source: Datastream, IMF Investment and Capital Stock Datasaet, 2021, GenAM

In principle the debt brake limits the federal annual increase in debt to 0.35% of GDP while the regions (Länder) are not allowed to take on any debt. Deviations to the upside and downside due to the business cycle are possible. However, currently the debt brake is seen as too strict and de facto a major obstacle for urgently needed infrastructure investments as cutting other, especially social expenditures, for financing seems politically impossible (at least if there is no conservatives-liberal coalition). There are **several ideas for reform ranging from a higher debt ceiling** (1% instead of 0.35%, IMF, German Council of Economic Experts), **special treatment of investments** (Scientific Advisory Council to the Ministry of Economics) or to **lengthen the adjustment** to the 0.35% threshold after a shock (Joint Economic Forecast of Institutes).

The public is divided, according to a recent poll a slim majority of 48% of voter want to stick to it while 45% want a relaxation. It is most popular among the extremes (AfD, BSW) while a majority of green and socialist supporters wants a relaxation. That said, the **political consensus slowly moves towards an adjustment of the debt brake**. The candidate of the CDU/CSU and most likely Germany's next Chancellor Merz recently stated that the debt brake was a technical topic and that it could for sure be reformed. Among the centre-parties only the liberals want to stick to it and even made compliance with it as a precondition to potentially enter a government.

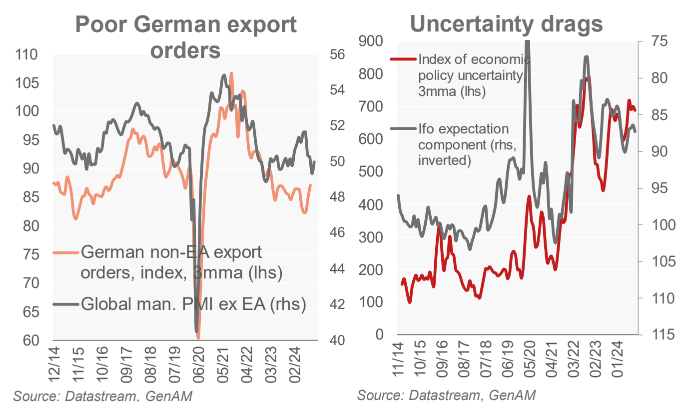
With a conservative-socialist government being our most likely scenario, **we look for a reform of the debt brake to facilitate public investment and defence spending**. However, it is unlikely to be fully scrapped in our view. And the reform will not come quick. It first needs to be discussed among the coalition partners and then pass the lower as well as the upper house with a two third majority.

Near term a pragmatic adjustment could be engineered more easily. The former three-party coalition had agreed to **adjust the business cycle component of the debt brake** to give more leeway in bad times. This would not have constitutional character and could be pushed through parliament more easily. Regarding **huge military spending needs** amid pressure from the new US administration to increase defence spending further we think that pragmatic solutions backed by a broad majority will in the end be found, e.g., by means of **special purpose vehicles**.

Bottom line, we do not expect that a reform of the debt brake will already be agreed on and become effective in 2025. Nor do we see a significant improvement in the infrastructure endowment next year.

US tariffs hit an industrial sector already under pressure

The German economic model strongly relies on exports. Vigorous global growth amid high competitiveness were key reasons why in the 2010 to 2019 period German growth was on average 0.8 pp above the EMU ex Germany one. Since then, however, it underperformed its peers by on average -1.3 pp. This coincided with a **declining contribution of goods and services exports to GDP growth** from 1.5 pp to just 0.2 pp in the respective periods. **Chinese growth** lost



Source: Datastream, GenAM

Source: Datastream, GenAM

momentum, **cutting trade links with Russia** pushed energy prices up and harmed competitiveness. **Increased competition in the automotive sector** in the wake of the transitions to EVs brought the economy's most important sector under structural pressure. The majority of firms sees a

deterioration of its competitiveness in Germany, the EU and globally according to an ifo survey. As a result, **restructuring amid job losses will stay on the agenda next year**.

With Trump taking office in January the next whammy is looming. He announced to levy general tariffs for imports to the US. In an extreme scenario the new US administration walks the talk and imposes a basic tariff of **20% on US imports from all trading partners and of 60% on imports from China**. The economic damage for Germany would be enormous, according to ifo exports to the US would fall by 15% and the ones to China by 10% as it would be massively hit. The calculated damage of € 33 bn amounts a **fall of exports by about 2% and implies a drag on output by 0.9% in terms of 2023 real GDP**. Looking beneath the surface, German manufacturing exports would decline significantly with the German automotive industry (-4.9%) and pharmaceutical industry (-4.7%) seeing the largest declines. On the other hand, the German service sector could even slightly increase its total exports, as they would partly replace US services in third markets and in the US itself, since US services become more expensive because of protectionist trade policies.

Admittedly, the full implementation of the Trump tariffs is a worst-case scenario. More likely to us, the US use the threat of tariffs as a bargaining chip to direct production into the US and to achieve goals in other policy fields, e.g., military spending. However, the **threat of tariffs alone will keep economic uncertainty high** and drag on investment activity.

2025 a pivotal year for Germany

In this environment we expect an only meagre **growth rate of 0.3% in 2025 keeping the economy close to stagnation**. This less than the consensus forecast of 0.7%. The risks are even tilted to the downside and mainly related to the imposition of US import tariffs which have the potential to push the economy into outright recession. Poor German growth will also drag on euro area growth rate which we see at only 0.8% for 2025 and contribute to a more dovish ECB.

That said, the **next year will be decisive for the German medium-term economic outlook**. The next government (assuming our base scenario of a conservatives and socialist coalition) will likely be more stable than the previous one. Near-term we expect no fiscal boost and deem a full scrapping of the debt brake unlikely. However, a reform towards more fiscal flexibility to master the enormous infrastructure spending needs seems likely to us. We see it as a necessary prerequisite to lift the economy's growth potential again. Restructuring in the manufacturing sector to recover competitiveness will need to continue and drag on investment, the labour market and confidence. Uncertainty from looming US tariffs comes on top. Germany is at the crossroads and 2025 will give indication whether there is some silver lining at the horizon.

Imprint

Issued by:	**Generali Asset Management S.p.A.** **Società di gestione del risparmio, Research Department**
Head of Research:	**Vincent Chaigneau**
Head of Macro & Market Research:	**Dr. Thomas Hempell, CFA**
Team:	**Elisabeth Assmuth |** Research Operations **Elisa Belgacem |** Senior Credit Strategist **Radomír Jáč |** GI CEE Chief Economist **Jakub Krátký |** GI CEE Financial Analyst **Michele Morganti |** Head of Insurance & AM Research, Senior Equity Strategist **Vladimir Oleinikov, CFA |** Senior Quantitative Analyst **Dr. Thorsten Runde |** Senior Quantitative Analyst **Dr. Christoph Siepmann |** Senior Economist **Dr. Florian Späte, CIIA |** Senior Bond Strategist **Guillaume Tresca |** Senior Emerging Market Strategist **Dr. Martin Wolburg, CIIA |** Senior Economist **Paolo Zanghieri, PhD |** Senior Economist

"Edited by the Macro & Market Research Team. The team of 14 analysts based in Paris, Cologne, Trieste, Milan and Prague runs qualitative and quantitative analysis on macroeconomic and financial issues. The team translates macro and quant views into investment ideas that feed into the investment process."

This document is based on information and opinions which Generali Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Generali Asset Management S.p. A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-am.com. Generali Asset Management S.p. A. Società di gestione del risparmio is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche.