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German fiscal package: a positive shock for the ECB

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- **The German fiscal package is an example of something that happens once in a century for a central bank: a positive exogenous shock.**
- **Central banks are accustomed to facing shocks, more often than they would like to. And among central banks, the ECB is the one that has probably faced the longest string of unexpected and dramatic negative shocks in its short history.**
- **But the German fiscal package, if adopted, will be a positive exogenous shock. It will support growth in Germany and in other countries; it will help the Eurozone get back to its potential more quickly than expected; and it could offset increasing deflationary forces linked to the economic slowdown.**
- **In this context, the ECB will have to adapt to this (positive) shock, as it has done for past (negative) shocks. In this paper, we detail the change to the ECB's scenario this package could trigger and give a first view of the consequences for the ECB's monetary policy.**

Exogenous shock

Despite the incredibly high level of uncertainty in the current context – as highlighted by Members of the Governing Council themselves – the ECB still has to consider economic developments and act accordingly. Even though, in the meantime, it knows that it can – and will – face new shocks at any point in time.

The ECB just suffered an exogenous shock. A huge one, in our view. And – it is rare enough that we will highlight this – it was a positive one.

The German fiscal package, if implemented (even partially) is a huge, unexpected, piece of good news for Germany, the Eurozone and the ECB.

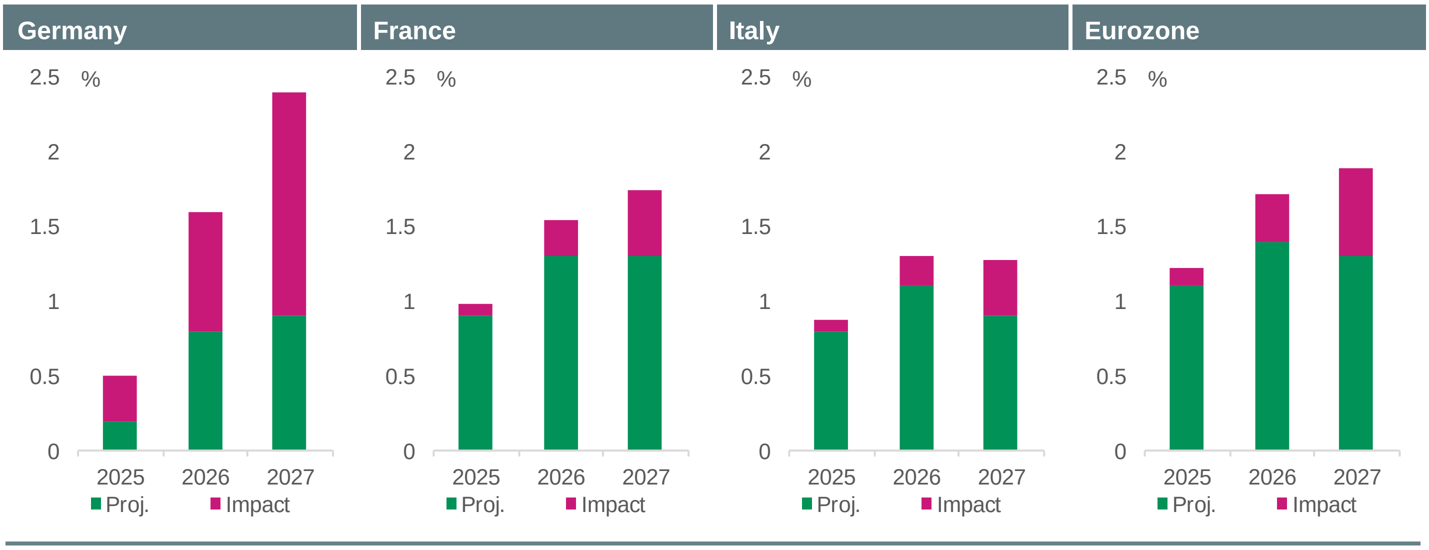
We know that there is still a lot of uncertainty surrounding this package: it has to be better defined, it has to be voted on and it has to be implemented. Nevertheless, unless it is opposed by the Bundestag, this package will have positive impacts on the Eurozone economy.

Impact on GDP growth

The impact on the Eurozone economy remains uncertain. Our macro strategist estimates that for Germany, this package could add 0.5ppt of growth in 2025, 1.0ppt in 2026 and 1.5ppt between 2027 and 2029. This central estimate is based on conservative assumptions on the fiscal multipliers, offset to a certain extent by the fact that we suppose that both the infrastructure plan and the defence plan are fully implemented.

France would benefit from a pass-through of 35% of this upward growth and Italy around 25%. Eurozone core countries would have an even stronger pass-through, whereas countries further away from Germany would have a smaller benefit.

In the charts below, we schematise the potential revision of the ECB's projections if we apply our own estimate of the impact of this fiscal plan – these are not our forecasts, only working assumptions for illustration purposes.



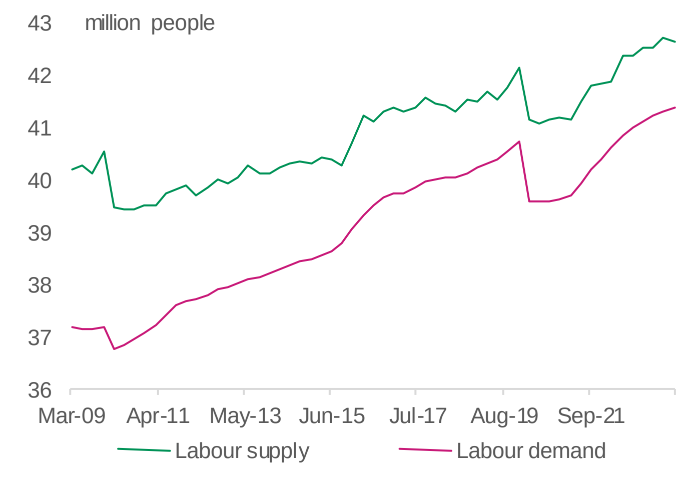
Source: ECB, Crédit Agricole CIB

Impact on inflation

Our inflation strategists estimate, for now, that the impact on inflation in their forecast horizon (until end-2026) would be rather limited (they have added 20bp on their forecast for core inflation at the end of 2026) and it would be muted for other countries.

Nevertheless, we can assume that the stronger growth – which will materialise beyond 2026 – pushing German GDP growth well above its potential, and France and Italy above their potential – could trigger upward inflationary pressure, especially in the medium term.

Tight labour market in Germany despite seven years of stagnation



Source: Eurostat, Crédit Agricole CIB

A limited easing of the labour market, still at abnormally high levels

Source: Eurostat, Crédit Agricole CIB

Another discussion we have had in-house, regarding the impact of the German plan, is linked to the tightness of the German labour market: despite more than seven years of economic stagnation, the German labour market remains rather tight. An economic recovery – or a fiscal package – could create further tensions on the labour market. This could result in one of three outcomes:

- There are significant gains in productivity and growth is stronger in Germany.
- The tightness of the labour market is too strong and the fiscal package creates mostly wage pressures and inflation; growth is not significantly stronger, but inflation is.
- Or Germany uses nearshoring to compensate for a tight labour market and Eurozone economies ex-Germany benefit more from this fiscal plan.

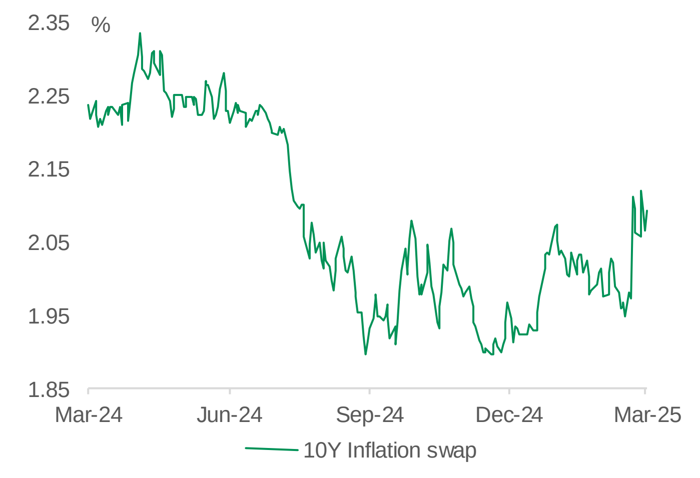
In either of these three situations, it would affect the ECB's monetary stance, towards a more hawkish bias.

Impact on financing conditions

Beyond economic growth and inflation, the ECB also has to consider financing conditions. The sudden repricing of the EUR swap and the EGB curves has triggered a tightening of financing conditions. Beyond the higher yields, however, we have to look through the different reasons for this repricing. We see three elements:

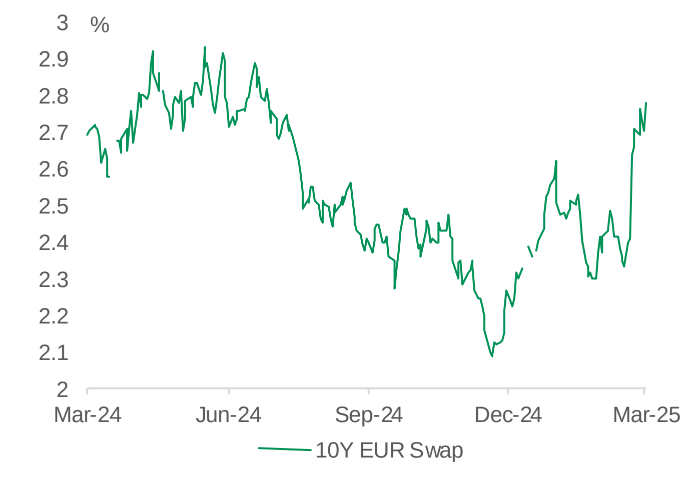
1. The fact that the market will have to absorb more issuance. This has triggered not only an increase in EGB yields, but also a tightening of asset-swap spreads. Asset yields have increased more than swaps, for the simple reason that there will be more assets in the market.
2. The market has also included an inflation impact: part of the increase has been due to the repricing of inflation
3. The market has also integrated that growth will be stronger in the future, and monetary policy could have to be more hawkish than expected as a consequence (our macro strategist would possibly suggest that the fiscal package has increased the r*, but mostly because he likes talking about r*).

Repricing of inflation



Source: Bloomberg, Crédit Agricole CIB

Repricing of EUR rates



Source: Bloomberg, Crédit Agricole CIB

The ECB should not fight all of these elements. On the contrary, the repricing of inflation swaps and the repricing of the future path of the ECB warrants a good transmission of the ECB's monetary stance. However, it is true that if the overflow of EGB issuance in the market triggers abnormally tight financing conditions, then it could have to ease its monetary stance slightly to compensate.

Nevertheless, the tightening of the financing conditions is, for now, insignificant in regards to the positive aspects regarding growth and inflation for most, if not all, Eurozone countries.

Consequences for the ECB

Until the announcement of the German package, there were three reasons for the ECB to continue its monetary easing: (1) declining Eurozone core inflation that would fall (marginally) below 2% in the course of 2026; (2) sluggish growth in the Eurozone, mostly due to stagnation in Germany, and sluggish growth in France & Italy (whereas other Eurozone countries were more on the verge of overheating); and (3) a neutral rate that could be lower than the current level (the ECB's estimate of the neutral rate is between 1.75% and 2.25%).

Now, this fiscal package will (marginally) support core inflation in 2026, and possibly more in the years after. It will support growth significantly in Germany, and it will improve growth in other countries, starting with Italy and France; theoretically all these countries could be at, or above, their potential growth by 2026. It could increase the neutral rate.

Conclusion

Before the German fiscal package was announced, we were on the hawkish side of the consensus, expecting a terminal rate at 2.25%, reached in April 2025. We will not pretend that we expected the announcement of this fiscal package (although we had been hoping for it for the past 15 years).

Before this announcement, we were already thinking it over in our head as we were not fully comfortable with our own scenario: we expect the ECB to slow its pace of cuts before its final rate cut. Consequently, if the ECB cuts in April, then it would likely cut again later this year.

Taking into account this exogenous shock, we will have to review our monetary policy scenario.

Overall, the German fiscal package reinforces our view for a more hawkish monetary policy than expected by the consensus. We do not believe, however, that it is fast enough to prevent the ECB from cutting once more. So we keep our terminal rate at 2.25%, and we will fine tune this with an official review of our scenario soon.

In the medium term, we can no longer rule out the possibility that the ECB will start thinking about hiking its rates in the forecast horizon.

Indeed, there is a world in which the ECB's macroeconomic projections of December 2025 will forecast GDP growth above 1.5% for 2026 and 1.7% for 2027; a core inflation around 2% for 2026 and increasing in 2027. In this world, the discussions about a rate hike certainly have their place.

Of course, other shocks could happen in the meantime; but applying a strict counterfactual to the ECB's scenario of the March Macroeconomic projections pushes for less accommodative monetary policy than expected a few weeks ago.

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