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Europe Watch - Quick Insights

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GERMANY: MERZ'S 'ART OF THE DEAL' - WHAT NEXT?

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Deal! The soon-to-be German Chancellor Friedrich Merz has just finalised an agreement with the Greens, which clears a first hurdle to pass a historic fiscal reform package that conservative estimates suggest would unlock ~2% of GDP/year between infrastructure and defence investment over the next 10 years. On the news, EUR/USD jumped again above 1.09 and German 10y yields rose by 5bps to 2.93. **Sure, there is always some devil in the details. First, the agreement suggests the short-term impact of the infrastructure fund could be marginally smaller. Second, as we flagged, the most hazardous hurdle for the package to pass – the vote in the Bundesrat on 21 March – has not been cleared yet.** All that said, though, today's deal further underscores our macro and market views for Germany and Europe (watch out for our latest Asset Allocation out today, too).

Agreement details – more for climate; marginally slower implementation. As expected, the Greens used their strong leverage to extract concessions on climate spending. Merz agreed to channel €100bn out of the €500bn-strong infrastructure fund to the existing climate fund. Moreover, the Greens requested all infrastructure spending to be earmarked for "new projects", to make sure it was "additive" to existing plans. **This is relevant to the short-run impact of the fiscal package because it could slow down the spending initially.** The recent experience of the €100bn special fund for the German army, subject to similar constraints, shows that the permitting of new projects is a lengthy process. On balance, though, given the dismal state of Germany's infrastructure, chronic lack of public investment until now and the loose definition of what constitutes "infrastructure" suggest that the impact of the fiscal stimulus, if approved, will be large, especially from next year.

As a side, we will also note that a somewhat slower implementation in the very short term should further limit concerns building among hawkish ECB officials that German fiscal policy will require an immediate response by the ECB. As we argued, while risks have risen of an earlier end to cuts, several factors point to the ECB retaining its easing bias so that the base case remains a 2% deposit rate this year.

Now, to the Bundesrat – the most difficult hurdle. The Greens' votes are necessary to achieve the required Bundestag supermajority. But for the package to be approved it will also need to pass a Bundesrat vote on 21 March. As we explained, even with Greens' votes, CDU+SPD+Greens are four seats short of supermajority in the Bundesrat. Moreover, Bundesrat conventions about delegates voting in line with the lowest common denominator of their home State coalitions could result in abstentions (mostly affecting the few seats held by the FDP), which is equivalent to voting against.

In sum, today's deal is another important step in the right direction; markets will still track the full approval process.

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