Germany agrees historic fiscal package and debt brake change

The German parliament has voted in favour of a huge fiscal package and changes to the debt brake. It's historic, and this is what it means for Germany and the wider world

The incoming German chancellor, Friedrich Merz, casts his vote on the historic measures

The German parliament has just agreed to a €500bn infrastructure fund and changes to the debt brake to allow for higher defence spending and more fiscal space for state governments. It passed with a two-thirds majority. After tough negotiations and a compromise between CDU/CSU, SPD and the Greens, the deal was almost sealed last Friday, but negotiations on the controversial move continued through the weekend.

Highest hurdle taken, Federal Council will be next

The official agreement consists of a €500bn infrastructure fund over the next 12 years, of which €100bn will immediately be channelled into the Climate Transition Fund. The remainder of the fund remains dedicated to additional infrastructure investments, with €300 billion designated for the federal government and €100 billion for the state governments. Also, defence spending of more than 1% of GDP will be exempted from the debt brake and state governments will be allowed to run annual deficits of up to 0.35% of GDP.

The final hurdle will now be the Federal Council (Bundesrat), where the regional states' governments will vote on the draft law. Here, the number of votes every state government holds differs according to the size of the population. And it is an unwritten rule that state governments only agree to a draft law if all coalition parties of the state government agree. The last potential stumbling block seems to be Bavaria, where the coalition partner of the CSU, the Free Voters, has not yet agreed to support the fiscal package.

Also, let's not forget that there is still no new German government. The coalition negotiations have only just started. After the public outcry after the release of a draft outline, we expect tough negotiations with potential tensions on where to cut government expenditure. Remember, the draft outline included proposals for VAT cuts for restaurants, a return of the exemption of the diesel tax for farmers, a higher minimum wage and other election gifts. Those measures alone would increase the German deficit significantly from its current 2% of GDP.

After today's vote, we would expect CDU/CSU to push for stricter austerity measures than initially included in the draft outline. However, once the fiscal package has also passed the Federal Council, it no longer matters who will lead the next government. Fiscal space is now a given.

Implications for Europe

The German debt brake had always been stricter than European fiscal rules. With today's decision, the brake is not officially dead but buried alive. Germany has given up on leading the group of fiscal frugals in Europe for the sake of boosting its economy. If the incoming government doesn't come up with additional structural reforms and longer-term austerity measures, such as changes to the pension system and the retirement age, then Germany will have a hard time convincing the rest of Europe to tighten its belt.

Cyclical rebound coming up but more is needed to restore competitiveness

Just loosening the fiscal debt brake, by the way, does not automatically lead to higher growth. In fact, the escape clause of the debt brake has been activated frequently over the last few years, and it hasn't prevented the German economy from falling into its current structural stagnation. Perhaps I could argue that things could have been worse.

The difference between a looser fiscal debt brake due to the escape clause and today's decision is the €500bn infrastructure fund. Implemented in the right way, investment in infrastructure should lead to at least a cyclical upswing. The caveat to all of this, however, remains that these measures alone - impressive as their size might be - will do very little to improve the economy's competitiveness. Modern infrastructure is essential for one of the world's largest economies, but it doesn't inherently drive innovation, sector transformation, or new growth opportunities.

Regardless, the chances of a cyclical rebound in the German economy on the back of positive sentiment effects and later actual spending have clearly increased. How long this cyclical rebound will last and whether it could become a structural recovery will now highly depend on whether or not the official coalition talks will eventually lead to real structural reforms. Otherwise, today's fiscal package will only be a very huge flash in the pan.

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