Germany's Dilemma: Is it the Right Time to Put the Brakes on New Debt?

What is a 'debt brake' rule?

Germany is one of a few euro area (EA) countries with declining public debt, set to slide below a Maastricht threshold of 60% to GDP by 2020, according to Germany's April 2016 Stability Programme. The decline in debt is enshrined in the national constitution as the balanced-budget rule or the 'debt brake'. This rule restricts the federal government's structural budget deficit – the actual budget balance adjusted for cyclical and one-off effects – to 0.35% of GDP as of 2016, while the structural budget balances of state governments have to be balanced by 2020. Only in exceptional circumstances can both layers of government deviate from the rule. New debt can be taken to fight either counter-cyclical economic problems or natural disasters. The former type has to be repaid during an economic boom, while the latter could be cleared "within a reasonable time", according to the constitution.

By resorting to the debt brake rule, the German government is pursuing a counter-cyclical fiscal policy – debt, which inflated after the 2009 crisis, should decline during an economic rebound. This policy should ensure that Germany complies with the European Fiscal Compact. However, the European Commission in its recent country report as well as the IMF have called for looser fiscal policy in Germany[1].

What justifies the European Commission's call for a looser fiscal policy?

The point is that while the debt reduction policy should strengthen Germany's individual credit stance, it could be less beneficial for the EA. A high and positive savings-investment balance in Germany, to which a budget surplus is an important contributor, cuts domestic demand due to fewer investments and therefore reduces Germany's imports. The latter would provide fewer stimuli to euro area economies, which depend on German demand. As an export market, Germany is of key importance for countries like the Netherlands, Austria and Luxembourg. The larger euro area economies – France, Italy, and Spain – have weaker links, but their exports to Germany are still in the range of 3-4% of their GDP. Still, the modest recovery expected for France and Italy in 2016 – 1.3% and 1%, respectively – could have benefited.

Will Germany benefit by sacrificing its balanced-budget policy?

Germany's potential benefits could be twofold. First, if Germany deviates from the balanced budget policy by allowing more public investment, it could boost its GDP growth in the short-term – more public investment increases orders for businesses facilitating public-sector demand and offsets sluggish investment growth in the German private sector, whose confidence has faltered from the slowdown in external demand. In the longer term, more investment – provided they are made efficiently – could boost labour productivity, which is crucial for Germany's future GDP growth. The country's shrinking and ageing labour force needs more capital to boost productivity to maintain, let alone increase, GDP growth.

Second, a boost in economic growth for Germany's closest import markets could have a ripple effect on other euro area countries, including the weakest, like Greece or Portugal. If and when the weakest EA economies strengthen, the benefits for Germany grow. The weakest countries' claims on EU rescue institutions, like the European Stability Mechanism, are likely to diminish, which reduces Germany's exposure, as one of the biggest contributors to the rescue fund, to the risk of non-payment from those countries.

[1] Country report Germany 2016, Brussels, 26.02.2016, p.60

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Are there risks for Germany in delaying its implementation of the debt brake policy?

In our opinion, the main risk is to have limited fiscal space at the time when it could be most needed. A decline in public-sector debt now can prepare the country for fiscal- and debt-related challenges in future. These challenges could come from public finances being put under pressure by increasing age-related expenditures, on the one hand, and slowing tax-revenue growth stemming from low GDP growth, on the other.

According to Germany's 2016 Stability Programme, age-related budgetary expenditures – pensions, healthcare, long-term care – could make up 21.2% of general government expenditure by 2030 versus 17.8% in 2010. Though the proportion does not seem overly large and the pace of increase not too rapid for a country where almost half the population will be aged over 65 by 2030 (UN population forecast), it should be noted that Germany has the lowest replacement rate of public pensions[2] among larger EA economies. This puts an increasing number of pensioners at the risk of old-age poverty. Given the public pension is the main source of income for most retirees in Germany, rising impoverishment could prove unsustainable in the long run. It is reasonable to assume that the increasing number of voters who belong to the older age groups are likely to push for more adequate pension benefits – with adverse effects on public finances.

If the public investment done in the past, which has triggered budget deficits, proves insufficient to have a knock-on effect on Germany's GDP growth and, as a result, on tax revenues, the country could find it difficult to balance future budgets and contain the growth in public debt. This could have adverse effect on its credit quality. A low efficiency scenario of larger public finances is entirely feasible, given the public sector provides a relatively small part of investment in the economy. In 2014 the general government accounted for 11% of investment in the German economy; the rest came from the private sector. Should the accelerated public investment fail to trigger larger investment in the private sector, the surrender of the balanced-budget policy could have been wasted.

[2] The replacement rate shows to what extent the public pension replaces wages and salaries.

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