Germany's 2022 budget: large fiscal stimulus and shift away from black zero fiscal policy

Germany's (AAA/Stable) budgetary and policy response to energy and digital challenges as well as the impact of Russia's invasion of Ukraine will shape near-term fiscal outcomes. Moreover, longer-term spending pressures make a subsequent return to pre-pandemic 'black zero' policies hard to achieve without significant fiscal adjustments. In addition to EUR 100bn one-off borrowing to fund defence projects in 2022 (about 3% of GDP), we expect higher annual expenditure to support the new government's objectives. This is on top of rising expenditure on pensions and the repayment of Covid-19 related debt from 2028. A return to budget surpluses is thus unlikely, underpinning the need for higher growth to maintain Germany's robust public finances.

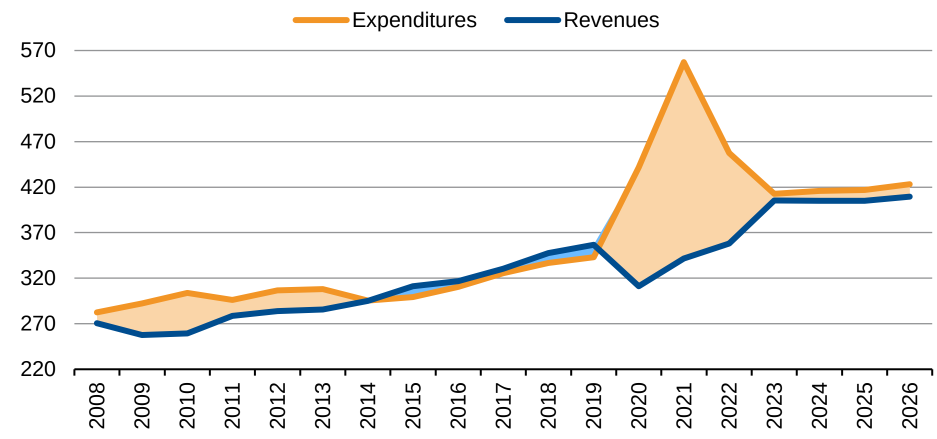
Germany's revised 2022 budget draft and financial plan until 2026, following the change of government, has now been published. The draft includes first fiscal commitments in response to the Russian invasion of Ukraine, on defence, gas reserves and higher energy prices. An amending budget, with significant fiscal impact, will be announced in the coming weeks to detail shifting priorities toward shielding the economy from rising energy costs. Further, continued spending on Germany's energy transition will remain a priority, also with a view to reducing dependence on Russia.

With the debt brake still suspended in 2022 due to the Covid-19 pandemic, the government plans to increase borrowing this year to a minimum EUR 199.7bn (5% of GDP), likely to be higher with changes from the upcoming amending budget. A significant portion of these funds will be held in special funds ('Sondervermögen'), outside the core annual budget, and will be spent over several years. The two main funds are a EUR 100bn fund for military spending and a EUR 200bn fund to support the transition towards a carbon neutral economy and the digital transition. Importantly, expenditures in future years of these funds will not fall under debt brake rules.

The additional borrowing in 2022 will increase Germany's debt-to-GDP ratio by around 3pp, although this is partially offset by nominal GDP growth. Still, Germany's debt brake ensures that medium-term public finances remain on a strong footing with debt levels set to fall from 70% of GDP in 2022 to 62% by 2026. However, we expect that the current coalition government will not return to the pre-pandemic fiscal surplus policy and instead make wider use of the flexibilities allowed within the debt brake framework. Over the longer-term, structural spending pressures will further limit any budgetary headroom.

Figure 1: German federal revenues and expenditure

EUR bn



Source: Ministry of Finance, Scope Ratings GmbH.

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Rising defence spending

Germany has never met its NATO commitments

In 2006, NATO Defence Ministers agreed to commit a minimum of 2% of GDP to defence spending to ensure the Alliance's military readiness. Allies also agreed that at least 20% of defence expenditures should be devoted to major equipment spending. Since the guidelines were agreed, Germany has never met these spending commitments (see **Figure 2**).

EUR 328bn cumulative spending gap to NATO commitments since 2006

The country's defence spending has gradually increased from 1.2% of GDP in 2015 to 1.5% in 2021, but persistent underspending has resulted in a cumulative spending gap short of NATO commitments of around EUR 328bn since 2006. Of this, we estimate the gap related to spending on major equipment at approximately EUR 97bn.

Military capabilities remain well behind other large allies

Following Russia's invasion of Ukraine, the government is planning significant changes to its defence policy. Chancellor Scholz announced that Germany will meet it's 2% of GDP spending commitment from 2024 onwards. This is in sharp contrast to the previous planned reduction in military spending before Russia's attack. To achieve this, in addition to the EUR 50bn (around 1.5% of GDP) allocated to the Ministry of Defence this year, the government plans to issue new debt and establish a special fund for the armed forces of EUR 100bn to fund armament projects. However, these financial resources will only be used over the next few years and therefore only narrow Germany's spending gap with militaries of other large European economies over time. Reducing this gap will require not only increased funding, but broader reform – since 2019, Germany's nominal military spending has exceeded France's and was only slightly lower than the United Kingdom's, but the country's air, land and naval forces remain significantly weaker (see **Figure 3**).

EUR 100bn new debt to increase debt-to-GDP ratio in 2022

The additional debt issuance of EUR 100bn is planned in 2022, which will result in a one-off increase in Germany's debt-to-GDP ratio of around 3pp this year. The increased budget flexibility, and the planned enshrining of the special fund in Germany's constitution, would ensure that NATO commitments can be met over the next few years.

Figure 2: German defence spending vs NATO commitment
EUR bn, %

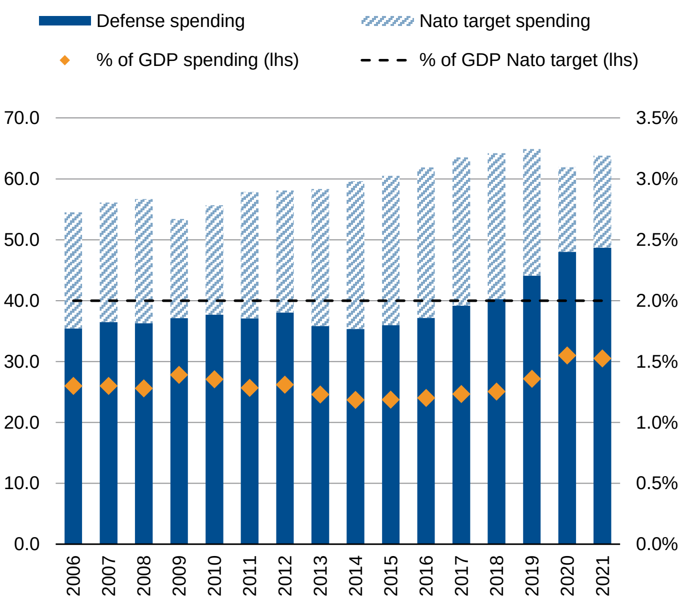
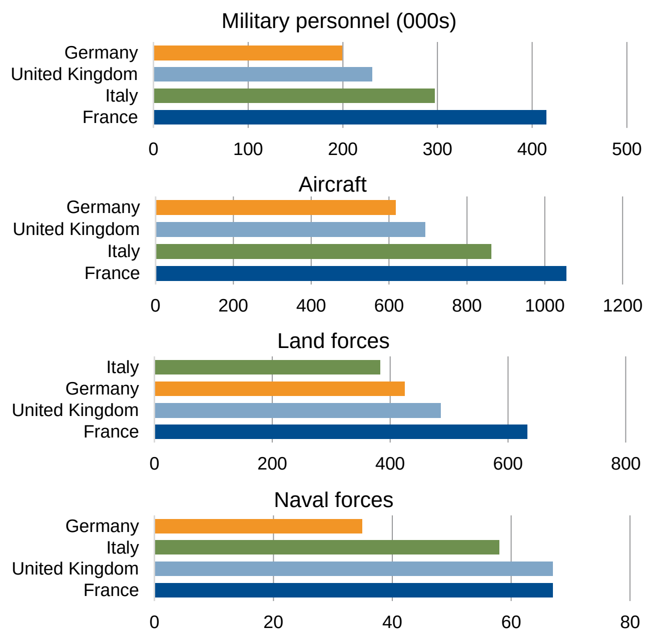


Figure 3: Europe's largest militaries compared



Source: NATO, GlobalFirepower, Scope Ratings GmbH.
Notes: Statistics on land forces include tanks, artillery and rocket-projectors; naval forces includes aircraft and helicopter carriers, destroyers, frigates, corvettes, submarines, patrol vessels and mine warfare

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Frontloading the green agenda

EUR 200bn for green spending until 2026

The government announced in March that EUR 200bn (6% of GDP) will be used to fund Germany's energy transition over the next five years. The aim is to reduce dependence on Russian energy imports while lowering emissions, supporting the hydrogen economy, and improving the network of charging points for electrical cars. In a sign of a broadening focus, the previous 'energy and climate fund' (EKF) will be re-labelled as the 'climate and transformation fund' (KTF). As such, the funds will not only support green infrastructure, but also be used to reduce environmental levies to ease pressures that households face from sharply rising energy prices.

Actual new spending commitments of around EUR 30bn

The announced investment commitments suggest a continuity of previous plans and reflect efforts to ease pressure on households from rising energy prices. While significant investment in the green transition is being made, the EUR 200bn fund includes actual new commitments of only EUR 30bn (see **Figure 4**). The remainder relates to reserves of the EKF, previous government commitments and the reallocation of excess government borrowing during the Covid-19 crisis. Part of the new commitments will be used to lower levies such as the renewable energy levy ('EEG-Umlage') which is planned to be abolished from July 2022 onwards.

Plans indicate a continued front-loading of public sector investment requirements

The government's current spending plans appear to be in line with previous estimates of *total investment needs to address the energy transition*. Finance Minister Lindner noted that the removal of the energy levy could cost up to EUR 50bn. If this was fully funded through the EKF / KTF fund, it would still leave around EUR 34bn per year over the next five years. Estimates of public sector spending requirements to tackle the energy transition in Germany vary widely and are highly uncertain. Previous assessments indicated spending requirements of about EUR 10bn per year until 2050. The current plans therefore reflect a front-loading of some of these spending needs.

Figure 4: Public sector green investment commitments
EUR bn

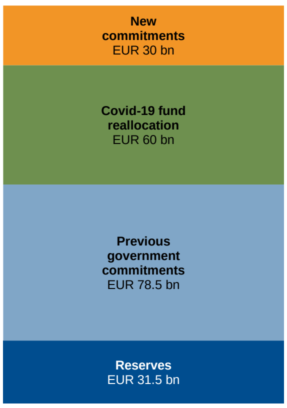
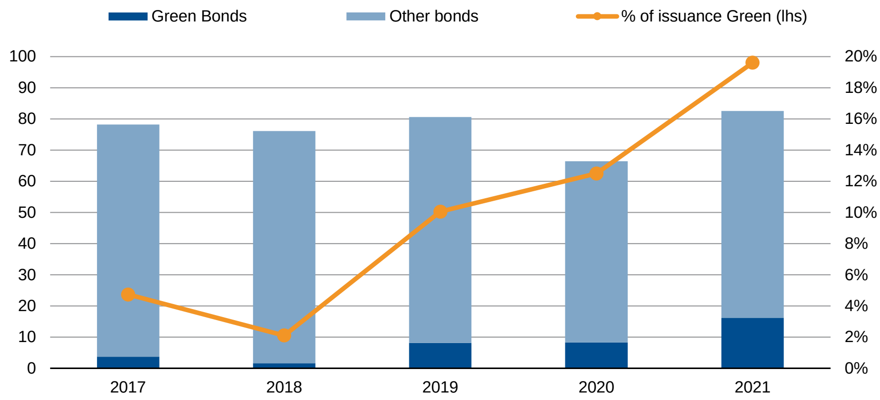


Figure 5: KfW bond issuance
EUR bn (lhs), % of issuance (rhs)



Source: Ministry of Finance, KfW, Scope Ratings GmbH.

Private sector participation will be crucial

The private sector is the most important investment channel to achieve an emission-free economy. The public sector can support these efforts through *Germany's well-established network of development banks*. Germany's largest development bank (KfW) has significantly increased green bond issuance in recent years (see **Figure 5**). Funds tend to be invested through commercial banks and can support infrastructure projects with private-sector participation. The ability of the government to simplify planning laws and bureaucracy will be crucial to incentivise private sector investments.

Germany's fiscal outlook: A return to the black zero?

Since 2011, the debt brake anchors budgetary outcomes

The sizeable fiscal packages on defence and the digital and energy transformation need to be seen in the broader context of Germany's conservative fiscal management since the 2008 financial crisis. This remains a core credit strength and is anchored by debt brake provisions. The federal debt brake came into force in 2011 and limits the budget deficit to 0.35% of GDP, allowing for cyclical deviations and certain financial flows.[1] The states' debt brake laws became binding in 2020, eliminating their structural deficits altogether.

Exemptions were used for borrowing in 2020-22

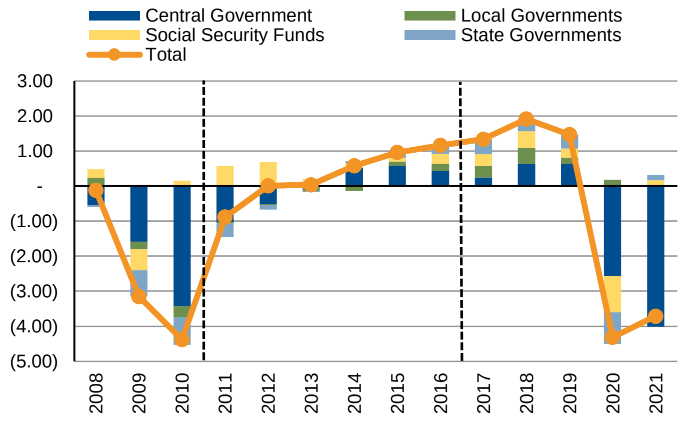
Debt brake laws contain natural disaster and other emergency clauses to allow for extraordinary borrowing. This was used during the Covid-19 pandemic from 2020-22. Due to the Russian invasion of Ukraine and its impact on energy imports and the broader economy, a further budgetary revision has been announced.

2022 borrowing likely to eclipse record borrowing in 2021

Equipped with extraordinary borrowing authorisations, the central government borrowed EUR 86bn in 2020 (2.6% of GDP) and EUR 143bn in 2021 (4% of GDP) (see **Figure 6**). For 2022, we project a fiscal deficit of around 6-7% of GDP, including EUR 100bn for defence spending and further substantial funds to address energy cost concerns.

Figure 6: Government budget balance

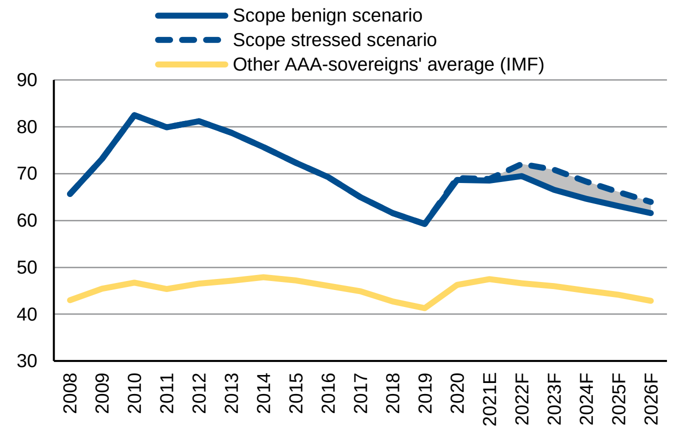
% of GDP, Maastricht definition



Source: Destatis, Scope Ratings GmbH

Figure 7: General government debt

% of GDP



Source: IMF, Scope Ratings GmbH

Return to 'black zero' unlikely

From next year, the government plans to return to a budget balance within the 0.35% of GDP limit, with changes likely should the Russia-Ukraine conflict last into 2023. Structural deficits at or close to 0.35% (or around EUR 15bn) would mark a significant change to pre-pandemic 'black zero' policies with average surpluses of EUR 16bn, or 0.5% of GDP over the 2014-19 period.

Russia-Ukraine war weighs on growth and fiscal outlook

The Russian invasion of Ukraine weighs on growth and fiscal outlooks and substantially increases forecasting uncertainty. **Figure 7** summarises our revised debt-to-GDP projections for Germany. This includes *updated projections for real GDP growth in 2022* of 3.5%, down from 4.4% previously. In a stressed scenario, with a prolonged military conflict and disruptions, projections include real growth assumptions of around 1.5% in 2022 and 1% in 2023. As a net importer of oil, gas and coal (EUR 93bn imports in 2021), higher import prices will weigh on Germany's external balance, while an outright import shortfall, e.g. due to an embargo, would decrease GDP by around 2.2pp in 2022, a recent study shows.[2]

[1] Due to a change in legislation in 2021, financial balances from extra-budgetary vehicles without their own borrowing authorisation, such as the climate and transition fund, will not be counted towards spending under the structural debt brake ceiling of 0.35% of GDP, and therefore not constrain other ordinary spending.
[2] Bachman et al 2022, What if? The Economic Effects for Germany of a Stop of Energy Imports from Russia, ECONtribute Policy Brief No. 028.

Longer-term spending pressures still linger, on pensions…

Over the longer-term but still within this decade, German public finances will also face increasing pressure from structural spending requirements, such as on pensions. The central government spent EUR 102.6bn in 2020, or 3.1% of GDP, to top up the main pay-as-you-go scheme (‘Allgemeine Rentenversicherung’)[3]. Given the country’s ageing society, the 2021 Commission’s Ageing Report estimates that public spending on pensions will go up to 11.5% of GDP in 2030 from 10.2% in 2019, about EUR 100bn annually.

…mandatory emergency debt redemptions from 2028…

Another item that will consume public resources from 2028 are debt redemption payments which are mandatory under the federal debt brake law. These could amount to EUR 11.1bn per year, or 0.3% of 2021 GDP, and be spread over 30 years.

… and the 2% defence spending pledge.

Finally, should the pledge to enshrine the 2% of GDP defence spending target into the country’s constitution materialise, this would mean approximately EUR 15bn in additional spending compared to pre-pandemic years over the longer term.

[3] Deutsche Rentenversicherung Bund, Rentenversicherung in Zeitreihen, October 2021.

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