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MACRO MORNING BRIEFING

November 15, 2024

Turning Off the Traffic Light

Structural challenges require a structural response in Germany

- Timing of new German vote already presents challenges
- Debt brake flexibility is a universal demand
- Bund demand in iFlow may yet provide reflation story

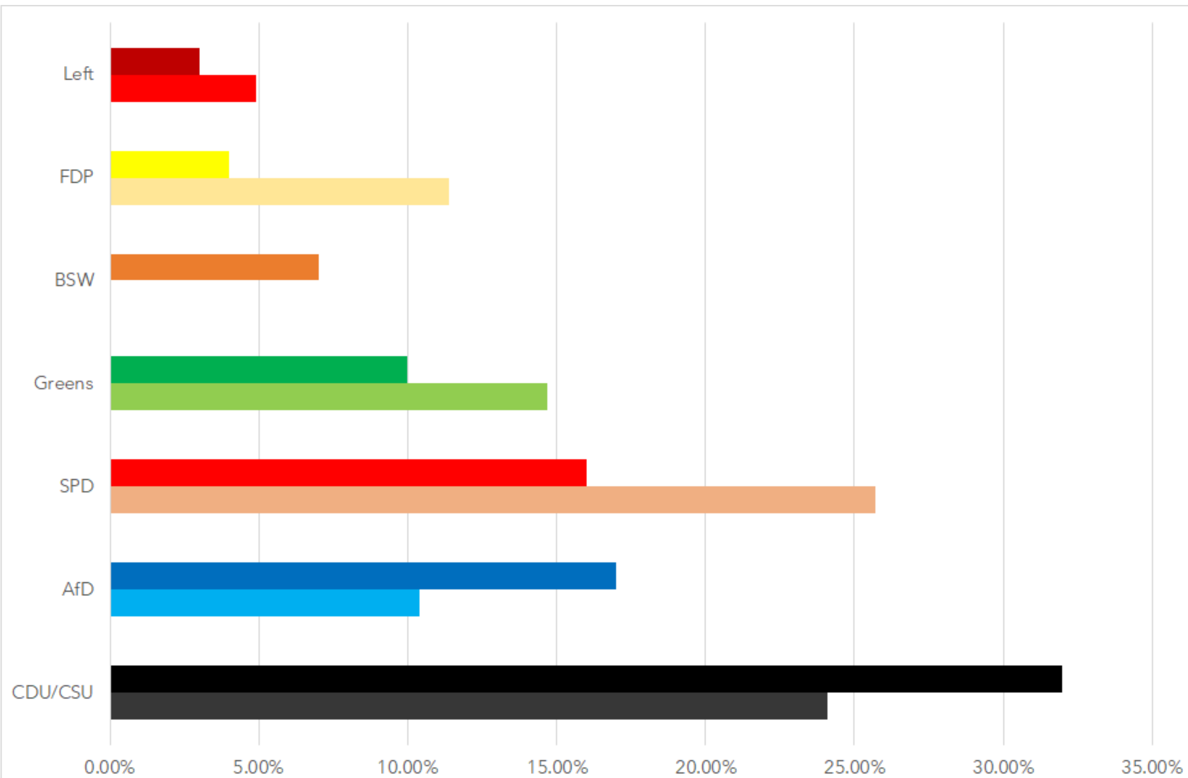
Next government must push for investment growth

In hindsight, it was a minor miracle that the "traffic light coalition" in Germany lasted as long as it did. After differences among the parties became irreconcilable and the Free Democratic Party (FDP) left the coalition, the German government no longer commands a majority in the Bundestag. Within the space of less than a year, parliamentary elections in the UK, France and Germany have all been called ahead of schedule. Even though the election in Germany will not be held for another three months, the global mood of anti-incumbency is unlikely to be any less potent.

The US election results and the prospect of general tariffs on manufacturing exports to the US present yet another challenge to German industry, which is already facing structural headwinds. While the focus in the country and in the EU at large remains on China, especially with respect to the automotive sector and lower demand for other European manufacturing exports, the US is a more important export destination for Germany. In 2023 exports to the US accounted for 9.42% of total exports and 15.3% of exports to non-Eurozone economies. The corresponding figures for China stand at 6.28% and 10.2%, respectively. The urgency of renewal for the sector, supported by public investment, is very clear, but the FDP's intransigence on the matter is now seen as damaging the country's national interests. Specifically, the party's refusal to countenance some flexibility over the constitutional “debt brake” is viewed as holding the country back. No matter the outcome of the election, the next government will be seen as having an investment-focused programme which could finally help turn expectations around.

Based on the latest polling (Exhibit #1), the opposition CDU/CSU is expected to comfortably win the next federal election and CDU leader Friedrich Merz will therefore become chancellor. However, on current evidence, the bloc will still fall short of winning an absolute majority, a feat that has only happened once in post-war Germany when the CDU/CSU achieved it in 1957 under Konrad Adenauer.

Exhibit #1: Latest Poll of Polls vs. 2021 Result

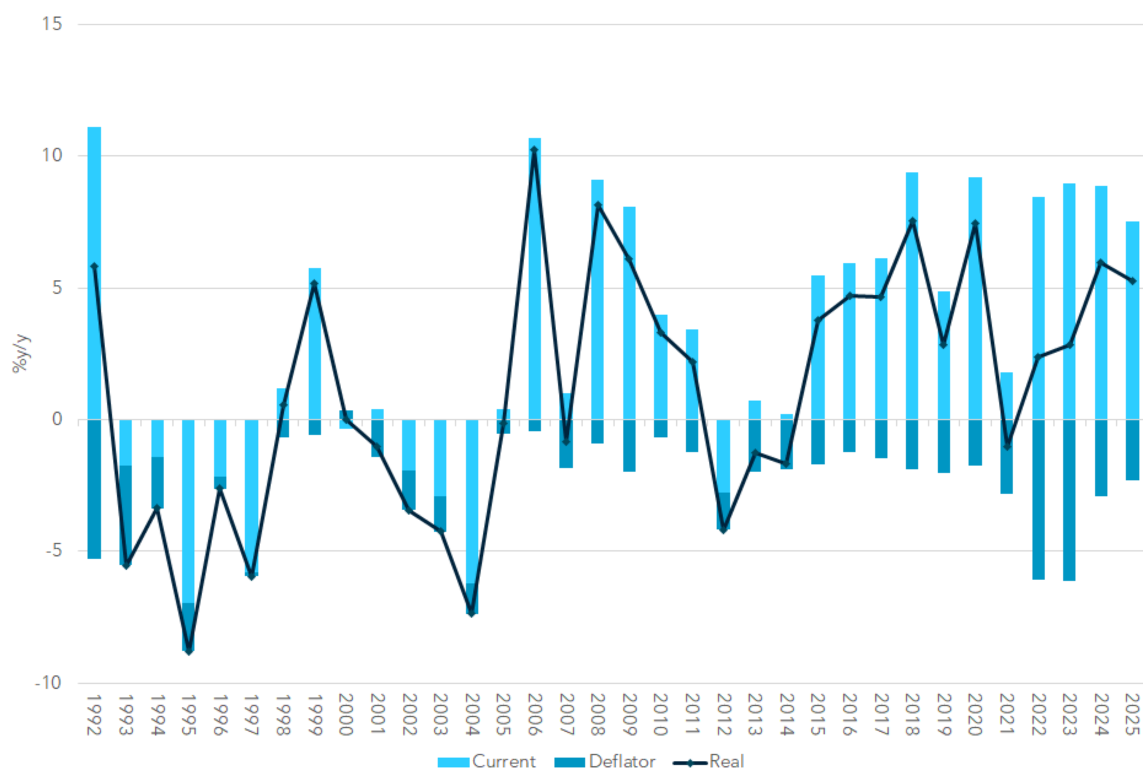


Source: Politico, BNY

Assuming he is victorious in the vote, Merz’s choice of coalition partner will likely attract the most attention, but we believe that launching an immediate investment programme is the absolute priority. This week Merz said the debt brake “can be reformed” and given that most potential parliamentary partners will be on the same page, the remaining question will revolve around the timing and scale of any such reform. The International Monetary Fund (IMF) notes that “the debt brake has served Germany well, most Directors concurred that a moderate easing could create additional fiscal room without endangering debt sustainability.” As changes will also require constitutional changes, the process will likely be slow and the IMF suggests that in the near term, further fiscal room could be generated by “pension reforms, reducing environmentally harmful subsidies, and other revenue and expenditure measures [and] improving public investment execution.”

Meanwhile, the surge in inflation over the last few years has clearly eroded the real-terms effect of investment growth. This problem was particularly acute in 2022 and 2023, when high nominal growth of gross fixed capital formation (GFCF) of close to 10%y/y was reduced to below 3% by the biggest deflator offset since German reunification in 1990 (Exhibit #2). Given the supply constraints at the time due to the Ukraine war and post-Covid recovery, execution of public investment was clearly affected adversely, which has resulted in very poor outcomes for productivity. The latter factor should be less of an issue for the next government, while highly variable outcomes are possible for the former even before the next chancellor takes office. Fiscal expansion will also help mitigate any impact from structural reforms. Despite their positive legacy for Germany, the lack of strong public investment during the Hartz Reforms period under Chancellor Schröder may have contributed to the Social Democrats’ failure to overcome the CDU/CSU in elections between 2005 and 2021.

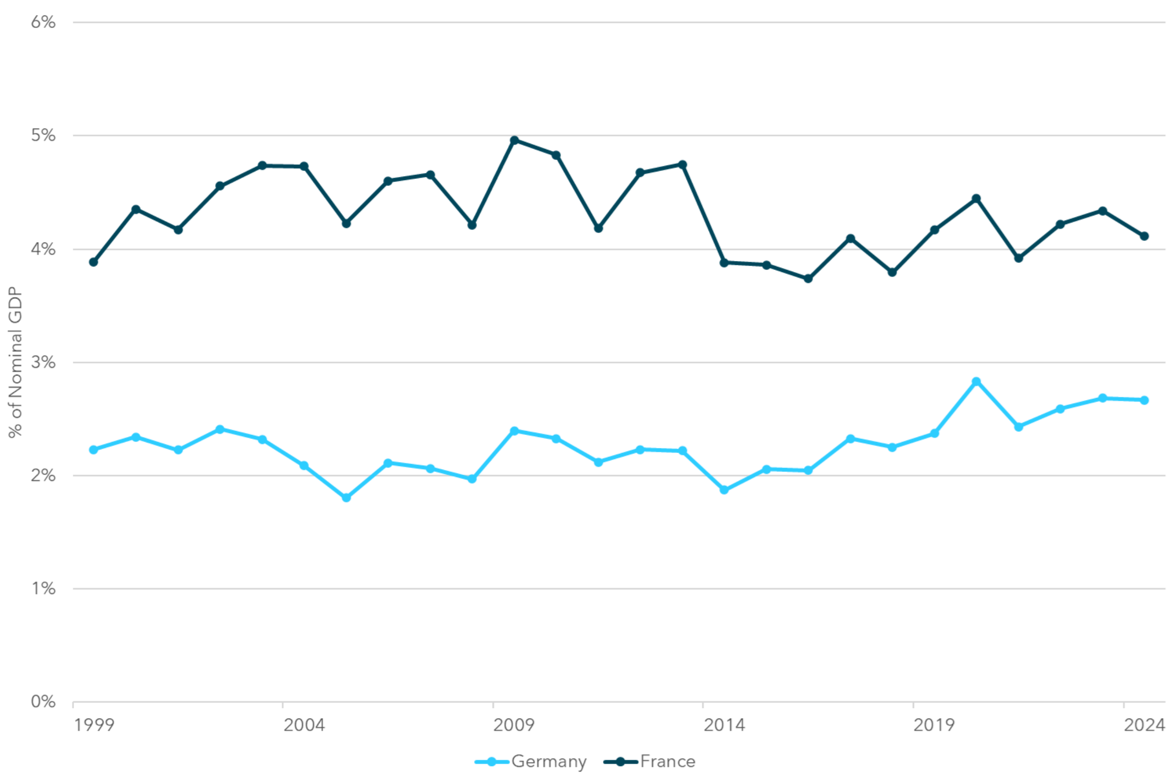
Exhibit #2: Nominal and Real Government GFCF, Germany



Source: Bloomberg, BNY

Sceptics of changing the debt brake would highlight that public investment in Germany is not low. In nominal terms, the growth rate of government GFCF in Germany has doubled over the past decade and is expected to hit EUR 130bn in 2025, according to the Directorate-General for Economic and Financial Affairs of the European Commission (DG-ECFIN), which is close to 24% of aggregate public sector GFCF in the Eurozone. Yet, despite having bigger fiscal capacity and lower borrowing costs, not to mention a larger economy, 2025 will be the first time since 1994 that total public GFCF in Germany will be higher than that of France in nominal terms (Exhibit #3), underscoring the lack of ambition or consistency in fiscal restraint. The need for Germany to shift gears also matters for the rest of Europe as it is the source of final demand for other smaller Eurozone manufacturing economies. Given the likelihood of high levels of GFCF – both public- and private-sector – in the US and China due to vastly different industrial politics, lack of action puts Europe at risk of being left further behind. In this context, it is also imperative for the next German government to take the Letta/Draghi reports seriously and push for EU-wide implementation.

Exhibit #3: Public Sector GFCF as % of Nominal GDP

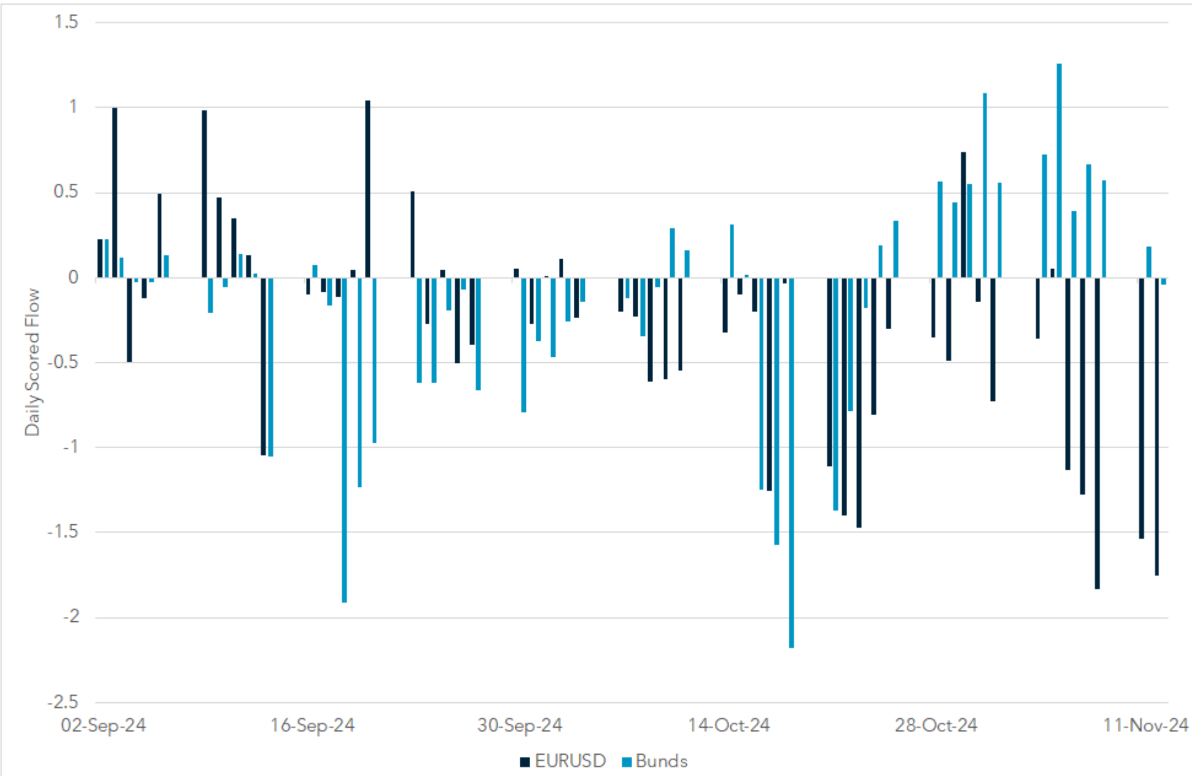


Source: Bloomberg, BNY

It is early days and the challenges for Europe and European assets remain profound. However, there are perhaps some early indications that markets can now revisit the Eurozone growth story. More assertive ECB rate cuts to stimulate the economy are a given and we believe a 50bp cut by the ECB is consistent with policy objectives. EURUSD selling may have been a popular expression of the US election results, and that is reflected in iFlow, but we can see that bunds, by contrast, are now seeing purchases and diverged from the currency’s flows – a departure from the co-movement in October. Towards the end of

October, it was apparent that the German government could not survive much longer, and a new fiscal approach could beckon. Lack of supply and low yields had persistently undermined bund flows throughout the year, but if “healthy” reflation is now a real prospect for the German economy, the fixed income market may yet revisit their bund positioning relative to benchmark. The market will have to wait until Q2 next year, but after three years of increasing stasis and no meaningful structural reform in two decades, there is an opening for change in Germany.

Exhibit #4: EURUSD vs. Bund Flow



Source: BNY

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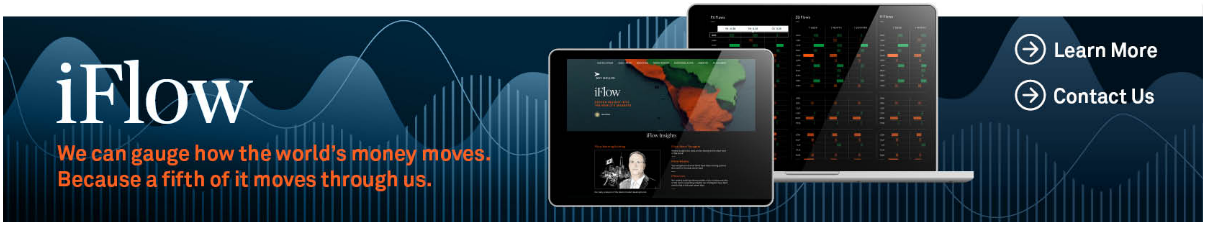

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