Ostrum
ASSET MANAGEMENT

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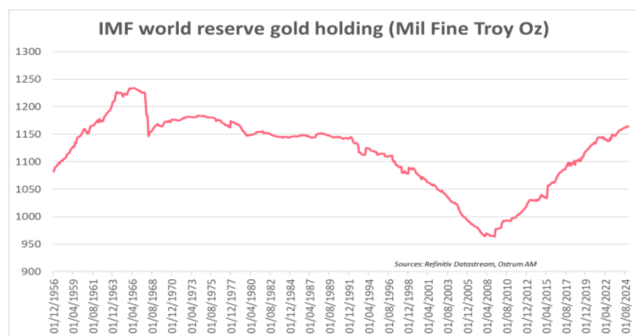
Topic of the week: German Elections: The Necessary Reform of the Debt Brake
by Aline Goupil-Raguénès

- The debt brake was the cause of the coalition's collapse. It will be at the center of discussions during the formation of the new government;
- This rule enshrined in law limits the federal government's new borrowing to 0.35% of GDP and prohibits borrowing for the federal states (Länder);
- However, after years of chronic underinvestment, Germany's investment needs are enormous in infrastructure, digitalization, and defense, especially given the pressures exerted by Donald Trump;
- The increase in public investment is likely to create a stimulus for private investment and generate productivity gains to offset the impending impact of the declining growth rate of the labor force;
- In light of the challenges to be addressed across the Rhine, a reform of the debt brake is necessary. It must be passed by a two-thirds majority in Parliament. A coalition of CDU/CSU with the SPD or the Greens could make this possible;
- This comes at a time when the EC has just proposed activating the safeguard clause to suspend the rules of the Stability and Growth Pact regarding investments in defense, in order to allow countries to increase their spending in this area.

Market review: Teflon markets
by Axel Botte

- Persistent inflation solidifies the Federal Reserve's status quo;
- U.S. retail sales plunge in January;
- The 10-year Treasury note falls below 4.50%, benefiting equity markets;
- Credit spreads tighten while volatility remains subdued.

Chart of the week



Gold prices have increased by more than 10% since the beginning of the year, reflecting central banks' interest in the precious metal. Their net purchases in Q4 2024 reached a 10-year high. Since the freezing of Russian assets due to the war in Ukraine, central banks in emerging countries, particularly the PBoC, have diversified their international reserves toward gold at the expense of the dollar (Treasuries), whose share in foreign exchange reserves fell to 57.4% in Q3, the lowest since 1994. Chinese authorities also plan to ease regulations for insurers by allowing them to invest 1% of their total assets in gold. This is related to their difficulties in achieving their yield targets due to a lack of medium-to-long-term assets with stable returns. This announcement is expected to further boost the rally in the precious metal.

Figure of the week

21,000

Cocoa stocks have reached a historic low, dropping from over 100,000 tons a year ago to around 21,000 tons in the London commodities market. To meet the increased demand during Valentine's Day, chocolatiers have been forced to seek alternative ingredients.
Source: Financial Times

Topic of the week

German Elections: The Necessary Reform of the Debt Brake

The early German legislative elections will take place on February 23. Given the context of recession, the numerous structural challenges to be addressed, and the massive investment needs, the reform of the debt brake will be at the center of discussions for forming a new coalition following the elections.

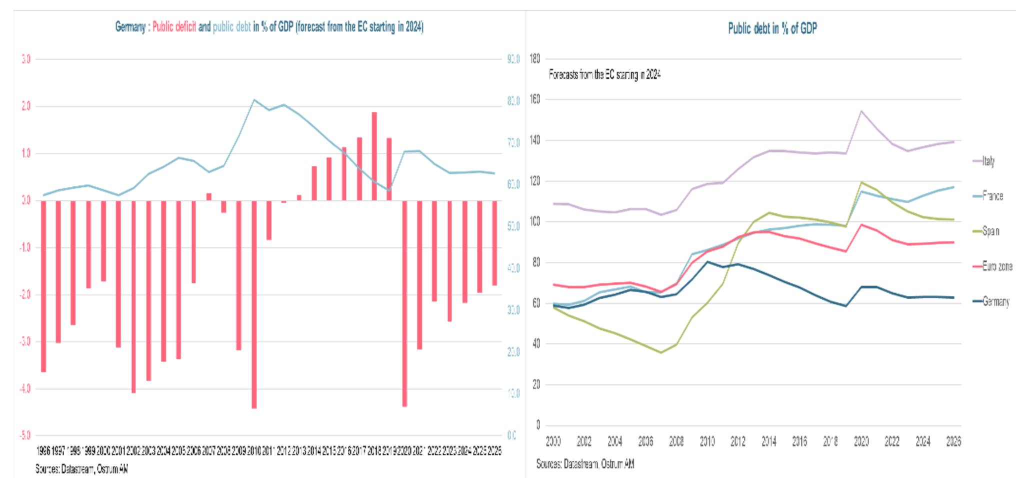
What is the debt brake?

New borrowing by the federal government is limited to 0.35% of GDP. The federal states (Länder) are not allowed to incur any new debt.

The debt brake is a budgetary rule enshrined in the German Basic Law aimed at strictly limiting new borrowing by the government. The structural component prohibits the federal government from increasing its borrowing by more than 0.35% of GDP in a given year. The rule is even stricter for the 16 federal states (Länder), as they are not allowed to incur new debt. In the event of a recession, the cyclical component allows for additional borrowing, which must be repaid within a reasonable timeframe when the economic situation becomes more favorable. There is a safeguard clause that allows for the suspension of this rule by a simple majority in Parliament in the event of a natural disaster or an exceptional emergency situation beyond the state's control.

This rule, adopted in 2009, facilitated a rapid decrease in the debt-to-GDP ratio following the global financial crisis.

The debt brake rule was adopted in 2009 during the global economic and financial crisis and enshrined in the Basic Law in 2016 for the federal government and in 2020 for the federal states (Länder). During this crisis, the public debt-to-GDP ratio rose significantly (from 63.1% of GDP in 2007 to 80.4% in 2010), as was the case in many other countries, due to the large-scale measures taken by governments. This rule facilitated a swift return of the ratio to pre-crisis levels (as early as 2017) and a return to budget balance by 2012, followed by surpluses from 2014 to 2019. This contrasted with other Eurozone countries, where the debt-to-GDP ratio remained significantly above pre-crisis levels. The rule was suspended from 2020 to 2023 due to the COVID-19 crisis and the subsequent war in Ukraine and its impacts on the German economy.



The debt brake as the cause of the coalition's collapse

The shock of the Constitutional Court's decision

The transfer of the special off-budget "COVID" fund to the "Climate" special fund was deemed unconstitutional, leaving a gap of €60 billion in the budget.

On November 15, 2023, the decision of the German Constitutional Court came as a real shock to the government. The court declared unconstitutional the use of a special off-budget fund, the "Fund for Transformation and Climate," which was intended to finance green investments. This fund was fed by the transfer of the "COVID" fund, which had €60 billion in unused funds. This ruling triggered a political and budgetary crisis, leading the government to suspend the debt brake rule once again, despite Finance Minister Christian Lindner's commitment to reinstating it in 2023. This decision made it much more difficult to circumvent the debt brake rule through numerous special off-budget funds that exist in Germany.

Intensification of tensions within the coalition

Urgency to act in the face of the ongoing recession and the related structural problems, particularly the significant past reliance on Russian energy.

In 2024, tensions intensified among the three parties in the coalition that has been in power since 2021: the Social Democratic Party (SPD), represented by Chancellor Olaf Scholz; the Free Democratic Party (FDP), represented by Christian Lindner as Minister of Finance; and the Greens, represented by Robert Habeck, Vice Chancellor and Minister of Economy. Germany is in recession for the second consecutive year, affected by both cyclical issues (household loss of purchasing power and tightening credit conditions related to the ECB's monetary policy) and structural challenges. It suffers from a loss of competitiveness, largely due to its past heavy reliance on Russian energy and the significantly increased in energy prices. Additionally, it faces intensified competition from China, particularly in the automotive sector, where Germany is the global leader.

Collapse of the coalition following the Finance Minister's refusal to suspend the debt brake again.

Faced with the difficulties of the economy and the increasing number of layoff plans in the automotive, chemical, and steel industries, coalition members all agreed on the urgency to act but not on the means to do so. The SPD and the Greens wanted to provide more flexibility in the debt brake to create leeway for supporting industry and making investments in the energy transition. The Minister of Finance was completely opposed to this. He refused the Chancellor's request to suspend the debt brake rule again, which ultimately led Olaf Scholz to dismiss Christian Lindner on November 6.

Need for reform

Proponents of budgetary discipline are in favor of such a reform: Joachim Nagel, Angela Merkel, the Five Sages, the IMF...

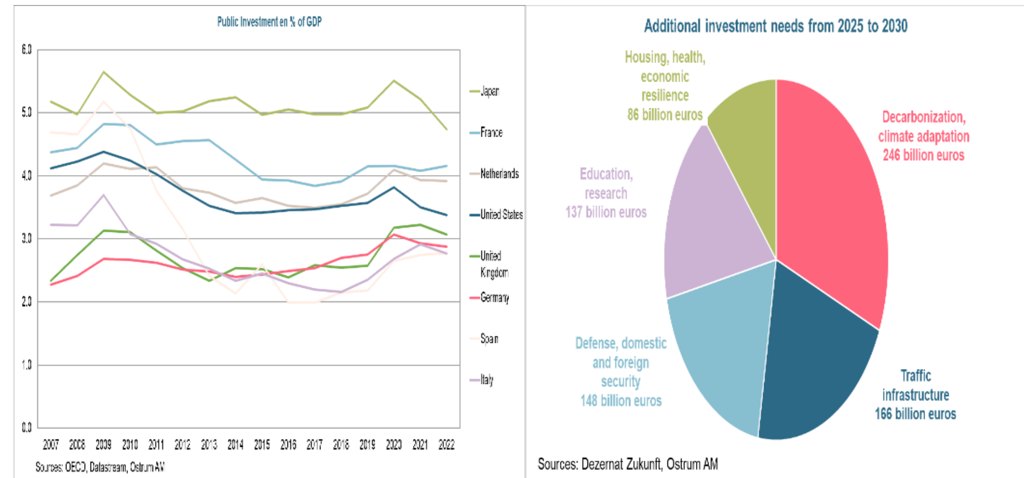
With the recession continuing for the second consecutive year and the structural weaknesses of the German economy, calls for a reform of the debt brake are becoming increasingly frequent. These calls are coming from various institutions and even proponents of budgetary discipline, including Angela Merkel, who was Chancellor at the time the rule was adopted in 2009; the President of the Bundesbank, Joachim Nagel; the German Council of Economic Experts (the "Five Sages"); the Cologne Institute for Economic Research (IW); and the IMF.

A chronic lack of investment

Public investment in Germany is the lowest among G7 countries.

The German economy suffers from a chronic lack of investment, particularly public investment. After the boom associated with reunification in the early 1990s, public investment declined throughout the rest of the decade, stabilizing at a low level and proving insufficient in some years to compensate for capital depreciation. However, public investment is essential for

investing in public goods and creating a stimulus for private investment. The consequences include reduced spending on research and development, slower productivity growth, and poor-quality infrastructure. This is reflected in deteriorating roads and bridges and an aging railway network. Public investment in Germany is among the lowest of developed countries, as shown in the graph below, and the lowest among G7 countries.



Massive investments needed for defense, climate, and digitalization

According to the think tank Dezernat Zukunft, an additional €800 billion in investments will be necessary between 2025 and 2030.

According to the IMK, €600 billion in public investments are needed over the next 10 years.

Massive investments are needed in digitalization, the green economy, and defense following Russia's invasion of Ukraine and Donald Trump's return to the White House. The think tank Dezernat Zukunft estimates these needs at nearly €800 billion over the period from 2025 to 2030, which amounts to just over 3% of GDP each year. Public investment plays a crucial role in this context. Mario Draghi noted in his report on competitiveness that, on average, public investment accounted for 20% of total investment.

A study by the Institute for Macroeconomic Policy (IMK) estimates the additional public investment needs at €600 billion over the next 10 years, or 1.4% of GDP per year. These investments would be aimed at making infrastructure, the economy, and society sustainable, taking into account climate protection and adaptation to climate change, energy transition, transportation, demographic change, and digitalization.

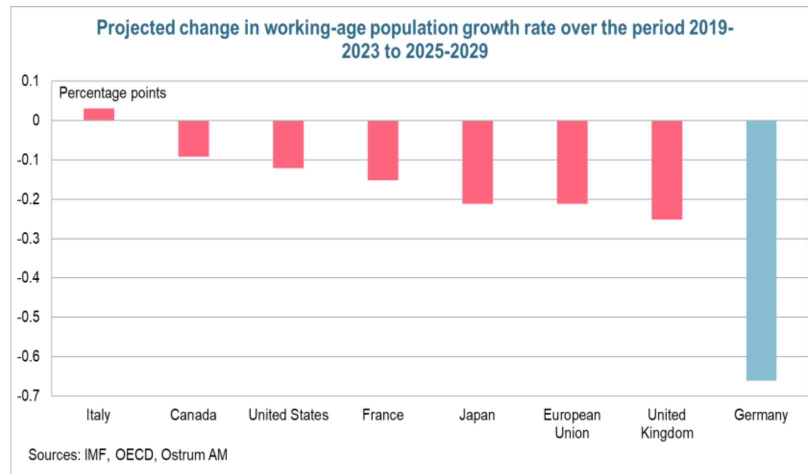
An easing of the debt brake would be one way to achieve these additional investments. Another method would be to utilize one or more special off-budget funds enshrined in law, such as the €100 billion fund for defense. In both cases, whether it involves reforming the debt brake or creating a special off-balance-sheet fund enshrined in law, a two-thirds majority vote from both chambers of Parliament is required.

Demographic challenge

Germany is the G7 country with the fastest declining growth rate of the working-age population.

Germany is the G7 country with the most significant decline in the growth rate of the working-age population expected in the coming years. Between the periods 2019-2023 and 2025-2029, the growth rate of the working-age population in Germany is projected to decrease by 0.66 percentage points according to the IMF, compared to 0.21 pp for the EU and 0.12 pp for the United States. This decline is a result of the end of the wave of migrants fleeing regional conflicts and the retirement of the "baby boomers." In the absence of productivity gains, this

rapid decline in the working-age population is likely to weigh on Germany's potential growth. This serves as an additional factor advocating for a massive increase in public investment aimed at generating productivity gains and improving potential growth.



Debt is expected to increase significantly starting in 2028

In addition to the significant investment needs, the federal government's debt is set to increase starting in 2028. The government will need to begin repaying emergency loans that were granted during the COVID-19 crisis and the energy crisis: initially amounting to €9.2 billion per year, which will then rise to €10.8 billion per year starting in 2031. Furthermore, the special off-budget fund for defense will conclude in 2028 and will need to start being repaid from 2031, at a rate of €3.2 billion per year until 2061. Without a modification of the debt brake rule, Germany risks being unable to take on new borrowing even as investment needs are very high.

Early legislative elections

According to polls, a coalition between the CDU/CSU and the SPD or the Greens is the most likely scenario. This would allow for the adoption of a reform of the rule with a two-thirds majority.

The conservative CDU/CSU party has consistently led the polls for several months, averaging 30.4% in voter intentions. It is likely to be in a strong position to form a coalition. The second party is the AfD, far-right, which has seen a significant rise in the polls in recent months (20.4%). The SPD comes in third with 15.4% of voter intentions, while the Greens are at 13.4%. The FDP is uncertain about reaching the 5% threshold. The CDU/CSU rules out any coalition with the AfD. The most probable scenario is a coalition of the CDU/CSU with the SPD or the Greens. As we have seen, both of these parties support a reform of the debt brake; however, this is not part of the CDU/CSU's program. Nonetheless, its leader, Friedrich Merz, has kept the door open to reform last November and more recently during the televised debate with Scholz, particularly to finance defense expenditures that could increase to 3% of GDP with Donald Trump's return to the White House.

The risk is the arrival of small parties in Parliament that could hold a blocking minority with the AfD.

If a coalition between the CDU/CSU and the SPD or the Greens opens the door to a reform of the debt brake, requiring a two-thirds majority vote, this will not be possible if smaller parties manage to enter Parliament and hold a blocking minority of one-third with the AfD.

The majority of Germans are now in favor of reforming or abolishing the debt brake.

A new and significant factor is that the majority of Germans are now in favor of reforming or abolishing the debt brake. This is reflected in a recent survey (January) by Forsa conducted for the German Council on Foreign Relations (DGAP): 55% of Germans believe that a reform should

be adopted or that this budgetary rule should be eliminated in order to finance the necessary additional investments. In contrast, 41% want to keep it unchanged. This marks a notable change from previous surveys, where the majority of Germans wanted to maintain the debt brake as it was; only 44% supported reforming or ending it in November, and 32% in July.

Ways to give it flexibility

One of the proposals would be to link new borrowing to the level of debt.

Several proposals have been put forward to reform the debt brake. The first, supported notably by Nagel and the Five Sages, would be to link new borrowing allowed to the level of the debt-to-GDP ratio. Joachim Nagel stated on February 12 that the Bundesbank would present a proposal to reform the rule after the early legislative elections. The Five Sages propose an increase in the structural deficit of 0.35% of GDP when public debt exceeds 90% of GDP, an increase of 0.50% of GDP when the debt-to-GDP ratio is between 60% and 90%, and an increase of 1% of GDP when public debt is below 60%.

The second proposal would be to allow the federal states (Länder) to also incur new borrowing, just like the federal government, given that many investments fall under their responsibility. The third proposal would be to create a golden rule that would exempt certain investments from the debt brake, particularly those related to defense.

Conclusion

The debt brake was the cause of the coalition's collapse, and it is expected to be at the center of discussions for the formation of the new government following the early legislative elections. A reform is necessary given the massive investments required in infrastructure, digitalization, and defense. Chronic underinvestment is weighing on Germany's productivity, growth, and that of other Eurozone countries, considering the significance of the German economy and the importance of intra-zone trade. Public investment is essential to stimulate private investment and generate productivity gains, which are increasingly crucial as Germany is set to experience a rapid decline in the growth rate of its working-age population in the coming years.

Aline Goupil-Raguénès

Market review

Markets in Teflon

Despite inflationary pressures, hopes for a resolution in Ukraine, and the decline in crude oil prices and long-term interest rates are reigniting a bullish trend in equity markets.

The logic driving financial markets is rapidly evolving. The fear of a resurgence of inflation in the United States has given way to optimism regarding a potential resolution to the war in Ukraine, which could (at what cost?) alleviate energy prices. Volatility in equities remains low. However, a notable increase in physical gold deliveries indicates a certain degree of caution, if not distrust, of central banks towards Treasuries. The immediate drop in equities and government bonds following the release of January's CPI was corrected the very next day. The prevailing uncertainty seems to validate the Fed's wait-and-see approach, which may already be regretting the accelerated easing implemented since September. The anticipated impact of erratic tariff announcements has diminished, and the dollar is weakening as the principle of reciprocal tariffs, now invoked by Donald Trump, comes into play. The U.S. administration appears to be navigating through uncertainty, with executive orders on federal spending being overturned by judges.

U.S. inflation rose to 3% in January. The annual revision of the price index, which downplays the weight of housing costs, will partially erase the anticipated disinflation for 2025. Rising food prices, transportation costs, and significant seasonal price fluctuations in January explain the unexpected uptick. Producer prices (+3.4%) reflect similar inflationary pressures. Retail sales registered a marked decline of 0.9% in January, following a strong year-end in durable goods spending. These contradictory signals complicate the situation for the Fed. Jerome Powell indicated before Congress that inflation remains a focal point. The increase in late payments on credit cards and auto loans, alongside a rebound in outstanding loans, suggests a limited impact from the Fed's monetary tightening, especially as the CFPB faces relentless challenges from an administration obsessed with deregulation. Japanese price data will likely lead the Bank of Japan (BoJ) to continue raising interest rates. In the euro area, growth has been revised upward to +0.1%. German industrial orders have rebounded at year-end, hinting at a potential exit from the tunnel ahead of upcoming elections.

Inflation and Donald Trump's foreign policy have significantly influenced pricing actions in financial markets. The 10-year Treasury note briefly touched 4.65% following the release of U.S. CPI before finishing the week below 4.50% after retail sales data. Long-term breakeven rates have also underreacted to the inflation surge. The Fed's monetary status quo will indeed aim to limit inflation expectations. The German Bund followed the Treasury note before retreating to around 2.40%. Sovereign spreads remain largely stable, with French OATs slightly outperforming. The 10-year swap spread has returned to positive territory. The rise in equities corresponds to the decline in long-term rates. Eurozone banks, buoyed by strong earnings and sector consolidation plans, continue to lead the market. The solid performance of bank stocks is reflected in the tightening credit spreads, including financial debts. Investment-grade credit in euros is trading below 80 bps over swaps. High-yield bonds are following this trend despite stretched valuations, with crossover spreads trading below 280 bps.

Axel Botte

Main market indicators

G4 Government Bonds	17-Feb-25	1wk (bp)	1m (bp)	2025 (bp)
EUR Bunds 2y	2.14%	+11	-9	+6
EUR Bunds 10y	2.49%	+13	-5	+12
EUR Bunds 2s10s	34.7 bp	+1	+5	+7
USD Treasuries 2y	4.26%	-2	-2	+2
USD Treasuries 10y	4.48%	-2	-15	-9
USD Treasuries 2s10s	21.3 bp	0	-13	-11
GBP Gilt 10y	4.53%	+7	-13	-4
JPY JGB 10y	1.4%	+8	+3	+2
€ Sovereign Spreads (10y)	**17-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
France	72 bp	+0	-2	-10
Italy	104 bp	-5	-5	-11
Spain	61 bp	-1	+0	-8
Inflation Break-evens (10y)	**17-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR 10y Inflation Swap	1.98%	-1	-6	+5
USD 10y Inflation Swap	2.59%	+1	+1	+13
GBP 10y Inflation Swap	3.54%	-4	-9	+2
EUR Credit Indices	**17-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
EUR Corporate Credit OAS	89 bp	-3	-12	-13
EUR Agencies OAS	53 bp	-1	-8	-9
EUR Securitized - Covered OAS	50 bp	+2	-5	-6
EUR Pan-European High Yield OAS	296 bp	-12	-24	-22
EUR/USD CDS Indices 5y	**17-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
iTraxx IG	51 bp	-2	-3	-6
iTraxx Crossover	279 bp	-9	-14	-34
CDX IG	47 bp	-1	-2	-3
CDX High Yield	292 bp	-5	-9	-20
Emerging Markets	**17-Feb-25**	**1wk (bp)**	**1m (bp)**	**2025 (bp)**
JPM EMBI Global Div. Spread	313 bp	-1	-10	-12
Currencies	**17-Feb-25**	**1wk (%)**	**1m (%)**	**2025 (%)**
EUR/USD	$1.048	1.669	2.005	1.2
GBP/USD	$1.261	1.941	3.608	0.7
USD/JPY	JPY 151	0.370	3.209	3.8
Commodity Futures	**17-Feb-25**	**-1wk ($)**	**-1m ($)**	**2025 (%)**
Crude Brent	$75.0	-$0.8	-$4.5	1.1
Gold	$2 899.8	-$8.4	$196.6	10.5
Equity Market Indices	**17-Feb-25**	**-1wk (%)**	**-1m (%)**	**2025 (%)**
S&P 500	6 115	1.47	1.97	4.0
EuroStoxx 50	5 520	3.01	7.22	12.7
CAC 40	8 189	2.28	6.22	11.0
Nikkei 225	39 174	1.00	1.88	-1.8
Shanghai Composite	3 356	1.01	3.52	0.1
VIX - Implied Volatility Index	15.37	-2.78	-3.76	-11.4

Source: Bloomberg, Ostrum AM

Additional notes

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