Fiscal shocks in Europe and China

Image source: iStock/Rawf8

PRIVATE BANKING

The world awakens this morning to news of large fiscal shocks in Europe and China. As President Trump is sticking to his promise of "America first" by revamping US geopolitical and commercial relationships, the two other key areas of the global economy have taken note and are preparing to bring government support to their economy.

Yesterday's announcements in Germany and Europe may be no less than a seismic shift in Europe's economic policies. Following a long economic decline and faced with the sudden realisation that it must takes its destiny in its own hands, Europe is finally ready to do "whatever it takes" on the fiscal side for supporting its defence and its economic competitiveness.

In parallel, China is taking steps to revive its ailing domestic sector in a context of mounting external headwinds. The amount of the announcements is significant and has the potential to alter growth dynamics in two regions that have struggled in the recent years.

The drawback is that this will come with a significant increase in public debt that will exacerbate an already concerning trend. The impacts of those fiscal shocks will be felt over the medium term, and while their full implications are still difficult to fully assess, this might be a long-lasting game changer for the dynamics of Europe and China.

Germany – "Whatever it takes", a U-turn in fiscal policy stance

Yesterday evening, an agreement was announced between the CSU/CDU, the winner of the last elections, and the SPD, its most likely partner in forming the next coalition and government, on a radical shift in Germany's fiscal policy stance.

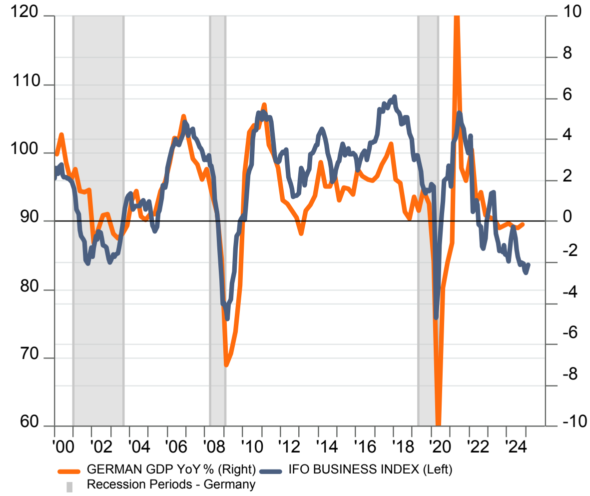
The plan should be adopted in the coming days or weeks, before 25 March at the latest, by the exiting Bundestag, where a two-third majority is likely to exist for validating those constitutional changes – this may no longer be the case in the new Bundestag resulting from February's elections.

In essence, the announcements are a huge loosening in Germany's fiscal policy, where a significant increase in public spendings and debt will finance unprecedented investments in defence and infrastructures:

- A EUR 500bn dedicated fund for infrastructure investments over the next decade will be created. The amount represents 11.6% of Germany's annual GDP, thus implying about 1% of fiscal support to economic activity per year for the next ten years. This will also help improving German economy's competitiveness for the future.
- The constitutional debt brake will be amended to exclude defence spendings above 1% of GDP from the public deficit limit. It paves the way to open-ended increases in Germany's defence spendings, without the constraint of the public deficit limit. Germany's future Chancellor Friedrich Merz has also pledged to do "whatever it takes" when it comes to defence spendings.
- Additionally, federal states will be allowed to run public deficit (capped at 0.35% of GDP) and will no longer have to strictly balance their budget.

This is a major development that will reshape economic policies in Europe's largest economy for the years to come. With a low public debt/GDP ratio of 63%, Germany has ample room to increase its public spendings. The infrastructure plan will have a direct positive impact on domestic activity, and the increase in defence spendings will also benefit the economy and especially all German industrial sectors geared to the defence industry.

The shift in fiscal policy stance will likely help Germany to emerge from a worrying economic dynamic



Furthermore, this announcement suggests that Germany's two main parties are already getting close to an agreement for forming a coalition, and that the sometimes-lengthy process of building a coalition might be accelerated by the current extraordinary circumstances. The announcement of a large infrastructure fund even opens the door to a potential broader coalition where the Greens would join the CDU/CSU-SPD coalition, with a robust 65% majority in the next Bundestag.

We see this announcement as a major and positive breakthrough for Germany's economic growth prospects, with positive spillovers for all of Europe.

Europe – Spending better and together in an era of rearmament

In parallel of Germany's announcements, the European Union also unveiled a plan for increased public spendings ahead of tomorrow's European Council. The plan puts Germany's effort in a broader European context of more fiscal space for member countries, with some of the effort made at the EU level with joint borrowing.

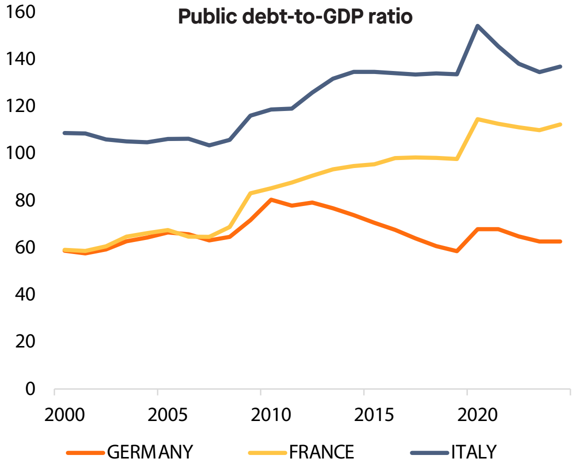
The main parts of the plan presented by European Commission Ursula von der Leyen yesterday are:

- A ReArm Europe plan, that will allow Member States to increase their defence spendings without triggering the Excessive Deficit Procedure of the existing fiscal framework.
- A EU loan facility of EUR 150bn to support Member States in financing their defence investment spendings, which would be a joint European financing for part of the required increase that European countries will have to face.
- Reviewing the EU budget to direct more funds towards defence-related investments.
- Facilitating and mobilising private capital financing for future European investments needs

With Germany abandoning its long-held doctrine of budgetary orthodoxy, it allows more pro-active fiscal policies to be implemented across all European economies. It also paves the way for joint European borrowings for the necessary investments that will have to be made in the coming years, not only on defence spendings but also on technological and infrastructure investments for raising European competitiveness (cf. Draghi report).

It is therefore not only about Germany abruptly shifting its stance toward fiscal policy, but also a broader change in Europe's attitude toward public spendings and deficits, where joint European borrowing and more budget flexibility for European countries will help providing the necessary investments for defence and competitivity, at the expense of rising public debt across all Europe.

Public debt will rise in Europe to finance defence and competitiveness investments, Germany has room for higher debt, and European joint borrowing might help debt-strained countries to finance the increase.



Source: Syz Bank, IMF

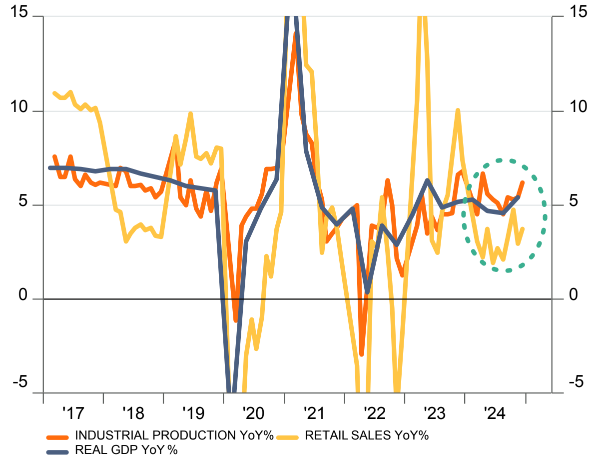
China – Fiscal support is finally announced to support domestic growth

It may be a coincidence of the calendar, today also saw the announcement by China of a long-awaited fiscal stimulus program. As US tariffs on Chinese goods are being raised again, China's Premier Li Qiang unveiled the government's economic targets for this year:

- A GDP growth of "around 5%" will be targeted again this year, a level that is above the recent growth rate of the world's second largest economy.
- To reach this target, the budget deficit will be raised by 1%, from 3% last year to 4% in 2025. This which will amount to a USD 180bn equivalent increase in public spendings finance by the issuance of ultra-long term special government bonds.
- Measures to support state-owned commercial banks and raise their capital (USD 70bn equivalent) will also be financed by additional government borrowing.

This morning's announcements are less of a surprise than the latest European developments as they were hoped since last Autumn. However, they still are significant as they materialise the expected support of Chinese authorities to an economy that has recently stabilised after a long slowdown but continues to record lacklustre domestic growth and will face additional headwinds from the increase in US tariffs.

Consumption has been the weak spot of China's growth recently, and today's announcements will aim at reviving domestic dynamics to counterbalance rising external headwinds.



Source: Syz Bank, FactSet Research systems

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