



Federal budget 2021

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Will the credit high be followed by a debt hangover?

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The adverse economic impact of “lockdown lite” appears to be under control, not least because legislators are pulling out all the stops from a fiscal policy perspective. But the measures could prove to be a test of strength for public finances. On the flipside, the bailout policy is causing fiscal costs directly attributable to the crisis to balloon. Policymakers are beginning to feel unsettled, with the German federal government publicly calling for the federal states to up their contributions to the crisis fund.

There's no denying that the federal budget is increasingly in trouble. Just two months after presenting its draft budget to parliament, the government almost doubled planned new borrowing practically overnight: from EUR 96.2 billion to some EUR 180 billion. The government had actually intended to make its first tentative steps toward restoring the “debt brake” from fiscal year 2022 by drastically reducing its net borrowing, but it now appears to have changed tack completely. Whether the “debt brake” is able to be restored by 2022 is another matter entirely.

There's no doubt that, with spending totalling EUR 498.6 billion – down slightly on planned spending in 2020 – the 2021 budget is the next XXL budget. One source of concern is the fact that over one third of planned spending next year is to be financed through debt. Low interest rates offer scant consolation. All in all, spending has been increased by some EUR 85 billion compared to September planning, but a closer look at the budget – and given the government's enormous existing provisions of some EUR 48 billion – reveals that the level of borrowing could have been considerably lower.

It may have been the right decision, and an important one at that, to loosen the shackles on the financial assistance and add supplementary aid schemes, but it must be ensured that things don't get out of hand. Admittedly, it's a fine line to tread. Many economists are now questioning the volume of the aid schemes, suggesting that wastage and deadweight are inevitable. If it keeps a lid on the likely pressure to consolidate, the government will need to pull out all the stops to preserve its fiscal resources by making more efficient use of them as the crisis progresses. In other words, a more efficient aid scheme for businesses is required as soon as possible.

No one really knows where the limits of sovereign debt are, but we are certainly nearing them. Against this backdrop, the new federal government will face major challenges and weighty decisions in fiscal and economic policy. After all, it will ultimately have to manage to put the public finances back on solid ground without overly squeezing the economy with even more burdensome taxes and contributions. There is probably no way around a major reckoning next autumn after the Bundestag parliamentary elections.

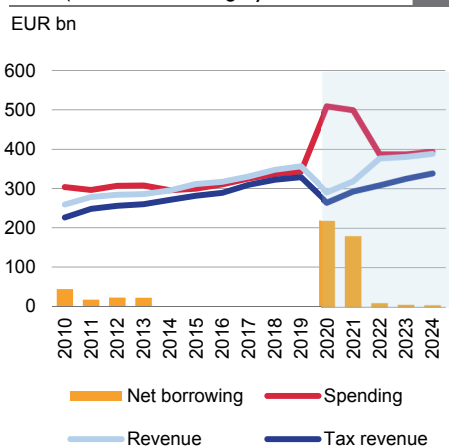


Expensive winter: Partial lockdown tearing deeper holes in the federal budget

The adverse economic impact of “lockdown lite” appears to be under control, not least because legislators are pulling out all the stops from a fiscal policy perspective. But the measures could prove to be a test of strength for public finances. On the flipside, the bailout policy is causing fiscal costs directly attributable to the crisis to balloon. Policymakers are beginning to feel unsettled, with the German federal government publicly calling for the federal states to up their contributions to the crisis fund.

November’s partial lockdown, which has now been extended to 10 January, is likely to cost the German government and its taxpayers dearly. A further EUR 15 billion to 20 billion of funding is set to be freed up in December, on top of the EUR 15 billion “extraordinary” bailout package agreed in November to compensate businesses and the self-employed affected by the partial lockdown (with the first wave of installments set to be made as quickly as possible) for up to three-quarters of their November revenue. The Germany’s Federal Ministry of Finance expects bailout payments in the high-revenue month of December to total approximately EUR 4.5 billion per week. If that wasn’t enough, the “New beginning aid for solo self-employed” (Neustarthilfe für Soloselbstständige) and the temporary aid scheme (Überbrückungshilfen III) – now extended until the end of June 2021 (at better conditions) – will also jack up government spending significantly.

Budget 2020/21 and financial plan until 2024 (federal core budget)



Sources: Federal Ministry of Finance, Deutsche Bank Research

Continuing on this path of extraordinary financial assistance, where compensation is tied to lost revenue, is set to lead to additional government spending of roughly EUR 15 billion for each month of lockdown. In other words, a potential extension of the current partial lockdown into the new year – e.g. until the end of February or even the end of March – would cost the German treasury a further EUR 30 billion to 45 billion. In view of these enormous sums of money, a new approach to bailout policy appears to be on the horizon: Federal Minister of Finance Olaf Scholz recently announced a desire to return to the previous temporary aid instruments from the new year onwards, however, in a much more comprehensive and expanded fashion than in the past.

Second wave of infections and another swath of financial assistance thwarting 2021 budget planning

Even though there is no way to predict how long the economic restrictions will last and how high the fiscal cost of the coronavirus financial assistance will ultimately be, there’s no denying that the federal budget is increasingly in trouble. New borrowing (including two supplementary budgets) has risen to a record EUR 217.8 billion this year alone. Although unlikely to use up all of its borrowing potential, due in part to cash outflow from immediate assistance and interim aid schemes so far falling considerably short of the expectations¹, government borrowing in the new year is likely to rise further. Just two months after presenting its draft budget to parliament, the government almost doubled planned new borrowing practically overnight: from EUR 96.2 billion (2.7% of GDP) to some EUR 180 billion (5.1% of GDP). The government had actually intended to make its first tentative steps toward restoring the “debt brake” from fiscal year 2022 by drastically reducing its net borrowing, but it now appears to have changed tack completely. It feels it has to put its foot on the accelerator

¹ See Becker, Sebastian (2020). Coronavirus interim aid scheme: A ripple or a mighty wave? Focus Germany. Deutsche Bank Research. November 27.



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once more. All told, new borrowing over the next two fiscal years is likely to remain at approximately EUR 300 billion, according to the Federal Minister of Finance. But whether the “debt brake” is able to be restored by 2022 is another matter entirely.

The XXL budget in detail: Born out of crisis or unnecessarily bloated?

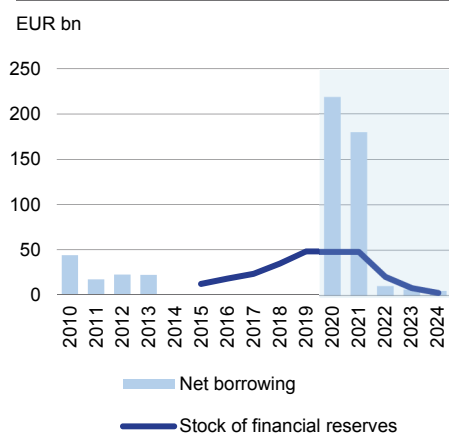
After last week’s fiscal bombshell, the question is not only about the sustainability of public finances, it’s how necessary the planned spending is. Criticism of the 2021 budget came from the opposition benches, with the Left party dubbing it an “election campaign budget” and the FDP warning that the current crisis could turn into a crisis for the next generation. There’s no doubt that, with spending totalling EUR 498.6 billion (14.2% of GDP) – down slightly on planned spending in 2020 – this is the next XXL budget. In 2019 before the coronavirus crisis, government spending stood at just over EUR 340 billion or 10% of GDP. Another source of concern is the fact that over one third of planned spending next year is to be financed through debt. Low interest rates offer scant consolation. All in all, spending has been increased by some EUR 85 billion compared to September planning, but a closer look at the budget reveals that the level of borrowing could have been considerably lower.

First of all, we have the 2021 budget and its associated borrowing, all of which is clearly dominated by the pandemic, containing EUR 39.5 billion of new coronavirus-related financial aid. It also includes EUR 2.7 billion for purchasing coronavirus vaccines and EUR 2 billion of compensation to hospitals. But there is also another budget item worth EUR 35 billion, which cannot be quantified in more detail, allocated to finance coronavirus-related spending (“general additional expenditure”). Given the government’s enormous existing provisions of some EUR 48 billion, which it intends to preserve, there is surely no need for this “buffer”.

Readjustment of interim aid scheme: More generous support, but also more targeted deployment

Planned new borrowing and balance of reserves (federal core budget)

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Sources: Federal Ministry of Finance, Deutsche Bank Research

In spite of the massive increase in borrowing from Berlin, many may be questioning whether the budget will ever materialise or, if it does, how long it will survive, something that will ultimately depend on two factors: firstly, how long the financial restrictions last, and, secondly, how policymakers intend to move forward with their bailout policy. One thing’s for sure: the government cannot continue to provide businesses with this kind of assistance for too much longer. Chancellor Merkel has already said that the government will not be able to shoulder the burden of the current bailouts for the entire winter alone, suggesting that the aid schemes will either be toned down or allocated on a more targeted basis and/or the federal states will be forced to up their contributions to the total cost. Calls from some federal politicians for more support from the federal states when it comes to the costs of the aid schemes have already seen political tensions be ramped up considerably.

It may have been the right decision, and an important one at that, to loosen the shackles on the financial assistance and add supplementary aid schemes, but it must be ensured that things don’t get out of hand. Admittedly, it’s a fine line to tread. Many economists are now questioning the volume of the aid schemes, suggesting that wastage and deadweight are inevitable. Businesses with a high percentage of variable costs, in particular, are likely to receive far more federal aid than they actually would have needed. One of the main points of criticism of the plans is that the aid should be based on fixed costs instead of revenue.



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Calculations by the German Economic Institute (IW) suggest that the government may have over-budgeted for its November and December aid schemes by up to EUR 10 bn. In other words, one out of every three euros in the aid package could have been saved. However, in an effort to get the financial assistance for November and December where it needs to be quickly, the government opted for a solution involving a relatively low amount of work and bureaucracy, with revenue as the primary benchmark. Even though some companies are probably in a better position now with the revenue-based aid scheme in lockdown than they would be without a lockdown, the vast majority remain under heavy strain despite the brief summer respite. Nevertheless, the calculations show that the government's financial assistance needs to be allocated in a much more targeted fashion moving forward to ensure that the economy, and also the treasury, emerges from this crisis with as little damage as possible.

If it keeps a lid on the likely pressure to consolidate, the government will need to pull out all the stops to preserve its fiscal resources by making more efficient use of them as the crisis progresses. In other words, a more efficient aid scheme for businesses is required as soon as possible. Not only that, another cost-benefit analysis is required on the increased financial assistance for workers on reduced working hours to up to 80% and 87% for workers with children, respectively (from the seventh month). This increase in financial assistance is not only extremely expensive, it could also stand in the way of inexorable structural change in the economy and working world, and only artificially delay inevitable unemployment for many people.

No one really knows where the limits of sovereign debt are, but we are certainly nearing them

This week, North Rhine-Westphalian PM and CDU leadership candidate Armin Laschet said what many people have been thinking for some time: the government cannot simply close everything down until further notice and cough up billions of euros in compensation month after month. Helge Braun, Head of the Federal Chancellery, has also said that there is a limit to what the government can do. And there they are: the limits of sovereign debt. Thanks to the abundance of liquidity and negative interest rates, the government should find it easy to raise the enormous amount of money it needs. However, the government is skating on increasingly thin ice pursuing a bailout policy funded on credit. Given the mounting demographic burdens, falling employment figures and decreasing potential growth, there is some considerable doubt whether the government's credit rating, and the interest terms calculated on the basis of it, will still be of such outstanding quality and at such low levels in ten to 15 years, respectively. There is also a false assertion that low or negative interest rates negate the need for sustainable public finances. In truth, fiscal policy that can only be maintained in a low- or negative-interest environment is akin to gambling on future interest trends. Rolling over government debt will only work in the long term for as long as interest rates are below the rate of GDP growth. Against a backdrop of falling growth (likely to highly likely given Germany's demographic development) and rising interest rates (not a certainty, but definitely a possibility – should partly depend on one major unknown quantity, namely the future rate of inflation), the current coronavirus policy may well be a nasty surprise for future generations further down the line.

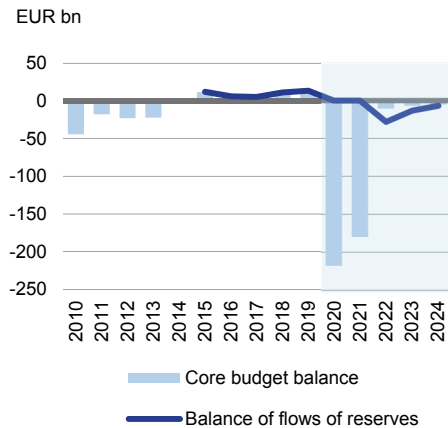


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Major reckoning due after parliamentary elections

Financial balance and balance of reserves (federal core budget)

3



Sources: Federal Ministry of Finance, Deutsche Bank Research

The sharp rise in the Maastricht debt ratio from just under 60% at the end of 2019 to over 70% represents a major financial policy burden, even though figures are likely to remain short of the record 82.3% of GDP set in 2010. According to think tank Stiftung Marktwirtschaft, the publicly announced debt is only the tip of the iceberg. When the implicit or “hidden” public debt is included, what is known as the sustainability gap (all explicit and implicit debts together) is expected to shoot up to over 400% of GDP in the wake of the second lockdown. Under these circumstances, it is probably only a matter of time before policymakers ask taxpayers to dig deeper into their wallets. The contribution guarantee of not more than 40% promised (so far) up to the end of 2021 (“social guarantee 2021”) is looking quite shaky as a result. The idea of a solidarity payment made by younger, healthier workers to finance healthcare spending has been floated, as have proposals for a one-time wealth tax, in both cases aimed at a one-sided increase in government revenue. Whether even higher taxes and social contributions are the right medicine for the post-coronavirus period seems highly doubtful with an eye to the high tax and contribution burdens already shouldered by companies and workers alike. The new federal government will face major challenges and weighty decisions in fiscal and economic policy. After all, it will ultimately have to manage to put the public finances back on solid ground without overly squeezing the economy with even more burdensome taxes and contributions. There is probably no way around a major reckoning next autumn after the Bundestag parliamentary elections. It is also clear that public finances can only recuperate on the back of true structural reforms to pensions, healthcare and long-term care (focusing on keeping spending growth at a sustainable level, in fairness to future generations). The reintroduction of the catch-up factor in the statutory pension insurance system would certainly be a start.

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