

End of an Era as Germany Hits Critical Turning Point

By BFI Capital Group

For decades Germany has been the emblem of fiscal prudence in Europe, rejecting reckless spending and borrowing to keep its finances in order. It was Germany that preached discipline and austerity at a time when the indebted South put the EU project at risk. Today, the nation is stepping onto an entirely new path sharply contradicting its past record. What this means for taxpayers, savers and the broader Euro area should not be underestimated.

The country's past success essentially boiled down to a simple formula: a broad export base, a strong labor force and, most importantly, fiscal restraint. The "Schuldenbremse," quite literally a "debt brake" in English, had a lot to do with this. It had constrained federal borrowing at 0.35 % of GDP, which was a very strict limit compared to EU budget rules requiring less than 3% and the 2024 US federal deficit of 6.4%. This clearly embedded discipline in the constitution had largely tied politicians' hands by keeping their spending ambitions in check. Schuldenbremse originally came about during the 2009 global financial crisis under Chancellor Angela Merkel and Finance Minister Peer Steinbrück and became legally binding for the federal government in 2016.

No other G7 country had such strict limits on new borrowing. It worked well for years as German governments managed to keep their expenditures within the Schuldenbremse limits, even often running small surpluses.

However, the covid crisis, slowing growth, declining labor force participation and then Russia's invasion of Ukraine put the country under strain. In 2020, the government invoked an emergency clause to borrow and spend more on pandemic relief. It did the same again in 2021 and yet again in 2022 to fund more defense spending. The pattern continued the next year too, with another emergency exemption in 2023. This finally pushed the Federal Constitutional Court to rule that the government had gone too far with its (ab)use of the emergency exemptions. Eventually, the Schuldenbremse controversy caused the then Social Democrat Chancellor Olaf Scholz's government to collapse in November 2024, as his coalition partners disagreed with him over this very issue.

In 2025, the new government decided to break free from this restraint and to remove many of these key checks and balances. The new fiscal framework removes core elements of the Schuldenbremse, paving the way for a wave of new borrowing. It didn't take long for politicians to enjoy their new legislative leeway: a €500 billion "special infrastructure fund" (Sondervermögen) was announced to finance spending on transport, hospitals, energy, and education, which is largely exempt from the debt brake rules. Defense expenditures can also now climb above one percent of GDP (the previous limit under the old rules) and

BFI Perspectives

We cherish independent and rational analysis.

Germany's federal states will gain more room to borrow. Additional spending categories, e.g., civil protection, foreign aid, etc., have also already been carved out.

The implications are clear on many levels. For one thing, as many other advanced economies know very well, you can increase borrowing to your heart's content, but if growth remains weak, this "solution" can be worse than the original problem. An unsustainable debt burden is the kind of situation governments tend to get themselves into but never out of, at least not without serious financial pain being heaped upon their citizens. Investor confidence is also bound to be impacted, while crowding out of private investment is also a legitimate concern. Last but certainly not least, there are justified fears over further fueling inflationary pressures.

There is another concern that has gone under discussed and under reported during the debates over the relaxing Schuldenbremse: The impact on generational fairness and on the social contract. If older taxpayers receive higher pensions and benefits, while younger workers face longer working lives, eventually higher taxes, and pensions and benefits massively eroded by inflation, the social fabric soon becomes strained. The current government seems to be already paving the road to that future. A panel of experts recently submitted a recommendation to chancellor Friedrich Merz that the age of retirement be raised to 73-years of age by 2060, up from the current 65. The chancellor had already warned that Germans must be prepared to work longer and harder to support the aging population and faltering economy, so that proposal couldn't have been welcomed by German workers, many of whom already took issue with their chancellor suggesting that they are not working hard enough.

Governments asking their citizens to pay the price for their own financial mismanagement and spending beyond their means is certainly nothing new, but it is certainly bound to hit a nerve in Germany after politicians circumvented their own constitutional rules in order to spend and borrow more. This is likely to have broader political and social implications, something investors and savers alike should continue to keep an eye on.

BFI Perspectives

We cherish independent and rational analysis.

BFI Capital Group Inc.

Bahnhofstrasse 29
CH-6300 Zug
Switzerland
Tel. +41 41 712 2710
Fax +41 41 712 2711
info@bficapital.com

www.bficapital.com

