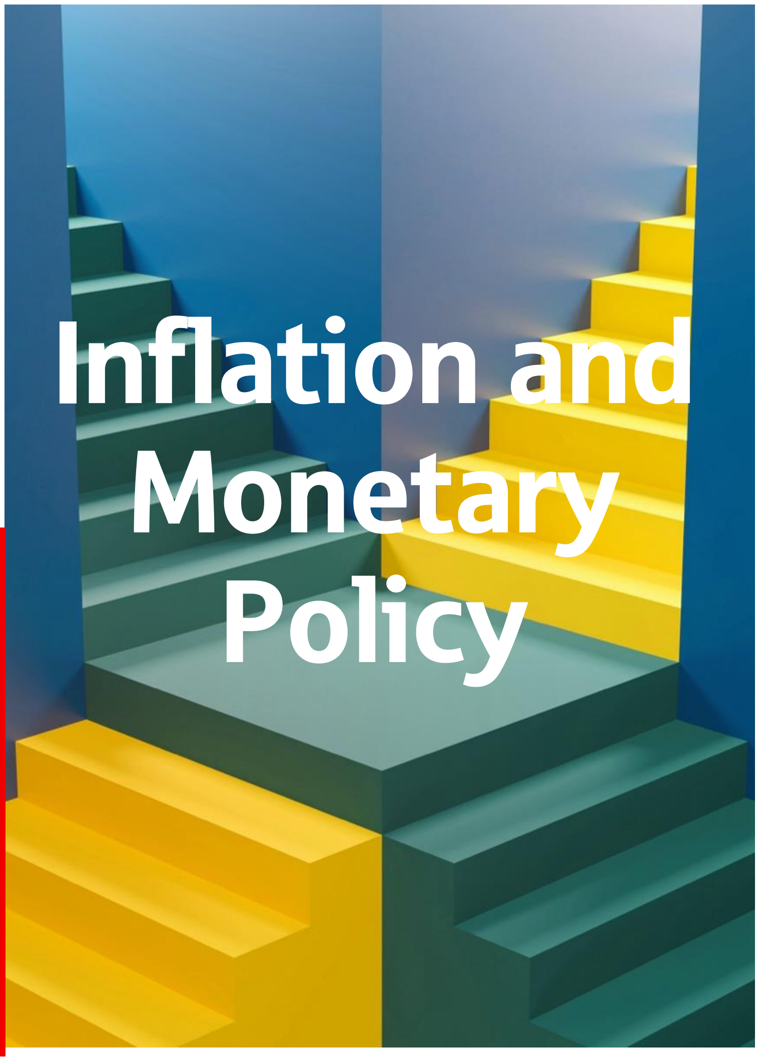
Finanzgruppe
Deutscher Sparkassen-
und Giroverband

STATEMENT
OF THE CHIEF ECONOMISTS

Inflation and Monetary Policy



24th March 2025

The price trend is back on a more stable trajectory again, but has not yet got back down to its target in many currency areas. This is the case in the euro area as well. Attention is currently focused primarily on the obstinately elevated rate of service prices. In such a situation, it is right that monetary policymakers should take their self-proclaimed "data-dependent approach" seriously and react flexibly to developments going forward.

- That prices for services are rising faster than those for industrial goods is nothing new. This is indeed in line with the long-term trend, and is structurally justified. The point is that productivity progress and factor intensities are very different in the two sectors.
- Favourable trends are needed in both sectors in order to bring the overall price trend successfully down the "last mile" leading to the goal of price stability. Services-price momentum ought to abate. At the same time, however, the beneficial stability of industrial-goods prices needs to be maintained.
- The ECB's monetary policy has been quite successful in containing inflation in recent years. The position does examine the questions of whether the reaction was "too late", "too little" or "too much".
- With trade disputes looming on the horizon, monetary policy is now exposed to new threats to which policymakers will have to respond.

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Inflation: 2024 produced mixed results on the inflation front

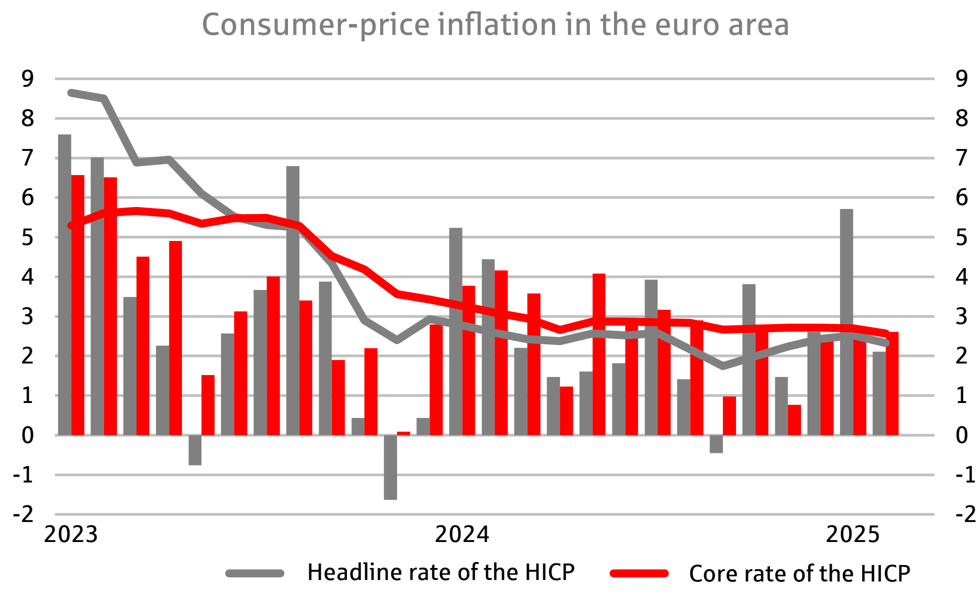
Inflation is lower than a year ago – but disinflation has stalled on its way down towards the 2 per cent target

At present, in the early stages of the new year, the inflation trend in the euro area is making a mixed impression. On the upside, it can be asserted that inflation has fallen even further over the past year from an already moderate level and, at 2.3 per cent in February, is now by three-tenths of a percentage point lower than one year previously. On the other hand, full-scale price stability, involving inflation rates that fully meet the target of 2 per cent has not yet been achieved.

The development of core inflation, which excludes food and energy prices as volatile components of the cost of living, is particularly mixed. For February, it showed an even greater gap to the 2 per cent mark at 2.6 per cent. At the same time, the core rate has only fallen minimally over the last five months. The overall rate even rose again by 0.6 percentage points from 1.7 per cent in September.

Core inflation gave cause for hope in the second half of last year - but the positive trend has not yet become entrenched

However, the development of the core inflation index adjusted for seasonal fluctuations, which showed an annualised rate of change of 2 per cent for the period from July to December 2024, is more encouraging. If this trend were confirmed in the coming months, core inflation would be half a percentage point lower than at present by the middle of the year. The circulating hopes of a reduction in core inflation are therefore not out of thin air - although they are not clearly predetermined. In January and February, the seasonally adjusted annualised monthly figures and the annual rate were initially on a par again.



Figures in per cent - lines: compared to the same month of the previous year
columns: calendar and seasonally adjusted compared to previous month, annualised
Source: Eurostat, ECB, own calculations

The residual inflationary pressure in the pipeline is certainly also a delayed consequence of robust wage increases. For example, the ECB's Indicator of Negotiated Wages did not peak for the current cycle until the third quarter of last year, reporting an annual increase in negotiated pay of as high as 5.4 per cent and fell to 4.1 per cent in the fourth quarter. Other indicators of wage cost development, such as hourly earnings in the commercial sector, peaked somewhat earlier and, with an annual increase of 3.74 per cent, showed a slowdown in momentum for the second time in succession. Overall, it can be said that the shortfall in the development of the cost of living in previous years has now largely been corrected. However, wage increases are unlikely to fall to the level of current inflation any time soon, which means that higher price increases can be expected where production or service provision is labour intensive.

Services inflation plays catch-up

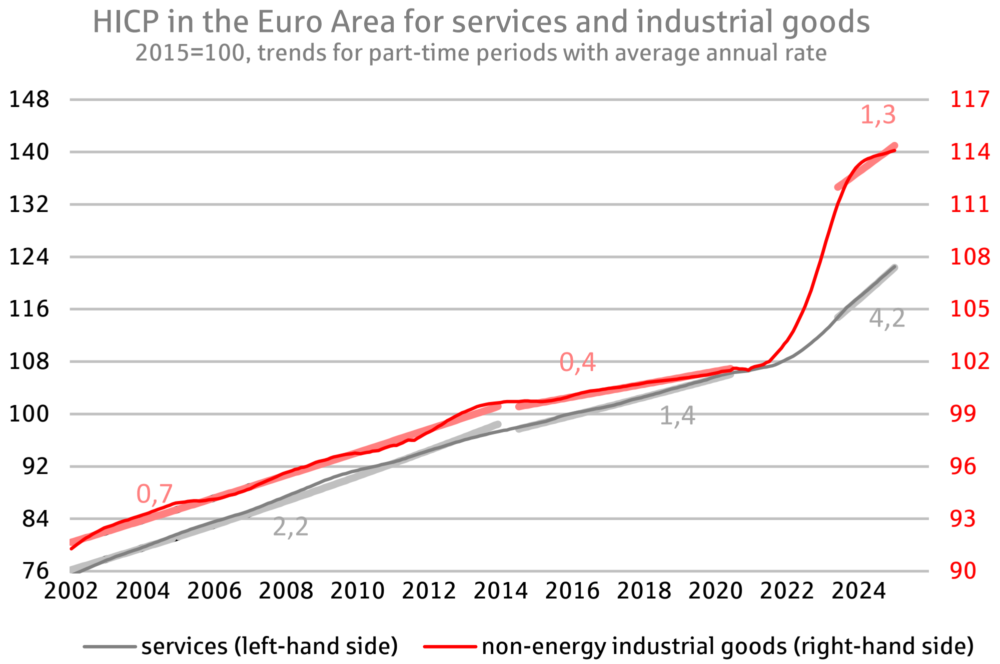
Moderate price increases for industrial goods, above average for services

A high proportion of labour costs is particularly noticeable in services, where inflation is currently still at a high level of 3.7 percent. In broad terms, this contrasts with very moderate price increases of 0.6 per cent year-on-year for industrial consumer goods excluding energy. However, they only account for a good quarter of all consumer spending in the euro area.

On closer observation,it should also be noted, firstly, that the price trends within the sub-groups of industrial goods are not uniform. For example, inflation in the consumer non-durables category is currently still running close to 2 per cent, but the rate of change for semi-durable consumer goods such as clothing came to just 0.3 per cent at the beginning of this year. The aforementioned average across all industrial-goods segments of approximately the same level is therefore primarily due to price declines in the consumer durables domain – price declines which have been observed for decades and amount to an emphatically long-term, almost secular trend, particularly in the case of household appliances and electronics. It should therefore be noted that the inflation rate is not particularly low in the industrial-goods category either, especially in the case of goods with a higher turnover frequency, which entails that many households still perceive inflation to be a pressing problem.

Secondly, a slower price trend for industrial goods compared to service prices is not an unusual finding. Rather, a shift in relative prices is structurally justified because the long-term productivity trend for more labour-intensive services is flatter. Since the start of monetary union, industrial goods have therefore become more expensive for consumers at rates that have generally been around a third of the inflation measured in the services sector.

Inflation-wise, the history of the euro area can be divided into two roughly equal halves: a first phase with annual price increases of 0.7 per cent for industrial goods and 2.2 per cent for services, and then a second phase (beginning in 2013 and lasting until the year in which the coronavirus struck) during which lower annual readings of 0.4 per cent and 1.4 per cent, respectively, were recorded for the two categories.



Source: Eurostat, own calculstions

Services inflation is playing catch-up following the price jump in industrial goods

In the chart above, both sub-indices are plotted as annual moving averages and scaled differently according to their respective typical long-term dynamics. Such a graphic representation makes it clear that industrial-goods prices spiked disproportionately sharply (by a cumulative 12 per cent) in the period marked by supply bottlenecks following the pandemic and the Russian attack on Ukraine. Even in absolute terms, their increase in the period from mid-2021 to mid-2023 was therefore a good three percentage points higher than the rate of services-price inflation over the same period.

Industrial-goods prices are not, as yet, a firm anchor for price stability

To that extent, it seems comprehensible that services inflation, which has weighed in at 4.2 per cent in absolute terms, has been running at a faster rate subsequently than the trend in industrial-goods prices, as it were playing catch-up. At 1.3 per cent, on the other hand, the increase in industrial-goods prices over the past two years is still too high for this category to already be deemed a firm anchor for price stability in the light of historical trends. This makes it all the more important for the overall inflation outlook that the annual rate of change for industrial goods can be held steady at its current lower level in the vicinity of 0.5 per cent.

Prominent leading indicators are beginning to cast initial doubts on this quest. For instance, the annual increase in domestic sales prices for consumer goods across the euro area edged up from its low of 1.1 per cent last April, to 2.2 per cent at the beginning of the year. Since the middle of last year, import prices for consumer goods have also been showing a year-on-year increase again, with the rate of change no longer seeming particularly low in December at 4.1 per cent.

Revealing details are embedded in services prices

Insurance and travel are likewise inflation hot spots

The various services-price categories are not rising in sync either – on the contrary, there are definitely inflation hot spots in this sphere too. The item which merits a mention first and foremost is currently insurance, even though it only accounts for 5 per cent of aggregate expenditure on services. The rate of change in this sub-category was still up in the double-digit range towards the end of last year, before falling back to still above 7 per cent in Februrary.[1]

The price trends for overnight stays and package holidays also stand out (inflation rates of 4.6 per cent and 8per cent, respectively, as against expenditure weightings of 5 per cent and 3 per cent, respectively. At almost the same rate of change (3.7 per cent), although admittedly with a downward trend in the interim, catering (which has a share of very nearly 20 per cent in aggregate services expenditure on the basis of the broadest definition in the euro area) is likewise still conspiring to keep overall inflation at its current elevated level.

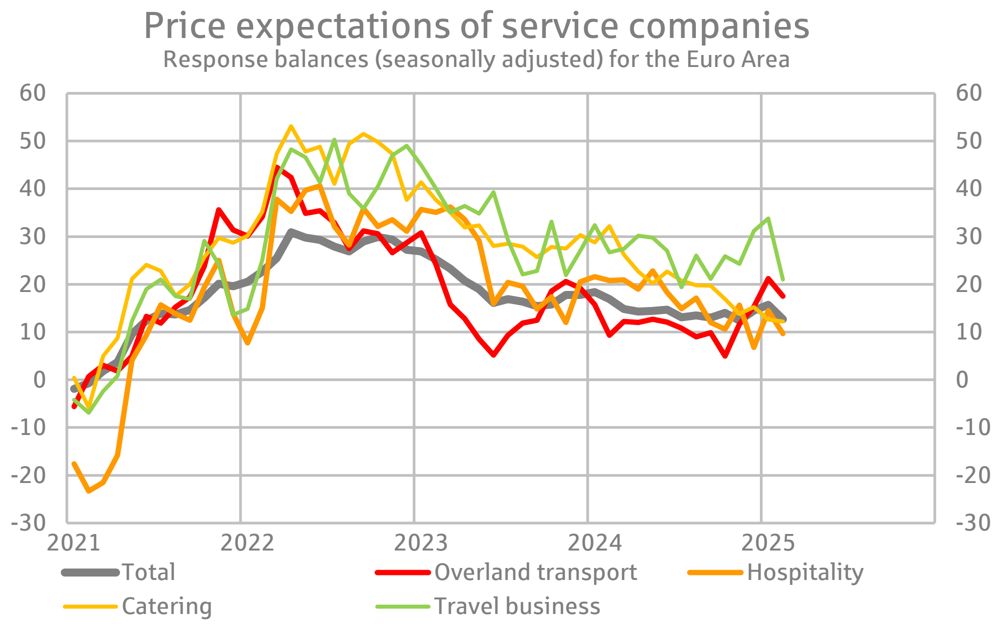
The trend in rental inflation is mitigating overall services-price inflation …

… but is going to stand in the way of a lower services-inflation path going forward

On the other hand, a moderating effect is deriving above all from telecommunications services (with an inflation rate of -2.74 per cent as against a weighting of 4 per cent) Passenger transport services with price increases of 2.7 per cent (expenditure share of 6 per cent) and the 2.9 per cent increase in rents. However, their weighting in the basket of goods and services is underrepresented in the HICP at less than 6 per cent and 13 per cent respectively.[2] An appropriate, higher figure would therefore reduce service inflation on the one hand. On the other hand, the statistically undisputed need to focus on "existing rents" does not reflect the immense increase in "asking rents" and "new-tenant rents" and therefore does not reflect the perceived inflation - i.e. rate of inflation which is subjectively felt to prevail - of many flat-seekers. What is more, the trend in "existing rents" is likely to continue to be marked for some time to come on account of trickle-down effects from higher conditions for new lettings, the implication being that a marginal acceleration, rather than a reduction, in rental growth as measured by the corresponding rent component of the HICP is on the cards.

[1] This development reminds us – for example with regard to more expensive building-insurance policies containing a natural-hazard clause – that not only efforts to limit climate change but also the consequences of insufficiently curbed climate change can fuel inflation. A qualification to be made here is that insurance premiums are a "nominal" values, meaning that the high inflation rates on this score simultaneously reflect the second-round effects of materials-price increases, wages and value appreciation.

[2] To date, the Harmonised Index of Consumer Prices (HICP) for the euro area does not yet adequately capture "net cold rents" (i.e. basic rents excluding heating and other utilities) for owner-occupied housing. Based on the dimensions of these two items in Germany, a rental weighting of at least twice the size would be on the cards if they were factored in.



Sources: European Commission, DG EcFin

In terms of service-providers' expectations, the empirical evidence on the ground is that there is currently a certain reluctance to raise restaurant prices and accommodation costs further. Regarding the net situation across all service-providers, however, the response balance is still slightly higher than in the last five years before COVID-19, when it averaged 6.7.

The gap between services inflation and industrial inflation is only going to close gradually, if at all

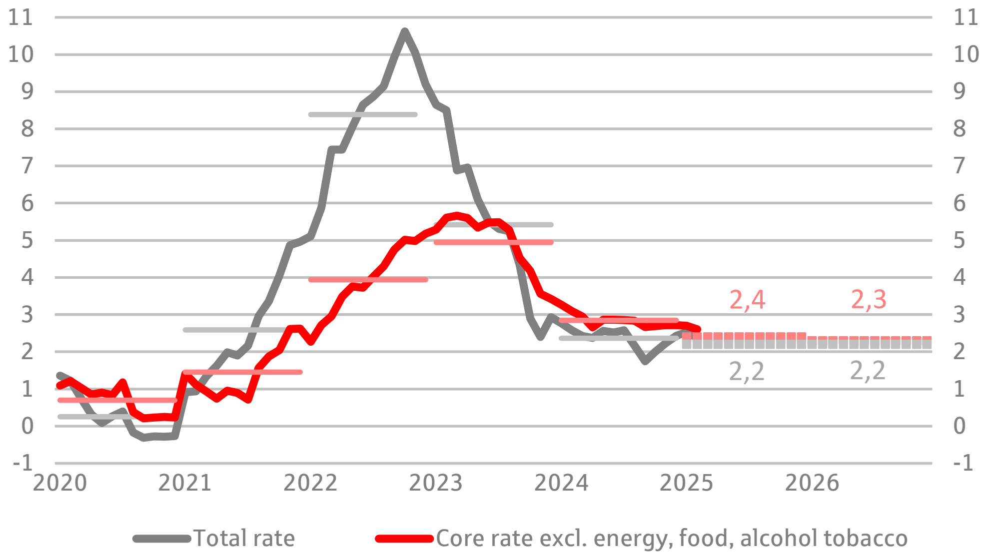
It is therefore important to keep inflation in the industrial-goods category at its current low level

This is a further indication that the sizeable differential between the price-increase trajectories for industrial goods and services will not be completely levelled out and may only be reduced slowly. Even if real wage growth should prove to be lower in future against the backdrop of low overall economic momentum and of the wage losses already clawed back since the inflation shock of 2022, a return of services inflation to a level of at least 2.5 per cent is only likely to be achieved very gradually. Hopes for a further convergence of the overall inflation rate towards the 2 per cent which spells price stability therefore depend largely on whether or not the inflation rate for industrial goods stays at its current low level.

Interim conclusion

Overall, inflation could abate further to a slight extent over the course of this year. However, the outcome of the latest survey by our authors implies that such progress will presumably not be sufficient to take inflation right to achieve the annual average target.

Consumer-price inflation in the euro area
Annual rates, in per cent
with forecast for 2025/2026 from the 'Joint Forecast' of the chief economists from January



Quelle: Eurostat, DSGV

Mission accomplished?

Exceptional circumstances have been prevailng in recent years

Although the last three years have been characterised in the euro area by the biggest wave of inflation seen during the last 50 years, we - in line with most experts - are not accusing central banks, including the European Central Bank, for being the main cause of this development. The high inflation rates witnessed in recent years were indeed more the result of exceptional circumstances (economists speak here of "exogenous shocks") than of poor monetary-policy decisions. The first instance of such exceptional circumstances was the coronavirus pandemic, which entailed heavy restrictions on production. At the same time, the large-scale support programmes launched by the governments of almost all countries provided demand stimuli, some of which were generated by enormous fiscal measures.

Major surge in inflation from 2021

This led to an outsized inflationary process that began in the autumn of 2021. This inflationary impulse was then significantly intensified by a second instance of exceptional circumstances - the outbreak of the war in Ukraine and the associated extreme increases in energy prices. The restoration of international production chains in the aftermath of the coronavirus phase and the restructuring of the global energy market caused the original inflation drivers to fade away or even temporarily reverse. In addition, the central banks in the US and the euro area curbed inflation expectations through significant increases in their key policy rates.

Too late?

Some factors were difficult to foresee

It was more during the phase of inflation breakout that observers of central-bank behaviour tended to criticise that countermeasures by monetary policymakers initially came through all too hesitantly. Did central banks misjudge the strength and duration of the emerging inflationary process, both in the United States and in the euro area? Critics of this persuasion take the line that central banks should have realised during the course of 2021 that the coronavirus-induced imbalances between macroeconomic supply and demand were bound to trigger a tidal wave of inflation. Instead, so this critical argument runs, monetary policymakers would not have reacted until 2022 and was therefore forced to take a drastic restrictive course. We believe that such a discussion is not very fruitful. Firstly, geopolitical events such as the outbreak of the war in Ukraine cannot be predicted. Secondly, market participants did not have a significantly better assessment of the situation at the time, as can be gauged from the signals being sent out by market indicators.

Methods have been adjusted post-crisis

Nevertheless, the European Central Bank has learnt and drawn conclusions from this episode, significantly expanding its analytical toolset to include scenario and sensitivity analyses. We consider this to be a meaningful and appropriate response to improve the appraisal of macroeconomic developments. All the same, it will still not be possible to predict future macroeconomic developments with any certainty. Econometric models work on the basis of data from the past. Their forecast results are reliable as long as the structures of the system fed into the underlying model remain the same. Yet if the structure of the economy changes – for example due to crises, technological developments or through a paradigm shift in political framework conditions – predicting economic developments on the basis of existing models will involve heightened uncertainty. This basic rule also applies to central banks, which are, however, well aware of this uncertainty factor.

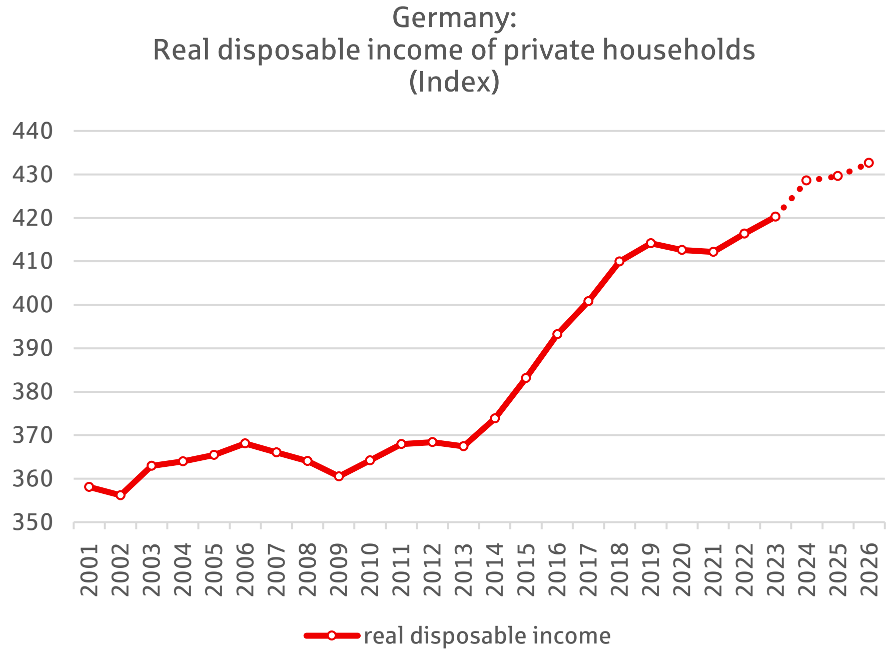
Too little?

The inflation problem was defused to a decisive extent over the course of 2024. As we have argued in the sections above, the momentum of inflation has been broken. Although a reversion to the 2 per cent target zone is not yet a foregone conclusion, the prospects of this goal being accomplished are favourable.

Lots of attention for the "last metres" up to the finish line

The question of when exactly inflation has come right down its "last mile" to the finishing line should really be a topic for panels of experts debating tenth-of-a-percentage-point changes core inflation development. This is not the case, though, in the real world: for the general public, the inflation problem has not yet been resolved. In the US, Donald Trump scored plenty of points in the presidential election campaign by accusing his predecessor Joe Biden of presiding over a rise in inflation. For many consumers in the euro area too, it would appear that inflation will only be a thing of the past when supermarket and restaurant prices have reverted to their 2021 levels. However, that is not going to happen, and this assessment is, furthermore, based on a misinterpretation of the concept of inflation: if the various statistical offices are now reporting that inflation is over, it means that prices will no longer continue to rise excessively from now on.

By contrast, the previous price increases have been offset by rising incomes, i.e. the high increases in collectively agreed wages and special payments over the past two years. Looking at German private households as a whole, such an offset has already occurred as a result of the partial catch-up in hourly earnings adumbrated above, due, in turn, to interim employment growth and increases in other income sources: in the Federal Republic, real disposable incomes as a whole are already higher again than before the high-inflation phase.



Source: Destatis

"Inflationary psychology" has not yet found a new equilibrium

The fact remains that it will take time for the grip of "inflationary psychology" on private households to be loosened - i.e. until consumers no longer feel subjectively poorer as a result of higher prices. It will probably take one to two years before consumers start to sense a new balance between higher prices and their higher personal incomes. Once inflation no longer plays a role in the decision-making of economic agents, the propensity to spend will increase again and the currently above-average savings rate will decline once again. We expect this process to slowly get into its stride in Germany over the course of the present year.

Too much?

Did monetary policymakers slam on the brakes too hard?

Some critics level the reproach that the monetary-policy stance over the past two years has been inappropriately restrictive and has hence hampered growth in the European economy. We cannot endorse such a position. On the contrary, the costs of running a restrictive monetary policy since 2022 have been unusually low compared to other phases. Although some sectors of the euro area economy, such as the construction industry, have had to contend with considerable negative effects as a result of the rise in interest rates, no recession has materialised in the euro area as a whole. In our view, the extremely poor performance put in by the German economy, which has posted declines in its gross domestic product in two consecutive years (2023 and 2024, with not insignificant odds of a third decline being sustained in 2025 as well), is due to pressures on the German economy that are unconnected with monetary policy. Furthermore, developments in the US demonstrate that, given the right framework conditions, thoroughly respectable growth rates can be achieved even if the monetary-policy stance is in restrictive territory. To be clear: the weak growth being reported in large swathes of the European Monetary Union is not down to monetary policy.

Inflation expectations are well anchored right across the board

Monetary policy is always also a matter of managing expectations: by ramping up key interest rates to record-high levels since the beginning of 2022, central banks have sent out the message that they are determined to comply unreservedly with their statutory mandate in turbulent times as well, even at the cost of economic risks. This commitment is one of the reasons why long-term inflation expectations among economic agents and financial-market participants have not become unanchored at any time during the inflation episode of the past three years.

The return to neutrality

A readjustment in the event of a weak economic trend

Monetary policy is defined as being restrictive if monetary conditions have a contractive effect on the economic trend. Such a policy stance would not be necessary at present, as the economic trend in the euro area is anything but exuberant, with wage and price trends stabilising, as sketched above.

On the contrary, economic growth in the euro area ground to a standstill in the final quarter of last year. Moreover, the signals from survey-based sentiment indicators are currently pointing to, at best, a very slight expansion during the first two quarters of 2025: The European purchasing managers' indices have only just climbed back above the expansion mark, but the broader Economic Sentiment has continued to lose ground. Despite the tariff round in broad US tariffs, which was averted for the time being at the beginning of February, there are risks to the downside and continued considerable economic policy uncertainty, which is putting pressure on the investment and spending behaviour of companies and private households.

A neutral monetary-policy stance is now appropriate

By contrast, hopes of an economic upswing are founded on an increase in private consumption stemming from a reduction in what is, at present, an unnaturally high savings rate. All things considered, we cannot deduce a recession scenario from this – a scenario which would suggest a rapid monetary-policy easing. At the present juncture, we consider a neutral monetary-policy stance to be appropriate this year. The policy alignment would only need to shift to expansionary if the risk scenario involving a further economic slowdown across the euro area were to become a clear likelihood.

Measuring whether monetary policy is expansionary or restrictive is no easy. One of several possible approaches is to look at the prevailing financing conditions.

The persistently sluggish lending and the renewed deterioration in the results of the Bank Lending Survey are currently striking. Where credit conditions for non-financial companies appeared to have stabilised last autumn, the banks reported a renewed tightening in the fourth quarter. This indicates that the financing conditions for the real economy remain strict and that the need for key interest rate cuts is correspondingly high.

Credit conditions strict due to risk situation, not due to monetary policy

On the other hand, monetary policy does not, in any way, necessarily need to be the decisive reason for such tight lending conditions. The banks surveyed have pointed to higher perceived credit risks and to lower risk tolerance. The latter could be influenced more by the ECB's supervisory activities than by general monetary policy. These two factors are having a strikingly strong impact in Germany and France – the two member states which are probably at present subject to the greatest political uncertainty in the euro area. In contrast, according to the banks, the interest rate level did not play a significant role in the net tightening of lending conditions observed during the fourth quarter, and indeed even contributed to the slight increase in loan demand. This indicates that the monetary-policy stance is probably no longer all that far from neutral.

Estimates for the neutral interest rate level

Another indication of the degree of monetary-policy restriction is the level of key interest rates. The problem here is that it is simply not possible to objectively measure the neutral key interest rate level for the euro area, nor is there agreement on which methods should be used to estimate it. According to our observations, plausible estimates of the neutral level lie within a broad range of 1.5 per cent to 3.0 per cent. The European Central Bank too has recently produced an estimate falling within this range. In view of the great uncertainty surrounding the exact location of the neutral key interest rate, we believe it makes the most sense to gradually approach the zone concerned and to observe the effects progressively unfolding on the real economy as part of a broader approach. The inference from our point of view is that the ECB would be well advised to switch off the autopilot, and ask itself whether further monetary easing is appropriate, at the latest when it next cuts the deposit rate at the latest when it next lowers the deposit rate to 2.5 per cent. Its own guidance implies that this is precisely what the ECB intends with its “data-dependent approach”. Today’s wisdom suggests that the easing cycle should come to an end, at the latest, at a key interest rate level of 2.0 per cent.

“Forward guidance” was a concept for when interest rates were at the zero bound

Whether or not even an expansionary monetary-policy stance may become necessary in the euro area this autumn will be decided on the basis of the economic trend up to that point. We are once again repeatedly hearing calls for “forward guidance” from various quarters; however, these fail to recognise the true function of this monetary-policy instrument used during the coronavirus phase: forward guidance is intended to strengthen the effects of monetary-policy instruments at the “zero bound,” i.e. with key rates at zero, as the impact of conventional instruments diminishes at that level. The point is that monetary policy, like capital markets, has since left this zero-interest-rate environment, and it does not look very likely at the moment that such an environment will take hold again any time soon.

Forward guidance is not in any way intended to give capital markets greater certainty about the future monetary-policy stance when the economy is navigating normal waters. In normal times, monetary policy remains data-dependent and therefore, to a certain extent, uncertain. If the ECB says that monetary policy can now, once again, be more geared towards expectations of the future economic trajectory, it is because there is probably somewhat more certainty now about economic and price developments than was the case in recent years, disrupted, as they were, by erratic shocks. That does not mean, however, that the central bank could, or should, promise economic agents a fixed monetary-policy path.

New threats to monetary policy

Monetary policy should not be overburdened with other goals than delivering price

Monetary policy offers no solutions to the current major political problems. New geopolitical rifts between the world's nations which are jeopardising global trade cannot be filled in by using monetary-policy measures. Not is monetary policy an instrument suited to the task of combating climate change. Although demographic upheavals in more and more countries around the world are prompting the research departments of central banks to consider changing their estimates for equilibrium interest rates, such shifts in demographics cannot be remedied by key interest rates. The weak growth that is frequently complained about, particularly in the euro area, has more to do with supply-side causes than with the demand side of the economy, which is able to be influenced by monetary policy.

Fiscal-policy headwinds

In a bid to combat inadequate economic growth, politicians are considering taking countermeasures by launching government spending programmes. We intend to analyse the extent to which such a strategy makes sense in a separate research paper. From a monetary-policy perspective, the resulting effect on government debt is of particularly relevance. As a result of the two global economic crises which have struck over the past decade and a half (the great financial crisis of 2008 and the coronavirus crisis which began in 2020), government debt has already risen significantly in almost every country in the world. In the euro area, the public-debt ratio, i.e. the ratio of government debt to annual gross domestic product, has surged from 74 per cent in 2000 to 90 per cent today.

What also needs to be counted in here are the roughly five percentage points of debt which have been accumulated by the central institutions of the European Union – burdens which are not clearly recorded in the statistics and which are not, at any rate, factored into any national-debt ratio. Although the most recent acute crisis has been over for some time (the coronavirus pandemic officially ended in May 2023), annual government budget deficits remain high in numerous nations. The obvious corollary is that the debt ratio in the euro area is destined to continue rising for the time being. And the next surge in debt is already waiting in the wings in connection with the need to finance European defence spending – a task which may, once again, not be accounted for appropriately when calculating national debt ratios.

Financial stability is a secondary condition that needs to be met

The pile of government debt becomes highly problematic from a monetary-policy point of view when it has grown so much that it jeopardises financial stability. If bondholders are no longer willing to roll over the government securities in their portfolios, this will inevitably undermine confidence in the banking system, or even in the financial system as a whole. Central banks then have to maintain financial stability, possibly at the expense of their actual goal of price stability. But even if it does not come to such a pass, conflicts with monetary-policy objectives can occur if highly indebted countries demand favourable financing conditions from their central banks, yet if such easy conditions are not appropriate due to high inflation. In such a predicament, monetary policy and fiscal policy will work against each other, resulting in macroeconomic disruptions. This is not, as yet, the main scenario for financial-market participants, but market indicators are already pointing to initial signs of a deterioration in the creditworthiness of certain countries within the Monetary Union. From a monetary-policy perspective, a warning therefore has to be issued that the debt leeway available to euro countries is definitely finite.

Assessing the latest fiscal-policy developments

The latest developments on the economic-policy front in Germany confirm this hypothesis that the available debt leeway is being exhausted at a rapidly increasing pace. In their exploratory talks, the possible coalition partners in the federal government which is still to be cobbled together agreed on large-scale fiscal-policy programmes designed to rearm Germany and to enhance national infrastructure – with the debt-brake mechanism anchored in the constitution being relaxed for this purpose.

Many imponderables remain

These measures, if in the end implemented, will have significant macroeconomic knock-on effects, although maybe not to the extent which the many zeros involved might suggest. Many questions remain open. For example, the time scale governing when the huge volume of investment is actually spent over the years is not yet clear, yet has an important bearing on any analysis of the ramifications to be expected. It could, for instance, be assumed that a EUR 500 billion special infrastructure vehicle with a life of twelve years would entail annual spending of a little over EUR 40 billion, which would correspond to slightly less than one percent of German gross domestic product. But how positive the resulting effect on economic activity proved to be would depend not only on the timeline for expenditure but also on the quality of the programmes concerned and on possible investment multiplier effects. In Germany, the image of infrastructure projects is that they have very long lead times; that would tend to imply that their effects would only kick in at a later date – only from 2026 onwards.

In any case, such a fiscal stimulus would not ratchet the GDP growth rate for Germany up higher by one percentage point each year. What we are talking about is rather an initial level effect, the reason being that economic activity would only be boosted one single time. That boosting effect would materialise at the point when the public sector ramps up its expenditure. Were the government to subsequently maintain the now higher investment volume, the higher activity level would be preserved, but that would no longer generate any further stimulus to GDP growth. If the envisaged special defence fund is assumed to be of similar dimensions to the special infrastructure vehicle, i.e. increasing government spending by one percent, the new debt-financed expenditure would entail an upward shift of around two percent in the path of German GDP. As such spending would be distributed across a number of years, it would indeed cause the Federal Republic's nominal gross domestic product to move back into positive territory but would certainly not suddenly produce any startlingly stellar growth rates.

A one-off level effect rather than repeated growth acceleration

Another consideration – and this is of relevance to the topic being addressed in this issue of "Statement" – is that part of the fiscal stimulus could well end up feeding inflation. The impact of public-sector expenditure programmes hinges to a decisive extent on exactly how much free capacity they encounter. And the fact is that capacities are comparatively tight in some of the domains referenced, for example in the defence sector, the armaments industry or the civil-engineering segment. In view of this, much will likewise depend on how credible private-sector corporations find the long-term rise in investment expenditure, and to what extent they are then prepared to invest in capacity-widening measures. What is more, a further inflationary effect may come into play indirectly via the labour market: the recruitment of new soldiers will reduce the labour supply in the civilian sector, which, via higher wages, could keep inflation higher for longer.

Part of the fiscal stimulus may possibly feed through into inflation

The key question, then, is how durable the fiscal stimulus will turn out to be. Sustainably higher real economic growth will only emerge if, for example, infrastructure investment or other measures aimed at enhancing Germany's locational quality, backed up by supply-side support, were to set in motion an upward spiral: expectations of consumers and corporate decision-makers improve, the private sector invests in fresh capacities and innovations, companies add new workers who, in turn, spend their new-found incomes. On a best-case scenario, such a virtuous circle of positive effects could multiply the effect of the very first euro of government expenditure. It goes entirely without saying, however, that this would presuppose a substantial long-term improvement in expectations across the economy. A specious mood lift created solely by a bigger budget could well prove a flash in the pan, fizzling out quickly. Money cannot build things on its own; nor can money, on its own, defend a nation. To rectify this situation, amendments to the economic rules prevailing in Germany are urgently needed.

The unavoidable consequence is that the economic programme of a new German government needs to give rise to more than merely money. Yet precious little has, so far, leaked out of the negotiations towards a new coalition in Berlin about

It is crucial that a fiscal stimulus should be supplemented by structural reforms measures designed to engineer sustainable optimisation of the locational conditions governing doing business in the Federal Republic. That is the case even though such measures are the paramount tasks which the future federal government will need to accomplish if persistent growth effects are indeed to ensue in Germany. What is urgently necessary is clarification that the new financing facilities (“special funds“) being mooted do not end up serving as “shunting yards“ in the sense that already planned investment gets shunted into the new special funds in order to free up capacities for further expenditure on (transient) consumption. It will be important to be particularly vigilant on this score during the implementation process as well, given that it has already been possible to ascertain such tendencies (cf. the plans to increase “extraneous non-insurance-related benefits” in the context of Germany’s statutory pension-insurance scheme).

It is true that Germany does still enjoy some debt leeway; yet if this fiscal scope is not made use of to boost the country’s long-term growth path, the expected stimuli will simply peter out after a number of years. Such a fizzle-out effect needs to be prevented. To that extent, measures such as effective streamlining of regulations and rectification of planning shortcomings, swelling the labour supply by flexibilising working-time regulations and by means of properly-managed immigration, enabling sustainable investment activity, providing tax-based incentives for investment and setting up a pan-European energy market are essential if the country is not to find itself saddled with the same difficulties some years down the line but, at the same time, with distinctly curtailed fiscal room for manoeuvre. It should also be remembered in this connection that monetary policy will not then be able to permanently ride to the rescue of Europe’s government budgets.

Permanent growth does not derive from higher budgets – and definitely not from ramped-up defence spending which, per se, is not productive in the sense that it makes a given economy more efficient. Permanent growth comes about by virtue of improvements, innovations, and private-sector investment. The provisional conclusion to be drawn, then, is that the decisions taken so far are a beginning, with regard to enhancing the economic situation in Germany, but that this process needs to be continued further by engineering robust framework conditions more suitable for the future.

Disclaimer

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