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Germany's fiscal reset: A preview for Canada?

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- *As the United States quickly shifts towards isolationism, fracturing military and trade pacts, governments have been left scrambling. So far, Germany may best represent this new world order as the traditionally fiscally conservative nation overhauled their budgetary outlook almost overnight.*
- *Specifically, a €500 billion infrastructure fund has been established and the government, after constitutional changes, effectively has issued itself a blank cheque for defence spending. In total, net new expenditures could exceed €1 trillion over the coming decade.*
- *In this In Focus, we apply a Canadian lens to Germany's fiscal reform. German spending would be roughly equivalent to C$700 billion when scaled to the size of Canada's economy. Is this affordable in Canada? More importantly, is this something we should expect?*
- *Pressure to ramp up defence spending in Canada is intensifying as Ottawa has long failed to achieve NATO's 2% guideline. The status quo path won't see this target met this decade and immediate compliance could require over $10 billion of additional spending.*
- *Non-defence spending pressures are also evident, made more intense by an ongoing federal election and accumulating campaign promises. Ottawa's deficit is likely to grow—perhaps to ~$70 billion in 2025-26—consistent with deteriorating provincial finances.*
- *Budget pressures will see Ottawa's debt level rise in coming years. We see scope for up to ~$100 billion in net new federal debt by 2030, a figure that would keep the debt-to-GDP ratio steady. Layer in new provincial debt and we're talking about a general government fiscal impulse that's directionally similar but only roughly half of likely German spending. Call it, Germany-lite.*
- *Credit rating agencies should permit spending of this magnitude assuming medium-term fiscal anchors remain in place. Risks are skewed to more debt and spending, however. Greater fiscal slippage and/or sub-par economic returns could lead to rating action and higher borrowing costs for the entire economy.*

Background: What happened in Germany?

Amidst acute geopolitical uncertainty and economic stagnation, Germans headed to the polls in late February for a federal election. Defence spending and revitalizing economic growth among the major ballot box issues. Most parties campaigned in favour of providing ongoing aid to Ukraine, although the degree of support varied. It was unanimously agreed that growth and competitiveness needed to be improved but how this was to be accomplished was debated (e.g., tax cuts vs. deregulation vs. infrastructure). Germany's fiscal laws severely limit the fiscal policy impulse so how much, if at all, these restrictions should be relaxed was also a key issue.

Ultimately, the Christian Democratic Union (and its sister party, the Christian Social Union), secured the most seats in parliament and efforts began to form a government. The SPD, led by outgoing Chancelor Olaf Scholz, was a natural partner and discussions began in the week following the election. Urgency to form a partnership grew after Volodymyr Zelensky's infamous visit to the White House, officials realizing Ukraine may be cut off from its largest source of aid.

On March 4th, the parties agreed to €500 billion in new infrastructure spending over the next decade and a significant increase in defence spending (more detail on the package follows), potentially totalling €1 trillion by the mid-2030s. However, this required changes to the constitutionally enshrined balanced budget amendment, better known as the debt brake, which sets the structural deficit at a maximum of 0.35% of GDP. The proposal sought to exempt defence spending greater than 1% of GDP from the debt brake but making this change required a two-thirds majority vote. (Note: Germany's plans would also be in violation of EU fiscal rules, but this is less of a binding constraint given lenient enforcement. The EU also recently loosened its rules with respect to defence spending and faces pressure to liberalize further).

Needing more support to secure a supermajority, the CDU/CSU and SPD courted the Greens and were able to obtain their votes in exchange for concessions. Together, the parties controlled 70% of the seats in the *outgoing* parliament, but not the *incoming* parliament, creating urgency to pass the plan before the new parliamentary session began. On March 18th, the infrastructure fund and debt brake amendment passed in the lower house, followed by approval in the second chamber and signing by the German President.

What does Germany's fiscal package entail?

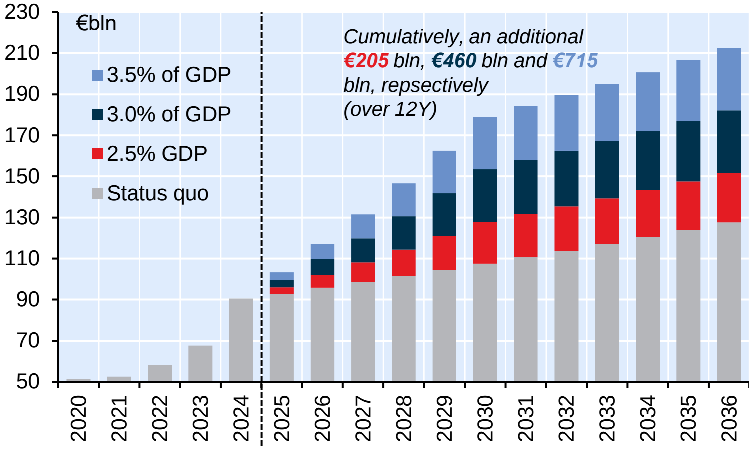
During negotiations, the plan as first reported has undergone change but its details and magnitude remain largely intact. The key specifics of the package are:

- A special, off-budget fund for infrastructure worth €500 billion. It is meant for *new* investment (defined broadly) and will be deployed over the next 12 years (originally, a 10-year horizon). Of this, €100 billion will be earmarked for climate investment (a concession for the Greens) and €100 billion will go to federal states and local authorities. Funding will be the responsibility of the federal financing agency, taking the form of an enlarged bund program.
- Defense spending above 1% of GDP will be excluded from the debt brake. The definition of defence spending has also been broadened to include intelligence, cybersecurity and aid for nations attacked in violation of international law (i.e., Ukraine). No specific defense spending package has been enacted but the constitutional amendment, in effect, creates a 'blank check' for the government.
- A looser set of rules for federal states, allowing them to run deficits of up to 0.35% of GDP, in alignment with the federal government.

The *total* net new spending from the deal is unclear, aside from the €500 billion for infrastructure (and deployment details of these funds are still to be determined). For the sake of illustration, if Germany's defense spending steadily grows to 3% of GDP, marginal expenditures could reach nearly €500 billion over the next twelve years. With infrastructure, this totals approximately €1 trillion.

Chart 1: What could marginal defence spending entail?

Potential scenarios for marginal German defence spending



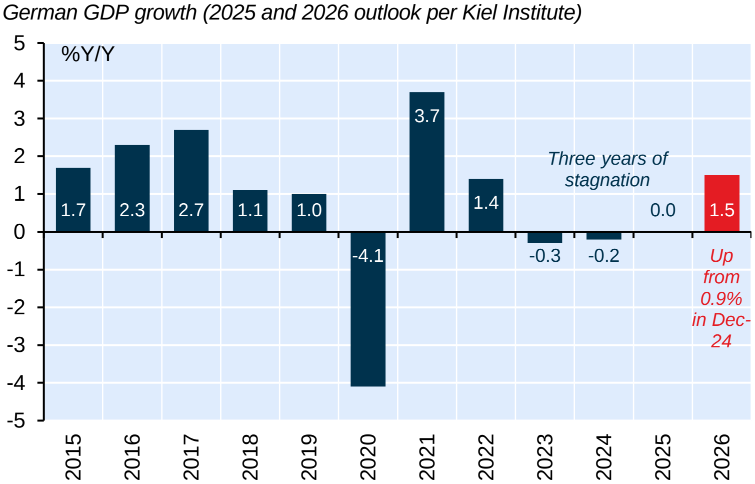
Source: NBC, NATO, BBG | Note: Status quo reflects 2.1% of GDP defence spending in 2024, per NATO. Assumes gradual, multi-year increase to stated share of GDP by 2030. A faster ramp-up would naturally involve more spending.

What has the reaction been?

The reaction to the fiscal overhaul has generally been very positive. Of course, additional defence spending capacity is beneficial for continental security and has been applauded by various European leaders. From a domestic perspective, new investment was viewed as much needed as the debt brake had contributed to underinvestment and aging infrastructure. Moreover, the GDP-boosting benefits couldn't come at a better time, as the German economy finds itself in the third year of a disappointing stagnation. While there's still much to learn when it comes to how and when new spending will be deployed, economists are revising up their outlook for German GDP growth (with expectations for new spending to really ramp up in 2026 and beyond).

Chart 2: Fiscal spending to deliver much needed GDP boost

German GDP growth (2025 and 2026 outlook per Kiel Institute)

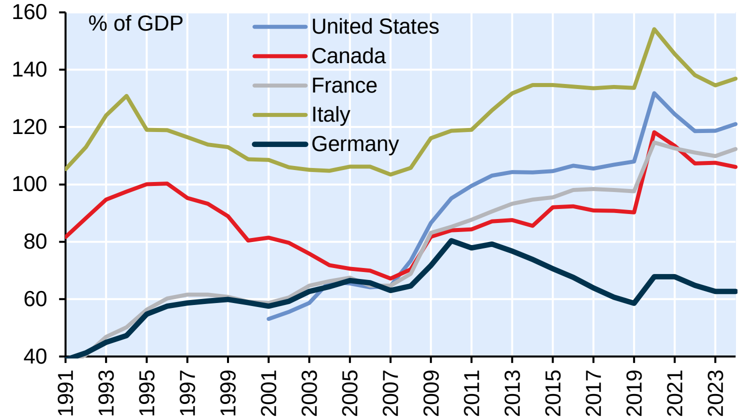


*Source: NBC, Bloomberg, **Kiel Institute***

Unsurprisingly, fiscal hawks are skeptical of new spending and the debt reform (and there are valid inflation concerns that stem from this). But from an affordability perspective, Germany has accumulated significant fiscal space, at least relative to other developed economies. Most peers bear *much* higher debt loads and while this gap may narrow, Germany will comfortably retain its advantage. Accordingly, credit rating agencies haven't been overly concerned. Fitch assessed Germany's fiscal room as "substantial," noting ratings pressure would only arise if spending increases were not "*eventually* offset by consolidation measures or a lasting improvement in growth prospects."

Chart 3: Germany has accumulated ample fiscal room

*General government **gross** debt burden (% of GDP)*

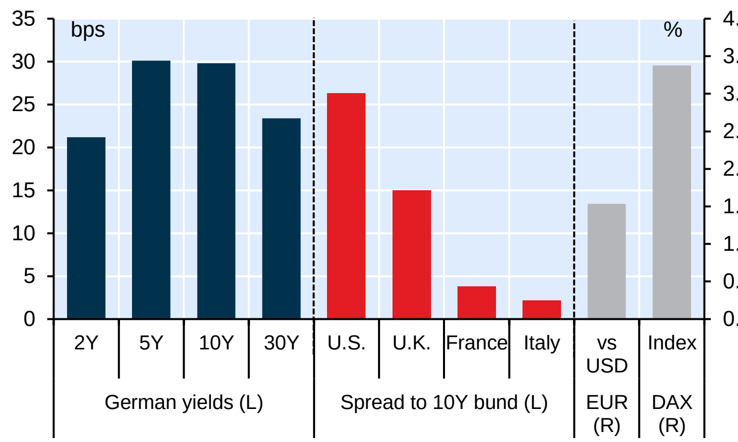


Source: NBC, IMF Fiscal Monitor (Oct-24)

The market reaction was notable too. Upon the package's announcement, bund yields shot up (more on growth optimism than inflation concerns), dragging yields for euro area peers along for the ride. The euro rallied and the DAX (Germany's main stock market index) was jolted higher.

Chart 4: Yields, euro and equities up post-announcement

Single day (5-Mar) reaction to fiscal package for major financial market variables

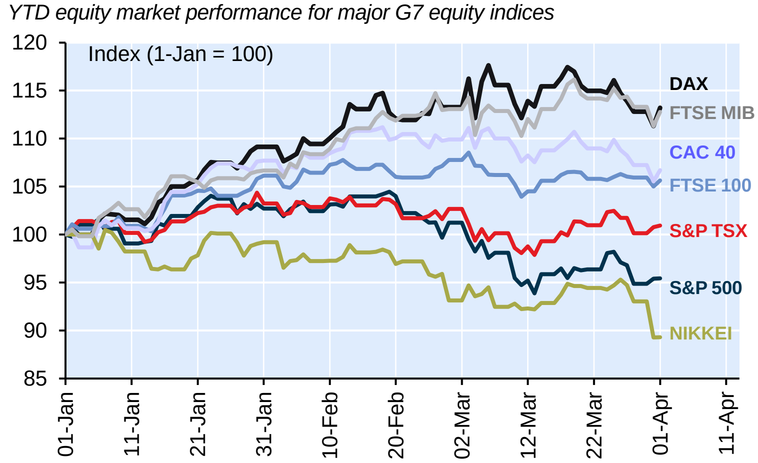


Source: NBC, Bloomberg

German equity strength wasn't limited to a single day either. The index was on a tear to begin the year on optimism for fiscal spending in Germany and at the broader EU level. Year-to-date, the DAX is the best performing G7 equity benchmark, outpacing the S&P 500 by >15%-pts.

Chart 5: German equities began 2025 on an impressive run

YTD equity market performance for major G7 equity indices



Source: NBC, Bloomberg | Note: Latest data point as of 1-Apr

Applying Germany's fiscal package to Canada

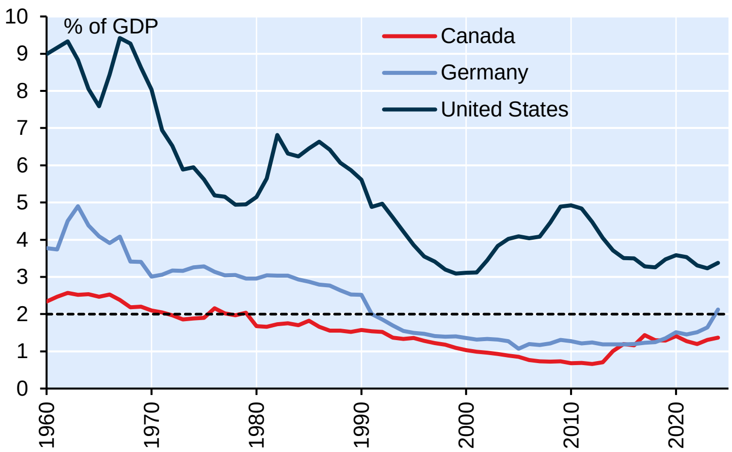
At ~11.5% of GDP, Germany's new infrastructure fund would be equivalent to roughly C$350 billion. Net new German defence spending remains an unknown, but it's widely speculated that this will be on the same order of magnitude as infrastructure investment. Together then, the recent German announcement would be equivalent to Canada's federal government announcing C$700 billion in new spending commitments spread out a little over a decade. That's roughly $60 billion per year or ~2% of GDP. For additional context, Canada's budgetary shortfall for this outgoing year was last estimated to be $50 billion. It's true that defence spending needs aren't *as* pressing for Canada but pressure is building here too…

Canada's lacklustre defence spending

Unlike trade and border security issues, the Trump administration's complaints about Canadian defense spending are more legitimate. Canada, like many nations, has failed to meet NATO's spending targets, which specify member states should devote 2% of GDP to defence. In 2024, NATO estimates Canada spent just 1.4% of GDP on defense (C$41 billion). Canada also fails to meet the secondary pledge that 20% of defense spending should be on major new equipment.

Chart 6: Canada has long underspent on defence

Defence spending as a share of GDP: Canada, Germany and the U.S.



Source: NBC, NATO

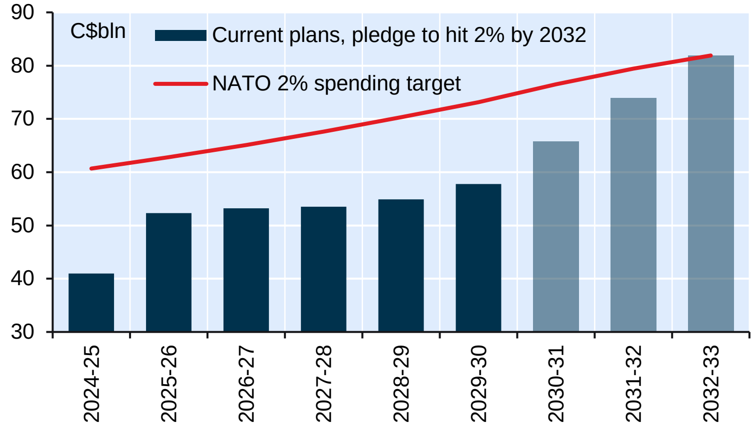
Moreover, analysis from Canada's Parliamentary Budget Officer (PBO) suggests that by the end of the federal government's budget horizon in 2029-30, defense spending will only reach 1.76% of GDP. While this shows some progress, a significant increase will still be needed to meet Canada's commitment to hit 2% by 2032, as outlined **last summer**.

We expect that the path to 2% will be accelerated in a new post-election budget. It's already clear defence is receiving more attention, evident in Liberal leadership debates and Prime Minister Mark Carney's recent pledges for military raises and Arctic security initiatives. While the timeline is unclear, Carney has stated Canada should reach 2% by 2030 "at the latest". Conservative leader Pierre Poilievre's stance isn't perfectly clear, but he is unlikely to prefer a more pacifist approach.

For illustrative purposes, if Canada were to immediately reach 2% of GDP in this fiscal year, spending would need to rise ~$20 billion versus 2024-25 levels, or an additional ~$10 billion versus planned 2025-26 levels. Whatever amount military spending is ramped up this year, it's unlikely that it will be funded by new revenue. That, of course, means the federal deficit will grow, Ottawa's debt to accumulate at a faster-than-planned pace.

Chart 7: Canada's plans are inconsistent with NATO target

Planned Canadian defence expenditure vs. level consistent with 2% NATO target



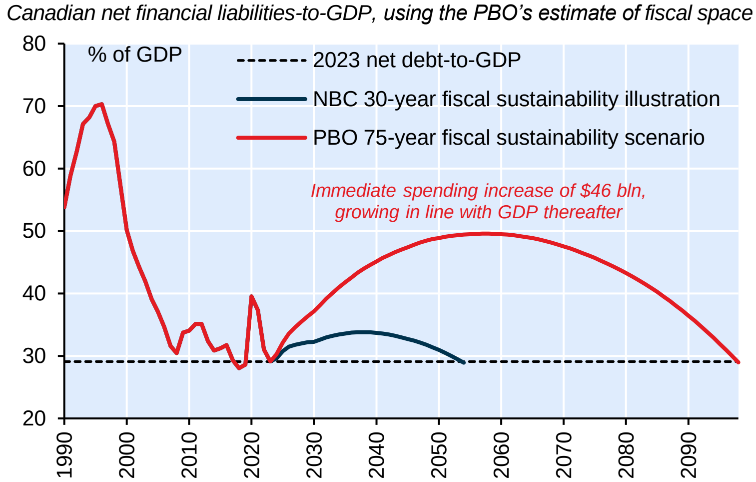
Source: NBC, PBO | Note: Dark blue = current plans; transluscent blue = implied path to 2%

Can Canada afford a German-style spending package?

The federal government undoubtedly has *some* fiscal room, but the degree of spending capacity depends on your perspective. Take the non-partisan PBO who reported last summer that the federal government's finances were sustainable *over the long run.* Their analysis implies Ottawa could increase spending (or reduce taxes) by $46 billion per year (equivalent to 1.5% of GDP) while maintaining fiscal sustainability. By that definition, spending capacity adds up to more than C$500 billion over the next decade. However, the PBO's definition of fiscal sustainability takes a *very* long-term perspective (specifically, it ensures that the debt burden 75 years from now is the same as it is today) and it would involve a growing debt ratio in the short-to-medium run. This nearer-term path, if travelled, is unlikely to be brushed aside by investors or credit rating agencies. Taking the PBO's framework and applying it on a shorter-term basis—say, 30 years—effectively halves the estimate of fiscal capacity.

Chart 8: This is what the PBO's 'fiscal sustainability' looks like

Canadian net financial liabilities-to-GDP, using the PBO's estimate of fiscal space

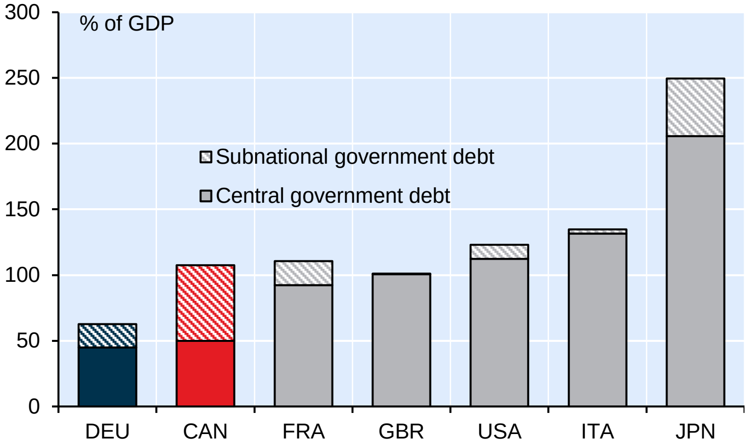


Source: NBC, PBO | Note: Estimates begin in 2024. 30-year scenario run by NBC, using same framework PBO uses for long-run fiscal sustainability analysis.

Perhaps a rising debt ratio in the short-to-medium run isn't the end of the world. That is what Germany is now effectively resigned to and investors and ratings agencies aren't too concerned. It's true, if you just consider the federal government, debt levels are very comparable. However, while Ottawa and Berlin carry similar levels of debt, the Canadian governance model is more decentralized, yielding more responsibility (and spending requirements) to the provinces. In other words, one must also view Canadian indebtedness more holistically. On a general government basis then, Canada's gross debt burden looks more like France, the U.K. and even the U.S.

Chart 9: Canada's debt burden is only partially a federal story

Gross government debt by central and subnational governments

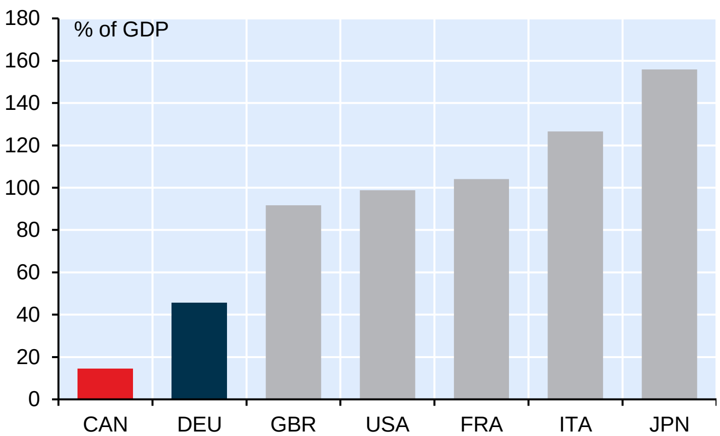


Source: NBC, IMF | Note: Latest data on central government data as of 2023.

Mitigating Canada's high levels of gross debt is a large pool of financial assets, much of which is in the social security system. Indeed, Canada owns the smallest general government *net* debt-to-GDP in the G7, lower than even Germany (who operates under a demographically-challenged pay-as-you-go system). While an actuarially sound social security system is helpful, this does not fully ameliorate elevated levels of gross government debt.

Chart 10: Net debt-to-GDP favours Canada

G7 general government net debt-to-GDP ratios: 2024



Source: NBC, IMF | Note: Based on IMF Fiscal Monitor (Oct-24)

Discussions of fiscal room are also nuanced at credit rating agencies:

- At the more negative end of the spectrum is Fitch. They favour viewing debt through a *gross* lens and downgraded Canada from AAA to AA+ back in 2020. They note that "a marked deficit increase and rising government debt over the medium term are negative rating sensitivities". At the same time they add, "Canada can handle a temporary shock without significant credit pressure, despite its elevated general government debt".
- Meanwhile, Moody's assesses that if "political consensus on maintaining sound public finances erode and government debt ratios rise materially above current expectations", there could be ratings pressure. While that doesn't sound exceedingly restrictive, we'd note that Moody's gives Canada's "fiscal strength" a Baa1 rating, weakness here offset by institutional/governance strengths.
- S&P, like Moody's, gives Canada its highest possible rating but here too, debt leaves the rating on somewhat shakier footing. On fiscal performance, Canada is ranked the worst of all 'AAA's and the agency notes downgrade potential if the "fiscal or debt position weakened substantially, absent policy signals from the government about future corrective actions, and this was accompanied by unexpected poor economic performance".

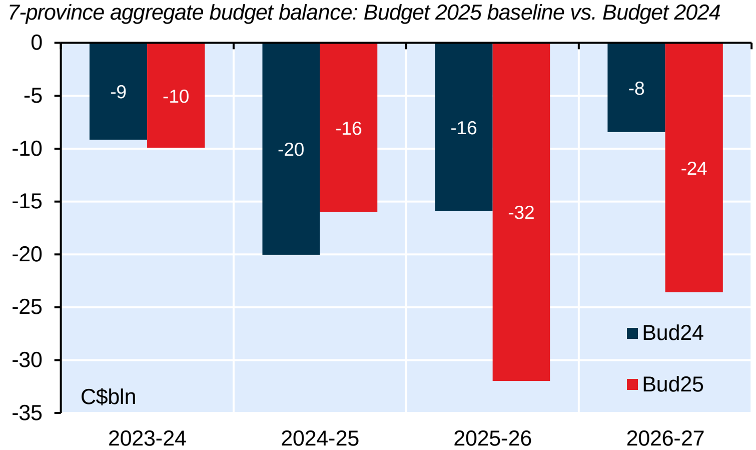
Undoubtedly, there is *some* fiscal capacity available to the federal government. Ratings agencies would likely be permissive of modest debt burden pressure in the short run assuming that it is *reasonably* contained and temporary. Legitimate investment spending that can boost potential GDP, rather than the lower-multiplier tax cuts/transfer payments, may also help Canada's case. To be sure, *how much room Canada has* is an important question, but the more important one is *how much room will ultimately be used*.

What kind of spending are we likely to see in Canada?

Between spending pressures on defense, infrastructure and net new promises on the campaign trail, it seems inevitable that the federal budget deficit is going to widen in 2025-26. That's been the *universal* experience at the provincial level so far this year, which we view as an **instructive preview** of a post-election federal budget. Parsing the 7 of 10 provincial budgets we've seen so far, budgetary red ink is estimated at $56 billion over the next two years compared to the aggregate $24 billion shortfall expected in 2024 budgets. We don't think the provinces yet to report will buck this trend either, with Ontario's fiscal plan to be most closely watched.

Chart 11: Provincial budgets weaken **(vs. prior year & prior plan)**

7-province aggregate budget balance: Budget 2025 baseline vs. Budget 2024



Source: NBC, prov govts | Note: Sums based on available 2025 budgets

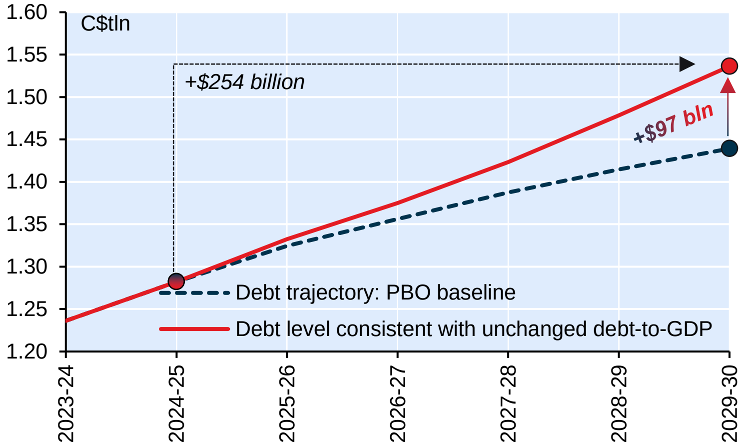
Coming up with a budget balance estimate for the feds can be challenging in the best of times, but federal campaign season makes it even more difficult as new multi-billion-dollar pledges are made on a near-daily basis. However, when it comes to setting expectations, we'll be bracing for a budgetary shortfall around $70 billion in 2025-26 (relative to a pre-election estimate of $47 billion, and an expected 2024-25 shortfall of $50 billion).

Extending the forecast horizon further is even more challenging. Detailed and fully costed platforms are unavailable, and geopolitical developments can quickly change the outlook. Fortunately, current Prime Minister Mark Carney offered a platform during his bid for Liberal Party leadership earlier this year. While details are light, Carney looks to separate operational spending from capital spending (à la municipal governments), with the intention of making major infrastructure investments. This doesn't look to be a 'blank check' fiscal plan though, as he has pledged to adopt a fiscal rule "[ensuring] that government debt-to-GDP declines over the forecast horizon".

This fiscal anchor is far less permissive than the debt path implied by the PBO's estimated fiscal room. Nonetheless, a Carney-led Liberal government could still involve a material pick-up in debt. Keeping the debt-to-GDP ratio steady through 2030 would involve an additional $250 billion from current levels or, more importantly, nearly $100 billion more than the **status quo path**.

Chart 12: Carney's 'fiscal rule' allows for *some* marginal debt

Baseline path for federal debt vs. path involving stable debt-to-GDP ratio



Source: NBC, PBO

Of course, depending on the use of investment dollars, GDP may be structurally boosted which would 'free up' more borrowing capacity. (A 1% boost to nominal GDP allows debt to climb an extra $13 billion in today's dollars.) Similarly, there's been a focus on unlocking efficiencies, which will allow for balance in the "operating budget" (in three years). Savings here could also be deployed in new investment spending. We're not going to delve into every possible permutation or potential second-order impacts, but we would simply emphasize that roughly $100 billion (over five years) is a realistic estimate of the new debt/borrowing a Liberal plan might entail.

The Conservative Party platform details are less developed but one would assume a CPC plan involves less spending, and thus less debt. However, there will presumably be no rush to balance the budget under a Conservative government either (between proposed personal tax cuts and capital gains exemptions, pledges are already at ~$25 billion). Whichever party wins the election and however much debt is ultimately taken on, it's likely to be front-loaded. Indeed, if there was ever a time to make structural investments in economic revitalization (and ramp up military spending), now is it. Moreover, Canada wouldn't be the only country to loosen its purse strings in the year(s) ahead. There may be strength in numbers here.

Coming back to the question of affordability, $100 billion in marginal debt over five years is manageable in our estimation. This figure, by its calculation, keeps the debt burden steady (over the medium-term), something that is likely to pacify ratings agencies. We recognize that debt ratios will likely move higher in the very near-term (at the federal and provincial level) but on a relative basis Canada is unlikely to jeopardize its fiscal edge versus key peers. (At the very least, it shouldn't deteriorate meaningfully.)

Risks, however, are skewed towards more spending and more debt. There will be no shortage of spending pressures/demands in the coming years. If federal fiscal sustainability becomes an afterthought, there's likely to be a credit rating impact, along with higher borrowing costs for governments (and ultimately households and businesses). There's also a philosophical question about whether this trade-off is "worth it", given Canada faces something of an existential threat. While we won't venture to answer that here, it's a question governments will have to grapple with in the years ahead.

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