LBBW Bereit für Neues

To the point!

Cross-Asset- and Strategy-Research

Is a German public debt tsunami looming?

Moritz Kraemer -- Chief Economist
LBBWResearch@LBBW.de

March 28, 2025

Perhaps, perhaps not: the devil is, once again, in the details

The waves are slowly calming in Germany, and tempers are settling after contentious constitutional amendments were hurriedly passed by the outgoing parliament, just before the newly elected Bundestag was constituted. These amendments enable the planned XXL debt package for defense, infrastructure, and climate protection. The now feasible new debt levels are gigantic.

Capital markets expect a debt boom

Accordingly, government bond yields have risen swiftly: investors expect that the government will walk the talk, and a tsunami of federal bond issuances is imminent. But it doesn't necessarily have to be that way. The constitutional amendment was the easy part. Deploying the funds timely and sensibly will be much harder.

Challenges in defense spending

Capacity bottlenecks for defense goods

Let's look at defense spending. Where will the capacities come from? Germany's largest defense contractor, Rheinmetall, generated less than €10 billion in revenue last year, and its order books are full for years. Now, potentially hundreds of billions in defense orders could be added. Who can deliver that? Remember, only about a quarter of the €100 billion special fund for the Bundeswehr set up in 2022 has been utilized, even though it is scheduled to expire at the end of next year. The rearmament is unlikely to happen as quickly as bond investors seem to assume.

Infrastructure: money alone is not enough

The same applies to the €500 billion special fund for infrastructure and climate investments. The construction industry also has limited capacities and is hampered by a shortage of construction workers. The industry must first invest and adapt to the growing demand. Additionally, funds remain unused in the budget every year because complex procurement and approval guidelines prevent them from being spent in time. To remedy this, the government must comprehensively reform administration and streamline processes. Will this happen quickly? Here, too, it seems that the larger debt framework will not necessarily lead to a massive or rapid increase in investments.

Potential growth and inflation impact the debt ratio

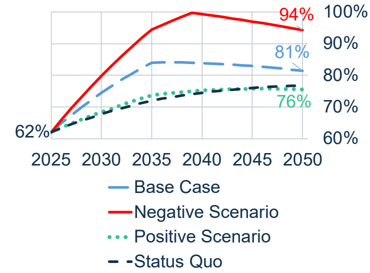
Depending on how quickly the funds can flow, the final target for defense spending, how potential growth, inflation, and interest rates evolve, very different trajectories for the debt ratio can emerge (see figure).

In the worst case, it could touch triple digits; in the best case, rising growth potential could reduce the debt ratio by 2050 to a level that it would also have reached on fiscal autopilot even without the constitutional amendment. Given the meager potential growth of 0.5% annually and the estimated general government deficit of 1.7% of GDP for 2025, the debt ratio would rise to more than 70% in the medium term even without added borrowing. And that is already sugar-coated, as the election promises already agreed upon in the coalition negotiations will further inflate the deficit. To cut a long story short: A solid forecast of Germany's debt path is currently not possible.

Risk of quick spending

The implications of additional German debt go well beyond its own borders. Not only have German government bond yields risen significantly since the package was unveiled, but also those in countries like France and Italy. This exacerbates their precarious budgetary situation further. Germany can still afford higher debt and interest costs. It still enjoys ample fiscal flexibility. But elsewhere, the risk of a sovereign debt showdown is growing.

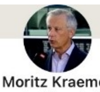
Simulations Public Debt Ratio Germany



Source: LBBW Research

Rising risks for the Eurozone

To get connected on LinkedIn, scan QR-Code



Moritz Kraemer
Chief Economist/Head of Research at LBBW || Senior Fellow SOAS University of...