



Federal Ministry
of Finance

Fiscal policy at a watershed moment – boosting growth and avoiding inflationary pressures

- Convenience translation of the German original -

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Fiscal policy at a watershed moment – boosting growth and avoiding inflationary pressures

We do not yet know the medium- to long-term global macroeconomic effects of the crisis currently besetting the European security order. What is clear, however, is that, following the shock stemming from the pandemic, our economy is now also being impacted by the illegal war of aggression against Ukraine and the problems in global supply chains, and this is slowing down the process of economic recovery in our country. At the same time, not only are energy prices soaring, but the prices of many other goods and services are rising more rapidly than we have seen for four decades. In the medium and long term, Germany is facing major challenges that could further dampen growth and increase inflation. These include digitalisation, decarbonisation, demographic change and the reorganisation of global trade.

In this challenging environment, Germany needs a forward-looking fiscal and economic policy that boosts growth through supply-side measures without further stoking inflation, and thus counteracts the risk of stagflation. It is important, in keeping with an ordoliberal, market-oriented policy approach, to boost productivity, create conditions to encourage more investment and innovation, and strengthen Germany’s position as an attractive place to do business in the face of international competition. By contrast, broad spending programmes and other demand-side approaches going beyond targeted, temporary stabilisation measures in times of crisis are counterproductive.

An *efficient, forward-looking and pro-active* fiscal policy is needed. *Efficient* means continuously setting spending priorities and evaluating expenditure. *Forward-looking* means exiting crisis mode and returning to normality as soon as possible in view of the global challenges facing us, in order to build up risk buffers that will enable us to address future crises, rising spending needs in our social security systems, and changes in the interest rate environment. *Pro-active* means that fiscal policy shapes our ability to successfully navigate the major transformations we are facing. These guiding principles will be fulfilled by a fiscal policy that is based on three pillars and thus safeguards Germany’s capacity to meet the challenges of the future: *short-term stabilisation measures* during the crisis, *pro-growth economic and fiscal policies* to boost productivity, and a clear focus on the goal of *fiscal resilience and fiscal stability*.

Efficient, forward-looking and pro-active fiscal policy

Stabilisation during the crisis	Growth through supply-side policies	Fiscal resilience
<ul style="list-style-type: none">> Extraordinary fiscal response> Stabilising the incomes of private households through targeted relief> Maintaining the economy’s productive capacity via limited and temporary assistance for companies that is gradually phased out> Supporting the structural shift in security and defence policy: modernising and reinforcing the Bundeswehr as an investment in freedom and stability	<ul style="list-style-type: none">> Promoting self-sustaining economic growth by boosting productivity and expanding capacity> Mobilising investment and strengthening market processes> Providing attractive conditions for innovation and start-ups> Reducing bureaucracy; promoting initial and continuing vocational training, research and development, and skilled immigration> Modernising public administrations and the public capital stock	<ul style="list-style-type: none">> Returning to normality and building up risk buffers> Promoting sustainable public finances to safeguard against interest rate risks and rising social expenditure> Reducing the debt-to-GDP ratio and complying with the debt brake> Ensuring favourable financing conditions as a result of credible institutions> Consolidating and investing via continuous priority-setting and evaluation> Reducing the number of special funds, boosting budget clarity

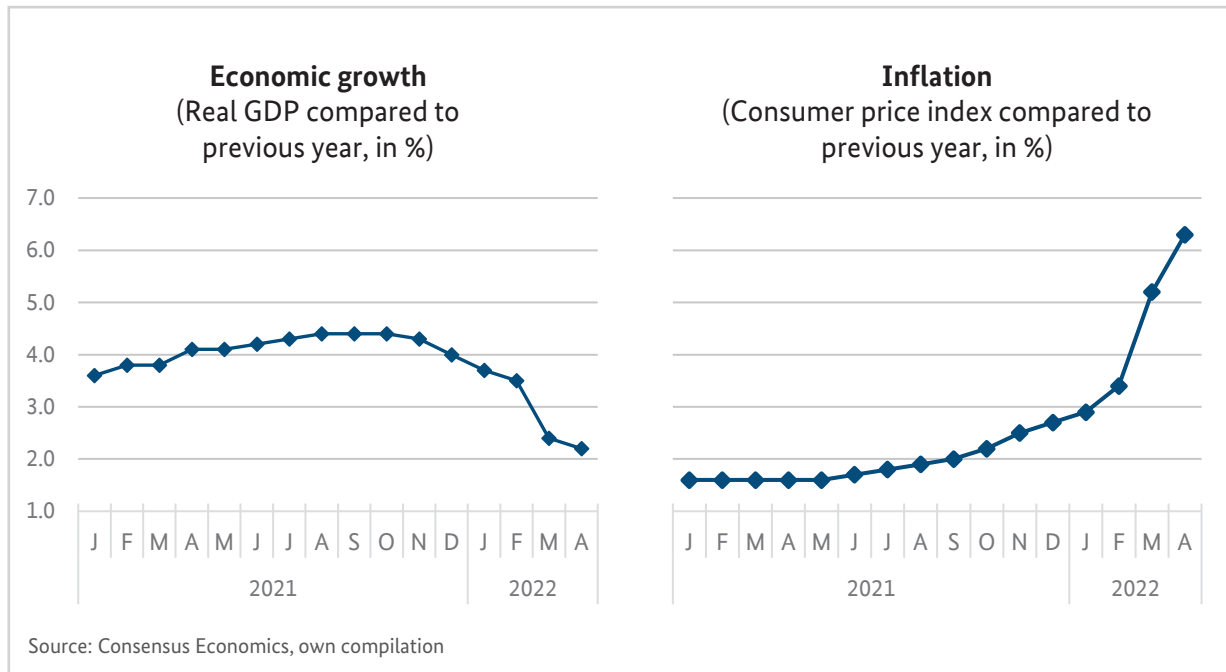
I. Current economic and fiscal policy environment

1.1 Muted economic recovery amidst rising prices

The economic impacts of Russia's illegal war of aggression against Ukraine, new virus variants and associated restrictions, and persistent problems in global supply chains are further delaying the recovery from the coronavirus crisis and the economic upturn. A strong post-pandemic economic recovery had been expected in Germany. However, this is proving to be slower than anticipated. The growth forecasts for 2022 have been repeatedly revised downwards (see the left side of Figure 1). The trend up to the start of this year is mainly attributable to two factors. First, economic activity was weakened by the prolonged public health measures taken to contain the pandemic as Germany experienced a new surge at the start of the year. Second, there are sustained supply shortages worldwide as a result of supply chain disruptions.

In this already challenging fiscal and economic policy environment, Russia's war of aggression and the sanctions imposed as a result are further weakening the economic outlook. The channels by which the consequences of the war are felt are clearly visible. Sharp increases in the prices for energy and raw materials are leading to an extended period of higher inflation rates and placing a burden on private households and, in particular, on energy-intensive companies. On top of this come greater economic uncertainty and additional supply chain disruptions, which are already resulting in lost output in some sectors. Consequently, not only are energy prices soaring, but the prices of many other goods and services are rising more rapidly than we have seen for four decades. Consumer price inflation forecasts have been repeatedly revised upwards in recent months (see the right side of Figure 1). It can currently be assumed that, at least in the medium term, energy prices will remain at a higher level than they were before the start of Russia's war of aggression. The aim of gaining independence from Russian energy supplies as quickly as possible is therefore likely to be attainable in the short term only under conditions of higher prices. In the medium term, higher carbon prices, which are important to promote decarbonisation, will drive up fossil fuel prices.

Figure 1: Correction of forecasts for Germany in 2022, based on consensus forecasts



Market-implied medium-term inflation expectations and those of institutional forecasters have both risen significantly as a result, and in the Euro zone they are now slightly above the European Central Bank’s monetary policy target; in other words, actual inflation is increasingly pushing up inflation expectations. The expectations of wage and price setters are another key factor in future inflation developments: while the inflation driven primarily by energy prices could, on its own, be temporary, there is a growing risk that higher inflation expectations on the part of companies and trade unions will feed into negotiations on wages and other agreements, and the current high level of inflation will thus become entrenched in the form of higher inflation rates in the medium term. Nominal yields and interest rates have risen recently in anticipation of a monetary policy response to high inflation in the euro area and a change of course in monetary policy, particularly by the US Federal Reserve. By contrast, real interest rates have fallen as high inflation rates outstrip the rise in nominal interest rates, at least in the short term. There is thus a risk of further, stronger market reactions.

At the same time, risk premia have risen, reflecting greater uncertainty; other things being equal, this puts pressure on the value of risky investments such as shares and corporate bonds. As uncertainty grows, investors’ appetite for risk falls, particularly in the field of venture capital; risk premia accordingly rise as the compensation expected for a continued willingness to take on risk. This squeezes companies’ financial flexibility and reduces their incentive to invest in the urgent modernisation and climate-neutral transformation of the German economy.

1.2 Medium-term factors can further dampen growth and increase inflation

Alongside the short-term developments, the medium- and long-term challenges facing the German economy are becoming more and more evident. Productivity growth remains low. Climate neutrality, like digitalisation, is an objective that entails fundamental changes to many workflows and business models. Demographic change is putting pressure on the labour market and our social security systems. The pandemic and the war show that supply chains need to be diversified more and realigned to boost resilience. All of these factors require special political efforts to pave the way for continued dynamic economic growth in future and to limit the risk of higher inflation rates.

Challenges for growth and prosperity as a result of weak productivity growth

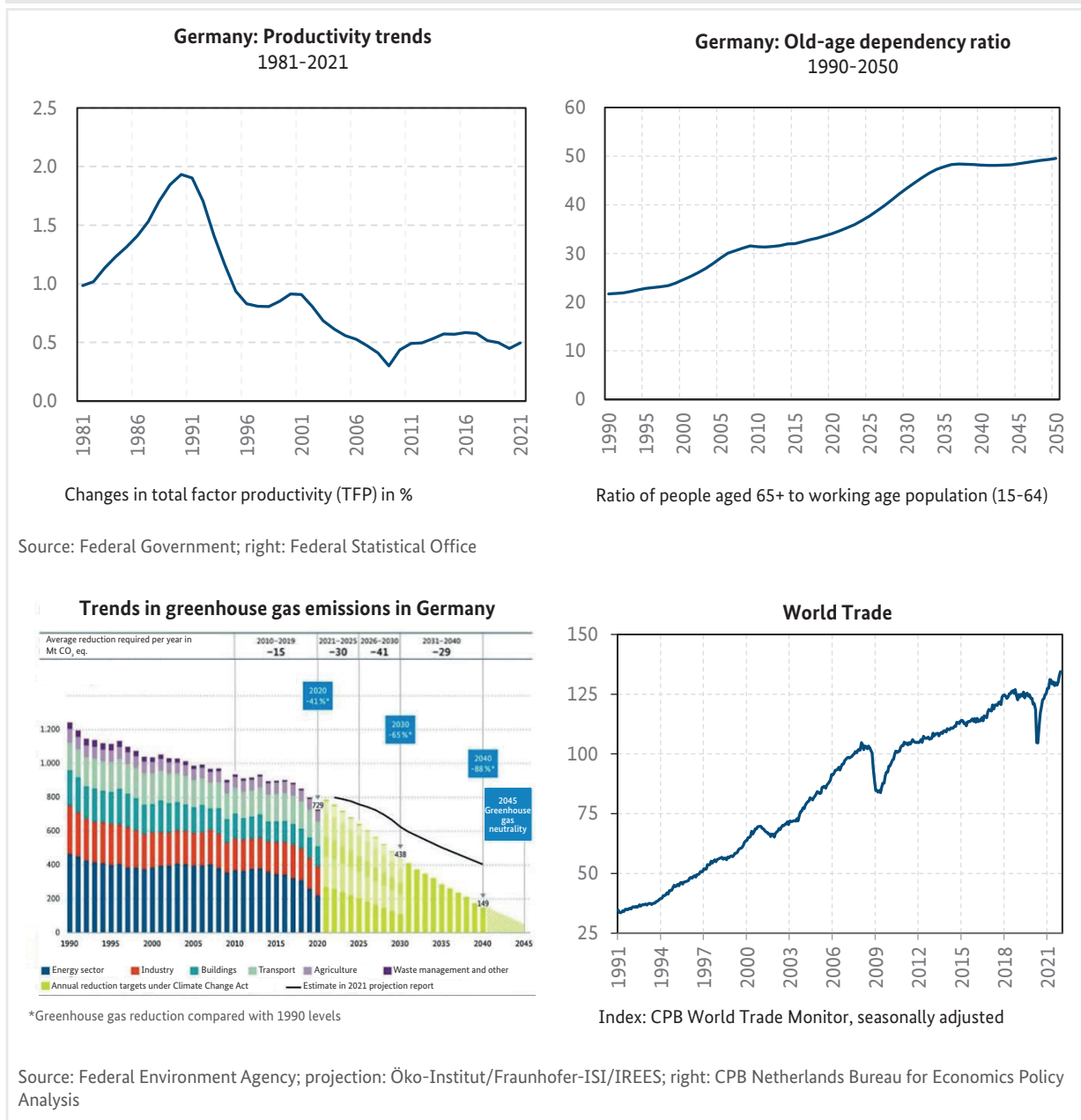
Productivity growth has fallen sharply since German reunification, and has remained at a low level since the global financial crisis (see the top left of Figure 2). Productivity growth is the key long-term driver of economic growth and the main economic lever for the thorough modernisation of an economy. It is essential as a major source of prosperity. Higher productivity growth also has a downward effect on prices, as the increase in prosperity is passed on to consumers via lower prices in cases where there is effective competition.

Demographic change is associated with risks in terms of inflation and growth

Following a temporary “demographic reprieve”, demographic change will accelerate sharply in Germany in the coming years. While in 2020 there were around 34 people of retirement age (65 and above) per 100 people aged between 15 and 64, this ratio will rise to over 43 per 100 by 2030 and to over 48 per 100 people of working age in 2040 (see the top right of Figure 2). Businesses will have access to significantly fewer workers. Skilled labour shortages exist in many sectors. As the falling labour supply is not currently being offset by higher productivity gains, population ageing has a negative impact on the economy’s potential output and thus on long-term economic growth.

However, an ageing population has the potential not only to dampen growth, but can also have an inflationary effect. Population ageing causes people of retirement age to make up a larger share of the population. As savings that people have built up over their working lives decline during retirement, aggregate consumption rises in line with the proportion of older people. The rise in the aggregate consumption ratio leads to an increase in either inflation or the real interest rate, while investment needs remain high. This is a global trend that could intensify further: while population ageing began some time ago in many advanced economies, it will gather pace in many emerging economies – particularly China – in future.

Figure 2: Key medium- and long-term challenges



A climate-neutral restructuring of the economy

Transforming the economy to be climate-neutral poses another medium-term risk in terms of inflation and growth. The federal government has created a legally binding framework for meeting Germany’s climate targets, including the target of climate neutrality in 2045 (see the bottom left of

Figure 2). However, climate action involves a fundamental restructuring of the German economy and rising prices for raw materials. The restructuring to achieve a climate-neutral economy goes hand in hand with massive structural change and thus entails major challenges for the competitiveness and the future of entire sectors – particularly in the absence of carbon emissions pricing at global level. If the necessary investment in

decarbonisation is not or cannot be made, or if disruptive adjustments were to take place, economic growth could be markedly weaker in future. Higher costs for CO₂ emissions may also contribute to rising production costs in the medium term and thus to rising consumer prices. While these energy price increases are necessary to create incentives for renewable energy sources and to drive forward decarbonisation with (green) hydrogen and synthetic fuels, there is a danger that these relative price changes, while intended, will be reflected in general inflation.

Geopolitical and geo-economic challenges

Developments in the global economy as a whole are also giving rise to major and more long-term challenges for Germany's open, export-oriented economy. The rise of China and India has shifted the balance of the world economy. The trend towards a multipolar world order goes hand in hand with geopolitical and economic opportunities and risks.

First, Germany's position as a key location for business and research is increasingly coming under international pressure, as it is competing with countries that are more innovative and digitally advanced, more forward-looking, less bureaucratic and, all in all, more growth-friendly. Germany risks becoming less competitive, especially given other economies' lead when it comes to the use of digital and innovative technologies (such as robotic automation or 3D printing) and to research and development. A loss of competitiveness would undermine the German economy's growth prospects.

Second, Germany's export-oriented economy is particularly dependent on the functioning and resilience of international supply chains, which are highly fragile when shocks occur, due to the high degree of global integration. If supply chain

disruptions continue over the short or medium term, this could have a lasting adverse impact on the German economy's production capabilities and place further pressure on prices. This is currently evident as the world's second-largest economy, China, which is deeply integrated in world trade, is continuing to pursue a zero-COVID strategy.

Third, there are downside economic risks and upside inflation risks in the event of a partial reversal or reorganisation of global trade. Globalisation has experienced three major shocks in a very short period of time: the US-China trade conflict, then the outbreak of the coronavirus pandemic (see the bottom right of Figure 2), and now, while the economic impacts of the first two shocks are still being felt, the effects of the war against Ukraine. Internationally, the industrial policy measures that have been and are being taken in response to these crises prioritise reducing dependence on strategic imported goods, such as energy and microchips. Germany is a particular beneficiary of the productivity effects of the international division of labour. If the shift away from international trade becomes entrenched, there could be a significant decline in growth momentum and disinflationary effects.

II. Supply-side economic policies

German economic and fiscal policy must set out suitable measures to prevent a period of lower growth and higher rates of inflation. Above all, the aim must be to boost growth without generating additional pressure on prices. The current environment should be seen as a signal to strengthen supply-side economic policies, particularly as there is a risk in this environment that a severe economic downturn coupled with undiminished higher inflation could result in a period of stagflation.

Sustainable growth is not produced by low interest rates and government measures to stimulate demand...

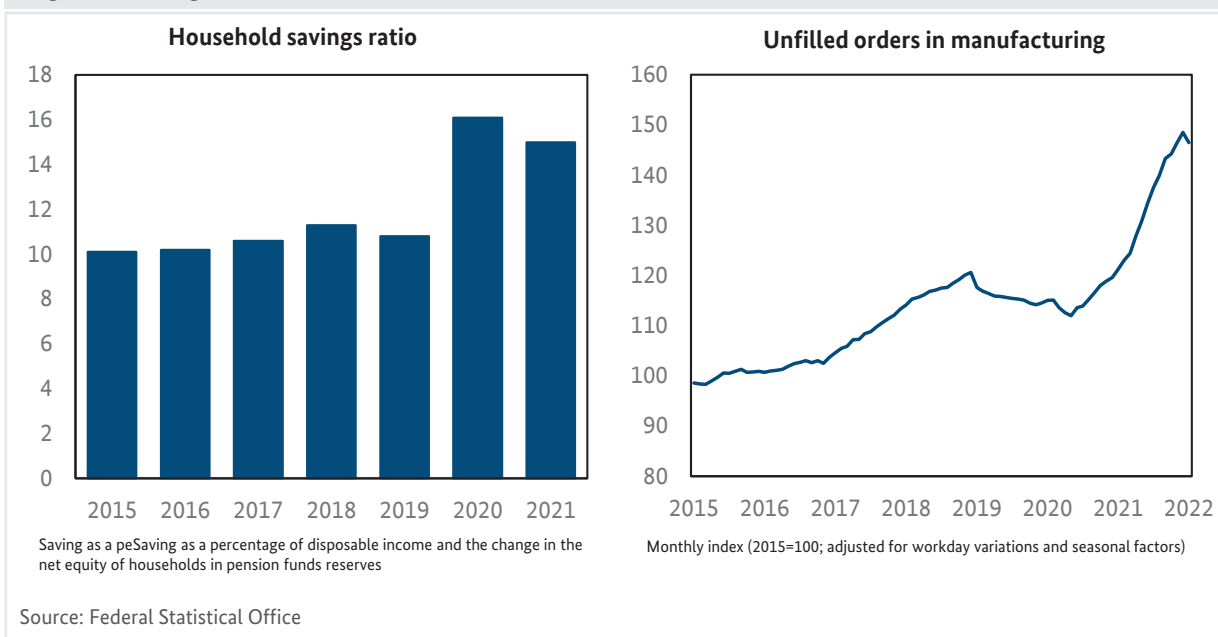
Rising productivity and an expansion of the economy's capacity, particularly at a time of monetary policy normalisation, pave the way for higher economic growth in tandem with lower pressure on prices. The current environment and its stagflation risks should therefore be seen as a signal to strengthen supply-side policies. It is important

to facilitate self-sustaining growth processes, to avoid further stoking inflation, and at the same time to lead the state out of debt. Announcing supply-side economic policies in a credible and predictable manner ensures they have a more rapid and efficient effect via expectations channels. Economic and fiscal policy must therefore credibly enhance Germany's future strength and competitiveness, in particular, and boost the pace of innovation and economic dynamism.

...but rather by boosting competitiveness and the pace of innovation in the private sector

In a crisis, the government needs to act and use the means at its disposal to support the economy. Targeted action has to be taken to alleviate hardship, and temporary support has to be provided to particularly hard-hit households and companies. Above all, it is important to avoid "scarring" from the effects of the crisis, i.e. to take action to prevent potential long-term damage, for example by

Figure 3: Savings and unfilled orders



catching up on investment. However, policy-makers cannot compensate for the loss of prosperity experienced by society as a whole as a result of higher energy prices. Particularly in view of the rise in personal savings during the pandemic (see the left side of Figure 3) and companies' large order backlog (see the right side of Figure 3), a policy to increase demand on a broad front would be counterproductive. The potential for the higher excess savings to be a source of consumer demand is partially offset by the fall in the purchasing power of disposable incomes caused by higher inflation. Instead, the key to sustainably boosting private investment and aggregate productivity growth is economic policy measures that target the supply side of the economy.

2.1 Boosting productivity

Higher productivity growth can have both a positive long-term influence on growth and a downward effect on prices.

Using the allocative function of the market and strengthening it via targeted policy measures

Boosting aggregate productivity growth requires a constant reallocation of productive resources such as labour and capital from companies with lower to those with higher productivity. This productivity-enhancing reallocation process is driven, first, by start-ups and the growth of young companies. To this end, the conditions for starting and scaling up viable companies must be improved. Second, the exit of companies from the market, freeing up productive resources that can be better used elsewhere, is an essential part of the process of creative destruction and a sign of effective competition. This is vital for the efficiency of market allocation and the pace of development. It is therefore all the more important to further strengthen the competition regime and reduce existing rigidities. In addition, aggregate productivity can be boosted by reducing administrative burdens and barriers in the areas of product and labour-market regulation.

Part-time continuing education and retraining courses help to improve the sectoral reallocation of workers. A well-functioning continuing education system is important not just for the efficiency of the reallocation process; it also helps to alleviate social hardships associated with this process. Continuing education can also be used to tackle skilled labour shortages via targeted offers for affected sectors.

Improving innovation processes and financing conditions for fast-growing companies

Roughly two-thirds of long-term labour productivity growth in Germany can be attributed to technological advances. The economy's innovation process plays a key role in this context. This includes initial and continuing vocational training, the development of new, research-intensive products and technologies, and their diffusion as marketable innovations. The intensified conversion of new knowledge into economic dynamism is crucial because, from a macroeconomic perspective, too little tends to be invested in the innovation process, particularly due to positive knowledge externalities and funding constraints. Limited access to venture capital in Germany by international standards, in particular, is likely to hinder the formation and upscaling of innovative companies.

Cross-cutting technologies in the field of digitalisation currently have a particularly high potential to raise productivity across the entire economy. While Germany plays a leading role in the EU when it comes to digital innovation, it lags behind worldwide leaders such as the United States, which has been very successful in promoting the development and diffusion of digital innovations (and the underlying infrastructure, such as computers and the internet), for example via the Defense Advanced Research Projects Agency (DARPA). Germany, meanwhile, still has a lot of catching up to do when it comes to the diffusion of digital technologies in companies and public institutions, as well as the development of digital and data-driven business models.

In an uncertain global environment, the government must provide insurance on the supply side

As an industrial and trading nation, Germany benefits disproportionately from the various productivity-enhancing effects of the international division of labour and from global economies of scale. The German economy and the industrial sector in particular are therefore deeply integrated in an ever-expanding global production network. Furthermore, global financial markets enable profitable foreign investments and the diversification of country-specific risks, thereby acting as insurance.

Given the changed security situation, moving away from an open trade policy and free trade would mean cutting ourselves off from the engine that drives global progress and allowing the source of German and European prosperity to dry up. However, we have already seen in the course of the coronavirus pandemic how high the global costs of global trade fragility can be. Now the new security situation is revealing that Germany and Europe also lack strategic reserves as a buffer against geopolitical risks. The crucial long-term advantage of free democracies and their alliances is their ability to learn and adapt. The current situation is a warning to set new priorities, address vulnerabilities, review mutual dependencies from the perspective of security policy and, where needed, engage in strategic retooling.

Europe must not leave the process of shaping the world trade system up to China, which recently concluded a comprehensive free-trade agreement (the Regional Comprehensive Economic Partnership – RCEP) with fourteen Asia-Pacific countries after years of negotiations. Germany should launch an initiative within the EU for global partnerships based on shared values, with the aim of protecting international trade as a source of prosperity and ensuring resilience by taking targeted steps to strategically unwind its ties with geostrategic rivals.

In the short to medium term, it is important to reduce existing cluster risks by diversifying international supply chains and energy imports. This is an investment in resilience to severe disruptions caused by security-related and other issues, not least in view of the increase in hybrid threats. From an economic perspective, the costs involved are essentially an insurance premium that has to be paid in normal times in order to have strategic independence and thus be able to act in crisis scenarios. This form of supply-side insurance by the government promotes greater stability by ensuring that the adverse scenarios we are currently seeing – due to supply failures or material shortages, for example – do not occur in future, or at least become less frequent. This results in more stable productivity growth and lower financing costs for transformative investment.

2.2 Increasing investment

Investment and the build-up of intangible assets (such as patents) play an essential role in turning knowledge into productivity growth and economic success. Investment helps to modernise the capital stock, promotes productivity gains, and boosts the country's competitiveness as a place to do business. In the current environment, where capacity utilisation is high, investment may push up prices of the goods concerned in the short term; however, over the medium to long term, rising investment leads to an expansion in productive capacity and to higher productivity. This has a lasting downward impact on prices. It is therefore important to revive investment, which slumped as a result of the crisis. Looking to the future, we should seek to raise the aggregate investment ratio in Germany to a higher level.

A key indicator in this context is private investment, as the private sector accounts for the lion's share (around 90%) of aggregate investment in Germany. As a result of the pandemic, companies' price-adjusted investment in plant and equipment plummeted by around 13% in 2020 (see the left side of Figure 4). That was the biggest fall in a single year

since the financial crisis. Investment rose again in 2021, but remained well below its pre-crisis level, only partially compensating for the pandemic-related decline.

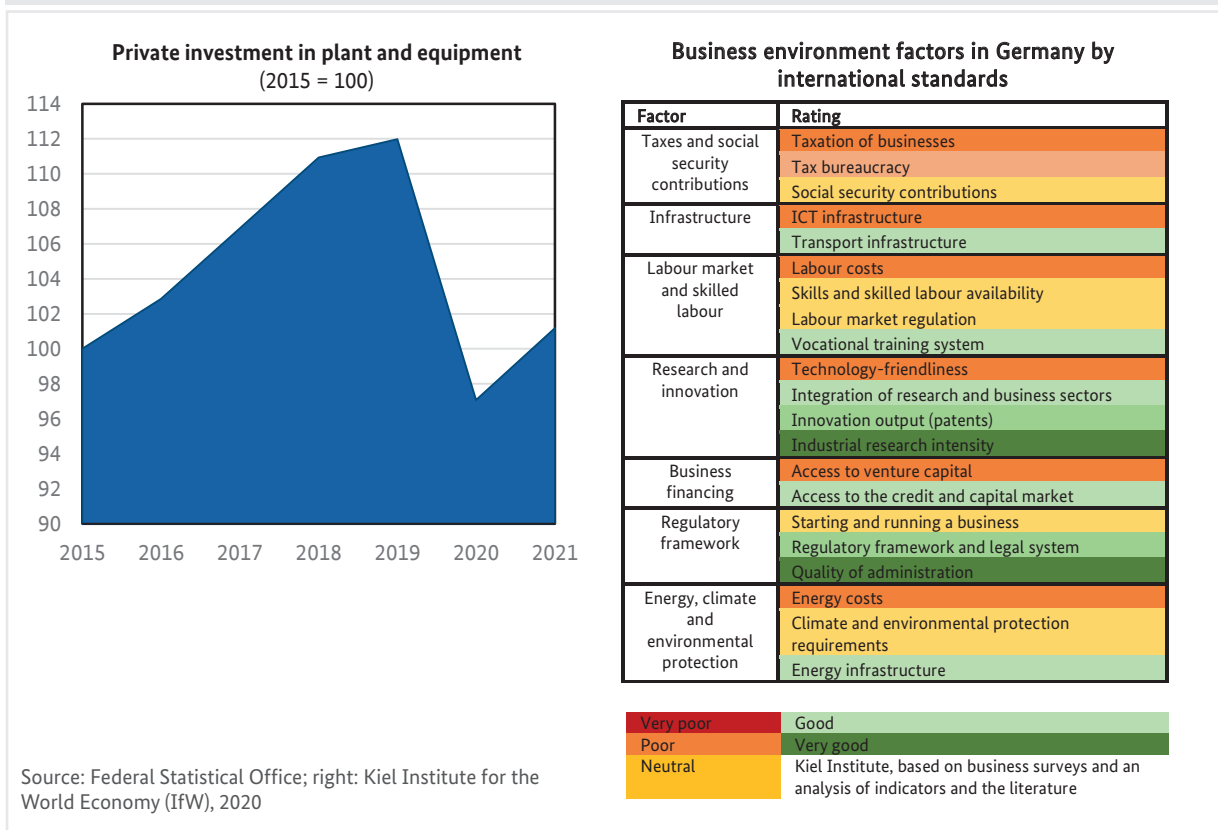
To increase private investment, it is important to establish attractive conditions for companies, take targeted steps to reduce uncertainty, and strengthen Germany's position as a good place to do business (see the right side of Figure 4). A more innovation-friendly environment is needed with a competitive tax system, modernised public administration, and faster planning and approval procedures.

The domestic business environment: unleashing the private sector

A key lever for a successful supply-side policy is the domestic business environment for companies, a context in which tax policy plays a significant role. The burden on corporations in terms of nominal tax rates is high in Germany by international standards. As far as effective average tax rates are concerned, Germany finds itself in the group of high-tax countries, behind France. Lower taxes for businesses by international standards offer, via companies' profit expectations, a strong incentive for innovation and investment. Innovation and investment determine companies' future productivity and thus ensure a continuous renewal of the private capital stock. A modern and competitive tax system therefore enhances companies' capacities, safeguards the future strength of the German economy, and paves the way for a continuous expansion of aggregate supply. Given the comparatively high taxation of companies in Germany, tax burdens should generally fall in future. However, care should be taken to choose the right moment for an additional fiscal stimulus. In the short term, there are supply-side constraints, particularly in industry and the construction sector, in the form of global supply chain disruptions and existing labour shortages. These should be at least partially resolved before a tax policy stimulus is enacted.

Lower production costs for companies, for example due to lower indirect labour costs or taxes, can help to make Germany more attractive for private investment by increasing the prospects of profit. In addition, creating a level playing field with other countries in some areas can make Germany a more attractive place to do business; regarding climate issues, for example, a climate club could be formed that helps to ensure a level playing field with global competitors in terms of imports and exports. Capacity expansion also requires a well-trained workforce; key factors here include education; initial and continuing vocational training; an increase in skilled migration; and suitable measures to ensure that migrants are quickly integrated into the labour market.

Figure 4: Private investment and business environment factors on the basis of surveys and indicators



A functional and modern public infrastructure plays no small part in making a country an attractive place to do business. Public investment in, for example, faster internet, a first-class transport network and reliable energy and electricity supplies contributes to this, as does investment in a modern and digital state. Currently, public investment expenditure in Germany is already at a record level. The benchmark figures adopted by the Federal Cabinet provide for over 50 billion euros in investment per year until 2026, the entire period covered by the current fiscal plan. The investment financed via the Climate and Transformation Fund and the special fund for the Bundeswehr come on top of this.

Against this background, the aim should not be to make additional funding available, for example by creating further special funds; instead, the focus for now should be more on effective measures to reduce bureaucracy and speed up planning and approval procedures, in order to ensure that the available funding is used rapidly, effectively and efficiently.

Particularly in the current environment, with economic uncertainty at a high level, a moratorium on additional burdens can help to support investment. New bureaucratic and tax burdens can jeopardise positive economic trends. Instead, existing obstacles and barriers must be rapidly and systematically dismantled, particularly with regard to the digital and climate-neutral restructuring of the German economy and the country’s infrastructure.

Finally, a reliable fiscal policy is a positive business environment factor. A stable fiscal policy, which is the aim of the German debt brake, implies a high degree of consistency in direct tax and fiscal policy instruments. In addition, the fiscal institutions ensure both the government’s ability to take effective action in times of crisis as well as the long-term viability of social security systems. This reduces uncertainty and stabilises the expectations of economic agents. A high level of planning certainty for investment, staffing and consumption decisions, as is provided for under current fiscal plans, stimulates

private investment. Prioritising public investment over additional social expenditure enhances the quality and the forward-looking nature of public finances.

2.3 Avoiding measures that would exacerbate the risk of a wage-price spiral

Maintaining price stability is the European Central Bank's primary objective. It has to use the instruments at its disposal to ensure that inflation expectations are and remain firmly anchored, including to prevent the emergence of a wage-price spiral. Monetary policy therefore has to respond decisively to persistently higher inflation rates. A targeted economic and fiscal policy can promote higher productivity growth and avoid inflationary pressure, and in this way support monetary policy in ensuring that consumer price inflation remains anchored at the European Central Bank's price stability target over the medium term.

Price rises for (fossil) energy imports signify a redistribution of real income from importing to exporting countries. If the Russian war against Ukraine continues for some time or escalates, further energy price increases are likely. In these circumstances, there is a risk that developments will mirror what happened following the oil price crises in the 1970s: high inflation rates driven by energy prices led to a fall in real wages in importing countries, and trade unions sought to compensate for this with high wage settlements. Companies responded by raising prices to preserve their profit margins, which again resulted in high wage demands, all of which contributed to rising unemployment in Germany.

Ultimately, it was the central banks that tackled inflation by using high interest rates to restore price stability, at the cost of plummeting production and sharply rising unemployment. The increase in labour costs as a result of the oil price crises led companies to invest more in capital-intensive production technologies, with the aim of

replacing more workers, given that the resource of labour had become more expensive. This is regarded as a major cause of the persistently high unemployment that plagued European economies in particular for many years after the 1970s crises subsided.

Measures that increase labour productivity and decrease the upward pressure on wages and prices will thus be most helpful in reducing the risk of a wage-price spiral and a de-anchoring of inflation expectations. Leveraging the pool of potential skilled labour, for example, can lower the pressure on wages and prices that is being caused in part by the growing shortage of skilled labour. At present, the unemployment rate in many sectors is already low, and skilled labour shortages exist in sectors such as IT as well as skilled crafts. These supply-side shortages can be addressed by, for example, improving incentives in the tax and benefits system, taking steps to boost labour market participation and expand continuing education and retraining, and further opening the labour market to skilled workers from abroad.

In addition, fiscal policy can avoid measures that fuel demand and thus drive prices up further. Such measures include, for example, extensive transfer programmes, as can currently be observed in the United States. Likewise, higher general government consumption expenditure is counterproductive.

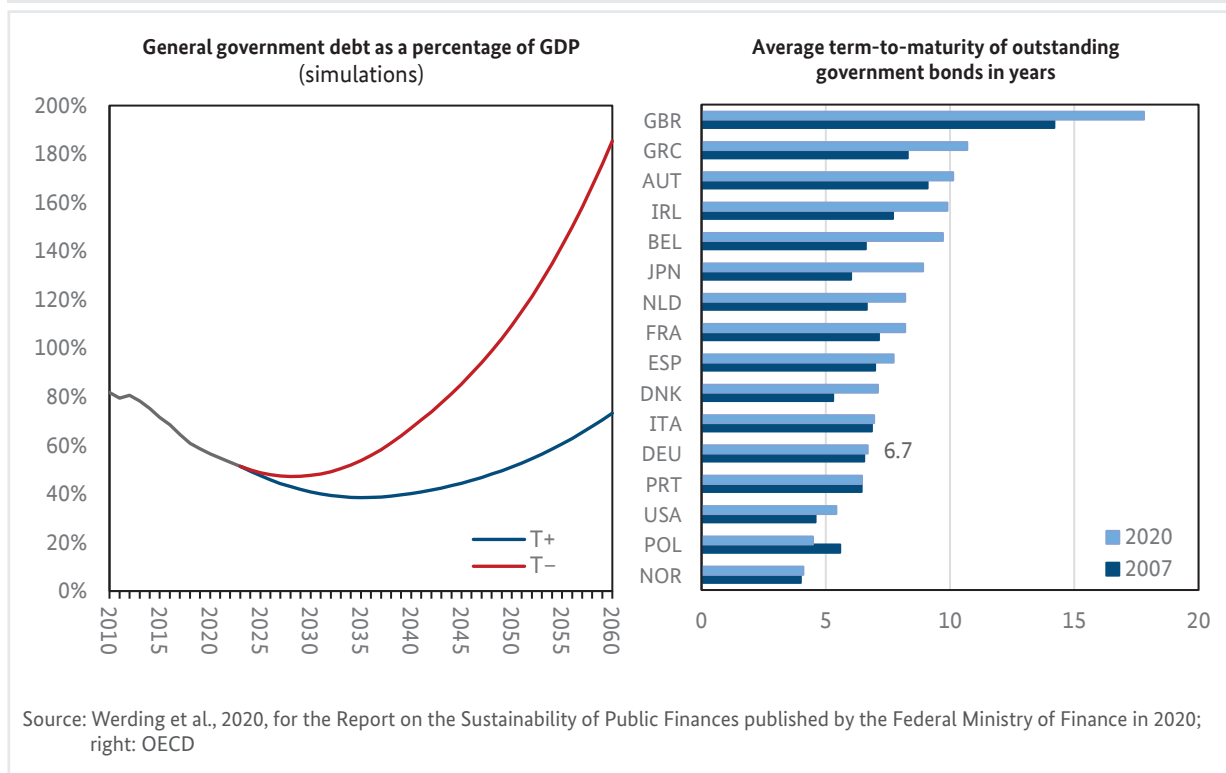
III. Maintaining sustainable public finances

Intertemporal government budget constraints are at the heart of the definition of fiscal sustainability. It is true that a government is not required to balance its budget every year without borrowing or to repay accumulated debt in full within a certain timeframe. Nonetheless, simply to maintain its creditworthiness, a government must be able to credibly demonstrate its ability to cover the debt it has accumulated and all future expenditures through future revenues.

The federal government’s most recent calculations in its Report on the Sustainability of Public Finances published in 2020, i.e. not including the fiscal impacts of the coronavirus crisis and the war in Ukraine, already demonstrated the need for significant fiscal adjustments to ensure that public debt remains on a sustainable trajectory over the

long term. The main reason for this is the marked demographic change taking place in Germany. The rising proportion of older people places pressure on social security systems in the long term and results in structural deficits in the fields of pensions, health and long-term care. Unless reforms are enacted to reduce these deficits, for example through longer working lives, skilled immigration, or the use of returns from a funded pillar to strengthen the statutory pension insurance system (“equity pension”), they will have to be offset by grants from the federal budget. The federal budget’s implicit coverage of the liabilities of social security systems transfers the demographic risk to the federal government.

Figure 5: Sustainability and maturity of government debt



However, the increasing volume of grants from public budgets masks the need for structural consolidation and reduces incentives to exploit efficiency reserves. The tax system, too, must take into account that, looking to the future, population ageing will mean that fewer working taxpayers are available. In other words, there are risks to long-term fiscal sustainability. Sustainability analyses – which take into account applicable law and simulations of future (demographically driven) additional expenditure – are used to calculate a fiscal adjustment requirement. This shows the scale of the long-term increase in public debt if no adjustments were made on the revenue or the expenditure side (see the left side of Figure 5). The graph shows that in both the pessimistic (T-) and optimistic (T+) scenarios, the debt-to-GDP ratio declines in the initial years. However, net borrowing caused by demographic trends soon drives an accelerating renewed rise in debt. Calculations by the International Monetary Fund and the European Commission reach similar findings.

It should be noted again that these calculations do not yet include the economic impacts of the coronavirus crisis – the debt-to-GDP ratio has risen to nearly 70% – or Russia's war on Ukraine. In addition, the two framework scenarios do not consider the interest rate risk, which has a strong effect on the projections: the fact that interest rates are starting to increase, at a time when growth expectations are muted, can, on its own, lead to sharply rising trajectories for the debt-to-GDP ratio and thus limit future fiscal space.

The impact of interest rate risk on public finances depends on the average term-to-maturity of outstanding federal securities. The maturities of the federal government's debt portfolio are short by international standards (see the right side of Figure 5). In fact, maturities actually became significantly shorter during the coronavirus crisis due to the increased issuance of short-term government bonds. Longer maturities shift the interest rate risk to the holders of German government bonds, who currently demand very low compensation for

this risk, mainly because financial markets regard federal securities as a safe haven in times of crisis.

To keep this status, it is important to rapidly reduce the debt-to-GDP ratio and continue to comply with the debt brake, making this reduction credible. While it is crucial to take fiscal countermeasures during a pandemic and a war in Europe, it is equally important to fully restore fiscal resilience in the following years in order to retain the scope to take effective action in response to future shocks. A rules-based fiscal policy geared to fiscal sustainability also makes a key contribution to price stability, as this is the only way to ensure that monetary policy can control the inflation rate over the medium and long term. Otherwise, the effect would be similar to having two people with their hands on the steering wheel.

Fiscal space and a credible reduction in the debt-to-GDP ratio are very important not just in Germany, but also in the other member states of what is a highly integrated monetary union. Boosting medium-term economic growth has a part to play in creating fiscal space. The other part consists of enforceable common fiscal rules that will lead credibly to falling debt-to-GDP ratios. Based on its current fiscal planning, Germany can succeed in bringing its public debt back below 60 per cent of GDP already in the second half of this decade, once again meeting the targets of the Stability and Growth Pact. In this way, fiscal policy sends a signal in support of fiscal stability beyond Germany's borders to the rest of Europe. This should be used to promote fiscal sustainability in all member states.

IV. Fiscal policy strategy

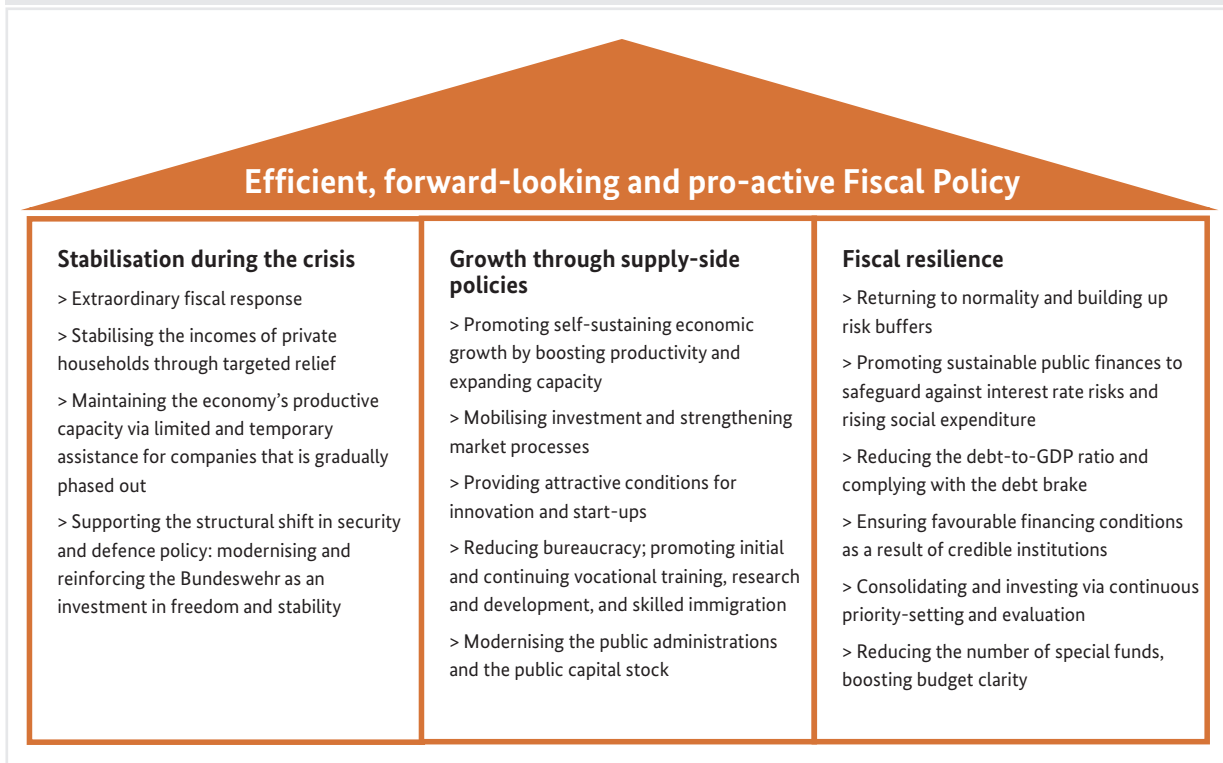
We do not yet know the medium- to long-term global macroeconomic effects of the crisis currently besetting the European security order. Economic developments in our country are subject to a great deal of uncertainty. On top of this uncertainty comes the enormous task of fully modernising the German economy. Germany needs a fiscal policy that is efficient, forward-looking and pro-active in the face of short-term crises and major challenges in the medium to long term. Efficient means that fiscal policy consistently sets spending priorities and continuously reviews the benefits for the economy as a whole – including by conducting regular evaluations and making greater use of spending reviews. At the same time, fiscal policy must take forward-looking, risk-based action in view of global challenges and changes in macroeconomic conditions. It is therefore important to exit the crisis mode and return to normality as soon as possible so that risk buffers can be built up for future crises, for rising spending needs in our social security systems, and for a changing interest rate environment. Risk buffers that already exist in the form of reserves should not be used to finance permanent, structural measures. At the same time, given the need to modernise Germany, fiscal policy clearly has a pro-active role to play in successfully addressing the medium- and long-term challenges.

These guiding principles will be fulfilled by a fiscal policy that is based equally on three pillars and thus safeguards Germany's ability to meet the challenges of the future (see Figure 6): first, short-term stabilisation measures during the crisis; second, pro-growth economic and fiscal policies to boost productivity, in keeping with an ordoliberal policy approach; and third, a clear focus on the goal of fiscal resilience and fiscal stability.

4.1 Stabilising incomes and preserving productive capacity in times of crisis

Germany is experiencing two crises of historic proportions within a very short period of time, in the form of the coronavirus pandemic and the illegal war of aggression against Ukraine. As these are rare and exceptional events that last occurred many decades ago, fiscal policy has to respond to the crisis with extraordinary measures to stabilise the situation and, in the current environment, find a balance between tackling the crisis and avoiding inflation. To this end, we want to deploy significant government financial resources, which we are able to do because of the risk buffers built up before the pandemic. A powerful and resolute response to the increase in uncertainty during the crisis is the first pillar of our fiscal policy strategy. Public finances are not ruined in a crisis. A crisis requires the government to act and use the options open to it. At the same time, we must avoid creating additional inflationary pressure so as to limit inflation risks. That is why we are designing our crisis response to be temporary, targeted and short-term. We cannot fully offset losses of income permanently, however, as this would strain public finances over the long term; we can only provide temporary support for companies whose long-term profitability is secure. We must let market allocation forces play out and, by doing so, advance Germany's modernisation. The changes wrought by the crisis are now racing towards us, however. We therefore need a fiscal policy response as a shock absorber, in order to soften the impact.

Figure 6: Fiscal policy at a watershed moment – boosting growth and avoiding inflationary pressure



Our response has three elements:

- First, we are stabilising people's incomes during the crisis. The sharply rising costs of electricity, food, heating and transport have become a significant burden for many people with low incomes, but increasingly this is also the case for middle-income earners. We are therefore stabilising incomes by taking targeted steps to alleviate the burdens resulting from the war and – like our European partners – providing urgently needed relief.
- Second, we need to protect the productive capacity of our economy in times of crisis. We are putting shock absorbers in place for companies affected by the war. To this end, we have launched targeted, temporary support measures for companies affected by the sanctions or the war itself. As things stand, companies mainly need to secure liquidity quickly, and so we are primarily supporting them with liquidity assistance. But we are

also making preparations in case the financial situation of companies deteriorates, and putting supplementary measures in place for the event that this occurs.

- Third, we are addressing structural changes brought about by the crises. In the case of the war, we are responding to the fundamental changes in Europe's security situation by increasing the funding for the defence budget in our current fiscal plan and in every budget year. Because we cannot correct at least fifteen years of neglect of the Armed Forces overnight in the current budget, we are setting up a special fund for the Bundeswehr with 100 billion euros in funding. We are providing this sum as an investment in freedom and will ensure that the funding is used solely to strengthen our alliance capabilities.

4.2 Strengthening economic growth through supply-side policies

The aim of our fiscal policy strategy's second pillar is to initiate self-sustaining economic growth by unleashing the allocative and productive forces of the market. In an environment of intact demand, high inflation and very high capacity utilisation, we can only achieve this kind of economic growth by boosting aggregate supply and productivity. By contrast, stimulus measures to boost aggregate demand, beyond short-term stabilisation measures in acute crises, would currently not be conducive to achieving this goal. Rising demand would come up against supply rigidity in the short term, and so prices would simply increase further, as economy-wide value added cannot rise immediately. It would therefore be inadvisable from an economic perspective – and would also be uneconomical and harmful in terms of public finances – to respond to the current high level of macroeconomic uncertainty by introducing major spending programmes (for example to boost consumption) or by expanding social benefits.

In other words, what is needed is a fiscal impetus that does not further stoke inflation and that creates the conditions for a self-sustaining trajectory of economic growth. Supply-side policies are therefore the first part of our insurance strategy against stagflation risks. Successful supply-side policies require the fiscal mobilisation of private sector investment and a political commitment to trust in market forces via targeted incentives. Given the scale of the mobilisation needed, providing funding to activate private investment will not be enough on its own. To boost private investment, it is therefore important to establish attractive conditions for companies, take targeted steps to reduce uncertainty, and strengthen Germany's position as a good place to do business. A more innovation-friendly environment is needed, with a competitive tax system, modernised public administration and faster procedures.

In the current environment of rising prices and ongoing supply shortages, coupled with the major challenges posed by transformations and the need for modernisation, it is essential for fiscal policy to avoid imposing additional tax burdens. In this environment, fiscal policy should provide targeted tax relief for companies in order to incentivise an increase in aggregate supply and reduce inflation risks.

We have set ourselves the goal of modernising the public administration and reducing barriers to investment, as one priority of the German Recovery and Resilience Plan (DARP). To achieve the necessary activation of private sector investment that has not materialised due to the pandemic, we already earmarked 60 billion euros for the Energy and Climate Fund in the Second Supplementary Budget Act 2021. The decision to maintain a high level of public investment will play a particularly important role in fostering private sector innovation. We are investing more in better infrastructure, education, innovation and a more resilient energy infrastructure.

We can best increase aggregate supply by easing rather than raising the burden on companies and strengthening the market's allocative function. As we seek to modernise Germany, we will therefore improve the conditions for start-ups, investment and innovation. To this end, we must fundamentally strengthen the availability of private capital for investment and, in particular, make it easier for young companies and start-ups to access venture capital. We will systematically reduce bureaucracy and make the public administration more agile and digital. We are improving conditions for businesses by halving the duration of planning and approval procedures in Germany, providing impetus for lower production costs, and increasing the availability of well-trained workers through initial and continuing vocational training.

For an open and export-oriented economy like Germany's, a fiscal policy strategy must set out responses to new international challenges.

Germany's fiscal policy has to respond to current developments and promote more resilient structures for global value creation, with the aim of enabling our country to adapt rapidly and bounce back strongly from crises. Fiscal policy can create positive externalities as part of a forward-looking approach, for example by funding research and development, and provide positive support for the diversification of the German economy's supply chains. Fiscal policy can help to unlock the potential of research and development, especially in key enabling technologies such as artificial intelligence, quantum technologies, biotechnology, genetic engineering and robotics, by making targeted investments to improve the data infrastructure.

4.3 Fiscal resilience and fiscal stability

If attempts to return to normality following the crisis fail, this will damage the sustainability of public finances. Only a return to normality will ensure that we have the fiscal space to take effective action in future crises, given the major challenges facing Germany in the medium and long term. Without sound public finances, there is a risk that federal securities will lose their role as a safe haven in times of crisis, eliminating the benefit to Germany's public finances in terms of financing costs. Returning to normality is therefore the third strategic goal of our fiscal policy, in order to safeguard fiscal resilience and fiscal stability. We will exit the fiscal expansion mode step by step and, after returning to normality, build up larger risk buffers. This will safeguard the sustainability of public finances, maintain the public's and companies' trust in the government's ability to take action, and counteract inflation risks. In an environment where inflation expectations are rising, fiscal policy must avoid causing additional inflationary pressure by being overly expansionary. In this context, fiscal resilience and supply-side policies are complementary goals that will have a downward effect on inflation and boost growth. A reduction in tax burdens to increase aggregate supply therefore does not have to clash with the goal of fiscal resilience, as a short-term reduction in tax revenues could, in the long term, be offset by higher tax revenues resulting from self-sustaining economic growth.

For too long, we have relied on the seeming certainty of sustained low interest rates and continuous economic growth. The economic upswing before the outbreak of the pandemic allowed us to forget that our prosperity is not a given and must always first be earned. We therefore need to take a good look at existing risks to sound public finances and make fiscal policy preparations for rising expenditure, especially as a result of demographic change, and higher future costs of public debt. The goal of fiscal resilience is the second pillar of our insurance strategy against short-term

inflation risks, and it also offers protection against the medium- and long-term risks to self-sustaining economic growth and sustainable public finances. After all, interest rates have already started to increase, and this is giving rise to interest rate risks that will narrow the fiscal space in the budget due to higher interest expenditure in the coming years. This makes it all the more important to keep risk premia for public debt as low as possible over the long term by making a commitment to credibly reduce the debt-to-GDP ratio and retaining the debt brake. Calling the debt brake into question, on the other hand, could jeopardise the goal of fiscal resilience and thus our ability to secure funding for the coalition's modernisation projects.

The fiscal rules to which we have signed up at European level and our constitutional debt rule are an integral part of our fiscal policy strategy's third pillar. At European level, we are pressing for strong, enforceable rules that will lead to a credible reduction in debt-to-GDP ratios. Thanks to its inherent flexibility, the debt brake has enabled us to deliver appropriate fiscal policy responses to recent crises; at the same time, however, the debt brake requires us to pursue sound fiscal policies across economic cycles. This fundamental concept of a symmetric fiscal policy is at the heart of our strategy of fiscal resilience, as it prompts us to continuously set priorities and review public spending – particularly when times are good. In other words, the return to complying with the debt brake's upper limit on new borrowing in the coming year 2023 is not contradictory given the current crisis, but rather the necessary and logical response of a forward-looking fiscal policy, given current expectations for the future development of the economy as a whole and the aim of being prepared for the next crisis. At the same time, it is an important contribution to maintaining the credibility of our institutions. To this end, it is also appropriate to abolish a number of existing special funds, include them in the federal debt, or repay them in full, as part of a return to placing greater emphasis on the principles of budget accuracy and transparency. We should not set up new special

funds – such as a special fund for “decarbonisation”, for which there are occasionally calls. The funding for the transformation of our economy already available in the Climate and Transformation Fund and the regular budgets is more than can be meaningfully spent in the current environment without crowding out private activities.

By gearing our fiscal policy towards fiscal resilience, we are paving the way for government action that is forward-looking, efficient and, at the same time, pro-active, by prioritising this coalition's initiatives and making a commitment to more outcome-oriented financial management. In the budget for 2023, even more than in the new federal government's first budget, our approach will be to limit ourselves to what is financially feasible, set out a vision for the next few years, and in doing so emphasise the new, modern priorities of this coalition. This means that we will consolidate while at the same time investing in areas where it is most necessary. We will safeguard both stability and growth by driving forward the transformation to a competitive, climate-neutral and digital economy. At the same time, the strategy at hand represents an urgently needed contribution to increasing the quality of public finances.

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