CHART OF THE WEEK

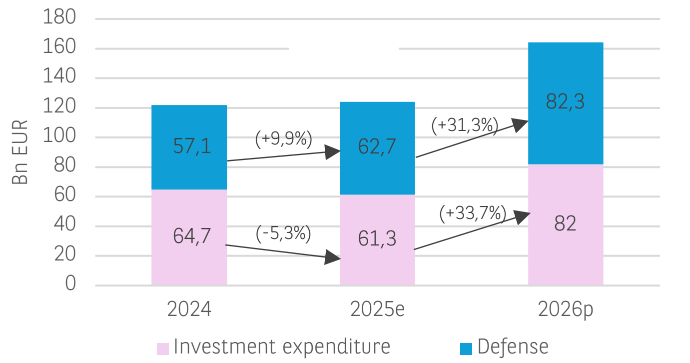
22 January 2026

GERMAN BUDGETARY SHIFT: TOWARD A 2026 UPSWING AND STRONGER GROWTH EFFECTS

Marianne Mueller

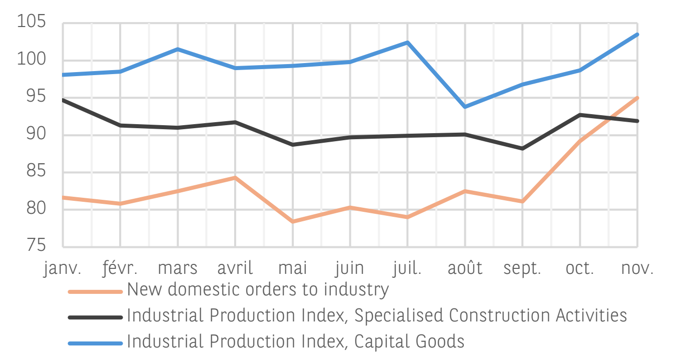
March 4 will mark the first anniversary of Germany's announcement of its plans for massive investments in defense and infrastructure. The increase in public spending in Germany has already contributed to end the two-year recession (2023-2024) by 2025 – mainly through defense investments, according to our estimates. Infrastructure investments, on the other hand, are currently below the planned amounts. 2026, however, is expected to see a clear acceleration of these programmes, which should bolster a strong pickup in growth and restore Germany's role as a driving force in the euro area.

TWO-SPEED INCREASE IN GOVERNMENT SPENDING



SOURCE: GERMAN MINISTRY OF FINANCE, BNPP ESTIMATES AND CALCULATIONS

EARLY SIGNS OF ECONOMIC RECOVERY



SOURCE: FEDERAL STATISTICAL OFFICE

Note: Infrastructure spending estimates include federal core budget spending and disbursements from the SVIK special fund, excluding transfers to the Länder and municipalities and to the KTF fund.

The Merz government has placed the economy at the heart of its agenda, with a focus on infrastructure and defense, coupled with support for private sector investment. 2025 saw the implementation of the government's strategy, with two major exemptions from the debt brake:

- A special off-budget fund of EUR 500 billion over 12 years dedicated to infrastructure and the low-carbon transition (SVIK);

- An exception from the debt brake on defense spending exceeding 1% of GDP (the goal is to increase defense spending to 3.5% of GDP in 2029, up from 2.4% today).

Increase in public spending. Under this impetus, federal spending has already risen significantly in 2025, by +6.2% y/y according to our estimates, supported by social and pension spending (+7.4%, contributing 3 percentage points to the increase in public spending), as well as defense (+8.9%, contributing 1.1 pp) and public services (+4%, contributing 1 pp). Conversely, the increase in investment spending remains limited (+2.9%); with budget allocations for public transport and road, rail, and communications infrastructure even decreasing (-18.7%). This decline seems to be explained by an accounting shift from core federal spending to the SVIK fund. Overall, our estimates – which include both federal spending and the SVIK special fund – point to a decrease in infrastructure investment in 2025 compared to 2024 (left-hand graph). This decrease can largely be explained by the lateness of the vote on the budget and the implementation of the SVIK, and by administrative simplification that has yet to be completed: unlike defense, which quickly benefited from simplified procurement procedures, administrative modernization remains at the stage of a published reform agenda, with concrete measures still to come.

First signs of growth in 2025. The gradual rollout of this policy has already begun to support growth, which reached +0.3% y/y in 2025, driven mainly by public consumption, expected to have risen by 1.5% over the year. Early signs of economic spillovers also appeared at the end of the year (right-hand chart), with a recovery in industrial production in November, particularly in capital goods, and a strong rebound in new domestic orders. In construction, the recovery is less clear, but production has been rising since October in specialized construction, breaking with its downward trend.

Upswing in 2026. The ramp-up is expected to reach a new level in 2026. The budget (including the SVIK) has already been approved, which will allow for faster deployment of public investment. In addition, the administrative reforms announced in 2026 and coming into force the same year should allow for better transmission of economic policy to the real economy. In the defense sector, geopolitical tensions and the launch of optional military service should further support German investment in this sector. The rise of German fiscal policy and its knock-on effects on the country's economy and the Eurozone as a whole support our growth forecasts of 1.4% in 2026 and 1.5% in 2027, with nearly 1 pp attributable to public spending (see Germany: the country launches its new growth cycle).

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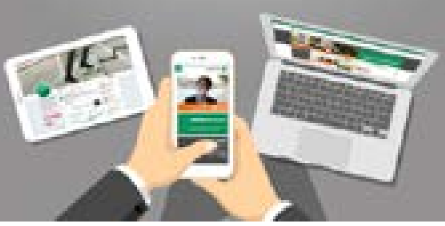

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