EDMOND DE ROTHSCHILD

MARKETING COMMUNICATION

AND EUROPE WOKE UP

There are decades when nothing happens, and there are weeks when decades happen. This is how one might sum up the general impression after the events of the past week, so profoundly have they upset geopolitical, economic and financial balances. The scene of tensions between V. Zelensky and D. Trump on Friday February 28 symbolized the break-up of the Atlantic alliance and the end of the peace dividend on which Western economies and financial markets have prospered in recent decades, leading Germany to overturn its entire fiscal and constitutional framework in order to gain the means to acquire strategic independence from the United States.

Even before the appointment of the new government, the future German Chancellor, F. Merz, adopted M. Draghi's phrase and announced a "whatever it takes" approach that redefines German policy in terms of defense and, more importantly, debt. This historic proposal includes four equally significant components:

1. **All defense spending in excess of 1% of GDP will no longer be included in the calculation of the debt brake.** Bearing in mind that Berlin currently spends almost 2% of its GDP on defense, this immediately frees up 1% of budgetary leeway, saving the new coalition from difficult negotiations to reduce public spending on other issues. It is important to note that no limit has been set on military spending, theoretically allowing Germany to increase its capabilities as much and for as long as necessary.

2. **A special fund of €500 billion over 10 years will be set up to invest in infrastructure, without being included in the calculation of the debt brake, representing a budget of 1.2% of GDP per year.** This measure is probably a concession to the SPD and the Greens, but it will provide major support for the German economy, some of whose economic woes are due to its aging industrial fabric.

3. **The German regions are now authorized to generate a deficit of up to 0.35%, whereas this was previously limited to 0%.** Given the great autonomy and economic weight of the Länder in Germany, this development is far from negligible. Indeed, if several of them exploit this new room for manoeuvre, the impact on sectors such as education and transport could quickly be felt.

4. **A structural reform of the debt brake will be discussed in the next parliament,** but this is now far from urgent in view of the measures detailed above, which will enable the German executive to free itself from the straitjacket imposed by the current rule over the next few years.

The ambitious proposal put forward by the new coalition between the CDU and the SPD must, however, be quickly approved by the Greens and passed before March 25, the end of the current parliamentary term, as long as the three parties have the two-thirds majority required to pass a constitutional reform. While legal recourse to the Constitutional Court cannot be ruled out, the likelihood of a deadlock appears relatively low, and the Greens are likely to support the text, which addresses many of their priorities.

Unsurprisingly, the effect of this historic announcement was considerable on the markets, as proved by the biggest daily rise in German yields since 1990. This momentum largely carried over to the rest of European yields, as investors took on board not only better growth prospects, but also government debt issuance set to increase significantly.

Regarding the first point, according to initial estimates and pending finalization of the plan, higher defense spending and public investment in infrastructure should result in an increase in German growth from +1% by the end of 2026 to +5% by 2028, compared with its previous trajectory. However, the exact impact will depend on a number of parameters. Firstly, the speed of implementation. Although Germany enjoys a higher level of administrative efficiency than many other European countries, the roll-out of a program of this scale will require, at the very least, several quarters, which means that results will not be visible before the end of the year.

Secondly, the fiscal multiplier, which is relatively low for military spending (around 0.5), but much higher for public investment (around 1 or more). In the short term, therefore, this good news will mainly offset the negative risks to German and European growth, particularly those associated with the trade war. In the long term, on the other hand, the impact will be major as the funds are deployed, stimulating both cyclical and potential growth.

Concerns about debt issuance are exacerbated by ongoing discussions to encourage other European countries to increase their defense spending as well. While Germany can afford such a stimulus plan without its debt trajectory becoming unsustainable (the debt-to-GDP ratio should only reach 68% by 2028), doubts are more acute when it comes to France and the peripheral countries. The European Commission's proposal would involve a €150 bn program of European loans to countries, as well as a relaxation of budgetary rules allowing them to increase their national military spending by €650 bn. These proposals appear difficult to implement, however, as the burden of additional debt would fall on countries that are already heavily indebted, which could fuel mistrust in the financial markets. Nevertheless, a compromise could probably take the form of a new joint debt program, led directly by the European Commission, or even a new entity if the UK or Norway wish to participate, or if countries such as Hungary were to oppose the project.

In any case, the face of Europe has definitively changed this week, and this paradigm shift will have lasting consequences on bond markets, with equilibrium levels being structurally revised upwards. In an increasingly threatening geopolitical context, this is the price to pay for the Old Continent to finally assert itself.

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