(Shutterstock)

German spending plans raise hopes for an economic lift

07 March 2025, 3:33 pm CET, written by UBS Editorial Team

The winner of Germany's recent election has announced plans to boost spending on defense and infrastructure, contributing to a rally in German equities and a swift rise in government bond yields. While the extra spending, if approved by lawmakers, will take time to feed into the economy, the fiscal shift has the potential to support economic growth and equity markets.

What happened?

Germany's chancellor-in-waiting on Wednesday unveiled plans for a major boost in defense and infrastructure spending, contributing to a 3.4% rally in the nation's DAX equity index on Wednesday and the swiftest rise in government bond yields since 2020. Friedrich Merz, whose Christian Democratic Union (CDU) alliance won Germany's recent election, has said the nation would do "whatever it takes" to fend off "threats to freedom and peace" in Europe, echoing then ECB President Mario Draghi's promise in 2012 to defend the Eurozone during the debt crisis.

Merz, who is in talks to form a coalition with the Social Democrats (SPD), plans to recall parliament to seek approval to free up funds of EUR 500bn for infrastructure spending and exempt defense spending over 1% of GDP from the "debt brake," a rule introduced in 2009 to cap the government's structural budget deficit at 0.35% of GDP. In addition, the proposal would extend the deficit allowance of 0.35% of GDP to German states (Länder), which currently must run a balanced budget, potentially doubling the government's borrowing cap to 0.7% of GDP per year.

The package still needs to be approved by the German Bundestag, with a two-third majority required. And given inevitable lags in fiscal policy, additional spending could only start to filter through to the economy later this year and into 2026. But despite these caveats, the bold fiscal plan has the potential to boost economic growth and support Eurozone assets.

The scale of the fiscal boost could provide a lift to confidence, even before increased spending boosts the economy. If this package passes, government spending could increase by around a cumulative 20% of GDP over the coming decade. It would also be the biggest fiscal shift in 80 years, surpassing even spending related to the reunification of Germany in the 1990s. The strong pro-growth signal from the move has the potential to support consumer and business sentiment well before funds start to be deployed. As such, the announcement places upside risks to our growth forecasts for Germany, and for Europe more broadly. It could also help offset potential headwinds to the Eurozone economy in the event of higher tariffs from the US.

Higher German government spending could add to an already improving backdrop for equities. The rally in DAX following Merz's announcement took the index's year-to-date gain to 16%, making it one of the best-performing markets in the world in 2025. Cyclical and defense-related sectors led the rise. Despite this recent rally, German and European equities remain inexpensive in relative terms, with multiple catalysts on the horizon. The new German government is pro-growth and has demonstrated a willingness to reform the debt brake, a move supported by Germany's healthy fiscal situation. The commitment to increased defense spending underscores this stance and may be followed by further investments, especially in infrastructure and renewable energy. After years of underinvestment, we believe higher fiscal spending would be well rewarded by equity markets.

The rise in bond yields presents an opportunity, given German's solid fiscal position. The 10-year Bund yield rose from 2.4% last Friday to 2.80% at the time of writing. We believe bond markets have overreacted with respect to the credit risk, and maybe even overstated the technical implications in the form of higher future bond supply. While the precise rollout schedule of Germany's extra spending efforts is yet unclear, we believe it's unlikely to challenge its Aaa/AAA credit rating. Even if Germany were to increase spending to the abovementioned levels over the next 10 years, and assuming a moderate growth multiplier, our simulations indicate that the debt-to-GDP ratio would still land in the mid-60% area by 2030 (assuming no other shocks to growth and debt).

We believe the government's plans have the potential to improve the investment outlook for Germany as well as the region. But uncertainties remain high, particularly concerning potential tariff risks, which we believe necessitates a selective approach. We continue to recommend gaining exposure to the DAX through structured strategies or, more selectively via our "Six Ways to Invest in Europe" theme. Alternatively, we still see the EMU industrial sector as well as EMU small and mid-cap companies as Attractive. Regarding fixed income, we view the rise in yields as an opportunity to lock in attractive yields in medium-tenor quality corporate bonds. Additionally, the significant shift in Europe's fiscal stance potentially benefits the euro and reduces downside risks, in our view. However, in the near term, we see risks of a pullback in the EURUSD as escalating tariff threats from the US could weigh on sentiment and limit further upside.

UBS