Is Germany Without Its Debt Brake on the Right Track?

Long before Germany's decision to initiate an aggressive military buildup in response to the Trump administration's new isolationist policies, a powerful chorus in Germany was heavily campaigning to loosen or reform the country's debt brake, the so-called *Schuldenbremse* enshrined in the German constitution. Many policymakers envisioned an aggressive infrastructure buildup paid for with public spending financed by much higher public debt. Such a constitutional change had long been thought undoable.

On the debt issue, Germany is in a unique position compared to most of its European neighbors. After peaking in 2010, Germany's debt-to-GDP ratio dropped to 63 percent, close to Europe's 60 percent target. For many if not most of Germany's neighbors, however, the debt situation for years has been a giant party of expansion. As Germany abandons its debt brake, the rest of Europe may feel encouraged to abandon any last vestiges of restraint.

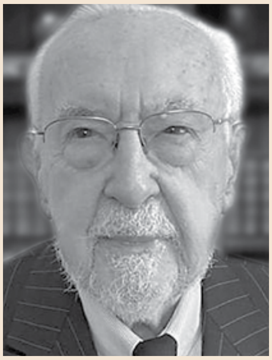
What will be the end result of a huge European debt expansion led by a Germany that now admits its military spending and spending on high-tech–related public infrastructure have been inadequate?

What kind of pressure will the European Central Bank face? Would the ECB be forced to buy massive amounts of the sovereign bonds of Germany's highly indebted neighbor countries to prevent the collapse of the financial system?

Could there be a run on the euro, with markets believing Europe's long-time financial anchor of credibility—Germany—had been compromised? Or could the euro strengthen with markets believing higher European growth rates are just over the horizon?

Global financial markets have been focused on China's serious and numerous economic and financial vulnerabilities. Should they also be focused on Germany? Or is the credibility of "Germany, Inc." so deep that global markets will assume European policymakers will figure a way out of any debt-related complication?

A selection of prominent economic strategists offer their thoughts.



I don't see how new credible rules for fiscal stability can be devised to replace the old ones.

JACQUES DE LAROSIÈRE
Former Managing Director, International Monetary Fund, Honorary Governor, Banque de France

Last March, Germany made two decisions that should be watched closely. First, it adopted an infrastructure plan worth €50 billion annually over twelve years to modernize the country in the areas of transport, energy, and more. Second, it passed a debt-financed military spending plan limited to 1 percent of GDP per year, that is, around €45 billion per year on top of the €50 billion annual defense budget.

The consequences of these unilateral decisions by Germany mean that the country will no longer comply with the Stability and Growth Pact's rule keeping public debt below 60 percent of GDP.

Germany's public debt stands at 63 percent of GDP. If the announced measures were implemented, the public debt ratio would rise to 90 percent within a few years.

This means that the imperfect and heterogeneous cooperative entity that has been the Economic and Monetary Union will become a zone without economic discipline and a block of debt whose *de facto* guarantor (Germany) will weaken. It could be argued that with a stronger infrastructure and army, Germany will be the beneficiary of this projected shift. But the weaker fiscal positions of Germany's neighbors will accelerate their problems. So the question arises: Will Germany, on top of its own financial requirements, take care of the weaker members financially?

It can be argued that this debt package will reduce the zone's structural current account surplus. Indeed, from this point of view, the German part of the Union would be in the process of normalizing and therefore the zone would benefit in terms of reducing its excess savings.

In any case, the change envisaged by the zone's leading economy represents a major paradigm shift. Given the sheer size of the budget at stake, I don't see how credible new rules for fiscal stability can be devised to replace the old.

If this is the case, the currency area—which is in fact the daily result of a diplomatic negotiation—will be exposed to financial crises and, one day, will face the credibility dilemma of Triffin.

The spreads among eurozone government bonds have remained quite stable or even fallen, which suggests that the new Stability and Growth Pact is quite credible.

LORENZO BINI SMAGHI
Chairman of the Board, Société Générale, and former Member of the Executive Board, European Central Bank

Germany's debt brake was set up in very special circumstances and probably not well designed. As a result, Germany's fiscal policy turned out to be excessively restrictive, especially in the second half of the past decade, with the debt-to-GDP ratio falling rapidly back to the 60 percent benchmark. Furthermore, domestic demand was too compressed, making the German economy excessively reliant on exports. It's fully appropriate that the rule has now been changed.

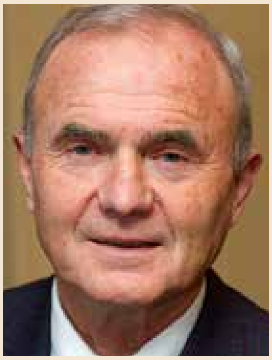
The Stability and Growth Pact has been recently revised and approved unanimously. There is no intention for other countries to break these new rules, as the memory of the sovereign debt crisis of the past decade is still vivid. This doesn't mean that it will be easy to put the debt on a downward path, especially in countries such as Italy or France, but the urgency is certainly recognized.

Not all countries have the same room for maneuver, but those like Germany that have such room should exploit it to strengthen defense spending and infrastructure investment. Germany's debt-to-GDP ratio is half that of the United States. Only five countries in the eurozone (Greece, Italy, France, Belgium, and Spain) have debts higher than 90 percent of GDP. What is important is that the dynamics of these debts are under control.

There is no need for the European Central Bank to buy German bunds or other government bonds, as the market has a lot of appetite for them. Long-term rates of all eurozone countries currently trade below U.S. rates. In fact, the ECB has been reducing its balance sheet quite rapidly, the so-called quantitative tightening, at a faster pace than that of the United States. The spreads among government bonds of the different eurozone countries have remained quite stable or even fallen, which suggests that the new Stability and Growth Pact is quite credible.

The recent appreciation of the euro suggests that markets are confident that the whole eurozone will remain stable, even in the face of external turmoil. There is no doubt, however, that Europe must implement structural reforms and further deepen its internal market to enable its companies to grow faster and invest to innovate and create jobs. This remains the priority for Europe but also the most difficult task.

Europe's problems are very different from those of China, but in any case, Europe's capital market remains amongst the most open and the rule of law is well respected. Europe has very solid companies that compete globally and are attractive to global investors. There is no political interference, comparable to that in China or more recently in the United States.



Bond vigilantes are needed more than ever, and this certainly applies not only to Germany and the Eurosystem.

OTMAR ISSING
Founding Member of the Executive Board, European Central Bank

Bond vigilantes will increasingly focus on Germany.

The reason for this is not superficial doubts about its status as one of the highest-rated countries. Such doubts will arise if the country fails to return to the sound fiscal policy of the past after the planned massive increase in public debt over the coming years. The implicit debt, especially from obligations in the public pension and healthcare systems, will also receive far greater attention than before.

The focus will be on the role of German government debt in the Eurosystem. With the start of monetary union, the interest rate on long-term German government bonds established itself as the anchor for interest rates in the monetary union. Even countries such as Italy or Greece with high government debt benefited fully from the low German interest rate level. For years, the spreads to German interest rates were barely significant.

This changed with the debt crisis in Greece and widening spreads. Following then-ECB President Mario Draghi's "whatever it takes" speech in 2012, spreads moderated substantially. Since then, bond markets have repeatedly reacted to worrying news about fiscal policy developments in individual countries with spreads occasionally moving up to around 4 percentage points, for example in Portugal (2016) and Italy (2018). The ECB's July 2022 announcement of the Transmission Protection Instrument has again calmed the markets and compressed spreads.

Immediately following the announcement of a €900 billion increase in Germany's national debt in early March 2025, interest rates on long-term government bonds in the eurozone rose by around 40–50 basis points, while spreads largely remained unchanged. This is probably the interpretation of the financial markets' assessment. The planned massive increase in public debt in Germany pushes up risk-free yields of euro debt.

Although Germany's debt ratio will rise from currently around 62 percent to presumably 80 percent and more, the markets do not see the country on the path of "convergence" towards the highly indebted member states of the monetary union. This could change if the increased public deficit spending is not coupled with decisive structural reforms, and thus fails to promote growth but instead prolongs the agony of an unsustainable welfare state and contributes significantly to price increases. In this case, risk premia could rise in Germany and euro countries with high debt sustainability risks. If the ECB in such a scenario triggered TPI, in spite of higher yields being largely caused by a worsening of fundamentals, it would risk pushing up inflation expectations.

The sooner the financial markets react to such negative developments, the more they can help warn against wrong decisions. Bond vigilantes are therefore needed more than ever, and this certainly applies not only to Germany and the Eurosystem.

A historic turning point for Germany and for Europe.

THOMAS MIROW
Former President, European Bank for Reconstruction and Development

We are experiencing an epochal break. With Russia's brutal attack on Ukraine in 2022, the post-Cold War peace order has come to an end. Now, the United States has put into doubt their longstanding security umbrella for their European allies, and has engaged in a 360-degree fight against globalization with a mounting risk of a disastrous international trade war. It is against this background that the German parliament adopted by a two-thirds majority, necessary to amend the German constitution, the legal framework for a major investment program in defense and public infrastructure.

Can Germany afford such a program? Will it endanger the country's debt sustainability?

And will it have dangerous knock-on effects on those EU countries that struggle already with very high debt burdens? This is what economists and commentators are currently trying to figure out.

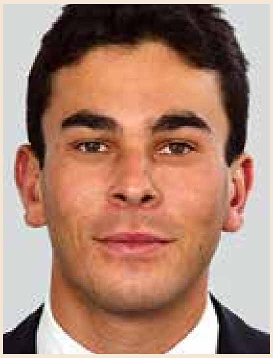
There are good reasons to believe that such a program, implemented accurately and in a timely manner, might prove a historic turning point for Germany and for Europe. Germany has had fiscal room for maneuver for some time, and for a weakening economy now is the right time to use this leeway.

For the program to be a complete success, however, important structural reforms, particularly addressing costly red tape and reducing bureaucratic burdens, need to be implemented simultaneously. In addition, supply—productive capacity—must increase as much as the financial resources. Then defense and infrastructure investments in Germany can have a significant multiplier effect and also spur higher medium-term potential growth of Europe's largest economy without inflation having to rise.

Market reactions signal that international investors are not inclined to lose their trust in Germany's financial stability. A debt ratio of between 80 and 90 percent, which is forecasted as a result of the program, is seen as unproblematic.

Considerably higher public investments in Germany, financed by debt, might also structurally strengthen the euro currency through higher economic growth but also by contributing to deepening the European financial market.

The European Central Bank's future stance will certainly depend mostly on other factors: the (difficult to forecast) impact of the current tariff conflicts on growth and on inflation, but also the willingness of France and Italy as the two other major euro economies to understand that Germany's fiscal situation is quite different from theirs and that, therefore, they are bound to finally limit their own deficits and constrain their excessive debt burdens.



PETER R. ORSZAG
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Germany's fiscal pivot is the right step at the right time.

Boosting growth and addressing European security needs should be the top priorities for German policymakers. Recent moves to lift the debt brake in service of these goals are welcome, provided the money is spent wisely. The gap in per capita GDP between the United States and Germany has more than doubled since 2005, while industrial production remains around 10 percent below its pre-pandemic level. With Russia knocking on Europe's door and U.S.-EU relations fraying, Germany's fiscal pivot is the right step at the right time.

To be effective, the fiscal expansion should channel capital into foundational infrastructure and energy projects that undergird Germany's industrial base—the sector where it has historically outperformed peers. The additional debt should not be used to finance legacy pension or defense procurement systems, which need structural reforms rather than temporary fiscal relief. And finally, the spending must be paired with labor market reforms that increase the pool of high- and low-skilled workers.

These considerations dominate concerns about the risks associated with a fiscal expansion. Germany's debt-to-GDP ratio is approximately 25 percent below the euro area average and the lowest among G7 countries. While fiscal prudence has enabled low borrowing costs and crisis resilience (such as its €1.3 trillion covid response), the rigid debt brake rules have also impeded public investment. Estimates suggest debt will reach 73 to 81 percent of GDP by 2035—still below the eurozone average—highlighting room for strategic spending without sacrificing fiscal credibility.

The costs of continued austerity are stark. Germany's economy contracted in 2023 and 2024, driven by weak household consumption, stagnating exports, and near-zero net public investment. If carried out effectively, Chancellor Friedrich Merz's adoption of a more expansionary fiscal approach could restore consumer sentiment and raise expectations for future growth.

History underscores the potential of public spending, when deployed appropriately. Post-World War II programs such as the Marshall Plan and Germany's *Wirtschaftswunder* rebuilt infrastructure and ultimately quadrupled industrial output by 1958. The easing of austerity measures tied to the Marshall Plan also reduced public discontent and diminished the appeal of communist parties across Western Europe. Merz's reforms echo this approach, aiming to modernize energy systems and reduce logistics bottlenecks to revive growth.

To be sure, Germany's fiscal expansion has costs, as underscored by Europe's interconnected debt markets. On the day Chancellor Merz announced the debt brake reform, the ten-year bund yield rose by 40 basis points—the largest daily increase since its 1990 reunification—with Italy, France, and Spain seeing surges of 25–40 basis points. Yet yield spreads across Europe have stabilized well below eurozone crisis peaks (Italy and Germany: around 100 basis points today versus around 500 basis points in 2012). As one Spanish official noted, "When Germany's debt cost rises, everyone else's does too."

Moments like this are precisely when it is worth running a bit of fiscal risk. By far the larger risk for Europe is to be stuck in a lower growth trajectory or to fail in bolstering its own defense.

Germany's increased investment in defense and infrastructure is a welcome shift. The continent has finally stopped sleepwalking.

MICHAEL HÜTHER
Director, German Economic Institute

For years, Germany faced international criticism for underinvesting in infrastructure and defense. Institutions such as the International Monetary Fund warned that chronic underinvestment threatened economic growth, while U.S. administrations accused Germany of free-riding on American military deterrence while prioritizing social spending. In fact, a peace dividend of over €600 billion was cashed in the last thirty years.

Germany's rigid fiscal framework, particularly the debt brake, has proven inadequate for investment needs even in normal times. Demographic pressures and weak growth further constrain fiscal capacity, with local governments struggling under high debt and investment demands. In this context, the government's €500 billion infrastructure fund over twelve years was both necessary and urgent, also signaling the private sector to expand its productive capacity.

However, inflationary pressures remain a concern due to Germany's limited production potential and demographic trends that could create capacity bottlenecks. Expanding the labor force is crucial, requiring measures such as discouraging early retirement, introducing flexible retirement models, incentives for extending annual working hours, and more managed migration into the labor market.

For Europe, Germany's increased investment in defense and infrastructure is a welcome shift. The continent has finally stopped sleepwalking through geopolitical realities and must take greater responsibility for its own security and economic resilience. As Europe's largest economy, Germany plays a key role.

The benefits outweigh the slight rise in credit risks. Our projections show that Germany's debt-to-GDP ratio rises moderately to just over 80 percent in the 2030s, still low by international standards and with respect to the challenges to be addressed (including restoring defense capability and strengthening competitiveness to enable decarbonization). Interest payments will remain manageable at an estimated 17 percent of government revenues, well below late 1990s and early 2000s levels. While bond yields have risen, they remain moderate compared to other European countries and, especially, to the United States. Additionally, fiscal improvements in Greece, Spain, and Portugal since the euro crisis bolster European stability.

Adapting the Stability and Growth Pact to new geopolitical realities—such as the Commission's decision to exclude defense spending from fiscal rules—is a prudent step. Nevertheless, beyond fiscal flexibility, stronger cooperation in European defense policy and procurement is essential for scaling in military production and the reduction of unit costs.

Germany and Europe's future hinges on two key areas: bolstering defense capabilities and ensuring economic competitiveness to attract private investment. Investments in defense and infrastructure, especially driven by Europe's biggest economy, will strengthen Europe's strategic position, ensuring security and long-term economic stability amid global challenges like deglobalization, protectionism, and geopolitical risks.

The first step has been taken. Now Europe, including the German government, must use this opportunity wisely through a comprehensive agenda for structural reforms. Former ECB president Mario Draghi's report on the future of European competitiveness not only provides the analytical basis for this, but also offers guidance for the necessary measures. It seems as if the EU Commission has understood this. The new German government will still have to find its way.

European countries that already have high public deficits may find it hard to meet the new geopolitical expenditure needs.

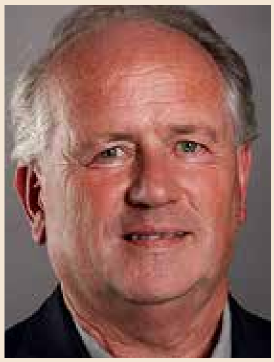
EWALD NOWOTNY
Former Governor, Oesterreichische Nationalbank

Germany implemented a constitutional debt rule ("debt brake") in 2011, limiting federal deficits to 0.35 percent of GDP and state deficits to zero percent of GDP. In March 2025, the German parliament agreed to effectively exempt defense-related spending from the provisions of the debt brake and approved the creation of a €500 billion investment fund, to be spent on long-neglected infrastructure and measures to combat climate change over the next twelve (!) years. From a historical perspective, this step can be seen as a justification of the country's traditionally strict/cautious fiscal stance, which allows it to loosen fiscal policy when needed. Considering the dramatic geopolitical shifts in recent years, this time of need has arrived now.

In the political sphere, the new fiscal stance may mean that Germany is reawakening and getting ready to provide the economic, political, and defense initiatives that Europe needs. How much of an impact this will have on the economy crucially depends on the quality and dynamics of implementation. At least over the next few years, a large share of military spending will involve imports from the United States. In the medium term, however, the new spending programs should lead to a stronger and better-coordinated European defense industry—and promote technological progress at large.

The new fiscal policy stance is expected to stimulate growth in Germany, which will, in turn, have positive effects for the other EU member states. This is especially relevant in light of the wide range of technological and export challenges facing Europe. The new stance may be expected to counteract potentially negative economic outcomes and should not lead to major increases in inflation.

With regard to capital markets, long-term bond yields have been on the rise for a number of reasons, leading to a steepening yield curve. Germany, given its inherent strengths, will remain a safe haven—but with the positive side effect of a broader and more liquid market for German bonds in future. A more difficult constellation is to be expected for other European countries. Those that already have high public deficits may find it hard to meet the new geopolitical expenditure needs. The EU Commission is addressing these challenges with its ReArm Europe, now Readiness 2030, program. While there are, indeed, numerous open questions regarding the details, the recent German policy decision may help provide answers to at least some of them.



The ECB will not be needed, even if the other European countries take on more debt themselves.

HEINER FLASSBECK
Director, Flassbeck-Economics, and Former Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

Germany is only in a unique position with its debt because it has been running a massive current account surplus of around 6 percent of annual GDP since the mid-2000s. The "party of expansion" among Germany's European neighbors has nothing to do with expansion, but rather with the fact that in a world in which private households and companies are net savers, the state has to take on the debt necessary to stabilize demand. This is imperative if you cannot run a current account surplus yourself, because the largest European country already occupies this role.

The result of Germany's new expansionary policy is certainly not a problem for the financial markets, as there is no alternative to the country, which will still have very low debt ratios even after the political U-turn. Take note of the situation in the United States, where even a much more expansionary policy and much higher debt ratios are easily digested by the markets. There, too, there simply is no alternative to government bonds as a rather safe asset in private portfolios.

When households and companies save on balance and the country has a current account deficit, the only investment opportunity for the collected savings is the state. It is extremely naive to believe that lenders in the United States could do without the state or—apart from a few days—put it under pressure by selling government bonds. Not only would they suffer huge interest losses, they would also run the risk of the central bank intervening and putting a quick end to the market turbulences.

So the European Central Bank will not be needed, even if the other European countries follow Germany's example and take on more debt themselves, so that the European debt ceiling of 60 percent of GDP is ultimately abandoned. This debt ceiling was never justified and, at a time when there are no longer any private debtors in the economy as a whole, it is nothing more than a ridiculous relic from an unenlightened age.

The euro will become stronger as a result of this operation because the U.S. administration is doing everything it can to eliminate the U.S. current account deficit, which will ultimately only work if the U.S. dollar depreciates. Furthermore, European debt levels are low compared to those in Japan and the United States, although, as explained above, the "markets" have to learn sooner or later that this is simply the wrong measure for assessing the solidity of an economy.

Other countries in Europe will not follow the German example. They do not have the fiscal space for it.

HOLGER SCHMIEDING
Chief Economist, Berenberg

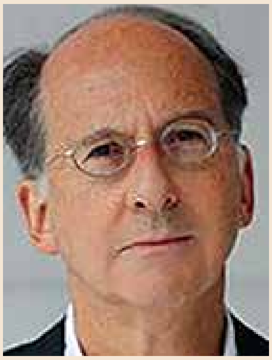
In its own bumbling way, Europe is finally getting its economic act together. Not perfectly at all, but much less badly than its top two global partners and rivals. By mid-April, less than three months after again taking office, U.S. President Donald Trump had destroyed almost all the global soft power which the United States had built up over eighty years. For a country with a persistent fiscal deficit of close to 7 percent of its GDP, his policy of undermining the trust of global investors while harming trend growth through high tariffs and fewer immigrants is a recipe for a painful fiscal reckoning in the future.

In China, the red emperor continues to squander capital on a grand scale by steering it into high-tech sectors which he considers relevant to eventually match the military might of the United States. The low return which China earns on its often state-subsidized or directed investment is the major reason why its citizens need to save so much to provide for their future.

In Europe, the pivotal country in the middle, Germany, is finally assuming the role it should have played for the last twenty years. Trying to correct a long period of underinvestment, Germany is ramping up defense and infrastructure spending. Some of that new money will be wasted, and opportunities to save costs will be missed. Unfortunately, that seems to be par for the course in any political system. However, some of it will help to strengthen the country. Together with some deregulation and a few other supply-side reforms, this could turn Germany into a normal growing economy again after three years of stagnation. And if Germany gets going, possibly after a trade-war hiatus first, it will help to lift the economic and fiscal outlook for other European countries, for whom Germany is typically the top trading partner.

With its low public debt burden, Germany can afford the new largess. Even if its debt-to-GDP ratio rises from its current 63 percent to some 75 percent within ten years, as seems plausible, that would still be only slightly more than half of the ratio which the United States may reach on its current policy trajectory. As long as Germany does not overdo its new borrowing, a somewhat deeper and more liquid market for Europe's top safe asset, the German bund, can even attract more capital into Europe.

Other countries in Europe will not follow the German example to any significant extent. They do not have the fiscal space for it. Most of them are further removed from the Russian threat than Berlin. And in most of them, citizens and businesses have better access to high-speed internet and the trains are more punctual than in Germany. They have less need to scale up their infrastructure spending as radically as Germany. Despite some likely waste of money and a need for further reforms to deal with the fiscal consequences of its aging society, the fact that Germany has modernized its fiscal straitjacket is good news for Europe and its financial markets.



Germany has enormous fiscal space. If it efficiently manages increased fiscal resources, it will bode well for a stronger economic future.

MARK SOBEL

U.S. Chair, Official Monetary and Financial Institutions Forum, and former Deputy Assistant Secretary for International Monetary and Financial Policy, U.S. Treasury

Germany has a long and enviable track record of adhering to stability-oriented policies.

In recent years, the German growth model's shortcomings came home to roost. After the global financial crisis, with an undervalued real German euro, lowflation, budget balance, high if not excessive national saving, and restrained domestic demand, Germany relied on its external sector and massive current account surpluses to support growth. In doing so, Germany reinforced a deflationary bias for the rest of the eurozone, especially during the euro crisis, and excessively absorbed global demand. Infrastructure needs were often not tackled. Defense spending remained below the NATO 2.0-percent-of-GDP target.

Then, the pandemic and Russian President Vladimir Putin's barbaric invasion of Ukraine took an added toll. Germany had to quickly halt outsized reliance on Russian energy. Its export-oriented growth model floundered amid slowing global growth and competition from China's further surge as a manufacturing and car-producing powerhouse. Growth stagnated.

The Olaf Scholz administration sought to address aspects of Germany's broken growth model, including through its *Zeitenwende.* But it was hamstrung, significantly because of a fractious coalition and strong opposition to abandoning the *Schuldenbremse* from the Free Democrats and Friedrich Merz's CDU.

In now calling for jettisoning the debt brake and massively increasing infrastructure and defense spending just as he enters office, Merz may look extremely hypocritical. That's hardly a first for a politician. But given Donald Trump's disgraceful blasts against Europe, shameful siding with Russia, and hugely misguided thinking on tariffs, Germany has legitimate reasons to doubt America's willingness to continue acting as a reliable partner—and that Merz, an avowed trans-Atlanticist, voiced these doubts so publicly adds legitimacy to the deep worries.

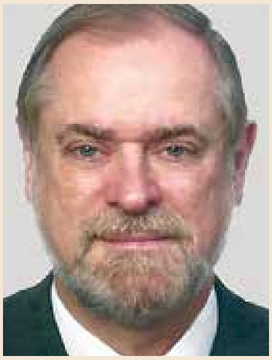
Germany has enormous fiscal space. It faces large infrastructure, climate, and defense spending needs. The proposed changes in fiscal policy will unfold over coming years. If Germany efficiently manages increased fiscal resources, it will bode well for a stronger economic future. That is in the interests of Germany, Europe, and the world.

Longer-term German rates have not risen much on the announcements and global investors will happily load up on bunds. Germany taking more responsibility for Europe's defense is highly welcome, especially given Putin's repugnance and Russia's threats. Germany's *volte-face* in no way absolves other EU members from pursuing necessary reforms.

Despite this splurge, Germany is not going to abandon its longstanding commitment to *ordnung und stabilität.* The ECB has strong credibility and can manage side effects.

It is extremely regrettable and depressing that Germany's abrupt radical change has been motivated by President Trump's apparent intent on tossing away America's remarkable—albeit imperfect—soft and hard power.

But whether due to America's self-defeating foolishness or CDU opportunism, Germany's changed position on defense and the debt brake is highly welcome.



Germany's planned debt expansion presents both opportunity and risk.

KLAUS F. ZIMMERMANN

Professor Emeritus, Bonn University, President, Global Labor Organization, and former President, German Institute for Economic Research

The United States' recent turn toward isolationism is reshaping the global political, economic, and military order. Its shifting stance toward Russia and erratic tariff policies have undermined confidence in U.S. leadership. Beyond diplomacy and security, the U.S. dollar's role as the world's reserve currency is now less certain. As global trust erodes, new trade zones and investment patterns are likely to emerge, disrupting long-established flows of goods, services, and capital.

Even if some of the erratic and economically unsound policies of Donald Trump are partially reversed, the global community is unlikely to forget the instability they introduced. This has already set in motion a reorientation of international relationships, with long-term consequences that will reshape alliances and economic partnerships.

Germany's debt brake, or *Schuldenbremse,* has proven to be an asset, since the low level of debt is now enabling the country to invest heavily in military equipment and growth-oriented infrastructure. Designed to prevent fiscal mismanagement, this mechanism must be preserved in a structurally sound manner for the long term.

Both Germany and the European Union are well-positioned to leverage the challenges posed by the new American policies to stabilize and enhance their own position. The size and innovative capacity of European markets provide a solid foundation for establishing new free trade zones with emerging economies.

As the issuer of the world's leading reserve currency, the United States has long relied on global financing of its national debt, particularly from countries such as China and Japan. Europe now faces both an opportunity and a risk in tapping into these financial sources for its own development. It is anticipated that China, among other nations, will strategically exploit these challenges by investing capital in Europe. Germany's central role in this dynamic process underscores the need for global financial markets to closely monitor its developments.

Germany's planned debt expansion presents both opportunity and risk. If the spending spurs growth in defense, technology, and infrastructure, the euro could strengthen as markets anticipate long-term European competitiveness. But poor execution would damage Germany's reputation and shake confidence in the euro as Europe's financial anchor.

For years, markets have scrutinized China's debt and political risks. But Germany's evolving fiscal strategy now deserves equal attention. "Germany, Inc." still commands investor confidence, but that trust depends on translating debt into innovation and resilience. If successful, Germany can reinforce European stability and help reshape a more multipolar global economy. If not, it risks undermining the very foundation of European financial credibility.

In short, the global economic balance is shifting—not just because of American missteps, but also due to how others respond. Germany's choices in the coming years will carry outsized weight. Stability in Europe, and confidence in the euro, now rest on its ability to adapt without abandoning the fiscal discipline that once defined it.

Markets should welcome Merz's move to stimulate Germany's sluggish economy—and Europe's—as uncertainty surrounding Trump's punitive tariffs is chilling global growth.

PHILIPPE LEGRAIN
Senior Visiting Fellow, European Institute of the London School of Economics and Political Science, and former adviser to European Commission President Jose Manuel Barroso

It seems odd to be discussing Germany's potential fiscal vulnerability at a time when President Trump's policy vandalism, notably on trade, is undermining trust in U.S. Treasury bonds as the ultimate safe haven in a storm. Far from worrying about a long-overdue borrowing spree to fund much-needed investments in defense, infrastructure, and climate measures, markets should welcome Friedrich Merz's move to stimulate Germany's sluggish economy, and the rest of Europe's, at a time when the uncertainty surrounding Trump's punitive tariffs is chilling global growth and challenging Germany's export-led growth model. In the short term, the boost to domestic demand will mitigate the hit from Trump's tariffs; in the medium term, a larger defense and construction sector, together with stronger neighboring economies, can help provide an alternative to manufacturing for the unreliable U.S. market.

Likewise, it seems bizarre to be talking about the rest of Europe "abandoning any last vestiges of restraint" at a time when U.S. fiscal policy is so reckless, and likely to become more so. For sure, governments such as France and Italy have much less scope to borrow than Germany does. But while EU fiscal rules are being eased for four years to permit higher borrowing for defense, market discipline is such that neither France nor Italy are planning their own additional borrowing spree. Given their fiscal constraints, and the huge global demand for alternatives to not-so-safe U.S. Treasuries, now would be the ideal time to launch a big push for joint EU borrowing for defense.

Given that Germany and other fiscally frugal northern European countries are also among those most worried about the threat from Vladimir Putin's Russia, the political obstacles to such a move are lower than ever. And if the likes of Hungary's pro-Putin prime minister Viktor Orbán try to veto the move, a special-purpose vehicle independent from the European Union could be established instead. This would have the added benefit of allowing non-EU partners such as the United Kingdom and Norway to participate too.

In these troubled economic times, the one thing to be optimistic about is Germany's recent decision to lift its debt brake.

DESMOND LACHMAN
Senior Fellow, American Enterprise Institute

In these troubled economic times, the one thing about which one can be optimistic is Germany's recent decision to lift its debt brake. That should allow Germany to provide a much-needed fiscal stimulus to both the German and European economies. It should also allow Germany to address its infrastructure and investment deficit as well as to reduce its large current account surplus which has been a great cause of trade friction with the United States.

As a highly export-intensive economy, Germany is particularly vulnerable to the marked slowdown presently underway in the Chinese economy following the bursting of that country's epic housing and credit market bubbles. It is also vulnerable to the Trump administration's aggressive import tariff policy. This has left Germany with little alternative but to engage in budget pump-priming if it wants to emerge from its two-year long economic recession. With a public debt ratio of around 60 percent of GDP, Germany is fortunate to have ample fiscal room to run a meaningful budget deficit for some time without having to be concerned about debt sustainability issues.

A budget stimulus should allow Germany to once again serve as the locomotive for the rest of the European economy. That in turn should provide some relief to the French and Italian economies. France and Italy presently have higher public debt-to-GDP ratios than they did at the time of the 2010 eurozone debt crisis and seem to lack the political will to address their public sector imbalances.

The lifting of Germany's debt brake also offers a glimmer of hope that it can reduce trade tensions with the United States. By stimulating investment and reducing national saving through an expansionary fiscal policy, Germany can plausibly make the case that it is doing its part to reduce its large current account surplus. It could also argue that it is doing its part to help weaken the dollar by reducing pressure on the European Central Bank to reduce interest rates to support the European economic recovery.

All of this is not to say that Germany's actions alone can get the world out of the present economic mess in which it now finds itself. For that to happen, the Trump administration would need to dial back its present policy of aggressive import tariff hikes and massive tax cuts and show some international economic leadership.

Germany is in decline, and the long-term outlook is bleak.

JAMES K. GALBRAITH
Lloyd M. Bentsen, Jr., Chair in Government/Business Relations, LBJ School of Public Affairs, University of Texas at Austin, and author,* Entropy Economics: The Living Basis of Value and Production *(University of Chicago Press, January 2025)

Though still the largest economy in Europe, Germany is in decline. Her neglected infrastructure is decayed, thanks to the debt brake. She has renounced nuclear power and Russian gas, in favor of unreliable renewables and expensive liquefied natural gas. Her industries are closing down factories and plants; many of her venerable firms are going bust. And now, facing failure in Ukraine, she has decided to rearm—a colossal and pointless waste undertaken solely for political reasons.

Germany's army and armaments cannot hope to meet Russia head-to-head and prevail—in a war that Russia will never initiate with NATO and that will turn nuclear in minutes if fought on Russian soil. Much of her money will be paid to American contractors, deepening trade woes while restoring neither industry nor infrastructure, and doing nothing for competitiveness in world markets. German living standards, already falling, will continue to fall.

Germany and Europe need a peace treaty, reliable energy, renewal of civilian infrastructure, and an economic strategy rooted in integration with Eurasia. It may be too late; the well is already poisoned. The Chinese and Russians, along with India, Iran, and other rising powers, can get along without Europe—or Germany, in particular. The converse does not hold.

Germany's suicidal policies—aided by destruction of the Nord Stream pipelines by (you can be sure) drunken Ukrainian amateur divers jumping from a sailboat into cold Baltic waters eighty meters deep—have already driven the euro down from a 20 percent premium to the dollar in 2021 to near parity in early 2025. In recent days, the dilemmas facing Germany and Europe are overshadowed by chaos coming from Washington, and the euro has been recovering—a bit. In the nature of chaos, short-term predictions are foolish. But the long-term outlook is bleak.

Forget talk about high debt levels in Europe. What matters is the long-term cost of borrowing.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Incoming Chancellor Friedrich Merz may be turning outgoing Chancellor Olaf Scholz's make-believe *Zeitenwende* into a reality that is long overdue. The constitutional debt brake mesmerized Germans for years into believing they could do nothing to arrest their country's decline into danger and decay. Now that the debt brake is broken, Germany has a chance to lead an invigorated European economy and a muscular response to Russian President Vladimir Putin's brazen aggression. Where Germany goes, the rest of Europe should follow.

Forget talk about high debt levels in Europe. What matters is the long-term cost of borrowing. Even after Merz's big announcement, German interest rates are below 1 percent in real terms across the entire term structure. Even Greece is able to issue ten-year bonds at a real rate of only 1.5 percent. Future generations have far more to gain from a secure continent and modern climate-friendly infrastructure than they will lose from debt yielding 1 percent. If Europe can manage real growth of as little as 1 percent, the debt need never be repaid and will not snowball into a crisis.

Of course, this does not mean there are no limits to public borrowing. If governments borrow more than markets currently expect, interest rates will rise. In large part, it would be the job of the European Central Bank to manage that rise in interest rates as it defends its mandate of price stability. At some point, the cost of borrowing may exceed the social benefits. But we are far from that point today.

Merz's gambit was sparked by U.S. President Donald Trump's tilt toward Russia and against Ukraine. Ironically, Merz may have Trump to thank for making it easier to finance his borrowing binge. The Trump administration's erratic tariff policies have scared global investors, who are fleeing U.S. assets and flocking into Europe. The euro recently hit a three-year high against the dollar. Euro strength will allow the ECB to keep lowering interest rates this year, further reducing the cost of public borrowing throughout the euro area.

Germany is finally rising to the challenge.

PIROSKA NAGY MOHÁCSI
Visiting Professor, London School of Economics and Political Science

Europe faces two existential threats: poor military preparedness on the one hand, and economic decline on the other. The nature, urgency, and scale of these two threats require that the fight against them be specifically linked and placed at the center European policymakers' agenda and action. Germany is best placed to drive this combat.

The first grave threat comes from Russia, particularly as the U.S. security umbrella provided since the Second World War appears to be rapidly weakening. The second threat is from what former ECB President Mario Draghi called in his 2024 report on European competitiveness the "slow agony" from Europe's growing productivity and innovation deficits *vis-à-vis* the United States and China and related worsening competitiveness.

European leaders appear to be more readily recognizing the urgency of, and acting upon, the military challenge. But Europe's survival demands that the second threat of economic decline must also be addressed and intertwined with action on the military front.

By necessity, the military sector should be the engine of Europe's re-modernization and growth.

History provides ample examples of efforts to link military and economic development. Some succeeded and some failed. A successful modern example comes from Israel, which, notwithstanding its idiosyncratic circumstances, can offer some important lessons.

Since its founding in 1948, Israel has had to link its defense priorities with economic policy, producing an impressive "defense–development nexus" that has evolved over time. Following an early period of state-led military industrialization and rapid infrastructure building, more recently a "start-up nation"-type military-economic development evolved, where military institutions fuel high-tech innovation and human capital development.

Key elements of this strategy include (i) high defense spending with large research and development subsidies particularly in high-tech areas; (ii) significant dual-use (military and civilian) state investment; (iii) procurement rules for the military sector that require significant local components to spur domestic spillovers; (iv) specific state programs to bridge in multiple ways the military and the tech sectors; (v) making the defense sector an engine of export-led growth; and, importantly, (vi) using the country's military service to diffuse high tech innovation for post-service civilian life. Some 90 percent of high-tech employees are military veterans (which is very high given the overall conscript rates of around 50 percent). In addition to know-how transfer, this has also provided the soft power of networks and team-building skills for civilian use.

Germany should be at the center of Europe's transformational strategy. It is the largest European economy, the host of many of the continent's global/regional supply chains, and enjoys low public debt levels and high domestic savings. The success of its economic transformation away from the manufacturing and automobile industries and Russia-dependent energy consumption will determine the fate of much of rest of Europe.

Germany is finally rising to the challenge. It has managed to rid itself of some of its former policy taboos. It has increased military spending in the wake of Russia's war on Ukraine and, crucially, recently eliminated its the constitution-enshrined debt limit with regards to defense and infrastructure spending. But it still suffers from serious underinvestment in digitalization and physical infrastructure in key areas. Both its supply and demand side issues argue for major transformational policies. It now needs to link nationally, and across Europe, the economic imperative with the military imperative.

For it to be truly transformational and cost-effective, this defense strategy must be embedded in a pan-European defense system, such as recently presented by the influential Brussels-based think tank Bruegel (Wolff, Steinbach, and Zettelmeyer, 2025). Their proposal for a European Defense Mechanism can include critical non-EU member countries such as the United Kingdom, Norway, and battle-hardened Ukraine.

The continent's central bank, the European Central Bank, headquartered in Frankfurt, Germany, can also help the process at the margins. Funding accelerated military re-development will affect Europe's nation states differently and may also impact the level of interest rates. To the extent that Europe's focus will now be a military-led redevelopment—or worse, a hot war—ECB purchases of sovereign or European-level bonds that fund this effort will likely become necessary (for non-euro area members via permanent currency swaps). Central banks were, after all, created to finance wars, and have participated in contributing to the mix of war finance instruments ever since. A confluence of bad scenarios may sadly necessitate their involvement, and central banks need to stand ready with the necessary processes and guardrails.

In a world of excess savings, governments must borrow aggressively from the private sector and deploy those funds to sustain demand.

CHEN ZHAO

Chief Global Strategist, Alpine Macro

Germany's decision to increase spending on infrastructure and defense marks a major policy breakthrough. For too long, its economy has suffered from excess savings, leading to prolonged stagflation. The German private sector saves 8–9 percent of GDP more than it invests, recycling these surplus savings abroad through large trade surpluses. However, with protectionism rising, Germany's reliance on net exports for growth is no longer sustainable. Ramping up public spending is now the only viable path to escape stagnation.

The Maastricht Treaty was signed in 1992 when inflation was Europe's primary threat. Today, the opposite is true—and concerns over debt and deficits are "much ado about nothing." Consider:

- U.S. public debt has tripled since 1980, yet interest rates have plummeted (both nominally and in real terms).

- Japan's debt-to-GDP ratio exceeds 200 percent, with budget deficits of 6–7 percent of GDP for thirty-plus years, yet rates have stayed near zero or negative for decades. Only recently have Japanese rates moved up more sustainably than before.
- China's debt-to-GDP ratio has surged from 30 percent to 90 percent since 2010, but interest rates have fallen below 2 percent.

The lesson is clear: In a world of excess savings, there is no such thing as "fiscal risk premium." Quite the opposite: governments must borrow aggressively from the private sector and deploy those funds to sustain demand. This is the only way to avoid chronic stagnation or deflation. Germany's move away from self-imposed austerity is a welcome—if belated—step.

Finally, Germany can self-finance its €1.0 trillion spending package, but other eurozone economies may not be able to. The deeper issue is the need for a fiscal union to preserve the euro's integrity—a longstanding unresolved challenge. As for debt monetization by the European Central Bank, the answer hinges on the economic context: if the eurozone faces deflationary risks and stagnation, the ECB should lower rates and monetize debt. If, however, excess demand and inflationary pressures are the problem, the ECB should raise rates and shrink its balance sheet.

For now, this debate is premature. What matters is that Germany—the eurozone's anchor—is finally adopting policies fit for today's economic realities.

Germany's fiscal reset is a welcome step and the warnings of budget hawks are overdone.

NEIL SHEARING
Group Chief Economist, Capital Economics

Germany's new government has taken a historic and positive step by reforming its strict fiscal rules—historic because it acknowledges Europe can no longer rely unconditionally on U.S. security support, and positive because it loosens the fiscal constraints that have contributed to a post-pandemic stagnation in Germany's economy. Yet the macroeconomic and financial impact may be more limited than many expect.

While attention has focused on increased defense spending, the reforms are broader. Plans include a €500 billion deficit-financed infrastructure fund and new rules allowing federal states to run small deficits. All told, the additional fiscal support might amount to about 1 percent of GDP a year over the rest of this decade. With growing uncertainty over U.S. security commitments, increased defense spending is necessary, but the poor state of Germany's infrastructure has also been a key drag on growth. These reforms begin to address both issues.

Fiscal hawks warn that deficit-financed spending threatens the long-term sustainability of Germany's public finances, but such concerns are misplaced. Germany's public debt is low by G7 standards, making it one of the few major economies in the world with space to loosen fiscal policy. Moreover, an increase in Germany's budget deficit will, all other things being equal, reduce its current account surplus—thus helping to alleviate a key "surplus" component that has contributed to global (and regional) trade imbalances.

The main reason for caution is more practical. Defense and infrastructure spending will take time to materialize. The initial focus will be on identifying "shovel ready" investment projects, but these are notoriously difficult to find. Likewise, it will be difficult to increase defense spending rapidly. The order backlog at Rheinmetall RHM, Germany's largest supplier to its defense industry, is currently equivalent to around three years of its annual turnover.

Moreover, the so-called "fiscal multiplier" for defense spending—which measures the bang for buck in terms of GDP—is typically quite low. The overall boost to annual GDP growth might be something like 0.5 percentage points a year. That would be significant, but still only enough to raise the annual pace of growth to around 1.0–1.5 percent.

Germany's fiscal expansion is good news for Europe, but its broader impact will be limited. While Germany is clearly important, it accounts for only one-third of eurozone GDP. So a 0.5 percentage-point boost to GDP growth in Germany might boost eurozone GDP growth by around 0.2 percentage points.

What's more, while Germany's shift may generate a permissive attitude toward fiscal policy in Europe, the reality is that most countries have limited space to increase borrowing. Indeed, the embrace of looser fiscal policy in Germany could compound the challenges facing fiscally constrained countries in the rest of the eurozone since the rise in bund yields (that is, the risk-free rate in the eurozone) is likely to push up borrowing costs everywhere but without the attendant benefits of higher economic growth.

Accordingly, while the economic consequences for the rest of Europe should be positive, they are likely to be more muted than some expect. Germany's fiscal reset is a welcome step and the warnings of budget hawks are overdone—but expectations of a swift economic boost in Germany and Europe more generally should be tempered.

Other currencies must now get bigger as the dollar declines.

CHRISTOPHER WHALEN
Chairman, Whalen Global Advisors

Is the fact that Germany has discarded its debt brake, the so-called *Schuldenbremse* enshrined in the German constitution, a problem for the European Union or the world? No. It is the natural evolution as the dollar system ends.

Many observers cling to the seventy-five-year-old post-Bretton Woods mindset, which supposes that the dollar is the stable global benchmark and other nations must exercise fiscal discipline to say within the guardrails defined by Bretton Woods. But the United States largely violated the key principles of Bretton Woods from the outset, thus other nations are forced to follow suit.

Many people think that Bretton Woods ended on August 15, 1971, when President Richard Nixon shut the "gold window," suspending dollar convertibility. "Although it was not Nixon's intention, this act effectively marked the end of the Bretton Woods system of fixed exchange rates," wrote Atish Rex Ghosh in a 2021 commentary for the Federal Reserve Board.

But is this really correct? In fact, I argue in *Inflated: Money, Debt, and the American Dream* (2025) that the United States effectively abandoned the ideal of price stability in 1933, when President Franklin Delano Roosevelt devalued the dollar and seized all private gold holdings. The gold that sits in Fort Knox today was stolen from the members of the Federal Reserve System and private citizens by the socialists who populated FDR's New Deal. But FDR's terrible deceit only worsened the Great Depression and led us into the Second World War.

Contrary to the popular post-war history since 1945, the United States has never subscribed to any limits on fiscal spending or inflation. The constant in U.S. history is that Americans don't like paying taxes. While conservatives have given rhetorical support to "price stability," the actual behavior of most American governments since World War II has been pro-inflation. Also, when we add the behavior of China to the global monetary equation since the 1970s, how does any other major nation resist the temptation to inflate?

The debate over the tariffs imposed by President Trump in 2025 illustrates the problem. In the pre-Bretton Woods world, the worry was that nations would devalue their currencies to increase nominal economic growth even as they lost ground in real terms, the proverbial race to the bottom. But in the fiat world created by FDR and confirmed forty years later by President Nixon, competitive inflation is the new paradigm. Get big as a currency or die.

Germany's abandonment of fiscal probity is not about Donald Trump or the Ukraine War. With the United States reaching the end of its tolerance for debt and inflation, other nations around the world will be compelled to inflate their currencies and economies to remain competitive. Remember, usage of the dollar as the global reserve currency has grown since the 1970s. Other nations use the dollar as a means of exchange not because Americans are inflation hawks, but because the dollar is the biggest global currency. Other currencies must now get bigger as the dollar declines.

Every crisis presents an opportunity. Trump's "America First" nationalism may force Europe to adapt to a multipolar world.

JOSEF BRAML
European Director, Trilateral Commission, and co-author with Mathew Burrows,* World to Come: The Return of Trump and the End of the Old Order *(Brixton Ink, 2025)

It was no mere coincidence that on the day Donald Trump's presidential election victory was announced, the governing coalition in Germany collapsed. The then-finance minister and leader of the libertarian FDP party, Christian Lindner, stuck to the austerity course, while Chancellor Olaf Scholz could no longer ignore the fact that Trump's return to the White House would require a dramatic realignment of Germany's post-war foreign policy, which would cost a lot of money.

Unfortunately, Scholz and his predecessor Angela Merkel let eight valuable years pass in which they could have prepared Germany and Europe for a foreseeable development. While Merkel recognized that Germany would "no longer be able to rely on America," she did not take any measures to adequately protect Germany's security and prosperity.

It is now up to Friedrich Merz, Merkel's long-time party rival and future chancellor, to make up for the failures and lead Germany and Europe into a new world order without Pax Americana. This will be all the more difficult since U.S. President Trump has not only terminated the transatlantic bond, but also wants to destroy the other pillar of German foreign policy, European unity. By endorsing certain anti-European parties across various EU countries, Trump, along with his associates JD Vance and Elon Musk, appears to be attempting to create divisions within Europe to gain more influence over its separate components.

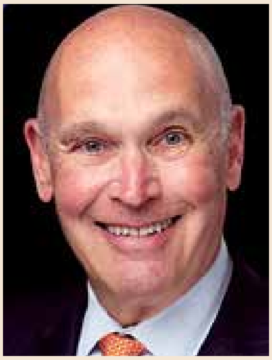
Every crisis presents an opportunity. Trump's "America First" nationalism may force Europe to address its strategic weaknesses and adapt to a multipolar world. Europe will need to defend its interests against the United States as Trump adopts a transactional approach with other powers.

Common debt could support Europe's defense and help finance Ukraine's reconstruction, balancing guns and butter, that is, military and social expenditures. Instead of using their foreign exchange reserves and savings to invest in U.S. debt and boosting the military-industrial complex, European countries and investors could focus on strengthening their currency, security capabilities, digital infrastructure, and future technologies in preparation for increased competition.

Given the vast U.S. government debt, a deep, liquid market of safe EU bonds would offer international investors an opportunity for risk diversification. Investors could park their money in euro-denominated bonds instead of U.S. Treasury bills. With a growing government deficit and rising interest rates, the U.S. fiscal situation is becoming increasingly untenable. By investing their capital reserves in the euro and strengthening Europe economically and militarily, the "old" continent could prepare itself for a world of geopolitical competition.

In this new world order, characterized by geoeconomic and geopolitical risk, only European unity can provide the necessary market power and options for action to ensure the continent's self-determination. However, before Trump's "second coming," terms such as "strategic independence" and "autonomy" have only concealed the European Union's insufficient decision-making and competencies that urgently need reform.

If the Europeans really seize this historic opportunity, then they should also have the courage to nominate Trump for the Charlemagne Prize. In order not to hurt his feelings, he should be honored for this alone, although Russia's Vladimir Putin and China's Xi Jinping certainly will also have helped Europeans overcome their nationalist vanities through their threats and actions.



In today's geopolitical environment, an expansion of the debt-to-GDP ratio is an unfortunate requirement for economic and national security.

FRANCIS J. KELLY
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Somewhere in Germany, a sly political pundit is probably creating a red baseball cap to be sent to President Donald Trump with the letters "MGGA" emblazoned across the front. "MGGA" would stand for "Making Germany Great Again"—because that is precisely what President Donald Trump set in motion with his new tariff regime, his broad policy of determined disengagement with Europe, and his goal to force a rough peace accord in Ukraine.

All of these factors have triggered, I believe, Germany's own version of "Liberation Day." Combined, they have forced the country's political establishment to boldly abandon its long-respected debt brake and approve more than €1 trillion in much-needed infrastructure spending and even more badly needed defense spending. This in turn will be heavily based on advanced technology that will have significant and quite positive commercial spin-off effects on Germany's long-term economy.

But the question now is whether this will encourage a potentially massive wave of sovereign debt issuance within the European Union in a race to compete with Germany. And won't this have an adverse impact on the euro? In my view, the answer is no. Indeed, the timing could not be better for Germany and the rest of the European Union to embrace more fiscal spending. The Trump tariffs alone have forced markets to look to the euro and the European bond markets as new safe havens, and that is not likely to change in the near term.

Moreover, for years economists and politicians on both sides of the Atlantic have fretted over Europe losing its competitive edge and its inability to build a robust defense capability. Recall Brussels was concerned enough to commission in 2024 former European Central Bank President Mario Draghi to draft a 400-plus page report detailing Europe's competitive failings and ways to fix them. Draghi explicitly stated that Europe's reliance on cheap Russian energy, boundless Chinese markets, and U.S. security is over.

Now Germany has stepped up to that challenge and put its money where its mouth is with the election of its new chancellor, Friedrich Merz. My guess is that €1 trillion is only a down payment on what Germany needs to ramp up its defense capability. It is time for the rest of Europe to follow suit.

Yes, we are likely to see an expansion of the debt-to-GDP ratio among EU countries—but in today's geopolitical environment, that is an unfortunate requirement for economic and national security. The good news is that in terms of fiscal guardrails, the European Union has succeeded in building a strong and effective central bank. The European Central Bank is more than capable of taking a commanding and prudent role in guiding (as well as deterring any profligate) debt expansion while assuring global markets of the viability of the European Union in the future.

There are rare moments in history when opportunity avails itself in extraordinary but brief moments, when politics, markets, and people are ready for a seismic change. For the European Union, that time is now. Indeed, "Making Germany Great Again" could be the spark needed to "Make Europe Great Again."

It seems quite unlikely that Germany will catch up with the likes of France in terms of fiscal disarray.

MORITZ KRAEMER
Chief Economist and Head of Research, LBBW Bank

The reform of Germany's debt brake was long overdue. Over the last quarter of a century, the country invested almost 1 percent of GDP less on public infrastructure than the EU average and its dilapidated state has become ubiquitous. But a lack of funds explains only one part of Germany's underperformance in public investment.

Another explanation is overly convoluted planning, permission, and procurement procedures. Even when Germany had a string of consecutive budget surpluses and the debt brake was not a constraint at all, public investment fell short of that of its peers. In order to make the great infrastructure leap forward, the country must also free itself of its sometime Kafka-esque administrative entanglement. Another bottleneck is supply constraints in the construction industry hobbled by capacity and staff constraints. At least there is now a twelve-year planning horizon, and building up the needed capacity becomes more attractive. Even so, markets should not expect a surge of government bond supply anytime soon. It will simply not be possible to spend the money as quickly as is now legally possible.

Similar constraints will hold back borrowing for the allegedly hundreds of billions of euros for defense. The industrial capacity currently simply does not exist. For example, Germany's largest weapons manufacturer, Rheinmetall, had a turnover of a mere €10 billion last year.

But eventually the spending and the borrowing will come on line. Defense spending is public consumption and does not create any positive cash flow down the road. Borrowing to finance such outlays is imprudent and will invariably increase the debt ratio. How much will be spent over the coming decade remains to be seen and will depend on future geopolitical developments.

Infrastructure spending, on the other hand, should enhance the economy's growth potential. This denominator growth will hold the debt ratio in check. If wisely spent, future growth dividends will bring in more tax revenue and cover the debt service.

It is not possible to predict with any confidence how much Germany's debt ratio will rise compared to the current fiscal stance. In the best case, it will not change much at all, and in the worst case, the ratio could reach triple digits. It will depend on how well targeted the spending is to enhance the country's weak growth prospects. It is therefore also not feasible to state whether the chain of the euro's stability anchor will rupture.

It seems quite unlikely that Germany will catch up with the likes of France in terms of fiscal disarray. If it were, it would not be popular. Concerns about too much debt are much more widespread in Germany than elsewhere. Households and companies borrow little if at all, if they have the choice. The fact that the German words for "debt" and "guilt" are identical is more than a mere coincidence. To paraphrase Mark Twain: "The news about the death of German stability anchor is much exaggerated!"

Using the fiscal lever is not an option for many other European countries, regardless of what the new fiscal framework will allow.

LORENZO CODOGNO

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The sense of fragility and uncertainty about the future has increased in Europe and Germany. Many shocks have hit the economy, unveiling its vulnerability. First, the pandemic caught Europe initially unprepared. Then came the invasion of Ukraine, which revealed how security and defense had been neglected for decades. Following that, the energy crisis displayed the misguided dependency on Russian gas and the lack of affordable energy resources throughout Europe, particularly in Germany. More recently, U.S. President Donald Trump demonstrated to Europeans that nothing could be taken for granted—not the protective security shield provided by the United States nor the unrestricted access to global markets for goods and services. In less than five years, Europeans have learned a bitter lesson that will be difficult to disregard in the future.

These unprecedented challenges require a different role for Europe in the world economy and substantial homework in the coming years. Needless to say, the focus should be on reforms to tackle the significant challenges and opportunities of our times, from artificial intelligence to robotics, energy security to geopolitical stability, and global governance. Fortunately, there is already a roadmap, the so-called Draghi Report, which the European Commission has wholeheartedly endorsed despite some difficulties at the national level. It is now beginning to be put into action. There is considerable work to do, especially regarding the supply side of the economy. Adequate funding for defense and security, infrastructure investment, and innovation are needed to achieve significant policy change.

It is very encouraging, in my view, that Germany is now taking a bolder approach to its long-standing problems and putting some money on the table to finance policy initiatives. As we have seen for NextGenerationEU, the announcement contributes to turning the mood and facilitating private investment. The amount already announced is an "envelope," that is, it will be a pot of funds available but not necessarily to be spent and will be spread over ten years. Implementation will be gradual, and this is good. Speeding up too much may lead to misallocation of resources, supply-side bottlenecks, and imbalances within the economy and *vis-à-vis* other European countries. Yet the signal is significant, not only for Germany. There is increased understanding by all policymakers that Europe needs to act together without relying on external sources to relaunch the economy and strengthen security and defense, which is a precondition for welfare-enhancing developments.

Fiscal discipline is the other side of the coin for a stable environment and to allow the economy to grow. It needs to be preserved. However, starting from a low debt ratio, Germany is in a good position to invest in its future amid current existential challenges. It is well understood that other European countries are more constrained and have far less fiscal space to support investment spending. Yet Southern European countries have benefited from European loans and grants within the NGEU-Recovery and Resilience Facility plan. Although these funds are supposed to be depleted by 2027, there will likely be a long tail. Moreover, spillovers from Germany will be substantial; thus, all other countries will benefit from Germany's fiscal support.

There is a clear understanding that using the fiscal lever is not an option for many other European countries, regardless of what the new fiscal framework will allow. This explains the cool reception among EU member states to the Commission's ReArm Europe Plan/Readiness 2030, which implies a debt-financed increase in defense spending. Understandably, many countries are reluctant to re-allocate urgently needed resources from other areas or take on additional fiscal and financial stability risks. However, if the European dimension gains a more prominent role in the future and spending is carefully managed to enhance efficiency and effectiveness rather than merely increasing military equipment stock, it would not necessarily require significantly higher security and defense spending.

I would not overplay the role of fiscal expansion and debt increase in the future. There is no immediate risk for public debt sustainability or imbalances. The European Union will not abandon its fiscally prudent approach. Never before has the European Union stood as a bastion of democratic values and economic stability as it does today. Instead, fiscal constraints will likely convince many reluctant countries to give up some national sovereignty to increase European sovereignty, thereby allowing further economic and political integration.

Never have the words of Jean Monnet, one of the architects of European integration, appeared as topical as they are today. He said, "I've always thought that Europe would be made in crises, and what would be the sum of the solutions we would bring to these crises." Developments over the past two-and-a-half decades accurately confirmed this statement, with small but significant steps undertaken towards integration. However, while paying attention to his thought-provoking ideas, Monnet always preferred action to writing. Today's multi-factor crisis will not only change attitudes, perceptions, and voter priorities, but also trigger policy action. And maybe we are not too far from these developments.

German bonds have repriced.

JIM O'NEILL
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I half suspected this question might be asked in jest, certainly, it seems to come from a presumption of so-called American exceptionalism and constant structural woes everywhere else. What is clear is that the Trump administration has effectively played a major role in what might turn out to be a major development for German, European, and global economic affairs. And then I also pondered, as a result of my first thought, that surely this isn't another one of those U.S. misunderstandings that link back to the mid- to late 1990s when so many U.S. business people and policymakers I met didn't believe or expect that the euro introduction was a serious ambition?

Anyhow, look at the financial market's response. Admittedly it has only been a short while, but as occasionally markets do ever so well in terms of anticipation, some of the movement happened before the German election and policy change announcements. Yes, German bonds have repriced, but so have equities and the currency, favorably. And it might well be the beginning of a sustained outperformance by European markets along the lines of what has—very occasionally—happened in the past, 2002–2008 being notable.

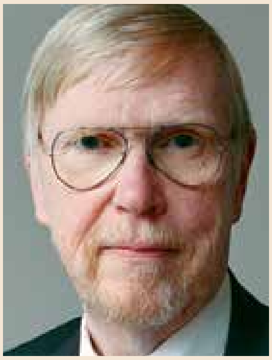
Many international economists, including myself, have thought that German economic policy was far too fiscally restrictive for far too long. Indeed, some argued that the core problem behind the euro crisis was not really profligate southern Europe, but a Germany that remained obsessed with an arbitrary debt-to-GDP limit of 60 percent, and along with it, its weak domestic consumption and high savings model and persistence with exports to the rest of Europe, and of course, the rest of the world. Apart from this being a clear recipe for an unstable European monetary union as it transpired, it meant that Europe's most populous nation and its largest economy was persistently vulnerable to things outside its control, such as economic weakness in those export markets. The euro crisis failed to shift this thinking. If anything, it consolidated this belief in the "German way."

But the combination of a collapse in Chinese demand for German goods, the coincidental shift to electric-powered cars, and of course, the energy crisis and dependency on Russia all laid the foundations for subsequent political events and Germany to shift gears. The rise of the Alternative for Germany party—despite its own apparent opposition to fiscal expansion—coming in turn with the reappearance of tariff-obsessed Trump, were the final ingredients for what, in my view, is a hugely welcome shift.

Even the remarkably conservative and usually cautious Bundesbank articulated the case for a shift in Germany's fiscal rule late last year, and as soon as I saw that, I thought it was simply a matter of time, and here you have it. While it is early days, this move could set the scene for a more vibrant domestically driven German economy, one that helps balance the EU and euro conditions better, as well as helping to reduce Germany's and the rest of Europe's dependence on the U.S. consumer.

Now, a further "unthinkable" might even seem feasible: that the euro system finally does create a more system-wide eurobond market with less national risk pricing, resulting in one that can offer a genuine alternative to the U.S. bond market.

Many in the United States and elsewhere will no doubt think this cannot be a sustainable future, given Germany's challenging demographics and the accustomed slow growth of old Europe. Now also consider what if there are steps to create a more genuine pan-European market in services, and not just goods, and at the same time—as markets have also started to worry—perhaps the real underlying consequence of Trump's policies is to inadvertently weaken the U.S. consumer. That will certainly all add to a narrowing of global imbalances, as many of the U.S.-based contributors to *TIE* know, especially those that have been in or around the U.S. Treasury these past forty years, but it might also be not so great for those who voted for this president, nor for some aspects of this odd notion of persistent U.S. exceptionalism, at least in the eyes of the markets.



With Germany converging toward the more indebted countries, the fiscal anchor for euro area interest rates and the euro will disappear.

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At the peak of the euro crisis in 2012, twenty-five EU countries (all except the United Kingdom and the Czech Republic) signed a Treaty (dubbed "Fiscal Compact") requiring these countries to introduce balanced budget rules into national law, preferably at the constitutional level. Inspired by the German debt brake introduced in 2009, countries were supposed to keep their structural budget deficits below 0.5 percent, or 1 percent if they had a debt ratio well below 60 percent of GDP. While Germany and a few other countries followed the rule, most countries did not. Thus, debt ratios for Italy and France, for instance, rose from 126 percent and 91 percent, respectively, in 2012 to 137 percent and 112 percent in 2024. By contrast, the German debt ratio fell from 79 percent to 63 percent.

Euro area countries with high and rising debt benefited from the superior credit rating of Germany as markets firmly believed that these countries would be bailed out if necessary to prevent default. The European Central Bank even reinforced this belief by establishing an instrument—euphemistically called "Transmission Protection Instrument"—to narrow bond yield spreads against Germany if deemed necessary.

Friedrich Merz, chairman of the Christian Democratic Union and new chancellor, promised comprehensive economic reforms coupled with continuing adherence to fiscal policy discipline during the election campaign. Few of his promises have survived the coalition negotiations with the Social Democratic Party, which enters the government despite having lost the election. Thus, with the new German government throwing fiscal frugality into the wind, the German debt ratio could rise to 85 percent of GDP or more over the next few years.

With Germany converging toward the more indebted countries, the fiscal anchor for euro area interest rates and the exchange rate of the euro will disappear. Euro area bond yields will increase on average, but the spreads may well narrow as German yields will catch up with others. When debt service costs begin to crowd out other expenses, governments will put pressure on the ECB to cap the increase in yields first by reinvesting maturing bonds from its quantitative easing program, and second by expanding its bond portfolio again. As the example of the Bank of Italy and the fate of Italian lira showed, monetization of government debt will eventually debase the currency. At this stage, the euro will have concluded its path from an originally promised hard currency like the Deutschemark to a soft currency like the Italian lira.

The saving grace for the inept policy of the German government—and other governments in the euro area—are the ludicrous policies of the Trump administration. When policy in the mightiest country of the world turns into satire and the U.S. president into a buffoon, financial markets have other things to worry about than the dull deficiency of a German government. Hence, the euro may well hold its own against the U.S. dollar and instead continue to depreciate against gold. ◆

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