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In Merz We Truss: Financial Market Reaction to Germany's Fiscal Package

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Overview

- This study analyzes capital market reactions to Germany's recent announcement of loosening fiscal restrictions for defense and state-level spending, while establishing a €500 billion infrastructure investment fund. In particular, we examine whether surging Bund yields reflect growth expectations or fiscal risk concerns.
- Clear evidence of growth expectations: The steepening German yield curve, rising stock prices, euro appreciation, and stable credit default swap prices collectively indicate that markets interpret Germany's fiscal expansion as growth-enhancing rather than a reckless fiscal bet.
- The contrast with the UK's Truss-Kwarteng episode is stark: Unlike the 2022 UK "mini budget" aftermath, which triggered a selloff across all UK asset classes, Germany's announcement has seen positive market reception across different asset classes, suggesting confidence in Germany's fiscal credibility.
- While the policy shift introduces some uncertainty, evidenced by modest increases in the European VSTOXX volatility index, this reaction appears calibrated and partially attributable to concurrent global market events, reinforcing the interpretation that markets view Germany's fiscal expansion as responsible.

Keywords: Fiscal Policy, Sovereign Debt, Yield Curve, Market Expectations, Debt Brake, Germany

- Diese Studie analysiert die Reaktionen der Kapitalmärkte auf Deutschlands jüngste Ankündigung, fiskalische Beschränkungen für Verteidigung und Ausgaben auf Länderebene zu lockern – und gleichzeitig ein 500-Milliarden-Euro-Investitionsfonds für Infrastruktur einzurichten. Insbesondere fragen wir, ob die steigenden Bund-Renditen Wachstumserwartungen oder Risikobedenken widerspiegeln.
- Klare Evidenz für Wachstumserwartungen: Die steilere deutsche Zinsstrukturkurve, steigende Aktienkurse, die Aufwertung des Euro und stabile Credit-Default-Swap-Preise deuten darauf hin, dass die Märkte Deutschlands fiskalische Expansion eher als wachstumsfördernd denn als fiskalisch bedenklich interpretieren.
- Der Kontrast zum Truss-Kwarteng-Haushalt im Vereinigten Königreich ist stark: Im Gegensatz zu den Turbulenzen nach dem britischen „Mini-Haushalt" 2022, die einen Ausverkauf über alle UK-Anlageklassen hinweg auslösten, wurde das deutsche Fiskal-Paket von den Märkten über verschiedene Anlageklassen hinweg positiv aufgenommen, was auf Vertrauen in die fiskalische Glaubwürdigkeit Deutschlands hindeutet.

- Während der Politikwechsel eine gewisse Unsicherheit mit sich bringt – erkennbar an leichten Anstiegen des europäischen VSTOXX-Volatilitätsindex, scheint diese Reaktion moderat und teilweise auf gleichzeitige globale Marktereignisse zurückzuführen zu sein. Dies untermauert die Interpretation, dass die Märkte Deutschlands fiskalische Expansion als verantwortungsvoll ansehen.

Schlüsselwörter: Fiskalpolitik, Staatsverschuldung, Zinsstrukturkurve, Markterwartungen, Schuldenbremse, Deutschland

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KIEL INSTITUTE FOR THE WORLD ECONOMY

In Merz We Truss: Financial Market Reaction to Germany's Fiscal Package

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As markets closed on March 6, the DAX had gained another 1.5%, contrasting with a decline in U.S. stocks. While this remains a developing situation, particularly regarding growing transatlantic tensions, capital market evidence from recent days does not support the notion that Germany has suddenly lost its status as a "safe haven". Rather, market reactions suggest confidence in Germany's ability to implement significant fiscal expansion.

1 Introduction

On March 4, Germany's prospective coalition government reached an agreement to pursue loosening fiscal restrictions on defense and state-level spending, while establishing a €500 billion dedicated fund for infrastructure investment. Since then, market reactions have been subject to considerable ambiguity in public discourse. In this policy paper, we analyze recent capital market developments, focusing particularly on whether surging Bund yields – characterized by some commentators as "the biggest jump in German Bund yields since the fall of the Berlin Wall" – reflect economic growth prospects or heightened risk concerns.

2 Analytical Framework

To disentangle different components of market reactions to policy announcements, we apply the framework developed by Jarociński and Karadi (2020). Though originally designed to separate "pure" monetary policy shocks from information shocks in central bank announcements, their methodology provides valuable insights for fiscal policy shifts as well. Their key observation is that when central banks set monetary policy rates, they signal not only their policy stance but also convey information about their assessment of the economic outlook.

Through this lens, we examine German Bund yields surging after the debt announcement. If the yield increase primarily reflects an "information shock" – i.e., markets learning that German economic prospects are better than previously thought – then higher yields should be accompanied by rising stock prices, euro appreciation, and stable or tightening credit spreads. Conversely, if the yield

[1]The paper represents the authors' personal opinions and not necessarily the views of the Bank of Greece or the Eurosystem.

increase primarily signals concerns about fiscal sustainability, as witnessed especially in the course of the European sovereign debt crisis, we would expect falling stock prices, euro depreciation, and widening credit spreads.

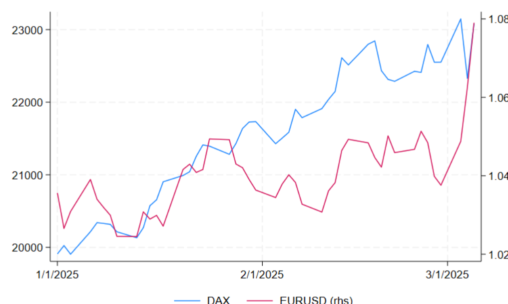
3 Evidence from Capital Markets

Examining Bund yields over time reveals a steepening yield curve (Figure 1a), with long-term rates rising faster than short-term rates. While this pattern could theoretically reflect pure inflation expectations, it typically signals expectations of stronger economic growth alongside inflation when combined with other positive market indicators (Harvey: 1988; Estrella and Hardouvelis: 1991). Conversely, a flattening curve would have indicated concerns about long-term risks.

Supporting this interpretation, German stocks rose alongside yields, and the euro appreciated against the dollar (Figure 1b). While European stocks had declined on March 4 following Trump tariff announcements, making some rebound expected, an increased risk perception would be inconsistent with the observed market recovery.

Figure 1: German Yield Curve, DAX Index and Euro vs Dollar

(a) German Yield Curve

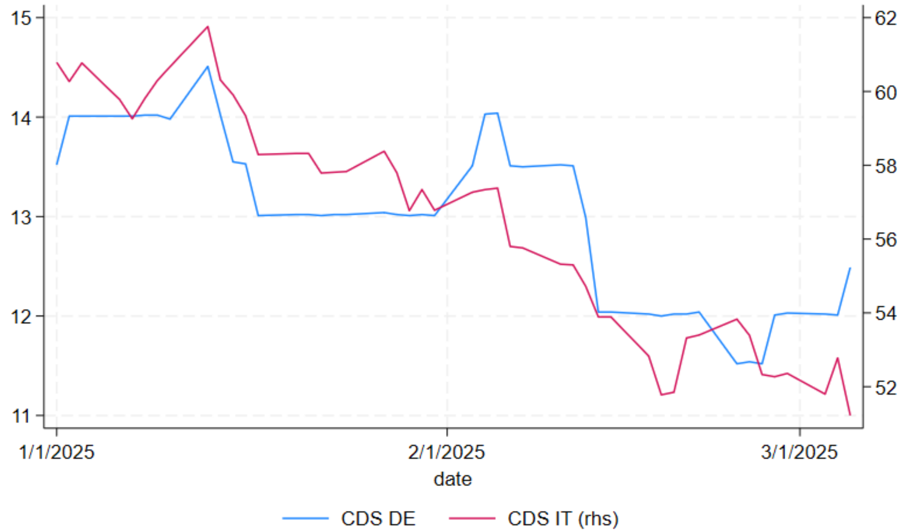


(b) DAX Index and Euro vs Dollar

Credit default swap (CDS) prices, which reflect perceived default probabilities, have not increased noticeably and remain relatively low. Some commentators suggested that rising German yields might trigger contagion risks for other Eurozone countries, particularly Italy. However, CDS prices on Italian debt actually fell slightly and remain at multi-year lows (Figure 2).

In the medium term, Germany's proposed fiscal and defense policy transformation may help mitigate broader geopolitical risks, potentially preventing risk premia from surging dramatically as they might otherwise in response to elevated war probabilities in today's transformed global landscape.

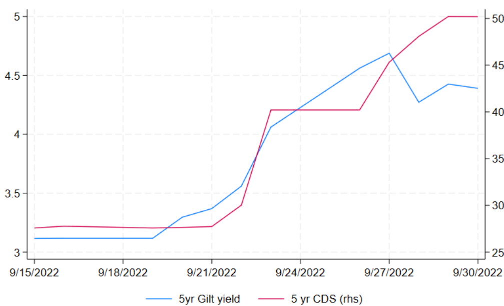
Figure 2: 5yr CDS for Germany and Italy



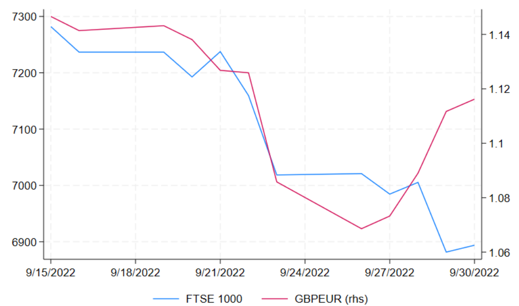
4 Contrasting with the UK's Truss-Kwarteng Episode

A particularly illuminating comparison is the gilt market reaction following the Truss/Kwarteng Budget in September 2022 (Wadhwani: 2024). The announcement of a "mini budget" with substantial tax cuts and associated debt increases also raised yields on UK government bonds (gilts) substantially. However, in sharp contrast to Germany's current reality, the UK yield spike coincided with rising gilt CDS, plummeting equity prices (FTSE100), and a collapse of the British pound to all-time lows against the dollar (Figures 3a and 3b). The gilt episode was characterized by investors selling off all types of UK assets – a dynamic diametrically opposed to what we observe in the German case.

Figure 3: Yield and CDS on UK 5y Gilts, FTSE 100 Index and Pound vs Dollar



(a) Yield and CDS on UK 5y Gilts



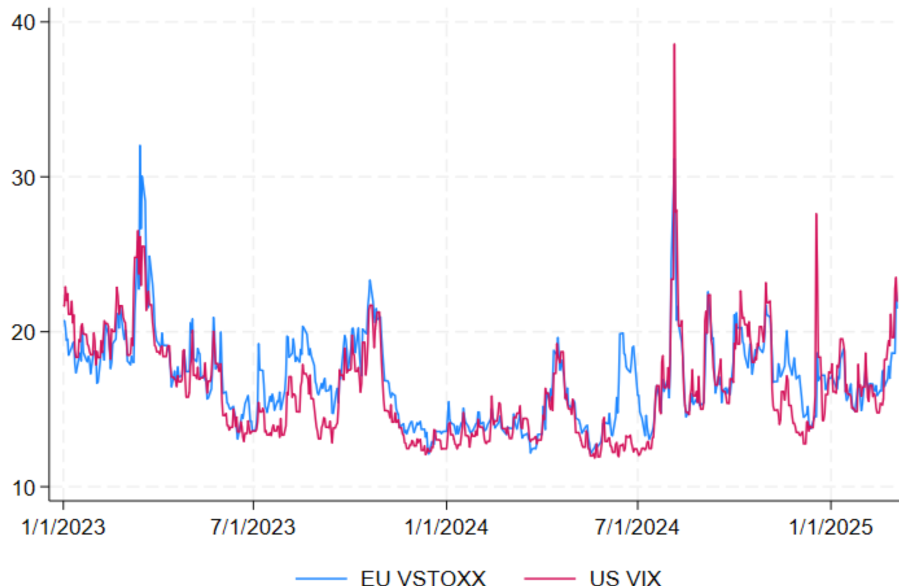
(b) FTSE 100 Index and Pound vs Dollar

5 Volatility and Market Uncertainty

Even positively viewed fiscal regime shifts create some uncertainty that is priced by markets. The measured volatility response suggests markets view this as a calculated policy shift rather than a desperate fiscal maneuver. The VSTOXX (European VIX equivalent) showed only a modest increase amid otherwise positive market signals (Figure 4), merely reaching levels comparable to those seen during Trump's election in November 2024, and in fact much lower than the brief stress of the yen carry trade unwind in August.

While German fiscal policy has been relatively predictable for years under the debt brake, this week's announcement – signaling a willingness to reform the debt brake and representing a structural break in German fiscal and defense policy – naturally introduces some uncertainty, even as the market's baseline view appears positive. Notably, the spike in European market volatility closely followed a similar spike in the US VIX, likely attributable to President Trump's concurrent announcement of tariffs on Canada and Mexico. This suggests that the volatility specifically attributable to Germany's policy shift may be even more modest than raw figures indicate.

Figure 4: Equity Market Volatility in Europe and the US



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