FRANKLIN TEMPLETON

MARCH 26, 2025

A new dawn of fiscal stimulus in Europe

Germany's recent decision to overhaul government borrowing constraints sparked optimism that new public spending will benefit companies across Europe. Craig Cameron of Templeton Global Equity Group outlines the opportunities.

Following the recent German elections, probable incoming Chancellor Friedrich Merz and his potential coalition partners have worked to explore ways in which Germany could overhaul the country's debt rules and unlock considerable spending on both infrastructure and defence. This comes at a time when Europe is looking to significantly increase defence spending, as US leadership has cast doubt on NATO mutual defence clauses and even temporarily withdrew supply of equipment and intelligence to Ukraine in its fight for sovereignty. We believe it is important not to underestimate the combination of these two shifts in Europe in terms of their economic impact and geopolitical implications.

This situation is of particular importance for Germany, as along with much of Europe, it has struggled to lift economic growth in recent years due to various political and structural headwinds. Indeed, Germany's real gross domestic product (GDP) contracted in both 2023 and 2024, as it faced higher energy and gas costs, causing output to decline in some sectors and weaker competitiveness globally. Recent geopolitical shifts, driven by the change in US administration, has created an incentive for European economies to spend on defence and has encouraged more meaningful near-term action on the German debt brake, a mechanism designed to limit the country's ability to deliver fiscal stimulus to protect its fiscal position. With Germany taking the first step with broad support at the European Union (EU) level, many countries may find that they can follow suit. Indeed, several sizable European economies presently operate with relatively low debt-to-GDP ratios due to the EU's historic debt rules, including the Netherlands, Denmark, Sweden and Poland. Going forward, we expect significantly higher spending at the individual country level, coupled with centralised European funding for extra defence spending.

As things stand, Germany appears to be moving to deliver a multi-year €500 billion package (~11% of German 2023 GDP), of which €100 billion will be specifically directed towards climate funding, with the remainder focused on "civil protection, transport, hospitals, energy, education, science, research and development, care and digitalisation". Meanwhile the European Commission is developing a €100 billion fund to support development of power purchase agreements to help install 100 gigawatts of clean energy annually by 2030 and has announced a €150 billion funding mechanism for defence spending by EU members. In total the European Commission is aiming to unlock €800

billion of additional defence spending. Trillions of investments could ultimately be committed across Europe, providing a sizable fiscal stimulus for these economies.

Across Europe, centrist parties have been under pressure from both ends of the political spectrum, indicating growing public frustration on a range of issues, including generally lacklustre economic growth. By investing meaningfully in infrastructure, Germany has an opportunity to create new jobs, boost GDP and improve the quality of life for its people. Well-structured investments can also lead to higher tax revenues over time, reducing the need for new debt issuance in the future. Among the options for government spending, infrastructure investment seems to us one of the most sensible choices. Such projects can generate a positive economic multiplier, creating jobs and facilitating trade, power and transportation development across the economy. Improvements in energy infrastructure could help lower energy costs for consumers and businesses, while higher defence spending could help offset the lower growth expected from Germany's industrial base after the loss of Russian gas. The special infrastructure fund in Germany looks to us to be a step in the right direction, and we believe it could be a positive catalyst for economic growth and investor confidence.

Positive market reaction greeted the proposed spending increases initially, and a variety of sectors and companies saw strong share price performance. In recent weeks, broader economic uncertainties—especially from the United States—have calmed this enthusiasm. Despite these challenges, there is still a sense of optimism that the spending will benefit companies in Europe, particularly those in the manufacturing and construction sectors. Indeed, Europe has continued to outperform the US market in 2025 thus far, marking a sizable shift in sentiment from late 2024. Importantly, investors appear comfortable with the suggested borrowing plans and Germany's proposed fiscal position. The ten-year bund yield remains below 3% at time of writing—below almost all developed economies outside of Japan.

Challenges do remain, of course. Major economies such as the United Kingdom, France and Italy remain more fiscally constrained and will need to make tough choices to ramp up defence spending. Meanwhile, complex regulatory processes and differing rules and structures across the various European countries remain an impediment to investment and have likely long been a drag on European competitiveness. Simplification and increased pragmatism, including greater integration on areas like infrastructure and energy investment, could also help accelerate economic growth. Indeed, many of these ideas were highlighted in the 2024 report that Mario Draghi, former Prime Minister of Italy, issued on the topic of EU competitiveness, which laid out some difficult truths for the bloc.[1] Therefore, how Europe balances the step-up in near-term investment and its efforts to simplify regulations will be crucial for Europe's economic potential.

European equities at a crossroads

Some areas of initial market euphoria have been tempered more recently, but we think there remains a strong case for improved regional economic growth which should translate

into opportunities for European equities more broadly. Persistently weaker growth has hindered European equity performance relative to US peers in recent years, and we are now seeing a reversal in these trends as leading economic indicators for Europe improve while those for the United States appear to be declining. This would suggest to us that this is not a short-term bump but a real medium-term opportunity. We see a variety of companies that can benefit from new investment, with domestically focused businesses particularly well-positioned to benefit over time.

At the sector level, what investors traditionally think of as "old economy" industries stand to do particularly well, whether suppliers of raw materials, engineering and construction businesses, staffing companies or industrials that provide equipment and power. Many of these feed into the rising expectations for defence spending as well, which is where the initial share price reaction was most profound. We also see opportunity in small- and mid-cap companies in Europe—a group which has really struggled since the peak of 2021.

Conclusion

These are early steps. A lot of detail and implications still need to be worked through, and effective execution of investment is often far more important than the headline number. Although the challenges remain considerable, Europe, and particularly the EU, has a habit of emerging from crises more unified. The current geopolitical environment has brought France and Germany, the two largest economies in the EU, closer together on many key points than they have been for decades. Meanwhile non-EU nations, including the United Kingdom and Norway also appear more closely aligned than they have been for many years as trade threats from the United States and aggression from Russia help to bind Europe together against common risks. These factors should help to improve and speed up decision-making. We believe it is important not to underestimate that the shift in Europe, as it could well be laying the foundation for a period of higher economic growth and robust European equity performance.