Decisive policy action has improved the balance of risks

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Policymakers in Europe have been jolted in action after being confronted with the realities of Trump 2.0. The blockbuster German fiscal package is a hugely significant development from a domestic perspective and could spur a solid growth resurgence in 2026. There are already signs of a positive confidence effect in the survey data.

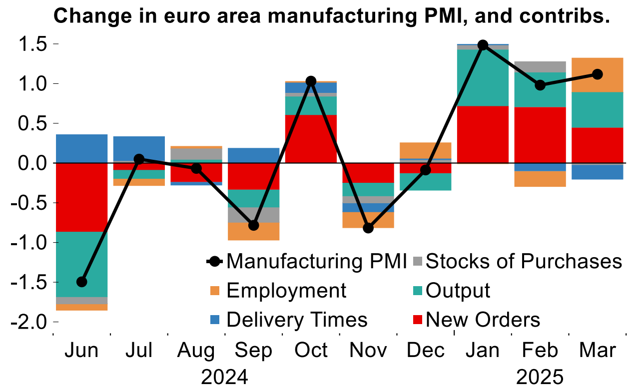
That said, the near-term balance of risks remains firmly tilted to the downside. Next week's US announcement on 'reciprocal' tariffs looms large over the global economy. We continue to expect significant measures on the EU with a clear risk of tit-for-tat escalation. However, the sea change in German fiscal policy both reduces the associated downside risks from a trade war and bodes well for longer-term competitiveness.

The fiscal shift in Germany provides something to cheer about, at last

Is there some defiant optimism in the air in Europe? Despite the looming announcement on US trade policy next week, the euro area manufacturing output index reached a 34-month high in the March PMI data. The reliable German ifo survey also moved higher this month. This improvement comes despite the range of external headwinds and heightened uncertainty around US trade policy in particular.

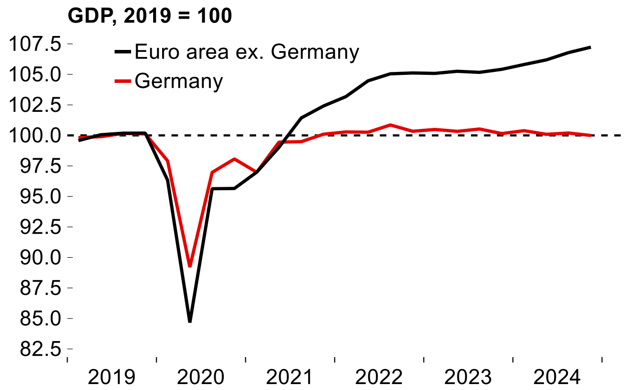
On the PMIs, we would highlight that 1) export orders have likely received a temporary boost by US importers looking to get ahead of any new tariffs, and 2) the overall survey figure is still only consistent with muted growth at the start of the year. Yet the growth backdrop could be a lot worse given the range of headwinds and we do think that this more decisive policy action in Europe is supporting confidence.

Euro area manufacturing sentiment has improved since the turn of the year



Source: S&P Global, MUFG Bank Economic Research Office

Germany has acted as a brake on the euro area economy since the pandemic



Source: Eurostat, MUFG Bank Economic Research Office

The most notable shift has been the blockbuster fiscal reform in Germany. We set out our initial views here, with an update here after the package was approved last Friday. There were some tweaks to the horizon which could slightly reduce the growth impact but make no mistake, this is a huge, positive demand shock for Europe's largest economy. The 500bn EUR infrastructure package is the most significant component. That's around 12% of German GDP in additional borrowing for spending which is domestic and cannot be saved, so the multipliers are likely to be high.

That said, the short-term growth outlook largely hinges on whether the urgency involved in the approval of the package will be carried over into its actual implementation. At this stage, we only know that the envelope is there, not how it will be used. For now, focus has turned back to the government formation process. The hope is that this will be completed in around a month and in turn the 2025 budget could be presented by July.

We see little point in backloading spending given near term risks to the outlook. The new German government, when formed, is likely to be mindful of the policy inertia under the previous administration. There are also various regional elections next year which supports quick action when it comes to disbursements. As an indicative forecast – and we stress there is a lot of uncertainty at this stage – we are now pencilling in German growth of 1.7% in 2026.

How fast will Europe rearm?

As well as the infrastructure package, German defence spending above 1% of GDP will now be exempted from the constitutional debt brake which limits the structural deficit to 0.35% of GDP. In other words, it will be possible to fund defence through borrowing and so there will be no legal constraints to increasing the defence-to-GDP ratio. That ratio stands at around 2% currently. An increase to somewhere in the range of 3.0 - 3.5% seems a reasonable assumption, but again we don't know the details or timeframe yet.

This shift comes as part of the wider European efforts towards rearmament as the continent looks to take more responsibility for its own defence. The EU has announced that there will be a carve out for greater defence spending from its fiscal rules as well as the issuance of up to 150bn EUR of joint debt for military procurement.

Broadly speaking, the fiscal multipliers from new defence spending, at least over the short-term, are likely to be worse than for those associated purely with infrastructure. However, the EU proposal to exclude the US, UK and Turkey from its rearmament fund suggests that the focus is to build domestic capacity (a gradual process) rather than increase military capacity as quickly as possible (which would mean high share of imports).

Whether that is a wise strategy remains to be seen but, longer-term, it would clearly be preferable from a domestic growth perspective. The Draghi report noted that 78% of EU defence procurement was from non-EU suppliers and 63% of that was accounted for by the US. The multipliers involved with domestic defence spending may improve over time following technology diffusion to other industries. Military spending is also likely to have a stronger effect on overall output during recessions (see e.g. here).

The end of the ‘peace dividend’ in Europe – how far will governments increase defence spending?

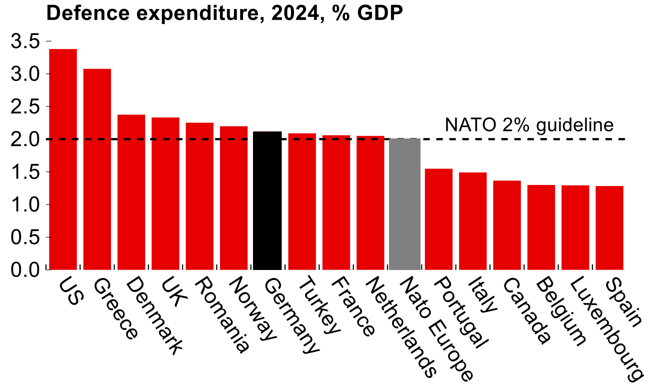
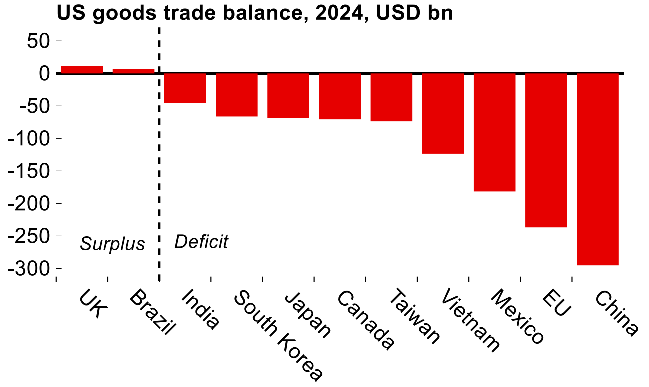


Chart shows NATO members since 1990. Source: NATO, MUFG Economic Research Office.

The last budget was expansionary with significant new borrowing for both current and capital expenditure



Source: US Census Bureau, MUFG Economic Research Office

The balance of risks has improved

The US administration’s announcement on “reciprocal” measures next week is looming large over the European (and global) economy. The threat is that tariffs will match a range of measures imposed by other countries, on an individual basis. Our base case is for targeted measures on certain economies, including the EU, rather than universal tariffs. But the pretext for escalation could be very high and there is clear scope for tit-for-tat responses to spiral.

In the case of targeted US tariffs, the direct, static effects may be prove to be relatively limited for the economy as a whole (see here), but there is plenty of scope for negative second-round effects. That includes a sharp weakening of the labour market from its current position of relative health (firms may have ‘hoarded’ workers in the hope that demand conditions will improve). That said, it is now reasonable to assume that new spending in Germany would be fast-tracked and/or re-directed in the event of a large negative shock (if tariffs can be labelled as such at this point), which reduces the downside risks. Higher military spending, both on domestically-produced equipment and personnel, would likely also have a cushioning effect.

Taking a longer view, a big dose of military Keynesianism could be exactly what the economy needs to escape from its industrial torpor of recent years. If used effectively, infrastructure investment is likely to be productivity-enhancing (there is a lot of low hanging fruit after years of underinvestment). We also see potential for crowding-in of private investment following this paradigm shift in German fiscal policy.

All told, we share some of the optimism seen recently in survey participants as Germany finally makes some use of its fiscal capacity. The immediate outlook is still dominated by the threat of tariffs, but, longer-term, risks are probably now tilted to the upside after policymakers have been jolted into action by the realities of Trump 2.0.

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