20 February 2025

Regime change in public debt? Lessons from reunification

Germany is not to be envied. Things are not running smoothly at the moment and, to make matters worse, the challenges for the near future seem to be growing exponentially. Trump's recent comments on Ukraine are perhaps just a foretaste. In addition, unlike the rest of the world, the country is already in its third year of recession - something that has never happened since the Second World War. At the same time, many neglected tasks need to be tackled in the coming years. The infrastructure needs a general overhaul, public housing construction needs to take off, the education system needs a complete overhaul and there is a huge need for action in terms of internal and external security.

Alarm bells are ringing, especially when it comes to external security. Although we are in the third year of a war in Europe, the Bundeswehr has achieved the feat of being worse equipped today than at the beginning of the war, despite the turning point. Orders for weapons and decisions regarding future troop structures have been extremely hesitant. Ever since the Munich Security Conference at the latest, we have been left looking like a poodle. The USA is gradually withdrawing from Europe and we may have to deploy peacekeeping troops in Ukraine this year. Assuming that around 200,000 soldiers are needed for this, it would not be unreasonable to assume that Germany would have to provide around 30,000 soldiers. Given the lack of soldiers and weapons, this will of course not work de facto, but it shows the situation in which the country finds itself.

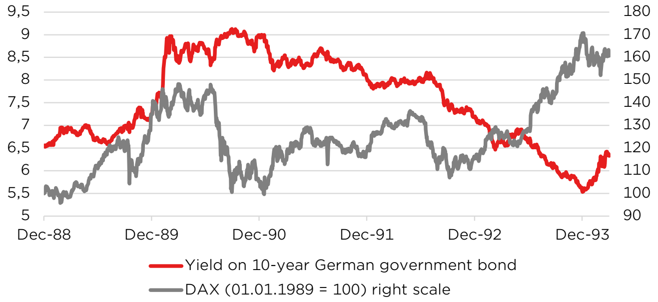
In a way, the situation is somewhat reminiscent of November 1989, when people were forced to rethink everything out of nowhere within a few weeks. One world order collapsed and a new one had to be created. In the case of Germany, a completely ailing East German economy had to be restructured from the ground up. All of this could only be managed with a dramatic increase in government spending and, as a result, an increase in national debt.

Today, people often forget the extent of the rethinking that had to take place within a very short space of time. For example, a special fund for the redemption of inherited burdens (171 billion euros) was set up to bear the financial burdens of the GDR and the costs of reunification. In addition, the “German Unity” special fund (83 billion euros) was set up to finance structural adjustments. At the same time, the debt of the new federal states increased massively within a short period of time, and the West German federal states and the federal government also made huge transfer payments to the new federal states over many years. To this day, there is no complete agreement on the extent of the transfer payments, which were largely debt-financed. The social sector in particular benefited significantly, but growth-oriented programs such as the investment allowance also played a major role. The Ifo Institute estimates that the total of all transfer payments from West to East (including state financial equalization and general federal tasks) was probably in the trillions[1].

[1] Effects of changes in transfer payments on the economic performance of the eastern German states

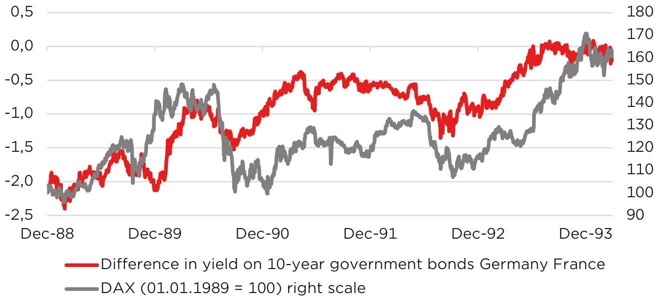
The fact that Germany was able to shoulder this incredible burden at all is still astonishing today, but should also be seen as an encouragement that the burdens that now lie ahead can also be overcome. However, there is widespread agreement that this cannot be achieved through budget restructuring alone. As was the case from 1990 onwards, this will only be possible by taking on additional debt. It would be presumptuous to believe that massive borrowing would bypass the capital market without a trace. It is therefore worth taking a look at 1990 and the years that followed.

DAX performance and yield on German government bonds with 10 years to maturity



Looking at the turn of the year 1989/1990, it is striking that the yield on ten-year German government bonds rose significantly within a few weeks. The bond market realized in a flash that a different regime would now apply. In this context, it is also interesting to note how German government bonds behaved relative to French government bonds during this period. At the same time as the fall of the Berlin Wall, the yield advantage of German government bonds over French government bonds fell significantly from -2% to -0.75% within a very short space of time. Interestingly, the DAX correlated very strongly with the spread between German and French government bonds during this market phase. At first glance, this correlation appears to be without deep logic. However, if one interprets the change in the spread as an estimate of the change in expected debt-financed government spending, the observation makes perfect sense. After all, an unplanned economic stimulus through government deficit spending always tends to have a positive effect on the stock markets in the short term.

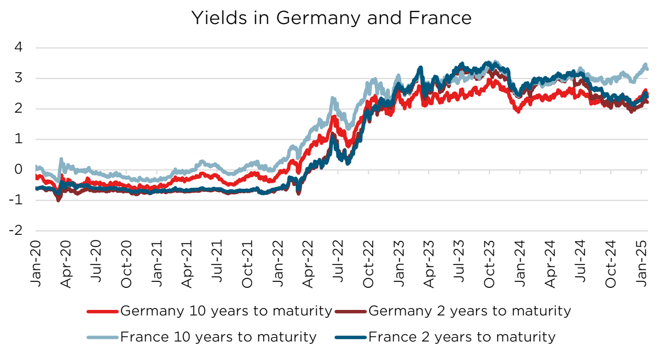
DAX performance and difference in yield between Germany and France



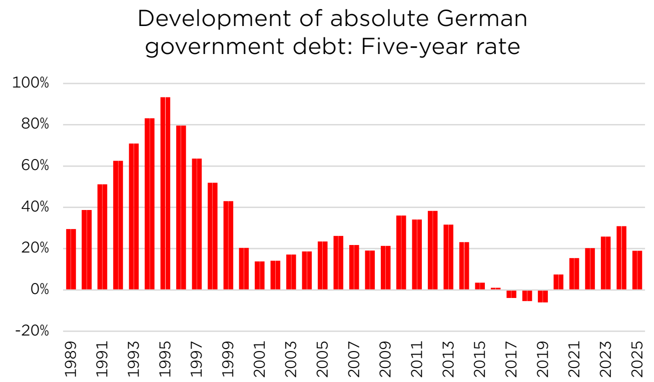
Lessons for the coming years

Assuming that the next German government agrees on a new concept for the debt brake or formally and legally sets up a huge new special fund in line with the existing debt brake, it is to be expected that bond yields could actually receive a further boost. So far, there is not much sign of this, at least at first glance. Yields on European government bonds rose significantly until mid-2023, after which they moved sideways. In reality, however, things are a little more complicated. Normally, government bonds with a remaining term of two years, for example, move roughly in tandem with longer-term bonds. Since summer 2024, however, an increasing decoupling has been observed here. While ten-year bonds have remained at roughly the same level, yields on two-year bonds have fallen in line with falling key interest rates. The relative unimpressiveness of long-term bonds could indicate that the bond markets are already secretly preparing for a new regime with a significant increase in government debt.

However, this seems to apply not only to Germany, but also to France. There is no other explanation for the fact that yields on German bonds have actually tended to fall in comparison to French bonds in recent years, partly because France is viewed critically by rating agencies due to the massive increase in national debt and political problems. In any case, there is a significant difference between the situation at the time of reunification and the situation today. Back then, Germany had to cope with a singular feat of strength, whereas this time the same applies, at least in part, to the whole of Europe.



Although Germany probably has the most homework to do, it cannot seriously be claimed that all other European countries are ideally equipped for the new challenges. It is therefore not surprising that France is now calling for the necessary additional military expenditure to be financed through common European instruments. The point at which a gradual communitization of European debt becomes likely could therefore come even sooner than we expect. We have always argued that this development is basically in the air, but that it would require an extreme occasion to take this step. Now that Trump is leaving Europe out in the cold and instead expressing some sympathy for the thinking of an imperialist Putin, this point could be approaching. Military experts have drawn up a list of weapons systems that the Bundeswehr would have to procure in order to have a certain "basic equipment" of weapons again. The benchmark would be to return to a number of systems in the various branches of the armed forces that is around 30% to 50% of the number of weapons systems in the various branches of the armed forces that were available to the Bundeswehr in the 1980s. If you calculate with known list prices - where available - you arrive at a volume of around 250 billion euros. This will require reactivated barracks, reactivated military training areas and additional soldiers. Roughly speaking, we can therefore assume a total of 350 billion euros in additional expenditure for Germany. For Europe as a whole, the requirement would certainly be over 1000 billion euros. A corona fund of 700 billion euros has been set up, so it would not be surprising in view of the developing drama if an agreement were reached to jointly issue European bonds in the amount of, for example, 1000 billion euros. Added to this would be a specifically German additional debt to finance all the other "construction sites". We must not forget that Germany could take on more than 1,600 billion euros in additional debt before it reaches the debt levels of other European countries. In percentage terms, this increase in debt would not differ significantly from what was observed in connection with reunification. At that time, German national debt almost doubled in absolute terms between 1990 and 1995. It would not be surprising if a development not dissimilar in scale were to be repeated in the next five years.



It would be presumptuous to believe that such debt will not drive up yields, even though we are talking about developments that will extend over many years. We therefore assume that the spreads between Bunds and other European government bonds will tend to converge, but that they will rise overall, at least temporarily. The speed and extent of this development will ultimately also (but not only!) be determined by geopolitical developments. The equity market would fundamentally benefit from this development, as was already observed in the course of reunification. For diversified portfolios, this development need not therefore be a disadvantage.

Dr. Christian Jasperneite

Market data

	As of	Change versus				
	21.02.2025	14.02.2025	20.01.2025	20.11.2024	20.02.2024	31.12.2024
Stock marktes	10:42	-1 week	-1 month	-3 months	-1 year	YTD
Dow Jones	44177	-0,8%	1,6%	1,8%	14,6%	3,8%
S&P 500	6136	0,3%	2,3%	3,7%	23,3%	4,3%
Nasdaq	19962	-0,3%	1,7%	5,3%	27,7%	3,4%
DAX	22330	-0,8%	6,4%	17,5%	30,8%	12,2%
MDAX	27575	-0,3%	6,0%	6,0%	7,1%	7,8%
TecDAX	3855	0,5%	6,8%	16,2%	14,7%	12,8%
EuroStoxx 50	5470	-0,4%	5,9%	15,6%	14,9%	11,7%
Stoxx 50	4713	0,2%	5,5%	11,0%	10,4%	9,4%
SMI (Swiss Market Index)	12833	-0,1%	6,6%	11,2%	12,0%	10,6%
Nikkei 225	38777	-1,0%	-0,3%	1,1%	1,1%	-2,8%
Brasilien BOVESPA	127601	-0,5%	3,9%	-0,5%	-1,8%	6,1%
Indien BSE 30	75303	-0,8%	-2,3%	-2,9%	3,1%	-3,6%
China CSI 300	3978	1,0%	3,9%	-0,2%	16,6%	1,1%
MSCI Welt	3894	-0,1%	2,8%	4,3%	18,9%	5,0%
MSCI Emerging Markets	1132	0,6%	4,8%	3,5%	11,1%	5,3%
Bond markets						
Bund-Future	131,60	-125	-24	-48	-166	-184
Bobl-Future	117,21	-29	18	-132	47	-65
Schatz-Future	106,75	-5	9	-1	135	-24
3 Monats Euribor	2,53	1	-15	-47	-141	-19
3M Euribor Future, Dec 2025	2,04	4	-4	-79	-81	14
3 Monats $ Libor	4,33	-1	-1	-29	-111	-4
Fed Funds Future, Dec 2025	3,95	1	0	-58	-55	4
10 year US Treasuries	4,49	1	-12	7	20	-8
10 year Bunds	2,50	10	0	16	15	14
10 year JGB	1,42	8	25	36	70	34
10 year Swiss Government	0,59	10	22	18	-27	31
US Treas 10Y Performance	598,56	-0,2%	1,2%	0,4%	2,4%	1,2%
Bund 10Y Performance	559,80	-0,9%	0,1%	-0,8%	1,4%	-0,8%
REX Performance Index	451,82	-0,5%	0,3%	0,1%	2,3%	-0,2%
IBOXX AA, €	3,04	7	-7	-1	-35	0
IBOXX BBB, €	3,43	6	-13	-8	-56	-3
ML US High Yield	7,38	2	-7	-7	-66	-27
Commodities						
MG Base Metal Index	430,56	0,2%	2,7%	2,5%	14,5%	6,2%
Crude oil Brent	76,03	1,4%	-4,7%	3,8%	-7,6%	1,7%
Gold	2926,97	0,9%	8,1%	10,6%	44,4%	11,5%
Silver	33,00	1,8%	7,8%	6,1%	43,1%	11,2%
Aluminium	2737,51	2,8%	2,1%	4,8%	26,9%	8,3%
Copper	9532,10	0,4%	4,0%	6,3%	13,2%	10,2%
Iron ore	107,00	0,2%	5,7%	5,0%	-16,4%	3,3%
Freight rates Baltic Dry Index	941	18,8%	-1,7%	-41,8%	-42,3%	-5,6%
Currencies						
EUR/ USD	1,0471	-0,1%	1,5%	-0,9%	-3,1%	0,8%
EUR/ GBP	0,8278	-0,6%	-2,2%	-0,4%	-3,2%	0,1%
EUR/ JPY	157,42	-1,7%	-2,4%	-4,3%	-2,9%	-3,5%
EUR/ CHF	0,9406	-0,4%	-0,2%	0,7%	-1,3%	-0,1%
USD/ CNY	7,2556	0,0%	-0,3%	0,1%	0,9%	-0,7%
USD/ JPY	149,65	-1,8%	-3,8%	-3,7%	-0,2%	-4,8%
USD/ GBP	0,79	-0,2%	-2,8%	0,1%	0,1%	-1,0%

Source: Refinitiv Datastream

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Simon Landt
+49 40 3282-2401
mlandt@mmwarburg.com

Jan Mooren
+49 40 3282-2132
jmooren@mmwarburg.com