Tomorrow's Affairs
Analysis of today
Assessment of tomorrow

By: Daniel Lacalle

European Bonds Slump After Spending Binge Plan

German bond yields have soared, with the 10-year bund yield rising to around 2.83%, a jump of 51% from the level of December 2023.

In the past month, yields have risen by 21%, triggered by Germany's historic "paradigm shift" spending plans, which include a massive defence and infrastructure package.

The sell-off in German bonds triggered an immediate domino effect on European sovereign debt, with French, Spanish, and Italian bonds declining as the European Commission announced a "Rearm Plan" to spend 800 billion euros on defence over four years, financed by new debt.

The European sovereign bond index is down 2.8% in the first two months of 2025 and has declined an extraordinary 14% in the past four years as concerns about persistent inflation add to rising fiscal imbalances and increasing debt plans.

The harsh reality is that European sovereign bonds are not a reserve asset in most balance sheets anymore, and pension funds and institutional investors are reducing their positions in European government debt.

This is the price of inflationist policies. European Union member states believed they could continuously increase their spending and debt because the European Central Bank would always be there to monetarily support them in times of difficulty.

However, this approach has resulted in the destruction of the currency and a decline in governments' solvency.

Merz abandoned his campaign pledge

The recent slump in German sovereign bonds was the worst since 1990. It occurred following Friedrich Merz's announcement of a “paradigm shift” in Germany, aimed at taking on debt and increasing the deficit “to boost growth.”

Merz abandoned his campaign pledge to avoid taking on more debt and succumbed to the Keynesian trap in an attempt to attract social democrats to a coalition.

> Politicians always announce a boost in growth from government spending and new debt, but it never happens

The Keynesian trap is always the same. Politicians always announce a boost in growth from government spending and new debt, but it never happens, and by the time the voter realises it, they announce that the government must increase taxes because the deficit and debt are too high.

The largest drop in German sovereign bonds since 1990 adds to four years of disaster in the price of European sovereign bonds. The popularity of the future German chancellor is already suffering before even forming a government, as he begins his tenure by breaking his campaign promise not to increase public debt.

European Rearm Plan

The announcement of the 800 billion euro European Rearm Plan, which appears highly ambitious and costly, exacerbates this situation. However, we cannot forget that 650 billion euros simply come from the sum of defence investment commitments already made by member states, and 150 billion euros are loans.

Although the European Commission insists there will be escape clauses and that increased debt for defence investment won’t be penalised, any investor understands that this makes no difference; it means much greater financial strain for states with no fiscal room and more money printing through borrowing, which translates into more inflation and higher taxes in the future.

To tackle the challenges of defence,

technology, and competitiveness, the European Union must do much more than just announce more debt.

The European Union has spent over 205 billion euros on fossil fuels from Russia since the start of the war. Therefore, the first thing the EU must do to strategically and economically rearm is abandon the 2030 Agenda and the directives that hinder investment and the development of natural resources. There is no European rearmament without mining.

> The EU and its member states must prioritise spending

Additionally, the EU and its member states must prioritise spending. Superfluous and politically motivated spending must be drastically cut to accommodate defence investments. Investors won't be fooled by a façade of debt.

The European Commission's excessive deficit protocol has become a ridiculous mechanism for disguising debt. In Spain's case, government debt under this protocol is 1.65 trillion euros, while the total issued public debt is 2.15 trillion euros.

Germany does not need to increase public spending, deficits, and debt to grow. Copying France's failed recipe will only lead them to end up in stagnation with uncontrolled debt and deficits.

Why has the market reaction been so negative?

Investing in defence is a necessary but not sufficient condition to innovate, grow value-added sectors and technologies, and lead. We need to do much more.

It is imperative that the European Union abandons central planning—the so-called environmental activism that only impoverishes, slashes tax and bureaucratic burdens, and stops penalising wealth creation and business growth. Every week, the European Union publishes an average of 18 regulations.

If the EU doesn't abandon its policy of extending and pretending, it will spark another debt crisis - Daniel Lacalle

Why has the market reaction been so negative? Despite a tiny rebound on Friday, Bloomberg's index of European sovereign bonds has fallen more than 14% over the past four years.

That's despite all the support from the European Central Bank. What happened? European sovereign debt has become almost toxic due to the inflationary policies implemented in recent years.

Eurozone states believed the European Central Bank would mask their severe fiscal deficiencies. Countries with unfunded commitments exceeding 300% of GDP also announce more debt every time they meet and expect nothing to happen.

If the European Union doesn't abandon its policy of extending and pretending, it will spark another debt crisis. European sovereign bonds have ceased to be a reserve asset, and latent losses since 2022 are significant. The European Central Bank itself has again reported losses of nearly 8 billion euros.

Investing in defence and infrastructure is fine, but only if the enormous amount of unproductive, inefficient spending that condemns the European Union to irrelevance is slashed. The EU will require more than just spending to overcome its current situation.