Goldman Sachs Exchanges

A German economic revival?

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Date of recording: June 3, 2025

Allison Nathan: It's a fascinating moment for the German economy. A new government is in place, and Germany plans to dramatically increase its spending on defense. Meanwhile, US tariffs could have a significant impact on the world's third largest exporter. So what's ahead for Germany and how are investors and business leaders making sense of this historic moment? I'm Allison Nathan, and this is Goldman Sachs Exchanges. Today I'm sitting down with Wolfgang Fink, the head of Goldman Sachs' Germany and Austria businesses.

Wolfgang, thanks for joining us today.

Wolfgang Fink: Great to see you again, Allison.

Allison Nathan: It's very nice to have you actually in New York. The last time we did this I think you were in Europe and I was here. So it's great to have you in person. So, Wolfgang, as I just said, our listeners may be aware that there is a new German government. It's been in place for a month or so. What has that meant for the business environment?

Wolfgang Fink: Well, I think the government that is now in place and actively working is quite a change. They call themselves a working coalition and they want to tackle many of the problems, some more structural long-term, some more short-term, that the country faces. Among them, importantly, the infrastructure of the country and lots has been written about that. The defense, in light of the war we have in Europe. Strengthen the defense capabilities of the country and also Europe and NATO in particular as to the European part. The other parts are clearly for the country to regain its competitiveness on the economic side with many of the issues there.

And European alignment. A big part is European alignment, making Germany strong again in Europe, and a force for good and some country you can count on. And lastly, tackle some of the migration issues that have, as in so many countries in Europe, been on the forefront of many electoral campaigns. And it's another priority that they want to tackle swiftly.

So that, in a nutshell, is the program. It’s a massive program ahead of them and they just started.

Allison Nathan: Yes. I mean, we recently spoke with John Waldron, our president and COO, and he was pretty optimistic that we could be at a turning point when it comes to some of that spending.

He made the point that there's a lot of fiscal room in Germany. It's been, you know, a standout in that sense, but there has been historically not that much willingness to use it. And if that's now changing, that could be quite important. So, where does that really stand at this point and, you know, is it something that could have really wide-ranging implications as John thinks it might.

Wolfgang Fink: Yeah, indeed it will. Because if you think about Germany, the GDP, the debt to GDP was still in a range that offered the government quite a lot of flexibility compared to other industrialized countries. And so far there has been a hesitation to use that headroom if I may call it this way.

Now they do that. They've changed legislation in order to be able to spend up to $500 billion in infrastructure and also amended legislation in a way that they can go and do defense spending outside the constraints of the regular budget, which would hopefully allow them to get up to 3.5% of GDP in defense spending only by the end of the decade.

So, ramp it up slowly, but clearly that will have an impact. In essence, it's a huge fiscal impulse that will come over the coming years. And we obviously have to see how that permeates into the economy and what kind of shape and concrete measures that will take.

Clearly the idea of a public-private partnership and sort of leveraging that amount with private capital is something we are closely watching and expecting to come as part of these measures as well.

So that's that part. But then also changes to increase the competitiveness on the company side, including taxes, including digital reform, i.e., to make the country more digital and allow that to happen. Germany has been a laggard in that regard.

And tactically, the key topic of bureaucracy that has been plaguing the country for many years now. In addition to the energy policy, which clearly is a big disadvantage in Europe cost-wise and in Germany in particular for companies. And then lastly, but not least, obviously, the trade policy, which is front and center.

So if you take all these measures that's coming and that will have a massive impact on the economy and hopefully also on the European economy as such.

Allison Nathan: Right. So these are the positive developments in policy, tailwinds potentially for growth. But as you just mentioned, there is the tariff headwind that could potentially be coming.

So how are leaders thinking about US trade policy at this point and the uncertainty around it?

Wolfgang Fink: Yeah, I think it has, as you say, it has a massive impact. So we shouldn't kid ourselves, the tariffs in the current form, our economists think about, hit the Eurozone with between 0.5 and 1% of GDP Germany clearly has been hit more than the average of the EU given its propensity to exports and to trade deficits especially with the US. So it has a massive impact and it will be a drag to growth on the Eurozone.

Now, how is it this happening? There's obviously discussions both on a supernational level with the EU. There are discussions on a national level as we see every day. And there's a discussion on a company level with the trading partner in the US. So you have various conversations going on at the same time, clearly the idea being, finding a realignment, it's just too important as a matter and as business for both sides to not arrive at a conclusion there, we would hope. And it triggers lots of measures, countermeasures from companies to deal with the situation. Most importantly, however, it triggers uncertainty, and that uncertainty permeates through the economy and in particular affects the consumer.

And that's what companies and the business in general are most worried about. How will the uncertainty play out in terms of demand and what does that do apart from all the other issues? So we're in the middle of that discussion. It's fascinating to see it to see it happening, but we would hope that we come to an alignment rather sooner than later.

Allison Nathan: And if you think about how companies are actually responding to this on the ground, are you seeing shifts in supply chain? Aare companies looking for new suppliers given this uncertainty you just mentioned?

Wolfgang Fink: Yeah, definitely. So you see a lot of activity there both on the supply chains. How do I adjust my supply chain and localize more? Is that even available? Do I have skill sets, capacities, logistics in place to do that? So that's a very active process. It goes further to factories. What's my plan to lay out worldwide? How do I optimize that? How do I create more local content, in particular in the US?

Obviously, also internal measures as to restructuring, you have to counter the current negative impulse. Think about all these cars sitting in some ports not being imported. Think about the question, how does the consumer get the product? How does the consumer react? And then the question of what do I offer in a particular geography? So which kind of product is still doable as opposed to not? If my engine comes out of the NAFTA, maybe I've still an advantage, if the engine is produced outside the NAFTA, the car is probably not saleable anymore from a price point. How do we adjust pricing models?

So all these kind of adjustment processes are ongoing as we speak. And these companies hope to arrive at some equilibrium where actually an economic deal still can be made. Again, otherwise you'll face some short-term, but hopefully not long-term disruptions and profit warnings and so on and so forth.

Allison Nathan: And the disruptions might not just be on the manufacturing or production side. I mean, are companies looking for new customers, new markets in the face of this?

Wolfgang Fink: Yeah, we've seen that as well. This process also started in China, by the way, as a sort of governments and companies became aware of quite substantial dependence in many instances on the Chinese markets.

Those efforts to diversify, China plus one, finding additional kind of markets, is underway. Now, it's not that easy because these markets aren't that sizable compared to, let's say, for German companies in particular. China on the one hand, and US on the other hand. So India, for example, has been talked about a lot is not that easy, but it's happening. South America, the whole Southeast Asian markets, but clearly it'll take a long time until you shift from what currently is China as a market and US in particular, to diversify. We have seen it starting, but we haven't seen massive numbers yet.

Allison Nathan: And you mentioned cars, obviously Germany is well known for cars, but are there other sectors that are really in the crosshairs of these changes?

Wolfgang Fink: Yeah, I think we have to say in particular, machinery and equipment industrial equipment, electricals, on the one hand chemicals, pharma, in particular, if there were pharma-specific tariffs, that would be a massive impact. Base materials like steel and aluminum and also obviously luxury goods and consumer goods out of Europe that are affected.

But I'd say that that part of what we are talking about are global shifts in traditional supply and demand patterns, when you look at some of the chemical inputs, there has been a constant shift to China as being the largest producer and market for those. When you look at some of the famous rare earth and these dependencies. So these discussions about, how do we realign supply chains in a more fractured world and create more local for local, have been ongoing for quite some time. I think the tariff now highlight these tensions that have been existing in our global sort of distributed world that's now going more local content again.

Allison Nathan: Despite this trade uncertainty that we have been discussing will certainly impact Germany as well as other European economies, European equities and German equities in particular are up quite a bit, really benefiting from this theme of fading US exceptionalism. Europe and Germany in particular, again, seems pretty well placed to be a beneficiary of that.

But from your seat, do you think that momentum is set to continue or is it a bit overdone at this point? I mean, at some point things get fully priced.

Wolfgang Fink: Yes, I think that's a fair point. I think at the moment you see this shift, investors readjusting, partly because the returns in the US and in the US dollar haven't been as good or not set to be as good going forward as they have been in the past. So you saw some of that realignment clearly, and I think the US dollar plays a role there as well, number one.

Number two, it is to be seen whether that can be sustained. If you think about the German DAX, 20% of its sales are done in Germany. So in essence, you're buying a global index. And so you have probably a slight shift in the composition, but you're still depending a lot on the global economy and how it's doing. And depending on that, you'll see that whether this momentum sustains. European valuations have been more favorable or less pricey than the US wants. So that gives you some headroom. I think we see that kind of slowly correcting, and that would obviously then stop the movement at one point.

And then you have to look at sectors. Clearly, defense infrastructure, financials to some extent, tech have been sectors that have been somewhat insulated from what we just talked about and therefore have been sought after. Also there we are arriving at pretty pricey valuations. Let's look at defense, for example, and I think something has to give. So we wouldn't see it as a sustained momentum. It's something which has started, but then obviously, the company earnings and performance has to catch up with it. And that's what we are looking for when we look at the next quarters that the companies will publish.

Allison Nathan: Right. So almost fully priced, we should say, in some of these sectors. Interesting. Let's talk about deal-making activity. When you think about this trade uncertainty, bond yields are much higher in the US and beyond. You know, what has the impact been so far and what to expect for the pipeline ahead?

Wolfgang Fink: Yeah, it's actually very interesting. So you would think that this environment lends itself to a kind of no-deal environment, given all the uncertainty and you would ask which corporate leader would now take decisions given that so many things are still up in the air and not nailed down. Having said that, we are actually seeing a quite good deal-making environment.

And we are seeing a lot of deals happening, though I would say in the category, more mid-sized transactions rather than large-sized transactions, given some of what we just talked about. And you have to look at the sectors again. I'd say that sectors are, the ones we talked about are more sought after than the, the classic cyclicals and some of the ones heavily affected.

That, to me, doesn't mean that companies aren't addressing issues and therefore going to market and trying to sell, but clearly buyers look careful in terms of valuations. We talked about the price and valuation. So still not easy to get these deals done or make this math happen.

But there's a good undercurrent of those type of deals in the sectors we talked about. So we are quite optimistic for the rest of the year. And clearly also the private equity business is going quite well. Companies have to come to market, portfolios have to be sold, and that basically gives us a good underpinning for our general M&A activity.

So I'd say we are cautiously optimistic with what we are seeing. And as the macro picture settles a bit more, we would expect this activity to pick up even more.

Allison Nathan: When you think about the underlying catalyst for the pickup and activity, because, as we just said, there's a lot of uncertainty, but why are companies re-engaging at this point? Is there just pent-up demand because there was a lull? How would you explain why now?

Wolfgang Fink: I would think that there's a bit of pent-up demand, also because we saw a slower environment last year. But then in general, very often the macro uncertainty we talked about is a catalyst for more fundamental change. Business and operating models have to be adopted. A restructuring finally have to be done.

You basically try to pull the levers that you control in this environment because you know that what you can't control can have a massive impact. So you get prepared. I would say it's sometimes getting ahead of the curve of macro uncertainty by doing your homework. And then things have to happen. Now that means obviously that sellers have to accept sometimes prices they're not absolutely content with, but compared to what they're facing, that's probably the option they have.

There are areas like technology where you would say they're somewhat insulated from what we talked about. The digitalization, implementation of AI, changing the go-to-market or the internal operations without an alternative. So they have to happen. So if you need a business or you need M&A to fulfill that objective, you’ve got to do it regardless of the macro uncertainty. So these sectors, or we talked about defense or infrastructure, those things, if you have an opportunity, you need to go for it. There aren't endless opportunities. So if one is presenting itself, you better be ready to take it.

Allison Nathan: So what's your advice to companies and investors that are navigating this really uncertain moment?

Wolfgang Fink: I would say the general economic underpinning is still strong. So stay close to your customers, make sure you're still in front of them with the best offering and ahead of your competition. The business is there, is out there. We talk a bit the probability of recession, but we don't see it yet materializing. So there's a still good underpinning in the, on the business side, number one.

Number two, be prepared for a quite volatile geo-economic environment. So stay nimble and flexible. I talked about ability to switch between plants, adjust supply chains. That's what you have to have in the scope of your daily judgments and decisions.

And then lastly, pull the levers you haven't pulled before. You know, try to restructure where you can. Look again at your operating and go-to-market models. Make sure digitalization is front of mind. Pull those levers that you haven't pulled so far in order to gain flexibility on the way.

Allison Nathan: Thanks so much for joining us here in New York, Wolfgang, and sharing your insights.

Wolfgang Fink: Thank you. My pleasure.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Tuesday, June 3rd. I'm Allison Nathan. Thanks for listening.

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