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The economic and political risks of re-arming Europe

Europe's major increase in defence spending is set to boost growth but beware of mitigating factors. Even with looser fiscal rules from Brussels, financing remains a challenge for countries with high deficits

European leaders with Ukraine's President Zelensky at this week's defence spending summit in Brussels

The proposed increase in European defence spending may be a 'watershed moment' according to the European Commission President, Ursula von der Leyen. And at a time when the eurozone economy has fallen back into stagnation, you might think that hundreds of billions of extra fiscal expenditure will be enough to revive Europe's stagnant economies. But we have doubts. While additional spending can make a difference to growth, it's not going to be immediate and the ultimate boost to GDP will be moderate in the coming years.

Of course, any boost to growth is to be welcomed. So, how will the proposals to unlock some €800bn work, and what will be the effect on government finances?

Eurozone defence spending is set to grow much further

Source: NATO, ING Research

Financing higher defence spending means stretched budget balances

While economically you could argue that more defence spending in the eurozone is welcome, from a public financing perspective, this couldn't come at a worse time. Many eurozone countries are still struggling with budget deficits that are too high. Countries such as France, Belgium and Italy have entered the so-called Excessive Deficit Procedure and are struggling to bring deficits down to 3% of GDP. Increasing defence spending to a higher NATO target will therefore be a challenge, especially as quite a few of the high deficit countries already struggle to meet the current 2% target.

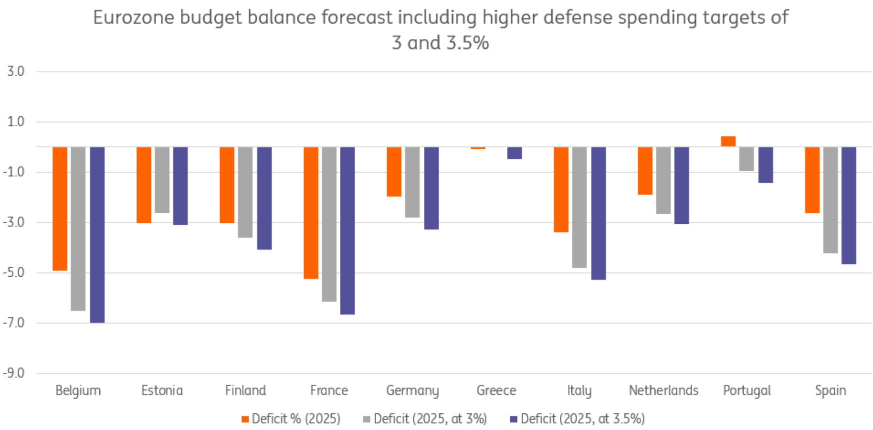
> *Hard political choices need to be made*

We discussed the new need for Europe to step up its defence efforts immediately after first talks about a possible peace agreement between the US and Russia on Ukraine and US vice-president J.D. Vance's presentation at the Munich Security Conference. Latest events in the Oval Office have only increased this sense of urgency. Back then, we delved into ways to finance additional defence spending. Today, we will focus on the possible implications for eurozone growth.

Take a look at the chart below. It shows the hypothetical situation in which countries increase defence spending immediately to a higher target of 3 or even 3.5% of GDP without changing any other government finances. This would result in a breach of the European Commission's 3% deficit rule for most eurozone economies. For France and Belgium, it would bring the deficit substantially even further away from that target. Hard political choices will need to be made as defence spending increases.

Germany is a special case as this week's proposals to create defence spending exceptions to the debt brake are likely to result in a sizeable increase in defence spending. Given its already low government deficit, Germany could lead the way in terms of additional spending. The jump in German yields shows that markets are expecting a much higher demand for government borrowing from Berlin.

Meeting higher NATO spending targets comes with hard political choices



Source: NATO, European Commission AMECO, ING Research calculations

Chart shows budget balance expectations of the European Commission for 2025, adjusted by the difference between 2024 defense spending and hypothetical targets of 3% and 3.5%.

The Commission's plans help tackle but don't solve market concerns

The Commission's plan to 'rearm' Europe and to unlock extra defence spending largely hinges on invoking the national escape clause of the Stability and Growth Pact again. According to the plan, this could potentially unlock €650 billion if countries allocate an extra 1.5% of GDP to defence, raising average EU defence spending to 3.5% of GDP. This approach would enable countries to exceed the 3% of GDP deficit threshold without triggering the Excessive Deficit Procedure.

The proposal includes creating a €150 billion fund from which countries can borrow specifically for defense purposes. This would be particularly beneficial for countries that face higher interest rates, as it would provide them with more favorable borrowing conditions compared to borrowing independently. However, borrowing from this fund would not be considered additional defence spending because it is intended to help countries meet the target of increasing defence spending by 1.5% of GDP.

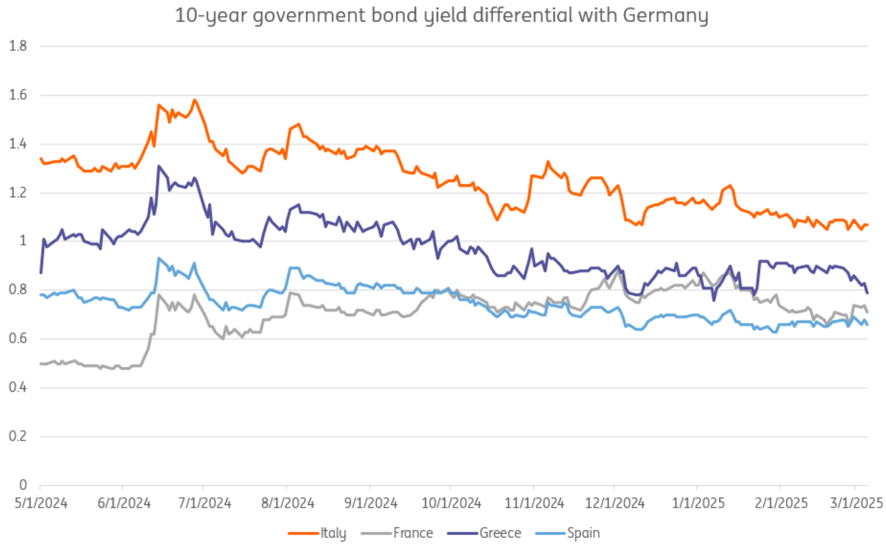
The plan also allows cohesion funds to be used for defence spending but it falls short of creating a shared fund for joint spending. The fact that the plan does not involve a hard target for spending, but more an estimate of what would happen if Europe used the escape clause to increase spending by 1.5% of GDP, makes it uncertain whether the €800bn mentioned by the Commission will be reached.

There is uncertainty about the market response

While the Commission's plans so far focus mainly on unlocking extra national spending and do not result in talk of a "Hamiltonian moment" like the NextGen EU announcement did, markets do remain very relaxed on the matter. Spreads have remained benign so far, which means that while interest rates are up, markets don't seem concerned about more indebted countries, at least not yet. To us, this implies that investors are still banking on more European unity in the face of geopolitical developments.

With spreads under control for the moment, that is a positive sign for extra spending. Then again, national governments will have to live with uncertainty about the market response to much higher defence spending without cuts elsewhere. For the high debt countries, in particular, this will add further to debt levels and could result in a lack of market trust at some point, which could curb defence spending or trigger budget cuts elsewhere even though the Commission is allowing it.

Spreads on government yields remain benign



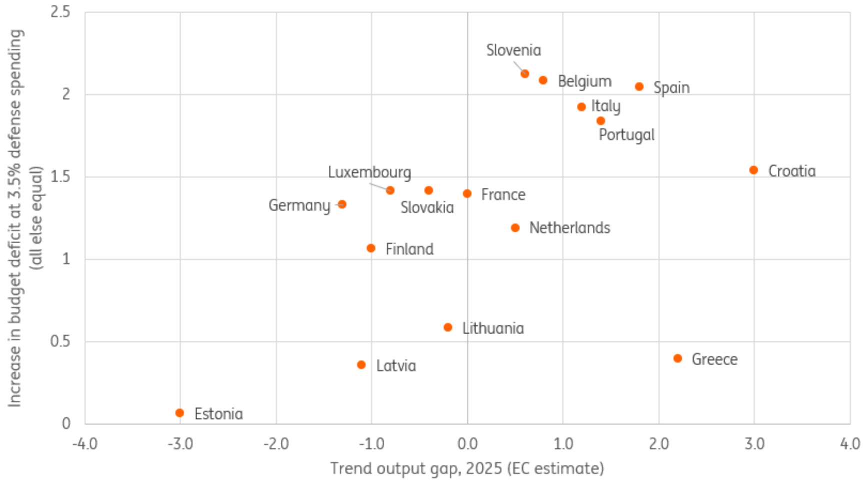
Don't expect economic miracles on increased defence spending

We expect defence spending to increase materially in the coming years, and 2024 already saw a strong improvement in European spending. Stronger orders could already come in now, but depending on the type of spending, defence orders have long lead times before resulting in actual investment.

The question is, what will this be spent on exactly? NATO estimates that about two thirds of additional eurozone defence spending last year went to equipment investment. Given Europe's low defence production capacity, this generally means that a lot of spending will result in higher imports. The European Commission estimates equipment investments to comprise around 80% of imports, while others like Bruegel think it'll be lower. While we do expect the eurozone to increase its defence production capacity, we think the initial extra investments will result in a sizeable amount of imports which will fade modestly over time as domestic capacity increases.

This means that while at face value rearming Europe sounds like a radical boost to eurozone fiscal spending and growth, the ultimate effect, at least in the first few years, is likely to be more moderate. We expect gains of 0.1% and 0.2% of GDP for the eurozone as a whole for 2026 and 2027. If more spending materialises and more domestic investment happens quickly, this could increase. We expect more upside risk given how quickly geopolitical concerns are mounting.

A spending boost is more welcome to some countries than others



Source: NATO, European Commission AMECO, ING Research calculations

A positive output gap in combination with a strong increase in spending to make higher defense targets could result in more inflationary pressures as it increases spending in an already more heated economy.

The upside risks for the ECB

For the European Central Bank, Europe stepping up its defence spending, changing the fiscal rules once again, and having Germany engage in a €500bn infrastructure investment fund will clearly present an upward risk on rates. The only question is how much. The inflationary pressures seem to be relatively soft given the expected muting factors, but that also differs across countries. Some countries that already have positive output gaps may run into inflationary pressures more quickly given the extra spending. Others, such as Germany, have more room at the macro level before broader capacity constraints cause wider inflationary pressures as you can see in the chart above.

A lender of last resort for eurozone governments

If European governments are now finally really taking over most of the work not only to rearm but also to regrow the European economy, the need but also the space for the ECB to continue cutting interest rates will fade quickly. Instead, with higher bond yields and a possible widening of spreads, the ECB will be needed elsewhere, namely as lender of last resort for eurozone governments. And that could be via the Transmission Protection Instrument or a kind of yield curve control as long as additional spending comes at the national government rather than European level. And it's worth pointing out that new ECB asset purchases are only one sovereign debt tension away.

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