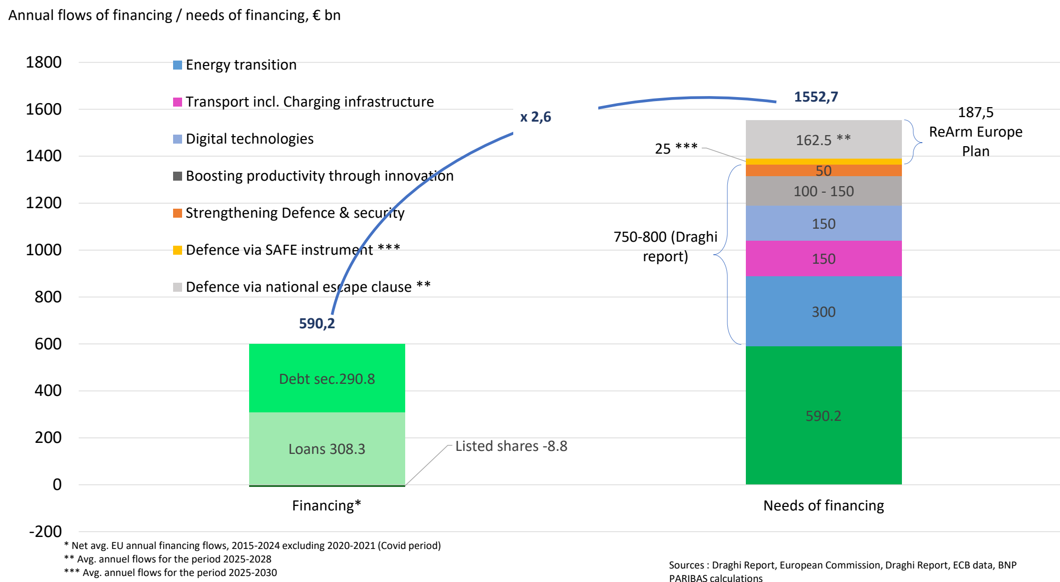
EU: REARMAMENT, ENERGY AND DIGITAL TRANSITIONS – THE SCALE OF THE EFFORT

A COLOSSAL FINANCING EFFORT



Faced with US disengagement, the European Union has decided to close ranks and reinvest massively in its defence. On 6 March, the European Council therefore approved a plan that would theoretically raise €800 billion. This plan is split into two parts. The first will allow each Member State to deviate from its spending trajectory by 1.5% of GDP on average over a four-year period, without being subject to an excessive deficit procedure. In theory, this mechanism would provide an additional €650 billion of budgetary leeway. For the time being, several national governments have announced that they will not make use of the escape clause (France) or are not favourable to it (Italy, Spain)[1].

The second mechanism is a dedicated financial instrument ("Security Action For Europe", SAFE[2]) issued by the European Commission, which would raise up to €150 billion to finance a loan facility guaranteed by the European budget and intended for Member States for their military spending. Coupled with the investments deemed necessary in the Draghi report[3] for the energy and digital transitions, these new European defence ambitions would require, according to our calculations, between €938 billion and €988 billion in annual funding up to 2028, then between €775 billion and €825 billion up to 2030.

In order to provide a measure of the effort required, we have calculated the average annual financing flows mobilised by the resident non-financial sectors (households, non-financial corporations and general government) of the European Union over the 2015-2024 period (excluding the COVID period). These amounted to nearly €600 billion, split almost equally between loans[4] and net issues of debt securities (listed share issues were negative due to share buybacks).

Leaving aside the external financing constraint, the needs (investment and consumption) covered by this "historical" net flow of almost €600 billion will continue, for the most part, over the next few years. The total of the "historical" and new financing needs is therefore an approximation, albeit extreme, of the scale of the financing effort required. According to our calculations, these additional needs would imply a doubling or tripling of annual financing flows up to 2028 (*see chart*).

1 According to our calculations, France, Spain and Italy's decision not to use the budgetary margin would reduce potential financing from €650 billion to €237 billion in cumulative terms and from €162.5 billion to €59.3 billion in annual flows between 2025 and 2028.
2 Proposal for a Council Regulation establishing the "Security Action for Europe (SAFE) through the reinforcement of European defence industry" Instrument ("SAFE Instrument"), COM (2025) 122 final, 19 March 2025.
3 Report commissioned by the European Commission from Mario Draghi, former President of the European Central Bank, in autumn 2023 and submitted to the President of the Commission on 9 September 2024. Draghi M. (2024), "The Future of European Competitiveness".
4 Source Financial accounts of the countries of the European Union. To avoid double counting, loans to non-financial corporations have been adjusted for intra-sector loans from other non-financial corporations.

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In practice, achieving such annual financing flows is challenging. Firstly, the combination of a considerable increase in bond issuances, the continuation of the ECB's QT and the slight rise in medium-term activity expectations should lead to sustained higher long-term rates. This should reduce budgetary leeway, thereby creating substitution rather than additional public investment and crowding out some private investment. In this respect, the bond market's reaction to the announcement of Germany's €500 billion defence and infrastructure investment plan (the 10-year Bund had gained more than 40 bp since the end of February before the recent easing linked to the US tariff announcements) provides an insight into the foreseeable effects. Secondly, some Member States, under budgetary constraints, may choose to reduce other expenditure so as not to increase either the public deficit or taxation.

These obstacles could be mitigated by appropriate economic policy decisions. Indeed, the greater the impact of these additional investments on economic activity, the more sustainable the increase in debt will be. From this point of view, the creation of a European military sales mechanism to channel spending primarily to the EDTIB[5], which will first be tested as part of a pilot project and then implemented from 2028, will, as a result, support the budget multiplier[6] by stimulating private investment in this sector in particular.

On the financing front, and while we wait for the emergence of the Savings and Investment Union (which saw its strategy unveiled by the Commission on 19 March), a pragmatic solution would perhaps be to ease - temporarily and with a recalibration aligned with the risk - the regulatory constraints weighing on bank financing and securitisations, so that the additional supply of financing would benefit the economy as a whole.

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5 The European Defence Technological and Industrial Base (EDTIB) is made up of a number of large multinational companies, ETIs and over 2,000 small and medium-sized enterprises (SMEs). The European Commission estimates its annual turnover at €70 billion.
6 According to the latest study by the Stockholm International Peace Research Institute (SIPRI) on global arms exports and military spending, European NATO members imported 64% of their weapons from the United States during the period 2020-2024. Between 2015 and 2019, this share was 55%.

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