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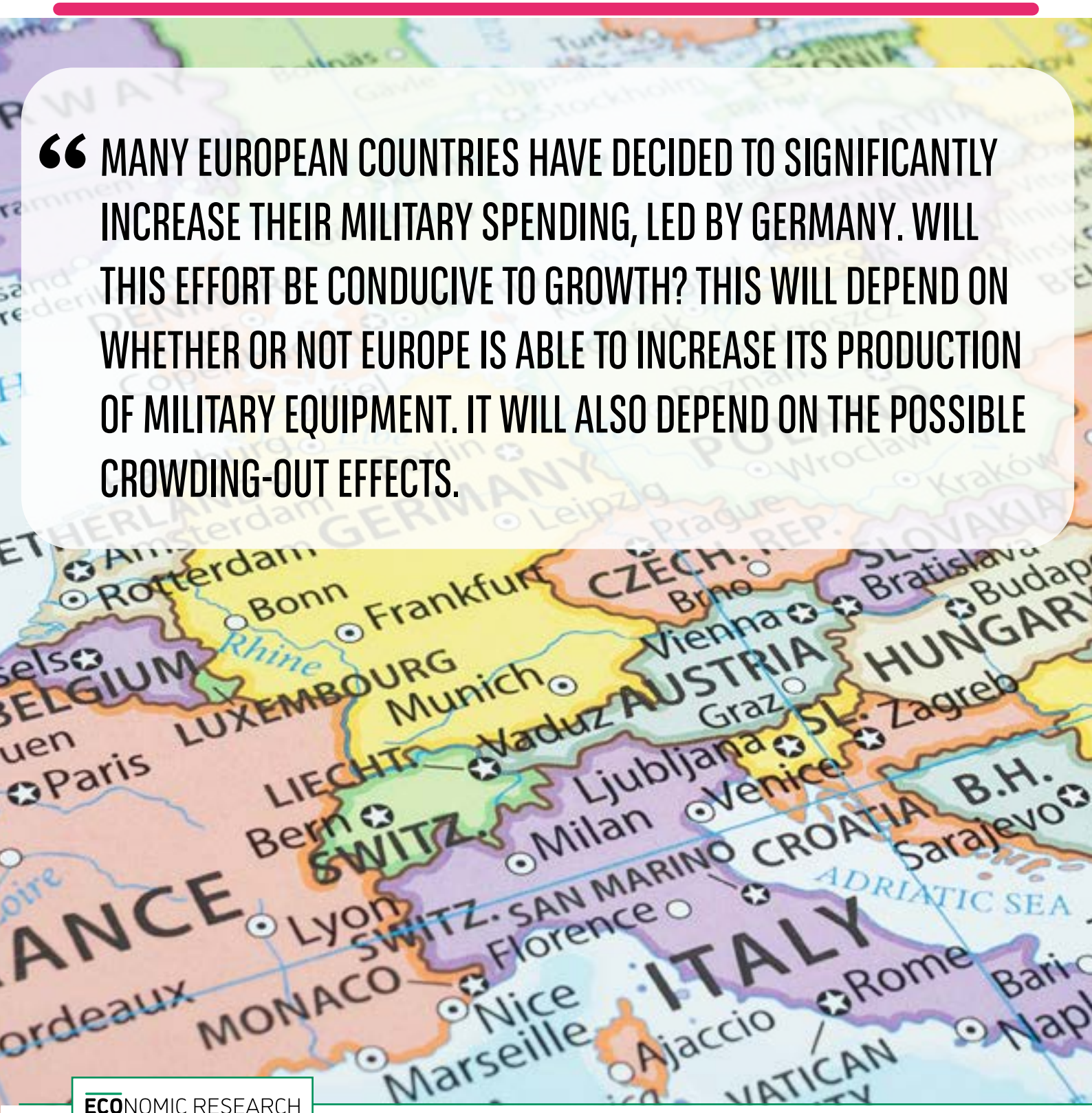

> “ MANY EUROPEAN COUNTRIES HAVE DECIDED TO SIGNIFICANTLY INCREASE THEIR MILITARY SPENDING, LED BY GERMANY. WILL THIS EFFORT BE CONDUCIVE TO GROWTH? THIS WILL DEPEND ON WHETHER OR NOT EUROPE IS ABLE TO INCREASE ITS PRODUCTION OF MILITARY EQUIPMENT. IT WILL ALSO DEPEND ON THE POSSIBLE CROWDING-OUT EFFECTS.

ECONOMIC RESEARCH

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REARM EUROPE: TURNING THE CHALLENGE OF REARMAMENT INTO AN OPPORTUNITY FOR EUROPEAN INDUSTRY AND GROWTH

Stéphane Colliac & Lucie Barette (with Leslie Huynh, intern)

Many European countries have decided to significantly increase their military spending, led by Germany. Will this effort be conducive to growth? This will depend on whether or not Europe is able to increase its production of military equipment. It will also depend on the possible crowding-out effects (inflation, interest rates) associated with an increase in public debt. The ability of European industry to meet demand (an increase in EU military spending from 2% to 3.5% of GDP) will be decisive. A reallocation of currently underutilised production capacity (mainly in the automotive and intermediate goods sectors) could help to increase production.

REARM EUROPE: TURNING THE CHALLENGE OF REARMAMENT INTO AN OPPORTUNITY FOR EUROPEAN INDUSTRY AND GROWTH

On 4 March, the European Commission announced a European rearmament plan (Rearm EU or Readiness 2030). It aims to mobilise EUR 800 billion to enable military spending in the European Union (EU) to reach 3.5% of GDP by the end of the decade (compared with 1.9% in 2024)[1]. This plan will be implemented by Member States as part of enhanced joint programming efforts to ensure the complementarity of national initiatives. However, several sources for joint financing have been identified, including EUR 150 billion included in the plan. Another possibility could be to include dedicated funding for the defence effort in the next EU budget.

On the very evening of the announcement, the newly formed German coalition announced its own plan: an increase in the defence budget made possible by excluding military spending from the debt brake rule if it exceeds 1 point of GDP. This would even allow Germany to eventually increase its spending to 5 points of GDP, as F. Merz recently suggested.

Will the implementation of these measures benefit European growth? Three critical points, which we will develop further, will enable us to assess their impact:

- The translation of defence effort into national budgets,
- Its impact in terms of budget deficit (as well as debt and interest rates), growth and inflation,
- The ability of European industry to produce the additional equipment needed to maximise gains in terms of growth, while reducing the risk of inflation. In this respect, the conversion of industrial sites could help in the short term, before investment in new projects makes it possible to increase supply in a more significant and sustainable way.

NATIONAL BUDGETS ALREADY ON TRACK

Several European countries had already begun to increase their military spending before 4 March 2025: Poland and the three Baltic States (whose military budgets already exceeded 3 points of GDP), Germany (increase from 1.5% to 2.1% between 2022 and 2024) and France, whose effort was more gradual (2.1% of GDP in 2024 compared with 1.9% in 2022). On the other hand, other countries, whose military spending was among the lowest in terms of GDP points, notably Spain and Italy, had not planned any increase (*Chart 1*).

The main change comes from the German plan. It does not formally indicate an amount, but states that military spending will no longer be limited by the debt brake rule. It thus establishes an open window, leaving it to the governing coalition to define the actual amount. However, our interpretation is that its implementation should be rapid, with military spending reaching 3% of GDP by 2027[2].

Spending is also expected to increase significantly in countries where it has so far been lowest, with the aim of rapidly approaching the current European average of 2 points of GDP. Spain and Belgium have already announced plans, and Italy should follow suit. In the Nordic countries, which have budgetary room for manoeuvre, the target of 3.5% of GDP by 2030 should be met, particularly in Sweden.

NATO MAIN MEMBERS' MILITARY EXPENDITURE IN 2024

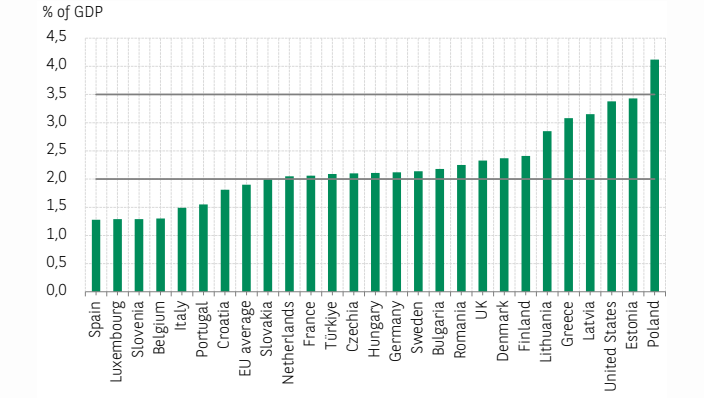

CHART 1 SOURCE: NATO

EUROPEAN UNION: ADDITIONNAL MILITARY EXPENDITURE FOR 2025-27 COMPARED WITH 2024 (BN EUR)

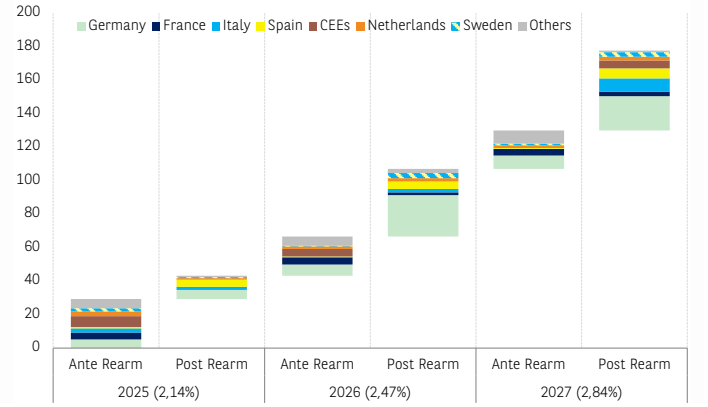

CHART 2 SOURCE: GOVERNMENTS, BNP PARIBAS

The additional effort will be more moderate for countries whose defence budgets have already been increased and/or whose budgetary room for manoeuvre is more limited. This is the case for France and the countries of Central and Eastern Europe.

Chart 2 shows the rise in military spending in the EU by country between now and the end of 2027. Compared with what was already planned and what was announced between early March and mid-June, the planned spending is consistent with the metrics set out in the Rearm EU plan. According to our calculations, military spending would increase by around 1 point of GDP (or EUR 180 bn), rising from an average of 1.9% of GDP in 2024 to 2.8% in 2027. It would therefore be on course to reach 3.5% of GDP by the end of the decade.

1 Since then, a target of 5% of GDP has been mentioned and could be adopted at the NATO summit at the end of June. The additional 1.5 percentage points (on top of the 3.5%) would involve including in military expenditure accounting certain expenditure that is incurred in parallel but is not currently included in this accounting (infrastructure, cyber defence and military satellites in particular). This would not necessarily be additional expenditure.
2 NATO Secretary General Rutte said that a 5% target would be submitted to the NATO summit in The Hague on 24 and 25 June, along the following lines: *'I will propose an overall investment plan that will total 5% of GDP on defence investment - 3.5% of GDP for core defence spending and 1.5% of GDP per year in defence and security related investments, like infrastructure and industry'.*

INCREASE IN MILITARY SPENDING AT CONSTANT BUDGET LEVELS OR RISE IN PUBLIC DEBT

Public finances and long-term interest rates

The consequences of this plan on member countries' public finances will depend on how they are adjusted to cope with increased military spending[3]. Some countries have already indicated that this will be done with a constant budget. This is the case for France, which has a large public deficit (5.8% of GDP in 2024) and has undertaken a multi-year consolidation programme to limit the increase in its public debt.

Others have increased their deficit and are therefore financing this budget increase through debt. This is the case in Poland (deficit of 6.6% of GDP in 2024 and debt rising from 49.7% of GDP in 2023 to 55.3% of GDP in 2024). Germany should follow suit. This is what is implied by the exclusion of military spending (above 1 point of GDP) from the debt brake rule.

According to our calculations, Germany would thus see its public deficit rise from 2.8% of GDP in 2024 to 5% of GDP in 2027 (when the defence and infrastructure investment plans will be fully implemented). Thereafter, austerity measures (envisaged but not detailed by the government) should enable the deficit to be reduced. However, this would not prevent an increase in the public debt ratio, which would reach almost 71% of GDP by the end of the decade (compared with 62.5% of GDP in 2024). In absolute terms, the debt would rise from EUR 2,692 bn in 2024 to almost EUR 3,750 bn in 2030 (almost +40%).

This increase would have a lasting impact on German interest rates: +40 bp between their current level of 2.5% and 2.9% at the end of 2025, and +40 bp again in 2026 and beyond. In the other major Eurozone countries, the defence effort would not be financed by an additional increase in debt (e.g. in France, debt would increase due to a particularly high public deficit, but not because of the rearmament effort). In Italy and Spain, the ongoing decline in the debt ratio would be slowed by additional spending (significantly less than in Germany, *Chart 2*), but would not be jeopardised.

However, as spreads with the German rate have already narrowed significantly, there is a risk that they will not contract enough to prevent a rise in long-term rates (Italy, Spain). In the case of France, if the spread remains close to its current level, the rise in German rates would be fully passed on to French rates. In Central Europe, the relatively contained level of public debt (55% of GDP in 2024 in Poland) has so far prevented an increase in long-term rates (which remain close to the highs reached at the end of the inflation period, i.e. 5.8% on the Polish 10-year). Moreover, the level of long-term rates will also depend on the anticipated and actual impact of rearmament efforts on growth and inflation (and therefore on monetary policy).

Impact of rearmament on growth and inflation in 2025-2027

Our public finance calculations, described above, include an estimate of the impact of additional military spending on growth[4]. This effect would be particularly positive for countries that increase their deficits. In Germany, according to our calculations, it would initially lead to an increase in public consumption (two-thirds of the effect) and public investment (one-third of the effect), proportions close to what has been observed on average in the EU so far, according to data from the European Council.

We then assume a multiplier effect greater than 1, despite the fact that some of the equipment will be imported. Nearly 80-90% of public investment concerns purchases of military equipment in EU countries. The imported proportion varies (10% in France, almost 50% in Germany).

Several effects would work in the opposite direction and support the multiplier:

- Investment in the private sector to meet the increase in public-sector orders, which would be facilitated by the conversion of underutilised industrial production capacity to meet this demand.
- The role of national fiscal policy, with the additional measures introduced by the German coalition. In particular, a mechanism for early amortisation of business investment in equipment[5].
- The existence of common European funding, mobilised only when production in the EU reaches at least 65% of the investment made (a fund known as SAFE, Security Action For Europe); this would provide further support for the multiplier effect of military spending, establishing a form of Community preference.

Ultimately, the impact on German growth would be +0.4pp in 2025, +0.7pp in 2026 and +0.6pp in 2027 (*Chart 3*).

GERMANY: BREAKDOWN OF INVESTMENT PLANS' IMPACT ON GROWTH

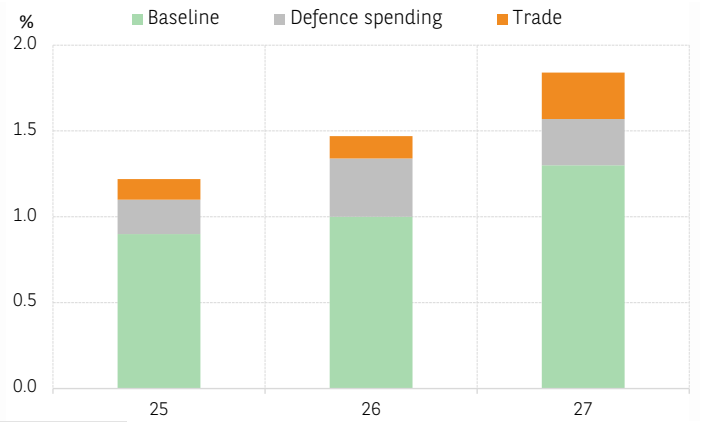

CHART 3 SOURCE: BNP PARIBAS

For those countries making this effort on a constant budget basis, the effect should be much more moderate, but it would be positive through two channels: a rebound in industrial production, which would benefit from a boost in demand (as discussed in the sections 'European industry running out of opportunities' and 'Rearmament to prevent further deindustrialisation') and the knock-on effect of additional spending on intra-zone trade, particularly in Germany.

As a result, the Eurozone is set to enjoy a growth boost of +0.3pp in 2025, followed by +0.5pp in 2026 and +0.5pp in 2027. Initially, this will come from military spending (and infrastructure spending in Germany). Apart from Germany, growth in low-spending countries (Spain, Italy) would benefit the most.

3 For more information on the overall financing of spending, beyond just the rearmament effort, see our chart of the week, 'EU: Rearmament, energy and digital transitions - the scale of the effort'.
4 See our estimate of the impact of Germany's plans on growth in Germany, "Germany: "whatever it takes"?", and of the plans of all European countries on growth in the eurozone, "US Tariffs: The Big Shake-up".
5 By amortising more of their investments in the early years, companies would see their taxable profits fall (and therefore their corporate tax in 2026 and 2027), before the government introduces a 15% to 10% reduction in corporation tax from 2028.

Over time, the knock-on effect on intra-regional trade would strengthen, to account for half of the positive impact in 2027 (*Chart 4*). The open economies with the best connections to Germany should benefit most from this effect (particularly the Netherlands, Belgium, Italy and France).

The consequences in terms of inflation are more uncertain. Inflation has fallen sharply in Europe, and the supply pressures observed at the end of the Covid period have largely subsided[6]. However, they remain higher than before the pandemic. Inflation is expected to remain around the ECB's 2% target in the medium term, for both the Eurozone and Germany. However, the current state of underutilisation of production capacity could mitigate this risk.

GROWTH IN EUROZONE: IMPACT OF MILITARY EXPENDITURE AND GERMAN INVESTMENT PLANS

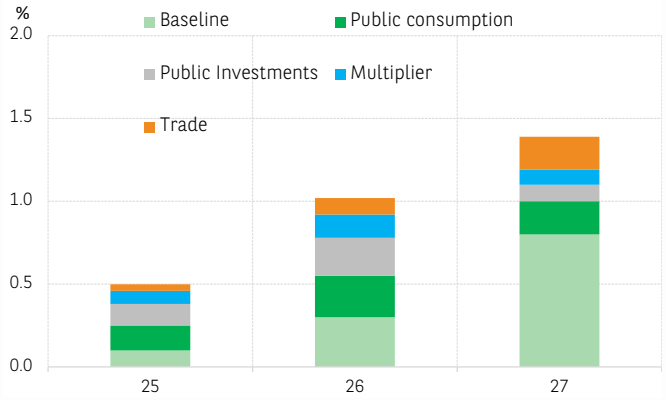

CHART 4

SOURCE: BNP PARIBAS

EUROPEAN INDUSTRY RUNNING OUT OF OPPORTUNITIES

Faced with a significant increase in demand and given the EU's ambition to significantly increase its strategic autonomy, the industry will have to adapt. It will therefore allocate a growing share of its production capacity to military equipment. Thus, the use of the EUR 150 billion of joint funding included in Rearm EU (the so-called SAFE funds, Security Action For Europe) assumes a European content of at least 65%, which should support the development of the industrial sector in Europe.

Far from being a constraint, this situation represents an opportunity for an industry suffering from persistently weak demand. In fact, European manufacturing output has fallen sharply compared to 2017, when production peaked, particularly in Germany. This loss of production is most severe in Germany and Italy, the two European leaders in terms of industrial production. It primarily affects the automotive and energy-intensive sectors (including chemicals, metallurgy and plastics), as well as textiles in Italy (*Chart 5*).

Despite a significant decline in demand over several years, production capacity remained high in anticipation of a rebound in demand that did not materialise. Against this backdrop, the further fall in the production capacity utilisation rate (CUR) observed in 2024 (*Chart 6*) carries the risk of some capacity being destroyed.

6 See our latest Inflation Tracker, April 2025

BREAKDOWN OF THE EVOLUTION OF THE INDUSTRIAL PRODUCTION INDEX COMPARED WITH 2017

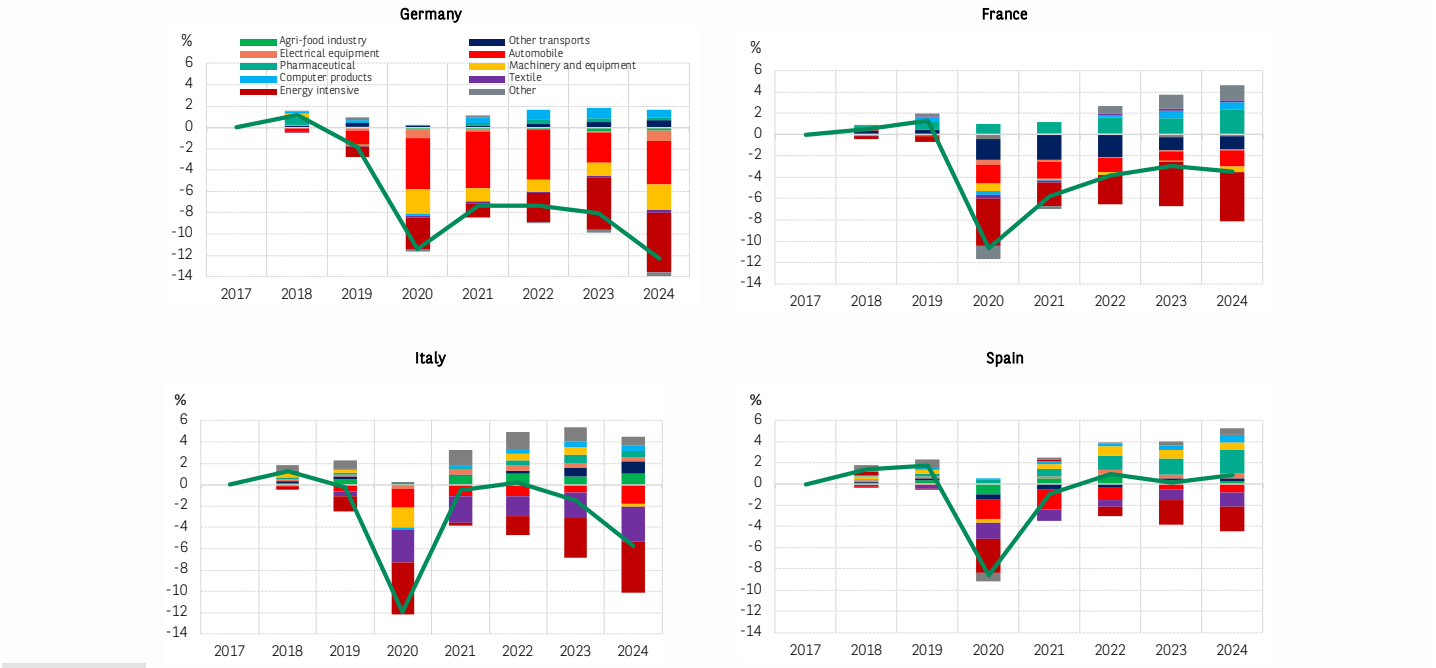

CHART 5

SOURCE: NATIONAL INSTITUTES OF STATISTICS, BNP PARIBAS

CAPACITY UTILISATION RATE (%)

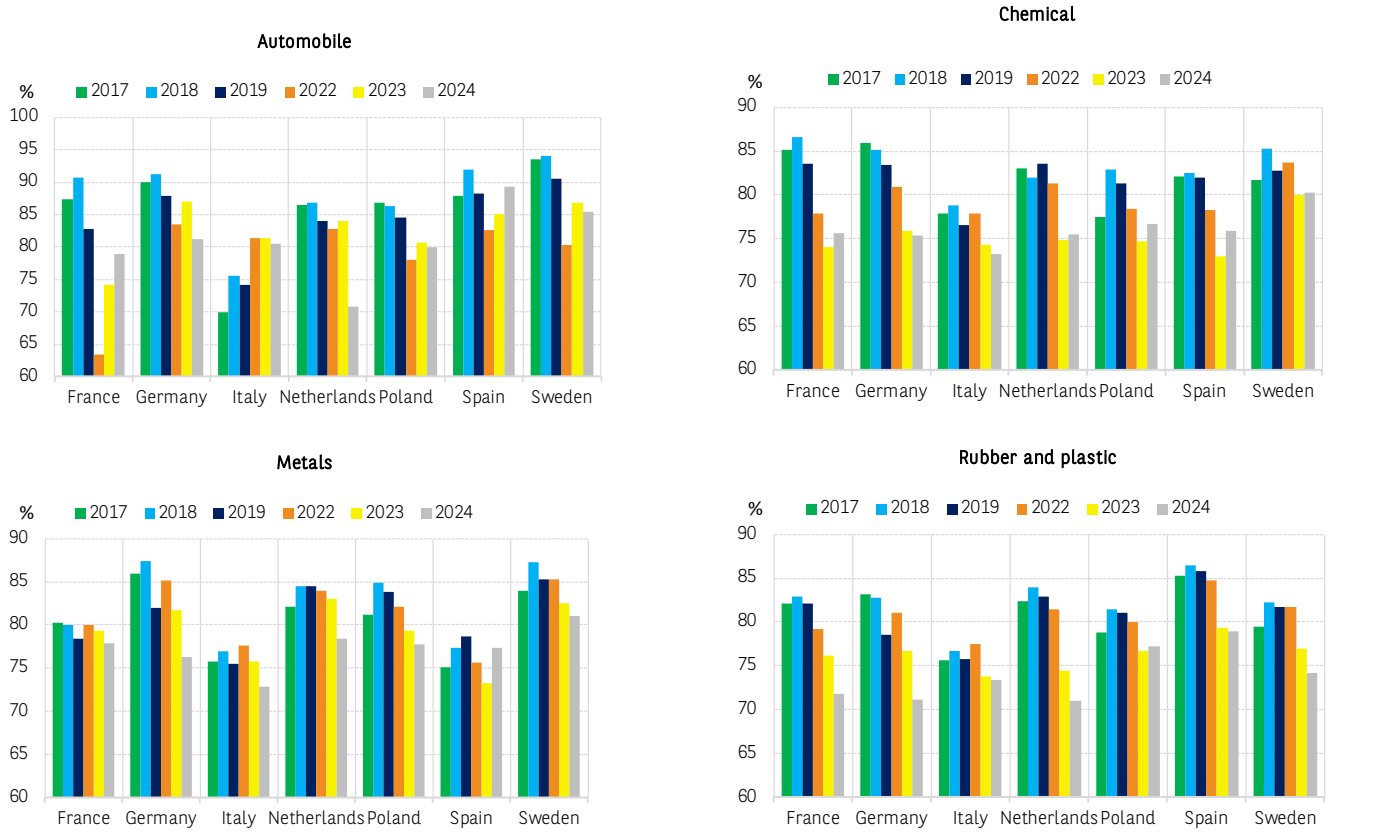

CHART 6

SOURCE: EUROPEAN COMMISSION

There are several examples of factories being converted to produce military equipment instead of civilian equipment (notably in Germany and France[7]), and other capacities could probably be reallocated. Indeed, the decline in demand that these sectors are facing appears to be at least partly structural.

In terms of external demand, the decline in Germany's export market share (the main exporting power in our sample of countries, hence our focus here) appears to be structural (*Chart 7*). On the one hand, the rise of China as a competitor is likely to continue unabated, mainly in the automotive, chemicals and electrical equipment sectors. On the other hand, the US market, which has been a real growth driver for German companies for the past five years, is likely to suffer from the Trump administration's new tariff policy.

In terms of domestic demand, we expect a moderate rebound in car registrations, which will not, however, close the gap with the pre-Covid levels[8] (the cumulative figure for the past 12 months is almost 20% below that level). A combination of cyclical constraints and structural challenges specific to the automotive sector is likely to slow its recovery, at least in the immediate term, leaving production capacity underutilised for some time. Another sector facing problems is housing construction (another major outlet for intermediate goods). Its lack of recovery is also limiting demand and contributing to underutilisation of production capacity.

EVOLUTION OF EXPORTS' MARKET SHARES (%)

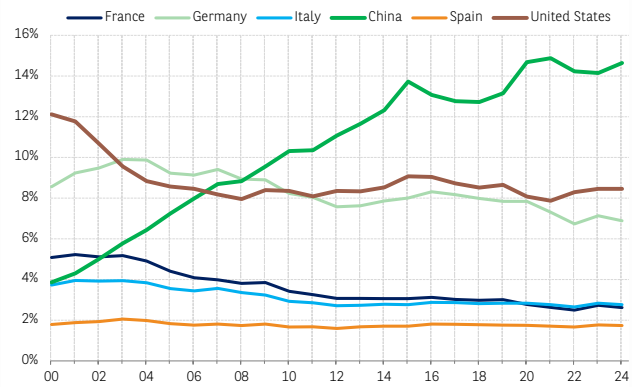

CHART 7

SOURCE: WTO

7 Notably the takeover of Fonderies de Bretagne y Europlasma in France and the reorientation of the Rheinmetall factory in Neuss towards the production of military satellites (instead of cars).
8 See the latest Cetelem Observatory study on the automotive sector (in French).

REARMAMENT TO PREVENT FURTHER DEINDUSTRIALISATION

The scale of the additional production capacity required to meet the increase in demand for military equipment is significant, given the announced rearmament effort. Not all industrial sectors are in the same situation. For example, the CUR does not appear to have declined in the aeronautics industry, which will also need new capacity to meet demand. On the other hand, the automotive, energy-intensive intermediate goods and electrical equipment sectors are underutilising their production capacity.

However, not all currently unused capacity is available for reallocation. An upturn in the economy would naturally push up the CUR. Nevertheless, a return to pre-pandemic levels seems unlikely, as these corresponded to levels of demand that are unlikely to be reached again. One reflection of this underutilisation of production capacity is the decline in labour productivity. In its latest estimate for France, the Banque de France highlights that productivity in the market sectors was 5.6 points lower at the end of 2024 than the 2010-2019 trend would have implied; 4.3 points would be sustainable (almost three quarters), which confirms our conclusion that these production capacities will remain underutilised in the future.

The decline in production capacity in the sectors mentioned or their conversion to military production could therefore also improve productivity (only the second option would have a positive impact on growth).

The 2022-2023 CURs, which are lower than pre-Covid levels, correspond to a period of high activity when industry began to operate at full capacity (at different times depending on the sector) in order to make up for major production delays that arose post-Covid. In our view, this situation corresponds to what could now be considered a peak in the cycle.

Between the average CUR level in 2022-2023 and the pre-Covid CUR peak, production capacity could therefore be reallocated, as it has not been used for more than 5 years[9]. To estimate what this would represent in billions of euros, it is also necessary to estimate the level of production in 2024[10].

Our estimate covers the largest European countries (Germany, Italy, France, Spain, Poland, the Netherlands and Sweden). The result is that, on average for the sectors mentioned, nearly 6.5 points of their production capacity could be reallocated, representing a potential cumulative production of nearly EUR 180 bn (a third of which in the automotive sector, *Chart 8*). Almost half of this amount would come from Germany, given the size of its industrial sector.

On average for our sample of seven countries, this represents almost 1 point of GDP of potential additional production. However, of the 1.5 points of GDP of additional military spending between now and the end of the decade (to increase spending from 2 to 3.5% of GDP), only part will be related to equipment spending (nearly 27% of EU military spending in 2024 according to European Council data, a proportion similar to that envisaged in the Belgian or Spanish plans). Even assuming that two-thirds of the increase in spending would come from additional investment in military equipment, this would represent the equivalent of 1 point of GDP per year: an amount roughly similar to what would be generated by the reallocation of unused production capacity.

EU: 'AVAILABLE' CAPACITY UTLISATION IN MAIN COUNTRIES (BN EUR)

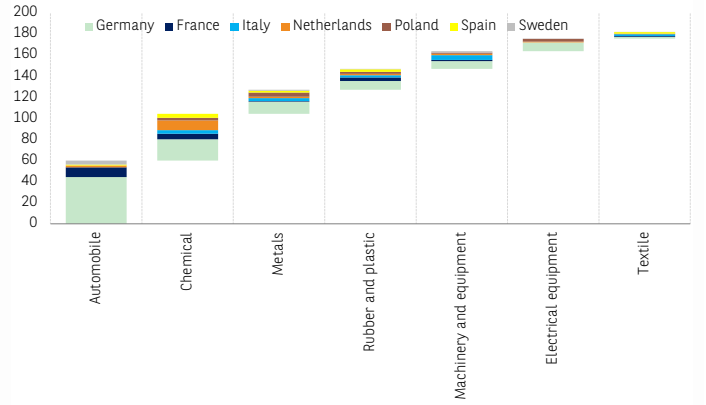

CHART 8

SOURCE: BNP PARIBAS ESTIMATES

Finally, meeting demand partly through existing sites could:

- Avoid a rise in unemployment in the event of the closure of a large number of industrial sites;
- Reduce the associated financing needs if these conversions limit the amount of investment required
- Speed up the production of military equipment if these reconversions were sufficiently rapid;
- Support productivity and therefore growth, one of the (sectoral) interpretations of the loss of productivity compared to pre-Covid is the loss of production observed in sectors where production capacity is underutilised (e.g. the automotive industry);
- Limit inflation by reducing supply constraints (fewer labour and land shortages if existing buildings are used).

In conclusion, certain conditions must be met in order for the rearmament effort to be successful and maximise its impact on growth. Visibility, which requires firm and sustainable public orders, is an important factor. Financing, which will involve mobilising both public and private resources, is another (*see our EcoWeek of 26 May 2025, "How can we finance the extra investment needed in the European Union?"*). Finally, the mobilisation of economic actors will also be necessary in order to organise more industrial site conversions. Germany has been doing this for many years, with the strong involvement of local authorities, municipalities and the Länder in particular, to transform industrial sites and brownfield sites, which is a perfect example.

Stéphane Colliac & Lucie Barette
(with Leslie Huynh, intern)

9 The peak of the pre-Covid CUR corresponds to 2017 for the automotive sector and 2019 for the other sectors.
10 Production in value terms is thus estimated for 2024 (the latest data observed corresponds to 2022 or 2023, depending on the country) using changes in production indices in volume terms, as well as producer price data available by sector.

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