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How Europe will pay for its defense

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European NATO countries must be strong enough militarily to deter a conventional attack by Russia. Joint EU debt, a relaxation of EU fiscal rules, new extra-budgetary funds in Germany – we discuss possible financing options.

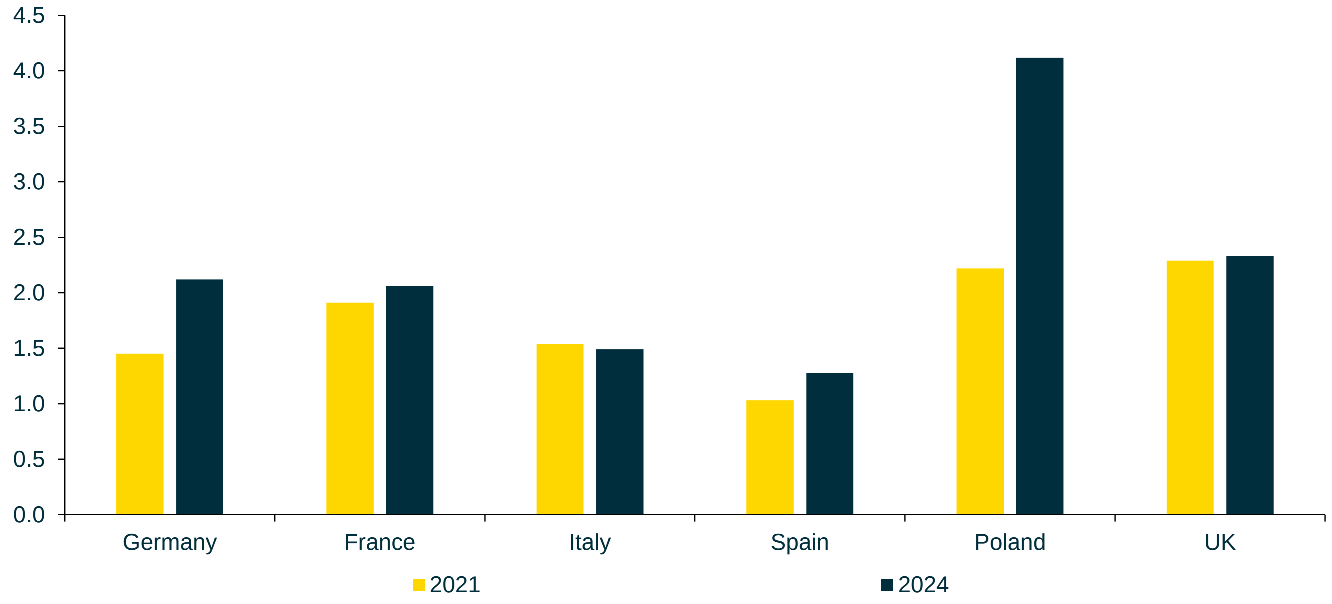
The Wake Up Call

US Secretary of Defense Pete Hegseth's speech to European NATO members was a wake-up call for politicians in the EU. According to Hegseth, the USA remains committed to NATO, but will no longer be primarily focussed on Europe's security in the future. Accordingly, the Europeans would have to take responsibility for their own conventional security in future. This means that in a few years' time, the armed forces of the European NATO members must be strong enough to credibly deter a possible conventional attack by Russia on the Baltic countries, for example. As most NATO countries do not currently have this capability, massive investment in defense is necessary. In this context, the US government has called for 5% of GDP to be invested in defense in the future. In the end, this could amount to 4% – twice as much as most countries currently spend (Chart 1).

In order to close the gap, Germany, for example, would have to cut its civilian spending by a quarter. This would hardly be politically feasible, even if there is considerable scope for savings with regard to social spending or the often inefficient climate policy. In the end, most European NATO members are likely to significantly increase their budget deficits in order to make themselves capable of defense. In the following, we outline how this could be realised.

Chart 1 - Most Europeans do not spend enough on defense

Spending on defense as a percentage of GDP, before the invasion of Ukraine and estimate for 2024



Source: NATO, Commerzbank Research

No short-term relaunch of the Corona Recovery Fund, ...

The most tempting solution for many southern European countries and France would be to finance the rearmament through joint European debt. A model for this would be the Corona Recovery Fund with its original volume of more than 800 billion euros, which was made available to the member states in the form of non-repayable grants and loans. But in terms of grants, the Corona Recovery Funds has already been exhausted. Furthermore, it does not provide any funds for military tasks.

In this respect, it is not surprising that some countries are calling for new joint borrowing – this time for armaments. Since the outbreak of the sovereign debt crisis in 2010, we have seen the eurozone moving towards debt mutualisation, so the Recovery Fund is unlikely to remain an exception. However, debt mutualisation would dilute the high credit rating of the northern countries of the monetary union, which is why it is very unpopular there. Nevertheless, in order to create sufficient political momentum for a new joint debt issue, a much deeper crisis than the one we are currently experiencing is required.

... but a further relaxation of EU fiscal rules

In contrast, a further relaxation of EU fiscal rules is likely to meet with little political resistance. EU Commission President von der Leyen said at the Munich Security Conference at the weekend that higher defense spending will not fail due to the fiscal rules. She will propose activating national escape clauses for defence spending. This is possible in the event of 'exceptional circumstances' that are beyond the control of a member state and have a significant impact on the state's public finances. In view of Russia's aggressiveness and the withdrawal of the Americans, the EU Commission is likely to affirm the existence of these conditions.

We believe that a corresponding relaxation of the EU fiscal rules is de facto a done deal, especially as the rules have already been watered down numerous times.

New extra-budgetary fund more likely than a change to Germany's debt brake

In Germany, a significant increase in defense spending solely financed by debt would currently not be possible due to the constitutional debt brake. However, the Parliament could amend the relevant paragraphs in the constitution to exempt investments from the rules of the debt brake. It could be stipulated that these are investments according to the definition of the National Accounts. Then, investments would include most defense equipment. If the debt brake is amended accordingly, the federal government could massively increase its defense spending.

However, the Christian Democratic CDU/CSU has so far officially stuck to the debt brake. This also applies to its candidate for chancellor, Friedrich Merz, who initially wants to use all other potential savings in the federal budget to finance tax cuts and additional defense spending. It is therefore questionable whether he will agree to a noticeable easing of the debt brake so quickly. It is more likely that a new extra-budgetary fund will initially be set up as an ad hoc solution.

What does this mean for the market?

Ultimately, most European NATO states will end up with significantly higher budget deficits, although they are already far too indebted in terms of the original 60% debt-to-GDP ratio of the Maastricht treaty and usually lack political majorities for meaningful budget consolidation. This supports our forecast that we have not yet seen the peak in the yield on ten-year German government bonds, especially as the ECB should end its interest rate cuts in the middle of the year at a deposit rate of 2.0%. In addition, the spread between government bond yields and the swap curve is likely to widen further.

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