Flash Economics

N° 41
April 17, 2025

If the Europeans increase their public deficits and military spending, the United States will face a financing problem

Europe's fiscal policy is to become more expansionary, particularly in Germany with investments in infrastructure (€500 billion over 10 years) and the relaxation of budgetary rules (the Schuldenbremse). Private investment (data centres, energy transition, artificial intelligence) will also increase in Europe.

This implies that the euro zone's current account surplus will shrink, as will the flow of savings from the euro zone to the United States.

When this happens, there will be a problem financing the US external deficit, which will normally lead to a depreciation of the dollar, a rise in US long-term interest rates, which have fallen recently as a result of lower growth expectations, and a decline in US growth.

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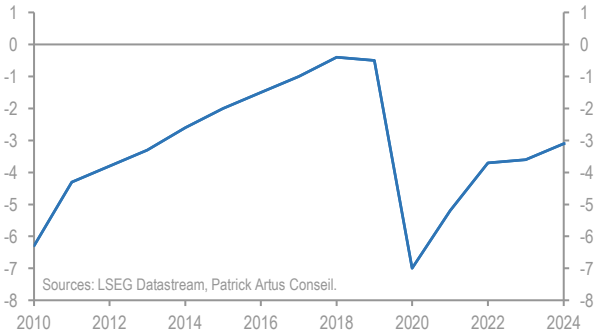
Europe's fiscal policy to become significantly more expansionary

The European Union's fiscal policy is set to become much more expansionary, due to:

- **The need for public investment, as suggested by the Draghi report** (investment in the energy transition, artificial intelligence and disruptive innovation);
- **The need for infrastructure investment** (transport, energy, data centres, etc.); Germany has announced a €500 billion infrastructure investment plan over 10 years;
- **Higher military spending**: if the European Union spent as much as the United States on defence, EU military spending would be 1.5 points of GDP higher.

We can therefore see that the **fiscal deficit of the European Union and of the euro zone** (**Chart 1**) **will increase in the coming years**.

Chart 1
Euro zone: Fiscal deficit (as % of nominal GDP)

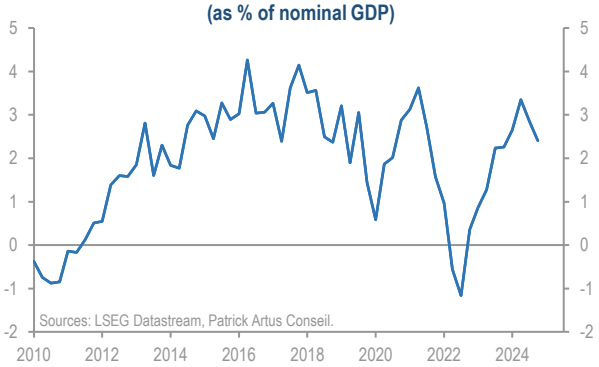


Moreover, additional private investment will be required (data centres, energy transition, artificial intelligence), which will contribute to making **greater use of Europeans' savings**.

Reduction in Europe's current account surplus and in capital flows from Europe to the United States

If public and private investment in Europe and military spending by European countries increase substantially, Europeans' savings will be used in Europe more, which will cause Europe's current account surplus to fall (**Chart 2**).

Chart 2
Euro zone : Current account balance
(as % of nominal GDP)



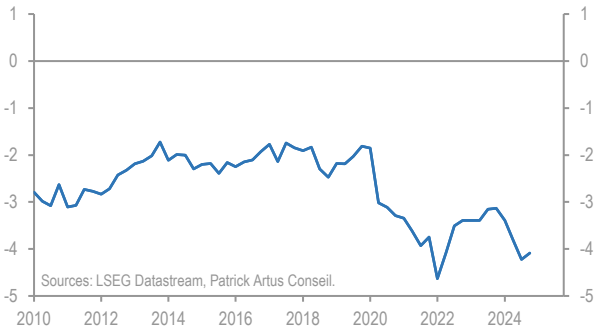
A rise of 1.5 points of GDP in military spending and of 2.5 points of GDP in investment (which corresponds to the public share of investment suggested by the Draghi report) would push Europe into a current account deficit situation. With the bulk of long-term

capital flows leaving Europe nowadays going to the United States, this development would result in **a sharp drop in capital inflows to the United States**.

Summary: which consequences for the United States?

A halt to long-term capital flows from Europe to the United States would result in **a problem financing the US external deficit** (**Chart 3**).

Chart 3
United States: Current account balance
(as % of nominal GDP)



A problem financing the external deficit normally has the following consequences:

- **A depreciation in the exchange rate** (in this case, of the dollar), **Chart 4**;

Chart 4
Euro/dollar exchange rate (EUR 1 = USD...)



- **A rise in long-term interest rates** (**Chart 5**), whereas since the beginning of 2025, long-term interest rates in the United States have been falling following the downward revision to the growth outlook;

Chart 5
United States: Interest rate on 10-year government bonds
(as %)



- **A drop in growth**, as necessary to reduce the external deficit which has become more difficult to finance.

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