Flash Economics

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A war economy is taking hold in Europe

Underlying growth in Europe is weak, reflecting stagnating investment, slowing consumption and, since 2022, export market share losses. Against this backdrop, European growth will depend increasingly on defence spending, which is rising in all countries, particularly sharply in central and eastern Europe and in Germany.

This increase will widen government deficits and, in turn, fuel an upward trend in long-term interest rates. That trend will be amplified by persistently high inflation, driven by energy and services prices, by the cost of industrial commodities and semiconductors, and by the increase in defence spending itself. Finally, the near-irreversible nature of this increase should be borne in mind.

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Weak underlying growth in Europe

Growth in Europe has been weak since 2023 (**Charts 1A and 1B**), with investment stagnating, consumption growth slowing (**Chart 2**) and export market shares declining since 2022 (**Chart 3**).

Chart 1A
Real GDP (Y/Y, %)

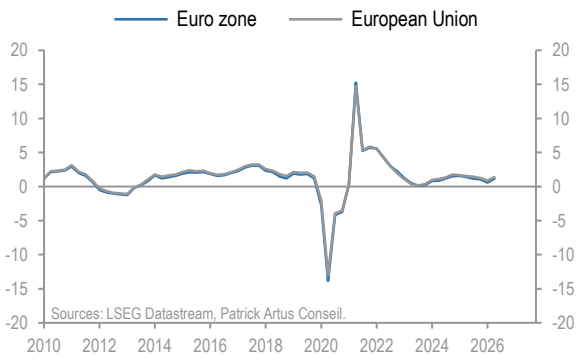


Chart 1B
Real GDP (Y/Y, %)

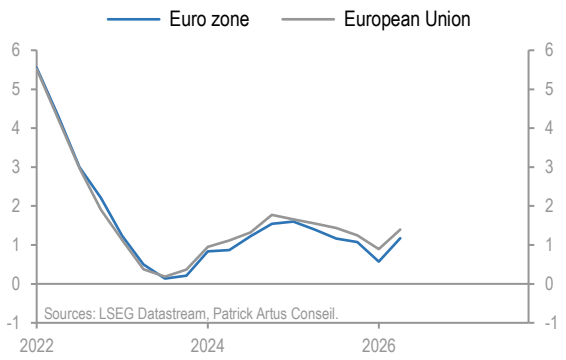


Chart 2
Euro zone : Household consumption and investment in machinery and equipment (volume, Q1 2010 = 100)

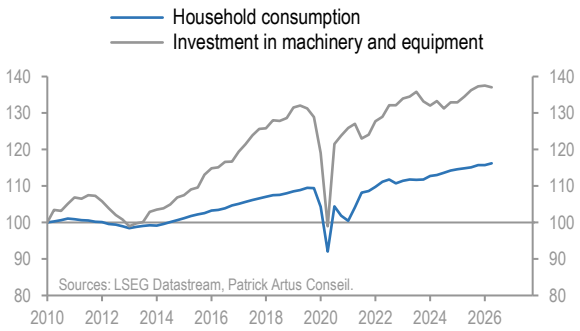
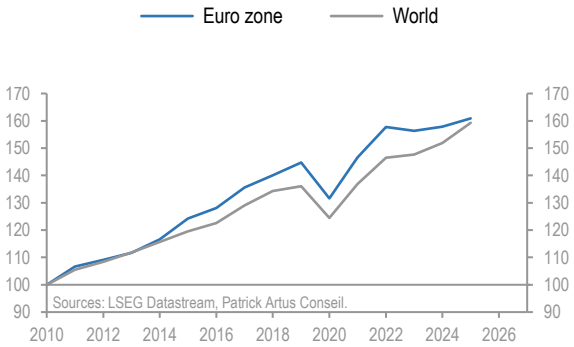


Chart 3
Exports of goods and services (volume, 2010 = 100)



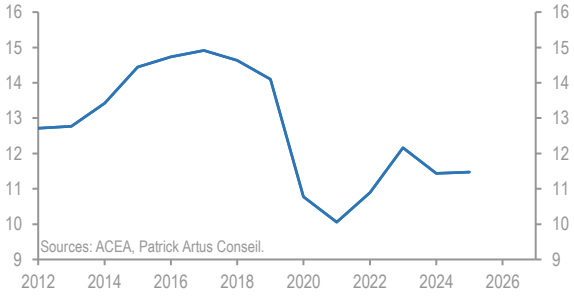
Two reasons may explain **the sharp increase in defence spending that has been announced:**

- the response to geopolitical risks, to Russian threats and to the withdrawal of the United States from Europe's defence;
- the desire to use the defence industry as a driver of growth, in order to offset the declining share of industry in the European economy (**Chart 4**), particularly in the automotive sector (**Chart 5**).

Chart 4
Manufacturing value added (as % of GDP, in volume terms)



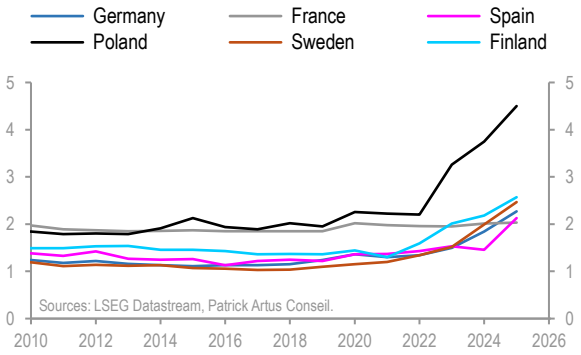
Chart 5
European Union: Passenger car production (millions of units)



Rapid increase in defence spending

Defence spending is now rising rapidly in Europe (Chart 6).

Chart 6
Military expenditures (as % of GDP)



This is particularly the case:

- in Germany, where the federal defence budget is set to reach €108 billion in 2027 (2.4% of GDP), rising to €183 billion in 2030 under the medium-term financial plan, by which time defence expenditure as defined by NATO will amount to 3.7% of GDP, compared with 1.2% in 2018 and 1.5% in 2023;
- in France, where the Military Programming Law provides for defence spending to rise from 2% of GDP in 2026 to 2.5% in 2030, while the country's NATO commitment is to reach 3.5% of GDP by 2035;
- in Spain, where defence spending has risen from 0.8% of GDP in 2016 to 1.4% in 2024 and 2% in 2026;
- in Poland, where defence spending has risen from 2% of GDP in 2018 to 4.5% in 2026.

The European Defence Agency expects defence spending by EU Member States to reach €454 billion in 2026, compared with €250 billion for Russia and – according to the US Senate – USD 1,050 billion for the United States.

Driven by this increase, the arms revenues of the 26 European companies ranked among the world's 100 largest arms producers rose by 13% in 2024 (+36% for German companies and +12% for French companies), according to the Stockholm International Peace Research Institute (SIPRI). A large share of these revenues comes from exports: the volume of arms exports by EU Member States rose by 36% between 2016–20 and 2021–25.

Consequences of higher defence spending

The first consequence of rising defence spending is **persistently high government deficits** (Chart 7). General government deficits are particularly high in Poland (7.3% of GDP in 2025) and France (5.1% of GDP in 2025). In Germany, the deficit is projected to reach 3.7% of GDP in 2026 and 4.1% in 2027, according to European Commission forecasts. High government deficits are contributing to **the rise in long-term interest rates** (Chart 8), a rise compounded by **inflationary pressures**, which are particularly pronounced in Poland (Chart 9). These pressures stem from rising prices for energy and services, for industrial commodities – copper in particular – and for semiconductors.

Chart 7
General government deficit (as % of GDP)

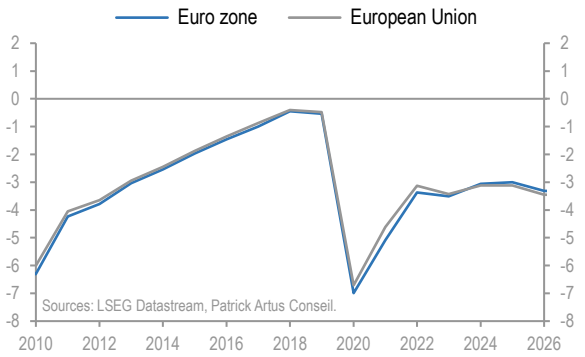


Chart 8
10-year interest rate on government bonds (as %)

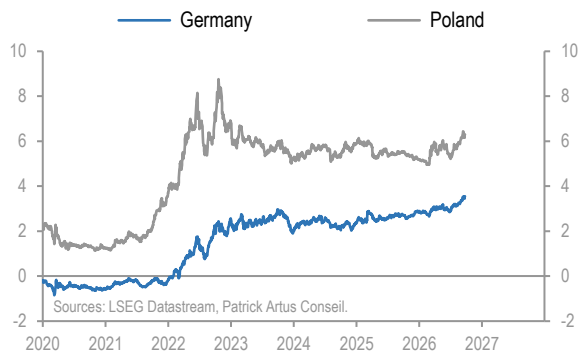
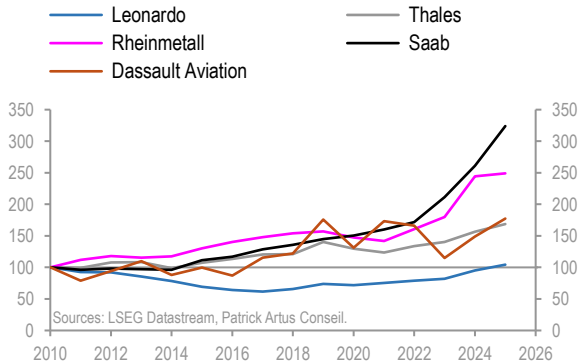


Chart 9
Inflation (HICP, Y/Y, %)



Higher defence spending also helps to sustain inflation, owing to its high commodity intensity and the market power enjoyed by defence companies. These companies' revenues are rising strongly (**Chart 10**), as are their earnings: in the first half of 2026, Rheinmetall's operating result rose by 74% year on year and Thales's adjusted EBIT by 10%.

Chart 10
Revenue (2010 = 100)



Conclusion: an understandable strategy, but not without risks

The increase in defence budgets in Europe reflects two factors:

- the military threats facing Europe, foremost among them the Russian threat, against the backdrop of US disengagement;
- weak underlying growth in many European countries.

However, this sharp and accelerating increase in defence spending carries risks, owing to:

- **its effects on government deficits**, on inflation and hence on long-term interest rates;
- **its near-irreversibility**, since the allocation of resources (employment, investment) to the defence industry will be difficult to reverse.

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