# Global Macro Research

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# A new dawn for European defence spending?

## European defence spending is set to rise. However, fiscal considerations and low growth multipliers will constrain the economic tailwind somewhat, while fractured procurement and reliance on arms imports need to be addressed.


**Key Takeaways**

- European defence spending will increase materially in coming years. A credible sovereign defence capability may require the EU to raise defence spending from just under 2% of GDP to around 3.5% in the near term, and higher still over the medium term.
- Key capabilities Europe needs to acquire include a major expansion of artillery production, as well as the creation of independent air defence and military intelligence capabilities. For now, a new nuclear capability under joint European command is unlikely.
- The European Commission is proposing mobilising €800 billion to finance this. Most would come from national borrowing facilitated by relaxed fiscal rules, alongside €150 billion of European-wide borrowing.
- But the actual increase in spending will depend on how different countries plan to make use of the new fiscal space. This is likely to vary based on existing debt levels, borrowing costs, and proximity to Russia.
- While the EU aims to develop sovereign capabilities in producing defence equipment, the need to rapidly rearm means that overseas suppliers will still be required. Alongside the US, countries that might benefit from this trend include Israel, South Korea, and the UK.
- The growth multiplier on defence spending is typically quite low, especially with the economy close to full employment. All told, we are incorporating a fiscal defence injection of 3.3% of GDP into our forecasts, lifting the level of Eurozone GDP by 1.5% over the next five years, with some modest upward pressure on interest rates.


**How much more does Europe need to spend on defence?**

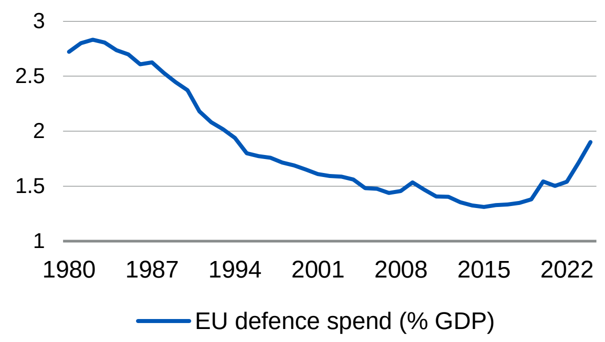
US foreign policy shifts and the full-scale Russian invasion of Ukraine have created the conditions for a rapid rise in European defence spending.

The US has indicated a waning commitment to NATO and the European security umbrella, and the Trump administration is putting increasing pressure on Europe to become more self-sufficient when it comes to defence.

Russia's full-scale invasion of Ukraine has thrown into stark relief the security threats to Europe and the continent's lack of military preparedness, while draining European military resources as the bloc supplies arms to Ukraine.

EU member states' total defence expenditure in 2024 was €326 billion, or 1.9% of EU GDP (see Figure 1).

**Figure 1: Defence spending has been increasing since 2019**




Source: Aberdeen, IISS, June 2025

This is some 30% higher than in 2021, just before the Russian full-scale invasion of Ukraine.

But it is still marginally below NATO's target of 2% of GDP spent on defence, which, in any case, is likely to rise to at least 3% of GDP later this year.

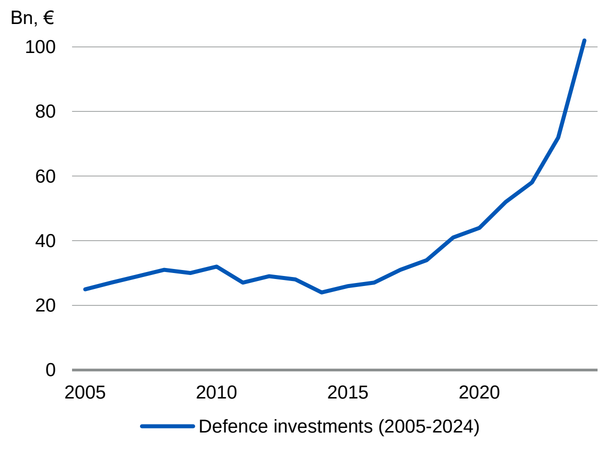
What's more, achieving full European security independence from the US may require the EU to go further still. A recent report by think tank Brugel for example argued that the EU would need to commit 3.5% of GDP to defence in the short term.

The European Commission's Readiness 2030 plan (formerly ReArm Europe) therefore aims to mobilise €800bn (5% of EU GDP) in additional defence spending over the next five years.

**What does Europe need to buy?**

Since the full-scale invasion of Ukraine, funding dedicated to new defence purchases has markedly increased. Of the €326bn spent on defence over 2024, €102 billion was on investment (see Figure 2). 88.2% of this was allocated to the procurement of new defence products, a 50% increase from 2023.

**Figure 2: Defence investment has rapidly increased since 2021**




Source: Aberdeen, European Defence Agency, March 2025

This proportion is likely to rise further, with NATO member states expected to agree to increase defence spending investments by 30% from current levels.

On 19 March, the EU Commission published its White Paper for European Defence Readiness 2030**.** In the immediate term, the paper calls for the replenishment of defence stocks required by Ukraine, particularly drones, large calibre artillery and air defence systems.

The paper sets out seven core capability gaps where investment should be prioritised (see Figure 3). These are:

- air and missile defence – Thales is leading a pan-European consortium developing integrated systems;
- artillery systems, ammunition and missiles, particularly 155mm ammunition, of which Rheinmetall is the largest European producer, and ballistic missiles, of which the majority are US firm Lockheed Martin's M142 High Mobility Artillery Rocket System (HIMARS), guided multiple-launch rocket system (GMLRS) – Rheinmetall and KNDS would be well placed to develop European alternatives;
- drone systems, such as those produced by Lithuanian UDS, French Delair and Latvian Atlas UAS;
- military mobility, which has been deprioritised over the last decade – KNDS Leopard 2A8s and the Rheinmetall KF51 Panther are popular choices;
- AI and cyber warfare – German Helsing is currently leading in this space;
- military intelligence and surveillance, such as the Boeing RC-135 SIGINT aircraft and the Saab GlobalEye; and
- strategic enablers and critical infrastructure protection, such as air-to-air refuelling aircraft, including Airbus A330 MRTTs.

**Figure 3: Rearmament presents opportunities for the European defence industry**

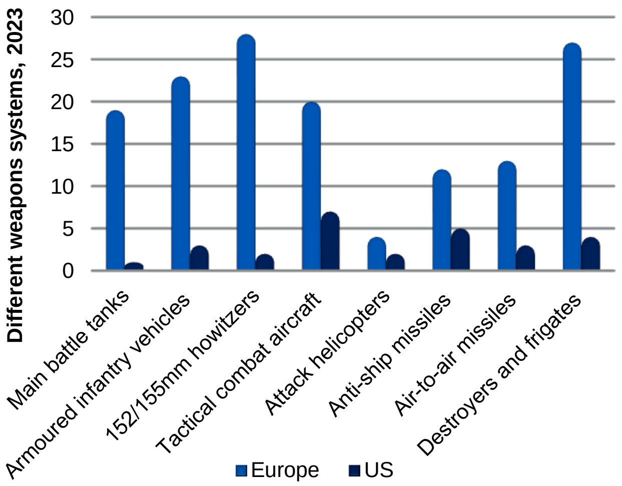

Source: Aberdeen, EU Commission, June 2025

The main reason behind these capability gaps is the fractured nature of the European defence production landscape (see Figure 4).

The fact that multiple European manufacturers are producing similar weapons systems, and a desire from governments to support national champions, is limiting production capacity and increasing prices. The European Commission estimates that a lack of cooperation results in additional costs of between €25 billion and €100 billion each year.

As such, joint procurement and production initiatives, alongside greater efforts to agree unified specifications, are likely to be a key aspect of a successful expansion in military capabilities.

**Figure 4: The European defence sector is highly fragmented**




Source: Aberdeen, McKinsey, June 2025

**How do nuclear capabilities fit into these requirements?**

While the UK and France have small independent nuclear capabilities, Europe's principal nuclear deterrent is provided by the US' much larger and more capable arsenal.

Any attempt to create a truly independent pan-European nuclear umbrella would have to involve full first-strike capability, intercontinental ballistic missile delivery platforms alongside the Anglo-French submarine and air-launching capabilities, and tactical nuclear weapons such as the variable-yield B61 gravity bomb.

Germany and Poland have called for conversations on European nuclear sharing, while France has signalled an openness to "strategic debate" on the issue.

However, these conversations have not acknowledged the significant effort required to expand European nuclear capabilities, or the political pushback that may come with a serious dialling up of nuclear stockpiling.

So, with no specific funding plan in place, we suspect that the nuclear status quo will remain in place – meaning the UK's minimum credible deterrence second-strike posture, France's more capable *force de frappe*, and a questionable US umbrella.

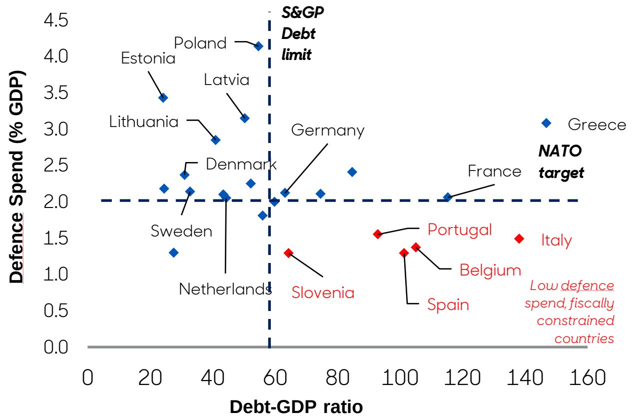
**How will the extra spending be funded?**

Of the €800 billion in additional European defence spending targeted in the Readiness 2030 plan, €650 billion is accounted for by the activation of the escape clause of the Stability and Growth Pact. This allows individual member states to increase borrowing for defence spending by 1.5% of GDP annually for the next four years, without breaching the EU fiscal rules.

The remaining €150 billion comes from Security Action for Europe (SAFE) loans, whereby the Commission borrows on capital markets and then makes onward loans to EU member states at a lower interest rate than they might otherwise pay.

But not all member states will take full advantage of the relaxation of the fiscal rules given market-imposed constraints on fiscal headroom, and domestic political considerations. Many of the European countries falling furthest below NATO spending targets are the most fiscally constrained (see Figure 5).

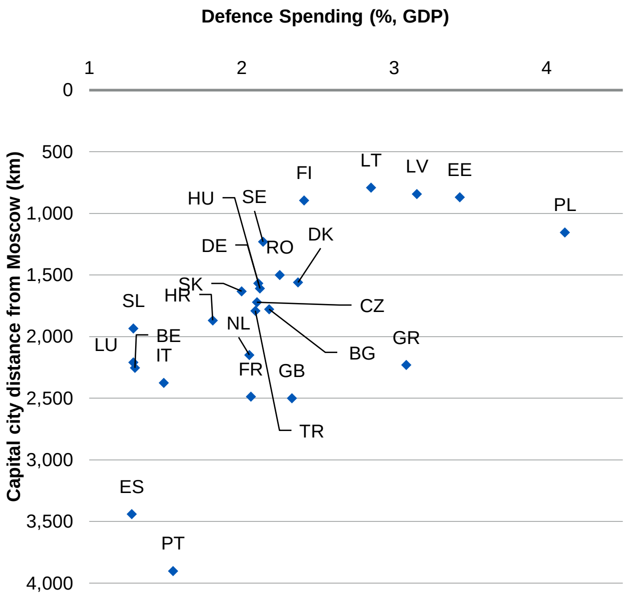
**Figure 5: European members states spending the least on defence are generally the most fiscal constrained**




Source: Aberdeen, NATO, Haver, June 2025

Moreover, SAFE loans come with relatively restrictive eligibility requirements such as minimum 65% European content rules, joint procurement, and enhanced governance, making it challenging to utilise the funding in full.

**Figure 6: Proximity to Russia has been a key determinant of European defence spending**

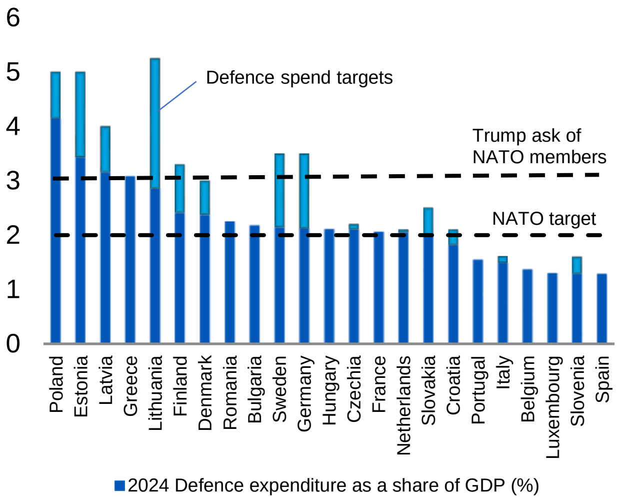



Source: Aberdeen, NATO, June 2025

### Who will spend most? Who will spend least?

Since the 2022 invasion of Ukraine, the bulk of European defence spending increases have occurred in countries closest to Russia (see Figure 6). This divide is likely to deepen, with Poland and the Baltic states planning to spend at least 5% of GDP on defence from 2026 (see Figure 7).

**Figure 7: More EU nations plan to hit 3% of GDP defence spending by 2026**




Note: Only countries in both NATO and the EU are included

Source: Aberdeen, NATO, June 2025

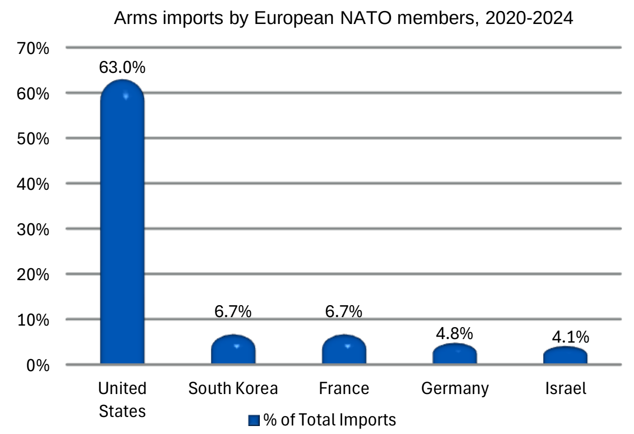
The main exception is Germany, where new Chancellor Fredrich Merz has announced a large increase in defence spending from just over 2% of GDP to 3.5%. But the country is somewhat unique in having a reasonable amount of fiscal headroom among the large European economies.

In France, the relatively unstable political and fiscal situation means President Emmanuel Macron may struggle to achieve his ambition of reaching 3%-3.5% of GDP, and even modest increases in defence spending may face a challenging passage through parliament. However, France's leading position within Europe in defence industries may help to deliver some increased spending.

### Who will Europe buy from?

Between 2020 and 2024, around 63% of weapons imports by EU NATO members were from US manufacturers (see Figure 8).

**Figure 8: The US dominates European NATO members' arms imports**

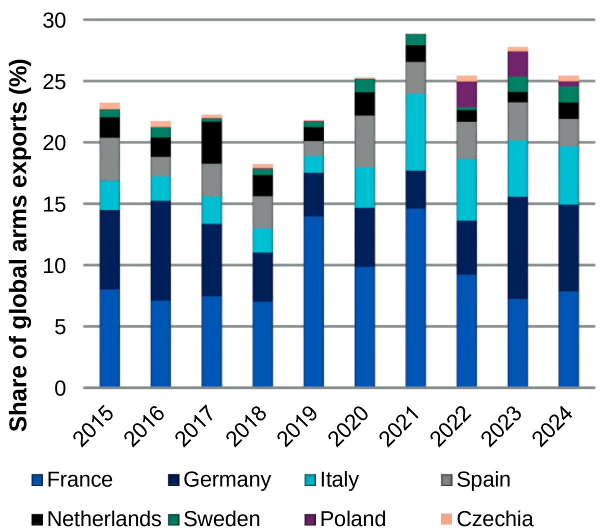



Source: Aberdeen, Bloomberg, June 2025

However, the drive toward self-sufficiency will encourage more procurement from EU manufacturers.

Most NATO EU defence-industrial capability resides in France, Germany and Italy (see Figure 9).

**Figure 9: France, Germany and Italy dominate the market**




Source: Aberdeen, IISS, June 2025

French manufacturer Thales will continue to be a major player in air defence capabilities. German Rheinmetall, Norwegian Nammo and French KNDS have also planned major increases in munitions production capabilities.

However, a step-change in European military production capacity is likely to take a minimum of three years to achieve, with deliveries of new weapons longer still.

South Korean companies including Hanwha and Hyundai Rotem are likely to be key beneficiaries given their major role in Poland's military expansion. The EU defence white paper also directly mentions Norway and Canada as key military allies.

The UK is in discussions about a defence procurement agreement with the EU, but even without one, long-standing integration into European military production will likely see UK-based companies such as BAE benefit. Indeed, BAE, Japan's Aircraft Industrial Enhancement Co Ltd and Italian firm Leonardo have launched a joint venture to develop a supersonic fighter jet designed to replace the Eurofighter Typhoon.

The EU will continue to depend on the US in the medium term for maintenance of existing military stock. Indeed, complete replacement of US contributions to European defence is estimated by the International Institute of Strategic Studies to cost around $1 trillion, including the acquisition of 400 tactical aircraft such as the Eurofighter, and the replacement of 128,000 US military personnel. This would amount to necessitating defence spending averages across the bloc to at least 3%, even before increases to capacity are considered.

**How much will all this boost economic growth?**

We think the impact of increased defence spending on European economic growth could be somewhat disappointing.

Defence spending tends to have a relatively low multiplier at the best of times. This is especially so in Europe, because, despite efforts to boost domestic production capabilities, much of the extra equipment will still be sourced from abroad.

And with Eurozone unemployment low, there is limited spare capacity to mobilise on defence production. Instead, increased defence output may crowd out other parts of the economy.

Overall, then, we expect €600bn (3.3% of annual GDP) of additional defence spend by 2030, which will in turn boost GDP by 1.5%. Much of the boost will be felt in 2026, 2027, and 2028.

Higher government spending and higher growth could push the neutral rate of interest (r*) higher over time. For now, we retain our estimate of 2.0% nominal for r*, but there is a chance policy rates settle higher.

**Authors:**

Lizzy Galbraith, Felix Feather and Harry Turnbull

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