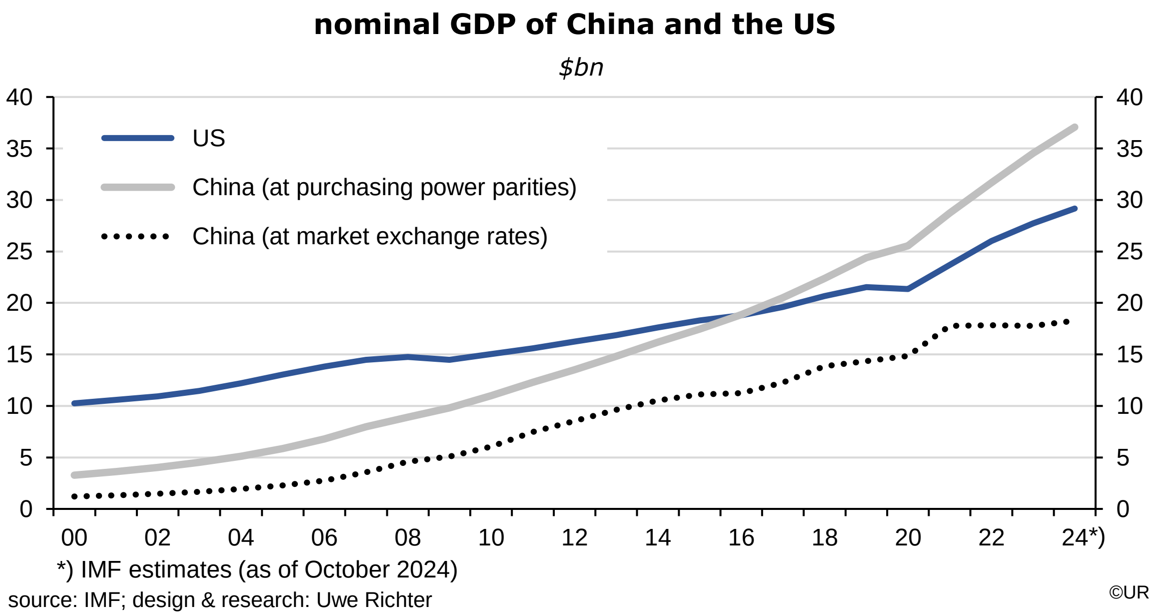
Europe responds

Mainz, March 20, 2025 | *Dieter Wermuth*

Irritatingly for some, the European Union has no ambition to become a world power. There is no imperialistic narrative which distinguishes it from the U.S., Russia or China. At present, about a dozen countries want to join the EU – because it is a community of 27 fairly rich nations which adhere to the rule of law and financially support the poorer states in the south and east of the continent. Territorial expansion is not in the EU DNA. Not one of the member states has been forced to join, and if they want to leave, they can, as the UK's Brexit has shown.

Even so: the global environment does not permit a pacifist foreign policy for long. After the Ukraine, Russia has its sights on the Baltic states, Moldova and perhaps even parts of Poland and Romania, China threatens to "bring home" Taiwan, and the U.S. government suggest to incorporate Canada, Greenland, Panama and the Gaza strip. To quote a sentence from Friedrich Schiller's drama about the medieval independence war of the Swiss cantons against the Habsburgs: "The very meekest cannot be at peace if his ill neighbor will not let him rest."

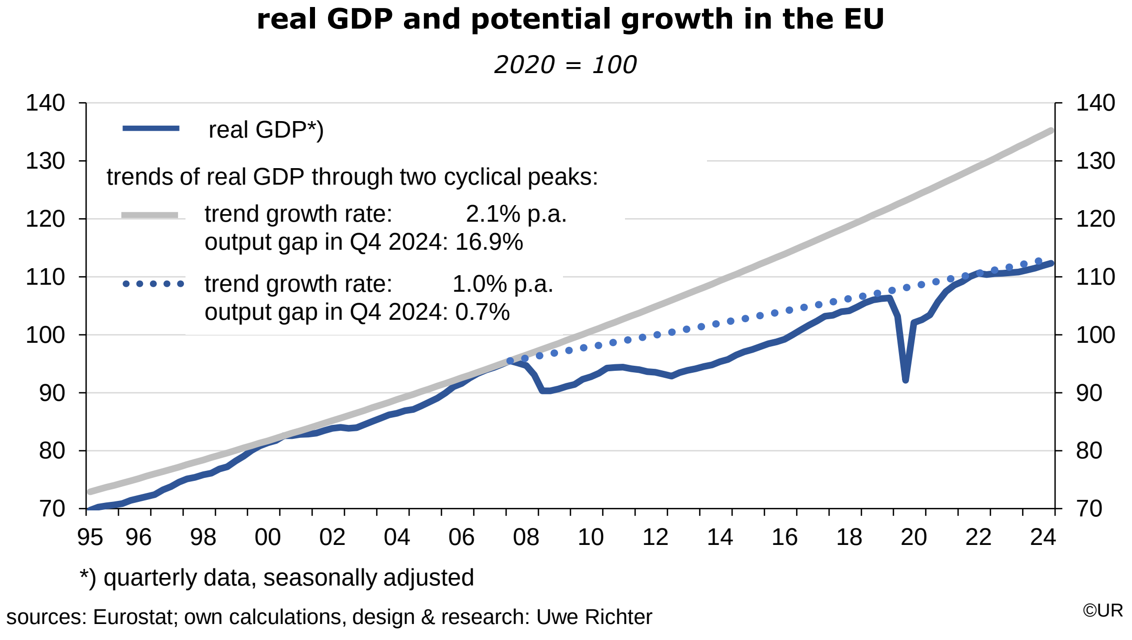
European countries are once again at a point where a common approach is called for, not least because it has become clear that the U.S. do not want to be their military protecting power any longer. That insight has not come as a surprise for observers who can add one and one and are aware of America's relative decline vis-à-vis China. In terms of purchasing power parities China's nominal GDP is presently about 30 percent bigger than America's, and the difference gets larger every year. Its real GDP trend is about two percentage points steeper – which explains why the *querelles européennes* are increasingly seen as an irritant. The U.S. military involvement in Europe is getting less affordable, just as its role as a global policeman.

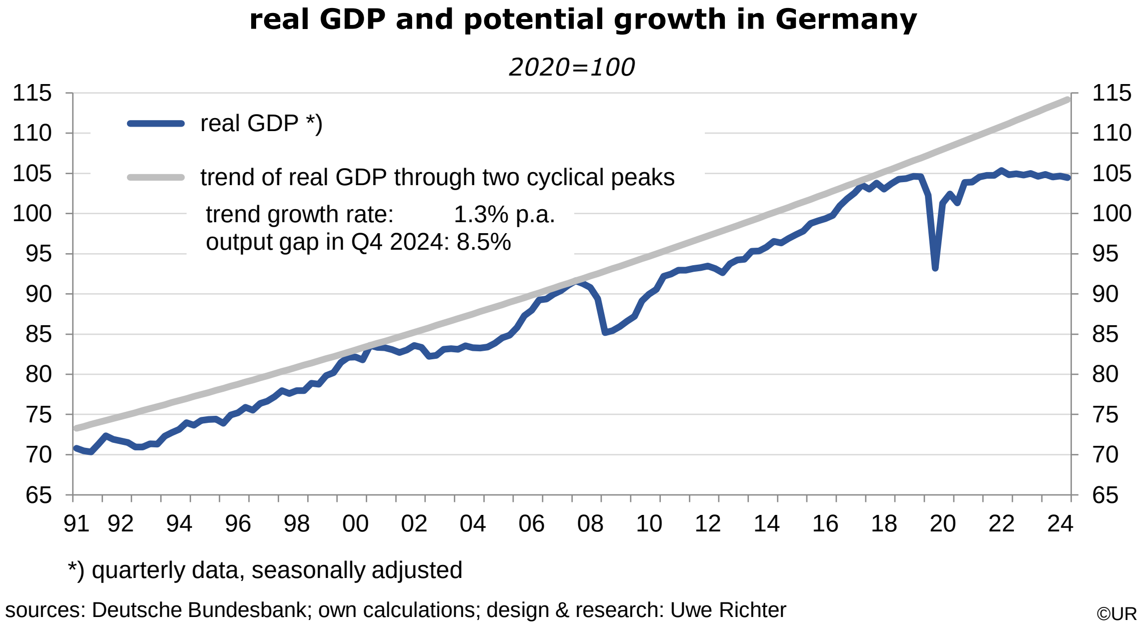


In recent weeks this shocking message has rattled European capitals. Suddenly reality cannot be denied any longer: The democracies of Western Europe are on their own. Taking, under time pressure, a realistic look at their military capabilities they discovered that they would probably not be able to respond appropriately if one day Russia would let its tanks cross the bridge in Narva to "liberate" the Russian-speaking minority in Estonia, a NATO member.

Everybody is now aware that the European peace project lacks a solid military basis. Wishful thinking is not enough any longer. All this has led to decisions about a significant increase in defence spending: within a short period of time it will probably reach something like 3% of nominal GDP, compared to about 1½% in 2024. This is the equivalent of an additional 300 billion euros if non-EU countries UK, Switzerland and Norway are included. It adds up to a total of 600 billion euros for defence per year. For comparison, Russia's estimated nominal GDP amounts to 2,100 billion euros – which in turn is less than one tenth that of Western Europe. There is a similarly huge difference in population: Russia has 145 million inhabitants, democratic Western Europe 530 million. In other words, if the EU and its likely partners decide to create common military structures (such efforts are now under way), Russia will not really be able to conduct a successful war against the West, even if it cannot rely on the United States anymore.

As a result of the long-time austerity policies of the EU, and of Germany in particular, today's so-called output gaps are very large. Production can be raised considerably when demand finally picks up. Since unused capacities are so large European inflation risks will remain moderate for several years. This is why German long-term bond yields (which are the benchmarks for euro area bonds) have gone up by just 40 basis points, to 2.8%, since the election of Donald Trump last November. Investors remain quite relaxed about inflation risks.





For many years, the German government has not only neglected its military but also its infrastructure. Net investments have occasionally been negative (ie, depreciations were larger than gross capital spending), meaning that the physical capital stock has shrunk (!). Given the Russian invasion of Ukraine, their belligerent statements in the direction of Western Europe, and the increasingly likely withdrawal of America's nuclear umbrella, the "old" parliament, which has been voted out in the national elections on February 23, but remains fully functional until March 25, has just cleared the way for an almost sensational – but certainly overdue – increase of debt-financed spending on infrastructure, climate projects and the military.

Defence spending will de facto no longer be restricted by the famous debt brake. Depending on the risk of war there will be no upper limit on military spending – whatever it takes. The infrastructure package, which includes climate projects, will reach no less than an additional 500 billion euros, ie, on top of what had already been planned, or almost 12 percent of nominal GDP, spent over a period of ten years. For this, a special-purpose fund will become part of the country's constitution; it will also be exempted from the provisions of the debt brake. On Friday, the Bundesrat, the upper chamber of parliament, representing the 16 federal states, will most likely give its ok for these proposals.

The additional spending on defence will be around 400 billion euros; most of it will take place in the near future. All new spending will be financed by debt, not, as after a similarly challenging situation, the reunification, in the early nineties, by higher taxes. Government debt was just 64% of nominal GDP last year.

The other countries of Western Europe will also strongly increase military spending, if not by as much as Germany. The further a country is away from the Russian border the less is there a sense of urgency. Moreover, large countries like France, Italy and Spain are already highly indebted and have supposedly little room for maneuver on the spending side.

It is not a given that additional government spending in Germany and the EU will actually boost economic growth. In its new forecast the OECD seems to think it will not. For 2025 real GDP growth for Germany and the EU is expected to be just 0.4 and 1.0% year-on-year, respectively. Stronger growth momentum must wait until 2026.

I think these forecasts are too pessimistic.

# # #