The economic aspects of rearmament

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Geopolitical risks feature unusually high in economic outlooks by international organisations. The challenge for economists is to predict and "quantify" the economic consequences of geopolitical tensions and armed conflicts. Broad trends can of course be drawn with respect to trade and investment flows (retrenchment) and to the efficiency of multilateralism (weakening and polarisation).

From an economic standpoint, and looking specifically at the consequences of an upcoming rearmament process and the expected increase in defence spending, there are two aspects to consider:

- The impact on fiscal policy: whether or not increased defence spending is making fiscal policy trade-offs more complicate. In times of fiscal consolidation and competing priorities, it could indeed crowd out growth and sustainable development-oriented spending in public education, health, infrastructure and climate transition. For Germany, Italy and Spain to raise their defence budget to 3% of GDP would be equivalent to almost 40% of their entire spending on public education.

- The impact on growth: whether a 1 euro spent on defence brings more, or less, economic benefits to economic growth relative to alternative public investment options. On that, the link between defence spending and economic growth is relatively underexplored in economic literature.

- Naturally the defence industry is expected to be a net beneficiary of any future rearmament process. Over the past 12 months, the S&P 500 contracted by over 5%. Yet nearly all the major arms producers saw their stock market capitalisation increased by at least +5%. European arms producers' shares literally skyrocketed.

The rise of geopolitical risks

Beyond the immediate suffering of populations, the challenge for economists is to predict and "quantify" the economic consequences of armed conflicts or the rising risk of it. Broad trends can of course be drawn with respect to trade and investment flows (redrawing of global supply chain alongside a US-China de-coupling or de-risking) and to the efficiency of multilateralism (uncooperative behaviours by nations leading to unperforming multilateral forums on trade, the environment, health etc.). The list is long of geopolitical risk factors in 2023 that could turn into armed conflicts or reaching new levels of conflict intensity.

- **Deadlock in Ukraine or a Russian victory cement the creation of a new iron wall**: The war in Ukraine could either end in a Russian victory – with the United States and the European countries giving up on Ukraine aid and accepting a cease fire agreement with the Russian regime. Alternatively, the war could continue on the eastern front of Ukraine, but with greater involvement of NATO member states. The RAND corporation suggests four different scenarios of escalation. Whichever the evolution on the battle front, Russia could fall into a "North Korean scenario: isolation and radicalization of a fortress-Russia, in which Putin or his successors would keep the country's population in a permanent state of war".

- **A just short of war conflict over Taiwan**: A miliary attack on Taiwan by China is a possibility by late 2024 and 2025. Tensions could build up in 2023 and escalate to a Chinese maritime blockade and no-fly zone over the island, expanding to the South East Asia sea, with substantial consequences over maritime traffic and the global supply of semiconductor chips, of which Taiwan holds a sizeable global market share.

- **Another Middle East crisis**: the candidates for prompting another Middle east crisis are many. Saudi relations with the United States could reach a point of no return, with unpredictable consequences both for oil prices and for the region's stability. Israel has the most right-wing extremist government in the country's history with equally unpredictable consequences, such as another intifada with catastrophic humanitarian consequences for Palestine, a shadow war with Iran turning into open conflict, limited operations against the Hezbollah in Lebanon etc. In Iran, the regime could toughen further the repression of its people, and adopt an even more aggressive stance against neighbours, comforted by the support of Russia etc.

Political agreement toward rearmament

In economic and fiscal terms, the immediate consequence of rising global insecurity is the prospect of increased defence spending, if not a new arms race. It is already happening in a number of emerging economies and in China in particular. The main change in 2023 could consist of a decisive increase in defence spending in OECD economies.

The US defence budget in 2023 is set reach the highest level since the peak of 2008-2011 during the Iraq and Afghanistan wars and the second highest since World War II. Overall, some USD858bn (excluding USD21bn in arms supply to Ukraine) would be committed in 2023, more than the budgets for the next 10 largest cabinet agencies combined. This spending would go hand in hand with increasing cooperation and investment in the digital sector in the face of increasing geopolitical competition. For the RAND corp. "the greatest risks are that a competitor will develop niche technologies (...) that threatens existing U.S. ways of waging war, or that critical dependencies will hamstring U.S. efforts in any extended conflict". It would also consist in more public-private partnerships "leveraging U.S. capital markets" and "deepening engagement" with private equity firms to facilitate technology integration into defence programs.

For Europe, a number of geopolitical thinks tanks have discussed pathways toward greater militarisation of European polity (see for example Carnegie). At EU-level, there are two recent processes that are suggesting greater political agreement on rearmament:

- **Scaling up EC-wide funding**: the European Defence Industry Reinforcement through common Procurement Act (EDIRPA) in July 2022 was the first ever coordinated defence spending initiative by the European Commission. In 2023, it would be followed by a more consequential and longer-term European Defence Investment Program (EDIP) including with strong tax incentives for member countries and business (such as a value-added tax waiver) backed by a relaxed version of the EU Taxonomy on sustainable investment (to facilitate financial investment in the arms industry) and a beefed-up version of the European Defence Agency. The risk of opposition by German fiscal hawks and other "frugal" member states would be averted: most of latter are precisely the most engaged in the military scaling up.

- **Stronger EU-NATO partnerships**: Following the Joint Declaration on EU-NATO Cooperation on 10 January 2023 emphasising Russia and other "authoritarian actors" that challenging "our interests, values and democratic principles", as well as "China's growing assertiveness and policies present challenges that we need to address", the EU and NATO would considerably expand and deepen cooperation beyond the traditional mandate of NATO, to conclude policy and information exchange on matters related to infrastructure, digital and technology, space and climate change. In this integrated EU-NATO framework, defence planning and spending would primarily benefit US business and their strategic industrial partners in Europe (the current EDIRPA was amended to eliminate already any "buy European" rationale). EU governments would turn to the United States and increasingly to other suppliers like South Korea and Israel to quickly fill their arsenals.

Competing public spending priorities

At national level, several OECD and NATO countries have already pledged to increase defence spending beyond the NATO 2% GDP target. Germany will invest an additional EUR100bn package in its defence, while Japan intends to put an end to the 1% GDP ceiling on military spendings it had observed since WWII.

In times of fiscal consolidation and competing priorities, this rearmament process could crow out sustainable development-oriented spending on public education, health, infrastructure and climate transition. The following table simulates the impact of defence budget reaching 2% of GDP (NATO's objective) and 3% of GDP (current level of South Korea) and compares it with current education spending. It shows the enormous budget efforts that a number of European countries would need to achieve for rearmament. For example, for Germany, Italy and Spain to raise their defence budget to 3% of GDP would be equivalent to almost 40% of their entire spending on public education.

Simulation of defence spendings reaching 2% and 3% of GDP and comparison with education expenditures

country	Defence spending 2021		Education spending 2019	Gap with 2% target	Gap with 3% target	2% gap /education gvt exp	3% gap /education gvt exp
	in USD Bn	in % GDP	in % GDP				
United States	801	3,5	5,9	0	0		
China	293	1,7					
India	76,6	2,7		0	0,3		
United Kingdom	68,4	2,2	4,9	0	0,8	0,0%	16,50%
France	56,6	1,9	5,3	0,1	1,1	1,8%	20,8%
Germany	56	1,3	4,3	0,7	1,7	12,4%	39,3%
Japan	54,1	1,1	3,3	0,9	1,9	23,7%	57,6%
South Korea	50,2	2,8	4,8	0	0,2	0,0%	4,2%
Italy	32	1,5	3,9	0,5	1,5	6,7%	38,4%
Spain	19,5	1,4	4,0	0,6	1,6	11,0%	40,0%
Brazil	19,2	1,2		0,8	1,8		
Netherlands	13,8	1,4	5,0	0,6	1,6	14,5%	32,3%
Taiwan	13	1,7		0,3	1,3		
Indonesia	8,3	0,7		1,3	2,3		
Norway	8,3	1,8	5,6	0,2	1,2	4,2%	21,5%
Sweden	7,9	1,3	6,9	0,7	1,7	10,1%	24,5%
Finland	5,9	2	5,6	0	1	0,0%	17,8%
Switzerland	5,7	0,7	5,4	1,3	2,3	30,8%	42,3%
Denmark		1,1	6,3	0,9	1,9	15,0%	30,3%

Source: SIPRI 2022 & OECD Statistics

Is defence spending good for the economy?

The link between defence spending and economic growth is underexplored in economic literature. The key element of uncertainty is the "fiscal multiplier" of defence spending – how much 1 dollar spent on the military effectively generates additional GDP growth. At one end of the debate, US defence spending and the US DARPA agency in particular are often seen as a historical contributor to innovation and the rise of the tech industry. There is also evidence of a correlation between the size of military spending and economywide productivity gains. But correlation does not necessarily indicate causality. At the other end, there is a concern about the diversion of resources and the misallocation of public funding to a handful of large defence companies. According to a recent report, compared to education and health, military expenditures are believed to have a low fiscal multiplier, even for countries that have a strong domestic defence industry. For Robert Reich: "All told, more than half of this giant spending budget is going to for-profit companies (such as Lockheed, Raytheon, Boeing, General Dynamics, BAE, and Northrop Grumman) whose stock prices are surging. The profits are going into executive pay, shareholder dividends, and stock buybacks. This is the military-industrial complex that Dwight Eisenhower warned of — on steroids".

Impact on the defence industry

Naturally the defence industry is expected to be a net beneficiary of any future rearmament process, which is already factored in by financial markets. Over the past 12 months, the S&P 500 contracted by over 5%. In the meantime, nearly all the major arms producers saw their stock market capitalisation increased by at least +5%. Yet European arms producers' shares literally skyrocketed: above +40% for BAE (UK), Leonardo (Italy), Dassault and Thales (France), +90% for Saab (Sweden) and +140% for Rheinmetall, the German maker of the Leopard 2 main battle tank.

Market capitalisation of OECD-based leading arms producers - January 2022- January 2023

Company	Country	Arms sales 2021	% of total sales	Market Cap Jan. 2023	1 Year change Jan. 2022-2023
		In USD Bn		In USD Bn	
Lockheed Martin	United States	60.34	90	117.33	+18.12%
Raytheon	United States	41.85	65	146.42	+11.56%
Boeing	United States	33.42	54	126.19	+11.29%
Northrop Grumman.	United States	29.88	84	66.98	+17.02%
General Dynamics.	United States	26.39	69	62.46	+8.95%
BAE Systems	United Kingdom	26.02	97	32.4	+43.77%
Leonardo	Italy	13.87	83	6	+49.23%
L3Harris	United States	13.36	75	40.38	- 1.93%
Thales	France	9.77	51	28.14	+48.24%
Huntington Ingalls	United States	8.57	90	8.71	+15.81%
Leidos	United States	8.03	58	13.19	+8.88%
Dassault Aviation	France	6.25	73	14.14	+47.40%
Peraton	United States	5.81	83		
Booz Allen Hamilton	United States	5.6	67	12.26	+13.03%
Amentum	United States	5.02	78		
MBDA	Europe	4.96	99		
Elbit Systems	Israel	4.75	90	7.41	+5.54%
Naval Group	France	4.74	99		
Rheinmetall	Germany	4.45	66	10.8	+145.22%
CACI International	United States	4.33	70	6.94.	+21.12%
Saab	Sweden	4.09	90	5.54	+90.85%
S&P 500					-5.92%

Source: SIPRI 2022 & ft.com