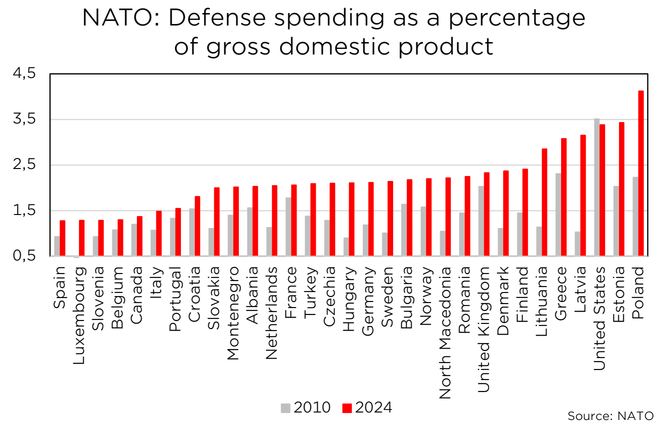
3 July 2025

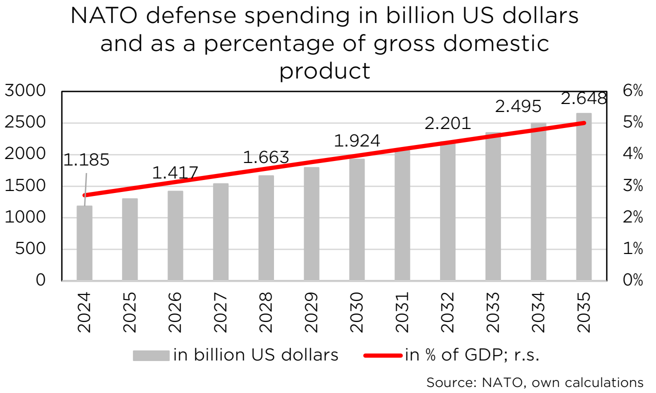
Why NATO's five percent target is so important for Europe

At its summit in The Hague in June 2025, NATO decided that all 32 member states should increase their defense spending to five percent of gross domestic product (GDP) by 2035, with 3.5 percent earmarked for direct defense spending and 1.5 percent for defense-related infrastructure. The previous target was two percent of their respective economic output to be allocated to defense spending. In 2024, NATO member states spent an average of 2.7 percent of their GDP on defense, with 23 countries meeting or exceeding the two percent target. In 2020, this figure was 1.7 percent (nine countries met the two percent target), and in 2010, it was 1.4 percent (five countries met the target). During this period, only Greece, Great Britain and the USA adhered to the agreed target, with the USA spending by far the most money on defense at around 3.5 percent.



Total NATO spending in 2024 amounted to approximately $1.185 billion, of which European NATO members contributed only about $293 billion. The highest defense spending of all member states relative to their economic performance last year was Poland (4.12 percent of GDP), Estonia (3.43 percent), and the United States (3.38 percent), while countries such as Spain (1.28 percent), Luxembourg (1.29 percent), and Slovenia (1.29 percent) were at the lower end of the scale.

Financial dimensions and development paths

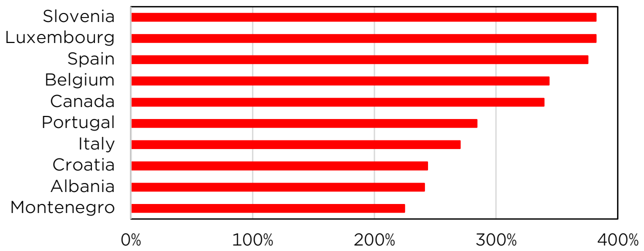


How will defense spending develop in the coming years if we assume that all countries achieve the five percent target by 2035 with real economic growth of just under two percent, and if we assume a linear increase in annual defense spending? In this case, NATO would spend $1,300 billion this year (2.7 percent of GDP), $1,924 billion (4.0 percent) in 2030, and $2,648 billion (5.0 percent) in 2035. NATO's EU members face a particularly significant challenge, as their defense spending currently averages only 2.0 percent of GDP. By 2035, these countries must increase their defense spending from the current $293 billion to $849 billion, an increase of 190 percent—significantly more than the NATO-wide increase of 123.5 percent.

Who will pay how much in the future?

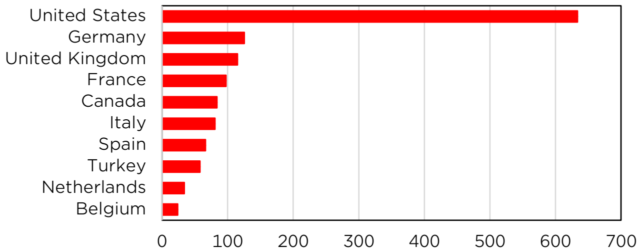
The largest percentage increases will be faced by the countries currently furthest from the five percent target. These include Luxembourg and Slovenia, each with a 382 percent increase by 2035, followed by Spain (375 percent), Belgium (343 percent), and Canada (339 percent). It is noteworthy that seven of the ten countries with the highest percentage increases are EU members, underscoring the particular challenge facing the European Union.

NATO: Countries with the highest percentage increase in defense spending between 2024 and 2035



Source: NATO, own calculations

NATO: Countries with the highest increase in defense spending in billion US dollars between 2024 and 2035



Source: NATO, own calculations

In absolute terms, the United States will see the largest increase, with an increase of $634 billion, followed by Germany ($126 billion), the United Kingdom ($115 billion), and France ($98 billion). Although the United States already spends 3.4 percent of its GDP on defense, its economic size means it will experience the largest absolute increase. Among EU countries, Germany will experience the largest absolute increase, underscoring the significant fiscal challenges it faces.

Germany's new strategy: exemption from the debt brake

Germany has made a fundamental U-turn in its budget policy to meet increased defense demands. After intensive negotiations between the CDU/CSU and SPD, a far-reaching reform of the debt brake was adopted in March 2025, exempting defense spending above one percent of GDP from the constitutional debt rule.

This reform theoretically allows Germany to invest unlimited amounts of money in defense, civil defense, intelligence services, and cybersecurity. The debt brake now only applies to defense spending up to one percent of GDP, which currently corresponds to approximately €44 billion. Anything above that can be financed at will through loans. In addition, a debt-financed special fund of €500 billion for infrastructure measures was established.

The German defense budget will increase dramatically: from approximately €52 billion in 2024 to a planned €62.4 billion in 2025. Medium-term planning envisages a continuous increase: €82.7 billion (2026), €93.4 billion (2027), €136.5 billion (2028), and €152.8 billion (2029). If Germany were to spend five percent of its GDP on defense today, this would correspond to €215.5 billion—more than quadrupling current spending.

The ReARM Europe program of the EU Commission

In parallel with national efforts, the European Commission presented the ambitious ReARM Europe program (also known as Readiness 2030) in March 2025, which aims to mobilize up to €800 billion for European defense. This program represents a paradigm shift in European defense policy and is intended to reduce dependence on American arms imports.

The program is based on five key pillars:

1. Activation of the national exemption clause of the Stability and Growth Pact: This allows member states to increase their defense spending without violating EU budgetary rules. An average increase in defense budgets of 1.5 percent of GDP could create fiscal space of up to €650 billion over four years.

2. Security Action for Europe (SAFE): A new €150 billion financing instrument offering member states loans with maturities of up to 45 years for defense investments. These funds will be raised on the capital markets and disbursed to interested member states upon request.

3. Expanded role of the European Investment Bank: The EIB should expand its lending to defense and security projects and collaborate with private investors.

4. Accelerating the Savings and Investment Union: Mobilizing private capital so that the European defense industry is not solely dependent on public investment.

5. Cohesion Policy: New opportunities for EU funding that allow member states to use cohesion programs for defense-related spending.

The ReARM Europe program focuses on critical defense areas considered essential for Europe's security:

• Air and missile defense systems

• Next-generation AI-assisted artillery

• Drone technologies with defense and attack capabilities

• Critical infrastructure protection

• Enhanced cyber defense

• Electronic warfare

Economic impacts: Growth effects of defense spending

The substantial increase in defense spending will have significant economic implications. A massive military buildup across Europe could achieve what governments have failed to do for years: stimulate sluggish economies, spur new innovations, and create new industries. Recent studies by the Kiel Institute for the World Economy show that increasing defense spending from 2 to 3.5 percent of GDP could boost economic growth in Europe by 0.9 to 1.5 percentage points. Research shows that defense spending has a substantial fiscal multiplier effect. A cumulative increase in military spending of 1 percent of GDP leads to a GDP increase of about 0.7 percent—a multiplier effect comparable to infrastructure or education spending.

There is, however, a crucial caveat: To maximize the benefits of increased military spending, countries will need to buy more equipment in Europe than they currently do, rather than predominantly from abroad. About 80 percent of European defense procurement currently comes from outside the EU. If Europe could develop and produce the next generation of defense technology locally instead of buying it from the US, the economic impact of additional defense spending could significantly boost growth in the medium term.

Military spending influences the economy in multiple, sometimes contradictory ways. In the short term, it can employ idle labor and capital and stimulate spending and investment by private firms and households. In the longer term, research suggests that military spending can generally increase the efficiency of the economy. Government defense contracts can promote economies of scale and spur innovation in civilian industries.

However, there are also hurdles to successful implementation. In an aging Europe, it may be difficult to find enough skilled workers. Furthermore, the money provided must be distributed to companies quickly and efficiently—this is particularly challenging given the complex and lengthy procurement procedures.

Financing the additional spending through higher taxes should also be avoided, as this could slow economic growth. However, this means that higher defense spending will also impact government debt. For countries with high government debt, such as Italy, Spain, France, and Belgium, increasing defense spending could pose a particular fiscal challenge. These countries could be forced to cut spending in other areas or further increase their debt to finance their military buildup.

Due to its large and currently underutilized industrial base and its comparatively low national debt, Germany could benefit more than many other countries from increased defense spending. The combination of the German debt brake reform and the European ReARM Europe program creates the institutional conditions for a historic rearmament effort that could also act as an economic stimulus package. However, the prospects of success depend crucially on the success of building a European defense industry that is less dependent on American imports. Only then can the theoretically possible growth effects actually be realized.

The investment case for European defense stocks

The new NATO defense spending target of five percent of gross domestic product by 2035 marks a historic turning point in European security policy and opens up extraordinary investment opportunities in European defense stocks. This unprecedented increase in spending, from the current two to five percent of GDP, will unlock hundreds of billions of euros in additional investment over the next decade and make European defense companies the primary beneficiaries of this structural change. European defense companies have decisive competitive advantages that make them the primary beneficiaries of this increase in spending: in the future, a large portion of European countries' defense procurement will be carried out by domestic suppliers. This preference is underpinned by the new EU policy "ReArm Europe," which explicitly favors EU companies.

The NATO five percent target represents more than just a pure increase in spending—it marks a fundamental reorientation of Europe toward strategic autonomy and defense readiness. The resulting multiplication of defense budgets over the next decade creates an exceptionally stable and predictable growth path for European defense companies.

The combination of massive spending increases, long-term political commitments, technological revolutions, and positive macroeconomic effects makes European defense stocks a compelling structural investment thesis for the coming years. Investors who bet on this megatrend can benefit from a multi-year supercycle in the European defense industry. This means that stocks in this sector are not a short-term and tactical investment - the NATO objective makes European defense stocks a permanent strategic portfolio building block for the next decade.

Carsten Klude

Market data

Stock marktes	As of 04.07.2025 09:21	Change versus 26.06.2025 -1 week	02.06.2025 -1 month	02.04.2025 -3 months	02.07.2024 -1 year	31.12.2024 YTD
Dow Jones	44829	3,3%	6,0%	6,2%	14,0%	5,4%
S&P 500	6300	2,6%	6,1%	11,1%	14,4%	7,1%
Nasdaq	20601	2,1%	7,1%	17,0%	14,3%	6,7%
DAX	23812	0,7%	-0,5%	6,3%	31,1%	19,6%
MDAX	30178	0,3%	-1,9%	9,8%	20,1%	17,9%
TecDAX	3858	0,5%	0,9%	6,7%	16,9%	12,9%
EuroStoxx 50	5307	1,2%	-0,9%	0,1%	8,2%	8,4%
Stoxx 50	4460	0,9%	-1,6%	-2,4%	-0,7%	3,5%
SMI (Swiss Market Index)	11938	0,5%	-2,1%	-5,2%	-0,6%	2,9%
Nikkei 225	39811	0,6%	6,2%	11,4%	-0,7%	-0,2%
Brasilien BOVESPA	140928	2,8%	3,0%	7,4%	12,9%	17,2%
Indien BSE 30	83096	-0,8%	2,1%	8,5%	4,6%	6,3%
China CSI 300	3982	0,9%	3,7%	2,5%	14,7%	1,2%
MSCI Welt	4063	2,0%	4,7%	10,8%	14,9%	9,6%
MSCI Emerging Markets	1237	0,8%	7,2%	11,3%	14,6%	15,0%
Bond markets						
Bund-Future	130,33	-16	-80	125	-5	-311
Bobl-Future	117,95	10	-117	5	208	9
Schatz-Future	107,34	2	-1	36	181	35
3 Monats Euribor	1,96	-2	-2	-40	-176	-76
3M Euribor Future, Dec 2025	1,79	0	5	-16	-95	-11
3 Monats $ Libor	4,41	2	-3	9	-106	4
Fed Funds Future, Dec 2025	3,85	11	-3	21	-20	-6
10 year US Treasuries	4,35	12	-9	16	-8	-22
10 year Bunds	2,54	-2	2	-15	-4	18
10 year JGB	1,43	2	-7	-2	36	35
10 year Swiss Government	0,41	1	17	-14	-30	13
US Treas 10Y Performance	618,99	-0,3%	1,6%	0,4%	5,5%	4,6%
Bund 10Y Performance	559,77	-0,4%	-0,6%	1,4%	2,4%	-0,9%
REX Performance Index	458,87	-0,1%	0,0%	1,3%	4,1%	1,4%
IBOXX AA, €	3,09	0	3	-9	-43	5
IBOXX BBB, €	3,43	0	-2	-19	-63	-3
ML US High Yield	7,34	-8	-42	-45	-81	-31
Commodities						
MG Base Metal Index	433,31	0,8%	4,1%	1,6%	0,0%	6,8%
Crude oil Brent	68,54	1,2%	5,9%	-9,2%	-21,2%	-8,3%
Gold	3337,91	0,4%	-1,1%	6,8%	43,3%	27,1%
Silver	32,54	0,0%	0,0%	-3,8%	10,5%	9,6%
Aluminium	2617,03	1,3%	6,3%	6,1%	5,7%	3,6%
Copper	10109,20	-1,1%	4,6%	4,7%	6,1%	16,8%
Iron ore	96,24	1,9%	0,3%	-7,7%	-12,8%	-7,1%
Freight rates Baltic Dry Index	1434	-7,7%	0,8%	-9,4%	-34,2%	43,8%
Currencies						
EUR/ USD	1,1773	0,7%	3,1%	9,0%	9,7%	13,3%
EUR/ GBP	0,8615	1,1%	2,1%	2,9%	1,7%	4,2%
EUR/ JPY	169,96	0,6%	4,3%	5,4%	-1,9%	4,2%
EUR/ CHF	0,9342	-0,4%	0,1%	-2,1%	-3,7%	-0,7%
USD/ CNY	7,1637	-0,1%	-0,6%	-1,5%	-1,5%	-2,0%
USD/ JPY	143,69	-0,5%	0,7%	-3,7%	-11,0%	-8,6%
USD/ GBP	0,73	0,5%	-0,8%	-5,1%	-7,2%	-8,3%

Source: LSEG Datastream

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