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Central Europe Economics

Rearming Europe, disarming fiscal constraints

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OUR TAKE

New defense-related loans give the CEE more flexibility in how to finance increased spending. However, the shift towards permanently higher defense budgets creates also real constraints. Regardless of fiscal rules, rising spending implies uncomfortably high debt trajectories. New spending will initially have low fiscal multipliers but over time the defense industry and military will compete for the labour. We treat the recent shift in Europe's policies as medium term pro-inflationary, even if these consequences are unlikely to materialize in the immediate future.

The aim of the European Commission's ReArm Europe plan is to facilitate a quick and significant increase in defense expenditures by EU states. Given the geopolitical position and potential security threats, Central European countries can be arguably among biggest beneficiaries of the plan. European Commission's proposal consists of two components. The first one assumes that the Commission will grant EUR 150 billion of loans to member states for defense investment. The second pillar assumes activation of the escape clause that could create space for additional defense spending by EU countries without a risk of triggering the Excessive Deficit Procedure (EDP).

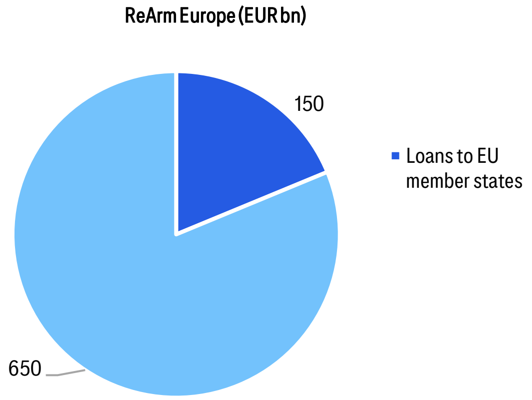
1. EUR 150bn in loans

At this stage it is unclear how new loans can be allocated to certain countries. For example when cohesion funds from the EU budget were allocated in the past, the exact amounts depended at least indirectly on a country's GDP per capita. In turn, when the post-pandemic RRF was divided between member states, the biggest beneficiaries were countries that suffered most as a result of the COVID pandemic. This time the allocation will need to take into account defense needs of particular EU member states, which to at least some extent will be a function of geographical location. From this point of view it seems likely the CEE may get potentially a relatively higher share in the pool of EUR 150bn loans than nominal GDP would suggest.

Figures 2 and 3 show a stylized scenario, assuming that the new allocation rule would be close to the average of the allocation used for RRF and cohesion funds. In such a case Poland could get more than 10% of the total loan pool while Czechia and Hungary around 4%. We treat these numbers as only very rough estimates and we think the actual split may differ for a number of reasons – for example lack of interest from some EU countries. In nominal terms this would imply EUR 15-20bn in loans for Poland and approx. 5bn for each Hungary and Czechia.

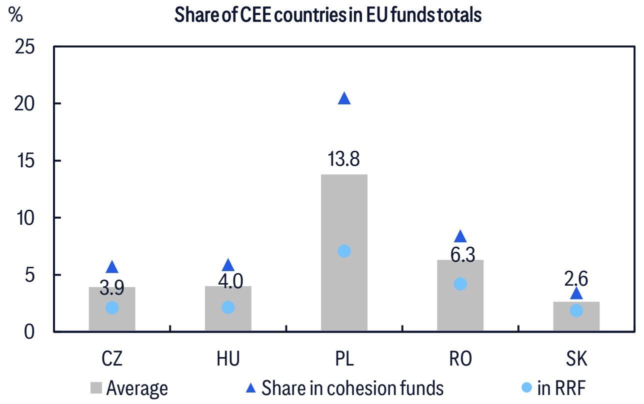
New defense loans would hardly be a game changer for CEE economies. The biggest benefit would be: a) some diversification of funding sources, which would give debt managers a bit more flexibility; b) some reduction in borrowing needs. As far as the latter is concerned, we think the new loan could be by 20-80 bps cheaper than the cost at which CEE countries could borrow in the euro market (for 5 year tenor). However, the benefit would be more significant when compared with the cost of borrowing in domestic market, where the difference in borrowing costs could be 120bps-380bps depending on a country. This would make new EU loans relatively attractive for CEE countries, but given the size of a loan pool it would have limited impact on overall debt service costs in the region.

Figure 1. Europe is planning to spend more on defense



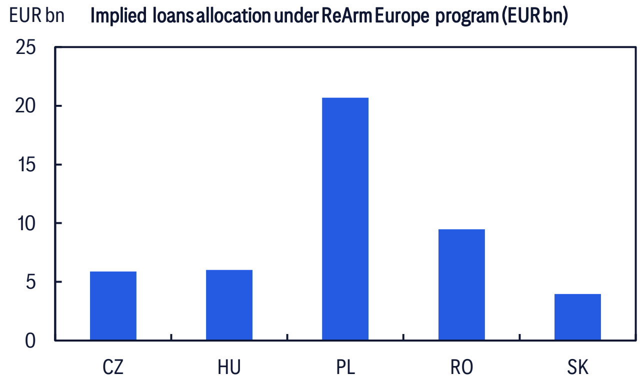
Source: European Commission, Citi Handlowy

Figure 2. If EU funds allocation is any guide, Poland could get more than 10% of new defense loans while Czechia or Hungary approx. 4%



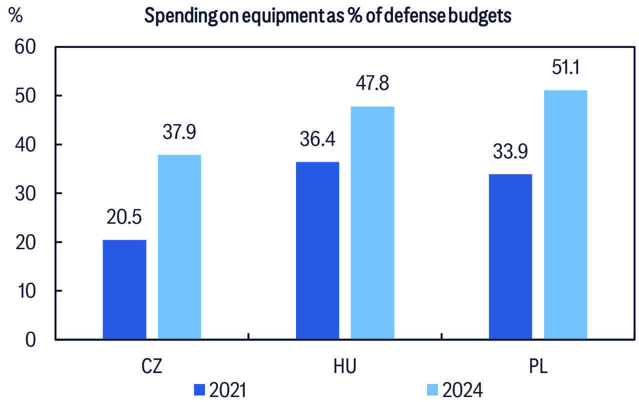
Source: Citi Handlowy Estimates, European Commission data

Figure 3. We assume ReArm Europe loans could reach EUR15-20bn in case of Poland



Source: Citi Handlowy Estimates

Figure 4. In the first stage defense budgets are spent mainly on equipment which comes mostly from imports



Source: NATO, Citi Handlowy

2. Activated escape clause

The European Commission intends to allow EU member states to spend more on defense by changing fiscal constraints. Currently countries that run the fiscal deficit above 3% of GDP are at risk of being put under the Excessive Deficit Procedure (EDP) that requires them to cut deficit over a given period. The Commission wants to activate the escape clause, which would mean that (at least some of) defense spending would not be included in deficit calculation for the purpose of the EDP. In other words countries with large defense spending would be given some leeway and would not be automatically required to bring the deficit lower.

It is uncertain what portion of the defense spending would get a preferential treatment. While presenting the ReArm Europe plan EC President Ursula von der Leyen mentioned EUR 650bn of additional defense spending over four years if EU states were to increase defense budgets by 1.5% of GDP. This particular number grabbed the headlines but we treat it more as an example of potential consequences than a policy announcement. It is not clear if the mentioned 1.5% of GDP will be in any way formally stated in the final proposal.

Among CEE3 countries, the ReArm Europe plan may be particularly important for Poland – a country a) already under the EDP, and b) with the highest defense budget in NATO. Currently the general government deficit in Poland is running at around 6% of GDP, i.e. three percentage points above the EDP limit. If the country gets some leeway on 1.5% of GDP of this difference, the authorities would need to cut the deficit by only ~0.5pp over next three years, roughly half of what was previously planned. Given that the bracket creep and lack of indexation of social spending generate annual fiscal tightening of as much as 0.4% of GDP, there would be no need for significant additional tightening.

In turn Czechia is currently running a deficit of less than 3% of GDP and is not under the EDP. The proposed activation of the escape clause would make it easier for the authorities to deliver on its promise to increase defense spending from current 2% of GDP to 3% by 2030 (Reuters, March 5th). However, the final outcome may be affected by the parliamentary election planned for autumn 2025 and the risk that the new government may have different stance on defense spending.

Real constraints can still bite

Although measures proposed by the European Commission make it easier for CEE economies to spend more on defense, this should not obscure the fact that serious constraints remain in place. Regardless of whether new spending is included in EDP calculation or not, higher expenditure without corresponding tax measures is likely to lead to an additional increase in general government debt. This may not be a big deal for Czechia where the debt is below 45% of GDP, but it is more of an issue for Poland (~55%) or Hungary (~75%). In particular, the upward debt trajectory in Poland means debt service costs may become a more important constraint, unless the fiscal spending in non-defense components is adjusted lower. Taking this into account we do not think the ReArm Europe plan will result in much bigger defense spending in Poland. Instead it will allow simply for more flexibility in tightening.

Another important issue is how new spending can affect economic activity. The case of Poland, Hungary and Czechia shows that the first stage of re-arming implies large investment in equipment purchases (Figure 4). For example, as per NATO data the share of defense expenditure spent on equipment in Czechia rose between 2021 and 2024 from ~20% to 38%. In Poland the similar change was from 34% to 51%. Large purchases of equipment in short period of time usually come from imports and therefore the fiscal multiplier of new spending is relatively low. Therefore we would expect that the short term impact of new defense spending will not be reflected in higher GDP, as higher defense investment will be offset by increased imports.

In this context what seems more important is a long term consequence. The change in geopolitical situation and new EU approach to defense spending suggest a new trend. In this new situation the de-globalization motivated by supply chain security could lead to higher production costs in the longer term. Furthermore, after first stage of increasing imports the higher defense spending will eventually feed also into higher domestic demand as European producers will start ramping up production and countries bordering with Russia will spend more on defense infrastructure. This assumption seems also consistent with Europe's attempt to minimize its dependence on military equipment imports from countries that may not be reliable sources in case of a conflict. Finally, the defense industry and the military will need to compete for workers with non-defense producers. This may not be a serious constraint in all countries, but in Poland already now the military personnel exceeds 1% of the country's male population, while the unemployment rate is below 3%. Over time the competition for labour will rise, with all its consequences for wage growth.

All in all, we think the shift to defense spending can exacerbate some of supply side constraints in the region and through simultaneously boosting demand

and hitting growth potential it can be pro-inflationary. In our view, inflation impact would materialize only with a delay, probably after 2026, as near term CPI performance would be driven more by changes in FX rates and energy/oil prices. However, it seems likely that in the longer term keeping inflation at the target could require relatively tighter monetary policy/higher real rates than in it was the case in the past.

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