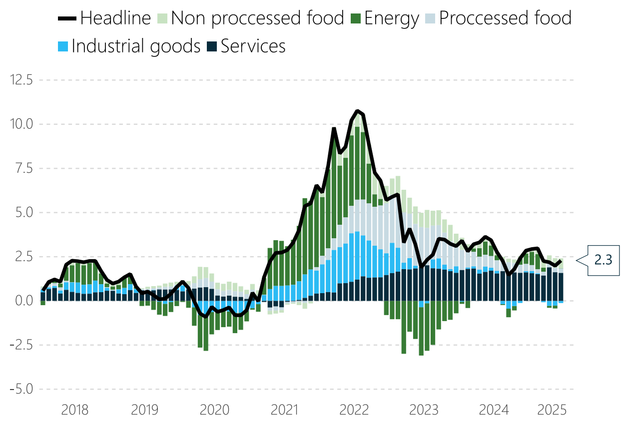
NATO's new defence spending target: analysis of the fiscal and economic impacts

NATO has agreed to raise the defence spending target to 5% of GDP by 2035, although Spain is proposing a limit of 2.1% to preserve fiscal sustainability and prioritise other investments. Although higher spending on defence can boost growth in the short term, the more ambitious scenarios entail significant fiscal risks, reinforcing the viability of the moderate approach proposed by the Spanish government.

Prices

Headline inflation ticked up to 2.3% (+0.3pp) in June. Meanwhile, core inflation was steady at 2.2%. The more inflationary components included transportation, where annual inflation increased by 1.2 points to -0.8%, shaped by the increased cost of fuels, in contrast to price corrections this time last year. Housing prices also ticked higher, by 0.4pp (to 4.2%), driven by higher gas prices and, to a lesser degree, higher fuel prices. In contrast, price growth eased in other components, such as leisure, culture and footwear, by comparison with May, curtailing the spike in headline inflation.

Headline inflation and contributions (% YoY, pp)

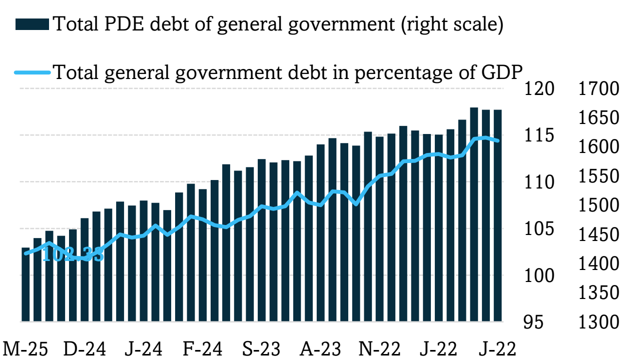


Source: Afi, INE

Public debt

Spanish government debt increased by 3.8% year-on-year in May to €1.66 trillion. However, the ratio of debt to GDP decreased by 2pp year-on-year to 102.3%, thanks to the growth in nominal GDP. The growth in public debt was concentrated at the state level (+4.4%) and was sharpest at the Social Security (+8.6%), as regional government debt increased by just 0.9%, while the local governments reduced their debt by 1.1%.

EDP debt at all levels of government (€ bn | % of GDP)



Source: Afi, Bank of Spain

...and what to watch for next week

From the 21th to the 25th of July		
23-Jul	Hotel Tourism Short -Term Trends	June
24-Jul	Labour Force Survey (EPA)	2Q-2025
	Industrial Price Index	June

NATO's new defence spending target: analysis of the fiscal and economic impacts

Spain has rejected NATO's 5% defence spending target, defending keeping it at 2.1% on fiscal sustainability grounds

At the recent NATO summit in the Hague on 24 and 25 June 2025, the member states agreed to the target of increasing their defence spending to 5% of GDP by 2035, earmarking 3.5% to core military defence and 1.5% to civil resilience, critical infrastructure and cybersecurity. The goal underpinning this commitment is to increase readiness for increasingly complex geopolitical situations.

Spain, however, has defended a different stance. The Spanish government has put forward an alternative proposal: keeping defence spending at 2.1% of GDP, which it views as a high enough bar to allow it to meet its collective security commitments. This position is based on the need to preserve fiscal sustainability and avoid having to deviate funding from social funding and productive investments. This discrepancy with the NATO target has generated some diplomatic tension with certain allies but also sparked a necessary debate about the balance between defence, growth and fiscal discipline. This week, we assess the potential impact of the different scenarios for public defence spending on Spain's key fiscal and macroeconomic metrics.

Spain will lift its defence spending to 1.6% - 1.8% of GDP in 2025, which is still well below the target of 2.1%, with four possible trajectories thereafter, which vary in terms of ambition and fiscal viability.

Current context and scenarios

In 2024, Spain spent around 1.3% of its GDP on defence, which is well below the target agreed with NATO (2%) and very far from the recently agreed long-term target. For 2025, the government has approved an extraordinary increase of €10.47 billion, which would imply total expenditure of 1.6% - 1.8% of GDP, depending on actual economic growth and the rest of the budget. Nevertheless, the target of 2.1% continues to look out of reach and the approved increase is just a first step.

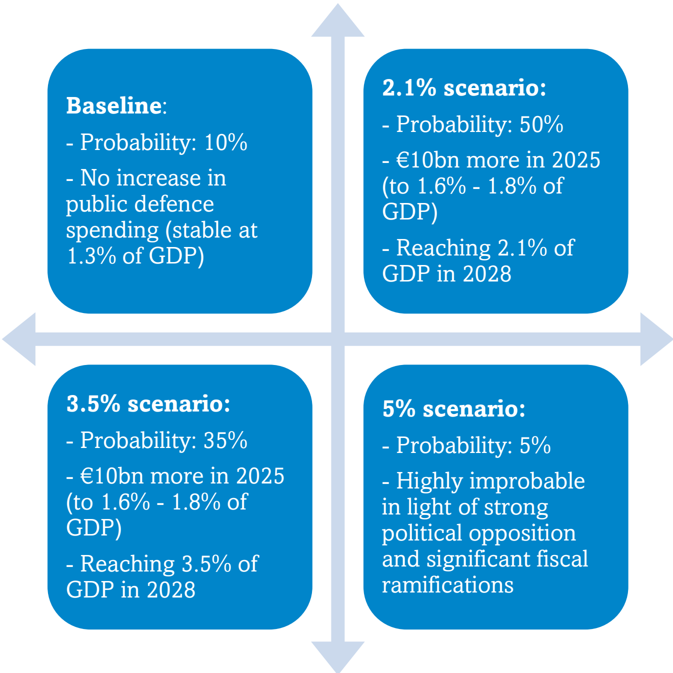
Starting from current expenditure (1.3% of GDP in 2024) and the increase anticipated in 2025 (to around 1.6% - 1.8%), we have defined four possible scenarios for the trend in defence spending in Spain over the coming years[1]. Each is shaped by the implied level of budgetary commitment associated with an estimated probability as a function of the prevailing political, institutional and economic climate:

1. **Baseline scenario**: Estimated probability: 10% No additional investment in defence beyond the trendline growth implied by the budget. Defence spending stabilises at around the level observed in 2024. This scenario is considered unlikely in light of the increase already approved for 2025 and external pressure to meet NATO commitments.
2. **Defence spending equivalent to 2.1% of GDP**: Estimated probability: 50% The announced increase of €10 billion materialises in 2025, with investment continuing to increase thereafter, reaching 2.1% of GDP in 2028. This is the most plausible scenario, in line with the Spanish government's proposal and offering a balance between external ambitions and internal fiscal sustainability.

[1] The fiscal and macroeconomic effects associated with each scenario are assessed in terms of the traditional equation of debt sustainability which relates the primary account, economic growth, interest rates and initial public debt level.

3. **Lifting defence spending to 3.5% of GDP**: Estimated probability: 35% In this scenario, in addition to the announced €10 billion increase in defence spending in 2025, Spain would accelerate growth in budget allocations in order to achieve the threshold agreed at the NATO summit for 2035 by 2028. This scenario would require a more expansionary fiscal strategy and greater internal political consensus. It is more ambitious but feasible in the face of further geopolitical deterioration or greater pressure from allies.
4. **Lifting defence spending to 5% of GDP**: Estimated probability: 5% This scenario assumes full compliance with the NATO target, including expenditure on civil resilience and capabilities, increasing defence spending from 2026. This scenario is considered highly unlikely in light of strong political opposition and its significant fiscal ramifications.

Exhibit 1. Scenarios for defence spending in Spain



Source: Afi

Higher spending on defence lifts economic growth but also raises the deficit and public debt. The 2.1% of GDP scenario offers the best balance between stimulus and fiscal sustainability.

Impact on fiscal metrics and growth

The growth in public spending on defence has significant implications for economic growth and the main fiscal variables, particularly if the incremental defence spending is financed structurally with long-term debt. The net impact depends on several factors: the composition of the expenditure (consumption vs. investment), the private sector response, complementary fiscal policy and the international financial environment.

From a theoretical standpoint, defence spending can act as a stimulus in the short and medium term[2] by sparking internal demand, activating strategic industrial sectors and boosting productivity to the extent the expenditure goes to investments in technology[3]. However, it also exerts additional pressure on the public finances by increasing the structural deficit and increasing, to the extent financed with debt, the debt-to-GDP ratio.

The scenarios defined above enable quantification of their effects:

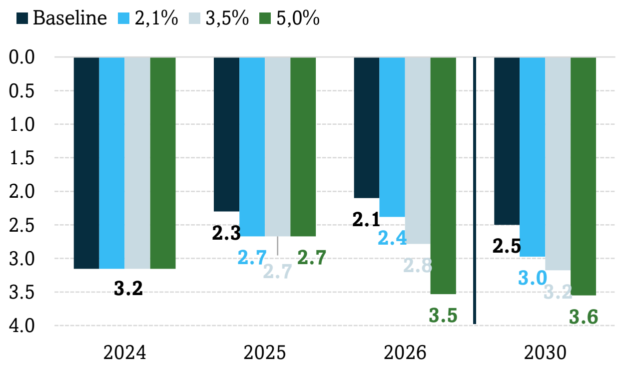
1. In the baseline scenario, the budget effort is nil and the fiscal trajectory does not change. The public debt ratio is expected to come down gradually from 101.8% of GDP in 2024 to 95.9% in 2030, accompanied by sustained GDP growth (+2.4% in 2025 and +2.2% in 2026) and a steady reduction in the deficit.
2. In the 2.1%-of-GDP-defence-spending scenario, the impact on growth is moderately positive (+0.3pp in 2025 and +0.1pp in 2026 and 2027), partially absorbing the growth in spending. Nevertheless, the deficit would be around 0.3pp - 0.5pp higher as a percentage of GDP between 2025 and 2027 and the public deficit would be nearly 2pp above the baseline trajectory at the end of the time horizon.
3. In the scenario of lifting defence spending to 3.5% of GDP, the growth boost is more significant (an additional 0.2pp in the central years) but comes at the cost of more patent fiscal deterioration: the deficit would return to over 3% of GDP in 2028, while debt would track nearly 3pp above the baseline trajectory.
4. And in the 5%-of-GDP-defence-spending scenario, growth would increase by between 0.3pp and 0.5pp per year between 2025 and 2028, but the fiscal cost would be significant: the deficit would not fall below 3% throughout the projection horizon, reaching 3.6% of GDP in 2030, while public debt would end up 4pp above the baseline scenario forecast.

[2] We already analysed the impact on growth and debt of a potential increase in defence spending in a previous Weekly (here). To do that, we used the fiscal multiplier calculated in this ECB article.

[3] However, in this report, we pointed out that the European Commission may contemplate making the fiscal rules more flexible around defence spending in the years to come.

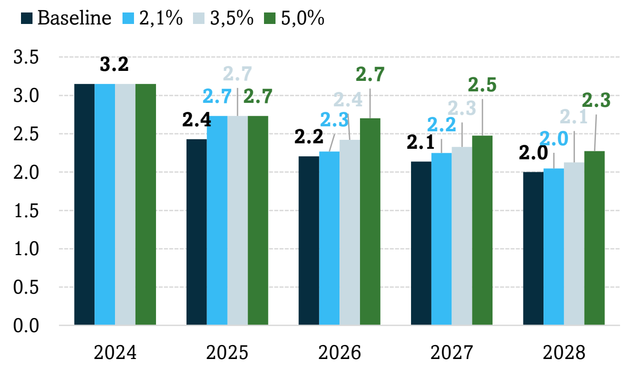
Although all of the scenarios for higher defence spending boost economic growth, their fiscal impact is not linear and is amplified the higher the spending ambitions. Scenario 1 (2.1%) offers a reasonable balance between economic stimulus and fiscal sustainability. In contrast, the more ambitious scenarios (3.5% and 5%) imply higher fiscal risks that should be assessed in light of the international context and the availability of European financing mechanisms.

Exhibit 2. Impact of the different defence spending scenarios on the public deficit (% of GDP). Afi simulation for 2025-2026 and 2030



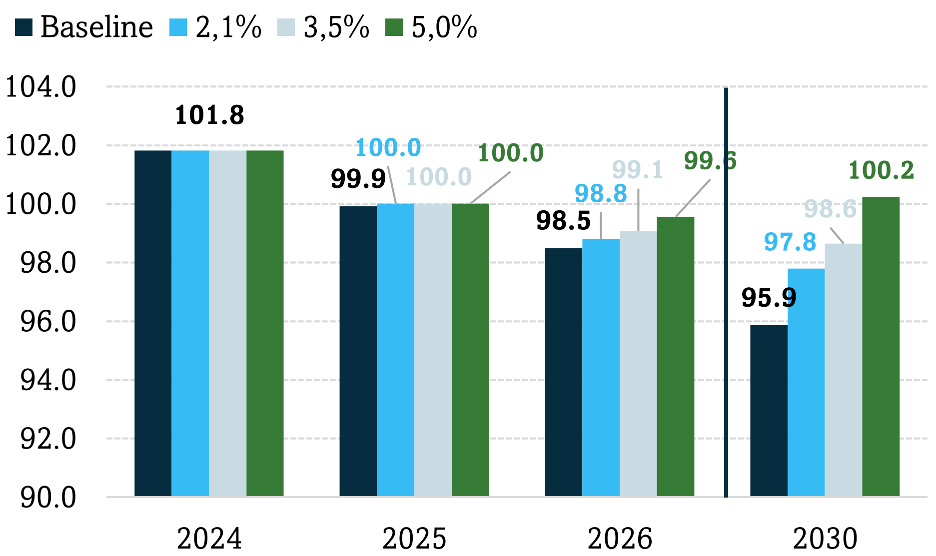
Source: Afi

Exhibit 3. Impact of the different defence spending scenarios on GDP growth (annual %). Afi simulation for 2025-2028



Source: Afi

Exhibit 4. Impact of the different defence spending scenarios on public debt (% of GDP). Afi simulation for 2025-2026 and 2030



Source: Afi

Impact on financial variables

The increase in defence spending could stress the debt curve and drive an increase in long-term interest rates in Spain in response to heightened perceived fiscal risks, increasing public borrowing costs.

Beyond the impact on growth and the deficit, another key risk is that an increase in defence spending could be perceived by the market as a source of fiscal deterioration, ultimately impacting on the sovereign debt curve. The increase in public debt, particularly if widespread at the European level as a result of NATO demands, could significantly alter the balance between supply and demand in the bond market.

High volumes of long-term bond issues tend to imply a steeper rate curve to price in increased duration and/or inflation risk and/or a fiscal risk premium, a movement which may be beginning to unfold, judging by the trend in the Spanish rate curve since the NATO meeting (Exhibit 5). Moreover, in the case of economies with high stocks of debt, like Spain and Italy, these effects may be amplified if investors perceive erosion of fiscal sustainability.

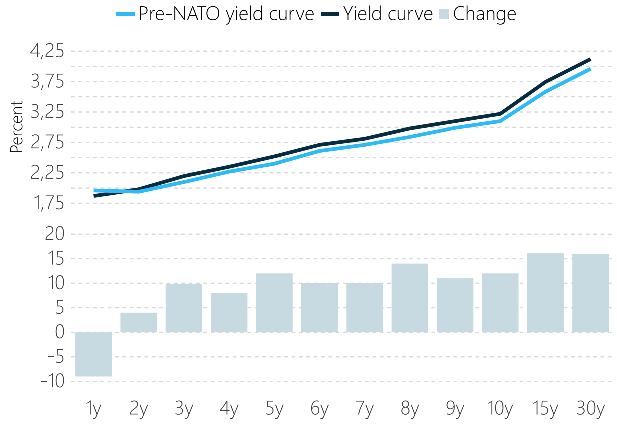
Several recent studies point to a possible tightening of the German sovereign rate curve in the coming years, of between 30bp[4] in the most benign scenario and up to 130bp[5] in the most adverse scenario, in which several countries opt to autonomously finance higher military spending. In the latter scenario, the 10-year German bond yield could top 4%, a level not seen since the turn of the century.

In Spain, this spike would be accompanied by a widening of the spread with respect to German bonds as a result of relatively higher indebtedness and reduced fiscal space. More specifically, the 10-year Spanish bond yield could move to between 4% and 5.4% depending on the scenario, structurally increasing the country's average borrowing cost in the years to come (Exhibit 6), with clear implications for the public budget.

[4] https://www.caixabankresearch.com/en/economics-markets/financial-markets/germanys-fiscal-shift-and-bund-when-security-comes-price

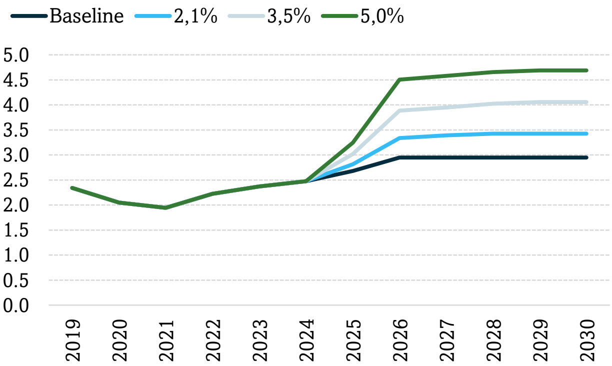
[5] https://www.reinsurancene.ws/10-year-bund-yield-could-rise-130-basis-points-by-2027-amid-increased-public-spending-reports-swiss-re/

Exhibit 5: Trend in the Spanish sovereign yield curve since the NATO meeting (%, bp)



Source: Afi

Exhibit 6: Impact on average borrowing rate. Afi simulation for 2025-2030 (%)



Source: Afi

Spain's public finances are of relatively little concern in the European context but external risks could pose a threat to fiscal sustainability if growth is undermined by an adverse global scenario.

Fiscal sustainability in the European context and external risks

Despite the pressures derived from increased spending, Spain's fiscal situation is not alarming on a relative basis. The public deficit has fallen below 3% and the ratio of debt-to-GDP continues to come down in the wake of the post-pandemic peak. By comparison with other European countries, Spain is consolidating its public finances, in line with the new European rules.

In addition, in the intermediate scenarios (especially the 2.1% scenario), the positive impact on growth would be sufficient to absorb part of the additional fiscal cost, leaving the debt ratios stable or even allowing for a small reduction.

However, the chief risk lies not so much with domestic fiscal policy as with the external context. An environment marked by persistent geopolitical risks, tariff tensions or heightened global uncertainty could erode growth by more than the boost provided by higher defence spending. In that scenario, growth could slow, undermining the primary accounts and reversing the improvement observed in recent years.

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