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Defence spending, fiscal stimulus and European integration

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- European defence and security spending is a thread that connects several disparate themes: the refugee crisis and the need to better secure EU borders; US criticism of Europe's NATO spending; and the move towards closer European integration.

- A Macron-Merkel alliance promises to push European integration. Strengthening the single currency area will take time. Progress towards a common treasury, stabilization funds and safe bonds is unlikely before 2020 – after the next European Parliamentary elections. These ideas are controversial, complex and not guaranteed to materialize.

- Defence and security issues, on the other hand, are more immediate and are starting to be addressed by policy with the recent European Defence Action Plan (EDAP). How far Europe is willing to go in this area could signal the appetite for progress in other areas too.

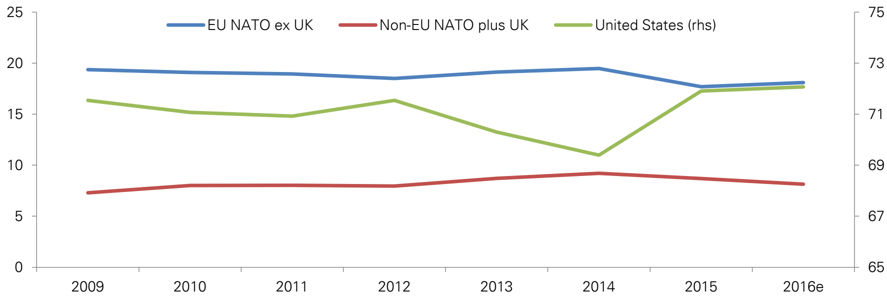
- In this report we do two things. First, we review the EDAP from a fiscal perspective. Our conclusion is the EDAP is too small to be considered an economic stimulus. If the project bond (leverage) element is fully exploited, the scale could be a little more relevant. A more meaningful economic impact would need either convergence to the NATO 2% of GDP defence spending target before the 2024 deadline or a higher target. However, merely meeting the existing target will be challenging enough in countries like Germany.

- Second, we present a framework to help markets judge integration initiatives in general. The key dimensions of integration initiatives are: the political objective, source of funds, fiscal sustainability, sovereignty and mutualisation. We identify more positive and less positive characteristics based on existing European institutions.

- Using this framework we judge the EDAP to be a very modest integration step at best. The political objective – closer Europe integration via defence policy – is a very significant political signal. The corollary is it is controversial. This limits the policy's scope and minimizes the fiscal sustainability ramifications. In terms of sovereignty and mutualisation the EDAP does not break new ground.

- Merkel and Macron have a unique opportunity to improve European institutions. The signaling benefits of integration should not be underestimated and may help restrain yields as the ECB gradually exits QE. However, achieving the headline objectives requires detailed mechanisms. We urge some caution. First, Merkel's support for Macron should not be misinterpreted as Germany saying the price for greater European solidarity has declined. Second, mutualisation will remain politically very difficult.

Figure 1: US defence spending equates to more than 70% of the NATO total



Source: Deutsche Bank, NATO

Defence spending trends

Recent defence spending trends. The economic crisis and attending pressures on public finances added to the trends in place since the collapse of the Soviet Union in early 1990s and pushed European defence spending lower. Spending by EU NATO members fell by 12% in real terms over the last decade. Spending is now 1.5% of GDP despite an agreement in 2006, and reconfirmed in 2014, to raise defence spending to 2% of GDP.[1]

European defence spending is at least bottoming out and beginning to rise – defence spending increased in 2016, led by Eastern European member states. However, at 1.5% of GDP in aggregate it significantly lags others, for example, 3.6% of GDP in the US and 4.2% of GDP in Russia. For comparison, Germany, France and Italy currently spend 1.2%, 1.8% and 1.1% of GDP on defence.

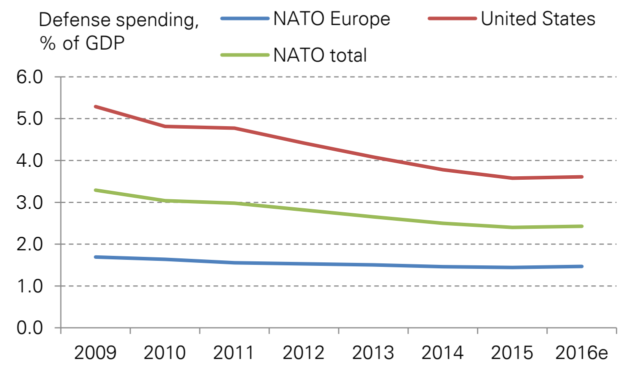
NATO spending target. The NATO defence spending target is 2% of GDP. The recent confirmation of the target by 2024, which is just a voluntary objective, is currently met by only 4 of the 22 EU NATO countries (Greece, UK, Estonia and Poland). For those furthest away, closing the gap implies a significant commitment of resources, e.g., Spain would have to increase spending 15% per annum.

Limited fiscal stimulus. From a level of 1.5% of GDP on average today, a linear convergence to the 2% 2024 target implies less than 0.1pp of GDP additional spending on defence per year for the EU. Since "stimulus" is calculated on a change basis, this implies no more than 0.1% of GDP stimulus for the economy per annum through the period of adjustment. This is not large enough to be considered equivalent to a fiscal stimulus programme.

Put differently, for defence spending to be a meaningful source of economic stimulus either the convergence to the 2% of GDP spending target will need to be more rapid or the 2% target will need to be raised. Given the strategic environment, there is likely to be pressure for the former if not also the latter. The question is, will European politics support it?

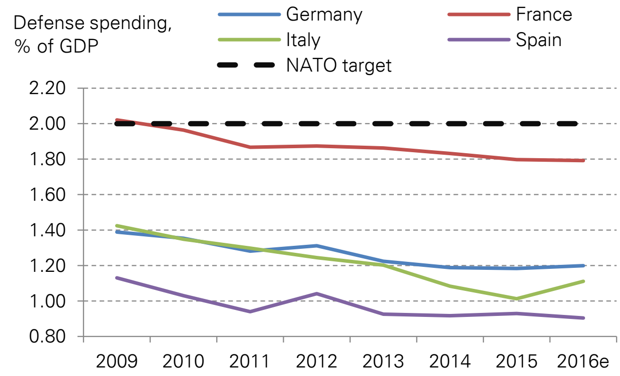
1 22 of the current 28 EU members are also members of NATO. The EU member states not part of NATO are Austria, Cyprus, Finland, Ireland, Malta and Sweden.

Figure 2: NATO Europe vs US spending – % of GDP



Source: Deutsche Bank, NATO

Figure 3: EMU Big 4 defence spending – % of GDP



Source: Deutsche Bank, NATO

The politics of European defence spending

Deeper defence integration foreseen in European treaties. The rapid agreement on plans for enhanced EU defence cooperation at the June European Council meeting has been a display of unity and preparedness for new areas of cooperation amongst EU countries as the Union faces the unprecedented separation from one of its largest members. Deeper European defence integration is by no means a new idea. In fact, it is explicitly foreseen in the EU treaty. But the topic remained dormant over the years, not least due to concerns in the UK that this would overlap with existing NATO capacities.

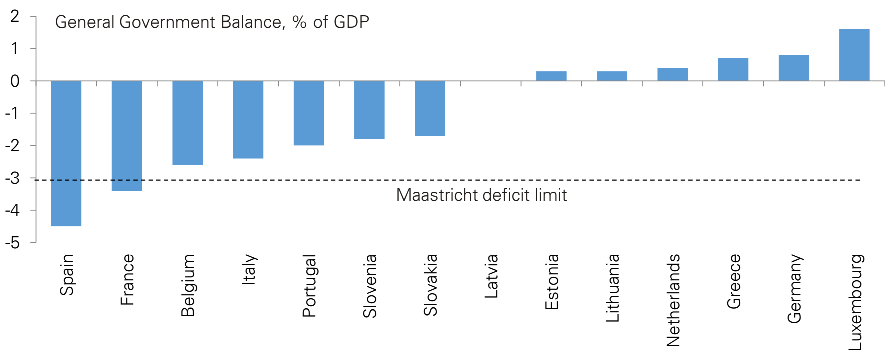
No 'EU army'. Following the UK's decision to leave the Union, France and Germany pushed to reinvigorate the plan and received support at a September 2016 meeting of EU defence ministers (excluding UK) in Bratislava. Current initiatives that foresee a "European Defence Fund" (more below), cost sharing for European battle groups and EU military missions of willing countries remain far behind the creation of an 'EU army' feared by critics. It would also not affect the neutrality of non-NATO EU members (any further defence integration is voluntary) nor interfere with the treaty commitments of NATO countries.[2]

European preference to spend 'better' rather than 'more'. Responding to repeated US calls for increased European defence spending, EU heads of state, including French President Emmanuel Macron and German Chancellor Angela Merkel, confirmed their commitment to the NATO objectives. However, feasibility will depend on several factors, including EU members' fiscal latitude, European and national policy preferences as well public opinion. Emphasizing national budget constraints, European initiatives for deeper defence integration focus primarily on more efficient use of resources, interoperability and reduction of duplicity in military (R&D/procurement) expenditures. The aim is to "spend better and improve value for money" rather than a substantial increase in overall spending.[3]This goes in hand with the understanding that an increased military budget not necessarily translates into more effective and operational armed forces.

2 See European Parliament (2016): "Implementation of the Lisbon Treaty provisions on the Common Security and Defence Policy (CSDP)" on Article 42(7) TEU.
3 See European Commission (2017): "Reflection Paper on the Future of European Defence" and European Commission (2015): "In Defence of Europe".

NATO commitment bound by EU Fiscal Compact. Current European defence integration plans do not include a European equivalent to the 2% NATO spending objective. Rather, NATO members that members of the euro area have to comply with the 3% of GDP fiscal deficit limit in the Stability and Growth Pact/ Fiscal Compact. Accordingly, leeway for spending increases varies substantially between members. The situation is different when it comes to the European Defence Fund (EDF). The EDF will be partly financed through the EU budget, with additional financing coming from national contributions. These will be treated as "one-offs" under the Stability and Growth Pact and therefore exempted from the Maastricht rule (more below).[4]

Figure 4: Euro area NATO member state fiscal balances (2016)



Source: Deutsche Bank, Eurostat

Defence spending politicized ahead of German elections. The question of defence spending is becoming more politicized ahead of German September parliamentary elections. SPD candidate Martin Schulz said that his party would not accept the US "defence spending logic" (Bloomberg, 25.06.2017). Schulz emphasized that the 2% of GDP NATO target is non-binding (Politico, 12.04.2017) and called the implied increase in defence spending from currently 1.2% of GDP unrealistic (Bloomberg, 17.05.2017).

Chancellor Merkel responded to US criticism by stretching the equal importance of German development aid (0.7% of GDP in 2016, meeting the UN target) but emphasized that Germany would do everything it can “in order to fulfil this commitment", with reference to NATO's spending targets (Politico, 18.02.2017).

There are also voices in Germany that call for an international security engagement that goes beyond the 2% of GDP NATO target. Wolfgang Ischinger, chair of the Munich Security Conference (MSC) and former German ambassador to the US, recommends a 3% of GDP target for international security spending, foreign defence, foreign policy and foreign aid (MSC, 18.02.2017). His proposal has the support of the German liberal party (FDP).

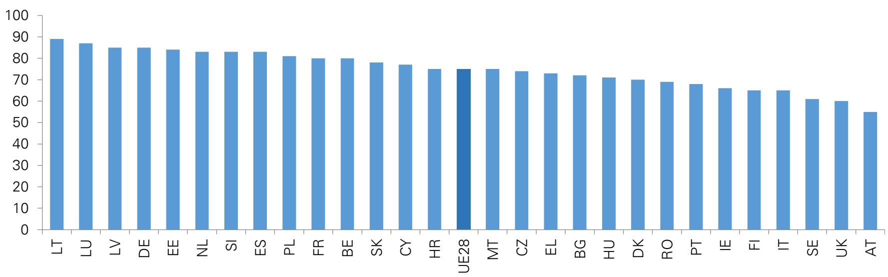
The public discussion about Germany's military role and strength within Europe has always been rather ambivalent, not least due to historical considerations that also find expression in the country's preference for ‘soft power’ and diplomacy. On the one hand, opinion polls show strong public support for a common EU defence and security policy in Germany (85% of respondents, according to

4 See European Commission (2017): “The European Defence Fund: Questions and Answers”.

Eurobarometer), one of the highest results in Europe (see chart). On the other hand, 55% of the German population oppose an increase of military expenditure towards 2% of GDP target, according to a recent Forsa poll (stern, 15.02.2017).

Also looking at the finance ministry's current medium-term budget planning (that foresees an average annual (nominal) rise in the defence budget of around 3.5% until 2021)[5] suggests that German military expenditures relative to GDP over the next years might rather remain close to the current levels than move more rapidly to the 2% target or beyond. However, adjustments of the medium-term budget are common under a new government.

Figure 5: Percent support for a common defence and security policy among EU member states (2016 Eurobarometer)



Source: Deutsche Bank, Eurobarometer

European Defence Action Plan (EDAP)

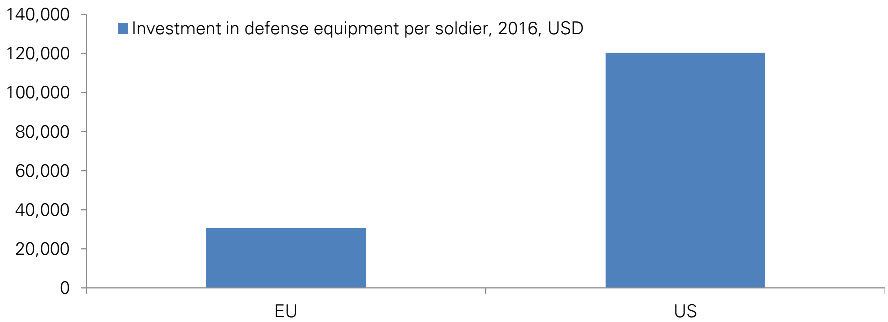
Quality vs quantity. To avoid a situation where the additional defence spending is sunk into personnel costs and wages and to start making up for the fact that the post-crisis spending crunch hit defence capital spending and equipment, the NATO commitment has a secondary target of spending 20% of defence resources on equipment procurement and R&D by 2024. Only 5 of the EU NATO members satisfied this requirement in 2015.

Collaboration. The economic crisis hit defence spending without any centralized coordination of where Europe could best afford to pull back on defence capital spending. One trend this may have provoked – strengthened by new external threats – is the increasing incidence of defence collaboration across countries, from joint training and exercises to equipment sharing and mixed brigades. Germany is at the leading edge of this trend with more bilateral and mini-lateral arrangements than any other European country.

European Defence Action Plan (EDAP). In November 2016 the European Commission unveiled the European Defence Action Plan (EDAP), the main element of which is a European Defence Fund (EDF). This fund has two parts: a "research window" to inject more public funds into defence R&D and a "capability window" to help member states reduce the cost of defence procurement. [6]

5 See Federal Ministry of Finance (2017): "Regierungsentwurf des Bundeshaushalts 2018 und des Finanzplans bis 2021".
6 In addition to the European Defence Fund, the EDAP also includes policies to help foster defence industry SMEs and strengthen the single market for defence.

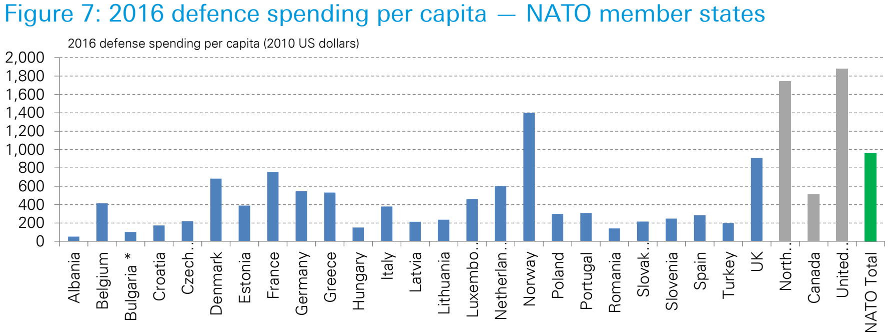
Figure 6: Europe lags the US in terms of defence equipment per soldier



Source: Deutsche Bank, European Political Strategy Centre/World Economic Forum

Research window. The commitment of financial resources is starting very small – EUR25m from the 2017 EU Budget and up to EUR90m in total by 2020. The Commission intends to propose annual spending of EUR500m in the next multi-annual Budget from 2021. This is still a tiny sum from an aggregate EU GDP perspective. It also compares to total EU R&D funding in the 2014-2020 Budget of EUR77bn.

Figure 7: 2016 defence spending per capita — NATO member states



Source: Deutsche Bank, NATO

Capability window. The intention is to support and incentivize joint procurement programmes, thus working with the need to raise defence equipment spending while also piggybacking on the European trend towards defence collaboration across countries. 80% of procurement takes place at a national level and the EU estimates that annual duplication costs in the range of EUR25-100bn.

The Commission lists three advantages from the capability window. First, the pooling and synchronizing of national contributions, allowing more efficient defence spending. Second, the "possibility" of a contribution from the EU budget (not fully defined). Third, facilitating access to flexibilities in the Stability and Growth Pact to allow offsets against deficit calculations.

The details are either less impressive or still absent. First, the pooling of national contributions refers to the pool of contributions from those countries involved in specific procurement projects for those projects alone. It is not a reference of a general pool whereby those with deeper pockets are willing to finance those with less financial resources. Second, the allocation from the EU Budget amounts to

EUR500m until 2020 and EUR1bn annually thereafter. Since the guidance is that the overall spending associated with the capability window – whether national contributions or EU funding – is about EUR5bn per year, the volumes are very small (0.05% of GDP).

Project bonds. The Commission documents say the capability window can be used to issue project-specific debt instruments. These instruments could be backed by (a) flows of funds from member states on specific projects, (b) guarantees/paid-in capital for specific projects or (c) guarantees/paid-in capital at an aggregate "umbrella structure" level within the capability window (details yet to be defined). It implies the EUR5bn could be levered up, making the volumes of spending proportionately larger.

We can take the ESM as an example of what could be achieved. In the ESM the ratio of lending to paid in capital is x6.25 (EUR500bn/EUR80bn). Using the same ratio, EDAP procurement spending could be as much as EUR31.25bn (0.3% of GDP per year). Since fiscal stimulus is based on the change in spending, there would be a larger – but still not very large – stimulus in the year of implementation only.

SGP incentives. There is an incentive for member states to make the most of the capability window and the leverage via project bonds. Any guarantees or paid-in capital from a member state into a project-related debt financing structure can be treated as a one-off within the Stability and Growth Pact and therefore excluded from the structural budget balance calculation when compliance with fiscal goals is being assessed.

Section 4: How to judge integration initiatives

A Macron-Merkel alliance is an opportunity to push European integration further, at least as far as the single currency area is concerned. Macron mentions common funds for investment spending, unemployment benefits and banking. Merkel has signaled her conditional support for a permanent euro area finance minister with a euro area budget.[7]

Outright fiscal integration (i.e., fiscal transfers) will be politically difficult, even in the longer term. We expect smaller steps towards a more integrated Europe. Merely attempting these integration steps will entail political costs and benefits. Their materialization, success and sustainability requires a careful balance between competing forces.

The value the market ascribes to an integration initiative is a function of the political objective of the integration initiative and the economic means by which that objective is achieved. Below we present the key criteria by which (spending-based)[8] integration initiatives will be judged. We then judge the EDAP against these criteria.

7 Merkel: "Of course, one can think about a joint finance minister if the framework conditions are right". She was also open to the idea of a euro area budget "as long as it's clear that this will truly strengthen structures and do meaningful things" (Conference of the Federation of German Industries, Politico 20.6.2017).
8 Spending-based integration is different from integration via harmonization of rules, e.g., the Capital Markets Union

Political objective

Endorsing integration objectives can be important signals in and of themselves, especially when they are totemic like banking union, defence policy, stabilization mechanisms, etc. The details are often left to follow, but merely achieving the consensus to formalize an integration objective can signal Europe's progress.

The EU has already gone into some detail in terms of identifying what it believes is required to create a stronger currency union with several "Presidents'" reports[9] and more recently a "reflection paper".[10] The latter mentions the possibility of an EU Treasury, stabilisation mechanisms and safe bonds. It is not just the currency union that Europe is thinking about either. There are also time being invested in thinking about the road forward for the EU in general. [11] We have commented on these reports. [12]

Source of funding

The resources have to come from somewhere – and it is not going to come from the ECB given the prohibition on monetary financing. Beware old money dressed up as new and overly ambitious leverage ratios.

New funds or old funds. One of the key questions is whether or not the funds being committed to a new initiative are new funds or not. For example, EUR8bn of the EUR20bn capital of the European Fund for Strategic Investments (EFSI) came from the EIB, thereby cannibalising another vehicle financing the European economy. It is not obvious, for instance, that the EUR5bn annual "capability window" in the EDAP is a commitment to spending additional resources or is merely the redirecting of resources to new uses (notwithstanding potential efficiency gains from reallocating existing spending).

On- or off-balance sheet. The Greek Loan Facility and the EFSF were created in a hurry in 2010. As bilateral loan facilities, both are accounted for "on-balance sheet". The ESM, on the other hand, is a superior structure. It is a standalone, separately capitalized facility and is "off-balance sheet". The paid-in capital was a one-off payment and therefore shielded in the calculation of fiscal deficits.

Private leverage. The EU often tries to take advantage of leverage. For example, the EUR80bn of paid in capital in the ESM backs total loans of EUR500bn. The EDAP mentions leverage, but does not detail yet what scale may be envisaged. Sometimes the EU stretches credibility of the scale of what can be achieved. For example, the EFSI can scale up its EUR20bn of capital and guarantees to EUR60bn of financial commitments. With private sector commitments, the EU believes the EFSI will drive EUR315bn of aggregate investment spending. This has yet to be proven. Note, because of the prohibition on monetary financing, the ECB will not provide the leverage.

9 http://europa.eu/rapid/press-release_IP-15-5240_en.htm
10 https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en
11 http://europa.eu/rapid/press-release_IP-17-385_en.htm
12 "EMU reflection paper – mere "wish list" or a plausible way forward", DB Focus Europe, 9 June 2017 and "The future of the EU: Which road to take?", DB Focus Europe, 24 March 2017.

Fiscal sustainability

More spending is not costless – someone has to pay and the larger liability needs to make sense from a fiscal sustainability point of view. Where possible, incentives should be created for structural reforms.

Volume of net spending. The EUR500bn firepower available to the ESM is impressive. The EUR5bn per annum associated with the EDAP is not. However, size does not equate to net spending. The ESM is a backstop – designed to replace financing that would ordinarily be supplied by the market – whereas the EDAP is not.

Fiscal rules. Considering that most member states are already in breach of the European public deficit and debt fiscal rules to greater or lesser degrees, to be effective an integration initiative that involves member states spending their own resources needs to be consistent with the Stability and Growth Pact rules. With the euro area public debt to GDP ratio around 90%, there is a trade-off between more flexible rules and debt sustainability. It would be different if common funds were being spent and no liability to a central facility was being incurred. This is politically controversial and someone still has to pay, either in terms of paid-in capital or guarantees (contingent liabilities).

Multipliers, pro-cyclicality and incentives for structural reform. Public investment spending tends to have higher multipliers, as does defence spending (the Commission says defence spending has a multiplier of 1.6). The multiplier is not just a function of the particular tax or spend policy. It is also a function of the circumstances. For example, multipliers tend to be higher when output gaps are more negative. According to the ECB, the output gap should be closed by 2019. There are a few ways to interpret this. First, the effectiveness of fiscal stimulus will decline going forward. Second, the objective should increasingly move to encouraging structural reforms rather than simply boosting spending. [13]

Sovereignty

Solidarity (the availability of resources) must be balanced by sovereignty (the cost of access). The smaller the cost, the tighter may be the cap on the volume of solidarity. Otherwise, the solidarity may not be politically sustainable.

Ex ante costs. Sometimes Europe looks for up-front policy implementation from all member states. One example was the Fiscal Compact – which strengthened the Stability and Growth Pact in various ways including the setting of the objective of balanced or surplus budgets and the introduction of a "debt brake" – as a precondition for the creation of and access to the ESM.

Ex post costs. Access to common funds, flexibilities within fiscal rules, etc comes with a price. For example, member states cannot access the ESM loans for bank recapitalization without at least financial sector policies having to be agreed or loans for sovereign financing without more broad-based fiscal and

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13 In last week's Focus Europe we looked at why Spain's structural unemployment rate remains so high. The answer does not lie with construction jobs or youth unemployment per se. The issues are limited worker mobility between regions, wages not adapting to local conditions and the prevalence of temporary employment. Internal adjustment between regions reinforces the need for structural reforms - exiting the euro would not solve this problem. Spain demonstrates the need for carefully designed, locally specific reforms. That implies a highly integrated policy approach by the EU. http://pull.db-gmresearch.com/p/10332-B9A4/284444394/DB_FocusEurope_2017-06-23_fcf9e57b-8ffe-4c10-9505-2b449d5cf5f4_604.pdf

structural policies being agreed. The more onerous the cost, the more the lending facilities play an ultimate backstop role only – a safety net used only in extreme circumstances. These facilities do not rule out uncertainty and volatility.

Mutualisation

This is the ultimate objective for integrationists and the red line for those who favour the original monetary union-only model. Mutualisation remains extremely contentious. We do not see genuine mutualisation of any significant volume without a significant crisis, and even then it is not guaranteed to be agreed.

Limited liability. The EU has no open-ended common spending facilities and follows different models for making common resources available to member states. With the ESM, all member state had access to the common poll of resources from the start. With the Single Resolution Fund (SRF), national resolution funds gradually co-mingles into a common pool over an eight year phasing in period up to the maximum EUR55bn.

Fiscal backstops. Sometimes facilities are not fully funded. To address the risk that the SRF might not have sufficient funds there are calls for it to have a borrowing capacity. One option is for it to have the authority to borrow resources on its own account. This would need to be underwritten by the member states and capped. An alternative is to give the ESM the power to lend to the SRF. However, this would reduce the resources available to the ESM and would contradict one of the lessons from the crisis, that is, the correlation between sovereign and banking stress.

Indemnity. In general, European facilities grant loans that need to be repaid. Sometimes the instrument that Europe invests in is not a loan, for example, the ESM direct recapitalization mechanism would take an equity position in a financial institution. A loan or bond is a known stream of cash flows. An equity is a different level of risk being taken with European "taxpayer" resources. To protect the value of the investment and ensure the right incentives, if a member states cannot afford to co-invest alongside the ESM any loss incurred by the ESM will be converted into a long-term loan, limiting mutualisation risk.

Figure 8: How to think about integration initiatives

1. Political objective

2. Economic means (structure and detail)

2.(a) Sources of funds Positive: Off-balance sheet structure Negative: Old money repurposed	**2.(b) Sustainability** Positive: Satisfies fiscal rules or cofinanced Negative: Deterioration in fiscal sustainability
2.(c) Sovereignty Positive: Balance between access and cost Negative: If does not incentivise reform	**2.(d) Mutualisation** Positive: Co-financing (transfers unlikely) Negative: Indemnification

Source: Deutsche Bank

Co-financing. One means of delivering financial resources to member states is the European Structural and Investment Funds. These funds are not loans and do not require indemnification. However, they do require the recipient country to have sufficient financial capacity to provide about 25-50% of a project's financial requirements. Since the crisis the EU has begun to reduce the co-financing rates to improve the capacity of weak countries to absorb the structural funds committed to them. A similar approach could be used with future integration initiatives, notwithstanding the issues regarding the source of the funds (new, old, leveraged) and the impact on net funding from the EU. Expect a high degree of central European control over the use of such funds.

EDAP as an integration initiative: politically significant, but very modest overall

Higher defence and security spending potentially connects several separate themes, from the refugee crisis and securing Europe's borders on the one hand to defending Europe against US criticism on the other. A common defence policy is also a route to a more integrated Europe. However, relative to the above integration criteria, the EDAP is a very modest policy at best.

In terms of political objective – closer Europe integration via defence policy – the EDAP crosses a significant historical rubicon as the EU has seen itself more as a "soft power" than as a military one (in fact, the EU's engagement in the UN peace mission is larger than the US, for example). The symbolism of a European defence policy is high. The corollary is it is controversial and this probably limits the scope of the policy, for example, the EU denies it is trying to create an "EU army".

Figure 9: EDAP as an integration initiative: politically significant, otherwise very modest at best

1. Political objective – significant positive: closer union via defense policy	
2. Economic means (structure and detail) – neutral to very modest positive	
2.(a) Sources of funds Not clear if old money or new; scope for leveraging private money	**2.(b) Sustainability** Not large enough to be a threat to sustainability. Private leverage incentivised by fiscal rules
2.(c) Sovereignty Assets procured must be consistent with EU objectives, but assets not owned or directed by EU	**2.(d) Mutualisation** Very small provision of funds from EU Budget; most risk is on the member state(s) procuring the asset(s)

Source: Deutsche Bank

In terms of source of funds and financial sustainability, it is not clear the EDAP is "new money"; we suspect not. The EDAP wants to utilize leverage and member states that do use project bond financing can avail of the Stability and Growth Pact shield on the paid-in capital or guarantees. But the size of the facility is very small so far. There would need to be an agreement to either hit the NATO defence spending target more rapidly than 2024 or raise the target to believe the EDAP has an economic stimulus element. We think Germany would do well to reach the original target, so expectations should be limited.

From the perspective of sovereignty and mutualisation there is little to suggest the EDAP is breaking any new ground in terms of (economic) integration. Other than the military assets being procured having to comply with centrally agreed requirements and procurement being opened up to other member states, there is neither common ownership of the assets nor a mutualisation of financial risk beyond the natural diversification of the two (or more) member states procuring the asset.

Appendix 1

Important Disclosures

*Other information available upon request

*Prices are current as of the end of the previous trading session unless otherwise indicated and are sourced from local exchanges via Reuters, Bloomberg, and other vendors. Other information is sourced from Deutsche Bank, subject companies, and other sources. For disclosures pertaining to recommendations or estimates made on securities other than the primary subject of this research, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr. Aside from within this report, important conflict disclosures can also be found at https://gm/db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

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