Economics

IN FOCUS

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Guns N' Roses

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In the current deep fog of confusion, there is one ray of certainty. Global defence spending is on the rise and, almost regardless of the scenario we end up with, it will likely continue to rise–quickly.

Is that a good thing or a bad thing? It's clearly bullish for defence oriented stocks. But what about the economy? Obviously it would have been preferable to have no security or foreign policy concerns, and to be able to invest that money in fields like healthcare or education. But given the pressure to increase defence spending, we should investigate the economic impact of that form of government spending. The bottom line: if spent wisely, the economic multiplier of defence spending can be larger than perceived, with multiple short-and-long-term positive spinoffs. In other words, defence spending does not crowd-out activity, it crowds it in.

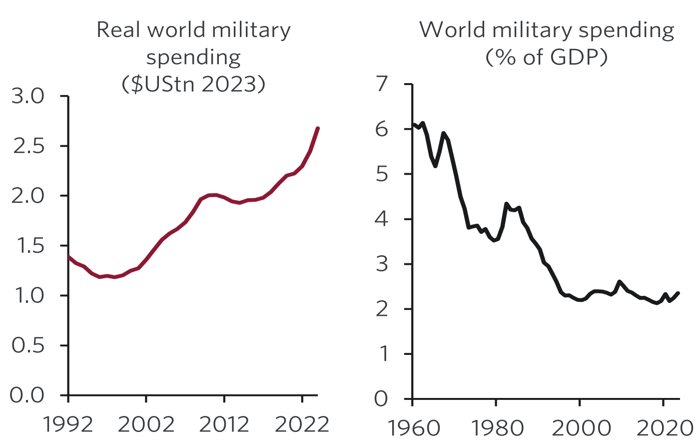
Trump is right on military spending

Although defence spending has been rising in real terms globally, as a share of GDP it has been stagnant, after declining sharply until the 2000s (Chart 1). Global defence spending currently sits slightly above 2% of global GDP, while NATO member countries combined spent 2.7% of GDP on defence in 2024.

Protected by distance from likely foes on its home turf, Canada is at the bottom end of the defence spending spectrum globally, having spent only 1.4% of GDP on defence in 2024 (Chart 2), joining seven other NATO countries that are currently undershooting the 2% of GDP target that NATO mandates. Those countries combined account for 14% of NATO GDP, with the US providing a strong offset to the under spending, as it invested 3.4% of its GDP in defence last year (Chart 3, left). That means that the US accounts for just under 40% of global military spending (Chart 3, right), and 66% of spending within NATO. Excluding the US, the rest of the world spends slightly below 2% of GDP on defence.

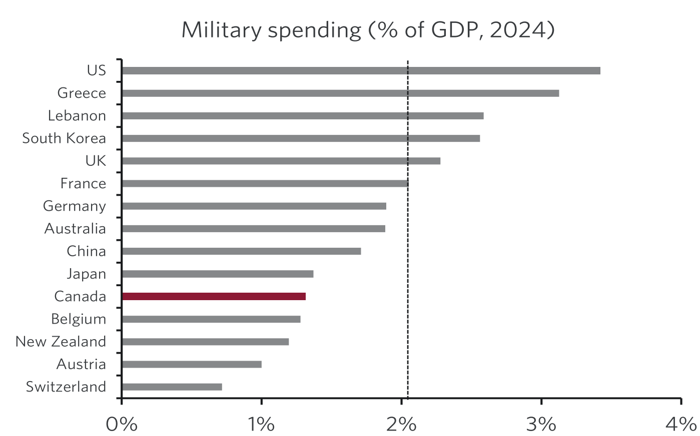
Zooming in on Canada, defence spending peaked at over 7% of GDP early on in the cold war, in 1953. Military spending fell gradually from there to a more sustainable level of just over 2%

Chart 1: Real military spending on upward trajectory (l), but hasn't kept pace with GDP growth (r)



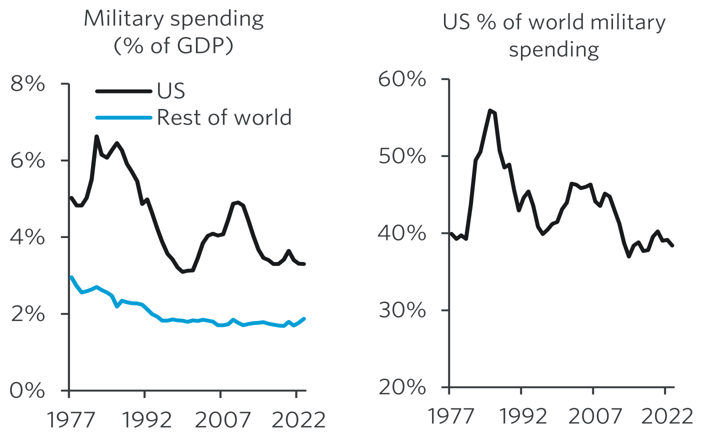
Source: SIPRI, World Bank, CIBC

Chart 2: Military spending in Canada extremely low



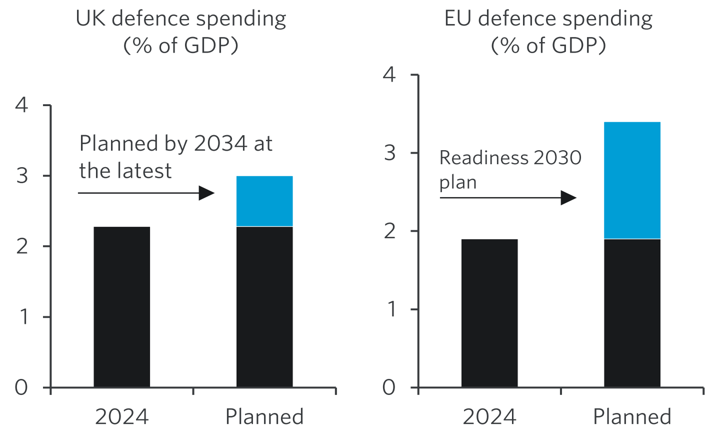
Source: SIPRI, CIBC

Chart 3: US leading the world in military spending (l), accounting for an outsized 40% of global spending (r)



Source: World Bank, CIBC

Chart 5: European countries are moving quickly to increase defence spending



Source: National governments, CIBC

by the mid-1980s. The decline to below the 2% target started in the 1990s under the Chretien government and continued under the Harper government, with total defence expenditures decreasing to just a hair above one percent of GDP starting in 2000, with the average annual level relatively stable around there since then. As a result of those periods of consolidation, the size of the Canadian Armed Forces has fallen by more than 40%.

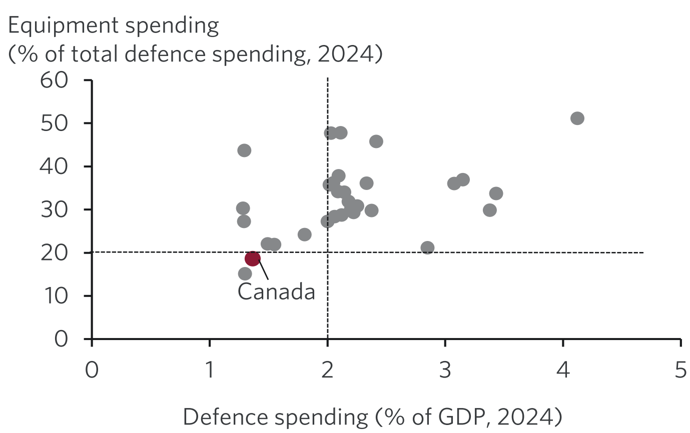
But Canada's underinvestment in defence goes beyond spending. In addition to the 2% of GDP mandate, NATO members pledge that at least 20% of that spending will go towards new equipment purchases. Canada is underperforming on that measure as well (Chart 4).

The trend is reversing

The downward trend in the global defence expenditure curve appears to be reaching a turning point, however, with NATO expected to increase the 2% defence target to at least 3%, and even talk about a 5% benchmark. Politicians have already begun to lay out plans for spending increases. Since the beginning of the Russia-Ukraine war, the UK government has committed to increase defence spending to 2.5% of GDP by 2027, up from 2.3% of GDP as of 2024. In the EU, defence spending amounted to 1.9% of GDP in 2024, and the Readiness 2030 package unlocks more flexibility for funding, which could see member states increase spending by 1.5% of GDP in the coming four years (Chart 5). Even in Japan, we are seeing movement in defence spending, with the latest budget calling for a 9% increase in spending, to reach almost 9 trillion yen, a record high.

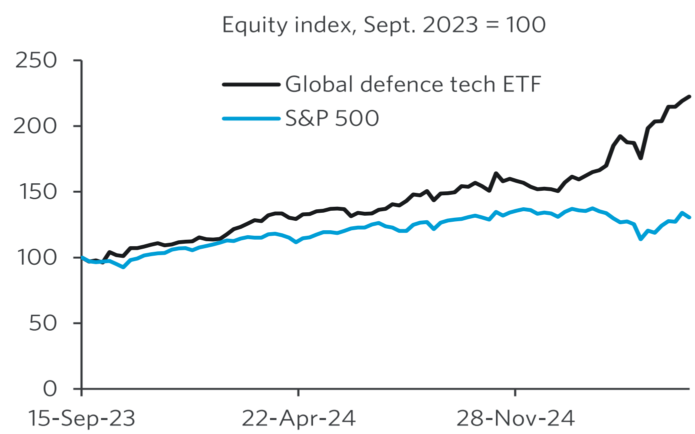
The US defence budget for 2025 is US$850bn, a 15% increase in real terms from decade-ago levels, but down slightly from 2024. Canada's Liberal spending plan that includes new defence spending of $31bn in the coming four years would be enough to hit the 2% NATO threshold, but the country may be pressed to aim higher still given where allies are headed.

Chart 4: Canada's defence spending skewed heavily towards operations, rather than equipment



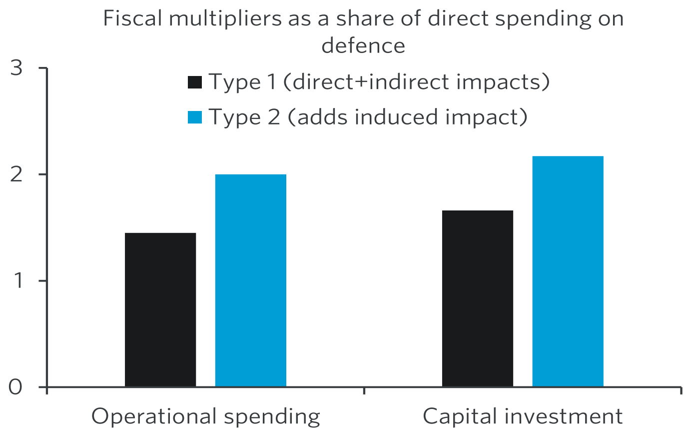
Source: NATO, CIBC

Chart 6: Global defence stocks reflect upside for higher spending



Source: Bloomberg, CIBC

Chart 7: Economic multipliers from defence spending in Canada



Source: StatCan, Canadian Global Affairs Institute, CIBC

Global defence stocks are already responding to this new reality. While the S&P 500 is down slightly year-to-date, global defence tech ETF shares are up 46% YTD (Chart 6), and the aerospace and defence sub-index on the S&P 500 is 16% higher this year, in line with new orders of defence aircraft for US manufacturers sitting 11% above year-ago levels.

Positive spinoffs

If you were unfortunate enough to take an Economics 101 course, you probably remember the guns and butter tradeoff as a classic example of the economy's production possibility curve. In a two-good economy, consuming more guns (defence) comes at the expense of butter and vice versa.

This is certainly the case for less developed countries (LDCs), where empirical evidence suggests a clear negative multiplier associated with defence spending. That is largely due to the fact that LDCs in general have lower government quality with a higher degree of corruption. Furthermore, rent seeking in the military along with inefficient operations tend to increase the cost of military spending. Another factor is that virtually all LDCs are net arms importers.

As for developed countries, the opposite is the case. Empirical evidence points to a clear positive economic multiplier from defence spending. After all, military spending should not be defined only by cost. The broad consensus is that the economy expands to accommodate at least part of the increase in defence spending, production, procurement, and employment. The only debate is with regard to the size of that multiplier.

The ultimate effect of that multiplier will depend on the economic environment in which the spending takes place. Tighter monetary policy in response to an increase in defence spending will clearly limit any positive impact. The same applies to the way that spending is financed. Debt financing as opposed to higher taxes will lead to a much larger multiplier. Another important factor here is the share of imports in overall military spending. The higher the share, the smaller the multiplier.

Clearly, Canada's limited domestic weapon producing capacity is a major factor impacting not only defence sovereignty, but also the size of the multiplier. The reality is that global military production is highly concentrated. The US and Russia account for no less than 55% of global arms exports, and 80% of total exports come from only seven countries combined. Needless to say, Canada is not among them.

But by far the most important channel in which defence spending contributes to long-term economic growth is in defence-related R&D. And here the evidence is very clear. Numerous studies on the topic reveal pure crowding in rather than crowding out. The larger the share of R&D in overall defence spending, the larger the positive spinoffs. And in fact, direct military investment in R&D underestimates the actual impact. Some of the most important innovations in the field have come from the private sector that is benefitting from de facto market guarantees from the government, which work to reduce risk significantly. The semiconductor industry during the cold war, the microwave, the internet, and GPS are some examples of the interplay between military and civilian sectors.

In almost every study that has determined the size of the defence multiplier, the US leads the way. Most of its weapons are produced domestically, while almost one-fifth of its military spending goes to R&D. The EU is lagging behind with only 5% of spending going to R&D and a large portion of military equipment coming from outside the EU, eroding the multiplier. Still, the EU stands to see a 0.8ppt direct lift to GDP from the Readiness 2030 plan over the coming five years, reflecting the €800bn in potential new spending. The indirect lift will be much larger.

Estimates of Canada's GDP multipliers tied to defence spending vary heavily based on the type of spending and the time from implementation. Statistics Canada's input-output model shows that type 1 multipliers, which only consider direct and indirect impacts of investment, range from 1.66 for capital expenditures to 1.45 for operational expenditures, although these don't take into account the offsetting drag if funded from either higher taxes or reduced govt spending on other things. That captures the immediate boost to activity from investment, but not the positive spinoffs down the line in the form of higher consumption tied to job creation in defence-related fields. When those impacts are added in, capturing the feedback between wages and production, the operational multiplier increases to 2.00 and the capital multiplier rises to 2.17, meaning that over the longer term, there are greater economic benefits tied to capital spending on defence versus operational, and the total positive impact on economic activity is at least double what is directly invested initially (Chart 7).

The impact would also be amplified in today's economy, where there is substantial economic slack, which would help to prevent crowding out. This means that the $31bn that the Liberals have earmarked for additional defence spending into fiscal 2028/29, which is 56% operational and 44% capital investment, could boost Canada's economy by up to $64bn.

But that $64 billion figure should be put in perspective. If the spending is financed by higher taxes, the multiplier effect will be notably smaller. Even debt financing will potentially work to reduce the size of that multiplier via higher long-term rates. And to the extent that the increase in defence spending comes at the expense of other programs, we will lose the positive impact of the multipliers associated with those programs. Simply put, increased military spending is not ideal, but if it is a given due to political circumstances, it is good to know that the defence multiplier comes with a positive sign attached to it.

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