

Funcas Intelligence

THE NEW ECONOMIC ORDER

A Fragile Détente

The Warsh Fed

The AI Gold Rush

Germany's Rearmament Dilemma

Europe Between Washington and Beijing

July 2026

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Funcas Intelligence (FI) is a publication directed towards a broad base of international and Spanish readers. Funcas Intelligence's focus is to identify and assess the game changers and relevant events of the global economy and the financial sector with potential impact for Spain.

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Germany's fiscal expansion marks a historic break in its post-Cold War model and shifts the focus to how welfare, infrastructure, and defense can be financed simultaneously in an aging economy with weak long-term growth prospects. Higher defense and infrastructure spending may boost short-term growth and strengthen European security, but its long-term success will depend on welfare reform, productivity gains, and more effective European defense coordination.

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While Washington appears increasingly interested in stabilizing its relationship with Beijing, Europe is becoming more concerned about the impact of Chinese competition on its industrial base. Europe's challenge is how to remain competitive in a world where both Beijing and Washington are actively supporting their strategic industries.

A Fragile Détente

The U.S.-Iran Memorandum, diverging central banks, and markets back in rally mode

- The Memorandum between the United States and Iran has significantly reduced fears of a prolonged disruption in the Strait of Hormuz, easing pressures on global energy markets and improving investor sentiment.
- The ECB raised interest rates by 25 basis points in June, citing renewed inflationary risks from energy markets, while the Federal Reserve kept rates unchanged at its first meeting under Chair Kevin Warsh.

United States: Warsh's debut and a Fed focused on inflation vigilance

The Federal Reserve maintained the federal funds target range at 3.50%-3.75% at its June 16th-17th meeting, the first Federal Open Market Committee meeting chaired by Kevin Warsh. The decision reflected a growing consensus that, despite moderation in underlying inflation, the energy shock triggered by the Iran conflict has not yet fully dissipated.

The first Fed meeting under Kevin Warsh signaled continuity rather than a major policy shift

The Fed's June decision signaled continuity rather than rupture despite the change in leadership. Markets had closely followed the meeting for clues about how Warsh would differentiate his approach from that of Jerome Powell. While the new Chair emphasized the importance of preserving the Fed's inflation-fighting credibility, he also reiterated that policy would remain data-dependent and responsive to changes in economic conditions.

The U.S. economy continues to show resilience. Labour market conditions remain relatively solid, household spending has moderated only gradually, and corporate earnings have exceeded expectations in most sectors. However, policymakers remain concerned that the recent energy shock could slow the disinflation process and delay any further monetary easing.

Financial markets interpreted the Fed's decision as moderately hawkish. Treasury yields moved initially somewhat higher following the meeting, while expectations for additional rate cuts in 2026 were pushed further into the future. Nonetheless, financial conditions remain supportive and credit markets continue to function smoothly.

Euro Area: ECB tightens as energy inflation re-emerges

The European Central Bank did not surprise many in the market at its June meeting by raising its deposit facility rate by 25 basis points to 2.25%. The Governing Council argued that the energy shock generated by the Iran conflict and the earlier uncertainty surrounding the Strait of Hormuz had created renewed

The ECB and the Fed are responding differently to the same energy shock

upside risks to inflation. Although the Memorandum between Washington and Tehran has significantly reduced immediate geopolitical tensions, policymakers judged that the increase in energy costs had already begun feeding through to prices across several sectors.

The ECB's rate increase highlights the different challenges faced by Europe and the United States. Unlike the U.S., the euro area remains more exposed to imported energy costs. While inflation had moved close to target earlier in the year, the combination of higher oil prices, increased transportation costs, and lingering wage pressures led the ECB to prioritize inflation containment over short-term growth support.

Economic growth in the euro area remains modest but positive. Services activity continues to outperform manufacturing, while lending conditions remain restrictive. The euro depreciated against the dollar after the ECB and Fed decisions as markets are reassessing the path of European and U.S. interest rates.

Global markets: Energy relief and renewed risk appetite

The U.S.-Iran Memorandum has shifted markets from energy anxiety back to risk-taking

The most notable market development over the last two months has been the sharp improvement in investor sentiment following the signing of the U.S.-Iran Memorandum. In the weeks immediately following the agreement, fears of a closure of the Strait of Hormuz receded significantly. Oil prices, which had surged during the peak of the conflict, retreated from their highs as traders reassessed supply risks. Natural gas markets also stabilized, particularly in Europe, where concerns about LNG supply disruptions eased considerably.

The decline in geopolitical risk premiums has provided powerful support for global equities. Equity markets have responded enthusiastically. U.S. indices have reached new record highs, driven by strong earnings, continued investment in artificial intelligence, and growing confidence that the global economy can absorb the recent energy shock without entering recession. European and Asian markets have also participated in the rally, although to a lesser extent.

Credit spreads remain compressed and volatility indicators have returned to levels seen before the Iran conflict. Precious metals have surrendered part of their safe-haven gains, while the U.S. dollar has traded in a relatively stable range despite the divergence between ECB and Fed policies.

Nevertheless, energy markets remain highly sensitive to geopolitical developments. Although the Memorandum has reduced immediate tensions, investors continue to monitor compliance by both parties and remain alert to any renewed threat to maritime traffic through the Gulf region. Periodic military actions by both parties, followed by resumptions of talks, have continued to provoke short-term fluctuations in energy and equity markets.

A new phase of divergence

The geopolitical shock has faded, but monetary policy divergence remains

The July 2026 environment differs significantly from that of only a few months ago. The immediate threat of a major energy supply disruption has diminished,

financial markets have recovered strongly, and fears of a global stagflationary scenario have eased. Yet the policy response has revealed increasing divergence among major central banks. While the Fed believes patience remains appropriate, the ECB has judged that inflation risks require additional tightening. This divergence reflects differences in economic structure, energy dependence, and inflation dynamics rather than fundamentally different policy objectives.

For investors, the key question is whether the recent improvement in sentiment can be sustained. The soft-landing narrative has survived another major geopolitical test, but the balance remains delicate. Energy markets, inflation expectations, and the credibility of the new Fed leadership under Kevin Warsh will remain central drivers of financial conditions during the second half of 2026.

As the year progresses, markets appear increasingly confident that the worst-case scenarios have been avoided. Whether that confidence proves justified will depend not only on central banks, but also on the durability of the geopolitical détente that has emerged in recent weeks.

The Warsh Fed

Between market expectations and institutional constraints

- Markets initially expected Kevin Warsh to tilt the Federal Reserve in a more dovish direction, but his first Federal Open Market Committee meeting showed that the committee remains more concerned about persistent inflation than eager to validate expectations of rapid rate cuts.
- Despite the focus on whether a Warsh chairmanship will lower interest rates, the most likely outcome is a more constrained version of the “Warsh Doctrine” than markets initially anticipated.

The Warsh doctrine combines a greater willingness to lower interest rates with a smaller Fed balance sheet, and a shift to what Warsh views as a clearer and more disciplined monetary framework

Introduction

Since Kevin Warsh’s appointment as the 17th chair of the Federal Reserve, investors have tried to define a “Warsh Doctrine.” In its simplest form, the doctrine combines a greater willingness to lower interest rates with a desire to shrink the Fed’s balance sheet, reduce its footprint in financial markets, and restore what Warsh views as a clearer and more disciplined monetary framework.¹

The appeal of this narrative lies in its ability to offer something for almost everyone. The White House sees the prospect of lower rates. Markets see the possibility of easier financial conditions. Fiscal conservatives welcome a smaller central bank. Critics of post-crisis monetary activism see an opportunity to redefine the Fed’s role.

However, his first Federal Open Market Committee (FOMC) meeting as chair on June 17 complicated this narrative. Warsh began his tenure with a unanimous rate hold, a more inflation-conscious forecast, and a review of Fed practices.²

FOMC firewall

While Warsh will undoubtedly influence the debate, he inherits an FOMC that remains more hawkish than markets initially expected

The FOMC determines U.S. monetary policy, not the chair alone. Warsh can shape the agenda, but he inherits a committee more hawkish than markets initially expected. In April, three members dissented in favor of removing language from the FOMC statement suggesting the next move was likely to be a cut rather than a hike, underscoring the difficulty of building consensus around easing.³

This constraint was evident on June 17. The FOMC voted unanimously to hold the federal funds target range at 3.5%-3.75%, reaffirmed its ample-reserves framework, and described economic activity as expanding at a solid pace. The updated projections were also less dovish than the market narrative had implied.⁴

The median participant expected personal consumption expenditures (PCE) inflation to end 2026 at 3.6% and core PCE inflation at 3.3%, unemployment at 4.3%, and the federal funds rate at 3.8%.⁵ Advocates of lower rates must explain why policy should ease despite stronger productivity growth, solid labor market conditions, and inflation still well above target.

Warsh's initial moves were more procedural than dovish. He announced the creation of five task forces —communications, balance-sheet policy, data sources, productivity and jobs, and inflation frameworks—to review the Fed's operating model.⁶ This allows him to reshape the institution's framework over time without forcing the FOMC into a lower-rate stance that many members may resist.

This institutional reality matters because it will be hard to implement the doctrine.

Artificial intelligence (AI) illustrates this change. Warsh has suggested that AI-driven productivity gains could expand supply and justify lower interest rates. The June FOMC statement acknowledged strong productivity growth and capital investment, but the committee did not treat them as grounds for easing policy. Many Fed officials worry that AI's short-term effects may be inflationary rather than disinflationary, given the enormous investment required in data centers, energy infrastructure, semiconductors, and related services.⁷

A similar debate surrounds inflation measurement. Warsh has floated giving greater weight to trimmed-mean inflation measures, which can sometimes look more benign than traditional core inflation indicators.⁸ But changing the inflation framework is easier to discuss than to implement. Fed officials have spent decades refining inflation metrics, and many committee members are unlikely to embrace a methodology if it appears designed to produce a more dovish outcome. If the review appears designed to justify lower rates while inflation projections remain above target, critics may argue that the Fed is changing its dashboard to reach a predetermined outcome.

Institutional reforms

The broader significance of a Warsh chairmanship may lie in his ability to implement institutional reforms.

The task forces are the clearest early sign that Warsh's chairmanship may matter most through institutional reform rather than immediate rate cuts. They map closely onto his critique of the post-2008 Fed: that it became too reliant on forward guidance, too active in financial markets, too expansive in its interpretation of economic data, and too willing to blur the line between monetary policy and broader economic management.

Warsh may find more support from the FOMC for his proposed balance sheet reductions.⁹ Since 2008, quantitative easing, emergency lending facilities, and extensive forward guidance have made the Fed a larger and more active market

Warsh has repeatedly argued that monetary policy should rely more heavily on interest rates and less on balance sheet interventions

participant.¹⁰ Warsh wants monetary policy to rely more on interest rates and less on balance sheet interventions. Many Fed officials may be receptive in principle. From June 2022 to December 2025, the FOMC reduced securities holdings by over \$2.2 trillion.¹¹

The policy debate is less ideological than operational: how far can the Fed shrink its holdings without undermining the ample-reserves framework that supports short-term rate control and money market stability? Past reserve shortages have disrupted money markets, and easier liquidity regulations, combined with a smaller Fed balance sheet, could compound the risks if reserves become scarcer than expected.¹²

Warsh also appears to believe that the Federal Reserve has expanded beyond its original mandate.¹³ His concern is not simply inflation or growth, but the growing tendency of markets to rely on central bank intervention. This philosophy could affect everything from crisis management to market communications.

Investors are also watching the lender-of-last-resort function. A more restrained Fed could set a higher threshold for emergency liquidity facilities, support for non-bank financial institutions, or dollar swap lines with foreign central banks. This is where Warsh's institutional agenda matters most for Europe: not because it guarantees a weaker global safety net, but because it introduces less predictability in how the Fed would respond in the next crisis.

Conclusion

The political context during Warsh's tenure further complicates matters.

Warsh takes office at a moment when President Trump is advocating lower interest rates and when concerns about Fed independence have become increasingly prominent. Yet it would be a mistake to assume that political alignment necessarily translates into policy compliance.

Some observers in Washington argue that much of Warsh's positioning reflects political pragmatism rather than ideological subservience. Regardless of whether this is true, the more relevant question is whether he can preserve institutional credibility while navigating intense political pressure.

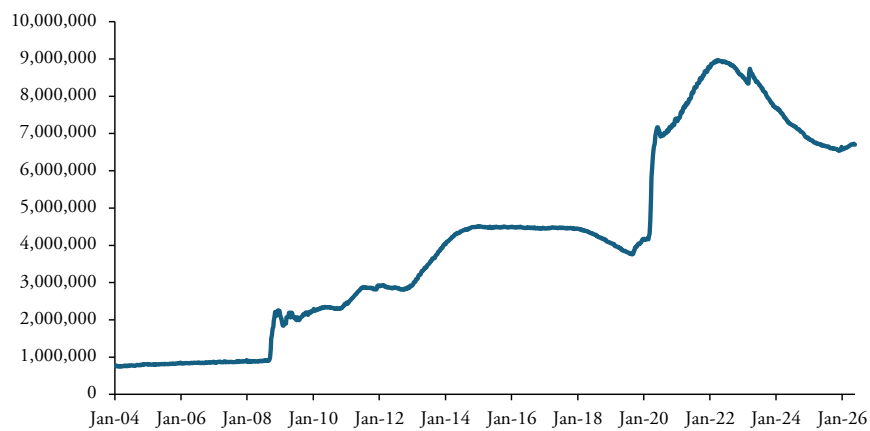
For decades, the Federal Reserve's greatest asset has been its credibility. The challenge for Warsh will be balancing institutional reform while preserving the confidence that allows the Federal Reserve to influence markets in the first place.

The "Warsh Doctrine" is likely to emerge in a more limited form than markets first expected

The most likely outcome is a more constrained "Warsh Doctrine" than markets initially anticipated. A dovish Warsh Fed would weaken the dollar, ease global financing conditions, and give the ECB greater room to lower rates. But the June meeting points to a more complicated outcome: a Fed that may become less interventionist before it becomes meaningfully easier on rates. If the Fed becomes more reluctant to deploy extraordinary liquidity

facilities during periods of market stress, European banks, governments, and firms could face greater funding volatility and a less predictable dollar backstop. For Europe, the Warsh era may mean that changes in the Fed's operational philosophy ultimately matter as much as changes in interest rates.

EXHIBIT 1.0 – TOTAL ASSETS OF THE FEDERAL RESERVE SYSTEM, JANUARY 2004 – MAY 2026
(USD MILLIONS)



Source: Federal Reserve Bank of St. Louis.

Notes

- ¹ <https://www.cfr.org/articles/what-to-expect-from-kevin-warshs-fed-in-the-first-100-days>
- ² <https://www.federalreserve.gov/newsevents/pressreleases/monetary20260617a.htm>
- ³ <https://www.economist.com/finance-and-economics/2026/05/27/kevin-warshs-troublesome-inflation-in-tray>
- ⁴ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20260617a.htm>
- ⁵ <https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20260617.pdf>
- ⁶ <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20260617.pdf>
- ⁷ <https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm>
- ⁸ <https://www.dallasfed.org/research/pce>
- ⁹ <https://www.reuters.com/business/finance/former-fed-officials-say-size-may-not-matter-balance-sheet-2026-05-18/>
- ¹⁰ <https://www.federalreserve.gov/releases/h41/>
- ¹¹ <https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm>
- ¹² <https://www.reuters.com/business/finance/warsh-faces-hearing-framework-smaller-fed-balance-sheet-emerges-2026-04-21/>
- ¹³ <https://www.cfr.org/articles/what-to-expect-from-kevin-warshs-fed-in-the-first-100-days>

The AI Gold Rush

Entering a second stage

- While frontier models remain strategically important, competitive advantage is increasingly shaped by access to compute, data centers, energy, distribution networks, financing capacity, and operational deployment.
- Meanwhile, as Silicon Valley pours hundreds of billions into AI infrastructure, Europe risks remaining an AI consumer rather than an owner of the platforms and networks generating most of its economic value.

Introduction

For the last two years, the AI debate has focused on which model is best: OpenAI's GPT, Anthropic's Claude, Google's Gemini, Elon Musk's Grok, Meta's Llama, or China's DeepSeek. Investors, policymakers, and the media have treated AI as a technological race in which the best model would capture the greatest value.

One of the most important current developments in Silicon Valley is AI's evolution from a predominantly software-driven business into a hybrid ecosystem where infrastructure, compute, energy, and deployment capabilities are becoming increasingly important.¹

Silicon Valley's AI race is increasingly being shaped by a broader ecosystem extending well beyond software

Technological revolutions do not automatically reward infrastructure owners. In the internet era, software and platform companies captured enormous value while telecommunications operators struggled despite owning critical infrastructure.² The broader lesson is that value tends to accrue to firms controlling scarce bottlenecks in the technological ecosystem—whether infrastructure, software platforms, distribution, data, or customer access.

In short, the AI gold rush is entering its second phase. The first rewarded innovation, while the next will likely reward firms that combine leading models with the infrastructure, financing capacity, distribution, and operational capabilities needed to deploy AI at scale.

Why OpenAI had to change

Nothing illustrates this transformation better than OpenAI. When it was founded in 2015, OpenAI presented itself as a research organization focused on developing AI for the benefit of humanity. Today, it is one of the most valuable private companies in the world and is widely expected to pursue a public listing.

OpenAI's evolution is not only philosophical. It also reflects the changing economics of frontier AI. As training and inference costs rise, access to compute, energy, cloud capacity, and financing becomes a strategic constraint.

Frontier AI has become extraordinarily expensive. The largest frontier model training runs now require enormous spending on chips, energy, cloud capacity, and engineering talent, with independent estimates suggesting future leading training runs could exceed \$1 billion.³

In the next wave of AI, value shifts toward whoever controls the scarce bottlenecks of the AI stack

Developing the next generation of systems increasingly resembles financing a large industrial project rather than launching a software company. This is why access to public markets and financing capacity is becoming almost as important as access to innovation, and scale is becoming a competitive advantage.⁴

OpenAI is not alone. Anthropic, OpenAI's closest rival in the frontier model segment, has also seen its valuation soar and has recently filed for an IPO. That the two leading independent AI developers are both being discussed less as technology start-ups and more as future public-market giants illustrates how rapidly the sector is evolving.

Elon Musk's integrated ecosystem strategy

Musk's AI strategy extends beyond the model itself to control key parts of the AI ecosystem

This changing landscape also helps explain Elon Musk's strategy. Unlike most competitors, Musk appears to be pursuing a more vertically integrated AI strategy. Through xAI, X, Starlink, SpaceX, Tesla's autonomous driving capabilities, and robotics, he is assembling assets across data, distribution, connectivity, and physical infrastructure. This may offer strategic advantages through tighter integration across the AI stack, but it also carries significant execution, governance, and valuation risks. The model should therefore be presented as a high-risk integrated ecosystem strategy, not as a proven template.

SpaceX is an important part of that strategy. The company is no longer simply a space-launch provider. Through Starlink, it operates one of the world's largest satellite communications networks, providing connectivity to businesses, consumers, governments, and military users around the globe. Together with xAI, X, and Tesla, it forms part of an ecosystem that combines data, connectivity, computing, and distribution. This illustrates how the next phase of AI competition may depend less on individual models and more on control of the infrastructure that allows AI systems to operate at scale.

SpaceX's IPO has reinforced this advantage. According to a June 3 filing, the company planned to raise up to \$86 billion, the world's largest IPO, and would prioritize its proceeds toward expanding its AI infrastructure.⁵ On June 12, the company raised approximately \$75 billion, making it the largest IPO in history and valuing SpaceX at more than \$2 trillion after its market debut.⁶

Whether this integrated approach ultimately proves superior remains uncertain. Recent volatility in AI-related equities suggests that investors are increasingly scrutinizing the profitability of large-scale infrastructure investments and the sustainability of AI-related valuations.⁷

The model wars are becoming less decisive

OpenAI remains the dominant brand in AI, but the gap between competitors has narrowed considerably. Benchmark rankings continue to change rapidly,

with leadership rotating across reasoning, coding, enterprise, and multimodal capabilities. This suggests that technological advantages may prove less durable than many investors initially assumed.

This does not mean models are becoming irrelevant. Frontier models remain strategically important, as illustrated by national security debates and export control measures governing advanced AI capabilities and model weights. The U.S. government's June 12 issuance of an export control directive banning foreign nationals from accessing Anthropic's flagship Fable 5 and Mythos 5 AI models underscores that leading models remain important strategic assets.⁸ In fact, the argument is narrower: as performance gaps compress, long-term advantage may increasingly depend on complementary assets surrounding the model.

As frontier models converge, competitive advantage is increasingly shifting beyond the model itself to include complementary assets

Anthropic has established itself as a credible challenger. Google has recovered ground through Gemini. Meta continues to invest aggressively in open-source models. And Chinese firms are advancing rapidly despite restrictions on access to advanced chips.

As performance differences between models diminish, competitive advantage increasingly shifts elsewhere. Scale, distribution, computing capacity, and financing capacity become more important than marginal improvements in intelligence.

The industry increasingly resembles cloud computing: several players may succeed, but only those able to sustain massive investment can compete.

Can AI become a profitable business?

Yet perhaps the most important question facing industry is whether AI can become a sustainably profitable business.

While revenues are growing rapidly, costs remain exceptionally high. Model developers must finance training, inference, data acquisition, and talent while competing aggressively on pricing. Infrastructure providers, by contrast, generate revenue regardless of which model ultimately wins. This distinction may prove critical.

The real winners may be the hyperscalers

The hyperscalers may be among the largest beneficiaries, but the profitability of the AI infrastructure cycle is not yet proven. High capex creates both strategic barriers to entry and financial risk if AI revenues fail to scale fast enough.

AI infrastructure may generate the greatest long-term value, but its profitability remains unproven

Amazon, Microsoft, Google, and Meta are collectively committing hundreds of billions of dollars to AI-related capital expenditures in data centers, networking equipment, semiconductors, and energy systems, reinforcing their position as the indispensable backbone of the AI ecosystem.⁹ Their capital expenditure plans increasingly resemble those of utilities or industrial conglomerates rather than traditional technology firms.

These firms possess something that many AI developers lack: the ability to finance massive infrastructure investments from their own balance sheets.

Amazon Web Services remains the dominant cloud platform. Microsoft benefits from its partnership with OpenAI. Google combines leading AI research with one of the world's largest cloud businesses. Meta is investing aggressively in both open-source models and computing capacity.

The relationship between model developers and infrastructure providers is therefore becoming increasingly symbiotic. OpenAI, Anthropic, and xAI may create applications that attract users and headlines, but their growth increasingly depends on the computing power, cloud capacity, and financing provided by hyperscalers.

As in the California gold rush, the most reliable profits accrue to those selling the picks and shovels.

U.S.-China competition

This broader framing is especially important when comparing the United States and China.

The U.S. approach remains heavily market driven. The state plays a role through export controls, defense procurement, research funding, and industrial policy, but the leading actors are private firms.

China may not need to dominate every frontier model category to become a formidable AI competitor

China is pursuing a different model. Its AI strategy is better understood as an ecosystem strategy.¹⁰ It combines state support, domestic chip development, cloud infrastructure, robotics, industrial automation, open models, manufacturing deployment, and the integration of AI into strategic sectors. Even if Chinese firms remain constrained in accessing the most advanced chips, China's industrial base gives it a distinct advantage: the ability to deploy AI at scale across factories, logistics systems, robotics platforms, electric vehicles, and manufacturing supply chains.

This matters because the future of AI will be determined not only by benchmark scores but also by where AI is used, how quickly it is embedded in production, and whether firms can turn intelligence into productivity. China may not need to dominate every frontier model category to become a formidable AI competitor. Instead, it may build an integrated industrial AI ecosystem that links software, hardware, automation, and state-backed deployment.

Europe's risk of missing the second phase

Europe has world-class researchers and industrial firms, but it remains dependent on foreign cloud providers, chips, and platforms.¹¹ At the same time, the United States dominates hyperscale cloud computing, while China builds a parallel ecosystem.

This matters because technological revolutions rarely reward only innovators. They often reward owners of the underlying infrastructure.

If Europe remains primarily a consumer rather than an owner of AI infrastructure, it risks capturing only a fraction of the economic value generated by technology.

The challenge is technological and strategic. Europe's objective should not aim to copy OpenAI. Its more credible opportunity lies in anchoring AI value in industrial deployment, sovereign compute, applied data, energy systems, and sector-specific operational AI.

Although Europe is unlikely to outspend the United States or China on frontier infrastructure, it has stronger opportunities in industrial AI, given its strengths in manufacturing, aerospace, energy, automotive, logistics, and engineering.

Conclusion

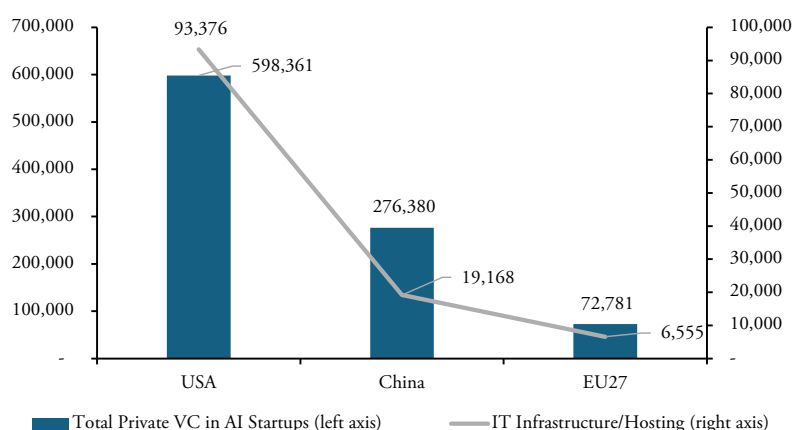
Between models and applications sits an emerging operational layer that connects AI to real-world organizations, workflows, and decision-making. For example, Palantir is building systems that connect AI to operational processes, governance, and enterprise decision-making.¹² As model performance converges, this layer could become increasingly important.

The first phase of AI rewarded innovation. The second phase is likely to reward firms that combine strong models with the infrastructure, financing capacity, operational systems, distribution networks, and execution capabilities needed to deploy AI at scale. The key question is not whether infrastructure will replace software, but which firms will control the most valuable bottlenecks across the AI value chain.

Although Europe is unlikely to outspend the United States or China on frontier infrastructure, it has a more credible opening in industrial AI, where its strengths still matter

The next phase of AI is likely to reward firms that combine innovation with scale, capital, and execution

EXHIBIT 2.0 – CUMULATIVE VENTURE CAPITAL INVESTMENT IN AI
(MILLIONS OF USD, 2012-2024)



Source: U.S. Federal Reserve.

Notes

- ¹ <https://www.iea.org/reports/energy-and-ai/executive-summary>
- ² <https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/the-critical-bets-on-the-future-of-telco-value-creation>
- ³ <https://hai.stanford.edu/ai-index/2026-ai-index-report/research-and-development>
- ⁴ <https://openai.com/index/five-new-stargate-sites/>
- ⁵ <https://www.ft.com/content/95286aa1-ee55-4a45-86b8-951cc0fb23a8?syn-25a6b1a6=1>
- ⁶ <https://www.reuters.com/world/china/big-techs-635-billion-ai-spending-faces-energy-shocktest-sp-global-says-2026-03-31/>
- ⁷ https://www.wsj.com/finance/stocks/tech-stocks-retreat-on-concerns-over-ai-spending-valuations-9776df5a?eafs_enabled=false
- ⁸ <https://www.anthropic.com/news/fable-mythos-access>
- ⁹ <https://www.reuters.com/world/china/big-techs-635-billion-ai-spending-faces-energyshocktest-sp-global-says-2026-03-31>
- ¹⁰ <https://merics.org/en/report/chinas-drive-toward-self-reliance-artificial-intelligencechipslarge-language-models>
- ¹¹ https://commission.europa.eu/topics/competitiveness/ai-continent_en
- ¹² <https://www.palantir.com/docs/foundry/aip/overview>

Germany's Rearmament Dilemma

How defense spending, demographic pressures and weak growth are reshaping Europe's largest economy

- Germany's fiscal expansion marks a historic break in its post-Cold War model and shifts the focus to how welfare, infrastructure, and defense can be financed simultaneously in an aging economy with weak long-term growth prospects.
- Higher defense and infrastructure spending may boost short-term growth and strengthen European security, but its long-term success will depend on welfare reform, productivity gains, and more effective European defense coordination.

Introduction

For decades, Germany combined relatively low defense spending with a generous welfare state, strict fiscal discipline, and an export-led growth model. Security was largely delegated to NATO, while public resources were concentrated on pensions, healthcare, and social protection.

That model is now under pressure. Russia's invasion of Ukraine, growing geopolitical fragmentation, and uncertainty about future U.S. security commitments have prompted Berlin to embark on its most ambitious military buildup since reunification. Germany is modernizing the Bundeswehr, rebuilding military readiness, and seeking a larger role in European security.

The result is an attempt to redesign Germany's fiscal priorities after years of stagnation and underinvestment. S&P Global Ratings describes the new fiscal package as one of the key drivers of growth from 2026-2028 but also warns that its longer-term impact on potential growth remains uncertain.¹

Yet defense is only part of the story. The recently agreed package of tax, pension, and healthcare reforms reflects growing recognition that Germany's fiscal and competitiveness challenges extend well beyond defense spending. Germany enters this new era with weak growth and mounting demographic pressures, both of which are increasing the cost of sustaining its welfare state. The debate is therefore no longer simply about how much Germany should spend on defense, but whether it can finance rearmament while preserving fiscal sustainability and its social model.²

Germany's real challenge: Growth, population aging, and fiscal sustainability

Germany's fiscal shift is taking place against a weak economic backdrop. After two years of contraction and near stagnation, forecasts differ in magnitude but point in the same direction: Germany is recovering, but only gradually.

Germany is undertaking its largest military buildup since reunification, forcing a reassessment of fiscal priorities that have shaped the country for decades

Germany's main fiscal challenge may not be defense spending itself, but financing an aging welfare state in a low-growth economy

The European Commission projects GDP growth of 0.6% in 2026 and 0.9% for 2027,³ while the German government and the German Council of Economic Experts expect GDP growth of around 0.5% in 2026.⁴ Deutsche Bank projects growth of 0.5% in 2026 and 1.3% in 2027,⁵ while S&P is somewhat more optimistic, projecting growth of 0.8% in 2026 and 1.4% in 2027-2028 as fiscal stimulus, defense spending, and infrastructure investment support domestic demand.⁶

However, Germany's economic model faces mounting pressure from weak investment, elevated energy costs, and intensifying competition from China. The result has been weak productivity growth and an industrial sector that remains below pre-pandemic levels. Germany also has one of Europe's oldest populations, and the retirement of the post-war baby-boom generation is expected to accelerate over the coming decade. Fiscal expansion can support demand in the near term, but it cannot borrow its way out of demographic decline, weak productivity, or declining competitiveness. Recent developments at Volkswagen illustrate the scale of these structural pressures. The company is reportedly considering eliminating up to 100,000 jobs and closing several German plants as it restructures in response to intensifying Chinese competition, weak European demand, and the costly transition to electric vehicles. The proposed restructuring highlights the broader challenges facing Germany's industrial model beyond the defense sector.⁷

Importantly, the coalition has also agreed on a broader package of economic reforms covering taxation, pensions, and healthcare. While politically significant, the measures are unlikely to provide a meaningful short-term boost to economic growth. The pension reform introduces a funded capital-market pillar, marking a first step toward modernizing Germany's retirement system. In the short term, however, it will require higher contributions from both employers and employees, increasing labor costs rather than stimulating growth. Its economic benefits, if they materialize, are likely to emerge only gradually as a larger share of retirement savings is invested in higher-yielding capital markets.⁸

Rearmament and new fiscal priorities

Germany became Europe's largest military spender in 2025, with defense expenditure exceeding 2% of GDP for the first time since reunification

Germany's defense spending has already moved decisively upward. Military expenditure rose by 24% in 2025 to approximately \$115 billion, making Germany Europe's largest military spender and pushing defense spending above 2% of GDP for the first time since reunification.⁹

The immediate financing challenge has largely been addressed through fiscal reform, but only by challenging the rules that had long defined Germany's fiscal identity. In 2025, Germany modified its fiscal framework by excluding defense spending above 1% of GDP from the debt brake calculation and creating a €500 billion infrastructure fund, giving Berlin room to borrow.

Borrowing eases the immediate financing challenge, but it does not eliminate the need for future fiscal adjustment. The European Commission estimates that Germany's annual fiscal deficit could increase to 4.1% in 2027,¹⁰ while S&P expects deficits above 4% during 2027-2029 and net government debt to rise to 67% of GDP by 2029.¹¹ Germany is therefore not facing an immediate

sovereign-credit problem, but these strengths buy time rather than obviate the need for reform.

Can defense spending boost growth?

Defense spending can support economic activity, create jobs, stimulate innovation, and strengthen strategic industries.¹² But the key distinction is between a short-term demand boost and a lasting improvement in potential growth.¹³

Fiscal stimulus through higher defense spending and infrastructure investment could support growth in the short term. However, the effect on potential output will depend on how much of this spending translates into productive investment. If higher spending primarily translates into foreign purchases or slow procurement, the domestic growth impact will be limited, and the fiscal costs will rise faster than military capability.¹⁴

Procurement reform and the European dimension

For years, the Bundeswehr has struggled with procurement delays, fragmented responsibilities, and excessive bureaucracy. Berlin has responded with reforms designed to accelerate acquisitions and strengthen cooperation with industry, but implementation remains a major challenge.¹⁵ Berlin's June 24 decision to cancel the €15 billion F126 frigate program, following cost overruns and delays, underscores how procurement uncertainty can disrupt industrial planning, unsettle investors, and complicate Germany's broader rearmament strategy.¹⁶

The issue extends beyond procurement. Smaller suppliers, dual-use technology firms, and defense start-ups often face financing constraints that limit their ability to expand production, making guarantees, co-investment structures, and other risk-sharing mechanisms increasingly important.

Germany's strategy also cannot be separated from broader European efforts to strengthen military capabilities. Greater coordination could lower costs and strengthen Europe's defense industrial base by reducing duplication and increasing economies of scale.

Yet the difficulties surrounding the Future Combat Air System (FCAS) and Germany's decision to back out of the Eurofighter project show how national procurement decisions can undermine wider rearmament plans.^{17,18}

These disputes raise broader questions about whether Europe can translate higher defense spending into genuine strategic autonomy. The risk is that it spends more while continuing to duplicate efforts across competing national programs, leaving governments with higher fiscal costs but less additional military capability than the headline budget suggests.

The political limits of rearmament

The most difficult aspect of Germany's rearmament may ultimately be political rather than economic.

Greater fiscal room can make policymaking easier in the short term, but it may also reduce the urgency to address Germany's structural problems.

Recent procurement decisions illustrate how national priorities can complicate broader rearmament plans

Borrowing buys Germany time, but it does not remove the need for longer-term fiscal adjustment

That matters because the reforms needed to improve growth and contain future spending pressures remain politically difficult.

Conclusion

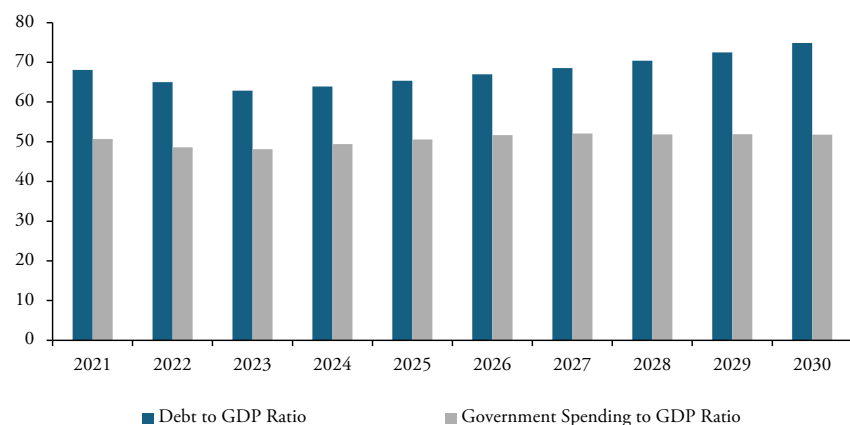
The immediate financing challenge has been eased through debt brake reform and increased borrowing capacity. The more difficult challenge lies ahead: ensuring that higher defense spending raises potential growth rather than simply adding new claims on an already strained fiscal model.

Germany still has room to maneuver, as its AAA rating and strong external balance sheet show. But that room is not unlimited. The most likely outcome is a combination of higher borrowing in the near term and the gradual implementation of recently agreed structural reforms including pension, tax and healthcare reforms, accompanied by greater pressure to improve public sector efficiency and deepen European defense cooperation.

The success of Germany's rearmament will depend on whether higher defense spending can be reconciled with long-term growth and fiscal sustainability

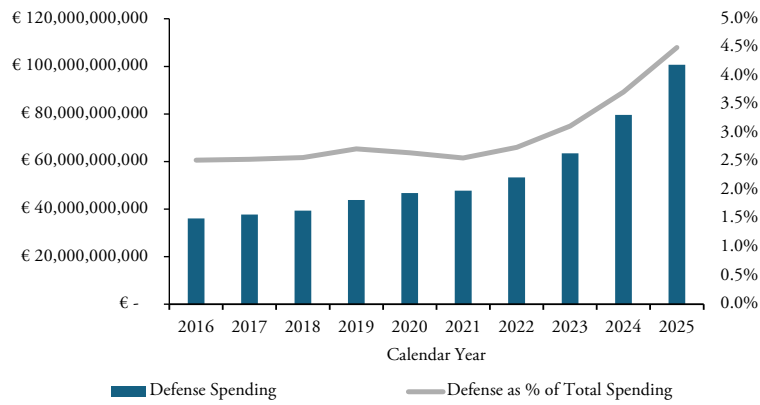
Germany can afford to rearm, but it cannot indefinitely expand defense spending, infrastructure investment, and welfare commitments simultaneously. Ultimately, the success of Germany's rearmament strategy will be judged not by the size of its defense budget, but by whether it can strengthen security without sacrificing competitiveness, growth, and fiscal sustainability.

EXHIBIT 3.0 – PROJECTED INCREASE IN GERMAN GOVERNMENT SPENDING AND DEBT (PERCENTAGE)



Source: Federal Reserve Bank of St. Louis and IMF.

EXHIBIT 4.0 – 10-YEAR TREND IN GERMAN DEFENSE SPENDING



Source: Stockholm International Peace Research Institute (SIPRI).

Notes

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Europe Between Washington and Beijing

The new competitiveness challenge

- While Washington appears increasingly interested in stabilizing its relationship with Beijing, Europe is becoming more concerned about the impact of Chinese competition on its industrial base.
- Europe's challenge is how to remain competitive in a world where both Beijing and Washington are actively supporting their strategic industries.

Introduction

For much of the last decade, the transatlantic debate on China seemed relatively straightforward. The United States pushed for a tougher stance, primarily because of concerns about technological leadership and strategic dependence on China. Europe, while sharing some of these concerns, generally preferred engagement, trade, and economic cooperation.

Today, that distinction is becoming less clear. A growing number of developments suggest that Washington and Brussels may be moving toward a surprising convergence, but from opposite directions. The United States, under President Trump, appears increasingly focused on stabilizing its broader relationship with China and prioritizing technological leadership, while Europe is becoming more willing to defend itself against Chinese economic pressure and is more focused on industrial resilience.¹

Europe's fears are increasingly economic

Europe's fears are increasingly economic rather than geopolitical. For years, European policymakers worried primarily about access to the Chinese market. Today, many are more concerned about Chinese exports entering Europe. Since 2021, EU imports from China have grown at a compound annual growth rate of 6%.²

Chinese firms have also rapidly expanded their presence in sectors that Europe considers strategic. China now accounts for more than 80% of the global solar panel manufacturing capacity, dominates much of the battery supply chain, and has become the world's largest exporter of electric vehicles (EVs).^{3,4} In 2025, China accounted for nearly three-quarters of the world's EV manufacturing and approximately 40% of global EV exports.⁵ Chinese manufacturers have also gained market share in industrial machinery, clean-energy equipment, and a growing range of advanced manufactured goods.⁶

Europe's concern is increasingly less about market access and more about industrial competition

The concern in Brussels is not simply the scale of Chinese exports, but the combination of industrial overcapacity, state support, and the speed at which Chinese firms have moved up the value chain.

Several sectors traditionally associated with European industrial leadership, most notably automobiles and clean-tech manufacturing, are facing growing Chinese competition.⁷ For example, despite Brussels's October 2024 decision to impose additional tariffs on Chinese-made EVs, EU sales of Chinese battery EVs (BEVs) have continued to grow. In the first four months of this year, Chinese brands accounted for 19.7% of the EU's total BEV market, up from 15.3% one year earlier.⁸

This explains the growing willingness of European institutions to investigate subsidies, impose tariffs, and scrutinize foreign investment, as well as the growing consensus among Member States for the European Commission to develop new industrial policy tools to strengthen the EU's trade defenses.⁹

And yet, despite the increasingly combative rhetoric from some EU Member States, particularly Germany, the June 18th European leaders' summit showed the strength and the limits of the emerging consensus. EU leaders broadly agreed that Europe's trade relationship with China has become more unbalanced, yet they stopped short of endorsing an immediate escalation.¹⁰ Instead, they urged European Commission President Ursula von der Leyen to continue "engaging in constructive dialogue" with Beijing while reviewing whether the EU needs faster, broader, and more complementary tools to defend itself against subsidized imports, export controls, and strategic dependencies.¹¹ While Washington increasingly fears China's technological rise, Europe increasingly fears China's industrial strength.

The United States faces a different challenge

The U.S.-China debate is increasingly centered on technological leadership

The U.S. debate, on the other hand, is different. Washington still views China as a strategic rival, but its central concern is technology and national security rather than import competition across the economy.¹² Washington seeks to maintain leadership in critical technologies, such as semiconductors, AI, advanced computing, telecommunications infrastructure, and defense-related technologies.¹³

While tariffs remain in place and tensions persist, recent developments suggest that the larger goal is to prevent China from dominating the technologies that will shape military power and future growth, and that both sides are seeking to avoid a broader economic confrontation.

The result is a subtle but important divergence between the United States and Europe. Washington is increasingly concerned about China's technological rise and losing its edge in the technologies that will drive future growth and military power. At the same time, Brussels is increasingly alarmed about China's industrial strength and fears losing the manufacturing base it needs to remain economically sovereign.

The real competition is between economic models

The debate is often framed around tariffs, but the deeper issue is how different economic systems generate competitiveness and technological leadership. China's rise has been driven by a combination of industrial policy, strategic planning, large-scale investment, and manufacturing dominance. The United States, on the other hand, relies more heavily on private capital, innovation ecosystems, and entrepreneurial dynamism.

Europe finds itself in a difficult position between the two. Unlike the United States, Europe lacks a deep and integrated capital market capable of financing innovation at scale. And unlike China, it lacks the centralized policy tools needed to direct investment quickly and decisively toward strategic sectors.

Europe often excels at research, engineering, and regulation, yet struggles to translate these strengths into globally dominant companies. Its challenges are increasingly visible in sectors ranging from EVs and batteries to AI, semiconductors, and clean technologies. Europe now faces competition from Chinese manufacturers supported by industrial policy and U.S. firms backed by deep capital markets and large-scale federal incentives, despite the Trump administration's partial rollback of the Biden-era industrial policies. The CHIPS Act, which has received nearly \$53 billion to bolster U.S. semiconductor manufacturing, has allocated \$33 billion thus far.¹⁴ Experts estimate the remaining credits from the Inflation Reduction Act for clean energy and advanced manufacturing will likely amount to over \$350 billion over the coming decade.¹⁵

Europe is increasingly squeezed between China's industrial scale and America's innovation ecosystem

Caught between Washington and Beijing

The risk for Europe is not simply Chinese competition. It is simultaneous pressure from both sides.¹⁶ Chinese manufacturers continue to expand their global market share, while U.S. industrial policies are attracting investment that might otherwise have flowed into Europe. As a result, Europe must simultaneously compete with China's manufacturing scale and U.S. technological leadership.¹⁷

If current trends continue, Europe risks becoming dependent on U.S. technology platforms while relying on Chinese manufacturing capacity in key sectors.

Europe risks losing control over critical technologies and industrial supply chains

Europe's strategic choice

The answer for Europe should not be protectionism. Nor should it be a return to the globalization model that prevailed before the pandemic, the energy crisis, and growing geopolitical tensions. Instead, Europe will need a more coherent strategy focused on competitiveness. This means improving Europe's ability to mobilize capital and scale innovation in strategic sectors while reducing the fragmentation that continues to hold back investment. Europe retains significant strengths in advanced manufacturing, industrial engineering, and several high-technology sectors, but it has struggled to scale those advantages into global leadership.

Europe's challenge is to remain open without falling behind

Europe's goal should be to develop a European model capable of competing with those of China and the United States while preserving its economic openness and industrial base.

Between dependence and decoupling

The debate in Washington and Brussels about their respective China policies is often incorrectly presented as a choice between engagement and confrontation.

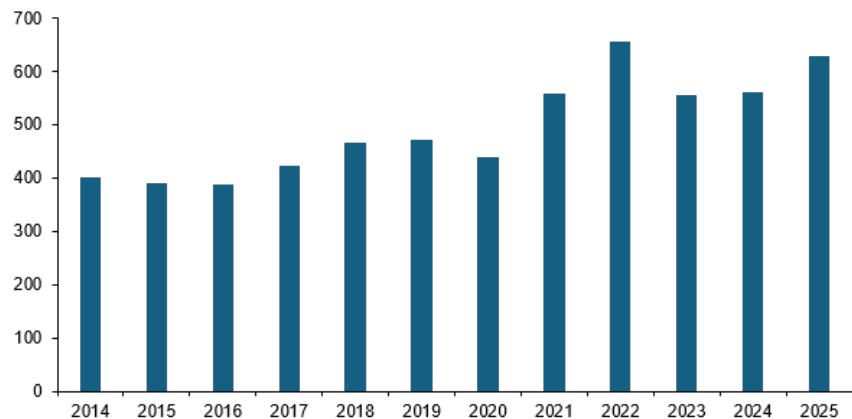
That is increasingly the wrong question. Neither the United States nor Europe appears willing to pursue full-scale decoupling. The economic costs would be too high. At the same time, neither side appears willing to accept growing strategic dependencies in critical sectors.

Europe and the United States may differ in their tactics, but they are gradually moving toward the same conclusion. The emerging consensus is one of selective competition: staying economically connected while reducing vulnerabilities in areas essential to national security, industrial capacity, and long-term competitiveness. Economic resilience now matters almost as much as economic efficiency.

The real question is whether Europe can compete without choosing between Washington and Beijing

For Europe, the real question is therefore whether Europe can adapt quickly enough to remain competitive in a world increasingly shaped by Chinese manufacturing strength and U.S. technological leadership.

EXHIBIT 5.0 – VALUE OF EU IMPORTS FROM CHINA, 2014 – 2025 (USD BILLIONS)



Source: United Nations COMTRADE database.

Notes

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