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## NATO's Baltic Vulnerability: Implications for Europe

When Sweden and Finland finally joined the North Atlantic Treaty Organization in 2024, the alliance gained important new territory and military capabilities on its northeastern flank. However, the expansion hasn't necessarily been enough to fully deter potential Russian aggression against NATO in that theater. Indeed, NATO's expansion has prompted Russia to increase its military resources there. Northeastern Europe and the Baltic Sea remain an important potential flashpoint for conflict between the West and Russia. In this report, we show how NATO remains vulnerable to Russian threats in the northeast. Against the backdrop of President Trump trying to reduce the United States' role in European defense, we also examine how the Russian threat is prompting shifts in Europe's defense and economic policy. We wrap up with a discussion of the resulting investment implications.

### Geography and Order of Battle

As shown in Figure 1, the accession of Sweden and Finland to NATO in 2024 led to a major increase in the alliance's European territory. The new NATO territory roughly equals that of France, Germany, and Poland combined. The geography of the land has some similarities to that of Norway, which for decades has been a key ally helping to deter Russian aggression against NATO in the north. Sweden's terrain is marked by frigid mountain ranges, vast forests, and a lake region. Finland is mostly low-lying and

flat, with a central lake district and high ground only in the far north and east. These land features would be of only limited defensive value for NATO in a conflict with Russia.

Figure 1

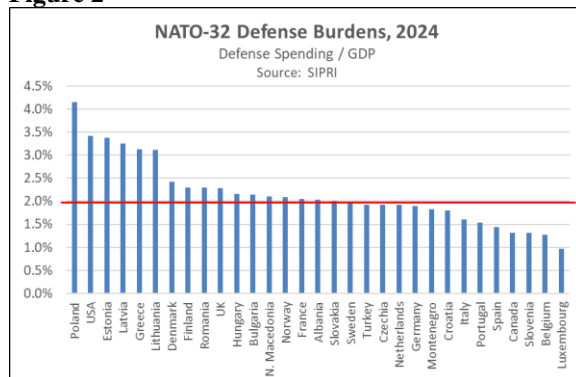


*NATO's northern flank expanded by Sweden and Finland (Source: cdrsalamander.substack.com)*

From NATO's perspective, the key geographic value of Sweden and Finland comes from their extensive coastlines along the Baltic Sea and the Gulf of Bothnia. Both nations are largely dependent on sea transport to connect with their NATO allies, but they also give the alliance more access to the Baltic's sea lanes, which Russia uses for much of its international trade. Russia does have ports on its Arctic coast, but despite global warming, those ports and the Arctic's sea lanes are still restricted by ice for much of the year. The accession of Sweden and Finland has made the Baltic Sea a virtual NATO lake, giving the alliance the potential ability to bottle up Russia's trade and naval operations and restrict its access to the Atlantic Ocean in time of war.

Reflecting their historical conflicts with Russia, their vulnerability to land attack, and their reliance on sea lanes, both Sweden and Finland have longstanding policies of robust, “whole of society” defense. According to the Stockholm International Peace Research Institute, Sweden spent 2.0% of its gross domestic product on defense in 2024, while Finland spent 2.3%. Those figures put the two countries near the top of European NATO members in terms of economic resources committed to the military (see Figure 2). Both nations [plan to increase their commitments even further in the coming years](#). Sweden and Finland have also provided NATO with access to important military bases on the north side of the Baltic Sea. In the Russian media map below (Figure 3), NATO’s major air bases in Sweden and Finland are shown by solid black dots, while its major naval bases are shown by white dots. In sum, the Swedish and Finnish armed forces have contributed credible war-fighting assets to NATO.

Figure 2



Nevertheless, despite the accession of Sweden and Finland on the northern shores of the Baltic, Figure 3 highlights that Estonia, Latvia, and Lithuania remain vulnerable to a possible Russian invasion on their southeastern shores. Like Sweden and Finland, these small Baltic states commit a lot of their resources to the military, including the ongoing development of a joint “Baltic Defense Line” consisting of

physical and technological infrastructure to slow any Russian assault. [They have also embraced an increased presence of NATO troops and bases on their soil](#). Still, they border directly on Russian territory. If Russian leaders ever judge that the US or other major NATO allies would hesitate in coming to the aid of their Baltic allies, they may well take a chance to seize them. In such an event, the geography and transport links between the Baltics and Russia could allow the Kremlin’s forces to overwhelm NATO’s forces there. [NATO leaders might belatedly commit their air and naval forces in Sweden, Finland, and elsewhere in the north to try to push back the invading Russians, but they could be trying to dislodge a \*fait accompli\*, which the Kremlin would likely back up with the threat of nuclear weapons](#). In sum, Sweden and Finland have strengthened NATO’s hand in the north, but it’s an error to believe they have eliminated the Russian threat.

Figure 3

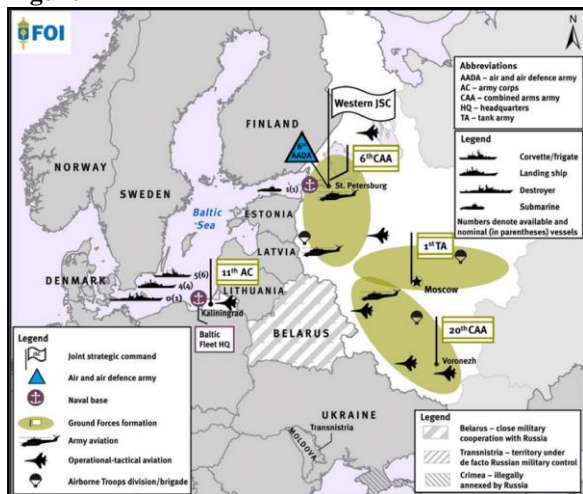


Major NATO air and naval bases in Sweden and Finland (Source: Arsenal.com)

Finally, it’s helpful to quickly review Russia’s military assets along NATO’s new northeastern border. For one thing, Russia maintains significant armed forces in its Western Military District directly opposite

the Baltics (see Figure 4). [More broadly, the overall Russian military is quite large, with a targeted personnel strength of 1.5 million troops, 600,000 of which are now fighting in Ukraine.](#) The Russian military is also equipped with a wide range of modern arms, including strategic and tactical nuclear weapons. It has lost enormous numbers of tanks, artillery pieces, and other equipment in the Ukraine conflict, but the war has also forced it to quickly expand its procurement of cutting-edge capabilities from allies and its own defense industry, including drones. The war has also forced the Russians to correct their early mistakes and learn effective new tactics using advanced technologies. All these assets could be brought to bear against NATO's relatively less experienced troops.

Figure 4



Key assets in Russia's Western Military District before Ukraine war (Source: ResearchGate.com)

### Implications for Europe

Because of NATO's continued risk of conflict with Russia in the northeast, and Russia's probable ability to rapidly rebuild its armed forces and defense industry if the Ukraine conflict eases up, we think European leaders will continue their recent efforts to rebuild their defenses and reinvigorate their economies. Below, we discuss how those efforts will not only lead

to further defense spending increases, but also encourage broader reform of Europe's industrial sector and approach to economic policy.

**Defense Spending.** The US and the rest of NATO began boosting their military outlays after Russia seized Crimea in 2014, but the pace accelerated markedly after Russia launched its all-out invasion of Ukraine in early 2022. Responding to US pressure and the threat of escalating Russian aggression, many European countries have pledged to sharply increase their military outlays even further in the coming years. For example, the German government has hinted that it will loosen its fiscal rules to hike its defense budget to as much as 5% of GDP, or 2.5x the current NATO target. [To facilitate such increases, the European Union has relaxed its fiscal rules for member countries and is implementing a 150 billion EUR \(\\$171.5 billion\) centralized loan fund under which EU countries can borrow for joint arms purchases.](#) Besides strengthening NATO's military capability over time, these efforts could provide near-term fiscal stimulus to the broader European economy and promote increased investment and innovation over the longer term.

**Defense Industry.** Importantly, the EU's new 150 billion EUR loan fund for joint procurement carries a "local content" rule under which the funds will only be available to purchase weapons systems in which at least 65% of the value of the components comes from the EU or from certain partner countries, including Norway, Iceland, the UK, Switzerland, Liechtenstein, and Ukraine. Since the individual European countries' own national defense budget rules are also likely to favor domestic producers, we suspect a large share of Europe's new defense spending will boost its own defense industry and related firms.



**Broader Industrial Development.** Over the longer term, we think the increased funds going into Europe's defense industry will also spur development and innovation in Europe's broader industrial sector. After all, much of Europe's new defense output will require inputs from suppliers outside the defense industry. Over the medium and long terms, a greater volume of money flowing through the defense sector may also spur innovations that will spread to the civilian sector, as often happened in the US throughout the Cold War. Finally, if the effort to boost Europe's defense industrial output is successful, it could be taken as a model for more aggressive industrial policies, potentially including important reforms such as deregulation, more flexible labor markets, and the formation of bigger and deeper capital markets.

#### **Analysis and Investment Implications**

Economists, investors, and policy leaders have long fretted about Europe's lethargic economic growth. For example, former European Central Bank chief Mario Draghi was tapped to produce a major analysis of the problem and suggest steps to address it. [His 2024 report identified many structural impediments to boosting European productivity, including excessive taxation and regulation, weak capital markets, and timid industrial policy, all of which discourage innovation and investment.](#) Private-sector analysts generally agree on those problems, but they [also flag issues such as slow population growth, high public debt left over from the Global Financial Crisis, weak consumer spending, and elevated energy costs following Russia's invasion of Ukraine.](#) Finally, the EU's consensus-driven political institutions and political polarization in its member countries are widely recognized as impediments to effective policymaking.

In our view, Europe's broad new acceptance of greater fiscal flexibility and higher defense spending will help stimulate better growth in the near term. However, it's not clear whether the Russian threat described here will be enough of a catalyst or shock to prompt a concerted effort to address Europe's structural economic headwinds. Dismantling at least some of those longstanding impediments would be needed before faster growth can be sustained in Europe over the longer term.

Against this backdrop, we continue to believe that **European defense firms** will enjoy strong revenue and profit growth in the near-to-medium term, boosting their stock returns. Based on the analysis above, we think **Europe's broader industrial sector** could also benefit from the knock-on effects of higher military budgets, more expansive public infrastructure investment, and potential loosening of regulatory burdens as the EU shifts from green initiatives toward a focus on security and growth. More generally, we judge that increasing uncertainty about US economic and political stability could continue to weaken the dollar, giving a boost to the **general European stock market** in the same period. A key question for the longer term is whether the Russian threat described here, combined with the pullback of US engagement, could spur European policymakers to finally agree to dismantle the major structural problems holding the economy back. If so, European stocks could provide outsized returns over a longer period, but the jury is still out on whether that will happen.

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