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August 11, 2025

Update on US and China Defense Spending

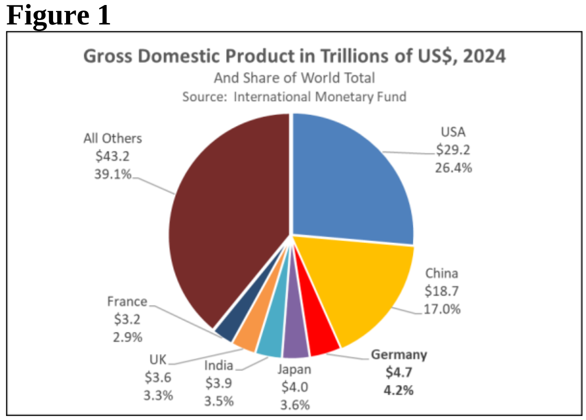
In our *[Mid-Year Geopolitical Outlook](#)*, we reminded investors that President Trump's import tariffs aren't the only issue between the United States and China, despite the media frenzy surrounding them so far this year. We warned that even as the trade dispute persists, China is continuing to press for geopolitical advantage by beefing up its armed forces, pushing an all-of-nation effort to surpass the US in science and technology, and launching a diplomatic charm offensive to exploit the US's weaker image as it cuts foreign aid, reduces its support for allies, and erects across-the-board trade barriers.

In this report, we focus on the US-China military rivalry from the perspective of "defense economics," i.e., the impact of a country's overall economic strength on its military effort and the impact of its military effort on the economy. Even though China is now facing significant, structural economic headwinds, we show that its high defense spending and relative fiscal flexibility will probably make it more challenging for the US to defend its position as the global hegemon. As always, we wrap up with the implications for investors.

US and Chinese Economic Strength

US gross domestic product (GDP) totaled $29.2 trillion in 2024, making it the world's largest economy. China's GDP, when converted to US dollars at market exchange rates, equaled $18.7 trillion, putting it in second place (see Figure 1). However, price disparities and differing economic structures matter. Adjusted for the purchasing power of the yuan, the value of Chinese GDP reached $38.2 trillion last year, ranking it first in the world and pushing the US into second place. (Unless otherwise noted, all figures in this report come from the International Monetary Fund's *World Economic Outlook* from April 2025.) These enormous sums mean that both the US and China potentially have immense resources to sustain and develop their military forces.

Figure 1



Of course, a country's recent economic output isn't the only determinant of its military potential. Another key question is how fast the economy is growing and how fast it might grow in the future. As a mature economy, the US has been growing only modestly for many years. Stripping out price inflation, the US's GDP grew at an average annual rate of just 2.1% over the last two decades. That growth reflected the US labor force expanding by about 0.7% per year and worker productivity increasing about 1.4% annually. US GDP growth improved to 2.5%

in the last 10 years as labor force growth accelerated to 0.8% and productivity improved even more.

China's economic growth averaged 7.8% over the last two decades, even though the workforce grew by less than 0.2% per year. The rest of China's growth reflected massive productivity gains. Chinese growth slowed to 5.8% per year over the last decade, in part because the labor force declined by almost 0.3% per year, but total Chinese productivity continued to rise rapidly, at a rate of more than 6.0%. Of course, China's economic statistics are widely seen as overstating the country's growth. Still, it seems likely that China's economy is growing much faster than that of the US, at least in terms of purchasing power parity (see Figure 2).

Figure 2

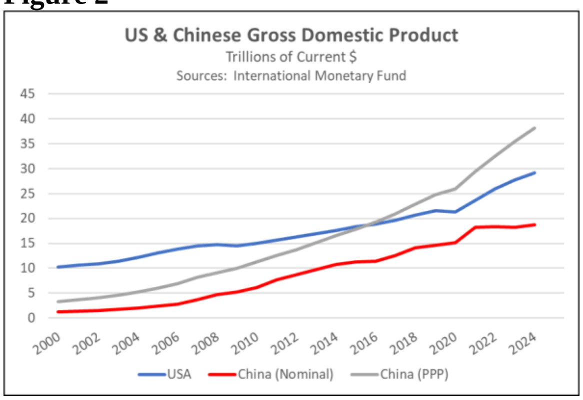


Figure 2 highlights a key issue that few other economists or strategists have noted: China's nominal GDP, when translated into dollars at market exchange rates, has been nearly stagnant for the last four years. This is because Chinese GDP in yuan has grown only slightly faster than the currency's depreciation versus the greenback. In contrast, when translated into dollars *and* adjusted for the purchasing power of the yuan, China's GDP growth is rapidly accelerating. This likely stems in large part from China's worsening problem with excess industrial capacity, which has driven down prices for producers and consumers without a commensurate change in the government-managed exchange rate. In simplistic terms, China's massive excess capacity, low prices, and supply-side efficiencies mean that resources can be channeled to the armed forces with relatively few opportunity costs. To keep Chinese industrial facilities and workers employed, the government may even be tempted to further accelerate its military build-up over time.

US and China Defense Spending

Based on the enormous resources they have available and their will for power, the US and China each spend a lot on their militaries. However, making direct comparisons between the two is difficult, as discussed below.

The US Defense Budget. Official figures show the US spent about $945.0 billion on defense in 2024, counting not only outlays by the Defense Department but also defense-related expenditures by other agencies. To compare defense budgets, however, we prefer to use data from the Stockholm International Peace Research Institute (SIPRI), which uses a consistent method to estimate each country's total defense outlays. According to SIPRI, the US spent about $997.3 billion on defense in 2024. The SIPRI figures show nominal US defense spending grew at an average annual rate of 3.6% over the last two decades and 4.4% over the last 10 years.

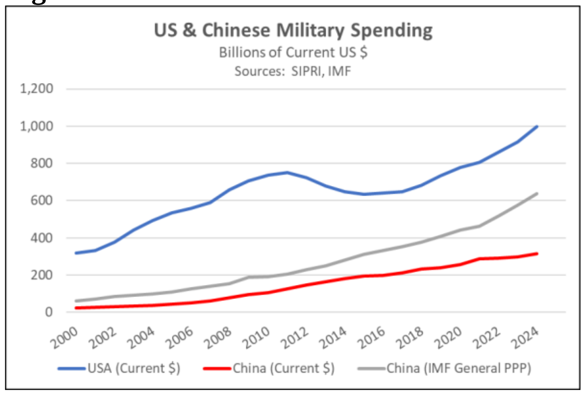
The Chinese Defense Budget. China's official defense budget was the equivalent of $236.1 billion in 2024, but SIPRI's data put total Chinese defense spending last year at $313.7 billion. The SIPRI data shows that China's defense spending grew at an average rate of 11.1% per year over the last two decades and 5.6% per year since 2014.

However, price differences and distortions from excess capacity, efficiencies, and subsidies suggest the purchasing power of China's defense spending is even higher. Adjusting SIPRI's estimate by the same purchasing-power ratios used for China's overall economy in the analysis above, we estimate that China's total defense spending in 2024 would have equaled $638.3 billion (see Figure 3).

- The observed growth in China's military hardware and tempo of operations is larger than the rise in China's official defense budget, so many analysts believe China has adopted the Soviet practice of hiding a lot of defense outlays in ostensibly civilian budget accounts and off-budget. This is especially likely considering China's explicit policy of "civil-military fusion," under which civilian firms are expected to seamlessly support the military. SIPRI's method probably captures a lot of this hidden and shared spending, but it may not catch all of it. Indeed, the most recent US Defense Department report on Chinese military power asserts that actual Chinese military spending exceeds Beijing's official budget by 40% to 90%, implying total spending of $330 billion to as much as $449 billion. Adjusting for the purchasing power of the yuan, this would imply that the value of China's total defense spending was between $671 billion and $914 billion last year.

- Based on statements in Congress, we believe the Central Intelligence Agency has developed a comprehensive estimate of total Chinese defense spending that is in the range of $700 billion per year, almost certainly including both hidden spending and purchasing-power adjustments. Mackenzie Eaglen, an analyst at the American Enterprise Institute, has used CIA methodologies to estimate that China's total defense spending totaled $711 billion as early as 2022, when US defense outlays totaled $860.7 billion. In sum, the evidence suggests that China's total defense spending rivals that of the US.

Figure 3

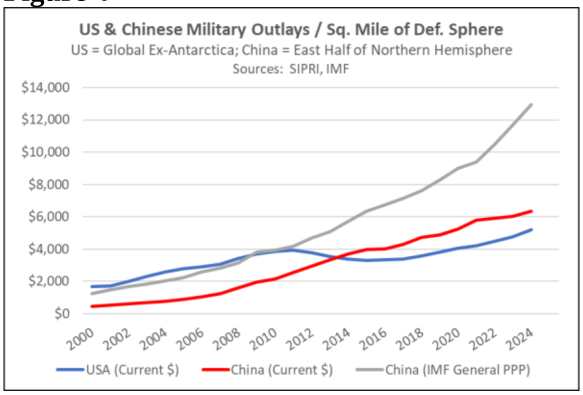


US and China Defense Burdens

No matter how big a nation's economy is or how fast it's growing, committing resources to defense will likely have feedback effects on the economy itself. In this section, we measure the US and Chinese defense effort and its burden on the economy in three distinct ways.

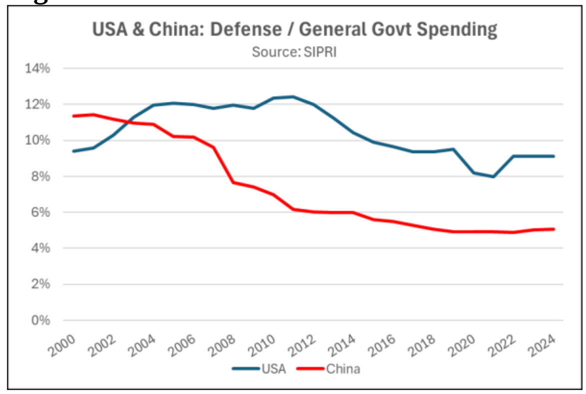
Geographic Intensity. As we've noted before, one way to gauge a nation's commitment to defense is to measure its military outlays per square mile of its defense sphere, i.e., the territory where its interests are most at play. Importantly, the US's defense spending reflects the costs of a well-established global hegemon, with hundreds of military bases all over the world, many foreign security commitments, and global interests. We therefore note that the US's total defense spending in 2024 was equal to $5,208 for every square mile of the Earth's surface excluding Antarctica (which is nominally neutral). If we assume China's core interests currently extend only over the eastern half of the Northern Hemisphere (one-quarter of the Earth's surface), its total adjusted defense spending in 2024 equaled $12,960 per square mile of its defense sphere. This suggests that China's defense effort is much more intense than that of the US (see Figure 4).

Figure 4



Defense/Government Spending. For a gauge of the defense burden that highlights the budget trade-offs and politics of military outlays, we look at how much of a country's total government spending is taken up by defense. As shown in Figure 5, defense currently takes up 9.1% of total government spending in the US (defined as all federal, state, and local government budget outlays). That's down significantly from the peak of 12.4% reached in 2011, at the height of the War on Terror, but it's still a big chunk of US public spending, especially considering the country's excess of government spending over revenues and its yawning debt. In contrast, SIPRI's estimate of total Chinese defense spending is only about 5.1% of public spending. Hidden spending not included by SIPRI could push the military's share of Chinese government spending closer to that of the US. However, China's authoritarian political system and somewhat better fiscal position suggest it could more easily boost defense outlays if it so chooses.

Figure 5



Defense/Gross Domestic Product. The final key gauge of a country's defense burden is the ratio of military outlays to GDP. This gauge is especially useful to determine whether a country's defense spending is so high that it could impinge on economic growth. As we've noted in the past, CIA research during the Cold War suggested a country's defense/GDP ratio can rise to about 10% before it starts to impinge on economic growth.[1] For defense burdens below 10% of GDP, the research suggests higher defense spending is not associated with slower growth rates. In fact, higher defense spending correlates weakly with higher economic growth (see Figure 6 on the next page).

As shown in Figure 7 on the next page, the SIPRI estimates suggest the US now has a defense burden of about 3.4%. That's much lower than the US's peak Cold War defense burden of 9.4% in 1967 and its peak burden in the Reagan era of 6.6% in 1986. It's also lower than the US's recent peak burden of 4.9% in 2010, during the War on Terror. Of course, the SIPRI figures suggest that even in the midst of the Cold War, the US defense

[1] In the 1980s, near the end of the Cold War, the CIA estimated that the Soviet Union was spending 16%-18% of its GDP on defense. Other analysts thought the defense burden was even higher. The large defense burden is widely seen as a cause of the Soviet Union's collapse.

burden never exceeded the 10% level at which it would have hurt economic growth. The figures suggest the US now could nearly triple its current defense spending and still not surpass that level. All the same, the data suggests the US defense burden is about twice that of China, where the SIPRI defense spending figure amounted to just 1.7% of GDP last year.

Figure 6

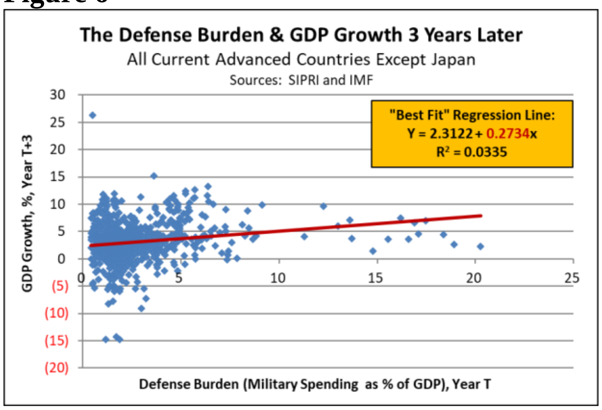
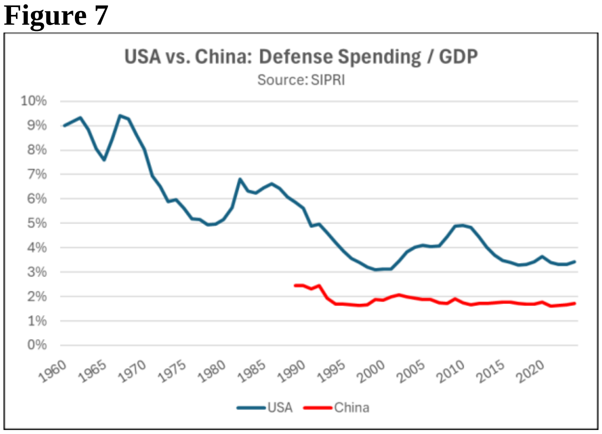


Figure 7



As noted above, SIPRI's estimate of China's defense spending may not capture all of the country's hidden or off-budget outlays. Based on the US Defense Department's estimate of how high China's all-in defense spending might be, the country's defense burden could be more than 2.4% of GDP. Nevertheless, even that would be less than the US defense burden and far below the level at which defense spending would weigh on the Chinese economy. This is consistent with our thesis that China probably faces much less severe political, economic, and fiscal trade-offs if it wants to sustain or increase its defense spending and further improve its geopolitical and military position in the world.

Analysis

As we've discussed before, the Chinese Communist Party has long stated its goal to achieve "the great rejuvenation of the Chinese people." The party's definition of this term includes a) erasing the vestiges of the "Century of Humiliation," when a weakened China was subjugated and exploited by foreigners, and b) reclaiming what they see as China's rightful place as the world's dominant political, economic, and cultural power. General Secretary Xi has laid down interim goals to make China a dominant military power by the time the Great Rejuvenation is achieved no later than 2049. Therefore, China will almost certainly continue to shower its armed forces with resources to build its strength and effectiveness over time.

The Great Rejuvenation likely requires that China would eventually try to replace the US as the global hegemon. However, as noted above, it is currently focusing its military investment on the Asia-Pacific region. That reflects Beijing's military strategy of "anti-access/area denial," by which it aims to deter the US and its allies from intervening in the event that it wants to seize Taiwan by force or grab territory from other countries in the region. In a worst-case scenario for the US and its allies, Beijing's intense military investment in its own region threatens to make the Western Pacific Ocean a Chinese lake.

Consistent with China's maximalist goals, this report has shown that the country's total military spending is already competitive with that of the US. Adjusting China's official defense budget for hidden spending and converting its total spending into dollars adjusted for purchasing power parity, we suspect that the resources China is funneling into its military are now 85% to 100% of US defense spending, mostly concentrated on the Asia-Pacific region. Importantly, China's current defense burden appears to be somewhat smaller than that of the US, whether its defense spending is measured against its total government budget or the size of its economy.

China's ability to spend on its armed forces is especially aided by its massive excess industrial capacity, while the US is already essentially producing at maximum capacity. This is radically different from the situation right before World War II, when the Great Depression left US industry with copious excess capacity available for military mobilization. Contrast this with Nazi Germany and Imperial Japan, which were already producing for war and had much less surge capacity to work with. Now, as shown by the US's difficulty in ramping up weapons production to offset what it has provided to Ukraine for its war against Russia, the US would face much more difficult political, economic, and fiscal constraints if it wanted to rapidly rearm to deter Chinese aggression in the Western Pacific. Our analysis here suggests China would be well positioned to respond to any US challenge by further boosting its military spending.

More broadly, China is not only continuing to make gains against the US and its allies in terms of military power, but also in terms of its technological capabilities and diplomatic success. It's true that China is now facing structural economic headwinds that we call the "Five Ds" (weak consumer demand, high debt, poor demographics, international decoupling, and policy disincentives). Nevertheless, China's economic growth probably still exceeds that of the US, and its excess capacity is available for further military expansion. In sum, the US position as global hegemon is becoming increasingly fragile, particularly given the strong trends of nationalism and isolationism in the US.

Investment Implications

In our view, the continuing rise of China and the US's increasingly precarious position as the global hegemon still support the major economic and investment themes we've discussed in the past. We still see the world fracturing into relatively separate geopolitical and economic blocs, which will likely push consumer price inflation higher and make it more volatile than during the post-Cold War period of globalization. That should also make interest rates higher and more volatile, although the government could respond by exercising financial repression, i.e., artificially holding down interest rates, possibly even below price inflation.

In this more fractured, tension-filled world, equities and commodities (especially precious metals) are likely to provide investors with their best returns, while debt obligations will likely be challenged. In the US equity markets, we currently have a neutral view between "value" stocks and "growth" stocks. After all, we have long believed that the stocks of well-run, dividend-paying companies in the value sectors, such as industrials, will have an advantage in the new economy marked by domestic re-industrialization and higher inflation and interest rates. At the same time, the rise of index investing and the US's large, dominant, innovative technology companies mean that there is often momentum in the US growth sectors, even if they are richly valued at present. Finally, as the current administration pursues its populist policy changes in the US, we see signs of a potential bear market in the dollar. We believe that will bode well for international stock returns. We continue to especially favor foreign defense stocks, as US allies ramp up their own defense spending.

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