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.

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

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.

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]

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

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.

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

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.

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

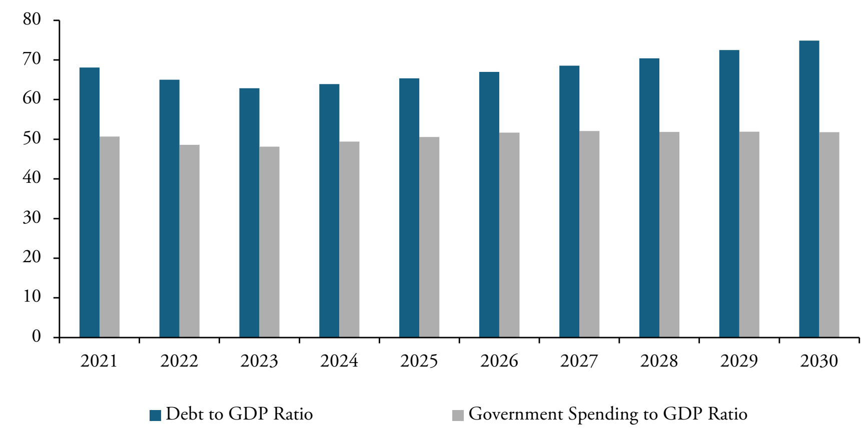
The immediate financing challenge has been eased through debt brake reform and increased borrowing capacity. The more difficult challenge lies ahead: ensuring that higher defense spending raises potential growth rather than simply adding new claims on an already strained fiscal model.

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

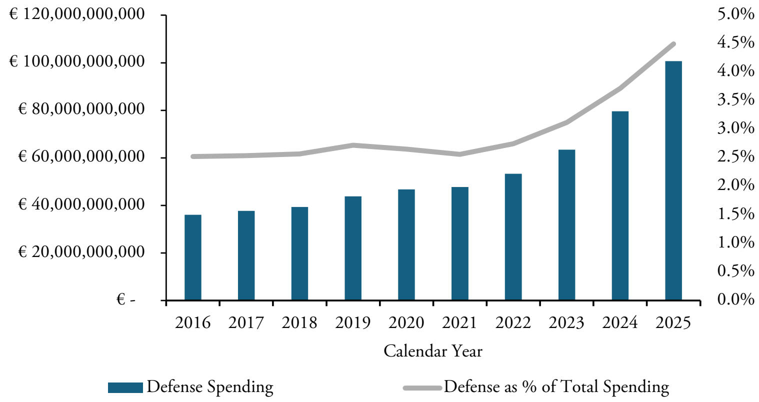
Germany can afford to rearm, but it cannot indefinitely expand defense spending, infrastructure investment, and welfare commitments simultaneously. Ultimately, the success of Germany's rearmament strategy will be judged not by the size of its defense budget, but by whether it can strengthen security 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

[1] https://www.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3551682

[2] https://www.ft.com/content/ea83015e-d26c-428f-bbbb-00a745a443a5?syn-25a6b1a6=1

[3] https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/spring-2026-economic-forecast-slowdown-growth-energy-shock-drives-inflation_en

[4] https://www.reuters.com/business/german-economic-council-cuts-growth-forecast-energy-prices-bite-2026-05-27/

[5] https://www.dbresearch.de/PROD/ID-PROD/PROD0000000000630753/Konjunktur_kurzgefasst.pdf

[6] https://www.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3551682

[7] https://www.reuters.com/business/autos-transportation/volkswagen-ceo-aims-cut-up-100000-jobs-next-years-manager-magazin-reports-2026-06-26/

[8] Eurointelligence Professional Daily Newsbriefing, July 3, 2026.

[9] https://www.sipri.org/databases/milex

[10] https://economy-finance.ec.europa.eu/economic-surveillance-eu-member-states/country-pages-including-country-reports/germany/economic-forecast-germany_en

[11] https://www.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3551682

[12] https://www.imf.org/en/blogs/articles/2026/04/08/wars-impose-lasting-economic-costs-while-more-defense-spending-means-hard-choices

[13] https://www.elibrary.imf.org/view/journals/002/2026/036/article-A001-en.xml

[14] https://www.imf.org/-/media/files/publications/weo/2026/april/english/ch2.pdf

[15] https://www.reuters.com/world/germany-seeks-make-defence-procurement-agency-more-agile-2026-05-20/

[16] https://www.ft.com/content/dc29d151-20f1-4179-947b-4843f5d5d81b?syn-25a6b1a6=1

[17] https://www.dw.com/en/franco-german-fighter-jet-project-collapses-after-industry-dispute/a-77466897

[18] https://edition.cnn.com/2026/06/08/europe/germany-france-drop-fighter-jet-project-intl-hnk