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Spending More, Delivering Less: Germany's Defence Finance Gap and the Case for a Multilateral Bank

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A STUDY BY

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Abstract

Germany has committed to raising combined defence and security expenditure to five per cent of GDP, a level without precedent in the country's post-war peacetime history. This paper argues that the principal constraint on translating this commitment into industrial capability is not fiscal capacity alone but institutional architecture. It identifies three interlinked coordination shortfalls that government instruments do not resolve: a regulatory constraint, whereby Basel 3.1 capital requirements and EU state aid rules constrain commercial banks' capacity to expand defence lending on the required scale; a working capital and growth financing gap, which leaves the downstream SMEs that constitute the core supplier base chronically undercapitalised; and a structural inflationary dynamic, whereby synchronised allied rearmament, absent supply-side intervention, converts nominal spending increases into scarcity-driven price rises rather than capability gains. A comparative analysis of three financing architectures – national SAFE facilities, Eurobonds and the announced Defence, Security and Resilience Bank (DSRB) – suggests that a multilateral institution of the DSRB type is the only model examined that could address all three shortfalls simultaneously. A supplementary note examines the UK-proposed Multilateral Defence Mechanism (MDM) and finds it complementary rather than a competing alternative: the MDM would coordinate procurement on the demand side, whilst the DSRB would mobilise capital on the supply side – a function that procurement frameworks do not themselves provide. Scenario analysis based on Harding's multiplier framework suggests that DSRB-backed financing could generate GDP effects for Germany that are both larger and more persistent than those of government alternatives, and that its supply-side mechanism could also mitigate the defence inflation that erodes the real value of nominal expenditure increases. The paper concludes that Germany's strategic interest in a DSRB founding membership rests on three pillars: fiscal, through the equity treatment of paid-in capital; industrial, through prospective procurement and financing flows to German primes and SME supply chains; and strategic, through influence over the institutional parameters of an emerging allied defence market architecture.

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**This working paper is circulated to stimulate discussion and invite feedback.*

1. Introduction

Germany's *Zeitenwende*, the strategic inflection point proclaimed by former Chancellor Olaf Scholz in February 2022 following Russia's attack on Ukraine, is regarded as the most far-reaching change of course in German security policy since the country's rearmament in 1955. In the four years since this declaration, Germany has, for the first time since 1992, met the NATO two-per-cent target, established a 100-billion-euro special fund, exempted defence, security and resilience expenditure exceeding one per cent of GDP from the debt brake, launched a 500-billion-euro infrastructure fund, and declared its intention to meet the 3.5 per cent core defence target by 2029, ahead of the 2035 NATO planning horizon, alongside the 1.5 per cent security and resilience component. On paper, this fiscal shift is real and historically significant.

Whether Germany can honour these commitments, however, is not merely a question of political will. It is also a question of the financing architecture. Germany's spending commitments require annual defence and security expenditure of around 216 billion euros, an increase of some 130 billion euros on current levels, and, once reached, sustained over the planning horizon. Meeting this requirement does not merely entail the German state borrowing and spending more, but also ensuring that the defence industrial base, in particular the thousands of small and medium-sized enterprises (SMEs) that form its Tier 2, 3 and 4 supply chains, receives the working capital, long-term credit and risk-sharing instruments necessary to build up production capacity on the required scale. The current financing architecture is failing precisely here, rather than in the government bond market, where Germany's AAA credit rating provides comparatively favourable terms.

Our paper argues that Germany faces three interlinked coordination shortfalls that government financing instru-

ments do not fully resolve. The first is a regulatory constraint: Basel 3.1 capital requirements¹ and EU state aid rules make it economically difficult for German commercial banks to expand lending to the defence industry on the required scale without external capital relief. The second is a working capital and growth financing gap: Germany's downstream *SMEs*, the industrial backbone on which any serious expansion of defence production depends, are chronically undercapitalised; the combination of ESG-related exclusions from institutional capital markets and a comparatively underdeveloped domestic growth financing ecosystem prevents demand signals from being reliably translated into production capacity. The third is a structural inflationary dynamic that transforms the first two coordination shortfalls from financial into strategic problems: without supply-side intervention, synchronised allied rearmament generates scarcity-driven price increases rather than capacity expansion, with the risk that Germany's nominal spending increases will be eroded in real terms before they reach the factory floor.

These three coordination shortfalls are not independent of one another. They reinforce one another and share a common origin: Germany's defence funding architecture was designed for a peacetime economy geared towards fiscal conservatism and declining demand for defence, and has not yet been restructured to meet the requirements of a deterrence-level capability. Incremental reforms such as the Deutschlandfonds and the reform of the debt brake are significant, but do not alter the underlying structure. One possible remedy is an institutional mechanism not currently available: a multilateral development bank (MDB) with a dedicated mandate for defence, security and resilience, paying particular attention to *SME* supply chains.

This paper evaluates this scenario through a comparative analysis of three defence financing architectures – SAFE facilities, Eurobonds, and the Defence, Security and Resilience Bank (DSRB) as the proposed multilateral institution² – drawing on Harding's (2025) multiplier framework to assess the respective growth effects for Germany. A supplementary note examines the UK-proposed Multilateral Defence Mechanism (MDM) and situates it as a demand-side complement to (rather than a substitute for) the DSRB. The key finding is that the DSRB offers the most comprehensive response among the alternatives examined. It is the only model examined that could simultaneously address all three coordination shortfalls identified above. SAFE facilities and Eurobonds address the demand side of the problem without affecting the supply side. The DSRB could address both.

2. Germany's strategic funding challenge

Germany's defence commitments illustrate the scale of the challenge ahead, even for a nation that is as creditworthy as Germany. In 2024, Germany spent around 87 billion euros on defence, reaching 2.12 per cent of GDP for the first time since 1992 (NATO, 2024). The revised NATO planning framework – 3.5 per cent of GDP for core defence expenditure plus 1.5 per cent for security- and resilience-related infrastructure by 2035 – would require Germany to bear annual expenditure of around 216 billion euros on a combined basis. Notably, Germany plans to achieve the 3.5 per cent core target by 2029. The approximately 130-billion-euro increase between the current level and the combined five per cent objective is not an accounting abstraction. It represents one of the largest peacetime fiscal adjustments ever undertaken by an advanced economy.

The constitutional framework has been amended to accommodate this scale of ambition. The debt brake reform of March 2025 exempts all defence, security and resilience expenditure exceeding one per cent of nominal GDP from the fiscal limit, which places expenditure up to that threshold within the ordinary fiscal limit while permitting borrowing for qualifying expenditure above it. Together with the 500-billion-euro infrastructure fund and the existing special fund, the legislative framework has been established for a substantial and lasting expansion of government defence spending.

Nevertheless, this fiscal shift masks an erosion of the real purchasing power of these investments. Inflation in defence equipment is estimated across NATO at between six and ten per cent annually, which is two to four percentage points above general consumer price inflation (EDA, 2025; NAO, 2023; Harding, 2025). For Germany,

¹The final Basel III reform package is termed 'Basel 3.1' by UK regulators, whilst 'Basel IV' is widely used in industry and continental European usage; no official 'Basel IV' standard exists. This paper uses 'Basel 3.1' throughout.

²The DSRB concept was first proposed publicly by Rob Murray in a Financial Times op-ed published on 20 April 2023 and was subsequently developed in an Atlantic Council brief published on 13 December 2024.

therefore, nominal budget growth of ten to fifteen per cent implies real capability gains of only three to six per cent after adjusting for defence-specific cost increases. This divergence between nominal commitment and real output is no coincidence. The Kiel Procurement Tracker directly documents its practical consequences: despite cumulative German procurement orders of around 170 billion euros since 2020, long delivery times, which frequently exceed three years, and the transfer of existing systems to Ukraine mean that the Bundeswehr's visible capability gains lag far behind the trajectory suggested by the headlines (Burilkov et al., 2025). This is not a Germany-specific phenomenon. A McKinsey (2026) report published ahead of the Munich Security Conference finds that European NATO defence industry order backlogs stand at approximately 3.7 times annual revenue, meaning the sector is, on current output, effectively booked out for close to four years, a metric consistent with persistently long delivery times and insufficient production scaling across the alliance. Key platforms are unlikely to achieve performance levels comparable to those of the early 2000s before the 2030s.

This discrepancy between what is spent and what is delivered reflects a structural feature of Germany's defence industrial position: a production base that was deliberately scaled back in the post-Cold War era and which is concentrated among a small number of large system integrators. Although large defence contractors' share prices may have risen substantially, the market capitalisation of primes does not resolve capacity bottlenecks in the downstream supply chain, which remains reliant on imported system components, with corresponding leakage from domestic GDP effects.

In other words, Germany's planned expansion cannot be delivered by system integrators alone. If downstream capacity does not expand, additional demand will increase import dependence and fuel inflation while domestic supply adjusts. The issue is not defence expenditure as such, but whether its financing crowds in private capital quickly enough to expand productive capacity (Harding, 2026b). The solution requires that German SMEs – those specialist suppliers that manufacture critical components, precision tools, high-performance electronics and propulsion systems – have access to scale-up working capital. Germany's AAA credit rating and the associated interest-rate advantage help on the government demand side, but they do not bridge the industrial funding gap. This calls for an institutional response.

3. Three coordination shortfalls in sovereign financing

3.1 Regulatory constraints: Basel 3.1 and the limitations of the commercial banking system

Germany's commercial banks face an unfavourable regulatory environment for lending along the defence industry supply chain. Under Basel III, the standard currently in force, loans to small and medium-sized defence companies already carry elevated risk weights, resulting in significant capital requirements for lending institutions; the Basel 3.1 output floor, being phased in across most G7 jurisdictions by 2030, will tighten these requirements further.

The capital-intensive, compliance-heavy and often export-controlled nature of defence manufacturing increases the perceived credit risk of these borrowers; concentrated risk exposures to a small number of procurement programmes further limit commercial banks' willingness to build up large loan portfolios in the defence sector (ITFA and Centre for Economic Security, 2025). High capital requirements significantly increase financing costs for defence companies. Whilst the OECD's Scoreboard for Germany (2026) reports an aggregate average interest rate for SMEs of 5.3 per cent for 2024, actual rates for SMEs in defence supply chains can be significantly higher: depending on the collateral available, rates of eight per cent or even double digits may apply, whilst some SMEs, start-ups in particular, often have no access to debt financing at all.

The systemic consequences of the Basel 3.1 framework for SME lending are supported by independent market analysis. Moody's (2026a) describes the output floor mechanism as a regulatory shift with far-reaching unintended consequences: banks that have hitherto relied on internal models (IRB) are required by the 72.5 per cent output floor to set aside significantly more capital for a broad class of corporate loans, regardless of the actual measured default risk. Unrated corporates are particularly affected: the standardised approach assigns them a flat 100 per cent risk weight, and the output floor progressively forces IRB banks towards this value,

eliminating the lower risk weights their internal models had previously assigned to higher-quality exposures³. Moody's specifically names Germany as one of the most affected jurisdictions in Europe, a finding that stems directly from the structure of the German corporate lending market, in which an above-average proportion of small and medium-sized borrowers do not have an external rating and rely on relationships with their principal bank.

The likely effect is that banks will seek to reprice lending, shift assets off their balance sheets where higher capital requirements render business unprofitable, and constrain credit availability, thereby diminishing the banking sector's ability to support the real economy (Moody's, 2026a). For the German defence sector, where SMEs and start-ups typically lack an external credit rating, are highly capital-intensive and, for regulatory and reputational reasons, have largely been excluded from institutional capital, this effect is particularly acute and is likely to be further exacerbated by the phased implementation of the Basel 3.1 output floor regulations from 2025 to 2030.

KfW's (2025a) announcement that its funding programmes would be opened to the security and defence industry only partly changes this situation. General corporate instruments, including the Climate Protection Initiative for Businesses and the Bank Loan for Sustainable Transformation, are now formally available to defence companies. However, the fundamental parameters that limit their effectiveness have not changed. KfW liability waivers for co-financing arrangements are generally capped at fifty per cent; as a result, a significant proportion of the credit risk remains on the balance sheets of commercial banks. For SMEs with an annual turnover of less than 50 million euros, loan ceilings under the standard KfW programmes typically do not exceed 25 million euros, which is often insufficient for the capital-intensive production expansions that Germany requires in the new geopolitical situation. Special schemes such as the UBR-222 programme extend the liability exemption to ninety per cent, but exclusively for liquidity protection against turnover-related losses resulting from the war in Ukraine, not for the long-term capacity investment required to meet demand at a deterrence level (Werner, 2025).

The more fundamental limitation is structural in nature. KfW guarantees, as state instruments, create national contingent liabilities and are subject to EU state aid rules, which restrict the conditions for partial risk assumption. This limits the extent of risk transfer. By contrast, a qualifying guarantee from an eligible AAA-rated MDB can permit credit-risk substitution under the Basel framework and may reduce the risk weight of a fully covered loan tranche to zero, thereby significantly lowering capital requirements and financing costs for downstream companies.

The current outcome is a commercial banking system that does not refuse to extend defence loans, but one in which the current regulatory framework makes such expansion commercially unattractive on the required scale without external capital relief. Regulators have, not without reason, described this dynamic as a pursuit of 'cemetery stability' (Breedon, 2024): excessive caution that stifles credit and economic dynamism precisely in those sectors where credit expansion and industrial capacity constitute a national security priority.

3.2 The working capital and growth financing gap: constraints on SMEs

Germany's defence industrial capacity relies disproportionately on SMEs and the *Mittelstand*⁴, which traditionally form the productive backbone of the German economy and today constitute the Tier 2, 3 and 4 levels of the defence supply chain. In the defence context, their importance is quantifiable and acute: SMEs generate around eighty per cent of German defence turnover (approximately 23 billion euros annually) and constitute the critical operational hubs of the downstream supply chain (LBBW, 2026; Handelsblatt Research Institute, 2026). System integrators cannot ramp up their production without functioning downstream supply chains, and the bottleneck in Germany's defence expansion does not lie with the prime contractors. It lies with the spe-

³The EU's SME Supporting Factor (Art. 501 CRR, as amended by Regulation (EU) 2020/873) partially mitigates these requirements for SME exposures specifically, applying a factor of 0.7619 to the first €2.5 million of an exposure and 0.85 to the remainder. For the capital-intensive production expansions at issue here, the blended relief converges towards 15 per cent, meaningful, but a different order of magnitude from the potential full risk weight substitution achievable under MDB guarantees.

⁴The term *Mittelstand* denotes more than Germany's SME sector: it is defined by the unity of ownership and management rather than by size thresholds (Pahnke and Welter, 2019), and includes the 'hidden champions', family-owned niche world-market leaders characteristic of German industrial exports (Simon, 2009). Its traditional strengths of long-term orientation and patient internal financing are increasingly strained by succession gaps and rising capital intensity, bearing directly on the sector's capacity to fund the transition examined here.

cialist component manufacturers, the precision tooling firms and the materials processing firms, each of which requires working capital to recruit staff, invest and scale up.

According to KfW Research (Körner, 2026), 40.5 per cent of German SMEs engaged in credit negotiations reported restrictive bank lending behaviour in the second quarter of 2026, the highest figure since the survey began in 2017. It extends an almost uninterrupted series of record highs since late 2024 and reflects a persistent widening of the size gap in credit access (Figure 2). Crucially, the restrictiveness these figures capture is only visible among firms that still approach their banks at all. That population has itself contracted: whereas roughly a third of SMEs reported credit negotiations in 2017, the share has been stuck at around one in five since 2021, falling to 19.3 per cent in the second quarter of 2026 (Figure 1).

Figures 1 and 2 chart credit demand and access for German firms by size class since 2017:

Figure 1
Share of enterprises in loan negotiations

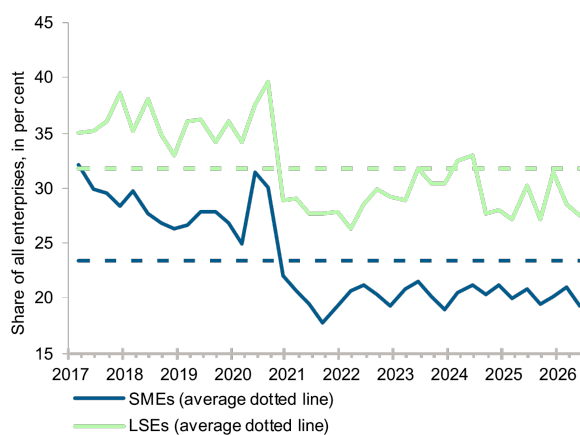


Figure 2
KfW-ifo Credit Constraint Indicator: How did banks behave in loan negotiations?

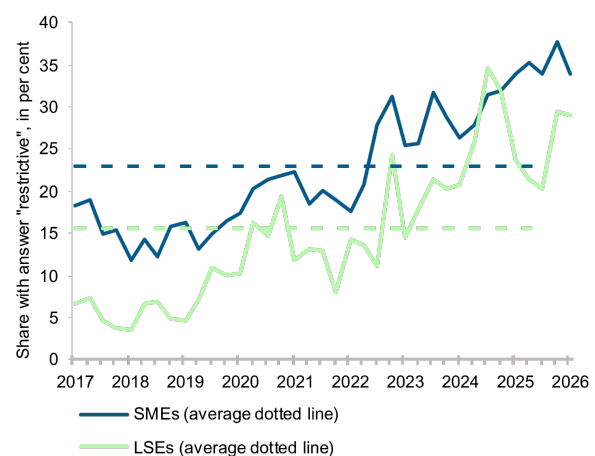


Figure 1/2: Credit demand and access of German firms, Q1 2017–Q2 2026 (KfW Research / ifo Institut, 2026)

Figure 1: share of surveyed firms in loan negotiations within the preceding three months (a proxy for credit demand); Figure 2: conditional share of those firms rating bank behaviour as 'restrictive' (KfW-ifo credit constraint). By size class, in per cent; dashed lines denote long-term averages since 2017.

Euro-area data confirm that this contraction in SME credit access is not confined to Germany. The ECB's Survey on the Access to Finance of Enterprises for the second quarter of 2026 recorded a sharp increase in bank loan interest rates: a net balance of 42 per cent of firms reported rising rates, up from 26 per cent in the previous quarter. Loan availability moved in opposite directions by firm size, improving for large firms (net balance: +4%) whilst deteriorating for SMEs (−4%) over the same period (ECB, 2026). Against this general contraction in SME credit supply, demand within the German defence supply chain continues to accelerate, driven by rising procurement contracts, a divergence likely to sharpen the credit constraint for downstream suppliers in particular.

The extent of the looming financing pressure is also evident from the trend in order backlogs. The order books of European defence companies rose from around 103 billion euros in 2017 to 291 billion euros in 2024, an increase of 183 per cent (LBBW, 2026). Applying the approximate German sector share to this figure yields a current backlog of around 50 billion euros attributable to German SME suppliers, which is likely to grow by a further 40 to 50 billion euros in the coming years if NATO procurement commitments become a reality. This backlog translates directly into a looming working capital constraint: SMEs must finance component procurement, stockpiling, staffing, certification and training, as well as production ramp-up, from their own resources, often many months before payments are received from system integrators or the state. The cash-flow mismatch between the timing of costs and cash inflows is at the operational heart of the SME financing problem, which threatens to worsen if procurement volumes continue to rise.

This gap is structural rather than cyclical in nature and reflects a longer-term problem within German industry, which the Zeitenwende has exposed but did not create. Overall, Germany's SME sector has been experiencing

a sustained contraction in real investment for several years, driven by high energy costs, weak domestic demand and restricted access to growth capital. The rise in SME bankruptcies, which according to the OECD (2026) increased by 52.6 per cent between 2023 and 2024 alone, is consistent with these pressures, although it does not by itself establish causation.

A related constraint affects German start-ups, which in turn lack venture capital. Despite Germany's reputation as a manufacturing centre and R&D hub, per capita venture capital stands at around US\$90 per year, less than a fifth of the US figure of US\$510 and below the levels seen in the United Kingdom, Canada and France (Startup Monitor Germany, 2025). However, this comparison underestimates the problem in the defence context, as it measures the aggregate depth of the capital market rather than the sector-specific exclusions that apply to defence-related activities.

Across Europe, around 44 per cent of defence SMEs rate their access to finance as difficult or very difficult (European Commission, 2025). In the German context, this figure is exacerbated by ESG-driven investment frameworks that have systematically excluded defence-related activities from institutional capital. Armaments and defence-related exclusion criteria remain among the most common negative screens applied to Article 8 and Article 9 funds under the Sustainable Finance Disclosure Regulation. Although there is no legal ban on defence investments, reputational and compliance pressures have led institutional investors, including many pension and insurance funds that would otherwise be natural providers of long-term capital to SMEs, to underweight or exclude the sector. For companies whose activities span dual-use sectors, ambiguity in ESG classification creates additional friction: security-related technologies, such as sensor technology, advanced materials, and artificial intelligence, have often qualified for public funding only if their military applications were downplayed or organisationally separated, creating governance frictions for firms and fragmenting value chains. An illustrative example is KfW Capital, which excluded direct investments in arms and ammunition companies until April 2025 but has since been able to indirectly support DSR start-ups through investments in venture capital funds.

Before these policy changes, defence start-ups, which often build the next generation of dual-use capabilities on which Germany's long-term technological sovereignty depends, relied heavily on foreign investors to bridge early-stage funding gaps. High-profile cases such as Helsing, which required capital from US and international sources to reach scale, illustrate the resulting dependence on foreign capital and the associated risk to Germany's technological sovereignty. Empirical studies generally suggest that around one in ten European start-ups financed by US venture capital relocate abroad over time (Weik et al., 2024), a pattern which, in the context of the German defence sector, would contribute to an outflow of talent, intellectual property and institutional knowledge that was initially intended to strengthen national sovereignty.

Safeguarding technological sovereignty is plausibly the main driver behind the Federal Government's recent announcement, as part of its Start-up and Scale-up Strategy (BMWE, 2026), of a new equity vehicle for public stakes in young, innovative companies of strategic relevance to defence and security. The Deutschlandfonds already pursues a similar goal and can finance strategically relevant sectors, including defence. Its record here, however, is still in its infancy: to date, only one defence-related investment under the Scale-up Direct programme has been publicly disclosed: a co-investment alongside HV Capital in Quantum Systems, a drone manufacturer valued at around US\$8 billion, in December 2025. Whether public equity vehicles can reach the broader supply chain is another question. A special survey of the KfW SME Panel finds that small and young firms in particular struggle more than others to access credit and external financing. Among SMEs that rule out credit financing, only eight per cent consider third-party equity as an alternative (Gerstenberger, 2026). The reluctance is understandable: for most young companies and SMEs, equity is a particularly expensive way to raise money, paid for in ownership shares and, often, voting rights.

The defence context adds a complication of its own. In a market where the state is both the dominant customer and the regulator, an equity stake held by that same state carries obvious sensitivities for founders and private co-investors alike. Multilateral vehicles such as the NATO Innovation Fund (NIF) partly address this concern: because public ownership is pooled across allied states, no single government sits in all three roles at once. Yet the NIF's mandate is deliberately narrow, reserved for the most innovative DSR ventures.

For the far larger population of established SME suppliers, the practical consequence remains a chronic shortage of working capital. Companies technically capable of expanding production are unable to access the necessary financing on economically viable terms, even though the number of companies entering the supply chain is ris-

ing: membership of the Federation of German Security and Defence Industries (BDSV), currently around 400 companies, is likely to grow substantially in the coming years as start-ups continue to gain a foothold in the defence and security sector and manufacturing firms switch to defence-related production (LBBW, 2026). Should this expansion materialise, the expected financing requirements are likely to increase significantly. The particularly high capital requirements of a new wave of German deep-tech start-ups are not taken into account here. The partial payments introduced by the Bundeswehr Planning and Procurement Acceleration Act (BwPBBG) do provide some relief for cash flow, albeit marginally. However, as long as banks remain cautious for commercial or reputational reasons, and regulatory rules continue to impose increased capital requirements without complementary risk-sharing mechanisms, the working capital gap in the German defence supply chain will persist. The Deutschlandfonds, with an indicated volume of around 30 billion euros, does signal a landmark commitment to the reorientation of Germany's financing architecture (KfW, 2025b). However, it remains a balance-sheet-based state instrument, and its capacity to support the scale and risk profile of downstream defence SMEs is inherently limited by the absence of comparable credit-risk substitution mechanisms.

What is noteworthy is that the German case exemplifies what may be termed the *productive capacity gap*, the latest stage in a documented lineage of financing constraints stretching from the Macmillan Committee (1931) through the Equity Gap and the Funding Escalator: innovation, demand and strategic necessity exist, but the institutional mechanisms required to convert those assets into productive scale remain insufficiently developed (Harding, 2026c). Comparative evidence shows the same scaling constraint recurring across Sweden, Norway, South Korea and the United Kingdom despite fundamentally different institutional models. This indicates that the gap is systemic rather than national and suggests that purely domestic instruments may be insufficient to close it (Harding, 2026c).

The underlying constraint is thus not capital scarcity but capital allocation: capital is available in global financial markets, yet the institutional mechanisms capable of directing that capital towards strategically important productive capability remain underdeveloped (Harding, 2026c). This is no longer merely an entrepreneurial constraint; it is a strategic one. The reframing matters for institutional design. If the binding constraint were capital availability, more sovereign spending would suffice. Because the constraint is allocative, the response must be institutional if the supply side is to adjust and therefore achieve '*productive security*' (Harding, 2026c).

3.3 Inflation trends: How higher budgets exacerbate the problem

The third coordination shortfall is, in some respects, the most strategically significant and the most politically counterintuitive. Germany's challenges in defence funding are typically framed as a resource constraint: too little money, which requires either increased government borrowing or other institutional arrangements. What this framing obscures is an equally important dimension: in the absence of supply-side intervention, additional defence spending does not simply fail to expand capacities. It actively erodes the real value of existing expenditure by generating scarcity prices and crowding-out effects in defence-industrial markets where supply cannot keep pace with synchronised allied demand.

Anticipated in the Draghi report (2024), the evidence points to this dynamic. Inflation in defence equipment across NATO economies stands at around six to ten per cent annually, significantly higher than general consumer price inflation (EDA, 2025; Harding, 2026a; NAO, 2023). In critical capability areas, the disparity is far more pronounced. Prices for artillery ammunition have risen by three to six hundred per cent since 2021, driven by the convergence of ongoing procurement for Ukraine with European rearmament needs, which are constrained by severely limited production capacities (European Commission, 2023–2025; SIPRI, 2025). In the most specialised segments of the supply chain, price dynamics are becoming discontinuous rather than incremental: a European manufacturer of optical components for high-energy laser systems is reported to have raised its prices from around US\$20,000 to around US\$350,000 per unit, an increase of 1,650 per cent, reflecting the conditions of a market with an extremely limited supplier base, non-substitutable inputs and effectively inelastic demand (Harding, 2025). Prices for main battle tanks have followed a similar trend: the Leopard 2A8 was procured by the Netherlands in 2024 at around US\$23 million per unit; a comparable Austrian procurement in 2025 involved unit costs of over US\$30 million (Defense News, 2024; Bulgarian Military, 2025).

Item-level data in Table 1 illustrate the breadth of this escalation:

Item	Approx pre-war price	Current price	Increase
122mm Grad rockets	\$800–900	\$6,000	+606%
152mm shells	\$1,200	\$5,727	+377%
125mm tank ammunition	\$1,200	\$7,420	+518%
155mm shells	\$2,120	\$8,490	+300%

Table 1: Defence industry data and reporting (2021–2025) on ammunition price escalation (Harding, 2026a)

Between the baseline of equipment inflation and the extremes of scarcity pricing, intermediate categories are also affected: missile and air defence systems have seen estimated cost escalation of 20–50 per cent, and semi-conductor input costs have risen by 10–25 per cent (Harding, 2026a).

For Germany, the macroeconomic implications are immediate. With nominal budget growth of ten to fifteen per cent and defence-specific inflation of six to ten per cent, real capability gains amount to just three to six per cent annually, less than a third of the figure suggested in the headlines. This arithmetic worsens in a scenario where increased government demand is not accompanied by measures to expand supply: higher procurement budgets translate into higher prices for the same quantities and reinforce the market structure of concentrated suppliers and limited competition that generates defence inflation in the first place. The key drivers are synchronised rearmament across NATO, which produces simultaneous demand shocks; limited industrial capacity, particularly among downstream SMEs; and a global security transformation that increases the costs of supply-chain reconfiguration. These drivers cannot be resolved by further government spending alone (Harding, 2025).

Germany’s comparatively favourable position (real gains of three to six per cent) reflects only the exceptional scale of its nominal expansion. The United Kingdom, with nominal growth of seven per cent against defence inflation of six to eight per cent, is experiencing near-zero real capability growth; the United States, at three to five per cent nominal against five to seven per cent inflation, fares little better (Harding, 2026a). Both illustrate a ‘spending more to stand still’ dynamic, and both prefigure Germany’s trajectory once the current fiscal expansion normalises. Without supply-side intervention, Germany is not exempt from this dynamic. It is merely earlier in it. The pressure is compounded by exogenous geopolitical shocks: disruptions to energy, shipping and critical-materials markets, exemplified by recurring tensions around the Strait of Hormuz, transmit cost-push inflation into fuels, explosives precursors and logistics, interacting with existing capacity constraints in a mutually reinforcing loop (Harding, 2026a). This exposure is already evident in firm behaviour. In response to escalating tensions in the Middle East, euro area firms report seeking alternative suppliers (36% for inputs and materials, 29% for energy) and increasing inventories or stockpiling (21%) as principal coping strategies – but large firms are markedly more likely than SMEs to have implemented such measures (ECB, 2026), leaving smaller downstream suppliers correspondingly more exposed to the cost-push dynamics described above.

The analytical implication is clear: without mechanisms to expand supply capacity and address the working capital constraints that prevent downstream firms from scaling up, Germany risks spending more on defence without building up more capabilities. This dynamic can be framed as a market failure, characterised by persistent underinvestment in capacity, supply concentration and misaligned procurement incentives, rather than as a cyclical cost-pressure phenomenon. Correcting this situation requires instruments that penetrate deep into the supply chain with guarantees, funding and risk-sharing mechanisms that national development banks do not currently provide at the required scale within the framework of EU state aid rules and Basel III/3.1 risk weighting requirements. Ultimately, defence outcomes depend not only on how much is spent, but on how effectively capital is allocated within the industrial system.

4. Architecture of the alternatives: SAFE, Eurobonds and the DSRB

Against this backdrop, three financing architectures are on the political agenda. Their basic structure, fiscal treatment and implications for growth differ in ways that are directly relevant to Germany’s strategic position.

National facilities modelled on the EU’s Security Action for Europe (SAFE) programme represent the fastest and, politically speaking, the easiest approach to implement. SAFE provides 150 billion euros in loans to participating member states for defence procurement within the EU’s fiscal framework. Its key advantage is speed: it expands national borrowing capacity on more favourable terms than bilateral market financing and

requires no new institutional infrastructure. Its limitations are by design. SAFE facilities are on-balance-sheet government instruments: borrowing directly increases public debt and reduces fiscal leeway under the Stability and Growth Pact. More importantly, SAFE lends to governments, not to businesses. It does not provide loan guarantees for commercial banks that finance Tier 2 to Tier 4 suppliers, nor does it address the working capital constraints that prevent downstream SMEs from scaling up. The demand side of the procurement equation receives capital; the supply side does not. Empirical modelling suggests that SAFE-like facilities generate short-term GDP multipliers in the range of 0.4 to 0.8, which tend towards zero within five years as debt burdens rise and supply chain bottlenecks persist (Harding, 2025; Barro and Redlick, 2011; Ramey and Zubairy, 2018).

Eurobonds, sometimes also proposed under the term ‘defence bonds’, go a step further. By pooling the sovereign creditworthiness of several states, Eurobonds could reduce national borrowing costs and alleviate immediate fiscal constraints, which is of considerable significance for highly indebted EU member states such as Italy and France. While joint EU borrowing for defence would mark a historic departure from the principle of national fiscal responsibility, Eurobonds, however designed, remain spending instruments, not reform instruments. Cheaper borrowing alone does not alter how efficiently money is spent: without procurement conditionality, incentives for the national duplication of industrial bases remain, and the liquidity deficit in the supply chain remains unresolved. Estimated GDP multipliers in the range of 0.8 to 1.2 are diminished when projects are carried out under nationally fragmented procurement arrangements that preclude the efficiency gains achievable under genuine institutional coordination (Harding, 2025; Olejnik, 2023).

The DSRB, announced by Canada, Albania, Belgium, Greece, Latvia, Luxembourg, Romania, Türkiye and Ukraine, seeks to address both the demand and supply sides simultaneously. It is designed as an MDB, collectively owned by member states, capitalised through paid-in and callable government contributions⁵, and, by virtue of its charter, liquidity, governance, risk management and preferred creditor status, suited to seek an AAA rating and issue bonds on its own balance sheet, backed by member capital commitments.⁶ Unlike SAFE, it would provide financing directly to the private sector along the defence supply chain, including downstream suppliers, system integrators and SME suppliers that are not reached by either SAFE or Eurobonds. Unlike government alternatives, DSRB guarantees could reduce the risk weighting on covered commercial loan tranches to as low as zero under current Basel standards, the mechanism through which they directly address the regulatory constraint identified above. And unlike any national instrument, it would concentrate risks on a separate balance sheet, which, through calculable backing by member states, could provide leverage and persistence beyond those available through the individual government alternatives examined here.

Table 2 presents a comparison of the three models based on the dimensions most relevant to Germany’s financing challenge.

Mechanism	Geography	Fiscal treatment	Supply chain	Leverage	Persistence
SAFE (national)	EU + selected partners	On-balance-sheet (increases public debt)	None – exclusively government lending, no access to SMEs or the supply chain	None	Low: multiplier falls to near zero within five years
Eurobonds	EU	Joint liability for debt; reduces government spreads	None – financing instrument without funding conditionality	None	Moderate: Cost savings do not resolve supply chain bottlenecks
DSRB	NATO + partners	Off-balance-sheet (paid-in capital recorded as an equity item)	Deep-Tier 2–4 coverage via guarantees and supply chain financing	High (5–8× paid-in capital through AAA bond issues)	High: capital deepening + private sector crowding-in + dual-use R&D spillovers

⁵Under the IMF’s Government Finance Statistics framework, paid-in capital subscriptions to multilateral institutions are classified as the acquisition of equity (a financial asset) and are accordingly excluded from the definition of government debt (IMF, 2014).

⁶The DSRB’s credit rating remains to be determined. The attainment of an AAA rating was publicly supported in a statement accompanying an advertisement published jointly by twelve major financial institutions in the Financial Times on 8 July 2026, endorsing the DSRB’s capital market proposition. Notably, as Marks (2026) indicates, a common misconception in assessing the creditworthiness of MDBs is that their credit ratings simply reflect the weighted average of their shareholders’ sovereign credit ratings. This is not the case. The African Development Bank, for example, holds AAA ratings from all major rating agencies despite a weighted shareholder rating of Ba2. Similarly, both the Asian Infrastructure Investment Bank and the World Bank maintain AAA ratings despite weighted shareholder profiles of Baa3.

Table 2: Comparison matrix of defence financing architectures. Source: Adapted from Harding (2025). Security Action for Europe (SAFE); Defence, Security and Resilience Bank (DSRB).

The comparison is analytically illuminating. SAFE and Eurobonds address the fiscal funding of demand; neither instrument addresses industrial capacity. The DSRB addresses both. SAFE-like facilities achieve the smallest and least durable multiplier effects; Eurobonds are more cost-effective than SAFE but lack procurement and supply chain conditionality; the DSRB would combine sovereign financing with supply chain guarantees to achieve the broadest and most persistent growth effects (Harding, 2025). The complementarity can be summarised briefly: SAFE generates the procurement contracts. The DSRB would create the industrial capacity to fulfil them.

5. The DSRB: Institutional Design and Mechanisms

The DSRB is best understood as the application of a tried-and-tested institutional model, the MDB, to a demand that this model has not previously served on this scale or with an explicit mandate: the financing of allied defence, security and resilience investments within a NATO-plus geopolitical framework (Table 3). The World Bank, the European Investment Bank and the European Bank for Reconstruction and Development have been operating on this structural basis for decades; their track record illustrates the model's operating parameters and its capacity to mobilise capital (Massa, 2011; Joint MDB Task Force, 2023; EBRD, 2024).

Profile	Defence, Security and Resilience Bank (DSRB)
Type	Multilateral Development Bank (MDB)
Mandate	To finance members' defence, security and resilience activities
Timeline	Charter negotiations concluded in April 2026, Target start of operations: Q1 2027
Headquarters	Canada (headquarters); Luxembourg (European Hub)
Instruments	• Public and private debt financing (e.g. loans, guarantees) • Equity financing (equity investments) • Capital market instruments (e.g. bonds, notes, securities) • Other financing instruments
Prospective founding countries	Canada, Albania, Belgium, Greece, Latvia, Luxembourg, Romania, Türkiye, Ukraine
Public financial market support	BMO Financial Group; Commerzbank; CIBC; Deutsche Bank; ING; J.P. Morgan; LBBW; National Bank of Canada; Piraeus Bank; RBC Capital Markets; Scotiabank; TD Bank Group

Table 3: Institutional profile of the DSRB (July 2026). The parameters reflect the framework agreed upon conclusion of the Charter in April 2026 and the joint declaration issued at the 2026 NATO Summit. Details remain subject to ratification by the founding member states.

The proposed capital structure of the DSRB is in line with the standard MDB architecture. Member states would contribute twenty per cent of the subscribed capital as paid-in equity⁷, the bank's capital base, which would likely be contributed in instalments and may count towards NATO's spending target, subject to the applicable accounting rules. The remaining eighty per cent would be committed as callable capital: a contingent liability that is only drawn upon once the bank's reserves and provisions have been exhausted. Notably, callable capital has never been drawn down in more than seventy years of multilateral banking history⁸. Rating agencies treat callable capital more conservatively than paid-in contributions: Fitch, for instance, assigns callable capital a

⁷An interesting design question is whether the Bank will follow the conventional MDB practice of allocating capital subscriptions broadly in proportion to members' economic weight (typically GDP), or whether Canada's initial paid-in capital will instead serve as an upper benchmark for subsequent major shareholders. The latter would cap the financial contributions (and consequently the voting influence) of larger economies, departing from the proportional shareholder model that characterises most MDBs. Germany, for instance, would receive a substantial discount despite having a GDP approximately 2.1 times that of Canada's, with the resulting capital shortfall absorbed by the remaining member states through comparatively higher capital subscriptions. Nevertheless, such a design could help address a persistent governance challenge in international organisations by limiting the concentration of decision-making authority among the largest powers while promoting a more balanced distribution of voting power for Middle Powers and Small States.

⁸Should credit losses ever exceed an MDB's ordinary loss-absorption capacity, they would be absorbed sequentially. Losses would first be covered by the Bank's income and provisions, then by its reserves, and subsequently by the paid-in capital of the entire membership. Callable capital could only be called once all of these resources had been exhausted, and then only on a pro rata basis in accordance with each member's capital subscription.

weight of only 10 per cent in its support assessment, and only where it is subscribed by sovereigns rated 'AA' or higher. An MDB's rating therefore rests primarily on its paid-in capital base, conservative leverage and the strength of shareholder support, with callable capital providing a supplementary buffer whose rating value depends directly on the credit quality of the subscribing members. A probable AAA rating would enable the DSRB to issue bonds at low cost on international capital markets and to convert every euro of paid-in capital into financing capacity with a leverage ratio of five to eight.

The size of an MDB's balance sheet depends, inter alia, on the number of member states, the level of paid-in capital, and the institution's capacity to leverage this capital through capital market operations. While projections at this stage remain inherently uncertain, the assumption that the DSRB's membership and capital base will expand over time is consistent with the historical development of most established MDBs. Table 4 therefore presents an illustrative scenario in which the Bank reaches €10 billion in paid-in capital by year 5 and €20 billion by year 10. Assuming a conservative leverage ratio of 5× paid-in capital and a 30:70 split between public- and private-sector financing, the resulting estimates provide a plausible indication of the financing capacity that the institution could mobilise.

Timeline	Paid-in Capital of all member states	DSRB BalanceSheet	Public sector: Lending to Member States	Private sector: guarantees / financing for SMEs in member states
By Year 5	€10 billion	€50 billion	€15 billion	€35 billion
By Year 10	€20 billion	€100 billion	€30 billion	€70 billion

Table 4: Indicative DSRB balance-sheet projections based on 5× leverage and an assumed 30:70 allocation between sovereign lending and private-sector financing, reflecting MDB practices and the DSRB's focus on SME supply-chain finance. The actual allocation and financing parameters will be set out in the relevant bylaws and operational policies.

The DSRB's financing toolkit can be grouped into four categories based on standard MDB instruments.

- Sovereign lending would provide member governments with long-term financing, for example, for procurement, infrastructure modernisation and stockpiling. Compared with direct market borrowing, such loans can offer longer maturities and better conditions for countries with tight fiscal constraints.
- Private-sector lending, including co-financing arrangements with commercial banks, would provide capital directly to system integrators and downstream suppliers that cannot access either SAFE or Eurobonds.
- Guarantees would allow commercial banks to extend credit to defence SMEs against DSRB cover, potentially reducing the risk weight on covered portions to zero where the eligibility conditions are met and freeing up bank balance sheets for further lending.
- Equity and mezzanine instruments would provide growth capital for start-ups and other companies in the expansion phase to support the scaling up of innovative DSR projects and dual-use technologies, and to strengthen the balance sheets of such firms where conventional debt financing is insufficient.

As is customary with MDBs, these financing instruments are exclusive to members, subject to limited exceptions that reflect the complexity of defence, security and resilience supply chains. If a member state wishes to procure tanks, submarines, or drones, for example, and draws on DSRB financing instruments to secure a funding advantage, contracts may be awarded only to companies based in other member states. This exclusivity follows directly from the bank's ownership structure: member states hold property rights in the institution through their paid-in capital. Extending access to its benefits to non-contributors would create a free-rider problem. An MDB, in other words, is not a subsidy mechanism but a bank that creates a multilateral financial ecosystem premised on positive-sum participation, in which financing advantages and spillover effects accrue to those who capitalise it. The exclusivity mechanism thus operates on two margins simultaneously: every euro financed through the DSRB could generate savings through more favourable borrowing costs, thereby increasing procurement purchasing power, and could also channel additional spending towards the supplier base of member states. As a result, procurement flows would be directed towards firms within the DSRB membership, particularly benefiting countries with diversified defence industrial bases such as Germany.

Procurement Flows	Illustrative member state financing advantage
Assumption	Medium-rated Country X (DSRB member) borrows €1 billion to procure equipment (10-year term).
Financing costs	Assume a 4.485% sovereign borrowing rate for Country X vs. 3.466% (DSRB loan)
DSRB benefit	€1 billion equipment procurement within the DSRB ecosystem
Indicative interest saving	More than 100 basis points, equivalent to more than €100 million in savings over the full term (potential additional procurement funds)
Ecosystem access	If Germany is a member, these procurement funds can flow into German industry.

Table 5: Illustrative €1 billion, 10-year sovereign loan on a bullet basis. The 4.485% sovereign rate is the average 10-year yield of prospective DSRB founding countries, excluding Ukraine; the indicative 3.466% DSRB rate reflects AAA-rated MDB funding costs plus a modest spread (Bloomberg, 29 July 2026). See Appendix A1/2. Actual outcomes vary by member state, tenor and market conditions.

The operational logic of private-sector instruments is most easily seen in concrete terms. Table 6 illustrates two representative SME financing constraints and the DSRB mechanisms that would address them.

Example	Scenario	Constraint	DSRB mechanism
(A) Advance Payment Guarantee	An SME has been awarded a contract by the BAAINBw and receives an advance payment of 10% of the contract value to finance its working capital. To protect the advance payment, BAAINBw requires the SME's commercial bank to issue an advance payment guarantee.	The commercial bank must bear both the economic risk of the guarantee and the associated regulatory capital requirements. To mitigate this exposure, it requires the SME to provide full cash collateral, effectively tying up the advance payment and preventing it from being used to finance production.	A DSRB counter-guarantee reduces the commercial bank's risk and lowers its regulatory capital requirements. This enables the bank to waive the full cash collateral requirement, allowing the advance payment to serve its intended purpose of financing the SME's working capital.
(B) Growth-Scale Mismatch	An SME receives a strategically important order whose volume exceeds its current annual turnover, creating a working capital requirement disproportionate to its existing scale.	Neither KfW nor the EIB can close the gap: KfW has no dedicated defence financing programme, and EIB financing is excluded because the firm operates in the explosives segment.	A DSRB guarantee that covers a large part of the credit risk makes the loan financeable, and the same mechanism can be extended down the supply chain to the SME's own sub-suppliers.

Table 6: Illustrative SME financing constraints and the corresponding DSRB guarantee mechanisms. The scenarios are stylised examples; actual risk-weight relief and collateral requirements will depend on the specific terms of DSRB coverage.

The institutional distinction between an MDB such as the DSRB and a national promotional bank such as KfW warrants clarification, as it is often argued in German policy debates that KfW could perform the same role as an MDB. KfW guarantees ultimately rely on the credit of the German sovereign and create national contingent liabilities. By contrast, DSRB guarantees would be issued on the Bank's own multilateral balance sheet. Adding this capability would reduce the share of SME industrial development that must be supported directly by KfW, federal guarantees or the federal budget, thereby improving fiscal efficiency without requiring additional public expenditure. In addition, under EU state aid rules, KfW liability relief in standard programmes is generally limited to fifty per cent of the outstanding loan. By contrast, qualifying MDB guarantees are intended to receive full credit substitution under the Basel framework, allowing banks to substitute the MDB's risk weight for that of the borrower, potentially reducing the applicable risk weight to zero. In particular, standard KfW SME loan ceilings, typically around €25 million, are often insufficient to finance defence-industrial capacity expansion at the scale required for effective deterrence.

This should not be interpreted as suggesting that KfW is not a necessary component of Germany's SME defence financing architecture. KfW remains necessary, but is unlikely to be sufficient to address the SME defence financing gap. An MDB such as the DSRB would complement KfW by adding a cross-border, multilateral guarantee capability that can achieve zero risk weight treatment where eligible, reducing the share of SME industrial development that must be supported directly by a single national promotional bank.

Complementarity with the Deutschlandfonds is equally relevant. Germany's state-backed investment vehicle extends public co-investments to start-ups and scale-ups, including those in the defence and security sector,

and may serve as an important signal to investors (KfW, 2025b). However, it remains a balance-sheet-based state instrument subject to national budgetary constraints, and does not provide the same credit-risk substitution, cross-border funding or deep supply-chain financing that the DSRB architecture is designed to provide. Both instruments are, however, complementary: the Deutschlandfonds mobilises domestic risk capital during the innovation phase; the DSRB mobilises allied capital during the scale-up and production phases. What the Deutschlandfonds cannot achieve on its own, however, is the multilateral guarantee mechanism that transforms Basel III/3.1 from a structural constraint on defence lending into an institutionally resolvable process and directly incentivises *house* banks to provide more effective SME supply chain financing.

This equity dimension extends beyond guarantees. As the financing-instrument taxonomy above indicates, the DSRB would also be able to deploy capital directly, providing innovative companies with equity rather than debt. The NIF offers a relevant precedent: it already performs this function today, including a multilateral shareholder structure that remains, to date, unique among allied institutions. An MDB such as DSRB could deploy a comparable range of instruments at a larger scale, effectively extending the Deutschlandfonds' innovation-stage funding logic to the allied level.

The supply-side orientation of the DSRB's guarantee mechanism, alongside its equity and mezzanine instruments, is not merely an institutional distinguishing feature but a principal reason why this analysis assigns it a larger and more persistent multiplier effect. A sectoral analysis of the defence-industrial economies of NATO Europe reveals that they generate around 149 billion euros in gross value added annually. Approximately 75 billion euros of this is generated along the supply chain, around half of total value added, and roughly 65 per cent of the 115 billion euros attributable to direct and indirect production combined, almost double the direct contribution of the defence firms themselves (40 billion euros) (LBBW, 2026). The employment effects follow the same distribution: of the approximately 1.99 million jobs linked to defence investment in NATO Europe, around 971,000 are in indirect supply chain roles. This empirical structure supports the theoretical argument as to why MDB-style financing generates more persistent multipliers than SAFE or Eurobonds: instruments that reach downstream suppliers capture the larger and economically more diffuse part of the value-added effect, whilst instruments that remain at the level of a systems integrator leave the majority of the potential growth effect untapped. The institutional logic is straightforward: rather than purchasing defence capabilities itself, the DSRB would shape the market that produces them, marking a shift from reactive procurement to proactive market shaping (Harding, 2026a).

6. A note on the Multilateral Defence Mechanism (MDM)

Following the first wave of European defence financing initiatives, the United Kingdom (HMT, 2026) proposed a further structure for sharing procurement risk internationally. Finland, the Netherlands and Poland have recently agreed to participate in this framework, termed the Multilateral Defence Mechanism (MDM). The analysis below draws on publicly available sources and is necessarily provisional, as the mechanism's full institutional parameters have not yet been disclosed and no treaty has been negotiated. Not least because the early MDM concept shares similarities with the NATO Support and Procurement Agency (NSPA)⁹, the available evidence provides a sufficiently clear basis for comparison with the DSRB, and for addressing the central question for Germany: whether the two frameworks would compete with or complement one another.

The MDM is intended to facilitate joint procurement among NATO and EU members by aggregating demand, sharing procurement risk and reducing unit costs. By pooling orders across participating states, it could provide defence manufacturers with greater certainty over future demand and encourage investment in additional production capacity. This benefit could be particularly important for SMEs, for which demand volatility remains a principal barrier to long-term capacity investment.

As currently described, the MDM would require no significant paid-in capital. It would instead extend sovereign guarantees through existing national promotional institutions, including UK Export Finance and the National

⁹The NSPA demonstrates the viability of multinational demand aggregation and joint procurement. However, an analysis by the French Institute for International and Strategic Affairs (IRIS) concludes that, despite a marked increase in NSPA activity since 2022, there is little evidence that European governments have shifted procurement systematically towards the Agency. Once the exceptional multinational Patriot missile programme is excluded, NSPA procurement has remained broadly stable relative to overall defence investment, suggesting that it continues to complement rather than replace national procurement systems (Santopinto & Rosazza Boneitin, 2025).

Wealth Fund in the United Kingdom, to jointly procured projects. The mechanism would therefore address risk primarily at the point of procurement. Its attraction to participating governments lies in the possibility of coordinating demand and supporting stockpiling without relying exclusively on conventional sovereign issuance or requiring an immediate increase in programme expenditure. In this respect, the MDM would preserve a degree of fiscal flexibility while distributing procurement risk across participants.

The MDM nevertheless raises important practical and fiscal questions. The ambition to increase stockpiles must be assessed against existing industrial constraints, as full order books already limit the capacity of suppliers to respond to additional demand. Stockpiling would also generate costs associated with acquisition, storage, insurance, security, maintenance and, where necessary, decommissioning. Unsold or obsolete equipment could require write-downs or write-offs. These issues cannot be assessed conclusively until the MDM's legal, accounting and risk-sharing arrangements have been defined. Whether its eventual design would be compatible with the balance-sheet strength expected of a AAA-rated multilateral institution will depend on how these liabilities and contingent risks are allocated. As an MDB, the DSRB would operate on a different institutional and fiscal basis.

Table 7 summarises the principal differences between the two frameworks:

Dimension	MDM	DSRB
Primary purpose	Coordinate joint procurement and share procurement risk	Mobilise long-term finance for defence investment and industrial capacity
Main point of intervention	Demand side, at the point of procurement	Supply side, across firms, banks and defence supply chains
Financing model	Sovereign guarantees delivered through existing national institutions	MDB capitalisation, guarantees, lending and balance-sheet intermediation
Paid-in capital	No significant paid-in capital envisaged	Requires paid-in capital from member states to acquire shares
Principal beneficiaries	Participating governments and firms supplying jointly procured programmes	Member states' governments and industries (SMEs, defence primes, supply chains)
Main policy contribution	Demand aggregation, lower unit costs, interoperability and procurement coordination	Commercial bank risk-sharing, long-duration finance and production-capacity expansion
Fiscal relevance for Germany	Procurement risk-sharing and diversification of funding channels	Equity treatment of capital contributions and multiplier financing effects
Principal limitation	Does not address the financing constraints of the industrial supply base	Does not coordinate national procurement decisions

Table 7: Comparative overview of the Multilateral Defence Mechanism (MDM) and the DSRB

The comparison points to a division of labour rather than institutional duplication. Neither the MDM nor the DSRB would provide Germany with a significant advantage in the narrow sense of reducing the sovereign borrowing costs of the federal government. This does not make the two frameworks substitutes. Rather, it demonstrates that they address different constraints. The MDM seeks to coordinate procurement and distribute risk on the demand side, whereas the DSRB seeks to mobilise capital and absorb financing risk on the industrial supply side.

This distinction also explains how the two mechanisms could reinforce one another. The aggregation of orders through the MDM could increase the predictability of demand, reduce procurement costs and support interoperability and standardisation. However, suppliers would still require sufficient working capital and long-term finance to expand production. The DSRB's guarantees on commercial bank lending, together with its capacity for syndicated and long-duration financing, could help firms respond to the demand generated by the MDM. Its instruments could therefore expand the volume of finance available to SMEs and supply-chain companies involved in jointly procured projects.

For Germany, the central question is therefore not whether to choose between the MDM and the DSRB, but whether participation in the MDM alone would be sufficient to support the longer-term transition to industrial preparedness. The preceding analysis suggests that it would not. Expanding the productive capacity of German defence SMEs and supply chains would require financial leverage of the kind that an MDB could provide through guarantees on commercial bank lending. A procurement-focused mechanism does not perform this

function. Instead, an MDM-only approach would likely aggravate the inflationary dynamic identified earlier. Demand aggregation without corresponding supply-side capital mobilisation concentrates additional purchasing power on an unexpanded industrial base. In other words: more money chasing the same goods.

The fiscal effects of the two mechanisms would also be related but distinct. Neither would produce an immediate budgetary uplift, and neither would remove the need for national defence expenditure. Both could, however, mobilise additional financing capacity while limiting short-term pressure on existing spending envelopes. There are consequently sound reasons for the two frameworks to develop in tandem. The MDM, if negotiated and ratified by key NATO and EU members, could respond to the need for coordinated procurement. The DSRB would perform a more permanent institutional role¹⁰ by providing capital mobilisation, balance-sheet intermediation and long-duration industrial finance. Certain functions that could support the interaction and individual objectives between the two frameworks, including multilateral guarantees, cross-border pooled procurement finance and long-duration syndicated lending, are likely to be more scalable when housed in a dedicated multilateral institution than when assembled solely through national sovereign instruments, where higher transaction costs arising from information asymmetries are probable.

The MDM and the DSRB can therefore be situated within a single capability-formation architecture. Within that architecture, the MDM would coordinate allied demand and distribute procurement risk, while the DSRB would mobilise liquidity and long-term capital across the defence supply chain (Harding, 2026c). Their relationship would be complementary rather than mutually exclusive: one would help create a credible and coordinated market for defence products, while the other would help ensure that the industrial base possessed the financial capacity to supply it.

The implication for Germany is straightforward. As with the NSPA, participation in the MDM could improve procurement coordination, strengthen allied demand aggregation and diversify the channels through which procurement risk is financed. This assessment is necessarily conditional on the MDM's final design. In particular, the final design must clarify how it differs from the NSPA, how stockpiling can be managed in a low-risk and financially sustainable manner, and how it could become successfully operational within a timeframe that is compatible with current defence-industrial constraints, especially given the almost four-year order backlog across the European defence industry identified by McKinsey (2026).

What the MDM would not address by design, however, are the financing constraint that continues to limit investment across Europe's defence industrial base, particularly in Germany. Those constraints require an institution capable of mobilising private capital at scale through guarantees and long-term lending. The central question for Germany is therefore not which of the two institutions it should support, but whether it can afford to remain outside the supply-side financing framework that the MDM does not provide and that existing national instruments have not been able to replicate.

7. Growth Effects for Germany: Scenario Analysis

The growth effects of alternative financing architectures are assessed using the multiplier framework developed by Harding (2025), which combines three strands of evidence: the academic literature on defence expenditure multipliers; empirical evidence on the growth effects of MDBs; and the capitalisation and leverage parameters of the respective models. This approach generates scenario-based estimates of GDP levels rather than point forecasts; the results should therefore be understood as orders of magnitude and underlying trends, not as predictions.

The literature on defence multipliers provides the starting point. Across the relevant studies, the short-term multipliers for additional defence expenditure in advanced economies typically range from 0.4 to 0.8 (Barro and Redlick, 2011; Ramey and Zubairy, 2018). When focused on domestic procurement and capital investment, the multipliers approach the upper limit; when channelled into imported equipment or labour costs, the effects tend towards zero (Becker & Dunne, 2021). More recent work adds important qualifications: Olejnik (2023) shows that multipliers in Central and Eastern Europe rise briefly to 1.5 before declining; SUERF (2025) shows that under optimal conditions (domestic-oriented procurement, fixed exchange rates, economic underutilisation),

¹⁰On the broader argument for institutional permanence in economic security architecture, see Harding, R. (2025). *The World at Economic War: How to Rebuild Security in a Weaponised Global Economy*. London: London Publishing Partnership.

multipliers can reach 2.0, but that these conditions are rare. For Germany, import dependence in certain platform categories and the concentration of early procurement contracts at the system integrator level point to the mid-range of this spectrum for government-instrument scenarios. The multilateral finance literature demonstrates that investments by MDBs generate larger and more persistent growth effects, primarily through the crowding-in of private capital and the supply chain financing mechanisms that characterise MDB operations (Massa, 2011; Joint MDB Task Force, 2023): a ten per cent increase in MDB commitments is associated with a 0.9 to 1.3 per cent increase in GDP, with the strongest effects in infrastructure and industry (Massa, 2011). For open economies, multilateral structures additionally reduce import leakage, e.g., the loss of multiplier effects to foreign suppliers, by localising supply chains within the membership: a mechanism directly relevant to Germany’s documented import dependence in key platform categories.

Table 8 presents a scenario analysis for Germany based on three financing configurations.

Scenario	Year 1–2 (GDP effect)	Year 5 (GDP effect)	Year 10 (GDP effect)
Scenario A: KfW alone (government baseline)	approx. +0.9–1.2%	approx. +1.5%	approx. +2.0 %
Scenario B: KfW + Deutschlandfonds (extended government scenario)	approx. +1.0–1.3 %	approx. +1.6–1.8 %	approx. +2.2%
Scenario C: DSRB + KfW + Deutschlandfonds (multilateral)	approx. +1.5%	approx. +1.8–2.4 %	approx. +3–4 %

Table 8: Indicative GDP growth effects for Germany under alternative financing scenarios. Note: The estimates are mean indicators within plausible scenario ranges; they should be understood as scenario projections, not as forecasts. Methodology based on Harding (2025), combined with multiplier estimates from Barro and Redlick (2011), Ramey and Zubairy (2018), Olejnik (2023), Becker and Dunne (2021), as well as SUEF (2025) and MDB leverage parameters from Massa (2011) and the Joint MDB Task Force (2023).

Scenario A: KfW alone, reflects the baseline government scenario. Short-term annual GDP effects in the range of 0.9 to 1.2 per cent materialise within one to two years and rise to around 1.5 per cent by year 5 and to 2.0 per cent by year 10. The main constraints are KfW’s programme volume limits, the 50 per cent liability cap, which leaves residual risk on banks’ balance sheets – and the lack of deep supply chain financing for downstream suppliers.

Scenario B: KfW in combination with the Deutschlandfonds, noticeably improves the domestic starting position, particularly for innovation financing and early-stage SME growth; estimates rise in the medium term to around 1.6 to 1.8 per cent by year 5 and 2.2 per cent by year 10. However, the toolkit remains constrained by government fiscal and regulatory constraints, neither the working capital gap nor inflation trends are addressed structurally.

Scenario C: DSRB in combination with KfW and the Deutschlandfonds, produces fundamentally different results, both in terms of magnitude and the mechanism of persistence. Short-term GDP effects of around 1.5 per cent emerge earlier, as larger and better-targeted financing envelopes achieve higher multiplier effects. The medium-term estimate of 1.8 to 2.4 per cent by year 5 reflects capital deepening, improved liquidity distribution in the downstream supply chain and risk mitigation for commercial banks through DSRB guarantees. The long-term estimate of three to four per cent by year 10 reflects the cumulative effects of dual-use R&D spillovers, productivity gains from a deeper and better-capitalised industrial base, and sustainable private capital crowding-in. Existing studies suggest that sustained increases in defence R&D can boost long-term productivity by around 0.25 percentage points annually, with potential cumulative GDP gains of one to two per cent after a decade where procurement is focused on high-tech and dual-use capabilities (Ruttan, 2006; Harding, 2025).

There is a further dimension that the GDP estimates do not directly capture, but which supports the direction of the findings. Because the DSRB’s guarantee mechanism would expand downstream production capacity, it would mitigate the scarcity-price dynamics identified above: firms that receive working capital and are able to expand production absorb demand shocks through volume increases rather than price rises, which reduces the inflation premium in procurement costs. For Germany, where nominal budget growth of ten to fifteen per cent currently generates only three to six per cent in real capacity growth, the supply-side effect of DSRB-backed investment would add a real capacity premium that goes beyond the GDP multiplier values alone. Defence

expenditure structured through an MDB does not merely increase GDP; it improves the real return on every euro of public funds spent.

8. Germany's strategic interest

The case for German participation in the DSRB is based on three converging strategic interests that no single national instrument is designed to address simultaneously.

The first is fiscal discipline within the framework of European regulation. Although Germany may be unlikely to draw on DSRB loans, membership would broaden the range of future financing options to include a counter-cyclical instrument that opens up additional scope for investment, particularly during periods of fiscal strain. Such strain is likely to intensify rather than ease. Following the Ankara summit's formalisation of progressive US disengagement from European conventional defence, Moody's (2026b) assessed the resulting reallocation of responsibility towards European NATO members as credit-negative for European sovereigns, precisely because it coincides with rising expenditure that must be financed against already-elevated debt trajectories, without a commensurate near-term increase in European industrial capacity to absorb it.

According to Commerzbank Research, under current expenditure trajectories, Germany's public debt-to-GDP ratio is likely to trend towards ninety per cent of GDP by 2035 (Krämer & Solveen, 2025), whilst the Bundesbank has signalled that a return to stricter budgetary discipline may be necessary after that date (Deutsche Bundesbank, 2025). In this context, DSRB membership is more than an accounting technicality; it represents a tangible fiscal advantage. DSRB loans would provide financing to most member governments on more favourable terms, less dependent of the strength of their national balance sheets, because an MDB's credit rating is determined by its own capital structure rather than by the creditworthiness of any single member state. Germany would in turn benefit indirectly from these financing advantages: Lower borrowing costs for partner countries could translate into additional procurement from German defence firms, thereby supporting industrial output and GDP growth.

Compared with the credit-negative implications that Eurobonds would carry for Germany, the DSRB would offer a considerably more attractive solution as the capital contribution required for membership would be too small¹¹ to have any material effect on Germany's sovereign credit rating, let alone on its sovereign borrowing costs. Given the documented positive effects of MDB financing on GDP growth, such an approach, particularly when combined with national promotional instruments, could support growth and, if those effects materialise, improve debt-to-GDP dynamics while providing a scalable mechanism for financing European defence capabilities. The latter should not be underestimated, as Germany's defence begins in the Baltic states, Ukraine and Poland – not at the River Elbe.

The second area of interest concerns industrial competitiveness. The Draghi report (2024) identified the financing of defence industrial capacity as central to European competitiveness and highlighted the need for demand aggregation and industrial coordination, all issues that the DSRB directly addresses. Germany's SME-driven industry is not merely a domestic economic asset. It constitutes the actual production base on which any serious expansion of prime contractors and European defence capabilities depends.

Germany's diversified defence industrial base, in particular, positions the country to benefit from both public and private-sector financing should it join this ecosystem. The magnitude of these benefits depends primarily on the size of the Bank's balance sheet and the relevant bylaws and operational policies adopted by the first Board of Governors, acting on behalf of the founding member states. Using the illustrative balance sheet trajectory (Table 4), together with the assumed 30:70 allocation between public- and private-sector financing, the analysis adopts a conservative allocation scenario for a member state such as Germany. Specifically, it is assumed that 15 per cent of DSRB private-sector financing accrues to German SMEs and that 20 per cent of DSRB-financed procurement by member states is awarded to German prime contractors. Germany's €1 billion paid-in capital contribution would be pooled with the contributions of other member states to capitalise the bank and secure Germany's access to its financial ecosystem. Table 9 presents the illustrative financing and procurement flows that could accrue to German industry.

¹¹ Assuming a paid-in contribution of €1 billion and callable capital of €4 billion, Germany's total exposure of €5 billion would amount to less than 3 per cent of its subscribed capital commitment to the European Stability Mechanism (ESM) and less than 11 per cent of its subscribed capital commitment to the EIB.

Flow into German industry	By Year 5	By Year 10
German SME share of private-sector lending and guarantee volumes (15% assumed)	€5.25 billion	€10.5 billion
German prime contractors' share of procurement financed via DSRB sovereign lending (20% assumed)	€3 billion	€6 billion
Total order and financing flow to German industry	€8.25 billion	€16.5 billion
German paid-in capital contribution	€1 billion (equity)	

Table 9: Indicative financing and procurement flows to German industry under the illustrative balance-sheet trajectory presented in Table 4. The calculation assumes that 15 per cent of DSRB private-sector lending and guarantee volumes accrue to German SMEs and that 20 per cent of DSRB-financed sovereign procurement is awarded to German prime contractors. These are conservative allocation assumptions for a member state with a broad and diversified defence industrial base. The actual allocation and financing parameters will be set out in the relevant bylaws and operational policies.

Approximately €8.25 billion in procurement and financing flows to German industry by Year 5, against a €1 billion paid-in capital contribution, an ROI of more than 8:1 within five years. The initial contribution (Government ROI) is expected to be recovered through higher tax receipts and GDP effects well before Year 5. Added to this are the innovation and productivity spillovers associated with sustainable (dual-use) R&D investments, which suggest a positive productivity effect extending beyond the defence sector. At a time when Germany's economic growth performance has slowed considerably compared with its G7 peers, the DSRB represents one of the few available instruments that combines security investment with a credible and sustainable growth mechanism.

The third consideration concerns efforts to achieve strategic autonomy. The DSRB is currently undergoing active institutional development. Founding membership would give Germany influence over the institutional parameters that will shape the bank's long-term operations: governance structure, weighted voting arrangements, procurement eligibility criteria, the treatment of dual-use technologies, and the selection of senior management. These are not administrative details, but the parameters through which a multilateral institution embeds a nation's industrial and strategic priorities into its operational DNA. As with any multilateral institution, founding members write the rules. Later members inherit them.

Financing can serve as a coordinating mechanism of allied security policy by giving strategic commitments operational credibility. The DSRB would institutionalise this logic. Whereas NATO provides the political security guarantees, the DSRB would provide the financial guarantees needed to underpin them.

9. Conclusion

At its core, Germany's defence funding challenge is not solely a problem of political will or fiscal leeway. It is also a problem of institutional architecture. Germany's current financing architecture evolved during a period of declining defence demand and fiscal prudence. With the Deutschlandfonds and the sector-specific reform of the debt brake, the German Federal Government has introduced instruments that acknowledge the end of this balance. However, the new equilibrium between supply and demand within the defence industrial base calls for an institutional solution that bridges the gap between sovereign ambitions on the demand side and the requirements of private capital. An MDB could build this bridge.

Our paper has identified three coordination shortfalls that government instruments do not fully resolve. Basel III/3.1 capital requirements and EU state aid rules constrain commercial banks' ability to scale up defence lending; qualifying MDB-backed guarantees could alleviate this constraint through credit-risk substitution, subject to regulatory eligibility. The working capital and growth financing gap reflects the chronic undercapitalisation of Germany's downstream SMEs, exacerbated by ESG-related exclusions from institutional capital markets and a comparatively shallow domestic growth-financing ecosystem. The inflationary dynamics of synchronised rearmament mean that, without supply-side intervention, additional government spending generates price rises rather than capability gains, thereby exacerbating the very problem it is intended to solve. An MDM-only approach could intensify this inflationary dynamic if demand aggregation were not matched by supply-side

finance.

The proposed DSRB is designed to address all three coordination shortfalls simultaneously. Its architecture could support fiscal flexibility within the framework of EU regulations. Its guarantee mechanism could provide Basel credit-risk substitution that KfW cannot provide to the same extent, subject to regulatory eligibility. Its supply chain financing instruments could reach downstream SMEs directly, expanding production capacity and dampening scarcity-driven price rises that are already eroding the real value of Germany's nominal expenditure increases. And its leverage ratio (five to eight times the capital contributed) could enable comparatively modest government contributions to support financing envelopes that paid-in capital alone could not support.

The scenario analysis presented above suggests that DSRB-backed financing could generate not only greater GDP effects than the alternative options analysed, but also qualitatively different ones: more persistent, more broadly distributed across the industrial base, and reinforced by supply-side productivity gains that conventional demand-side expenditure does not generate. Germany's strategic choice is not between the DSRB and the status quo. It lies between incremental improvements to a funding architecture that was never designed to meet deterrence-level requirements, and an institutional break that redefines the fundamental financial conditions for allied security investment. A nation that cannot finance its own deterrence in the long term will spend more without becoming any safer.

Germany would not be alone in this. Schularik and Binder (2026) argue that Germany's defence funding problem has an equivalent at alliance level: fiscal constraints among NATO partner states create pan-European bottlenecks in production capacity, and the pace of investment in deterrence is just as significant as its volume. Front-loading investment to achieve credible deterrence requires financing instruments that national budgetary cycles, which are tied to annual budgets and medium-term financial frameworks, are not well suited to provide. This alliance-based argument adds an external justification to a case for collective financing arrangements of the DSRB type: Germany not only faces constraints that cannot be overcome through national instruments alone; the industrial capacity underpinning allied deterrence is itself a public good that no single alliance member state can provide on its own. At the same time, it is essential to institutionally define the framework for liability limitation to preserve one's own fiscal sovereignty, which is a core prerequisite for any form of effective deterrence. The DSRB would address these conditions as a vehicle for growth, driving targeted investment and crisis resilience. Operating outside the federal budgetary framework but alongside existing national instruments, it could strengthen industrial capacity without requiring additional federal borrowing.

The historical significance of Bretton Woods lay not in the creation of individual institutions, but in the establishment of an institutional architecture capable of aligning finance, productive development and international cooperation (Harding, 2026c). The DSRB should be understood in similar terms: not as another financing facility, but as one element of an institutional architecture through which allied nations convert economic strength into productive capability, and productive capability into security.

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Appendix

A1 Sovereign bond yields

Countries	5y	10y
Albania	3.69	4.67
Belgium	3.20	3.70
Canada	3.18	3.62
Germany	2.93	3.19
Greece	3.29	3.89
Latvia	3.38	3.81
Luxembourg	3.10	3.33
Romania	6.83	7.11
Türkiye	5.33	5.75
Ukraine	n/a	n/a

Note: Ukraine's credit risk cannot be priced on the basis of reliable figures, given the current situation and the ongoing restructuring of sovereign debt Source: Bloomberg (29 July 2026)

A2 Indicative DSRB bond yield

References	5y	10y
EUR Midswap	3.060%	3.196%
Spread EIB above swap	4bp	21bp
Spread EBRD above swap	6bp	22bp
Spread IBRD above swap	6bp	23bp
Assumed DSRB spread above swap	10bp	27bp
Indicative DSRB yield	3.160%	3.466%

Source: Bloomberg (29 July 2026)

Methodological notes

- The yields presented represent a snapshot as of the reference date. Both the risk-free rate and credit spreads are subject to continuous market movements and can shift considerably; for example, pronounced interest rate movements have been observed in recent months, driven among other factors by developments in the Middle East, the resulting rise in oil prices, and the subsequent changes in inflation expectations. The yields shown should therefore not be understood as permanently representative.
- Sovereign yields were derived from government bonds outstanding in the market. Where no bond with a residual maturity of exactly five or ten years was available, yields were interpolated from the available curve.
- For states without a sufficiently liquid EUR bond curve, yields were derived from government bonds issued in local currency and converted into EUR-equivalent financing terms using current cross-currency swap parameters. The results depend on the underlying market assumptions and swap conditions.
- The financing costs shown for the DSRB are purely indicative and rest on the assumption that supranational issuers such as the EIB, the EBRD, the IBRD (World Bank) and comparable institutions constitute appropriate reference peers.
- The indicative DSRB yield is derived, following standard capital market practice, as the sum of a risk-free EUR mid-swap rate and an assumed credit spread. The assumed spread is anchored to the observable spreads of comparable supranational issuers, plus a moderate premium reflecting the absence of a market and issuance history for a new issuer.

- The actual credit spread of a future DSRB issuance would depend materially on its final design. Key factors would include the composition of the membership, the capital structure, governance arrangements, the design of capital call mechanisms, and the final rating.
- Accordingly, the spread actually demanded by the market may under some scenarios deviate substantially from the values presented.