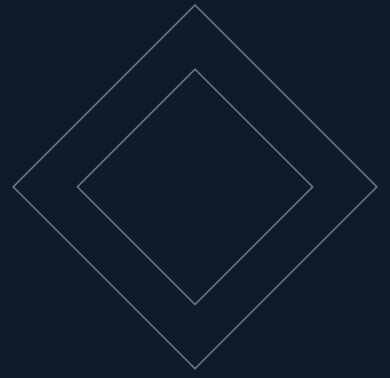




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Germany's defence SME finance gap: why access to capital is a strategic vulnerability

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A STUDY BY

Dr Rebecca Harding

Independent Economist · Rebeccanomics

Rebeccanomics

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Germany's defence SMEs face a systemic access-to-finance challenge that has become a strategic vulnerability. Dr. Rebecca Harding on the evidence, the mechanisms, and what multilateral instruments could unlock.

Dr. Rebecca Harding | 17 March 2026

Executive summary

This document is based on a review of documentary evidence largely published since April 2025 on the defence SME funding gap in Germany. The core findings are:

Defence production depends heavily on SMEs. In Germany, SMEs generate around 80% of defence industry turnover (about €23bn) and form the backbone of the defence supply chain.

These companies must finance production themselves before revenue arrives. SMEs often need to fund materials, inventory, certification, and production expansion months before payment, creating large upfront financing needs.

Bank lending to SMEs is tightening, not improving. 37.8% of German SMEs report restrictions on bank credit, the highest level since 2017, and only one in five SMEs even attempts to seek bank financing.

Defence order books are expanding faster than SME balance sheets. European defence company backlogs have grown from €103bn in 2017 to €291bn in 2024, implying about €50bn of backlog linked to German SMEs that must finance production capacity.

There is already a measurable financing gap. Estimates suggest €2–4bn in equity financing and €1–2bn in debt financing is missing for German defence SMEs, and this gap is likely to grow as the sector expands.

Defence spending is rising rapidly across Europe. However, the SME supply chains that manufacture much of the equipment lack sufficient access to credit to scale production. The clear risk is that defence budgets can increase faster than industrial production capacity. The issue is therefore not a lack of demand for defence production, but a shortage of capital available to the companies that must expand manufacturing capacity.

Introduction

This document is a summary of documentary research scanning publications from banks, industry representative organisations and academia/think tanks to assess the scale of the defence SME funding gap in Germany. The German government voted for big changes in the way that defence would be funded in the country in March 2025. The publications assessed are largely from after that date, to give a realistic picture of the need for increased SME financing now in spite of the scale-up of overall funding to defence. As highlighted by Commerzbank, defence SMEs do not have the levels of capital across Europe generally that they need.

Figure — Commerzbank Research (Oct 2025): Defence SMEs' challenges accessing debt & equity finance; R&D and production dominate demand for capital. Survey of 143 EU defence SMEs. Source: CSIL, SpaceTec Partners, Commerzbank Research.

Commerzbank is one of Germany's largest banks for funding SMEs through lending but cannot meet increased demand — not for lack of willingness, but because defence SMEs lack the capital depth and balance sheet strength to scale production in line with demand, particularly given long procurement cycles

and high upfront investment needs. For banks, this creates a risk-return mismatch: lending to SME suppliers without direct access to government contracts is capital-intensive and difficult under current regulatory and cooperative financial frameworks. German SMEs constitute around 80% of the current defence turnover in Germany (which totals €23bn) and face a number of strategic and financing challenges according to LBBW:

Current order backlog at European defence companies rose to €291bn in 2024. Assuming a stable share for Germany / DACH, this suggests a current backlog of around €50bn for German SMEs. With around €200bn per year of needed investment in Europe, one could expect the backlog for German SMEs to increase by another €40–50bn over the next ten years, given they are primarily bank-financed and limited by their balance sheet size.

There are currently 400 members of the German defence association. This is expected to scale as innovative defence companies gain traction and manufacturing businesses transition to defence — to around 2,000 businesses. This will at least double if not triple the anticipated financing requirements.

Critical points specific to Germany's Defence Industrial Base

First, the German defence sector is SME-driven but dominated by systems integrators/Primes. This means that while SMEs play a critical role in the supply chain, they rarely control final contracts or procurement relationships. This affects their access to finance since SMEs cannot currently use government contracts directly as collateral.

Second, the financing gap will increase as NATO targets rise from 2% to 5% of GDP. Much of this expansion in spending is forecast to be consumption (i.e. equipment procurement) rather than investment, requiring different (non-VC) mechanisms for delivering private capital to the market.

Third, the way in which defence procurement is currently structured, and its interface with private credit, means that the growth effects of increases in German defence financing are likely to be limited. A more flexible approach to SME and supply chain financing will help address this, and private credit is a core part of the solution.

To summarise, there are still major difficulties for German SMEs without targeted financial instruments; increased defence spending risks:

- concentrating funding in large primes
- leaving SME supply chains undercapitalised
- slowing the expansion of Europe's defence industrial capacity.

Detailed Findings

Generally defence SMEs in Germany are positive about future growth within a European context but are pulling out of the US because of uncertainties. This suggests an even more pressing need for rapid scale-up funding in the form of debt and equity. As early as 2024, the OECD argued that German SMEs would benefit from more debt-based finance to encourage exporting and international growth.

There is a lack of German-based VC for SMEs — they have had to go abroad for funding. This particularly affects German aerospace businesses. More recently the same commentary argues that while there is plenty of money in German defence generally, this is failing to reach the SME sector and will affect its capacity to scale.

There is a need for collaborative financing that is debt-based for SMEs across Europe.

According to the KfW-IFO report, 37.8% of SMEs in Germany report restrictions in accessing bank credit — the highest levels since the survey started in 2017. Only one SME in five is actively trying to access bank credit as a viable financing option. While this is not defence SMEs specifically, it highlights that credit conditions for SMEs are not improving.

Basel IV requirements make the cost of capital high and therefore lending to smaller SMEs inviably expensive, pulling the banking sector away from essential debt-based financing for defence SMEs. There is a requirement to bring ESG considerations in line with the requirements of private credit in the sector.

European defence SMEs generally say they need procurement contracts in order to unlock supply chain funding and a reduction in ESG reporting requirements.

The gap in funding for SMEs in the defence sector is around €2–4bn for equity financing and between €1bn and €2bn for debt financing in Germany. Europe's focus should be on debt-based solutions according to the Kiel Institute.

There is a hole in financing for German SMEs under different assumptions for %GDP contributions to NATO according to Hubertus Bardt (IW Köln, January 2025). NB: this needs to be treated with caution because it is data from before the large-scale expansion in German financing.

Figure — Bardt, H. (IW Köln, Jan 2025): projected funding gaps in billions of euros as spending targets rise from 2% to 5% of GDP. Own calculations. Note: predates the 2026 large-scale expansion in German defence financing.

Schularik & Binder (2026) argue that Germany has dedicated money to defence spending but needs to match its financial strengths with the capacity to create long-term scalability against the likelihood of long-term conflict. Key is the capacity for rapid expansion in productive capability, which is not evident at the moment; Germany should be open to collective defence finance because of the need to frontload spending to scale quickly for deterrence, the guns-vs-butter constraint elsewhere in Europe, and the way joint liabilities ensure European financial autonomy.

Germany has a per-capita investment gap in defence SMEs compared to the US and France. The US spends around €510 per head on defence SMEs, the French €108 and Germany €90. Thus, while the Deutschlandfonds is to be welcomed, it is too little without significant private sector engagement. The Association of German Start-ups argues for an acceleration of private credit and debt-based finance to enable rapid scale-up. The German Chamber of Commerce and Industry (IHK) agrees there needs to be an effective financing structure for rapid scale-up and international growth but does not prescribe debt financing alone.

The core argument is that the spending scale-up flows primarily to large primes through procurement contracts. SMEs need a different mechanism — patient, guaranteed, intermediated debt — which is precisely what a multilateral bank structure provides and what the market alone is still not delivering as of mid-2025.

LBBW internal research (2026) highlights the following challenges:

Industrial scale-up will require significant CapEx: higher volumes imply investment in production lines, machinery, tooling, testing infrastructure, certification capacity, and broader industrial ramp-up.

Bridge financing is a core constraint: interim funding needs are rising materially, especially for working capital, order pre-financing, inventory build-up, and guarantee lines.

Backlog growth increases financing pressure: order backlog at European defence companies rose from €103bn in 2017 to €291bn in 2024 (+183%). Suppliers must finance production expansion well before cash is collected.

The bottleneck sits in the supply chain, not only at prime level: large contractors rely on a broad base of mid-sized suppliers, so funding constraints at SME level can directly slow delivery capacity.

SMEs are structurally more exposed: key constraints include limited capital reserves, limited staffing, and dependence on larger customers.

The economic impact is heavily supply-chain driven: annual defence investment in NATO Europe translates into roughly €149bn of gross value added, with about €75bn generated indirectly along the supply chain.

Employment effects are concentrated beyond the primes: around 1.99 million jobs are linked to this investment effect in NATO Europe, including about 971,000 indirect jobs in the supply chain.

Innovation financing is part of the picture: R&D spending by European defence companies has increased by 54% since 2018.

Suppliers account for roughly 50% of total gross value added (€75bn out of €149bn), and about 65% when comparing only direct and indirect value added (€75bn out of €115bn), almost double the direct contribution of the defence firms themselves (€40bn).

According to Deutsche Bank, general credit constraints interact with procurement in ways that disproportionately restrict access to finance for defence businesses. SMEs have to finance component sourcing, materials and inventory, certification and testing and scaling from their own revenues before they receive payment from primes or government. Since short-term credit has declined by 0.9% year on year to December 2025 and medium-term lending by around 3.1%, this is likely to cause real challenges for scaling the SME defence industrial base quickly. Multilateral mechanisms for addressing the SME cross-border supply chain funding gap were developed during the pandemic and can be used as a benchmark for a multilateral funding framework now.

Conclusion

The evidence reviewed suggests that Germany's defence financing challenge is not simply one of increasing public spending, but of ensuring that financial flows reach the SME-driven supply chains that underpin the country's defence industrial capacity. While recent policy changes have significantly expanded fiscal space for defence, the mechanisms required to translate this spending into scalable industrial production remain incomplete. SMEs face tightening credit conditions, limited access to venture capital, and structural barriers in procurement that prevent them from leveraging government contracts to secure financing. Given that suppliers generate a substantial share of defence-related economic value added and are responsible for much of the sector's innovation and manufacturing capacity, these financing constraints risk becoming a critical bottleneck in Europe's ability to expand defence production. Addressing this gap will require new financing structures that combine public guarantees, private credit, and collaborative European financing mechanisms capable of providing the long-term, intermediated capital needed to support SME-led scale-up across the defence industrial base.