How Defense Financing Actually Works

The Capital Markets Mechanics Behind European Rearmament

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IDEA IN BRIEF

THE GAP

Europe has committed €800 billion to defense. The political and strategic debates are well documented. What is almost entirely absent from public discussion is the operational mechanics: how the money is actually raised, who creates the instruments, how capital markets absorb the debt, and how the money flows from bond auction to ammunition factory.

THE MECHANICS

Defense finance operates through a chain of institutional decisions, capital markets operations, and procurement pipelines. Each link has its own logic, constraints, and failure modes. This paper traces the chain end to end—using Germany as a worked example—and explains why the plumbing determines the pace of rearmament.

THE IMPLICATION

The gap between political commitment and operational delivery is not primarily fiscal—it is procedural. The institutions that must convert political will into flowing capital are slow, fragmented, and in several cases still being built.

When a head of state announces a defense spending increase, the public narrative moves immediately to geopolitics:

What threat justified it?
What capabilities will be acquired?
How does it change the balance of power?

These are important questions, but they skip the most consequential step: how the money is actually raised, channelled, and spent.

Between a political commitment and a signed procurement contract sits a chain of institutional, legal, and financial mechanisms that determines whether pledged euros become operational capability or remain aspirational numbers in a summit communiqué. This paper explains that chain, in steps, instrument by instrument, and traces it in detail through Germany, the country that has undertaken the most ambitious fiscal reform for defense in post-war European history.

As the constraints on European rearmament become increasingly procedural and financial rather than political, it is critical that policy-makers and financiers understand these mechanics. Increasingly, the political will exists, however the growing bottlenecks are institutional: the speed at which instruments can be designed, the legal bases on which they rest, the capacity of capital markets to absorb defense-related issuance, and the procurement systems through which money is translated into capabilities.

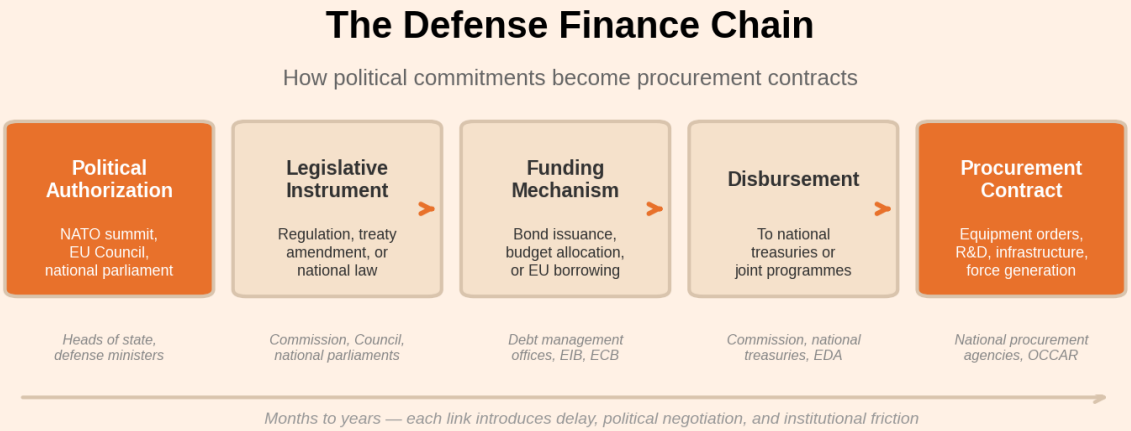

Figure 1: *The defense finance chain. Each link involves different actors, different legal bases, and different timelines. The bottleneck is rarely the first link.*

WHERE THE €800 BILLION COMES FROM

The €800 billion headline figure is not a single pool of money. It is an aggregation of at least six distinct financing channels, each created by different institutions, funded through different mechanisms, and subject to different constraints. Understanding what each channel actually is—and is not—is essential to evaluating whether Europe's rearmament plans are financially executable.

National sovereign borrowing remains by far the largest source. When a member state increases its defense budget, the additional spending is typically financed through general government borrowing—the same mechanism that funds healthcare, pensions, and infrastructure. The national escape clause of the Stability and Growth Pact provides regulatory permission to borrow more, but it does not change what capital markets are willing to lend. Countries with low debt and strong credit ratings can access this channel easily. Countries with high debt cannot.

EU-level instruments provide a second, smaller channel. SAFE offers €150 billion in EU-backed loans. The European Defense Fund and EDIP provide roughly €10 billion in grants. The EIB has opened defense lending at €3.5 billion per year. These instruments are real and operational, but they are a fraction of what national budgets must deliver.

Germany's debt brake reform is the single largest national commitment—approximately €200 billion in additional borrowing capacity through the mid-2030s for defense above one percent of GDP. This is permanent and constitutionally embedded. But it applies only to Germany.

Private capital mobilization is the most speculative channel. The Commission has proposed guarantees that could leverage up to €200 billion. But European defense companies face structural barriers to private capital: ESG exclusions, fragmented regulation across twenty-seven jurisdictions, and investor caution about government procurement timelines.

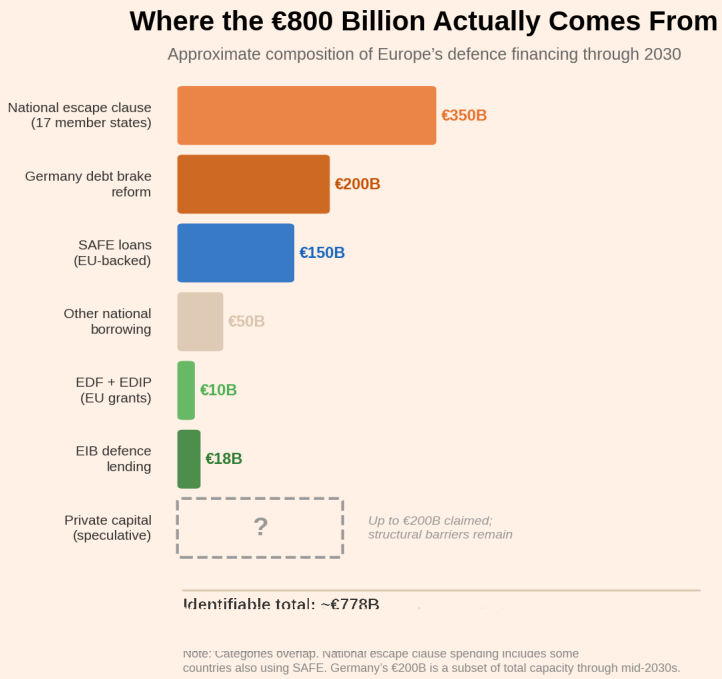

Figure 2: *Approximate composition of Europe's defense financing through 2030. The national escape clause dominates but expires in 2028. Private capital remains speculative.*

HOW SOVEREIGN BORROWING WORKS

The mechanics of sovereign borrowing for defense are identical to borrowing for any other government function. Each member state has a national debt management office responsible for issuing government bonds. Germany's Finanzagentur issues Bunds, Bobls, and Schätze across maturities from six months to thirty years. France's Agence France Trésor issues OATs. Italy's Department of Treasury issues BTPs.

These agencies conduct regular auctions—typically weekly or fortnightly—through a system of primary dealers: large banks authorised to bid in government bond auctions and to make secondary markets. A German Bund auction, for example, involves roughly thirty primary dealers (Deutsche Bank, BNP Paribas, JP Morgan, and others) submitting competitive bids. The Bundesbank acts as fiscal agent, managing settlement through the Euroclear system.

Defense spending is never earmarked at the point of issuance. When the Finanzagentur auctions a ten-year Bund, the proceeds enter the general federal budget. The Bundestag's annual budget law determines how much is allocated to defense versus healthcare, education, or pensions. There is no "defense bond"—the fungibility of sovereign debt is a feature, not a bug. It means defense spending competes with every other fiscal priority for the same pool of borrowed money.

This is why sovereign creditworthiness is the binding constraint, not the escape clause. Germany can unlock €400 billion because its debt-to-GDP ratio is sixty-two percent and its Bunds are the benchmark risk-free asset in Europe. Italy cannot replicate this because its debt stands at a hundred and thirty-eight percent of GDP, its BTPs trade at 130 basis points above Bunds, and additional issuance risks triggering investor concern about fiscal sustainability.

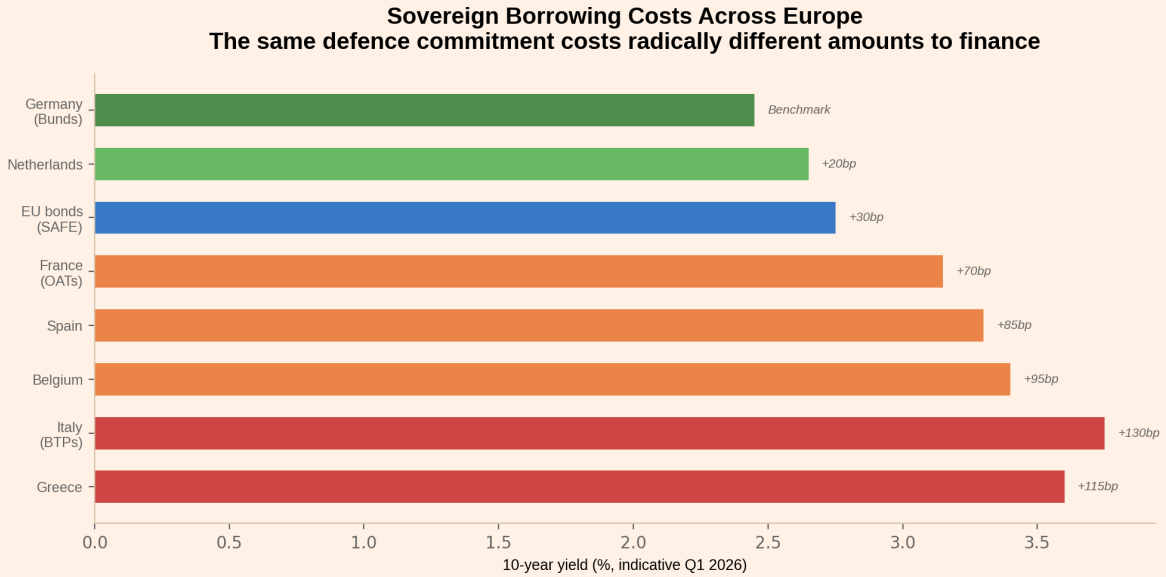

Figure 3: *Sovereign borrowing costs across Europe. The same defense commitment costs radically different amounts to finance depending on who is borrowing. Indicative 10-year yields, Q1 2026.*

The escape clause changes what governments are allowed to borrow. It does not change what markets are willing to lend. A country paying 3.75% on its debt faces a fundamentally different fiscal reality from one paying 2.45%.

HOW EU-LEVEL INSTRUMENTS ARE CREATED

EU-level defense financing requires a legislative process fundamentally different from national borrowing. Each instrument needs a legal basis in the EU treaties, a proposal from the European Commission, and approval through either the ordinary legislative procedure (co-decision between Parliament and Council) or emergency provisions.

SAFE illustrates the full chain. In March 2025, the Commission proposed a regulation under Article 122 TFEU—the emergency provisions—to create a €150 billion loan facility. The Commission was authorised to borrow on capital markets on behalf of the EU, using the EU budget as a guarantee. The Council adopted the regulation by qualified majority in May 2025, bypassing the Parliament under the emergency legal basis. Total elapsed time from proposal to adoption: approximately ten weeks.

Once authorised, the Commission's Directorate-General for Budget manages issuance. The EU issues bonds through a diversified funding strategy of syndicated placements (where a group of banks places bonds with investors) and regular auctions via Euroclear. EU bonds carry a double-A credit rating, which is below Germany's triple-A but above Italy's, and trade at spreads of roughly fifteen to thirty basis points above Bunds.

The proceeds are disbursed to member states that submit national defense investment plans, which must demonstrate joint procurement: countries buying equipment with at least one other EU member receive preferential terms. The Commission assesses plans, approves disbursement tranches, and monitors implementation, a process modelled directly on the NGEU recovery fund.

Critically, SAFE loans are debt on member states' balance sheets, meaning that the EU borrows cheaply, but the member state must repay this debt. For Italy, SAFE offers a marginal advantage of perhaps fifty basis points below sovereign rates, but the liability is real. In other words, SAFE reduces the cost of borrowing, but it does not eliminate the need to repay.

How Each Instrument Works

The mechanics differ radically — from sovereign bond auctions to EU-backed credit facilities

Instrument	Created by	Funded by	Recipient	Repayment	Timeline
National escape clause	EU Council (SGP activation)	National sovereign bond issuance	National treasury	National debt	2025–28 (4 years)
SAFE loans	EU regulation (co-decision)	EU bonds on capital markets	Member states (via plans)	Member state repayment	2025–30 (5 years)
Germany debt brake reform	Bundestag (⅔ majority)	German federal bonds (Bunds)	German federal budget	German national debt	Permanent
EDF / EDIP grants	EU regulation (MFF budget)	EU general budget	Consortia & member states	No repayment (grants)	2021–27 / 2025–27
EIB defence lending	EIB Board (policy change)	EIB bond issuance	Defence firms & states	Borrower repayment	Ongoing (€3.5B/yr)
Private capital mobilisation	Commission proposal	Private investors (guaranteed)	Defence & dual-use firms	Commercial terms	Speculative

Figure 4: *The mechanics of each financing instrument differ radically—in who creates them, how they are funded, who receives the money, and on what terms.*

THE IMPACT ON CAPITAL MARKETS

European defense rearmament is adding tens of billions of euros per year to an already enormous sovereign bond market in which EU-27 governments collectively issue roughly four trillion euros annually. Defense-related borrowing—perhaps €400–500 billion cumulatively through 2030—represents a meaningful, but not overwhelming, increment relative to total issuance.

The more consequential question is not the total volume of new issuance, but where it appears, which sovereigns issue it, at what maturities, and at what credit risk.

Defense borrowing will not be evenly spread across the yield curve or across sovereign issuers. Consider that countries already facing elevated borrowing costs such as Italy, France, Spain, and Belgium are being asked to increase issuance precisely when fiscal sustainability concerns are most acute. For these issuers, incremental defense borrowing risks widening sovereign spreads, increasing marginal funding costs, and raising the sovereign risk premium embedded in all domestic credit markets. A 25–50 basis point widening on €2–3 trillion of outstanding debt is not trivial; it compounds rapidly through unmanageable debt service.

This creates a potential feedback loop.

If investors begin to worry about a country's rising debt, they demand higher interest rates to lend to it.

Higher interest rates mean the government spends more each year just servicing its existing debt; and as debt service rises, the room left in the budget for everything else — including defense — shrinks. That, in turn, can deepen market concerns about long-term sustainability.

In that sense, defense borrowing is not simply "more debt." In highly indebted countries, it interacts with already fragile public balance sheets. The cost of borrowing does not remain constant; it moves with confidence.

The EU's own borrowing works differently. Since the pandemic recovery program (NGEU), EU-issued bonds have become a recognised and trusted asset in global markets. Large institutions — pension funds, insurance companies, central banks — are comfortable holding them. The new SAFE bonds are therefore likely to find buyers without difficulty.

The real risk here is political rather than financial. EU bonds are priced on the assumption that member states stand behind them collectively. If that political commitment were ever questioned, the value of EU bonds would adjust quickly.

There is also a maturity issue. Governments do not borrow only for one year; they issue bonds that last ten, twenty, even thirty years. If much of the new defense borrowing is long-term, markets must absorb large quantities of long-dated debt at a time when the European Central Bank is no longer buying bonds as aggressively as it once did. That means private investors must take up more of the

supply, and they will demand a price that reflects risk.

Further, government bonds are not just investments; they are also used as collateral in the financial system, and banks and funds use them in short-term funding markets. Therefore, if more debt is issued by countries already perceived as risky, those bonds may be treated as less desirable collateral during periods of stress, which can affect funding conditions more broadly.

The investor base matters too, as most European government bonds are held by large institutional investors operating under ESG frameworks. Sovereign defense borrowing itself is not screened out, but investment into defense companies often is. That creates a real imbalance: governments may borrow heavily to fund defense procurement, while private capital remains cautious about directly financing defense manufacturers. Therefore public borrowing increases, but private capital does not necessarily scale alongside it.

For investors, European rearmament therefore has three practical implications:

— Borrowing costs may diverge further between stronger and weaker sovereigns.
— Long-term bond supply will increase.
— Capital allocation pressures may intensify within industrial sectors, especially aerospace and defense.

None of this destabilizes European capital markets on its own, but it does shift incentives and pricing at the margin, especially if defense spending becomes a permanent structural feature of budgets rather than a temporary response to crisis.

The broader point is that defense finance does not sit outside the financial system; it actually reshapes borrowing patterns, interest rate dynamics, investor mandates, and sovereign risk perception.

Thus rearmament is not only a geopolitical event, it is a capital markets event..

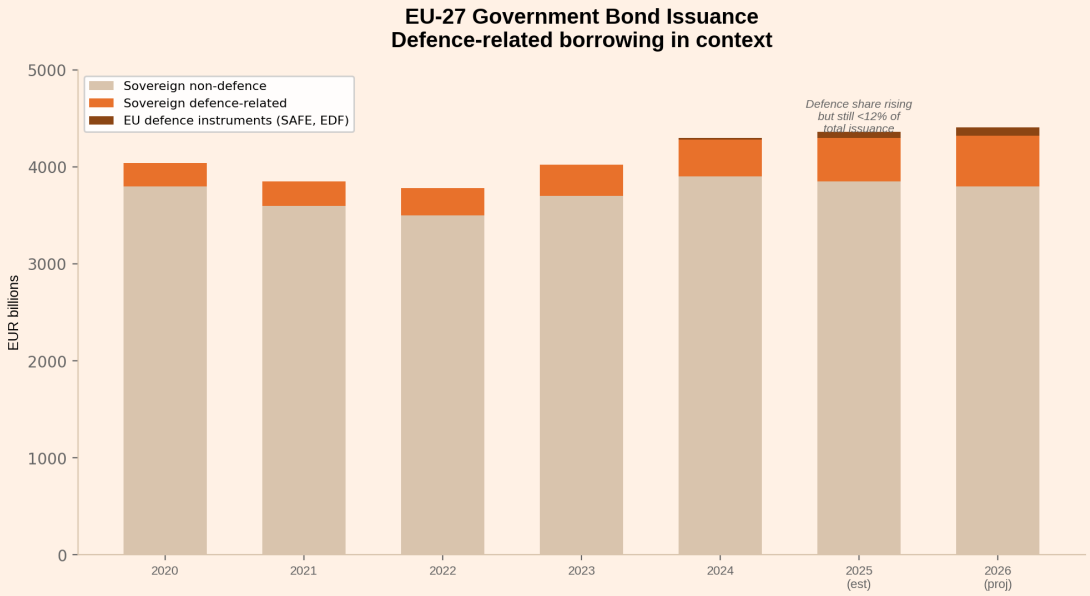

Figure 5: *EU-27 government bond issuance with defense-related borrowing highlighted. Defense remains a small share of total issuance but is growing rapidly.*

GERMANY: THE FULL CHAIN

Germany offers the clearest case study of how defense finance works end to end, as it has undertaken the most ambitious single-country reform through a constitutional amendment which permanently exempts defense spending above one percent of GDP from the debt brake.

Step 1: Constitutional authorization. In spring 2025, the Bundestag passed an amendment to Article 143h of the Basic Law with the required two-

thirds supermajority. The Bundesrat (representing state governments) consented to the amendment which creates permanent borrowing authority for defense spending above one percent of GDP—estimated at roughly €200 billion in cumulative capacity through the mid-2030s, on top of the €100 billion Sondervermögen (special fund) established in 2022.

Step 2: Annual budget allocation. Each fiscal year, the Federal Ministry of Finance (BMF) proposes a budget law, and the Bundestag's Budget Committee negotiates the defense envelope with the Ministry of Defense (BMVg). Germany's defense budget has risen from €53 billion in 2024 to approximately €75–80 billion, with further increases projected. The infrastructure fund is managed separately under its own governance.

Step 3: Bond issuance. The Finanzagentur issues German government securities across the maturity spectrum of roughly €450 billion in gross issuance annually. Auctions follow a regular calendar published in advance whereby primary dealers submit competitive bids and the Bundesbank acts as fiscal agent. None of this issuance is labelled as defense-related; it enters the general federal budget.

Step 4: Procurement contract. The Federal Office for Equipment, Information Technology and In-Service Support (BAAINBw) manages defense procurement. Major programs currently in execution include thirty-five F-35A fighters from Lockheed Martin (€10 billion), 123 Leopard 2A8 tanks from KNDS (€3.2 billion), Boxer infantry fighting vehicles from ARTEC, and the Arrow 3 missile defense system from Israel Aerospace Industries. Each program follows its own contracting timeline, from requirement definition through tender to contract award.

Step 5: Delivery. This is where the timeline stretches: The first Leopard 2A8s are scheduled for 2026; the first F-35As for 2027; Eurofighter Tranche 5 aircraft may not arrive until the 2030s; FCAS—the Franco-German-Spanish sixth-generation fighter—has an initial operating capability target in the 2040s. The money authorized in 2025 will be producing capabilities for decades.

Figure 6: *Germany's defense finance chain traced end to end. Each stage involves different institutions, different legal bases, and different timelines.*

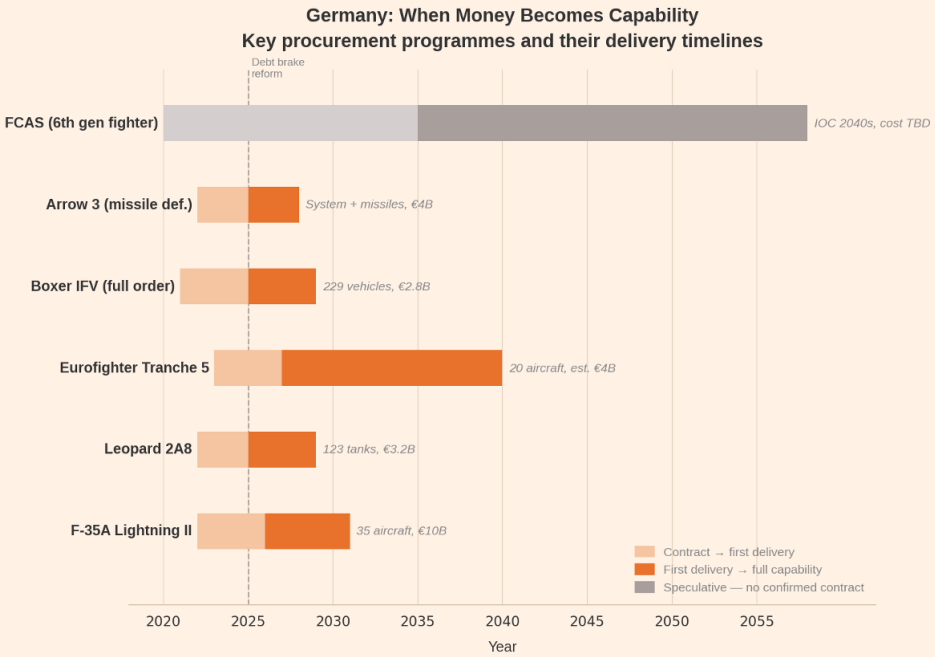

Figure 7: *Key German procurement programs and delivery timelines. Light bars show contract-to-first-delivery; dark bars show first delivery to full operational capability.*

HOW THE MONEY REACHES PROCUREMENT

Between a disbursed euro and an operational weapons system sits the dreaded procurement process. At the national level, each country follows different procedures: France's DGA manages a state-directed system, Germany's BAAINBw runs competitive tenders, and the UK's DE&S operates yet another model. Each has different timelines, contracting norms, and industry relationships.

For EU-funded joint procurement, the process adds multiple more layers, as member states must agree on common requirements, which are notoriously difficult when twenty-seven countries have different doctrines, fleets, and industrial interests. They must identify a lead nation, negotiate workshare, and execute contracts satisfying both EU disbursement conditions and national procurement law. For example, OCCAR manages several multinational programs, and the European Defense Agency facilitates coordination, but neither can override national decisions.

The result is that procurement (not financing) is the *true* bottleneck; money can flow from capital markets to national treasuries in weeks, but signing a multinational procurement contract can take months to years, and delivering the equipment takes years to decades. Germany's experience illustrates this vividly: the debt brake reform unlocked hundreds of billions in a single legislative act, but the F-35s will not arrive until 2027 and FCAS will not fly until the 2040s.

Money can flow from capital markets to treasuries in weeks, but turning that money into signed procurement contracts takes months to years, and turning contracts into delivered equipment takes years to decades. The European plumbing determines the pace.

THE INSTITUTIONAL CONSTRAINT

The mechanics described here are the binding constraints on European rearmament, not the political will which already exists, and not the money, which can be raised. The constraints are institutional, and include the speed at which instruments can be legislated, the terms on which capital markets absorb the issuance, the capacity of

procurement systems to convert money into contracts, and the willingness of private investors to hold defense-related assets.

Unfortunately, Europe does not have one defense finance system, it has twenty-eight: one for each member state plus the EU's own instruments. These operate under different legal frameworks, access capital markets on different terms, and connect to procurement processes of vastly different speed. The €800 billion headline aggregates all of them, but the money flows through channels of radically different capacity.

Germany can mobilize four hundred billion euros because it reformed its constitution, has manageable debt, and operates capital markets of extraordinary depth and liquidity. Italy, France, and Spain must navigate high existing debt, higher borrowing costs, and fiscal rules that constrain manoeuvre. The Baltic states have fiscal space but tiny economies. The EU's own instruments provide a bridge, but it is *not* a permanent architecture.

The lesson from Germany's experience is both encouraging and sobering. Encouraging, because it demonstrates that a major European democracy *can* enact permanent fiscal reform for defense in a matter of weeks when the political will exists. Sobering, because even with unlimited fiscal authority, the procurement pipeline converts money into defense capabilities at a pace measured in years and decades, not months.

Until Europe builds a unified defense finance architecture that effectively pools risk, equalizes borrowing costs and connects capital markets directly to procurement at continental scale, the plumbing will remain the binding constraint on whether the political will to rearm converts into the industrial reality of rearmament.

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*This article draws on two formal frameworks: coordination architectures and adaptive bandwidth (from "**Institutions as Coordination Architectures**") and architecture lag and premature markets (from "**Market Formation as a Systems Engineering Problem**"). Companion articles: "How Do You Pay for Rearmament?" and "Europe's Defense Problem Isn't Spending."*

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