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Germany Under Strain: Economy, Rearmament, Politics and Markets

By

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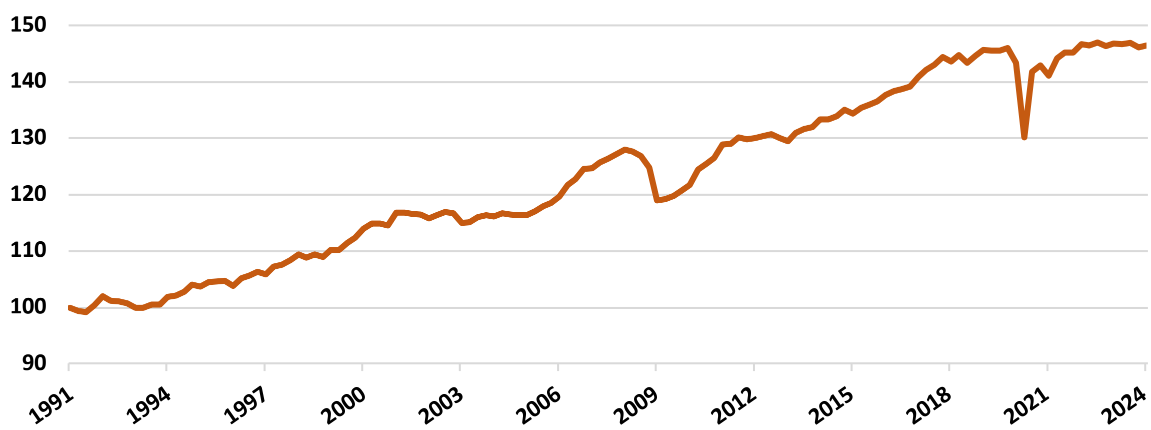
Executive Summary

- A harsher geopolitical environment requiring industrial mobilisation, rising competition from China eroding its industrial base, and a deep domestic backlash reflected in the AfD's rise, rooted in economic insecurity and resistance to rapid social change.
- Germany is in its longest growth slump since WWII, with output barely expanding, weak consumption and exports, soft labour-market momentum, and downside risks from tariffs, a strong currency and political uncertainty, pointing to continued stagnation into early 2026.
- Growth should pick up from mid-2026 as defence and infrastructure spending lifts demand and exports recover, but higher debt, a record tax burden, slow investment rollout and persistent structural constraints mean the rebound will be gradual rather than transformative.
- Its export exposure looks similar to peers, but a decade of under-investment, weak domestic demand and a rising tax burden tied to ageing have eroded competitiveness, making broad social and productive investment, not trade retrenchment, the key to reviving growth and containing political backlash.
- Germany's planned defence surge to 3.5% of GDP by 2029 gives it unmatched room to manoeuvre in Europe, but domestic resistance — highlighted by the collapse of the conscription bill — exposes deep political and cultural constraints on sustained militarisation.
- Berlin is using defence spending as an economic strategy, funnelling roughly half of a €377bn procurement plan to domestic champions like Rheinmetall and Diehl, accelerating rearmament but reinforcing Europe's fragmented and costly defence-industrial structure.
- The AfD's rise is rooted in economic insecurity and regional decline, especially in eastern Germany, and establishment attempts to contain it through a political "firewall" and security framing have failed, as its support grows and approval of Chancellor Merz collapses.
- Merz's failure to win EU support for using frozen Russian assets, blocked by a fiscally constrained France and reluctant partners, underscores a widening Franco-German imbalance, with Berlin increasingly driving EU initiatives alone while Paris lacks the political and financial capacity to deliver.
- Germany's fiscal expansion pushed Bund yields sharply higher before a pre-Christmas pullback, while equities have stalled after early gains.

Key Picture: The German Economy Has Stalled After Decades of Solid Growth (Real GDP, Q1 1991=100)



Source: Fred

Germany faces multiple, overlapping challenges. First, it must navigate a sharply altered geopolitical landscape and mobilise its industrial capacity and political resolve, even as a pervasive sense of industrial crises undermindes confidence. This challenge is compounded by China's rise, which has turned into a direct competitive threat to Germany's industrial base.

in addition, the surge of the far right consitutes a systemic political challenge. The rise of the Alternative for Germany (AfD) reflects deep dissatisfaction among a significant minorty with what Germany has become since reunification. That nationalistm takes different forms, but its right-wing variant is defined above all by opppoistion to Germany's growing social diversity – a transformation so profound that it must be taken seriously to understand contemporary Germany.

Economy: The Long Stagnation

Over the past three years, Germany has posted positive growth in just two quarters, shrinking by an average 0.1% quarter on quarter since Q4 2022. Germany narrowly avoided recession this year, with stagnation in Q3 after contraction in Q2. The economy expanded by 0.3% y-o-y, the same pace as in the previous period with private consumption (-0.3% QoQ) and net exports weighing on growth, while public spending (+0.8%) and investment (+0.3%) offered limited support.

This marks Germany's longest period of stagnation since World War II. The near-term outlook remains weak. Tariffs, a stronger currency, and political uncertainty are likely to keep investment and consumption subdued, pointing to continued stagnation in Q4. Beyond that, conditions should improve in 2026 as fiscal stimulus kicks in, even though structural challenges will persist.

After several years of contraction, the Bundesbank expects a gradual recovery. Presenting the new Forecast for Germany, Joachim Nagel said growth will remain subdued at first in 2026 but strengthen from the second quarter, driven by higher government spending and a rebound in exports. Defence and infrastructure outlays will lift public demand later in the year, while exports recover, residential construction stabilises, and rising wages and an improving labour market support consumption. Higher capacity utilisation should also revive business investment, with growth accelerating notably in 2027.

Particularly, the Bundesbank expects modest growth of 0.1% in Q4 and a similar pace in early 2026. Germany's economy is set for a gradual recovery next year, with stronger momentum from 2027, supported by higher public spending on defence and infrastructure, according to the Bundesbank. GDP is forecast to grow by 0.6% in 2026, 1.3% in 2027 and 1.1% in 2028, with the 2026 outlook slightly weaker and the 2027 outlook marginally stronger than in June. Growth is expected to pick up from the second quarter of 2026, driven by government spending and a rebound in exports.

Inflation is expected to fall more slowly than previously forecast, reflecting strong wage growth and smaller declines in energy prices. HICP inflation is projected at 2.3% this year, 2.2% in 2026, and around 2% in 2027–28. Consumer inflation was unchanged at 2.3% in November 2025, in line with preliminary data and October's reading. Energy prices fell 0.1% year on year, as lower electricity and district heating costs offset higher fuel and heating oil prices. Food inflation stayed muted at 1.2%, its second-lowest level this year. The EU-harmonised inflation rate rose to a nine-month high of 2.6% year on year, while falling 0.5% month on month.

Higher defence and infrastructure spending, tax cuts and transfers will raise public debt. The deficit ratio is projected to reach 4.8% in 2028 and debt 68% of GDP. Nagel reiterated the case for reforming the debt brake to enable investment while gradually reducing deficits and bringing debt back toward 60% of GDP over the long term.

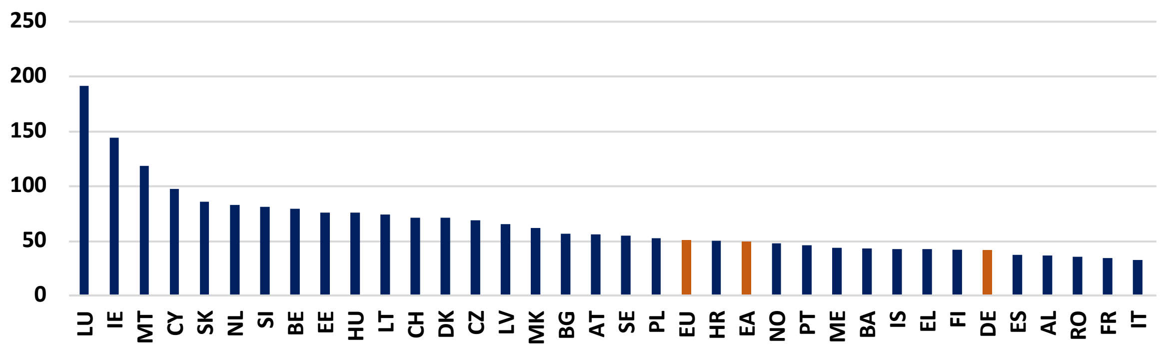
The tax and social contribution burden is projected to hit a record 41.5% of GDP in 2025, driven by higher defence spending, infrastructure investment, and rising pension, health and unemployment costs. While combined public and private investment could add about 0.5 percentage points to growth next year, government investment plans are unlikely to scale up quickly.

Consumer spending is expected to stay below potential despite inflation easing to around 2%, as labour market conditions soften. Unemployment is forecast to hover near 3 million, overall employment to stagnate, and industrial job losses to continue, further dampening the outlook.

The German Puzzle

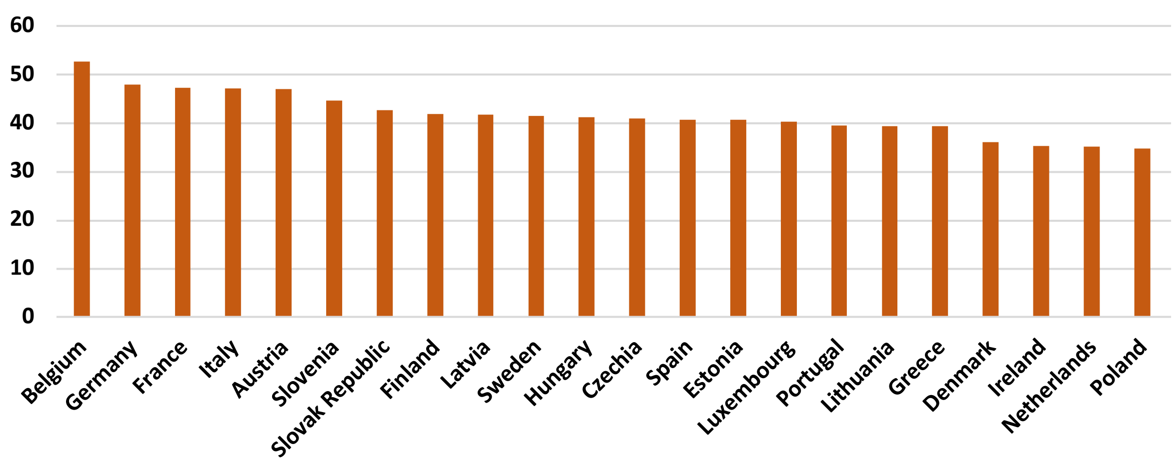
Why is the downturn so persistent? The common narrative blames Germany's reliance on exports, but the data suggests the problem coould be home-grown. Germany's export mix is not drastically more exposed than its peers. Approximately 55% of German goods exports stay within the EU. Of the remainder, roughly 10% go to the US and just over 5% to China. This structure closely mirrors the EU aggregate. Blaming trade openness fails to explain the depth of Germany's industrial weakness compared to other open economies (**Figure 1**).

Figure 1: Exports of Goods and Services in % of GDP



The real culprit is a decade of under-investment. Germany's aggressive reduction of public debt since 2009—while peers expanded theirs—depressed aggregate demand and left infrastructure to rot. The tax and social contribution burden, projected to hit a record 41.5% of GDP in 2025, is a symptom of an aging state playing catch-up. In 2024, In 2024, the one of the largest tax wedge for this household type was observed in Germany (**Figure 2**).

Figure 2: Total Tax Wedge, 2024 (as % of labour costs)



Source: OECD

The consensus is shifting: Germany needs large-scale investment not only in tanks (Rheinmetall) or railways (Deutsche Bahn), but also in human capital, education, housing and healthcare. The failure of centrist politics to address the crumbling public sphere has created a vacuum that the far right is now trying to fill. Social investment is therefore the only viable firewall against these forces.

Plans for Rearmament

By 2029, Germany is set to spend €153bn a year on defence, roughly 3.5% of GDP, marking its most significant military buildup since reunification. This fiscal firepower dwarfs its neighbours: France plans to reach roughly €80bn by 2030, hampered by debt exceeding 110% of GDP. Poland, though NATO's top spender by share of economic output (allocating €44bn or 4.7% of GDP this year), is struggling to sustain such outlays without compromising its wider budget. Germany's stronger balance sheet gives Berlin a room to manoeuvre that others simply lack.

Yet, under Chancellor Friedrich Merz, this defence turnaround masks a persistent political fragility. While Merz has pledged to make Germany a "pillar of European security", exempting defence from the constitutional debt brake to triple spending within five years, execution remains contested. On October 13, the government abruptly cancelled a press conference on expanding conscription following a revolt by the Social Democratic Party (SPD), the junior coalition partner. The collapse of the bill, which aimed to expand the armed forces from 182,000 to 260,000, exposed the shaky foundations of Berlin's renewal. The SPD's rejection of mandatory registration highlights how deeply the reluctance to militarise runs in German political culture, even within the governing coalition.

Industrial Strategy & Procurement

Berlin is pitching this rearmament not just as security, but as an economic strategy following two years of recession. Internal documents seen by *Politico* outline a €377bn overhaul through 2035, with roughly half the value—about €182bn—earmarked for domestic champions.

This "German-first" approach is already visible in immediate outlays. In late 2025, the parliamentary budget committee approved 30 major procurements, lifting the year's total to a record 103 projects valued at €83bn. Rheinmetall is the primary beneficiary, securing orders for Puma and Boxer armoured vehicles, as well as the new SPOCK tactical radar satellite system (a joint venture with Iceye) to enhance AI-enabled reconnaissance. Diehl Defence follows, anchored by the IRIS-T missile systems that will form the backbone of Germany's future air defence.

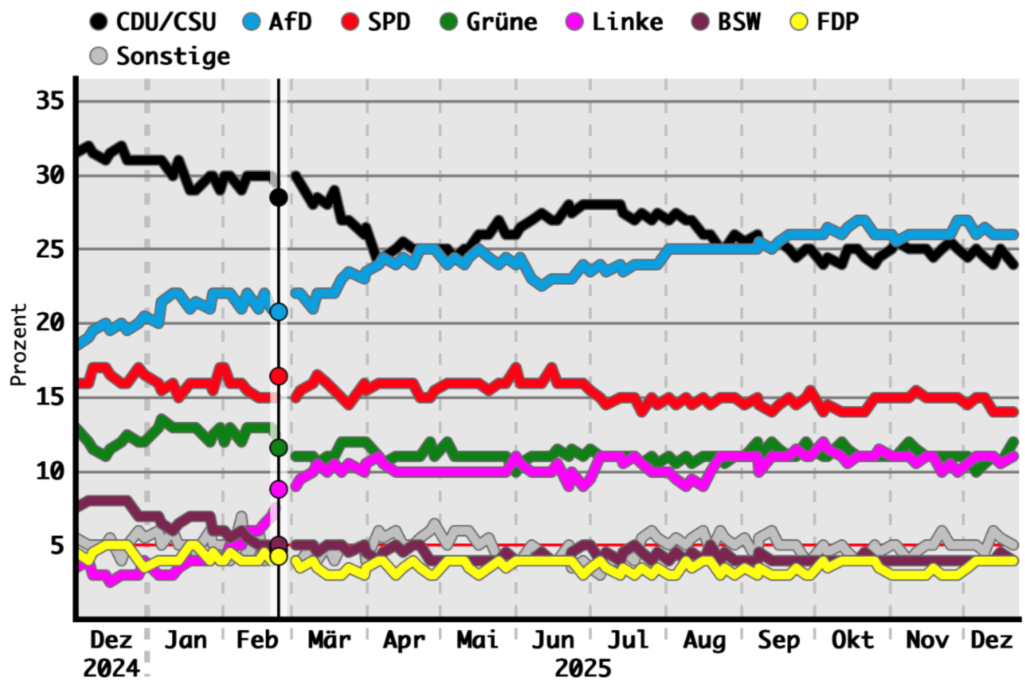
The shopping list is extensive and diverse, covering upgrades to Patriot systems, Meteor air-to-air missiles, Taurus NEO preparation, and extra interceptors for the Arrow missile defence system. Naval capabilities are also being boosted with torpedoes for U212CD submarines. Defence Minister Boris Pistorius highlighted these approvals as evidence of faster procurement despite provisional budget rules.

However, the focus on national champions perpetuates European inefficiencies. Resistance to joint EU procurement means Europe's fragmented defence industry continues to produce far more weapon systems than the US, driving up costs and limiting scale.

Germany's Fractured Political Landscape

Growing support for the far-right AfD reflects profound discontent with declining living standards and inequality. The failure to shield German industry from the energy price shock has haunted the national economy, threatening to turn the 2020s into a "lost decade." Economists Tom Krebs and Isabella Weber argue that while the energy price cap (introduced in late 2022) was the correct instrument, its delayed implementation allowed economic insecurity to metastasize into political rage.

Figure 3: Opinion Poll Trend by INSA from December 2024 to December 2025



Source: Dawum.de

This correlates with broader studies linking populism to government inaction during crises. The impact is most visible in Eastern Germany, where the re-widening wealth gap has solidified the AfD's dominance. Here, the party is not merely an opposition force but the primary voice of a specific, collective despair. unlike other voters, 62% of AfD supporters believe Germany is heading toward a terminal crisis resolvable only through "regime change", a sharp contrast to the optimism of the political mainstream.

The establishment fears the AfD could eventually breach the *Brandmauer* ("firewall") and enter government. To counter this, the CDU has increasingly framed the party as a security threat. During a recent Bundestag debate, a CDU MP accused the AfD of being steered by the Kremlin, citing the party's detailed parliamentary questions on Ukraine arms deliveries and energy infrastructure. While the CDU portrays these inquiries as evidence of a "Russian proxy," the strategy dismisses the voters' demand for transparency regarding the war.

This security-focused strategy has failed to stem the tide. A new Forsa poll for RTL/NTV shows a sharp slump in support for Chancellor Friedrich Merz. Since taking office in May, 75% of respondents express dissatisfaction. Most critically, the AfD has overtaken the conservatives, leading with 26% support against the CDU/CSU's 25%.

A Shift in Franco-German Leadership at the EU

German Chancellor Friedrich Merz failed to secure EU backing to use €210bn in frozen Russian assets to support Ukraine after France withdrew its support, citing legal risks and fiscal constraints. As Italy and Belgium opposed the plan, President Emmanuel Macron ultimately aligned with them, blocking the initiative.

The episode highlights a growing imbalance in the Franco-German relationship: an assertive Berlin, emboldened by Merz's expansive defence and infrastructure agenda, versus a constrained Paris weighed down by high debt and political fragility late in Macron's term. Hopes of reviving the traditional Franco-German engine have faded, with Germany increasingly driving EU initiatives alone.

Merz also fell short on pushing through the EU–Mercosur trade deal, as Macron again teamed up with Italy's Giorgia Meloni to delay a decision. While the summit did yield agreement on a €90bn EU-backed loan to Ukraine, leadership gaps were evident, with Germany pushing and France often unable to deliver.

Despite broad alignment on Ukraine, defence and strategic autonomy, tensions are mounting over trade, defence industrial projects and EU leadership, underscoring a role reversal in which Germany is proactive but France is politically and fiscally constrained.

The Market: Bunds, Stocks and Euro

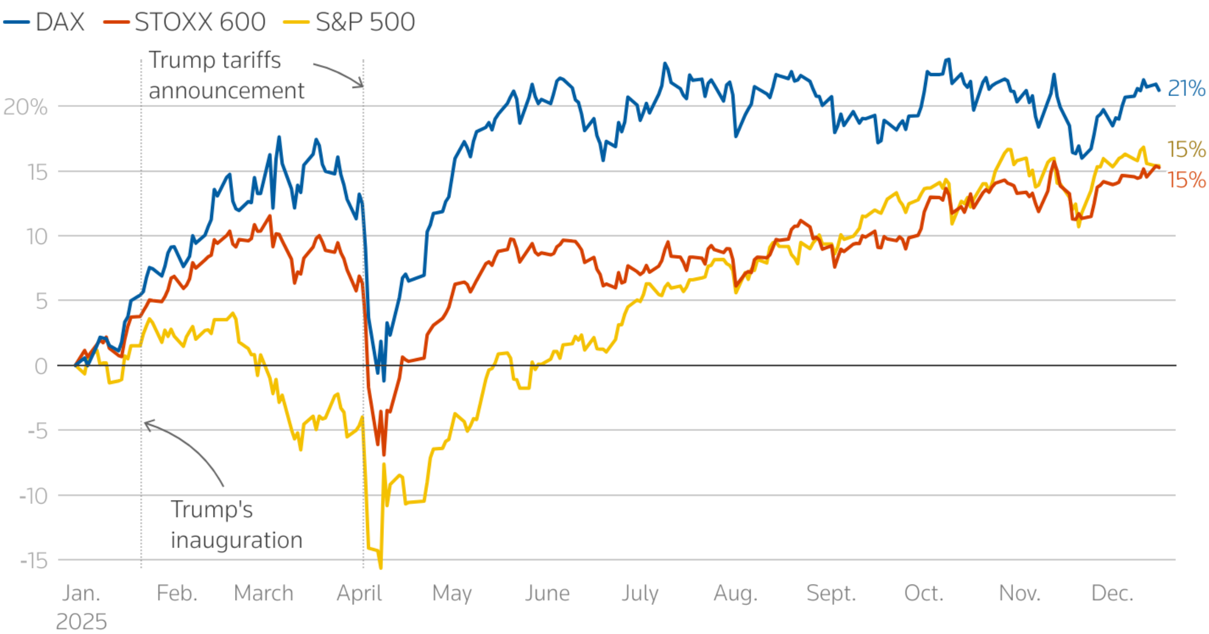
As Berlin opens the fiscal floodgates, the structural reality of the German bond market is shifting from scarcity to abundance. Germany is heading toward significantly higher leverage, with approximately €850bn in cumulative net borrowing planned through 2029. This heavy issuance, combined with the ECB's balance-sheet runoff, is keeping structural cheapening pressure on Bunds. 10-year Bund yields have risen relative to short-term rates, a steepening of the curve last seen after the global financial crisis. In October, 30-year yields hit 3.53%, their highest level since 2011 on increased borrowing.

Despite this structural shift, German debt retains a relative premium. With a debt-to-GDP ratio of just 62% in 2024, Germany's starting point is far stronger than the UK (~100%) or the US (~124%). Bunds also account for roughly 20% of the dwindling global AAA bond universe (which stands just below $10tn), preserving their role as the ultimate collateral in times of stress.

Ahead of Christmas, thin trading volumes provided a temporary reprieve from the sell-off. Global bond markets caught a brief breather as yields retreated from recent highs. Long-dated German yields eased from a 14-year peak amid thin pre-Christmas trading, while Japanese bonds rebounded after leading earlier sell-offs. Germany's 30-year yield slipped to 3.51% and the 10-year benchmark fell to 2.88%. Safe-haven assets such as gold and silver rose on heightened geopolitical tensions. Markets were also reassured after comments from ECB board member Isabel Schnabel dampened expectations of further interest-rate hikes.

Investors remain cautious. Analysts warn of execution risks given Germany's weak track record on public investment, and several institutes have downgraded 2026 growth forecasts. German equities are up 20% this year but have stalled in the second half, while European stocks trade at a roughly 35% discount to US peers — leaving scope for inflows if Germany delivers and sentiment improves.

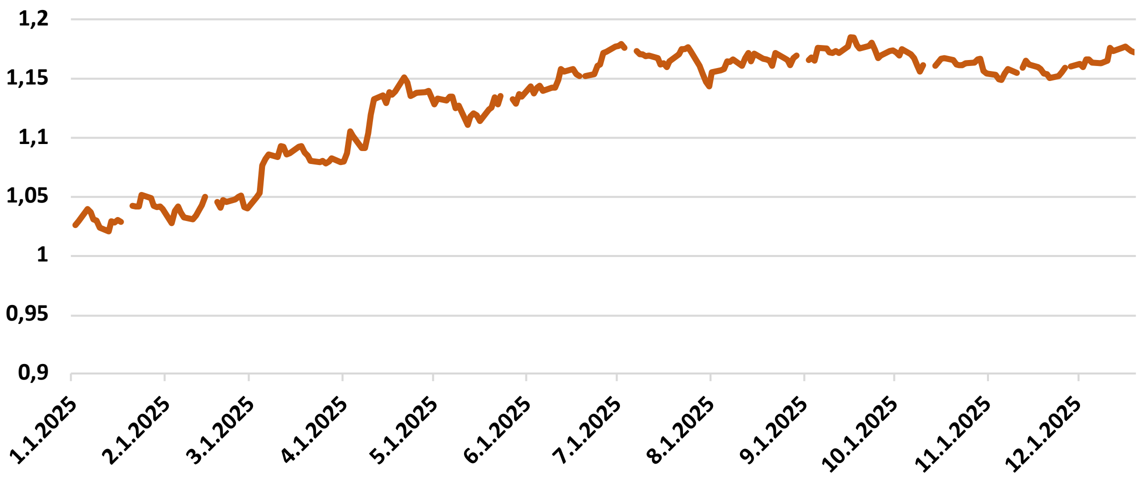
Figure 4: German Equities Have Outshone US Stocks in 2025



Source: Reuters

Earnings growth, a potential Ukraine ceasefire, and reconstruction spending could lift European assets, though gains may be sector-specific. Meanwhile, the euro's 2025 rally has stalled, with its next move likely driven more by US dollar dynamics and Federal Reserve policy than by Europe alone.

Figure 5: USD/EUR



Source: FRED