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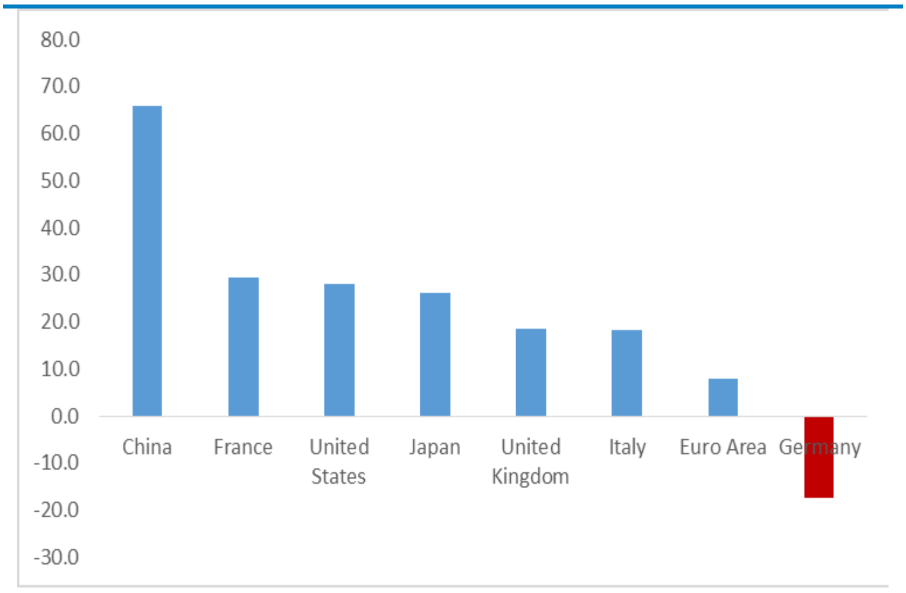
Dear fellow macroeconomists and monetary analysts,

This is the second Budget Watch note in our new regular monthly series. The accompanying note focuses on the short- and medium-term budget trends in five of the six major monetary jurisdictions as our monthly monetary analysis, with particular attention on the latest month (or quarter). (The Eurozone has 21 member states, and we will track budget news in some of the large ones from time to time.)

War and military expenditure are major enemies of control over public spending and deficits. In the months just before May the Federal deficit in the United States of America was generally lower than in the same months a year earlier. But in June and July this improvement did not continue. Deficits were \$120b. and \$431b. in June and July 2026 respectively, compared with a surplus of \$27b. and a deficit of \$291b. in June and July 2025 respectively.

So for the two months together the deficit increase was \$287b. The US federal budget deficit for fiscal year 2026 is projected to hit \$2,100b., according to revised estimates from the Congressional Budget Office (CBO), well up on the CBO's . CBO's initial February forecast of \$1,900b. The Supreme Court ruling that struck down executive emergency tariffs may be part of the explanation, but surely more fundamental are the costs of the hostilities in the Gulf with Iran. Here we see the damage that the cost of war can do to the public finances of even the world's most powerful country.

Change in public debt as % GDP 2025 on 2010

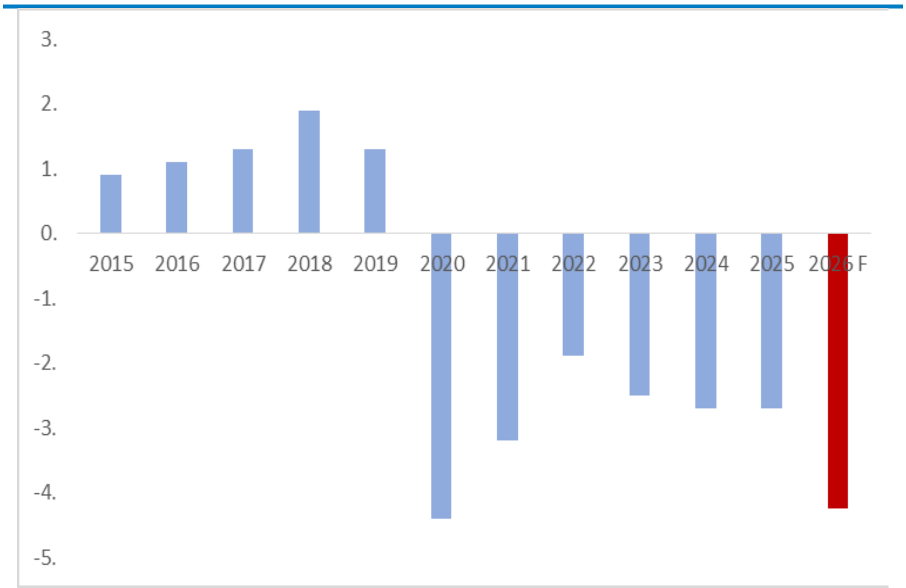


Source IMF database

At least the Trump administration has a major achievement, of a sort, on the defence front. Pressure on the USA's European allies has obliged them to increase their own defence spending. European governments would have responded to this challenge anyway, but further urgency has come from the intensification of the war between Russia and Ukraine. All European nations (apart perhaps for Spain) have upped their defence plans and commitments, with Germany taking the lead. Chancellor Scholz in February 2022, as the invasion of Ukraine began, used the phrase *Zeitenwende* – meaning a "a turning of the times" or an "historic turning point" – to covey the shift in the German attitude. In the decades leading up to 2022 Germany was unusual, in that – unlike most large advanced nations – it reduced the ratio of public debt to gross domestic product. Thus, in the 15 years to 2025, which were badly affected everywhere by the Covid epidemic, the ratio of public debt to GDP *fell* by over 17%. In other leading nations the common tendency was for this ratio to increase, sometimes substantially.

But, with the enormous proposed increases to the German defence budget, we ask the question, "is the period of German fiscal strength drawing to a close?". As outlined in the chart below, before the Covid-19 pandemic Germany run modest fiscal surpluses. Covid pushed the deficit above 4% of GDP in 2020, but it was then falling back nicely until 2022. Now the German Federal Ministry of Finance estimates a deficit of 4.3% in 2026 and 4.8% the year after, very much the same as in the pandemic period.

Germany annual fiscal deficit % GDP (2026 forecast German Federal Ministry of Finance in red)



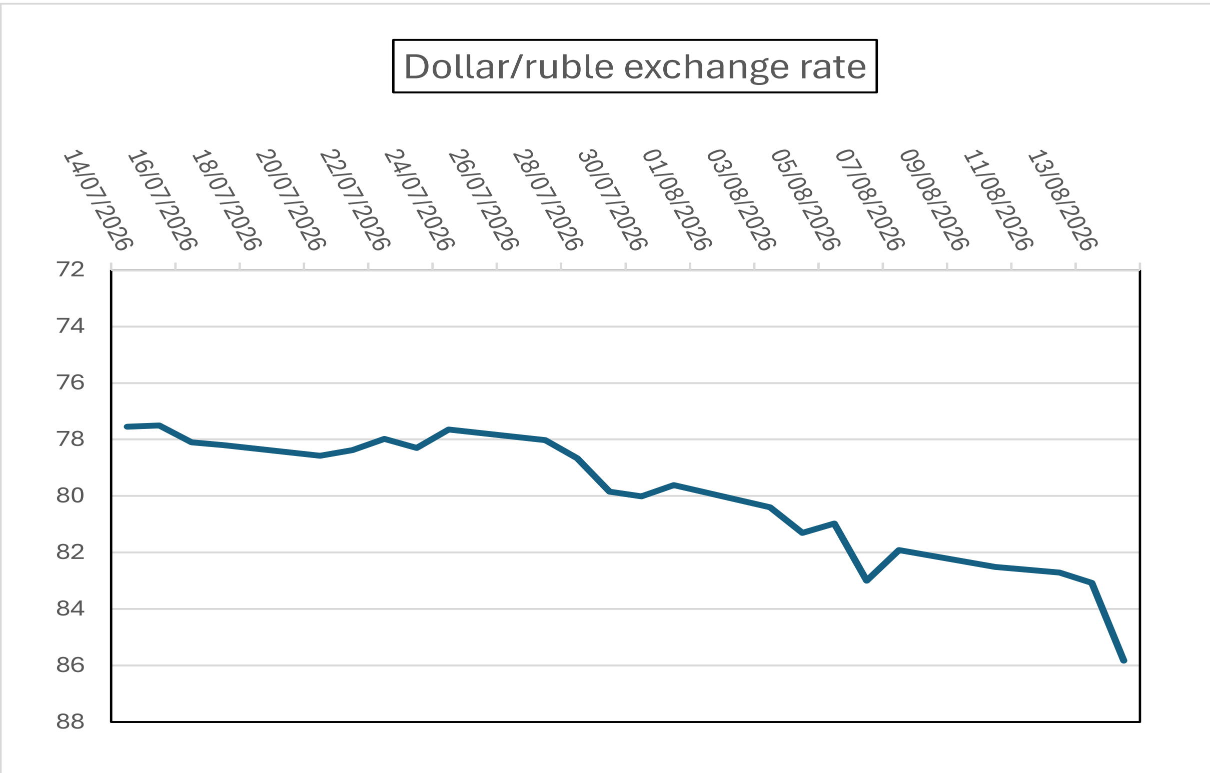
Source https://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Press_Room/Publications/Brochures/german-progress-report-2026.pdf?__blob=publicationFile&v=3

The fiscal deterioration is substantially due to the planned growth of defence spending. Actual defence spending between 2020 and 2025 almost doubled to €86.4b. or – relative to national output - to 2.4% of GDP from 1.5%. But that was just the start. The defence budget is expected to rise by a further €100bn to €183.7b. or so by 2030, equivalent to 3.7% of GDP. In nominal terms that would be a fourfold increase in a decade. Roughly speaking, defence will account for 29% of federal spending by 2030, up from just 10% in 2020. Even with forecast restraint in other budgets, so great in scale is the proposed increase in German defence spending that Germany risks undermining its current strong fiscal position. The ratio of general government debt to GDP is widely expected to breach 70% by 2028 and to rise further in later years.

But none of this will be a surprise. Last year Germany amended its constitutional debt brake (*Schuldenbremse*) to exempt defence and security spending, even of more than 1% of GDP, from its structural deficit limits. Even if the debt-to-GDP ratio were to exceed 80% of GDP, that would seem manageable relative to, say, France or Italy, which have much higher figures.

Obviously, crucial here is the development of the war between Russia and Ukraine. If the war were to stop in late 2026, sceptics about the value of all the extra spending on jets, missiles, drones and so on might speak up. Fighting has now continued for four-and-a-half years, with Russia apparently resisting any kind of peace overtures. It has become easy to assume that the war will go on indefinitely. In fact, the nature of the war – and the intensity of the exchanges – have varied greatly over its four and a half years. Russia has increased its output of ballistic and glide missiles, and they are doing more damage now than at any previous point since February 2022. But Ukraine has mastered drone technology in an extraordinary and unexpected way, *and its drone output – with undoubted help from Germany, Britain, France and other countries – is rising rapidly*. Drone swarms can be targeted accurately at targets over 2,000 kilometres from the Ukraine border. At present, about half of Russia's oil refining capacity has been taken out. It can be repaired, but that will take months. In those months yet more drone swarms will be sent to damage or destroy any still intact oil refining capacity…

What will be a good signal of possible Russian exhaustion? One indicator to watch is the exchange rate. Before February 2022 the Russian ruble was fully convertible, with no exchange controls and no black markets. Since then exchange controls have been introduced and interest rates have been kept at high levels to protect the currency. The dollar was worth just under 80 rubles in early February 2022 – and its value four years later, as measured by the "official" rate, in early February 2026 was almost exactly the same. However, a black market in bank notes had started to emerge, marking a return – if only a partial one – to Soviet times. For much of 2026 the rate has remained steady. But in July and August the official ruble has weakened sharply and the discount in the black market has increased. The chart below speaks for itself. Effectively, the ruble has lost about 10% of its value against the dollar in a month.



Is the Russia-Ukraine war, like German defence spending, at an historic turning point? And, if the war does come to an end quite soon, will the *Zeitenwende* – as at present envisaged in Germany's fiscal plans – still be necessary? Even if it is necessary, will that be to the same extent?

(Note that this time we have not said much about Japan or the UK. We will return to these countries in next month's Budget Watch.)

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