



Q&amp;A

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## How will Europe manage risks amid tariffs and geopolitical turmoil?

Europe's structural challenges are well known. Pressures to increase defense spending look set to add further strain. What options do European sovereigns have?

It appears likely that many European governments will respond to new geopolitical realities by raising defense expenditure, towards and in some cases beyond 3% of GDP rather than 2%. In the short term, this will raise deficits and debt. In the medium term, fiscal sustainability will depend on the combination of growth, fiscal policy and financial market deepening.

For example, Germany recently proposed a massive defense and infrastructure package that will raise debt, but could also boost growth. Germany's fiscal growth tradeoff is made easier because at around 63% of GDP, its debt burden is much lower than those of some other large economies, such as France and the UK, which have public debt above 100% of GDP.

One way of mitigating the fiscal consequences of defense spending is to reduce costs of borrowing and buying through pooling of financing and joint procurement of defense needs, which will also help to reduce fragmentation in defense capabilities. This idea underpins the European Commission's proposal for EUR150 billion of loans, mainly repurposed from unused capacity under the Recovery and Resilience Facility. Additional joint borrowing through some inter-government special purpose vehicle may also be possible.

Moreover, if the pivot towards higher spending and debt is combined with measures that create attractive investment opportunities for Europe's vast pool of savings, it could deepen financial markets.

There are multiple possible scenarios, from pessimistic ones of fiscal deterioration and economic malaise to optimistic ones where defense spending revives economic and financial dynamism.

Alongside those mounting geopolitical risks, we have rising trade tensions globally, and US tariffs specifically. How do you see their impact on Europe?

It's important to focus on actual policies announced and not the headlines, which can vary from day to day. On that basis, we think potential US tariffs will cut Europe's annual GDP growth by about 0.2 percentage points, reflecting EU exports to the US amounting to 3% of its GDP. This may seem small, but tariffs will likely weaken business confidence and delay investment at least in the short-term.

The impact on sectors with significant exposure to the US will be more significant than at the country or EU level. We expect the auto and chemical sectors to be most affected, as their value-added exports to the US represent around 18% and 25% respectively, and their complex supply chains make companies vulnerable to potential tariffs imposed by the US on other countries, such as Canada and Mexico.

The EU's response – such as counter-tariffs or other measures – could have a material impact at both the macro and sector level, as well as in its overall relationship with the US. The greater the friction, the more damaging to the economy, not just through trade, but investment and financial markets as well.

Where does that leave some of Europe's historically leading industries, and what policies can Europe take to strengthen the competitiveness of its leading industries?

Let's take a couple of industries where Europe has a leading role: one established, one new.

First, the auto sector. European automakers have long been global leaders, and in 2024 still accounted for 40% of the industry's revenues, compared to around 25% for the Japanese manufacturers.

They are under pressure though, given some big structural challenges, including a declining market share in China, the difficult transition to electric vehicles and increasing geopolitical tensions.

Even so, European automakers have some key strengths. They have scale. And they have good balance sheets, with average debt-to-earnings of 1.5x and very strong cash reserves. So they should be able to capitalize on these strengths to help them through the transition.

Second, the wind turbine sector. European companies have established a leadership position in this much newer industry, providing around 75% of global wind installations outside China. Even so, the sector has experienced profitability challenges partly driven by inherent volatility in demand and supply chain constraints.

In terms of policy, we see the European Commission's recent proposal to relax emission reduction targets as providing greater flexibility to automakers. Even so, the revised targets are still relatively onerous at a time when the demand for electric vehicles in Europe has been slowing, partly driven by the suspension of subsidies in some countries. But public investment like Germany's big fiscal package could help strengthen manufacturing in innovative technologies and defense.

The European Commission's recently proposed Clean Industrial Deal and Omnibus package also try to tackle that by following many recommendations to strengthen EU competitiveness and create a more business friendly environment. However, the lack of clear, new and easily accessible funding sources will hamper private investment for new clean technologies. For example, the US Inflation Reduction Act under the Biden Presidency, although of a comparable size to the EU green transition funding package, provided five to ten times more financing to manufacturing in the US compared with what is proposed in the EU.

### Talking of a more business friendly environment, how can Europe close the innovation gap with the US and retain scale-ups?

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There are three areas we would highlight.

First, we just touched upon the European Commission's initiative to create a more business-friendly environment by cutting red tape and streamlining reporting requirements and regulations. For instance, the EU's risk-based AI Act focuses on transparency

and accountability, but also imposes significant compliance requirements. In contrast, the US and UK favour flexible, innovation-friendly frameworks to foster competitiveness. Policymakers need to consider the balance between safety and transparency versus innovation and growth.

Second, we think that public-private partnerships will be beneficial, especially for innovative projects or 'public goods'. However, most of the public funding will likely come from member states with strong fiscal metrics, given the opposition to additional joint EU borrowing.

And third, we would welcome progress on the Savings and Investments Union to retain domestic savings and unlock the required private funding. Europe's savings rate at 15% in 2024 was almost three times higher than in the US, but about 20% of euro-area savings are invested in debt securities in international markets in search of higher returns.

And harnessing that capital is all the more necessary if Europe is to become more independent in artificial intelligence, for example. Global investment in new data centre capacity alone will exceed \$2 trillion over the next five years. That will in turn require deeper capital markets, enabling developers and sponsors to finance their data centre projects via the corporate credit, leveraged loan, bank, CMBS, ABS, private credit and now project finance markets.

### Indeed data centres are one of the initial components of Europe's AI independence, but they use a lot of energy. Can Europe compete despite having higher energy prices than other countries? What can policymakers do?

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Strengthening Europe's position in AI will indeed require data centres, which consume significant amounts of energy. Accelerating Europe's green transition by building out renewables and nuclear over the next decade could reduce energy prices in the long term. But the EU has no quick fixes in the short term given Europe's lack of natural gas resources and power price parity with the US may be decades away.

The strengthening of Europe's position in AI and digital technologies also requires deep high-quality fibre and mobile networks. Fibre-to-the-premises networks only reach 56% of households in Europe and 5G population coverage stands at 81%, which is behind other advanced economies. Among the European Commission proposals under consideration to support high-quality network deployment are more relaxed merger controls that could trigger market consolidation and facilitate the creation of larger telecom companies better able to make the investments required to build these high-quality networks.