EU sovereigns face four key risks from US policy shifts

Decisive action needed to counter disruptive US de-globalisation policies

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Rising tariffs, lower growth, higher defence spending, deeper political fragmentation and rising dollar-denominated borrowing costs are set to weaken the European credit outlook unless Europe unites and implements bold reforms in response.

US president Donald Trump's renewed push for anti-globalisation policies spanning trade, finance, fiscal policy, energy and immigration has far-reaching implications for Europe and the creditworthiness of its member states.

Four principal risks stand out:

i) **Trade and supply-chain disruptions.** Higher tariffs targeting sectors and/or countries – such as China, Mexico, Vietnam, Germany, Japan and Italy – with which the US has a large trade deficit could disrupt European exports and manufacturing supply chains.

ii) **Higher defence expenditure.** European sovereigns may be forced to increase military spending to reduce reliance on US military and security commitments amid the persistent threat from Russia.

iii) **Deeper political fragmentation.** US support for far-right parties may accelerate political instability within Europe complicating consensus-driven policymaking at the EU level.

iv) **Higher dollar-denominated borrowings costs.** An appreciating dollar driven by tighter Federal Reserve policies and global risk aversion could exacerbate borrowing costs mostly for emerging markets such as Ukraine, Egypt and Türkiye but also CEE sovereigns such as Hungary.

Table 1: Four key risks from US policy shifts and potential policy options to mitigate impact

Risk	Impacted sovereigns	Mitigation
Tariffs	High trade surpluses with US (DE, IT)	**De-risk** (strategic FTAs, deepen single market) **Appease** (buy US energy, military equipment, renegotiate CBAM, adjust existing US import tariffs **Counter** (impose tariffs on US)
Security & defence	Low defence budget (DE, ES) Proximity to Russia (CEE, Nordics)	Centralise financing and procurement at EU level
Political instability, fragmentation	Elections (DE, PL) Fragile governments (FR)	Compromise at the national level *Coalitions of the willing* at EU level
Stronger dollar	EMEs, Türkiye, Hungary	Buildup of reserves Prudent debt management, local-currency issuance

Source: Scope Ratings

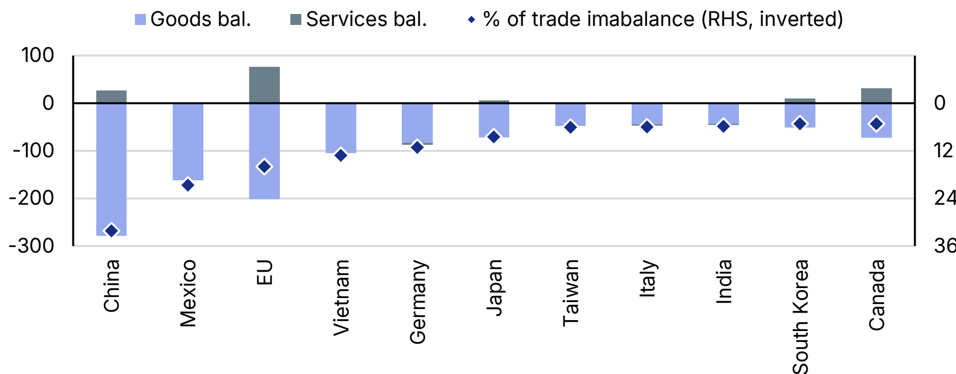
1. Potential tariffs on Europe likely to affect Germany and Italy the most

Five countries account for around 77% of US trade deficit

China, Mexico, Vietnam and Germany collectively account for 77% of the US' overall trade deficit. While the US has a services surplus with the EU of around USD 75.7bn, the goods deficit is large at around USD 202bn. Past attempts to lower the trade deficit with Germany during President Trump's first term were not successful, which may encourage the use of more targeted trade barriers in the future.

Figure 1: US goods & services balance by country

year to Q3 2024, USD bn



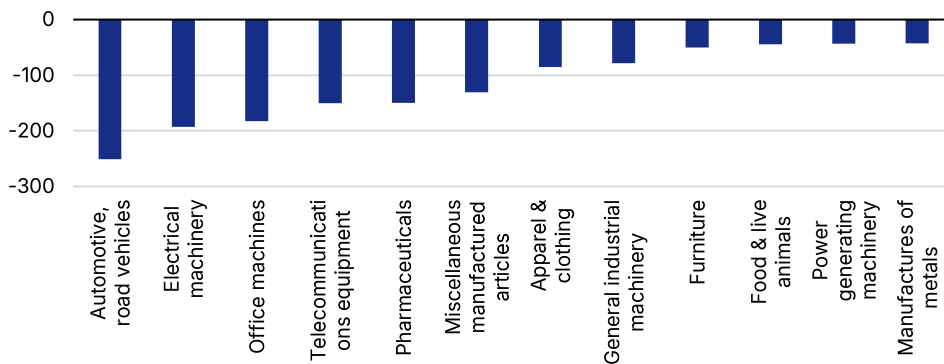
Source: IMF, Scope Ratings

Five sectors account for around 70% of US trade deficit

Five sectors account for around two-thirds of the US goods deficit, led by the automotive sector (USD 250bn), electrical machinery (USD 189bn), office machines (USD 167bn), telecommunications equipment (USD 138bn) and pharmaceuticals (USD 138bn).

Figure 2: Top deficits in trade of goods by category

2024, USD bn



Note: Goods classified according to the Standard International Trade Classification (SITC).
Source: US Census Bureau, Scope Ratings

Tariffs on automotive sector would hit Germany, Italy the most

The significant automotive trade deficit with the EU reflects the asymmetry in trade flows, with the EU exporting to the US around 15% of total European automotive output while US vehicles exports to the EU account for just 2% of total US automotive production.

Should the US impose additional tariffs on the EU's automotive sector (currently 2.5%), German and Italian automotive industries would be affected the most as around 25% of Germany's and 30% of Italy's extra-EU automotive exports go to the US, compared with around 5% of their Spanish and French counterparts[1].

[1] Oxford Economics: Driving into uncertainty: How Trump's tariffs could derail Europe's automotive powerhouse

Escalating trade tensions between the US and China are likely to disproportionately affect Germany given the country's close trade ties with China as Germany's second largest trading partner in 2024, with a trade volume of EUR 246bn, after the US with a trade volume of EUR 253bn. There are significant supply chain interlinkages as China is Germany's largest source of imports (12% of imports) while the US remains Germany's largest export destination (10% of exports).

US tariffs on China to hit Germany most

To mitigate risks associated with shifting US trade policies and reduce reliance on Chinese imports, Europe has several strategic policy options, broadly categorised as de-risking, appeasing and countering. Advancing strategic free trade agreements with other jurisdictions and deepening the integration of its single market as well as accelerating the savings and investment union would help mitigate the adverse impact of US tariffs. These measures are critical to boost Europe's long-term economic resilience and growth potential.

EU mitigation policies can be de-risking, appeasing or countering

Policies aimed at appeasing the US administration could include higher purchases of US gas and military equipment, adapting the EU's forthcoming carbon border adjustment mechanism, effective January 2026, or reducing existing tariffs on US imports and raising tariffs on China to demonstrate alignment with the US. These measures could ease near-term economic and political concerns and potentially lead to the suspension or cancellation of proposed tariffs. However, appeasing strategies would likely increase the EU's dependence on the US on energy and defence while also potentially undermining the EU's leadership in progressing the green transition.

Finally, imposing counter-tariffs targeted at politically sensitive sectors in the US may either result in renegotiated tariffs, which would be credit positive, or alternatively lead towards an escalation of trade tensions, a credit negative.

2. Higher defence spending to curb fiscal space, unless financed at EU level

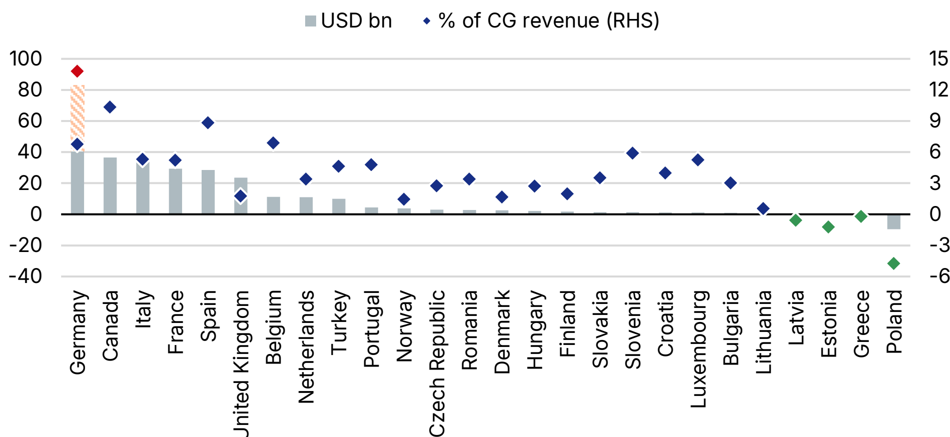
The second important impact on Europe from Trump's policy shift is the structural impact on fiscal budgets. Higher defence expenditures are necessary not only to meet President Trump's demands but also to strengthen deterrence against Russia's security threats.

Defence expenditure to structurally affect EU budgets

To meet a potentially revised 3% of GDP NATO defence expenditure target, up from the current 2% target, EU member states would need to allocate, on average, an additional 0.8% of GDP each year. Relative to annual central government revenues, this implies an increase in the share of the budget being spent on defence of around 5-10pp, led by Spain (9pp), Germany (7pp), France and Italy (both around 5pp). Increased military expenditure could support GDP growth in the EU if spending is directed at EU military equipment purchases rather than imports from the US.

Figure 3: Estimated budgetary effort required to reach 3% of GDP defence spending target

EUR bn (LHS), % of central government (CG) revenue (excluding social security funds, RHS)



Note: Orange bar and dot reflect the final estimated budgetary impact once Germany's one-off funds expire.
Source: NATO, IMF, Scope Ratings

For Germany however, we note that the budgetary impact is larger once the one-off funds from its EUR 100bn special defence fund are spent by end-2026. To reach a hypothetical 3% target, the 2024 budget allocation for defence spending would have to rise from 11% (EUR 52bn, or 1.2% of GDP) to 27% (EUR 130bn).

Germany likely to be most impacted after 2026

Given already stretched fiscal budgets, the financing of security, defence and the reconstruction of Ukraine could be increasingly shifted to the European level, most likely via the EU as well as the EIB and EBRD (all rated AAA/Stable)[2].

Political, financing incentives may push security, defence to EU level

Such a move would provide more sustainable financing and could also create economies of scale in defence and security procurement. The centralisation of EU security and defence would mark a significant political step towards a closer union. In addition, depending on the design of the financial instrument, it could also contribute to a permanent increase in the supply of European safe assets, strengthening financial stability across the region.

3. Rise of far-right parties, deeper political fragmentation call for EU governance shifts

The third major challenge faced by the EU stems from the potential for deeper political fragmentation exacerbated by President Trump's support for far-right parties and leaders across Europe. Where such parties are not in government, their growing influence is visible in how mainstream parties are adopting elements of the far right's policy agenda.

Far-right parties complicate finding policy at the EU level

The upcoming German elections, and the extent to which the far-right AfD will influence German policy even if it is not part of the next government, will be critical in shaping Germany's as well as the EU's political priorities. Similarly, Marine Le Pen's influence over the French legislative agenda until the next presidential elections in 2027 will be important in shaping France's role in EU reforms.

Traditional political parties will need to compromise more than they have in the past to navigate this growing political divide. In addition, the EU may need to move away from unanimity and qualified majority voting at the European Council towards decision making based on 'coalitions of the willing'. This may reduce the blocking power of single member states and political parties and could facilitate progress on important European projects such as the savings and investment union but also financing European defence and energy infrastructure.

'Coalitions of the willing' may be needed to advance EU reforms

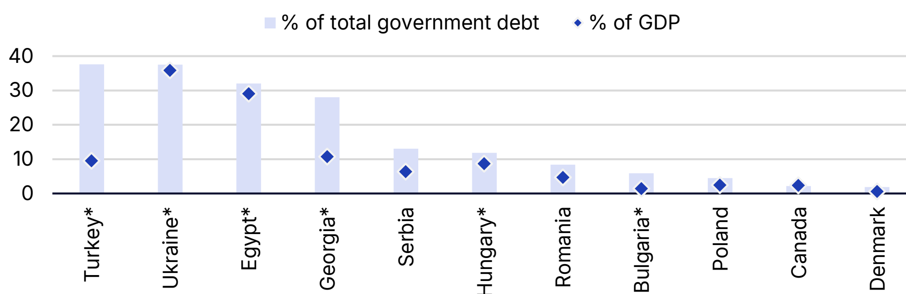
4. Stronger dollar raises borrowing costs for EMEs, select CEE sovereigns

Finally, Trump's policy agenda – including higher tariffs, mass deportation of illegal migrants, deregulation and the anticipated tax cuts – is expected to fuel inflationary pressures and slow, if not reverse, the Federal Reserve's easing of monetary policy.

Countries with large borrowings in dollars face higher financing risks

Figure 4: USD-denominated government debt

latest data available



*Central government debt

Source: Eurostat, World Bank, IMF, Bloomberg, national debt management offices.

[2] Investments in the defence and security sectors are subject to dual-use requirements and exclusion criteria for weapons and ammunition.

Stronger dollar promises higher financing costs in EM countries

As we expect other central banks to continue with their monetary easing cycle, the dollar could strengthen further. This would lead to higher borrowing costs for countries issuing in dollars, especially emerging markets, where reliance on external financing remains substantial. Among our rated universe this includes countries such as Ukraine (SD), Egypt (B-), Türkiye (BB-), Georgia (BB) but also CEE sovereigns such as Hungary (BBB), Romania (BBB-) and Serbia (BB+).

Importantly, we note that dollar-denominated government debt exposures relative to economic output remain broadly moderate across most of these sovereigns, with the exceptions of Ukraine and Egypt (around a third of GDP). For these sovereigns, a stronger dollar increases the debt servicing costs, as more of their local currency is needed to meet dollar-denominated obligations. This can strain national budgets, particularly for sovereigns with high levels of external debt, increasing debt sustainability risks.

Premium on strong external financial buffers, diversified funding

Additionally, a stronger dollar can lead to inflationary pressures, capital outflows, and rising borrowing costs, as investor demand shifts to safer dollar assets. This often forces governments to raise interest rates, cut spending, or adjust fiscal policies, which can slow economic growth and worsen financial instability.

Enhancing external buffers, particularly by increasing foreign-exchange reserves, is a crucial risk mitigation strategy. Over the medium term, diversifying away from dollar funding through euro-denominated issuances or local-currency funding (depending on the development and depth of local capital markets) can structurally reduce dependence on the dollar.

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