COMMENTARY
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Uncertain Times

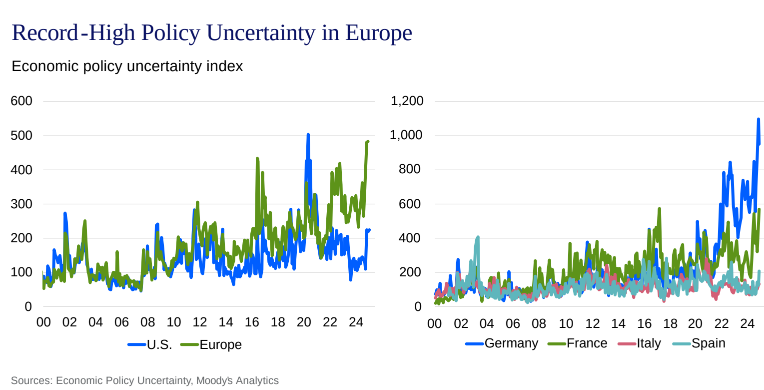
A historically high level of uncertainty has been a major factor holding back the euro zone economy.

- Policy uncertainty is running high in Europe.
- U.S. policy is a significant source of uncertainty, but difficulties around setting national and EU-level policies are also creating an environment of caution.
- The lack of clear policy direction will weigh on growth.

Uncertainty introduces caution and drags on the economy as consumers and firms, unsure of their future, reach the conclusion that the best thing to do is to sit and wait. If uncertainty goes on long enough, it can have permanent scarring effects.

Since the start of COVID-19, European households and firms have faced waves of uncertainty, leaving them unsure of what the future holds. This uncertainty has grown in recent weeks now that the U.S. has embarked on a tariff war, and uncertainty is unlikely to come down any time soon. For Europe, this “Trumpian uncertainty” is not limited to the potential for the U.S. to levy tariffs. There is uncertainty around the extent of retaliation and the possibility of a spiraling trade war, uncertainty around Europe’s competitiveness in the face of U.S. protectionism, and geopolitical uncertainty given Trump’s comments on Greenland, Russia-Ukraine, and the Middle East. Europe’s weakened economy and numerous vulnerabilities mean there is considerable anxiety around U.S. policy and its impact on Europe.

It is also unclear how Europe could protect itself if it gets dragged into an economic and geopolitical war with the U.S. Member states face fiscal constraints and have different political agendas. While the EU may step up to provide support, the process of getting member states to agree could be fraught. Just as much as Trump’s policies could affect Europe’s future, so could its own.



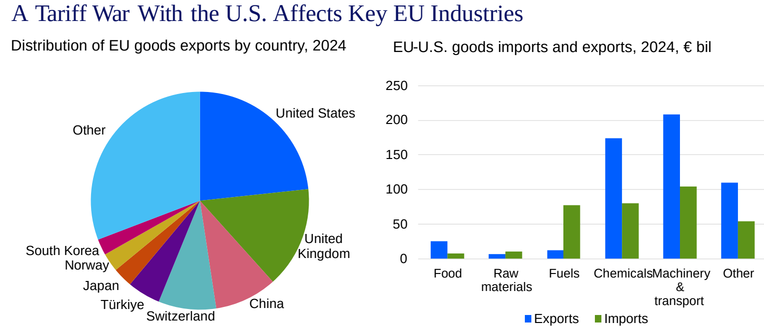
Policy uncertainty on both sides of the Atlantic is, therefore, a cause for concern, and an empirical measure confirms this. The economic policy uncertainty index for Europe shows a steady increase in recent years. This is not surprising given the various policy challenges Europe has faced and continues to face. These include the response to COVID-19, the Russian invasion of Ukraine, Europe's energy policy, its structural problems around competitiveness, its domestic politics, and its relationship with China to name a few. Add to that the new winds blowing from the U.S. administration and it is easy to understand why policy uncertainty in Europe stands at an all-time high. There are also considerable differences across major European countries, with higher policy uncertainty in France and Germany and less in Italy and Spain. This could reflect the greater sensitivity of the former countries to Trump's policies as well as their own political problems, which have been affecting fiscal and industrial policy. Policy uncertainty has also increased in the U.S. recently, though it is not as high as in Europe, presumably reflecting the more robust state of the U.S. economy.

Sources of policy uncertainty

There are a number of reasons for policy uncertainty in Europe.

Trade policy. A global trade war is in full swing, and with new U.S. tariffs on iron and steel, the EU has already fallen within Trump's crosshairs. The extent of the impact and potential escalation is unclear as the EU may decide to appease Trump and mute its response; it may even manage to negotiate tariffs away. The EU has been here before, and it has shown a willingness to retaliate. The problem this time is that the stakes are higher and the impact bigger. Moreover, some countries are more vulnerable than others. Germany is a far bigger goods exporter to the U.S. than, say, Spain, and Germany's fragile automotive sector, a key employer, is likely to draw Trump's ire next. The unequal impacts will make it difficult for the EU to negotiate a swift common response, especially given its decision-making structure. Uncertainty over the extent or duration of U.S. tariffs, and the extent of any tit-for-tat retaliation, complicates decision-making for firms. Households also will be concerned about the potential impact on prices and jobs.

A Tariff War With the U.S. Affects Key EU Industries

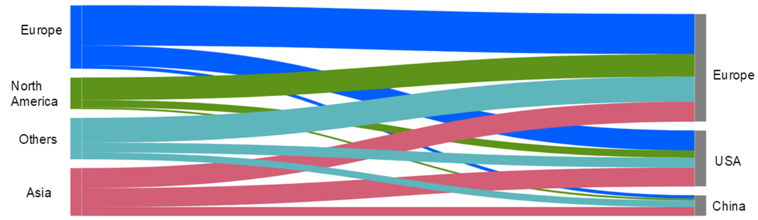


Sources: Eurostat, Moody's Analytics

The EU-U.S. alliance. Much more speculative but weighing on the long term is the prospect of both economic and geopolitical scarring. The retreat from globalisation has started with a tariff war. But it is early, and matters could go much further, as the EU itself has recently hinted. The EU could invoke its recently introduced Anti Coercion Instrument, which gives the EU broad powers to retaliate and could move the stand-off from trade in goods to services and other areas. Both sides stand to lose in the ensuing tit-for-tat, and economic boundaries could be redrawn. While we are not at the point where such broader measures are being openly discussed, the mere possibility of such a wide-ranging breakdown in the relationship is troublesome. In addition to their sales to the U.S., firms will be concerned about their investments in the U.S. and their reliance on U.S. tech services. The U.S. is the largest destination for cross-border investment from Europe, and an economic war could not only lead to flows drying up but could also adversely impact existing operations in the U.S.

Europe Invests Significantly in the U.S.

Announced capital expenditure by source (L) and destination (R), 2019-2024



Sources: ORBIS Cross Border Investment, Moody's Analytics

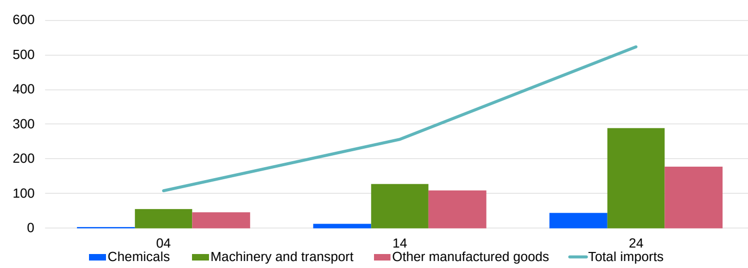
There are also geopolitical concerns such as the resolution of the Russia-Ukraine war and the threat to Greenland. The impact on firm and household uncertainty is a matter of conjecture now, but these issues could become of much bigger concern.

China policy. A trade war also adds to the uncertainty around a rebound in global economic prospects. One reason why Europe's trade-based economy has struggled in recent years is its reliance on improvements in key export markets, particularly China. With China already struggling and now set to suffer under the weight of higher tariffs, this creates further difficulties for European firms.

Europe has been seeking to reduce its trade imbalance with China, and last year, it levied tariffs on Chinese EVs to address concerns about unfair Chinese practices. China has rapidly climbed the technology curve in the past decade, leaving Europe vulnerable not just to a loss of sales in China but also to Chinese competition at home. With Chinese exports to the U.S. now facing even higher tariffs, China may resort to trade diversion and seek to sell more goods to Europe, further pressuring domestic firms. The EU response will be difficult to calibrate.

China Is the EU's Largest Import Partner

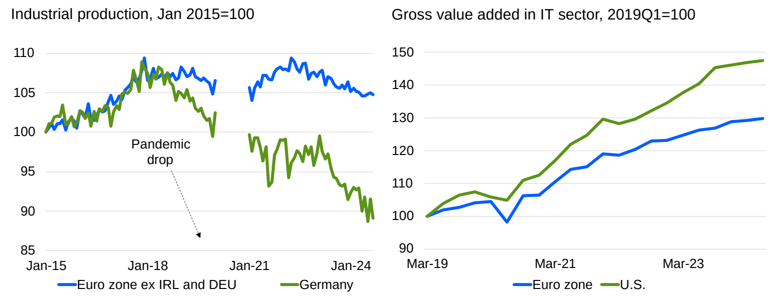
EU goods imports from China, € bil



Sources: Eurostat, Moody's Analytics

European industrial policy. Concern has been brewing around the issue of European competitiveness more generally for a while. Pressured by China, Europe has been losing ground in industries in which it traditionally enjoyed a competitive advantage such as automotives and energy-intensive industries. At the same time, a lack of innovation has meant that it is losing out to the U.S. in new industries such as artificial intelligence. It is not a given that Europe will lose its position as an industrial powerhouse, but neither is it assured that European policy will revive Europe's fortunes. As the Draghi report points out, there is much about the EU that needs to improve in order to breathe life into an increasingly moribund industrial sector, and this will also require significant investment. There is also a need for better industrial policy at the national level, as domestic criticism of Germany's *Energiewende* or energy transition shows. Policy needs to move in multiple directions, from the big bazooka of investment spending to market reform and removing frictions for firms.

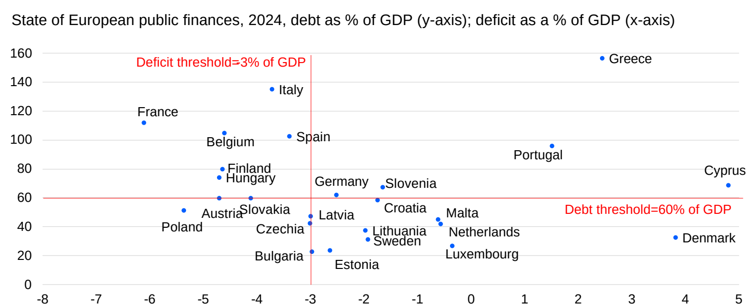
Industry Struggles, While Tech Trails



Sources: EU Commission, World Population Review, Moody's Analytics

Fiscal policy. The future of European fiscal policy is a final key source of uncertainty. At the European level, the issue of how much to spend on priority areas has to be coupled with the issue of how to. The EU budgetary process is criticised for being both insufficient and arcane. Allowing the EU to borrow more would create the big bazooka, but equally important is streamlining the process for spending in order for it to be effective. There are also fiscal concerns at the national level. French politics shows how tricky things can get after Emmanuel Macron's snap election led to a very unstable government being formed. One prime minister and several months later, a budget has just been passed with François Bayrou surviving a no-confidence vote. Spending cuts lie ahead if Europe's fiscal rules are to be met, while a steep increase in borrowing costs awaits if the government shirks its responsibilities. Then there is the prospect that the next German government will reform that country's famously conservative "debt-brake rule", which could reverberate across euro zone bond markets as it results in a reset of yields across countries. At best, lack of clarity around the direction of fiscal policy holds Europe back; at worst, it risks creating sovereign stress.

Fiscal Constraints Affect Major European Countries



Sources: Eurostat, Moody's Analytics

Economic impact of uncertainty

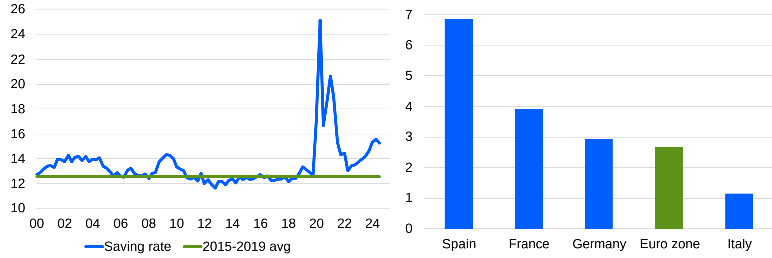
Uncertainty can weigh on the economy in a number of ways: Firms defer investment decisions, consumers are likely to delay big-ticket purchases and add to their savings, investors trim their holdings of risky assets, and lenders reduce their risk appetite.

The impact of the uncertainty facing the euro zone is arguably clearest for consumers, in the form of unusually high household saving rates. The spike in savings over 2020 and 2021 largely reflected restrictions on service consumption amid the COVID-19 lockdowns, leading to extensive debate over when these "excess savings" would be spent. But rather than dropping back as households spent these funds, as seen in the U.S. over the past couple of years, euro zone saving rates experienced a renewed increase and remain well above pre-pandemic averages. This has gone hand in hand with continued weakness in consumer confidence, with the Economic Sentiment Indicator remaining close to its lowest level on record outside of recessions.

Savings Rates Much Higher Than Before Pandemic

Euro zone gross household saving rate, %

Saving rate by country, change vs. 2015-19 avg, ppts



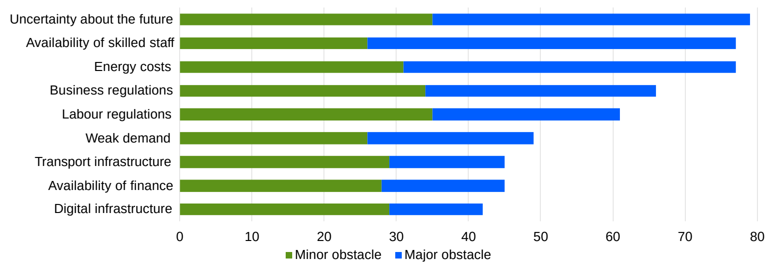
Sources: Eurostat, Moody's Analytics

The enduring caution of households has been an important driver of the underperformance of the euro zone economy since the pandemic. Real household consumption was still 4.6% below its pre-pandemic trend as of the third quarter of 2024. However, if the gross household saving rate dropped back to its 2015-2019 average, consumption would be 3% higher, and the shortfall relative to the pre-pandemic trend would shrink to only around 2%.

Fixed investment in the euro zone is still a huge 16% below its pre-COVID-19 trend, and uncertainty appears to be playing an important role here too. According to the European Investment Bank's 2024 Investment Survey, 79% of EU firms cited uncertainty about the future as an obstacle to investment ahead of any other factor.

Uncertainty Is the Single Biggest Barrier to European Investment

Obstacles to investment in the EU, 2024, % of firms

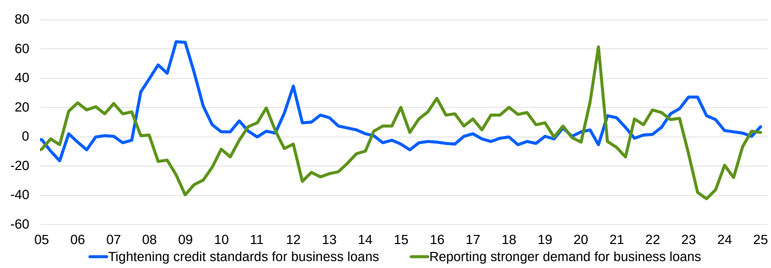


Sources: European Investment Bank, Moody's Analytics

Uncertainty is far from the only explanation for weak investment; energy costs, staffing availability, regulations and financing conditions also feature prominently in the EIB survey. That said, the latter may also, in part, reflect the impact of uncertainty on lenders. The European Central Bank's bank lending survey shows a widespread tightening of credit standards for business loans in recent years, which has continued over the past couple of quarters even as demand for loans has started to revive.

ECB Survey Shows Continued Lender Caution

Net % of banks, past 3 mo



Sources: ECB, Moody's Analytics

Overall, it seems clear that the historically high level of uncertainty has been a major factor holding back the euro zone economy. Uncertainty over future economic prospects has kept consumers hesitant to spend, even as real wages rebounded from the 2022 energy price shock. Rising uncertainty has also compounded the hit to business investment from tight financial conditions and muted global growth. To the extent that some of the current drivers of uncertainty—such as the immediate direction of U.S. trade policy or fiscal policy in France and Germany—should eventually clear, the implication is that part of the economic drag will fade. And with uncertainty often driving consumers and firms to delay and not necessarily cancel spending decisions, this could imply a period of stronger growth once pent-up demand is unwound and accumulated savings are spent. However, other sources of uncertainty are more fundamental and could weigh on European economies for years to come.