Funcas Intelligence

SHIFTING ALLIANCES AND RISING RISKS

July 2025

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Funcas Intelligence (FI) is a publication directed towards a broad base of international and Spanish readers. Funcas Intelligence´s focus is to identify and assess the game changers and relevant events of the global economy and the financial sector with potential impact for Spain.

FI is produced by the staff of Funcas under the direction and supervision of Managing Editors Ms. Alice Faibishenko and Mr. Juan Núñez-Gallego. We would like to especially thank Santiago Carbó Valverde for providing the views expressed in the article titled, *A Global Balancing Act.*

Contents

A Global Balancing Act

Rate cuts, currency divergence, and geoeconomic realignments

→ The ECB continues its easing trajectory while the Fed points to conditional openness to policy shifts, creating growing transatlantic monetary divergence.

→ Inflation and economic growth remain asymmetrical, complicating central bank mandates globally.

As the first half of 2025 concludes, the financial and geopolitical landscape remains fraught with tension. While the post-April 2nd tariff negotiation period in the U.S. has technically entered its final days, consensus remains elusive. U.S. trade representatives have signalled openness to bilateral exemptions, yet China, Brazil, and India have hinted at retaliatory frameworks tied to digital services and critical minerals.

The result is a fragile situation layered over persistent economic uncertainty. Financial markets have shown heightened sensitivity to central bank decisions, fiscal imbalances, and real-time geopolitical developments.

U.S.: Monetary patience in a highly politicized climate

The Federal Reserve continues its wait-and-see approach, holding rates steady at 4.25% -4.50%. However, new messaging in June's FOMC minutes hints at a possible shift. Chairman Powell, while reiterating the need for "convincing evidence" of inflation moderation, acknowledged that "a window may be opening for limited recalibration."

The Fed continues its wait and-see approach, holding rates steady at 4.25%–4.50%; however, June's FOMC minutes hint at a possible shift

The White House intensified its rhetorical push for rate cuts, citing wage stagnation and softening in non-residential investment. Nevertheless, the Fed remains cautious. While headline inflation dipped to 2.4% in May, core inflation has proven sticky at 2.8%, with housing and services components still at high levels.

Bond markets have reacted with cautious optimism: the yield on 2-year Treasuries declined by 18 basis points in June, and volatility–while still elevated–has retreated slightly from April peaks. However, the inversion of the yield curve continues to reflect deep investor unease.

Europe: Rate cuts deepen but structural headwinds persist

The ECB announced its eighth consecutive rate cut in mid-June, lowering the deposit facility rate to 2.00%. Policymakers remain committed to easing

The ECB cut rates for the 8th time in a row in mid-June, bringing the deposit facility rate to 2.0%

despite some lingering inflation pressures, particularly in some southern economies where food and energy prices have not fully normalized.

Tariff turmoil and global economic uncertainty seem to be having a greater negative impact on prospects for the U.S. economy and the dollar than the widening U.S.-Eurozone rate gap, such that dollar-denominated assets are taking a hit

The ECB's easing has widened the U.S. Eurozone rate gap. However, the euro keeps appreciating against the U.S. dollar (well above 1.18 dollar/euro). Tariff turmoil and global economic uncertainty seem to be affecting more negatively the prospects for the U.S. economy and the dollar, such that dollar-denominated assets are taking a hit.

Investor positioning: Treading the tightrope

In fixed income, investors are increasingly barbell-structuring their portfolios, balancing short-duration inflation-protected assets with selective long-duration bets on easing cycles. The divergence between U.S. and European monetary paths has created fertile ground for currency-hedged carry trades and relative value strategies.

Equities remain range-bound, with investor enthusiasm tempered by geopolitical uncertainty. The tech sector, driven by AI and semiconductor dynamics, continues to outperform, but signs of sector fatigue keep emerging. Energy and industrials have become more attractive as hedges against geopolitical supply shocks, particularly in natural gas and critical materials.

Alternative assets–particularly infrastructure and renewables–have seen renewed interest, driven by both inflation protection features, and policy tailwinds related to energy sovereignty.

On 12 July, President Trump announced he would increase tariffs on all EU goods to 30% if the two sides do not reach a deal by 1 August

The next quarter will be decisive. On 12 July, President Trump announced he would increase tariffs on all EU goods to 30% if the two sides do not reach a deal by 1 August. He also threatened to raise tariffs even higher if the EU retaliates. Funcas plans to assess the implications of the announcement in the months ahead. The Federal Reserve's Jackson Hole Symposium in late August may mark a turning point in forward guidance, while the ECB will face pressure to justify further easing as inflation shows signs of persistence.

Investors will need to remain agile, monitoring not only interest rate decisions but also geopolitical developments

Investors will need to remain agile, monitoring not only interest rate decisions but also geopolitical developments. In a world where policy is reactive and crosscurrents are increasingly non-linear, staying ahead will require global awareness, tactical accuracy, and a large tolerance for unclear trends and ambiguity.

De-Dollarization

Assessing the euro's strategic positioning

→ The United States' role as the anchor of the global financial system is being challenged by many factors, such as perception of the U.S. weaponization of the dollar, growing efforts from other countries seeking to reduce their reliance on the dollar, U.S. fiscal concerns, and concerns about the independence of the Federal Reserve, creating opportunities for other countries to play a greater role, but also creating risks.

→ As the de-dollarization trend gains momentum, the EU appears well-positioned to partially capitalize on this evolving landscape, provided it acts proactively; however, it also faces numerous constraints that will limit its growth.

Introduction

For decades, the United States has been the anchor of the global financial system, a status that has afforded the country significant economic and political advantages. However, the dollar-centric order is currently being challenged, prompting central banks and corporations to reduce their reliance on the dollar and diversify their currency holdings. From 2015 to 2024, the dollar's share of global foreign exchange reserves dropped from 66 to 57%.[1]

This de-dollarization trend is driven by many factors, including the perception that the United States has weaponized the dollar's role in international finance. The U.S. government's frequent use of economic sanctions to advance its foreign policy goals, as well as its coordinated ousting of Russian financial institutions from the SWIFT payments system in 2022, has undermined trust in the neutrality of the dollar-based financial system.

An increasing number of countries are exploring alternatives to dollar-denominated trade, including through the use of digital currencies.[2] China, which has long advocated for the internationalization of its renminbi (RMB), is at the forefront of efforts to challenge American financial supremacy and encourages countries to experiment with non-dollar transactions, leveraging emerging technologies, including China's digital RMB.[3] Russia's central bank also announced in July 2024 that importers and exporters could use cryptocurrencies in cross-border settlements under foreign trade agreements as part of an "experimental legal regime."[4] In addition, the BRICS bloc of nations, initially comprising Brazil, Russia, India, China, and South Africa, has announced plans for a digital currency cross-border payment solution to reduce its reliance on the U.S. dollar.

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Confidence in the dollar is eroding due to the ballooning U.S. national debt, concerns about the independence of the U.S. Federal Reserve and U.S. monetary policy, and weak economic growth prospects. The U.S. debt-to-GDP ratio is 121%, double the benchmark widely considered to be fiscally sustainable.[5] Yet, there is little political appetite for reducing the debt. The U.S. Congress has just approved the One Big Beautiful Bill Act, a measure expected to add trillions to the national debt.[6] Since assuming office in January, Trump has publicly criticized U.S. Federal Reserve Chairman Jerome Powell for not lowering interest rates. Trump has reportedly considered selecting and replacing Powell in the fall, even though Powell's term does not expire until May 2026.[7] Moreover, Trump's aggressive and unpredictable use of tariffs has also clouded the prospects for U.S. economic growth, creating U.S. policy uncertainty.

Investors are looking for safe haven assets and other avenues during this period of uncertainty. Refuge currencies such as the Swiss franc and the Japanese yen have performed well against the dollar recently, but also have to manage the unanticipated consequences of increased flows.[8] Swiss inflation turned negative in May as the surge in the franc has reduced the prices of imported goods and put pressure on the central bank to cut rates below 0%.[9] The Japanese yen has strengthened faster than Japanese policymakers wanted, which forced the Bank of Japan to abandon its plans to raise interest rates.[10]

This shift away from one dominant currency is not without historical precedent. The British pound sterling was the cornerstone of global trade and finance before it ceded its status to the U.S. dollar by the mid-20th century. The sterling's decline was gradual and accompanied by deep institutional change, suggesting a possible scenario for a transition away from the dollar.[11]

While the euro was not initially conceived as a currency to rival the dollar, but rather to underpin, through economic rationale, the project of EU integration more deeply, leaders have long harbored ambitions for the euro to play a more significant international role. As the de-dollarization trend gains momentum, the EU appears well-positioned to capitalize on this evolving landscape, provided it acts proactively; however, it also faces numerous constraints that will limit its growth.

Risks of de-dollarization

Global risks

Replacing the dollar with a basket of currencies would likely increase transaction costs, increase exchange rate volatility, reduce price transparency, and complicate liquidity management

A transition away from dollar hegemony poses significant risks for the global financial system. A decline in the international demand for dollars could trigger a corresponding weakening of its value. Such a development would create significant instability, particularly for emerging markets that hold large amounts of dollar-denominated debt. Replacing the dollar with a basket of currencies would likely increase transaction costs, increase exchange rate volatility, reduce price transparency, and complicate liquidity management.

On a geostrategic level, such a shift could also lead to the formation of competing financial blocs. Countries could then utilize these alliances as a diplomatic tool or a means of pressure, heightening geopolitical tensions and further fragmenting the global economic order.

U.S. risks
For the United States, de-dollarization would have far-reaching consequences. Chief among them is the potential loss of its "exorbitant privilege," which allows the United States to finance deficits at lower interest rates than it would otherwise incur.[12] The loss of this financing advantage would result in higher interest rates for the United States. In turn, this would raise borrowing costs for the U.S. government, exacerbating the nation's fiscal challenges. A depreciating dollar would also increase the cost of imports, potentially stoking inflation.

A diminished role for the dollar would also curtail U.S. geopolitical power. It would reduce its influence over global economic governance and undermine U.S. leverage in enforcing sanctions. It could also reduce foreign capital inflows into U.S. equities, bonds, and real estate, depressing asset valuations and decreasing market liquidity.

EU Risks
Despite potential gains from de-dollarization, a move away from the dollar would also present risks and challenges to the EU. Volatility in euro exchange rates could increase if the euro assumes a more prominent international role and appreciates due to heightened global demand. Such an outcome would create uncertainty for exporters. Furthermore, many EU countries hold substantial reserves denominated in U.S. dollars and maintain financial institutions with heavy dollar exposures.

The European banking sector would be more acutely impacted. Nearly a quarter of European banks have insufficient U.S. dollar funding to cover their exposures to the currency, leaving them exposed to liquidity shocks.[13] This vulnerability highlights the fragility of the EU's financial system, such as the impact of geopolitical instability or changes in U.S. monetary policy.[14]

Nearly a quarter of European banks have insufficient U.S. dollar funding to cover their exposures to the currency, leaving them exposed to liquidity shocks

This structural shortfall also creates a critical dependency on the U.S. Federal Reserve, which can provide emergency dollar liquidity via a swap line arrangement. This arrangement, however, may no longer be guaranteed in the future.[15] Despite vehement pushback from some U.S. officials, President Trump and other senior members of his administration have provided ample evidence via their public comments about transatlantic relations to doubt the reliability of these swap lines and whether Trump would place additional conditions on them. To prepare for such a scenario, ECB supervisors are asking some of the region's banks to assess their need for U.S. dollars in times of stress, and as needed, reduce their exposure to dollar funding.[16]

The euro's prospects
The European Commission has emphasized the need to "strengthen the international role of the euro" to reduce vulnerabilities and enhance the EU's strategic autonomy.[17] The eurozone possesses many of the attributes necessary for reserve currency status, including a large economic area, strong legal institutions, a credible and independent central bank, and macroprudential tools to manage the risks associated with large and volatile capital flows.[18]

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However, structural impediments limit the euro's global growth, such as the EU's fragmented capital markets. Unlike the United States, which offers a single, deep, and highly liquid market for government debt, the eurozone is a collection of separate sovereign debt markets. The EU also lacks a fiscal union, which would ideally include a common safe asset and a centralized treasury. The lack of a fully implemented banking union further compounds these issues, limiting risk-sharing across the monetary union.

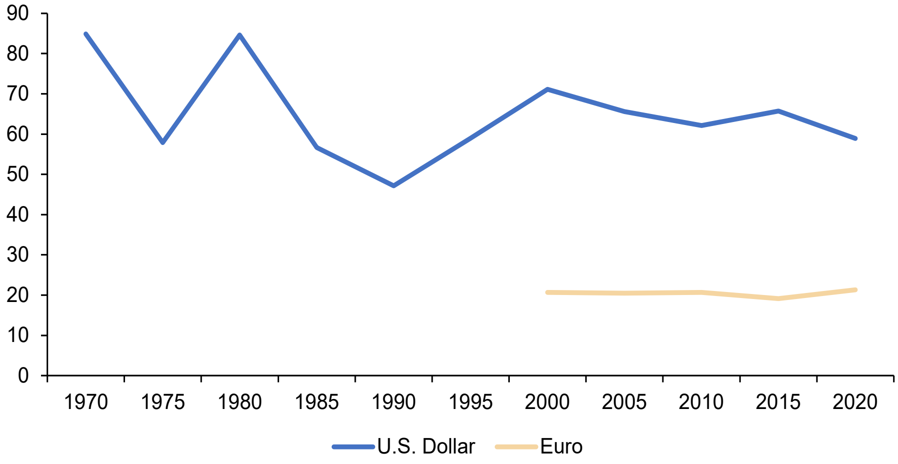
Deep liquid capital markets are critical to rival the dollar, but the size of the U.S. Treasury market ($28 trillion) dwarfs the €1.8 trillion market for German government bonds.[19] The global role of the euro also remains limited. The euro only accounts for one-fifth of global foreign exchange reserves.[20] Lastly, the EU lacks the military power necessary to prevail and maintain the value of its assets in the event of a conflict.[21]

Conclusion

Funcas believes that the current global shift away from the U.S. dollar could result in an increased international role for the European currency if the EU acts boldly to deepen its financial union

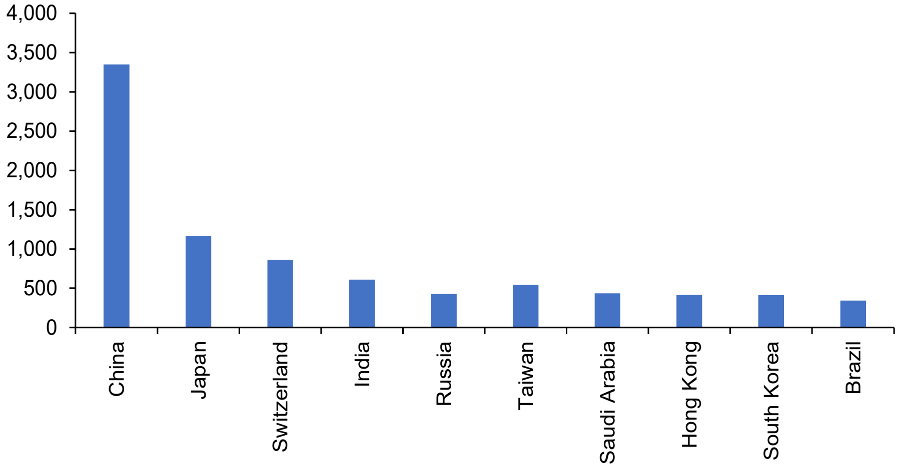
Funcas believes that the current global shift away from the U.S. dollar could result in an increased international role for the European currency if the EU acts boldly to deepen its financial union. There are a number of steps EU leaders could consider. First, they could increase the availability of safe assets. Investors require deep, liquid, and safe asset markets. The EU could accomplish this by issuing more joint debt instruments, building on the precedent set by the Next Generation EU (NGEU) recovery fund, to replace the fragmented landscape of national sovereign bonds gradually.[22] Second, they could delay the scheduled repayment of the NGEU funds to retain the large stock of highly rated securities and enhance the euro's attractiveness as a reserve currency.[23] Third, they could pre-fund future spending as part of the EU's negotiations over the next seven-year budget (2028–2035). This could be done through jointly issued euro-denominated bonds, which would offer another tranche of safe assets for global investors. Fourth, they could deepen international trade and expand trade agreements, such as passing the pending Mercosur trade deal with Argentina, Brazil, Paraguay, and Uruguay, to foster the broader use of the euro in cross-border settlements and contracts.[24] Lastly, they could offer financial tools to encourage trading in euros. Developing a digital euro, increasing the availability of euro-denominated swap lines, and fostering deeper capital market integration could support a greater international role for the euro.

EXHIBIT 1.0 – U.S. DOLLAR AND EURO SHARE OF GLOBAL FOREIGN EXCHANGE RESERVES, 1970-2020



Source: International Monetary Fund data.

EXHIBIT 2.0 – TOP 10 COUNTRIES WITH THE LARGEST FOREIGN EXCHANGE RESERVES (VALUE OF NON-GOLD RESERVES IN U.S. $ BILLIONS)



Note: Based on the last data reported, ranging from October 2024 to May 2025.
Sources: IMF data, World Bank data, and Central Bank of the Republic of China (Taiwan).

Notes

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[2] https://www.cfr.org/backgrounder/dollar-worlds-reserve-currency

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[4] https://www.cbr.ru/eng/press/event/?id=18884

[5] https://www.worldpoliticsreview.com/us-dollar-transition-hegemony/?one-time-read-code=375420175054148312103 9

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[7] https://www.cnbc.com/2025/06/26/dollar-hits-fresh-lows-as-trump-attacks-threaten-federal-reserve-credibility.html

[8] https://www.reuters.com/world/europe/dollars-crown-is-slipping-fast-2025-06-12/

[9] https://www.reuters.com/business/retail-consumer/swiss-inflation-turns-negative-first-time-since-covid-pandemic-2025-06-03/

[10] https://asiatimes.com/2025/05/how-trump-made-japans-yen-great-again/#

[11] https://www.worldpoliticsreview.com/us-dollar-transition-hegemony/?one-time-read-code=3754201750541483121039

[12] https://www.ft.com/content/5bc02699-3eda-465b-bd73-f5e8b9573ae8

[13] https://www.ft.com/content/882e200c-8055-41ce-a52f-2620e6cbdab0

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[15] *Ibid.*

[16] https://www.reuters.com/sustainability/boards-policy-regulation/ecb-supervisors-press-banks-dollar-funding-over-trump-concerns-sources-say-2025-05-14/

[17] https://finance.ec.europa.eu/eu-and-world/open-strategic-autonomy/international-role-euro_en#:~:text=An%20increased%20international%20role%20for,according%20to%20rule%2Dbased%20multilateralism

[18] https://www.ft.com/content/5bc02699-3eda-465b-bd73-f5e8b9573ae8

[19] https://www.ft.com/content/70565fda-ae7d-4c06-80ee-b460dc8de43e

[20] https://www.reuters.com/business/finance/dollar-keeps-losing-market-share-euro-is-no-winner-either-ecb-study-2025-06-11/

[21] https://business.columbia.edu/research-brief/dollars-dominance-military-financial-power

[22] https://www.ft.com/content/c02cdfac-8c46-4b67-9a3b-2aa4312852b9

[23] *Ibid.*

[24] *Ibid.*

The EU's Electric Vehicle Industry

Squeezed by China and the United States

→ Europe's electric vehicle industry is being squeezed by China's state-backed EV promotion policies and the rising protectionism in the United States at a time when Brussels is seeking to phase out new petrol and diesel cars to meet its climate neutrality goals.

→ These geopolitical tensions are forcing EU policymakers and carmakers to evaluate options to mitigate or reduce their exposure to these pressures.

The EU's automotive industry, a key driver of the continent's economy, including its growing EV sector, is facing mounting pressure from two geopolitical forces: aggressive, state-backed competition from China and rising protectionism from the United States.

The EU's battery electric vehicle (BEV) market share grew from 1.9% in 2019 to 13.6% in 2024.[1] Although Europe has traditionally been a challenging market for foreign carmakers, the number of Chinese-manufactured BEVs registered in the EU surged from 0.4% to 19.5% during this period.[2]

In 2022, the EU imported 314,000 Chinese BEVs–63% of its car imports from China–while exporting 17,000 to China. By contrast, 112,000 EU BEVs were shipped to the United States in 2024, representing 15% of the bloc's car exports. Imports of U.S.-made BEVs were nearly 19,000, or 11% of total U.S. car imports.

The Chinese model of state-backed competition

China's growth in the EV sector is the result of a long-term industrial strategy of large state subsidies, state-encouraged domestic competition, control over the global supply chain, and strategic foreign investments.

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Beijing invests heavily in its EV industry, providing an estimated $230 billion in rebates, sales tax exemptions, infrastructure subsidies, and research and development support between 2009 and 2023.[3] In 2024 alone, the Chinese conglomerate BYD received $527 million.[4] This robust support allows Chinese EV makers to undercut EU prices.

The government champions the national industry, which fosters domestic competition and leads to improved EV quality and lower prices.[5] Chinese EVs sold domestically are two to three times cheaper than those sold abroad.[6] BYD's Seagull model, for instance, launched at $7,765 — a price EU EV carmakers cannot match.

Chinese firms dominate the battery supply chain as well. They control a significant portion of the global processing of essential raw materials, such as lithium and cobalt, and the manufacturing of finished battery cells. This gives Beijing significant leverage and leaves European firms dependent on their top competitor for the most critical EV component.

As part of the government's Made in China 2025 strategy, China has been pursuing a domestic industrial policy to manufacture more high-value goods like EVs. The country has more than 200 EV manufacturers that produce more cars than what is needed to meet domestic demand, resulting in a surge of exports to find foreign buyers.[7] Chinese exports to the EU rose from 1% in 2019 to more than 50% in 2023.[8] More than half of Spain's BEV imports are from China.[9] In Germany and France, Chinese BEVs represent 16% of the market.[10] At the European level, BYD surpassed Tesla in sales for the first time in April.[11] BYD has also announced plans to release low-cost compact cars in Europe, which will further accelerate its growth in the region. This is notable because the transition from petrol to EVs in small cars has taken longer due to tight profit margins and the challenge of making cheaper versions, given the high price of batteries.[12]

Chinese firms are also expanding their influence and presence in Europe. In 2024, Hungary, Italy, and Poland signed agreements with China that emphasized their support for Chinese investments in the EV sector, and the French government said that Chinese automakers like BYD were welcome in the country.[13]

Chinese firms are acquiring European car companies and making significant EV-related investments in the region. Zhejiang Geely Holding Group, a Chinese car conglomerate, acquired Swedish carmaker Volvo Car Group in 2010. It also holds a majority stake in Polestar, another Swedish car manufacturer. BAIC Group, a Chinese company, became the largest stakeholder in German carmaker Mercedes-Benz Group in 2022. Hungary, the first EU country to receive significant Chinese EV-related FDI, is hosting two EV plants and two EV battery plants.[14] Chinese battery maker CATL and Dutch carmaker Stellantis announced a $4.3 billion investment in Spain in December 2024.[15] The Chinese company Chery and the Spanish company Ebro are also establishing operations at the former Nissan plant, located in the Barcelona Free Trade Zone, to manufacture vehicles. In January, the press reported that Volkswagen, a German carmaker, was in talks with Chinese companies about leasing or selling its underperforming factories.[16]

Taken together, these developments show that China is either hollowing out or slowly overtaking the European car industry.[17]

U.S. tariffs and subsidies

In March, President Trump announced a 25% tariff on all vehicle imports, including EVs from the EU, to protect U.S. carmakers. On 12 July, he said he would increase tariffs on all EU goods to 30% if the two sides do not reach a deal by 1 August. He also threatened to raise tariffs even higher if the EU retaliates. Funcas plans to assess the implications of the announcement in the months ahead. These tariffs make European cars less competitive and threaten to disrupt the deeply integrated transatlantic supply chain. The U.S. tariffs will be particularly difficult for Germany, which accounts for over 70% of the EU's car exports to the United States.[18]

President Biden pursued a different approach to support U.S. carmakers. The Inflation Reduction Act (IRA), adopted in 2022, enhances domestic EV supply chains with subsidies and tax breaks for North American-made EVs and batteries. This law made European cars less competitive and created a powerful incentive for European firms to shift investments and production to qualify for the benefits. The IRA's EV incentives, however, are under threat as Trump has announced his opposition to them, and both houses of the U.S. Congress have included provisions in companion legislation to phase them out rapidly. Congressional Republicans are under pressure to adopt the legislation quickly, as it is a legislative priority for Trump's second term.

The IRA's EV incentives, however, are under threat as Trump has announced his opposition to them, and both houses of the U.S. Congress have included provisions in companion legislation to phase them out rapidly

The EU's response: A diplomatic tightrope walk

To address the influx of cheap Chinese EVs, Brussels investigated Chinese EV subsidies and subsequently imposed provisional tariffs of up to 45% on these vehicles.[19] Beijing's initial reaction was retaliatory, but both sides have returned to the negotiating table.

To address the influx of cheap Chinese EVs entering the EU, Brussels launched an investigation into Chinese EV subsidies and subsequently imposed provisional tariffs of up to 45% on these vehicles

Despite the EU-imposed tariffs, Chinese carmakers pivoted to exporting cars that were exempt from the tariffs, like petrol-powered cars and hybrids.[20] They are also increasing their investments to relocate production in Europe to avoid the tariffs.

The EU is in negotiations with the United States to secure tariff relief. It had initially planned to respond to Trump's steel and aluminum tariffs by slapping tariffs of up to 50% on €21 billion of U.S. imports in April, but it postponed them to allow time for talks.

The response from EU carmakers to the tariffs has been mixed. Mercedes and BMW initially said they would absorb the costs, while Stellantis temporarily halted some North American production.

A crossroads for EU policymakers and carmakers

In response to the deluge of Chinese EVs, the EU does not have many good options. Firms could restructure their supply chains to reduce their reliance on China, although this is a costly, time-consuming, and probably unrealistic option. Funcas believes Brussels should acknowledge that it will be nearly impossible for European firms to compete with Chinese EVs and should therefore prioritize mitigating the impacts associated with the increased number of Chinese EVs in the EU market. To do so, Brussels and Member States could pursue Chinese greenfield investments in the EV sector that would help create jobs for EU citizens, facilitate the sharing of technological know-how, and limit market distortions and security risks.[21]

Funcas believes Brussels should acknowledge that it will be nearly impossible for European firms to compete with Chinese EVs and should therefore prioritize mitigating the impacts associated with the increased number of Chinese EVs in the EU market

The EU could respond to the United States by imposing tariffs, but this tit-for-tat escalation would harm both economies and create uncertainty for the EV sector. Increasing manufacturing in the United States is another option, but it may come too late to take advantage of the IRA subsidies and tax breaks before they are phased out.

To pursue relief from the U.S.-China squeeze, European firms would be wise to ask Brussels, Washington, and Beijing to seek a more stable trade environment. They should also diversify into markets like Canada, Mexico, South Korea, and Japan.

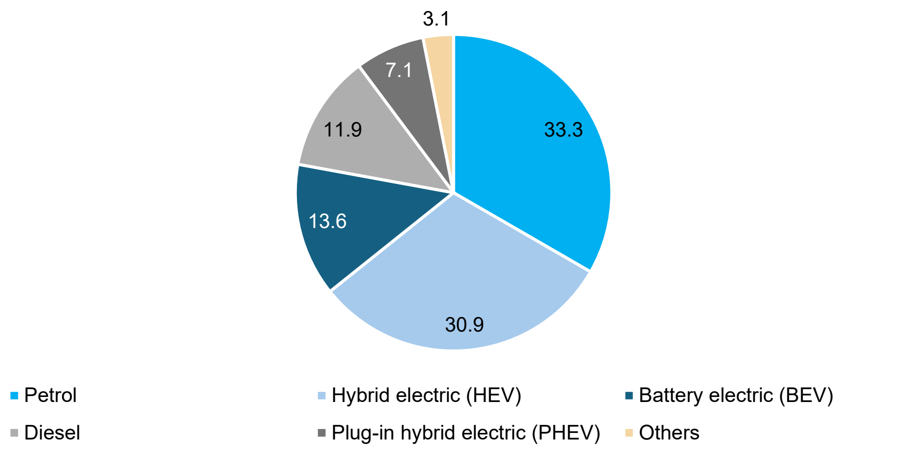
The EU's regulatory scheme regarding EVs is also in flux, which could dampen demand for EVs. The EU voted in 2022 to ban the sale of new internal combustion engines (ICE) vehicles by 2035 as part of its strategy to achieve climate neutrality by 2050. However, since then, Member States and the car industry have been successful in weakening the rules, including watering down emissions regulations.[22] They may likely have further success later this year in weakening or reversing the ICE mandate. As well, the effort to reduce ICE, which was challenging from the beginning, is becoming increasingly unrealistic as EV market share is well below goals.

In any event, European Commission President von der Leyen has agreed to review the regulation and is committed to simplifying regulations for European businesses to promote economic growth.

Another challenge for European EVs is the weak network of charging stations throughout the 27-member bloc and the deployment of charging stations is falling well below objectives. There is a significant correlation between the availability of public charging points and the sales of BEVs. Some of the countries with the most expansive charging networks also have some of the largest market shares for BEVs.[23] Brussels and Member States could increase collaboration with the private sector and energy providers to expand charging networks and to reduce EV range anxiety.

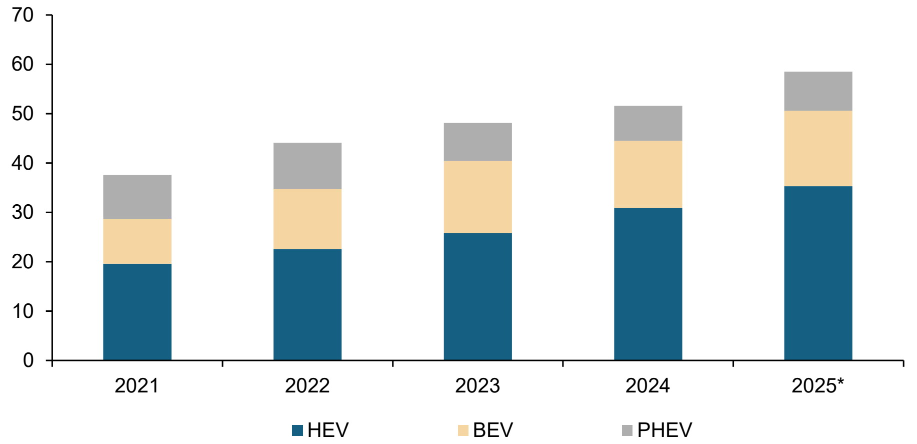
The path forward will determine if the EU remains a global EV leader or becomes collateral damage in the U.S.-China geopolitical competition and the EU's campaign to stimulate economic growth.

EXHIBIT 3.0 – PERCENTAGE SHARE OF NEW EU CAR REGISTRATIONS BY POWER SOURCES IN 2024



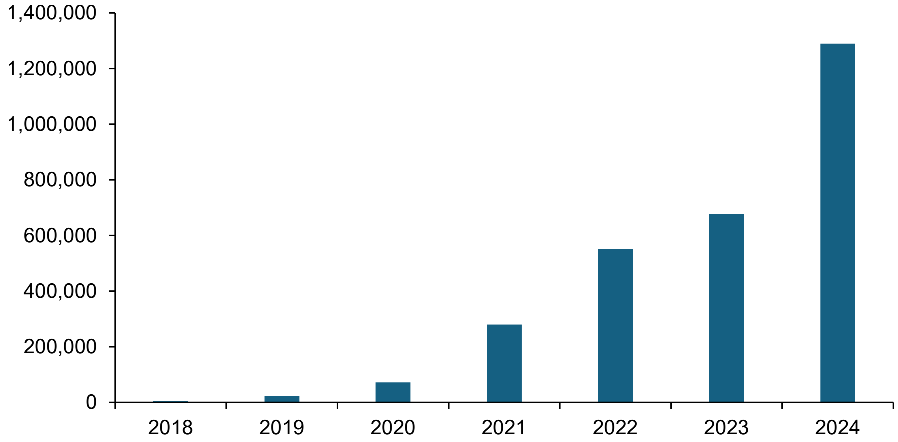
Source: European Automobile Manufacturers' Association (ACEA).

EXHIBIT 4.0 – PERCENTAGE SHARE OF EVS REGISTERED ANNUALLY IN EUROPE, 2021-2025*



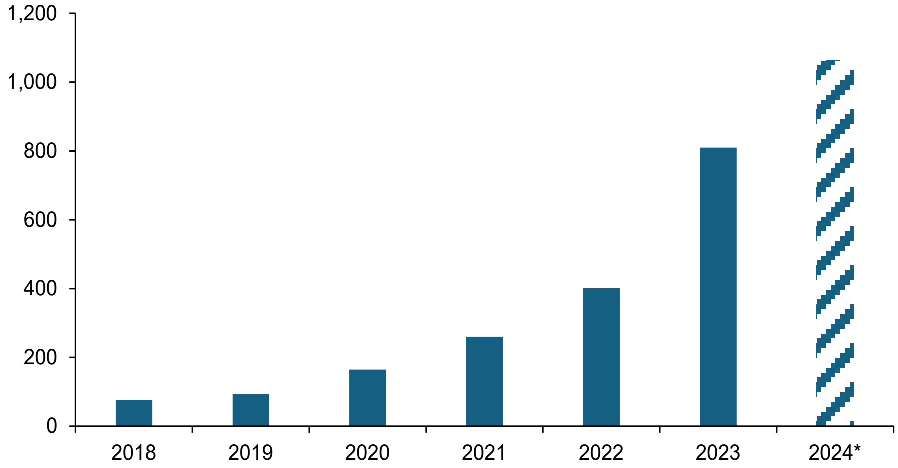
Notes: Europe includes the EU 27, Iceland, Norway, and Switzerland.
*2025 includes data from January to May.
Source: European Automobile Manufacturers' Association.

EXHIBIT 5.0 – CHINESE EV EXPORTS TO THE EU, 2018-2024



Source: China Passenger Car Association (CPCA).

EXHIBIT 6.0 – CHINESE GOVERNMENT SUBSIDIES TO CATL ($, MILLIONS)



Note: 2024 total is projected based on the January to June 2024 total of $532 million.
Source: CATL.

Notes

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Big and (Not So) Beautiful Fiscal Slippage

The new U.S. fiscal legislation and the deteriorating outlook for the U.S. fiscal position

→ The new U.S. fiscal legislation is forecast to lead to marked deterioration in the U.S. fiscal position, prompting credit rating agencies to further downgrade the United States sovereign credit rating.

→ Mounting debt, limited appetite for fiscal responsibility, and higher long-term interest rates risk permanently damaging the attractiveness of U.S. assets.

The new U.S. fiscal legislation seeks to extend tax cuts and introduce additional spending

Markets have responded to the new United States fiscal bill with volatility and an increase in long-term bond yields

Markets have responded to the new United States fiscal bill with volatility and an increase in long-term bond yields. The fiscal legislation, also referred to as the "Big Beautiful Bill", which was passed by both the House and Senate and signed into law by President Trump on July 4th, seeks to extend most of the tax cuts introduced in 2017 under the Tax Cuts and Jobs Act (TCJA), in addition to introducing several other tax breaks and spending measures.

Days after the new legislation was unveiled to the United States House of Representatives, Moody's – the last major credit rating agency to do so – downgraded the U.S. credit rating to Aa1 from Aaa. The downgrade took place amid a sharp increase in U.S. sovereign yields, particularly on long-dated bonds, with the bill adding to investor unease over U.S. assets and follows volatility and uncertainty fueled by abrupt trade policy shifts since January. While various political and technical factors have been behind rapid swings in U.S. yields since January, there has been a steady upward drift in 10 and 30-year Treasury yields since last fall, with rates on the 30-year settling near to 5% since mid-May.[1]

The U.S. fiscal position is expected to deteriorate significantly

Moody's estimates that the fiscal legislation would see the size of the U.S. federal deficit widen from 6.4% of GDP in 2024 to almost 9% by 2035, with debt rising from 98% of GDP to about 134% over the same period

Moody's estimates that the fiscal legislation would see the size of the U.S. federal deficit widen from 6.4% of gross domestic product (GDP) in 2024 to almost 9% by 2035.[2] Accordingly, Moody's projects that the total U.S. federal debt burden will increase from about 98% of GDP in 2024 to about 134% in 2035.[3] Note that Moody's estimates are based on the initial version of the bill introduced in May. There have been some changes to the bill that would see the amount of additional debt increase compared to Moody's May assessment - but

Moody's has not updated their projections. In dollar terms, the non-partisan congressional budget office (CBO) anticipates that the new law will add an additional 3 trillion dollars to the federal debt including interest costs by 2034 compared to pre-bill forecasts.[4]

The growing deficit will be increasingly driven by non-discretionary spending, including interest expense, with new revenue generation expected to be minimal. Mandatory spending is estimated to reach 78% of total U.S. federal expenditures in 2035, up from about 73% in 2024.[5] Notably, interest payments on the U.S. federal debt are on track to account for 30% of revenue by 2035, compared to about 18% in 2024, and less than 10% in 2021.[6]

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Equally concerning to Funcas are the limited macroeconomic benefits expected from the new spending. The Budget Lab at Yale forecasts that the bill's additional spending will boost GDP growth by just 0.2 percentage points annually over 2025-2027, before its impact lowers growth. Similarly, the Penn Wharton Budget Lab envisions only a 0.5% increase to the level of GDP by 2034.[7] The limited effect on growth is partially due to the expectation that the Federal Reserve would have to tighten monetary policy in order to keep inflation anchored near 2%.[8]

The limited effects for growth are in part due to the anticipated inflationary nature of the bill, which will require tighter monetary policy from the Federal Reserve to keep inflation anchored near 2%

The shifting fiscal landscape signals a structural shift in risk perceptions
Rising yields and the credit rating downgrade also signify eroding confidence in the capacity to respond to future shocks along with a structural shift in risk perceptions.[9] While ratings agencies continue to recognize the economic and financial strengths of the U.S., including strong macroeconomic policy institutions, and the U.S. dollar's dominance as the global reserve currency, which generates significant demand for U.S. assets, the shift toward increasingly large deficits point to an erosion in fiscal sustainability and flexibility. Indeed, in recent years, with limited appetite for fiscal responsibility across the political spectrum, analysts have noted declining demand for U.S. bonds.[10]

If adverse developments or policy shifts were to trigger a change in investor preferences, prompting a rapid migration out of dollar denominated assets and a sharp rise in borrowing costs, interest expenses could rise rapidly. Such a move, if sufficiently large, could alter the trajectory of the debt, raising concern among investors and sparking a vicious feedback loop of rising rates and larger deficits, coupled with contagion to private credit markets and financial sector balance sheets.[11] Likewise, current forecasts for U.S. deficits do not factor in extraordinary events or crises, which could see GDP contract and debt swell further – especially if a robust fiscal response were required. This could include the fiscal and growth impacts of increased military spending and a spike in oil prices that might result from an escalation in conflict in the Middle East or elsewhere. Indeed, the deteriorating U.S. fiscal position has potentially placed the U.S. on a similar path to many European economies just prior to the eurozone's debt crisis, where default expectations morphed from zero to a small, yet positive number, causing an outsized increase in sovereign yields.[12]

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The precipitous rise in debt will also push U.S. policy makers up against the legal debt ceiling with the 5 trillion dollar increase in the debt celiing included in the final bill only providing temporary relief. Should the balance of power change in Congress, political brinksmanship, fraught down-to-the-wire negotiations, and government shutdowns will likely resurface. Some episodes of negotiations have even culminated in credit rating downgrades, including in 2011, when Standard & Poor's downgraded its U.S. rating citing political polarization and insufficient steps to right the fiscal outlook. [13]

Rising long term interest rates are putting further pressure on government finances

Over the decade up to the end of 2021, yields on inflation-indexed 10-year U.S.Treasury bonds averaged just 0.09% but since 2022 the real yield has averaged almost 1.5 %

Another factor that Funcas anticipates will complicate the U.S. fiscal outlook is the marked increase in long-term real interest rates compared to the 2010s. Over the decade up to the end of 2021, yields on inflation-indexed 10-year U.S. Treasury bonds averaged just 0.09%, but since 2022 the real yield has averaged almost 1.5% (Exhibit 1). A number of factors – which are unlikely to change in the coming years – have led to rising real interest rates, including record high levels of public and private debt, geopolitical tensions, trade fragmentation, rising military expenditures, the investment needs of AI, and populism, as recently highlighted by Kenneth Rogoff.[14]

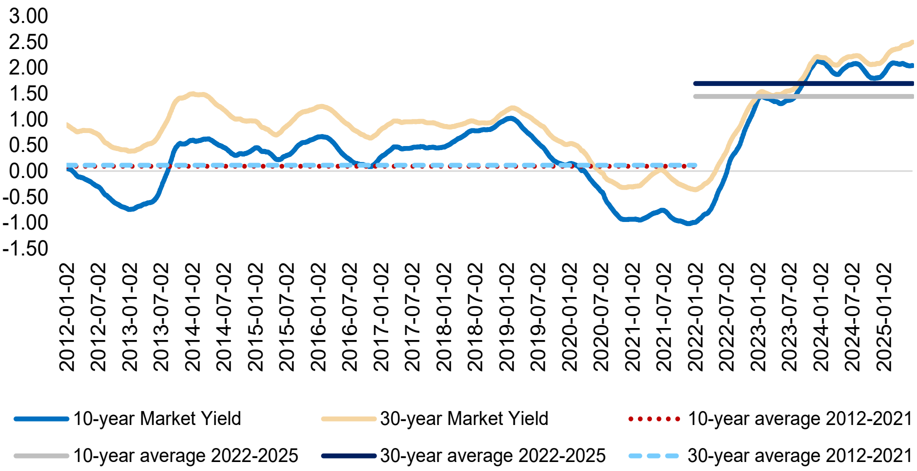
The attractiveness of U.S. assets may be at risk

Funcas believes that the deteriorating U.S. fiscal position, combined with limited appetite for fiscal responsibility and increasing political polarization, risk permanently damaging the attractiveness of U.S. assets

Funcas believes that the deteriorating U.S. fiscal position, combined with limited appetite for fiscal responsibility and increasing political polarization, risk permanently damaging the attractiveness of U.S. assets. An early signal of this trend may be the continued appreciation of the euro against the U.S. dollar, despite widening monetary policy divergence between the euro area and the U.S., following the European Central Bank's recent policy rate cuts.[15]

Given that as yet there are no viable alternatives to the U.S. dollar, with high debt and rising real interest rates, and elevated volatility and uncertainty, the global economy appears to be entering a "(Not So) Big and Beautiful" era. Against this backdrop, even limited capital movement away from the U.S. and subdued demand for U.S. bonds has the potential to spark difficulty in the U.S. Treasury market. Indeed, at some point falling demand for bonds is bound to come up against market scepticism about just how much additional debt the U.S. can afford, forcing some degree of a correction, potentially with serious knock-on effects for the U.S. and global financial system.[16]

EXHIBIT 7.0 – MARKET YIELD ON 10 AND 30 YEAR U.S. TREASURY SECURITIES INFLATION-INDEXED -% (90 DAY MOVING AVERAGE)



Note: The exhibit shows 90 day moving average of daily market yields on U.S. Treasury Securities at 10-Year and 30-Year Constant Maturity, Quoted on an Investment Basis, Inflation-Indexed, Percent, Daily, Not Seasonally Adjusted.
Source: Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis.

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The UK's Strategic Realignment

Recent trade deals with the EU and United States

→ UK Prime Minister Keir Starmer is recalibrating Britain's global posture through trade agreements with the EU and the United States to restore stability and strategic influence following Brexit.

→ While most of these deals have not yet been finalized and are not expected to yield significant economic returns to the UK, they mark a shift in the government's approach in an increasingly volatile geopolitical landscape.

Introduction

Since taking office in July 2024, Prime Minister Keir Starmer has sought to restore the UK's global standing. In May, the UK signed trade deals with two of its closest allies, the EU and the United States.

Scope of the UK-EU and UK-U.S. Agreements

UK-EU Agreement

The new "strategic partnership" announced at the May UK-EU Summit represents an update to the relationship after the UK's exit from the EU in 2020. It enables the British fishing industry to have direct access to the EU agri-food market. This should assist exporters who have found it challenging to negotiate border controls.[1] The UK and EU have also agreed to link their emissions trading systems, allowing British energy firms to participate in the EU electricity market. This would be expected to increase energy security, lower prices, spur investment, and promote decarbonization. In addition, the deal opens the door for British participation in the EU's proposed €150 billion defense procurement program. This would allow British firms to bid for joint procurements.[2]

The UK business community has broadly welcomed the deal, although details remain vague and it is expected to yield limited economic benefits.[3] More detailed negotiations will be needed in the future to make these agreements legally binding. And even once finalized, the deal would likely only deliver between 0.3 and 0.7% growth.[4]

The UK business community has broadly welcomed the deal with the EU, but details remain vague, and the economic benefits will be limited for the UK

UK-U.S. Agreement

The UK-U.S. deal, as initially announced, lacked detail and merely provided a framework for continued trade negotiations in specific sectors. In June, Trump and Starmer announced they had finalized negotiations on part of this framework. Trump agreed to lower tariffs on British car exports from 25 to 10% for the first 100,000 vehicles shipped annually. He will also exempt tariffs on exports of jet engines and aerospace components. The framework aimed to eliminate the 25% U.S. tariffs on steel and aluminum exports, but those issues remain under discussion, along with others. In exchange, Starmer granted the United States greater market access for beef, ethanol, and industrial products.

There are, however, reasons to be skeptical about the agreement. First, the United States is still subjecting most British exports to the "reciprocal" tariff rate of 10%. Second, the UK ceded to U.S. demands to exclude China from some of the UK's strategic supply chains.[5] Lastly, the deal still requires additional negotiation on other topics. More than two months after the original agreement was signed, there is still no clear timeline for these additional negotiations or for when the additional tariffs will be reduced or lifted entirely.[6] Further complicating matters, Trump has a well-documented history of reversing his positions.[7] When asked about assurances the UK would not face future tariffs, Trump said, "I like them – that's their ultimate protection."[8] This statement underscores the anxiety that the entire deal may not be finalized or endure.

A post-Brexit pivot with the EU

Despite the UK-EU deal, the UK remains isolated from the EU market

London and Brussels have heralded the agreement as a "reset," but those claims are exaggerated. Despite the UK-EU deal, Starmer is committed to Brexit and the UK remains isolated from the EU market. It does not reintegrate the UK into the Single Market or the Customs Union.

In strategic terms, the agreement strengthens cooperation at a time when both need each other to face some of the continent's significant challenges. It also represents the first substantial effort to restore institutional cooperation since the divisive Brexit negotiations. This portends a future in which both sides may continue to develop arrangements to allow them to collaborate without reviving past institutional processes and avoid reigniting ideological debates.[9]

Symbolic win for Starmer and Trump

The UK-U.S. agreement is not "historic" as Starmer claimed, nor will it deliver significant economic growth; however, it is a symbolic victory for both Starmer and Trump

The UK-U.S. agreement is not "historic" as Starmer claimed, nor will it deliver significant economic growth; however, it is a symbolic victory for both Starmer and Trump.

The UK was the first country to secure a trade deal with Trump after he announced global reciprocal tariffs on 2 April. The agreement was driven by a pressing need to buy time, defuse rising tensions, stabilize the bilateral relationship, and reaffirm the UK's special relationship with the United States. British officials likely calculated that concluding a deal swiftly would be better than waiting for a possible broader negotiation and risking future escalation.

It was also driven by a need to help the British economy. British exports to the United States fell by $2.7 billion in April, marking the largest monthly decline since records began in 1997. This likely contributed to the 0.3% contraction in GDP from March to April.[10]

The United States not only secured UK concessions but also obtained a positive public announcement to alleviate growing unease about Trump's trade policies.

An emerging foreign policy doctrine

The UK's agreements with the EU and U.S. reflect a geostrategic approach by the Starmer government to pursue broad frameworks and leave the details to be negotiated later. This gives the UK more flexibility and helps lock in early wins, even if significant benefits ultimately are elusive.

The UK's agreements with the EU and U.S. reflect a geostrategic approach by the Starmer government to pursue broad frameworks and leave the details to be negotiated later

The EU deal aims to reposition the UK in Europe, rebuild trust, and gain influence in a region where Britain remains economically and diplomatically intertwined. The U.S. deal, in contrast, is a calculated short-term maneuver to de-escalate tensions, demonstrate relevance to Washington, and create space for longer-term planning.

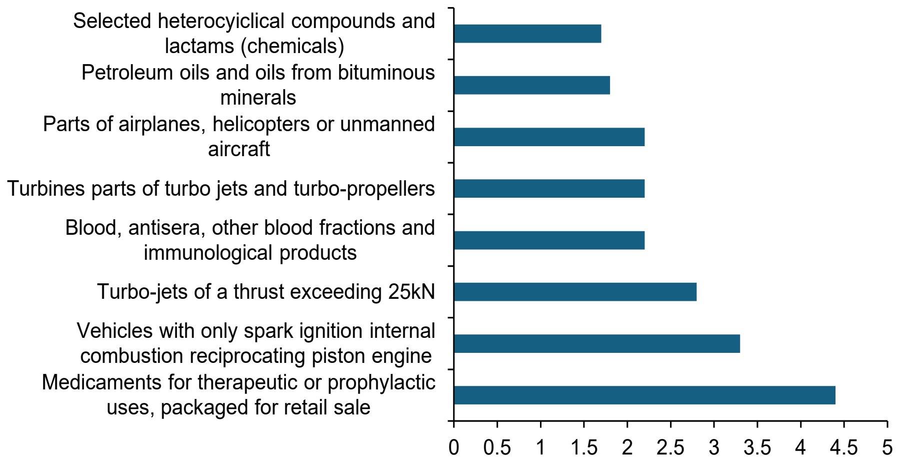
This strategy also hedges against uncertainty in global politics. Recognizing that Trump has thrown alliances, including transatlantic relations, into flux, London is positioning itself as a pragmatic and dependable actor.

Diplomatic gains, domestic economic headwinds

Starmer's early moves on the international stage enabled him to secure agreements with key partners. Funcas assesses that once the UK's deals with the EU and the United States are finalized, they will have a modest economic impact and fail to address the country's systemic challenges, such as weak economic growth and stagnant productivity. With analysts predicting a weak jobs market and low growth rates for the remainder of the year, voters may soon overlook these trade deals if they become anxious about the country's lackluster economic performance.

Funcas assesses that once the UK's deals with the EU and the United States are finalized, they will have a modest economic impact and fail to address the country's systemic challenges, such as weak economic growth and stagnant productivity

EXHIBIT 8.0 – THE UK'S TOP 10 EXPORTS TO THE UNITED STATES IN 2023, RANKED BY VALUE OF EXPORTS (IN USD BILLION)



Note: Group names have been simplified for clarity. Full details can be found using the following 6-digit HS code aggregates: 300490, 870324, 841112, 300215, 710813, 870340, 841191, 880730, 271012, 293379.
Source: UN Comtrade.

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