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Global trade redefined: Defence

Dealing with tariff uncertainty

April 2025

This report has been developed in collaboration with the Strategy& team, PwC's global strategy house. Together, we transform organisations by developing actionable strategies that deliver results.

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Introduction

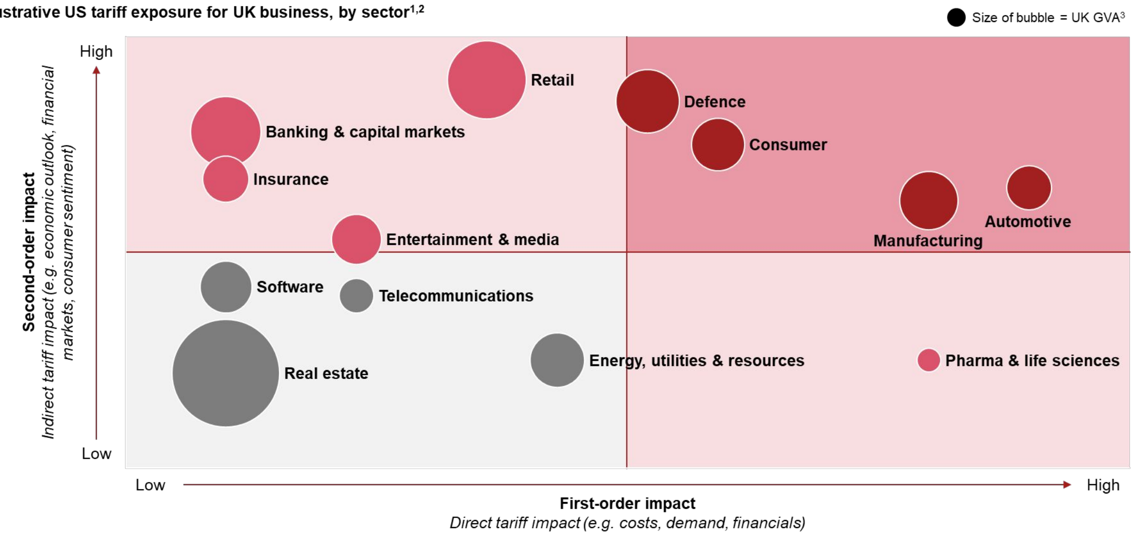
The imposition of tariffs under the Trump administration has heightened strategic uncertainty for the UK defence industry. While direct impacts are limited, due to the UK's role as a net importer and its specialist subsystem exports to US-led programmes, the broader geopolitical shifts are significant. Protectionism and national sovereignty concerns have prompted reassessments of defence partnerships, challenging the established order within NATO and the EU.

The highly regulated nature of the sector buffers it from immediate impacts as it is time consuming and expensive to move to alternative supply chains for critical elements of major defence programmes. Either through limited supply (e.g. small numbers of global suppliers with the required depth of capability) or constrained demand (e.g. supplier or part embedded in regulatory approval), the level of supply chain inertia is likely to mean the defence sector is less likely than others to move quickly to reconfigure affected supply chains. In those areas where change may be possible, limited visibility into extended supply chains often adds to the uncertainty, complicating proactive strategic changes. As the industry adopts strategic patience amid political volatility, the second-order impact of the US tariffs is likely to be a doubling down on developing sovereign capability within the UK and European defence supply chain and a reduced reliance on the US. Short-term strategies include diagnosing supply chain exposure and exploring alternative markets, while long-term plans focus on investing in domestic capabilities, collaborating with international partners, and pursuing strategic M&A to enhance defence autonomy and competitiveness.

Some common industry actions:

1. Assess first-order impact versus second-order impact
2. Understand variation by sector within an industry and interdependencies across industries
3. Adopt a mix of ‘no regret moves’ in the short term and strategic choices in the longer term
4. Identify both risk mitigants and growth opportunities
5. Embed ongoing resilience to respond to geoeconomic shocks

Illustrative US tariff exposure for UK business, by sector[1,2]



Notes: 1. Estimated tariff impact assumes measures stay in place for a prolonged period, in line with Strategy&'s ‘Break and reorder’ scenario; 2. Featured sectors account for c.60% of UK GVA (Gross Value Added); 3. Estimated 2024 GVA based on ONS data

Where we are today

On 2 April 2025, the US administration announced a sweeping package of tariffs on imported goods. It marked the country's most significant departure from liberal trade policy since the Smoot-Hawley Act of 1930. The scale of the measures suggests a structural pivot in US trade strategy. Given their breadth, and the growing likelihood of retaliatory responses from key trading partners, businesses now face a materially more volatile and uncertain global trading environment.

What happened on 'Liberation Day'?

The Executive Order introduced a dual framework of restrictions: broad-based 'baseline' tariffs alongside more targeted 'reciprocal' measures. The EU was subject to 'reciprocal' tariffs of 20%, China 34%, with certain South-East Asian economies facing higher rates still. The UK was included under the 10% 'baseline' category. Certain exemptions were made for pharmaceuticals, critical minerals and semiconductors.

Prior to this, there were also a number of product-level distinctions, for example steel and aluminium and automobiles were previously singled out with a 25% tariff.

On 9 April, reciprocal tariffs were paused for 90 days for most trading partners. The 10% 'baseline' tariff introduced on 5 April now applies for all countries, except China, for which a 145% tariff applies to most goods.

A further revision was introduced excluding smartphones, computers and other electronics. US officials have indicated that further sector-specific measures are likely. The international response has been mixed:

- **Retaliatory tariffs** from countries such as China and Canada, which have imposed tariffs on a wide range of US goods.
- **Diplomatic engagement** from the UK and EU, signalling efforts to secure exemptions or negotiate new terms.
- **Unilateral liberalisation** from a small number of economies, which have opted to remove tariffs on US imports entirely, albeit from a starting point where most US goods were not subject to tariffs.

Looking ahead

Recent US statements suggest further restrictions may be introduced in select product categories. Economic theory holds that when trade flows are disrupted, capital flows are rarely far behind.

Asset markets are already reacting. We've seen volatility across equities, fixed income and foreign exchange – some of which may reflect repositioning by non-US central banks, many of whom hold large exposures to US government debt. This adds another layer of complexity for firms already contending with uncertainty around tariffs, supply chains and pricing.

> Trade is the hinge between economic theory and political reality. When it swings, the whole house can shake."
>
> **Barret Kupelian,** Strategy& and PwC UK Chief Economist

What could happen next

Three scenarios to plan for the short term

In the near term, scenario planning will be essential. Over time, a reassessment of supply chain configuration, investment strategy and risk management frameworks may prove unavoidable in the face of an increasingly fragmented global trading system.

To help clients better understand how tariffs could evolve, we've devised three scenarios. Given the unpredictable and fast changes happening, we've chosen to limit these to tariff policy. However, we are mindful that the current changes to US tariff policy is likely to spill over into second- and third-order impacts.

Stabilise and rebuild

Reversal of the US's position on tariffs, coupled with time-bound trade negotiations with its main trading partners, including Canada, Mexico and China.

To limit market uncertainty, there is regular forward guidance on the state of the trade negotiations. The US's main trading partners strike limited trade arrangements by the end of the 90 days suspension period (i.e. 8 July 2025). These come into force by the end of the calendar year. In the interim, the 'baseline' tariffs continue to apply for most economies, including China.

Divide and deal

Reversal of US position on tariffs coupled with time-bound trade negotiations with some of the US's trading partners (EU, UK, Canada and Mexico included) but excluding China (and potentially some other South-East Asian economies).

- For those counterparts where a trade arrangement is agreed by 8 July 2025, these are put in place by the end of 2025/Q1 2026. In the interim, the 'baseline' tariffs remain in place.
- For those counterparts where a trade arrangement is not agreed upon within the 90 days, reciprocal tariffs are re-imposed, consistent with the 2 April 2025 announcement.
- For China, tariffs remain in place consistent with the US's latest announcements and Chinese policymakers react in kind.

In the medium to long run, the ex-US G7 economies set up cooperation mechanisms which lead to gradually closer trading, regulatory and investment cooperation.

Break and reorder

Trade negotiations with most of the US's trade counterparts, including the EU, UK, Canada, Mexico and other advanced economies break down. The US doubles down on its necessity to swiftly eradicate the goods trade deficit with the rest of the world. The US reimposes 'reciprocal' tariffs by 8 July 2025. With this in mind, the EU, Japan, China and other economies retaliate in equal measure. As these economies import less than they export to the US, retaliatory actions spill over into the services sector (e.g. digital services) and potentially to public procurement.

In the short to medium run, the ex-US G20 economies set up trade, regulatory and investment cooperation mechanisms at very rapid pace. In this scenario, we could also see some non-European economies seeking a Customs Union arrangement with the European Union. We could also see some South-East Asian economies forging closer trading relations with China. These changes are also rapidly reflected in investment flows.

Taking stock of tariffs

Understanding the impact on the defence sector

A perspective on the sector overall

The imposition of tariffs under the Trump administration has introduced considerable strategic uncertainty for the UK defence industry. While direct, first-order impacts appear limited due to the UK's position as a net importer and its export focus on specialist subsystems integrated at Tier 2* and Tier 3* levels into US-led programmes, the broader consequences are more far-reaching and impactful.

The core concern is the second-order impact: a shifting geopolitical landscape characterised by rising protectionism, a renewed emphasis on national sovereignty, and a growing desire across western nations, including the UK, to reduce reliance on foreign, particularly US-based, defence infrastructure. The rhetoric accompanying the Trump-era policy stance has exacerbated this uncertainty, prompting reassessments of longstanding defence partnerships within NATO, the EU, and globally.

The highly regulated nature of the defence sector acts as both a buffer and a constraint. On the one hand, it tempers the short-term fallout by limiting supplier substitution and protecting existing contractual relationships. On the other, it entrenches dependencies, especially on US technologies and systems, that are difficult and slow to unwind. Moreover, the opacity of extended supply chains, particularly beyond Tier 2*, makes it challenging for most UK defence firms to accurately assess or quantify the financial impact of trade policy shifts.

This lack of visibility, compounded by political volatility and uncertainty around the permanence of US policy, makes proactive investment or strategic repositioning challenging. With firms hesitant to commit to large-scale capex or reconfiguration of supply chains amid what may be a transitory policy posture, the industry is effectively in a holding pattern. In this context, strategic patience is prevailing, but at the cost of agility and long-term resilience, creating an uncomfortable position as the global defence order continues to evolve.

There is also the prospect of dual use and military designated ITAR components and technology being restricted to previously approved third party countries if the US chose to lever it's position. This could leave complex non US systems and products vulnerable due to their componentry.

Primary Impact
Secondary Impact

Segment	
OEMs **Systems Manufacturer**	With limited platform exports to the US from UK Original Equipment Manufacturers (OEMs), recent tariff announcements will likely have limited primary impact to their business operations and outlook. In the longer term, the rearmament of Europe in response to the 'America First' posture (including tariffs) will likely lead to increased capital flow to European OEMS and Systems manufacturers.
Sub-systems Manufacturer **Component Manufacturer**	For subsystem and component manufacturers in the UK that are part of the supply chains for US defence programmes, the imposed tariffs will likely have a primary impact requiring them them to consider available mitigation options. Such tariffs may lead to a reconfiguration of those supply chains in the longer term. The question in the short term is likely to be, who will be asked to absorb the immediate inflationary cost increases of the tariffs – the supplier or the customer?

**Tier 1 (primary suppliers providing major systems or components directly to OEMs or defense agencies), tier 2 (suppliers providing components or services to tier 1 suppliers), and tier 3 (suppliers offering more specialised parts and services to tier 2 suppliers)*

Taking stock of tariffs

Assess the impacts and short term actions

Tax and operational assessment

While the medium to long-term structural impact on the defence sector may ultimately be significant, such shifts are likely to unfold gradually. Any operational responses or strategic interventions will need to be carefully phased over time. In the near term, however, the immediate priority for defence operators is to thoroughly assess and quantify the tariff implications from a tax and operational perspective. The following actions can be taken now and may have a meaningful impact on your business's overall exposure.

01 Conduct/validate impact assessments, including understanding the physical product / material flows.

02 Review eligibility for tariff exemptions and exclusions, for example goods in transit before 12.01am EDT on 5 April 2025. HTSUS heading 9808 provides a potential mitigation strategy for articles for use of the U.S. government. These are subject to additional requirements and presentation of documents to qualify.

03 Understand the country-of-origin rules and place where goods are substantially created.

04 Understand the value build up of the price to ensure the custom value is correct and review cost components.

05 Consider from a transfer pricing perspective that intercompany product pricing is correct and that any revised pricing (of product or wider services) adheres to the arm's length principle (and aligns with customs considerations).

06 Consider the US specific valuation principles.

07 Review contracts to confirm whether they include a tariff cost adjuster / escalator in terms of cost

08 Consider the impact on any changes to the above on the income tax position in the US and other jurisdictions.

Navigating the potential fallout

Short and longer term actions you should take

There are several short and longer-term moves that the defence industry can consider to respond to the evolving market situation. Reach out to us to discuss which strategic options can best protect your business and how to approach your implementation plans.

Short-term 'no regret' moves	Moves to capture maximum value over the longer term
• Consider the tax points noted on the previous page, and evaluate the impact on income tax, transfer pricing and tariffs (taking a holistic tax view).	• Invest in domestic production and technology capabilities to reduce dependency on foreign suppliers and enhance the sovereignty of UK defence capabilities.
• Conduct a thorough diagnostic to understand the supply chain footprint and exposure to US tariffs and identify vulnerable areas and potential cost implications / commercial risk.	• Collaborate with trusted international partners, such as NATO allies, to share resources and capabilities and ensure collective security and capability.
• Access comprehensive data on suppliers and contracts and review the contractual terms related to tariffs and price adjustments.	• Pursue strategic M&A opportunities to acquire local or regional capabilities that are currently sourced from the US or that can provide a competitive edge in the defence market.
• Explore alternative markets and suppliers, particularly within Europe, to mitigate the risks of supply chain disruptions and diversify the customer base.	• Monitor the changing dynamics of international trust and collaboration, and adapt the defence procurement strategies accordingly.
• Understand the ITAR status of subsystems and componentry and any potential destination impact that may occur.	• Consider the overall tax model (customs, transfer pricing, direct and indirect taxes) implications and impact of any supply chain reorganisation so as to fully evaluate the options through an integrated business and tax perspective.
	• Produce ITAR free versions of products and systems.

“

In a sector where tempo, timing, trust and transatlantic partnerships have been the backbone for past success, US tariffs on UK defence imports risk undermining the integrity of supply chains, causing programme delays and weakening the interoperability that underpins the allied security ecosystem.”

Ian Hillier, PwC UK Aerospace and Defence sector leader

Key contacts

Contact us to discuss how best to respond to the changing rulebook for global trade.

Cara Haffey

PwC UK Leader of Industry for Industrial Manufacturing and Services

cara.haffey@pwc.com

Ian Hillier

PwC UK Aerospace and Defence Sector Leader

ian.j.hillier@pwc.com

David Turner

PwC UK Aerospace & Defence Tax Leader

david.j.turner@pwc.com

Barret Kupelian

Strategy& and PwC UK Chief Economist

barret.g.kupelian@pwc.com

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