Clifford Chance

Thought leadership

Defence – navigating strategic disruption

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Key takeaways

1. Tectonic changes in great power politics and rapid technological advancements are reshaping the geopolitical landscape and creating the impetus for greater growth and investment in the defence sector.
2. In Europe, a key concern is how enhanced defence capabilities will be funded, with private capital positioned to play an important role if terms palatable to governments can be agreed.
3. In the US, the Trump administration's ambition dramatically to boost defence expenditure presents opportunities not only for established industry players, but also new entrants and start-ups.

The defence sector is growing rapidly, perhaps unsurprisingly given a world stage that is more unstable than we have seen for decades. Alongside geopolitical tensions, advances in technology are providing both an impetus for, as well as the means of, innovation in this sector. In this briefing, we look at the challenges facing governments as they move to increase global defence spending, and the opportunities that are likely to arise in this era of strategic disruption.

The shifting geopolitical landscape

The current geopolitical landscape is being shaped by several overlapping changes. “What is surprising and will continue to be surprising in years and probably decades to come is the combination of structural trends, which have historical precedents, but were not happening simultaneously, as they are today,” says Mircea Geoană, former NATO Deputy Secretary General.

One familiar dynamic is the emergence of challengers to the dominant world power. “The US is not declining sharply, but nevertheless the rise of others is reducing the relative strength of the West,” says Geoană.

This, he suggests, may have knock-on effects for security relationships globally. While he rules out a “total decoupling of Europe from the US”, he does foresee a “strategic emancipation” for the continent. “I see a reconfiguration of the defence, industrial and innovation base worldwide,” he says. “I’m seeing Korea playing a big role in Europe in my home country of Romania and in Poland. I’m seeing Israel playing a lot of cards in Germany. I’m also seeing players such as Brazil coming to the European defence market.”

The world is also reckoning with rapid technological advances. While industrial revolutions are nothing new, Geoană believes the current rate of change outstrips anything we’ve seen before. “What we are witnessing today is basically a merger of an already explosive industrial revolution with AI, biotechnology and any number of other things,” he says. “It’s a metatransformation coming from technology.”

In addition to these changes, countries around the world are undergoing profound shifts in societal attitudes, upheavals to their social contracts and economic restructuring. Against this backdrop, the definition of security has expanded beyond traditional military defence and national sovereignty to encompass economic security, supply chain resilience, technological sovereignty and the protection of critical infrastructure. “The definition of security is so broad that it encompasses everything,” says Geoană. “There’s no piece of industrial activity, business or human societal endeavour that doesn’t have some form of security component.” The character of war is also changing – we are seeing more hybrid-conflicts, as well as new frontiers, be it cyber, space or AI.

Geoană predicts that one way governments will strive to meet the challenges posed by these shifts in the global order will be more interventionist industrial policy. He also predicts the changing landscape will give rise to more ad hoc combinations of nations and industry. “You can’t look at the world of today and tomorrow through the lens of existing experience. Our mindset must be as flexible and agile as the transformative times we’re living in,” he adds. “We have a chance to navigate these very turbulent times. But expect turbulent times for years and decades to come.”

Europe is losing momentum

In this challenging environment, there is greater demand for investment and growth in the defence sector. Alessandra Genco, former CFO of defence contractor Leonardo, says that healthy double-digit topline growth figures from the defence industry in recent years are testament to the sector doing its part to meet states' security requirements.

However, collaboration and pragmatism may be needed if Europe is to continue to bolster its capabilities. NATO Allies' spending commitment of 5% of GDP – 3.5% on core defence requirements and an additional 1.5% on related expenditure – looms large over this topic. "Lately I feel, as Europeans, we are losing momentum," says Genco. "What concerns me most is I feel we're going to have two categories of countries within Europe: the haves and the have-nots – those who can afford to push towards the 3.5% and 5% targets, and those that can't."

For Genco, budgetary constraints are the key hurdle that needs to be overcome and that will determine future European defence capability. "If there is not enough budget capacity in an individual country, the way forward is to pool capabilities and go in the opposite direction of where the Future Combat Air System ended," she adds, referencing the joint Franco-German fighter jet project, which was abandoned in June.

"Let's try to pull together requirements and ask industries across the globe to come together collectively and propose solutions with products that are not only interoperable, but possibly with the same products across a number of countries so we do not duplicate efforts," Genco continues.

She advises that it may be necessary for states to compromise on some requirements, "taking one step back to take two steps forward", particularly in view of the European Commission's Readiness 2030 initiative, the timelines for which – Genco warns – are already under pressure.

"That's not because industry hasn't been ready to push forward, but because there is not enough spending capacity and there is not enough of a cohesive effort at the level of different countries to move forward." She points to the Italian Government's decision in May to pull back from the EU's Security Action for Europe (SAFE) scheme as a case in point: having intended to draw down close to €15 billion, Giorgia Meloni's government now intends only to borrow between €4 billion and €5 billion. In another regard, Italy may provide a model to follow: the country has partnered with Japan and the UK on the Global Combat Air Programme, a multinational fighter jet project.

The role of private capital

As for where the next wave of investment in defence will come from, there are no easy answers. If common debt at the European level proves unviable, and there is not enough capacity in individual countries' budgets, governments may look to private capital to make up the shortfall. However, this too could weigh heavily on government balance sheets, particularly in view of the Maastricht criteria faced by the EU member states.

"There is clearly a lot of private capital that is interested in the industry, and the ESG concerns that have prevented many investors getting closer to the sector are being tamed. There is a lot of smart capital that is approaching the industry now," says Genco.

"The question is whether this capital can be used in a non-recourse manner by governments. If that were to be the case, I think private capital could have a major role in the industry. Otherwise, it may be challenging for private capital to be a major substitute for public funding."

US opportunities

Across the Atlantic, the Trump administration's ambition to increase the US defence budget to US$1.5 trillion should give rise to a wealth of opportunities, both for defence sector incumbents as well as new entrants.

"Opportunities are available; the challenge is how to get at them," says Renée Latour, a Clifford Chance Partner based in Washington, DC. "It requires thinking of defence not just in terms of things that go 'bang' and 'boom'. We're seeing defence being conceptualised much more broadly as national security. It means data, technology, the nuts and bolts and widgets that go into the supply chain and everything else that surrounds it."

This approach to defence and security means entities are now partnering in ways they previously might not have done, transcending nation state partnerships. This presents opportunities for non-US contractors and investors. "From the US perspective, if you can bring some sort of national security benefit to the US with an investment from or partnership with a non-US entity, you're going to have quicker access," says Latour. "The Department of War – formerly Department of Defense – has promised an expedited review and approval process."

Just as technological progress is reshaping the geopolitical landscape, it is also creating opportunities in the defence sector as advancements outpace the US Government's regulatory rulebook and resources. "The speed at which technology is developing and AI is changing things is something that regulators can't possibly keep up with," Latour adds.

She continues: "You're seeing a lot of new actors in the space, not just the historic behemoths in the defence sector. You're seeing startups, new technology and partnerships that you might not have seen before, when things were driven by government grants and long-term government contracts.

International law

As to whether public international law (PIL) is keeping pace with the changing geopolitical and defence landscape, Clifford Chance's Director of Public International Law, Joanne Neenan, has a relatively optimistic outlook.

"Rules which form the bedrock of PIL, such as those governing the use of force and the conduct of hostilities are withstanding the test of time. For example, a majority of States agree that existing rules apply to cyberspace and cyber weapons. Disagreements as to how existing rules apply aren't exclusive to new domains."

Neenan offers some caveats to her primary view. "In some new areas, such as artificial intelligence, State positions' on the application of PIL are less advanced and global norms are still evolving."

She continues: "We also face the challenge that, while PIL primarily applies to States, non-State actors- such as individuals and corporations- are both active and influential in conflict and defence environments. How and if international law will adapt to this reality, and how it will interact with the growing body of national regulation, remains an evolving picture."

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