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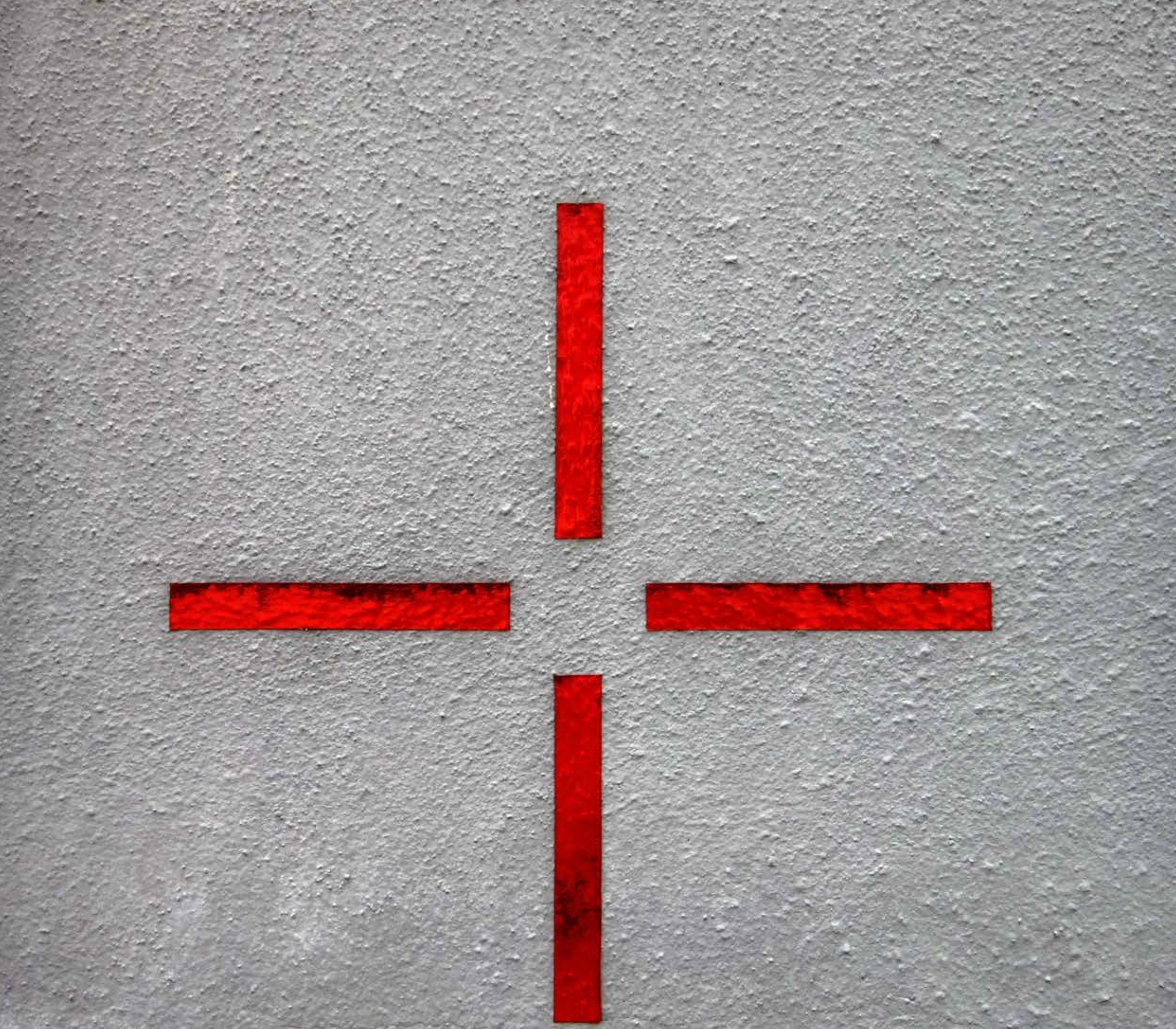

André Sapir, Jacob Funk Kirkegaard and Jeromin Zettelmeyer examine how Europe can hold its own in a multipolar world

Patrick van Schie argues that European countries should grow up militarily within NATO

Patrick Minford demonstrates how the US is damaging its long run prospects by pursuing protectionism

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The power of words and the fragility of democracy

Over the past three decades, political discourse has increasingly devolved into a battleground of inflammatory labels. Terms such as "fascist," "right-wing extremist," "Islamophobic," "racist," "transphobic," "homophobic," and "misogynist" are frequently weaponised against political opponents. This rhetoric, coupled with assertions that "the science is settled" on contentious issues, stifles debate and enforces conformity with elite consensus views. Dissenters risk being "cancelled," marginalised, or worse—targeted for their beliefs. Labelling someone a "right-wing extremist," for instance, can escalate beyond rhetoric, potentially placing them in the crosshairs of violence, as seen in recent politically motivated incidents.

This toxic polarisation has fractured the political landscape. The centre, once a moderating force, is now often branded as "extreme left" in the parlance of earlier decades, while the right is caricatured as "knuckle-dragging thugs" or "far-right extremists." Both sides cling to their ideological packages, leaving little room for consensus or rational dialogue. Such division recalls Martin Luther King Jr's warning about the "ultimate weakness of violence" as a descending spiral that multiplies evil rather than eradicating it. In Germany, for example, a surge in politically motivated aggression—ranging from intimidation to physical attacks—illustrates how suppression, even when non-violent, fuels a cycle of polarisation, radicalisation, and societal fragmentation.

At its core, democracy rests on two interdependent pillars: the right to vote and the right to free expression. Voting enables citizens to participate in governance by selecting representatives or shaping policies. Free expression, equally vital, fosters open debate, allows criticism of authority, and ensures the exchange of ideas that inform democratic decisions. When free speech is curtailed, the ability to form and articulate political opinions is undermined, weakening the democratic process itself.

The rise of online censorship and restrictions on free thought, particularly when aligned with elite consensus, threatens to erode these democratic foundations. In Europe, measures such as content moderation laws or sanctions against dissenting voices risk sliding toward "illiberal democracy," where elections persist but fundamental freedoms are curtailed. This environment stifles the open exchange of ideas, raising critical questions about whether such a climate can sustain the innovation and growth that thrive on intellectual freedom and diversity of thought.

Democracy can endure under strain, but it flourishes only when free expression is robust. The current trajectory of polarisation and censorship demands a renewed commitment to the principles for which millions have sacrificed. To secure a future of prosperity and unity, society must resist divisive rhetoric, reject suppression, and champion the open discourse that underpins true democratic vitality. ■

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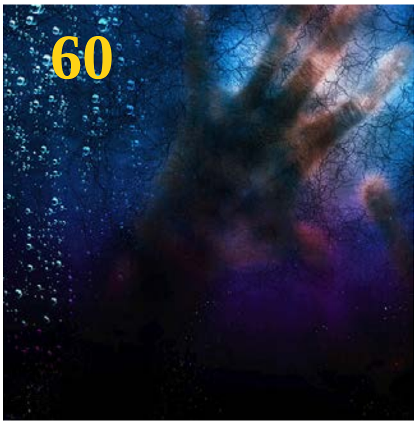
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Free trade remains the best policy

Patrick Minford is Professor of Applied Economics at Cardiff University

It has always been obvious to economists that the massive Trump tariff rollout in early April would be hugely damaging-to the US. Tariffs seem to many politicians to be a way of forcing foreigners to pay for their country's exports, so making a gain for their voters; they also seem to think that by protecting their home industries they are scoring a gain in higher home output.

Unfortunately, in the world markets where trade takes place, none of this is true. In fact the opposite is true; the cost of tariffs on imports is paid by home consumers, while the rise in home output in the protected industries causes the contraction of more efficient unprotected industries, which lowers overall output.

Table 1 shows what happens with a 10% US tariff according to our world trade model; we use the model that fits best-the 'Classical' model, which assumes that world markets act in a highly competitive manner. What the tariff does is cause a loss of welfare for the US of around 8% of GDP*.

Roughly half of this is due to reduced output as resources leave the most productive sectors and move into less productive protected ones. The other half is due to consumer welfare losses from higher prices.

Now that US average post-deal tariffs have reached 17%, the implied US costs are up to 13% of GDP. As for other countries the costs are minimal; this is because they can all divert their exports to other parts of the world market.

These are the long run costs. More immediately we also see short run effects causing lost output both in the US and abroad and raising US inflation as the tariffs raise prices.

It may appear as if President Trump has got away with his tariff policies in spite of these and other criticisms from economists like us. But in the short run exporters to the US may be willing to absorb some of the tariff cost to keep the US market until they can divert their exports elsewhere at the better prices available in world markets.

This will keep US prices down for a while. But once they have diverted their output to other world markets paying the normal world price, they will charge the same prices to US importers. So the US inflation hit will come through.

As for output, in the short run it depends on demand. So US demand will be set by US monetary and fiscal policies, which are likely to be expansionary. Similarly foreign demand will be set by the equivalent foreign policies, especially in Europe and China.

But these are likely to offset the deflationary tariff effects only partially, as fiscal deficits are high and interest rates already lowered. We have yet to see how the world economy settles down in the short run as the tariff fog disperses. But in the long run output depends on supply.

With the tariff raising the US prices of home manufactured output, manufacturing will expand as resources are switched from services, which give the US its comparative advantage and so are more productive. Hence overall output will fall.

What these figures underline is the self-harm from tariffs, explaining why most other countries have been reluctant to retaliate by raising their own tariffs. The exception was China for which the short run effects were highly threatening, given its huge excess capacity in its chosen and highly subsidised hi-tech sectors like EVs and batteries.

By retaliating with tariffs on the US only, it avoids the long run tariff costs as its consumers simply switch to non-US products so that import prices remain unchanged.

However, China's economy is slowing as its excess capacity is hard to divert to other countries, now resisting dumping, and its home policies are unable to offset home deflation due to the collapse in property and the loss of consumer confidence. In Europe generally public debt is high and limiting the scope for fiscal stimulus, while monetary policy has already eased as much as may be possible given the need to keep inflation down.

It is these short run problems with US tariffs that create the temptation to retaliate. In the interwar period, there was general retaliation as countries tried to protect the demand for their home industries in the face of falling export demand.

So far retaliation has been the exception rather than the rule; China has retaliated against the US only but with the US targeting other parts of SE Asia to which China exports, this restriction may not last.

What this all means is that the US is damaging its long run prospects by pursuing old-fashioned protectionism, and the rest of the world will be reducing its US trade. US and world growth will probably be slower in the short run, as further policy loosening is difficult.

However, it is worth spelling out why free trade has been the best policy for the US as well as the world at large. Even as the US has now contracted out of trade, the rest of the world will need to rebuild the world trade order without it and not be tempted to join in a general trade war.

"In the long run protection by the US alone will not affect the rest of the world and can be ignored, so that merely US trade collapses"

Why globalisation and free trade is good for the common man-the disastrous mistake of Trump has been to fail to see this and other countries must avoid the same trap

It is widely said that today's 'populist' agendas include the rejection of 'globalisation' and 'free trade' in favour of 'nationalism' and protectionism. Certainly it is true that the Trump agenda did include these.

Yet this agenda is a disaster for the US common man who voted for it, as we saw above. As for the rest of the world, it should strongly resist being sucked into a trade war and must maintain free trade.

We illustrate why China should not retaliate with Table 2 showing the effect of China raising its tariffs in the same way

Table 1. World trade model simulation of 10% tariff by the US on agriculture and manufactures imported from all other countries/blocs

10% tariff on manufactures and agriculture by US	UK (% change)	Euro (% change)	US (% change)	CH (% change)	RoW (% change)
Y (GDP)	0.15	0.47	-5.38	0.33	0.27
Y_A	0.00	0.00	0.00	0.00	0.00
Y_M	-32.58	-19.99	82.86	-10.65	-21.95
Y_S	7.29	5.03	-19.80	6.03	6.45
Y_D	0.15	0.47	-5.38	0.33	0.27
E_A	0.56	1.24	-15.36	1.66	1.29
E_M	0.04	0.18	-1.35	0.53	0.47
E_S	0.18	0.53	-5.91	0.11	0.08
W	-1.55	-1.55	12.80	-1.55	-1.55
H	4.27	4.27	-7.87	4.27	4.27
L	-61.23	6.38	244.55	6.38	6.38
N	-0.16	-0.16	1.21	-0.16	-0.16
H	0.58	0.58	-2.00	0.58	0.58
L	-5.11	-4.73	-33.31	-5.01	-5.01
K	0.42	0.82	-4.32	0.52	0.55
P (CPI)	1.15	1.55	5.23	1.36	1.28
P_A	0.81	0.81	10.89	0.81	0.81
P_M	0.00	0.00	10.00	0.00	0.00
P_S	2.06	2.06	2.06	2.06	2.06
Pw_A	0.81	0.81	0.81	0.81	0.81
Pw_S	2.06	2.06	2.06	2.06	2.06
P_d	0.84	0.84	12.02	0.84	0.84
Welfare	-0.26	-0.39	-8.17	-0.42	-0.29

Notation: y=output; E=Expenditure; N= unskilled labour force (w=its wages); H- skilled labour force (h=its wages); L=land (l= land price); K=capital; Pw=world price (world price of manufactures is numeraire); subscripts-A=agriculture; M=manufacturing; S=services; D=non-traded

Note on welfare measure: Welfare loss from the tariff is computed as: [Welfare percent =% output loss/GDP+consumer surplus lost-Terms of Trade gain- gain as % of GDP], where the consumer surplus loss=percent rise in CPI x 0.5 and the TOT gain=% rise in world price of exports/world price of imports x share of trade in GDP.

as the US in retaliation. It shows the same self-harming effects as the US move.

In China's case welfare falls by 7%, with about 3% coming from the fall in output and the rest from consumer welfare due to higher prices. Again the effect on other countries is small.

This US-China tariff war only badly damages those two countries, the damage in each case coming from self-harm. It does seem now that both countries are discovering this and gradually retreating to a lowering of these tariffs.

Notice that in fact China has at no stage put a tariff on others than the US; but if it did, it would have no long run effect on them, as they would all divert their exports elsewhere. The main gain for them from this Chinese policy is that there are no short run demand effects coming from China.

What this underlines is, as already noted, that other countries should not retaliate with their own tariffs, since this will only reduce their welfare further. To illustrate this (Table 3), we show the effects of a general application of 10% tariffs to all goods (manufactures and agriculture) from all other countries.

Now all countries are raising their goods prices internally by 10%, causing an initial world-wide shift of output into goods from services and of demand from goods into services.

However, this creates world excess demand for services which must be resolved by a rise in world service prices to eliminate these shifts in supply and demand. The overall result is a general rise in prices, damaging consumer welfare through the loss of surplus.

Notice that all these prices are expressed relative to the baseline world price of manufactures, which is kept fixed equal to 1, as the 'numeraire', so assuming zero inflation which the model does not calculate. Thus in this simulation the price of consumer goods rises by about 10% relative to consumer incomes, reducing the real value of consumption and losing half of this as surplus.

Table 2. World trade model simulation of 10% tariff by the US and China on agriculture and manufactures imported from all other countries/blocs

10% tariff on manufactures and agriculture by US & CH	UK (% change)	Euro (% change)	US (% change)	CH (% change)	RoW (% change)
Y (GDP)	1.86	2.02	-3.80	-3.26	1.86
Y_A	0.00	0.00	0.00	0.00	0.00
Y_M	-54.48	-33.74	67.07	25.60	-36.38
Y_S	14.18	10.02	-15.36	-18.52	12.67
Y_D	1.86	2.02	-3.80	-3.26	1.86
E_A	5.91	5.34	-10.84	-16.18	9.02
E_M	0.35	0.78	-0.95	-5.16	3.28
E_S	2.24	2.27	-4.17	-1.03	0.56
W	-1.90	-1.90	12.41	12.41	-1.90
H	8.76	8.76	-3.90	-3.90	8.76
L	-65.63	-5.69	205.46	38.64	-5.69
N	-0.19	-0.19	1.18	1.18	-0.19
H	1.04	1.04	-1.55	-1.55	1.04
L	8.34	9.10	-23.75	-22.95	8.42
K	1.59	2.33	-3.15	-1.93	1.67
P (CPI)	1.37	2.56	6.22	6.30	1.88
P_A	0.36	0.36	10.40	10.40	0.36
P_M	0.00	0.00	10.00	10.00	0.00
P_S	3.82	3.82	3.82	3.82	3.82
Pw_A	0.36	0.36	0.36	0.36	0.36
Pw_S	3.82	3.82	3.82	3.82	3.82
P_d	0.08	0.08	11.18	11.18	0.08
Welfare	1.46	0.58	-7.22	-6.55	1.08

Notation: y=output; E=Expenditure; N=unskilled labour force (w=its wages); H-skilled labour force (h=its wages); L=land (l= land price); K=capital; Pw=world price (world price of manufactures is numeraire); subscripts- A=agriculture; M=manufacturing; S=services; D=non-traded.

Conclusions

What all this shows is that globalisation and free trade are good for the economy and the average voter. Unfortunately, ignorant and ambitious politicians have tried, often successfully, to persuade this voter that he/she has been unfairly treated by the market forces these have unleashed, that they have been 'left behind'.

Yet take for example American households: they have benefited from one of the fastest per capita growth rates in the OECD. While some industries have contracted, such as coalmining in West Virginia, the West Virginian residents like other voters displaced by global competition have enjoyed the massive expansion of Medicaid, Medicare and Social Security paid for by the economy's growth and resulting tax revenues.

By contrast the Trump agenda, notionally designed to benefit the 'left behind', is causing them acute harm, both in the short and the long term, as our tables reveal.

It is vital that the rest of the world refuses to retaliate against this US trade-destroying agenda. The temptation is there to retaliate to prevent the short run effects of export disruption and reduced demand from the US-just as happened in the 1930s.

But in the long run protection by the US alone will not affect the rest of the world and can be ignored, so that merely US trade collapses. This will permit the rest of the world to rebuild the world trading system until the US once more rejoins it at some future date. ■

Table 3. World trade model simulation of 10% tariff by all trade blocs on agriculture and manufactures

10% tariff on manufactures and agriculture by ALL	UK (% change)	Euro (% change)	US (% change)	CH (% change)	RoW (% change)
Y (GDP)	-0.07	0.04	0.02	0.07	-0.02
Y_A	0.00	0.00	0.00	0.00	0.00
Y_M	-0.34	0.09	-0.02	0.20	-0.09
Y_S	-0.02	0.03	0.03	0.01	-0.01
Y_D	-0.07	0.04	0.02	0.07	-0.02
E_A	-1.05	0.03	0.00	0.28	-0.13
E_M	0.11	0.04	0.02	0.13	0.47
E_S	-0.12	-1.55	0.02	0.02	0.08
W	9.41	9.41	9.41	9.41	9.41
H	10.26	10.26	10.26	10.26	10.26
L	-56.98	18.05	160.09	18.05	18.05
N	0.90	0.90	0.90	0.90	0.90
H	0.08	0.08	0.08	0.08	0.08
L	-6.37	-6.37	-6.37	-6.36	-6.36
K	0.39	0.38	0.38	0.39	0.40
P (CPI)	10.45	10.32	10.29	10.28	10.38
P_A	10.56	10.56	10.56	10.56	10.56
P_M	10.00	10.00	10.00	10.00	10.00
P_S	10.26	10.26	10.26	10.26	10.26
Pw_A	0.51	0.51	0.51	0.51	0.51
Pw_S	10.26	10.26	10.26	10.26	10.26
P_d	10.70	10.70	10.70	10.70	10.70
Welfare	-4.55	-5.54	-5.97	-5.46	-4.78

Notation: y=output; E=Expenditure; N= unskilled labour force (w=its wages); H-skilled labour force (h=its wages);L=land (l= land price); K=capital; Pw=world price (world price of manufactures is numeraire); subscripts-A=agriculture; M=manufacturing; S=services; D=non-traded.
Note on welfare measure: Welfare loss from the tariff is computed as: [Welfare percent=% output loss/GDP+consumer surplus lost-Terms of Trade gain- gain as % of GDP], where the consumer surplus loss=percent rise in CPI x 0.5 and the TOT gain=% rise in world price of exports/world price of imports x share of trade in GDP.

** Details of this model-fitting exercise can be found in Minford, P, Xu, Y and Dong, X (2023) 'Testing competing world trade models against the facts of world trade', Journal of International Money and Finance, 2023, vol. 138, issue C.*


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Piero Cipollone discusses how a digital euro would support Europe's strategic autonomy and monetary sovereignty
Michael Barr sounds the alarm about the potential impact of Washington's push to massively deregulate the financial sector
21ST CENTURY FINANCE
Michael Barr examines the issues around Artificial Intelligence and the labour market
21ST CENTURY FINANCE
Patrick Minford discusses the deep hole that UK governments have dug for the British economy
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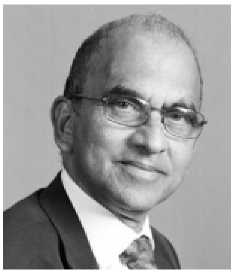
21ST CENTURY FINANCE



How Trump should have tackled the trade deficit

Vijay Joshi is Emeritus Fellow of Merton College and David Vines is Emeritus Professor of Economics and Emeritus Fellow of Balliol College, at the University of Oxford

One does not have to be a Trumpist to believe that the large and persistent trade deficits of the US need correction. In 1980, the US was a net creditor to the rest of the world by an amount equal to 20% of GDP. In 2025, it is a massive debtor. US external debt is now 90% of GDP and rising unsustainably (Bayoumi and Gagnon 2025).

Trade deficits will have to be reduced materially to prevent a crisis down the road. The question arises: how best could Trump have achieved this objective when he took office? This is a non-trivial question in counterfactual history.

We think that for any such policy, the starting point must be fiscal consolidation. Such fiscal consolidation could be combined with either tariffs or with a currency depreciation. The latter would be better. But in the case of the US such a currency change could only be achieved in the presence of some kind of 'Mar-a-Lago currency accord'.

Some observers have been calling for fiscal consolidation and others have been arguing for a 'Mar-a-Lago accord'. The contribution of this column is that we identify a need for both approaches.

Thus, our column is in the same spirit as the articles by Obstfeld (2025) and Clarida (2025). We develop our argument by going back to the ideas in James Meade's book on the balance of payments (Meade 1951), as set out by Trevor Swan, and as developed by Mundell, Fleming, and Dornbusch.

Trump has imposed tariffs on US imports to improve the US trade balance. But tariffs without concomitant macroeconomic retrenchment would not do this. If the exchange rate is floating, as in the US, tariffs tend to *reduce* exports.

This is because the reduction in demand for imports would tend to strengthen the exchange rate directly; and exchange rate appreciation is also likely since the rise in interest rates caused by higher domestic economic activity would lead to higher capital inflows.

Moreover, the central bank is likely to reinforce the rise in interest rates in response to the tariff-induced rise in the price level. In a fully employed economy such as the US, the success of tariffs as a policy to switch demand towards domestic goods is thus conditional on there being sufficient fiscal contraction to make room for the extra demand for domestic goods. (Note that the US dollar has in fact depreciated.

Needless to say, this is because of the chaotic manner in which Trump's tariffs were introduced, which created huge uncertainty, reduced the incentive to invest, raised the risks of a US recession, and created doubts about US creditworthiness.)

Currency depreciation is an alternative way to switch demand towards domestic goods and improve the trade balance. But that too requires fiscal consolidation. If the exchange rate is floating, the only way to bring about a currency depreciation without causing inflation is if there is also – at the same time - a fiscal contraction.

That is because in a fully employed economy, the central bank will only be prepared to reduce interest rates if there is, at the same time, some kind of fiscal tightening. Given that the currency is floating, such a depreciation of the currency will divert demand away from imports and stimulate demand for exports, replacing the demand for domestic goods which has been reduced by the fiscal consolidation.

There are other, less conventional ways to weaken the dollar – for example, by taxing capital inflows (Pettis 2025, Pettis and Hogan 2024, Tett 2025) – but these would be inadvisable. Interfering with the market for government securities would run the risk of destroying confidence in the dollar as a safe haven. That would certainly damage dollar dominance in the longer term and, even worse, might lead to an immediate financial crisis.

So, both tariff increases and currency depreciation require fiscal consolidation if they are to be used as a policy that switches demand towards domestic goods and so improves the trade balance.

But tariffs are likely to be worse than currency depreciation as a form of expenditure-switching policy. There are at least four reasons for this (Dornbusch 1987, Bordo and Levy 2025, Baldwin 2025a, 2025b).

First, a tariff acts on imports alone, while a currency depreciation acts both to reduce imports and to increase exports.

Second, tariffs bring with them efficiency costs in that US consumers pay more to obtain goods at home than from cheaper sources abroad (and the higher the tariff, the larger the cost).

Third, a tariff on imports is likely to lead to a reduction in the profitability of exporting, to the extent that protected import-competing goods are inputs into the production of exports, reducing the degree to which the expenditure-switching policy will be successful.

Finally, the US economy may become less productive over time as a result of import-competing firms being sheltered from foreign competition.

Of course, a tariff will cause foreigners to supply their exports at a cheaper price, especially for a large country such as the US, thereby improving the US terms of trade. This 'optimum tariff' argument has long been recognised as valid from a purely national perspective. (The height of the optimum tariff depends on the degree of market power possessed by the tariff-imposing country.)

Nevertheless, all tariffs, including optimum tariffs, hurt trading partners and therefore invite retaliatory action by foreign policymakers. A trade war is virtually certain to bring large losses all round, including to the tariff-imposing country (in this case, the US).

It appears, therefore, that fiscal consolidation in association with a weaker dollar, is the right way for the US to improve its trade balance.

Despite what we have just said, there has been a tendency to assume (eg. Pettis and Hogan 2024, Pettis 2025) that the US is powerless to resist a flood of excess savings from China and other surplus countries. Martin Wolf (2025) has also argued along similar lines:

"The analysis suggests that the benefit to the US of its persistent net capital inflows is the ability to have a larger fiscal deficit and so grow its public debt. This does not look like a good bargain. ***But if the government cut its deficit, while the external inflow continued, the outcome could be to drive the private sector into deficit, either via a slump in its income or a surge in its spending. The former means a recession. The latter means asset price bubbles… …."*** (our highlights).

In Wolf's view, US fiscal policy needs to remain expansionary in order to prevent the unemployment that would ensue from the deflationary impact of excessive savings in China and elsewhere.

We disagree. Our answer is that an external inflow to the US would not continue at the previous level because of the fall in US interest rates which we have described above; it is this fall in foreign inflow which would enable the fall of the dollar.

"It appears that fiscal consolidation in association with a weaker dollar, is the right way for the US to improve its trade balance"

Our view is thus that an appropriate fiscal/monetary policy mix could deliver some improvement in the US trade deficit even if the US acted unilaterally in the way that we have described.

Nevertheless, since the US is a large country, it is important to analyse the effects of US action on the rest of the world, and to consider how foreign countries might respond. The best – globally cooperative – outcome would be one in which there is an expansion in aggregate demand in China – and in some other surplus countries – at the same time as there is fiscal consolidation in the US.

In that case, extra demand from China and elsewhere would absorb the excess of exports over imports from those countries to the US – which is what has been enabling the US to run a trade deficit in the first place. And in that case the depreciation of the dollar would also ensure that, within the US, demand switched from the purchase of imports to the purchase of home-produced goods, thereby sustaining the demand for such goods even although there had been fiscal consolidation.

No unemployment of resources would emerge, either in the US or anywhere else. The need for a cooperatively agreed outcome of this kind is what a 'Mar-a-Lago accord' should seek to achieve, which is why such an accord is needed. The idea of some kind of Mar-a-Lago accord thus has to be taken much more seriously than it has been, by, for example, Paul Krugman (Krugman 2025).

This is sort of outcome which the US should pursue, rather than attempting to sustain the demand for home-produced goods by means of a fiscal policy which remains expansionary, or indeed by means of tariffs. A flood of imports into the US is not inevitable. But it can only be avoided if there is global cooperation of the kind which we have described.

Of course, such cooperation may not be forthcoming. If the US were to act on its own, without a contemporaneous expansion of aggregate demand abroad, the outcome would, indeed, be a slump in demand and output in the US. This would then be spread abroad by a reduction in the US demand for imports. Such deflationary effects on foreign countries would be amplified by the depreciation of the dollar which the US policy was seeking to bring about.

In these circumstances there would, of course, be a danger of foreign retaliation. Currency wars are possible, just like tariff wars (Corden 1994: Appendix 13.1). The Chinese monetary

authorities – and those in other countries – might resist the depreciation of the dollar, sending the effects of fiscal austerity straight back to the US, in the way that is feared by Wolf and Pettis. This is the outcome which it is crucial to avoid.

How might the world actually achieve the kind of orderly international adjustment which we have described, thereby avoiding a currency war and currency chaos? In particular, how might a weaker dollar be sustained in the face of the likely monetary policy reactions of trading partners?

Any dollar depreciation that is large enough to reduce the US trade deficit materially (say, 33%) would have significant foreign repercussions. The reactions of key countries, such as China, Japan, and the euro area, would be critical.

Here it is relevant that ever since the amendment of the IMF Articles in 1987, the world has had a 'non-system' of exchange rates, in which each country can have any exchange rate regime of its choice (Corden 2004).

Imagine, therefore, that China and Japan shadow the US dollar in response to a dollar depreciation. Adjustment would obviously be impeded. (Note that both these countries have resisted floating at various times in the past – China systematically and Japan sporadically). Moreover, since most of the adjustment would then be forced on to the euro area, Europe would also have good grounds to resist. That is a recipe for economic chaos.

A material reduction in the US trade deficit would thus require macroeconomic cooperation between the key countries. (Countries in the rest of the world would be likely to shadow one or other of the key currencies.) The good news is that the appropriate direction of policies in the medium run is clear enough, given the macroeconomic positions of the countries in the accord.

In the US, there would have to be fiscal contraction and monetary expansion. In China, measures would be required to increase public and private consumption (not investment), combined with exchange-rate appreciation (Gourinchas *et al* 2024).

In Japan, measures to increase household and corporate consumption are called for, along with monetary tightening. In the euro area, there would need to be measures to increase public and private spending (on both consumption and investment), together with tighter monetary policy.

The bad news is that the appropriate medium-run direction of policies may conflict with various short-term considerations. This is clearly true of fiscal consolidation in the US, but the point is more general than this.

Richard Clarida argued recently that the Plaza accord of 1987 was only successful *because* it involved a cooperative policy adjustment of this kind (Clarida 2025). He is surely right.

Finally, how would the foregoing considerations affect dollar dominance? It is pertinent to note that exchange rate changes in the dollar so far (including dollar depreciations) appear not to have made much difference to dollar dominance. However, these exchange rate changes have been largely market-

determined. What if, as above, the dollar depreciation is brought about by deliberate policy?

We suggest that, at the present conjuncture, dollar dominance is much more at risk from the inexorable build-up of US public and external debt. If dollar depreciation and associated exchange rate appreciations were explained to the market as designed to help reduce global imbalances and thereby put the world economy, including the US, on a more stable macroeconomic footing, this is likely to be accepted by the market as a necessary move. Changes in currency dominance will nevertheless happen over time, but they will be gradual, not sudden (Eichengreen 2025).

Of course, this approach is a far cry from Trump's actual policy, and from the policy advocated by his advisors. But it would have had a much greater chance of working out well for the US economy, and the world economy. ■

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The financial sector and global dollar system

The US administration's approach to financial markets mixes deregulatory policies with a range of other policies that are largely without precedent. Gary Gensler, Lev Menand and Joshua Younger catalogue the relevant policy shifts and consider how these shifts may impact financial stability, capital markets, and the global dollar system

The second Trump administration's approach to financial markets and institutions mixes familiar deregulatory policies with a range of other policies (financial and non-financial) that are largely without precedent and may lead to significant structural change in the long term. Combined, these policies have the potential to affect the financial sector in at least four ways.

First, they could threaten the foundations of the global dollar system – mutual cooperation, trust, and interdependency, both between the producers and consumers of financial instruments and among the nations that constitute the dollar bloc. Second, they may undermine financial stability by loosening prudential standards, especially with respect to limits on leverage. Third, they can jeopardise consumer and investor confidence by relaxing regulatory standards and lessening financial law enforcement. Fourth, they could frustrate the financial crimes and sanctions regime, notably by promoting stablecoins, which can be used beyond the reach of governments to enable various forms of illicit activity.

These effects, in turn, could have a negative impact on the economy in the medium to long term. They raise the risk of financial instability and a messy deleveraging. They also may put upward pressure on interest rates for public and private dollar-denominated debt.

Although the global dollar system has proven robust to past disruptions, and remains well entrenched, the administration's new stance, if pursued to its logical end, could increase financial fragility and impair capital formation.

If that comes to pass, a future exogenous shock to the economic or financial system would pose significant risk to economic growth if policymakers are unable, in the face of such a shock, to come together swiftly to avert a disorderly monetary contraction.

This article proceeds in two parts. First, it catalogues the relevant policy shifts that are likely to affect the financial sector. Then it considers how these shifts may impact financial stability, capital markets, and the global dollar system.

Policy shifts

In its first hundred days, the second Trump administration has taken a range of steps that directly affect the financial sector. They also have taken other steps (not directly related to finance), particularly in relation to international alliances and the administrative state, which may, in the long run, have significant effects on the financial sector. Some steps are of the sort that often follows a change in party control in Washington.

For example, the administration has adopted deregulatory and de-supervisory approaches to banking and markets frequently pursued by prior Republican administrations. Other steps, however, are more dramatic. For instance, the administration has asserted presidential supremacy over financial regulatory agencies, undermined central bank independence, and disrupted US relations with historic allies, all in ways with little to no precedent.

Deregulation

Banking

The core framework for the prudential regulation of US banks is provided by an international agreement known as the Basel Accord. Formed in the wake of a major international banking crisis in 1974 (Braun *et al* 2021)[1], and championed by the United States, Basel was created to level the playing field for dollar-denominated banking around the world. That, it was hoped, would forestall a race to the bottom in regulatory standards that could fuel dollar-based financial bubbles and ultimately precipitate acute monetary contraction.

Towards this end, the latest agreement, known as Basel III, was introduced in 2010 in response to the Global Financial Crisis. It was designed to significantly reduce leverage at global banks and tighten equity and liquidity requirements on the largest, most systemically important institutions.

The new US administration is now considering stepping back from the Basel framework. For the last several years, banking regulators have been working on the final round of rule changes associated with the Basel III agreement known as 'Basel III endgame'.

This April, Secretary of the Treasury Scott Bessent questioned whether it made sense to continue with those changes. Instead, he told a group of bankers that *"we could borrow selectively from them"* to the extent that *"they can provide inspirations."*

And more generally, Bessent asserted that *"[w]e should not outsource decision making for the United States to international bodies." "Instead, we should conduct our own analysis from the ground up to determine a regulatory framework that is in the interests of the United States"* (Bessent 2025a).

The administration so far has suggested several changes to banking regulation that deviate noticeably from current Basel standards. Most notably, it has questioned the current calibration of the limit on bank leverage (the 'leverage ratio'). Secretary Bessent has criticised it as *"too frequently binding"* (when compared to risk-based capital rules) (Bessent 2025a).

He also has recently floated excluding Treasury securities from consolidated measures of leverage, which would be at odds with current Basel standards (Tarullo 2023). The Office of the Comptroller of the Currency (OCC) also has rolled back stricter merger review policies for national banks and federal savings associations (rescinding a 2024 policy statement and amending, without notice or comment, a 2024 final rule).

Consumer and investor protection

A similar liberalising push is apparent in other areas of financial regulatory policy. Most notably, the administration has nearly shuttered the Consumer Financial Protection Bureau (CFPB). Established as an independent federal agency by Congress in response to the 2008 financial crisis (as part of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010), the CFPB was intended to better protect American consumers from fraudulent and deceptive practices in the offering of financial products.

As Rohit Chopra, who ran the agency under President Biden, recently put it: "At its core*, [the CFPB] is a law enforcement agency. It takes big financial institutions to court who cheat consumers, whether it's a credit reporting agency or a large bank or a credit card giant*."

Various lawmakers have been attempting to defund and disable the CFPB since its founding (Sitaraman 2021), and the first Trump administration sharply curtailed its enforcement actions (Peterson 2019). But the new administration has functionally dismantled the organisation, slashing its funding, firing the vast majority of its staff and leaving it without a dedicated leader (see Chapter 8 by Neale Mahoney).

Investor protection is also facing reversals. To date, the Securities and Exchange Commission (SEC) has delayed implementation of new rules related to Treasury markets mandating clearing for much of the Treasury market (SEC 2025; see also Yadav and Younger 2025). The SEC also has indicated a desire to make it easier for retail investors to invest in private funds (*"Such higher-risk, higher reward investments can help complete a diversified portfolio"*) (Uyeda 2025).

The new administration also has rapidly embraced cryptocurrencies. In his first week in office, President Trump signed an Executive Order designed to fashion the US into the *"crypto capital of the world."* In March, the White House announced a Strategic Bitcoin Reserve and a US Digital Asset Stockpile. In April, the Department of Justice announced that it would disband its National Cryptocurrency Enforcement Team. Also in April, the new SEC Chair gave his first speech to a crypto roundtable, stating his view that the rise of cryptocurrencies would help to *"modernize aspects of our financial system"* (Atkins 2025).

Presidential supremacy over regulators

The White House also has asserted unprecedented claims to control government agencies including the financial regulators (see Chapter 3 by Gensler and Menand in this volume). These regulators have long benefited from significant autonomy from White House staff, especially in formulating legislative rules such as capital and liquidity requirements (Congressional Research Service 2023).

Under the administration's new policy, financial regulators will have to submit all proposed rules for review to the Office of Information and Regulatory Affairs (OIRA) in the White House, which can reject those proposals by declining to pass them back to the agencies for promulgation.

President Trump also has claimed the power to remove financial regulators at will, despite statutory language barring the president from removing them except for cause. This change may result in partisan domination of previously balanced multimember commissions such as the Federal Deposit Insurance Corporation (FDIC), the SEC, and the Commodities Futures Trading Commission (CFTC).

Further, the downsizing of agencies along with changes to civil service protections are likely to reduce policymaking capacity, lowering the expertise and experience of their staffs.

Central bank independence

In an even sharper break from recent administrations, the White House has attacked the legal foundations of central bank independence in the United States. In a recent Executive Order, the administration has asserted power to control the regulatory and supervisory functions of the Federal Reserve. While the Executive Order disclaims the power to control 'monetary policy', this distinction may not end up amounting to much.

After all, the regulation of financial institutions is monetary policy, and a White House determined to relax monetary conditions could effectuate such a policy through changes to the rules governing bank balance sheets[2].

The administration also has shown little regard for monetary policy autonomy. On multiple occasions, the President has publicly called for a more accommodative stance. For example, in May he wrote: *"With these costs trending so nicely downward, just what I predicted they would do, there can almost be no inflation, but there can be a SLOWING of the economy unless Mr Too Late, a major loser, lowers interest rates, NOW."*

By statute, the president is permitted to remove Federal Reserve governors only 'for cause'. The new administration has called this limit into question, however, at several points. For example, in April, the President said that *"Powell's termination cannot come fast enough!"* The President also subsequently stated that *"if I want him out, he'll be out of there real fast, believe me."*

The President already has fired a half dozen officials on multi-member commissions similar in structure to the Federal Reserve (see Chapter 3). Further, these statements about having the authority to remove Chair Powell are consistent with legal positions the administration has already staked out in court.

Although legal observers have questioned whether the Supreme Court would accept an attempt by the President to ignore 'for cause' removal provisions in the Federal Reserve Act (allowing the president to remove Federal Reserve governors at will), the President also has made statements suggesting that he may have cause to remove Chair Powell.

For example, the President said: *"I don't think he's doing the job. He's too late. Always too late. A little slow and I'm not happy with him. I let him know it."* Though the President has subsequently said that he was not going to remove Chair Powell, these comments at the time may have been in an effort to lay the ground for 'neglect of duty' and 'inefficiency' – two recognised 'for cause' removal grounds (Manners and Menand 2021)[3].

Stablecoins

The administration's stance toward stablecoin issuers is of relevance to the monetary system. Stablecoins are digital assets designed to maintain a constant value relative to more traditional currencies. By far the most common application has been to mimic a US dollar. This is typically achieved by holding short-term, low-risk US dollar-denominated securities

"Although the global dollar system has proven robust to past disruptions, and remains well entrenched, the administration's new stance, if pursued to its logical end, could increase financial fragility and impair capital formation"

and bank deposits in a 'reserve fund'. Stablecoin tokens are 'minted' when funds are deposited; they are 'burned' when holders ask for their fiat currency back (subject to restrictions after being redeemed, either for currency or in kind) (Gorton and Zhang 2023).

The stated goal of stablecoin issuers is to create 'on-chain' dollars which are imbued with all the technological advantages of cryptocurrencies but maintain access to the payments and economic networks used by more traditional monies. Practically, they have offered people a way to move dollars outside of the banking system via transfers on permissionless (ie. open) blockchains.

They initially were created because many cryptocurrency intermediaries were unable to get bank accounts due to their inability or unwillingness to sufficiently comply with anti-money laundering requirements. Their primary use, by far, has been within the crypto trading and lending ecosystem. At present, the size of the market is between $200 and $250 billion and is dominated by two issuers, Tether and Circle.

An Executive Order released days into the new administration called on federal agencies to *"[take] actions to promote the development and growth of lawful and legitimate dollar-backed stablecoins worldwide."*[4] Congress is currently considering legislation that would provide a legal framework for banks and nonbanks to issue stablecoins.

In May 2025, the US Senate voted to debate a bill which, if enacted, would regulate stablecoin issuers operating in the United States. It would require issuers to back reserves at least one to one with highly liquid short-term assets (eg. Federal Reserve liabilities, Treasury bills, repurchase agreements, and demand deposits at federally regulated commercial banks), not pay interest, and confirms that such issuers are financial institutions under the Bank Secrecy Act.

These steps address a number of issues raised during the Biden administration. (President's Working Group Report on Stablecoins *et al* 2021) As the legislation would address stablecoins issued or sold only in the United States and stablecoins could still be transferred on permissionless ledgers, it leaves open their overseas use outside of the money laundering laws.

In a separate set of developments, the US Treasury Department announced that it has removed the requirement that US firms comply with Congressionally mandated beneficial ownership data collection. This had been an important initiative by Congress and prior administrations to fill holes in entity ownership information to best enforce anti-money laundering and sanctions laws.

International alliances

In its opening months, the new administration has taken an aggressive stance towards historical allies. The White House has challenged the sovereignty of independent nation states including Greenland, Panama, and even Canada. It has terminated longstanding international programmes such as USAID. Through the imposition of tariffs that are in many cases prohibitively high, it has upended a global trading system that has been in place for generations.

In recent months, market observers have raised concerns that the administration's adversarial posture might affect the future reliability of Federal Reserve central bank liquidity swap lines. Central bank liquidity swap lines are a key element of the existing global dollar system. These swap lines, often referred to as simply FX swap lines, are standing arrangements between the Fed and foreign central banks to lend dollars against foreign currencies.

They date back to 1962 when they were first used to stabilise offshore dollar markets as well as for exchange rate management (McCauley and Shenck 2020)[5]. Large-scale provisioning of offshore dollar liquidity using the swap lines proved essential in the Global Financial Crisis (Fleming and Klagge 2010) and Covid pandemic (Choi *et al* 2021).

Financial and economic consequences

The new administration's policy direction may have a range of possible financial and economic consequences including undermining the global dollar system, increasing risks to financial stability, reducing consumer and investor protections, and weakening controls on illicit financial activities.

The global dollar system

The global dollar system is an extensive and complex network. It is the product of a political project begun after World War II to build an international economy centred on the US dollar. This project, carried on by presidents of both parties, produced deep and liquid global capital markets and bank-based payment systems run on dollars as the international 'key' currency (Mehrling 2002)[6].

Its stability depends on the confidence of a wide variety of participants. That confidence ultimately flows from governments, and particularly the willingness of those governments to cooperate amongst each other and, to some extent, sacrifice some of their own sovereignty in the interest of the collective whole. As one former Secretary of the Basel Committee on Banking Supervision once put it: *"Global financial stability is a public good."* Governments cooperate not to check each other but to provide this public good by checking the markets.

Many of the second Trump administration's moves threaten to erode the trust that undergirds the system (Rogoff 2025). The first and most consequential area of concern is an uncertainty regarding the current administration's willingness to backstop global dollar liquidity.

Although nothing concrete has been made public, the adversarial posture of the administration toward historical allies has led some to question whether, due to a combination of domestic political considerations and geopolitical brinksmanship, the swap lines may not be available or not active in time to avoid damaging scenarios in a future financial crisis (McCauley 2025)[7].

The FX swap lines are not just a crisis fighting tool, they are critical to confidence in the global dollar itself. In the same way that federal deposit insurance and access to the Federal Reserve's discount window are critical to ensuring the safety and interoperability of the $20 trillion bank deposits issued by the US banking and credit union systems, the swap lines smooth out and lubricate the daily operations of dollar-issuing banks and the over $12 trillion in Eurodollar deposits across the world.

In other words, the stability of the global dollar system as presently constituted rests on the uninterrupted and mostly unconditional access to US dollar liquidity[8]. This element of the global dollar system is often overlooked, due to the perceived pre-existing commitment of the Federal Reserve and the US government to offer it when needed.

This may be a reflection of military and political alliances that have themselves, until this administration, also been considered as firm commitments. Without reliable and timely access to emergency dollars, the next global crisis would be significantly more severe (Ricks 2016). Even if participants in the global dollar system were to come to believe emergency liquidity might have political strings attached, it could potentially precipitate a crisis in the first instance.

Stepping back from the Basel Accord also could have negative repercussions for the global dollar. The Accord may not always be popular with each of its participating countries. International agreements rarely are. But they have proven effective at fostering a congruent set of principles to safety and soundness regulation – a key element of maintaining confidence in the global dollar system without requiring depositors to be fully versed on the intricacies of each local banking system.

Without it, the global dollar system could come to resemble the 'free banking era' of the 19th century in the United States, when substantial regional variation in bank regulation was a major impendent to the free flow of capital and, ultimately, a material drag on economic growth (eg. Sprague 1910, Jalil 2015).

In that vein, Secretary Bessent's comments and the broader posture of the administration represent a potentially worrisome departure from prior norms. While the United States, under prior administrations, has not implemented all of the recommendations of the various Basel Accords, it has generally made a good faith attempt to incorporate the spirit of those standards[9].

If the United States. were to deviate significantly from international standards, it is plausible that other countries may feel both license and competitive pressure to abandon them as well. The frequent panics and rampant instability of the United States' antebellum banking system still serves as a valuable lesson for those who might consider going down that road.

That said, to date the administration has taken few concrete steps toward changing regulatory standards. One exception of great relevance internationally is the potential for changes to the implementation of Basel III in the United States. The devil will be in the details. Modest deviations from international standards are commonplace.

More substantial changes, however, could contribute to the unravelling of international economic and financial cooperation. Such an unravelling could, in turn, trigger a global deregulatory unwinding that could be difficult to stop.

Among other things, the global system allows the US government to borrow at lower interest rates and supports robust economic growth (Levine 2003); a shift to other currencies and away from dollars could reverse these effects over time.

Financial stability

The administration's relaxation of regulatory standards has the potential to increase risks to financial stability by contributing to the buildup of additional leverage across the financial system over time.

That large financial institutions do not internalise the costs of their failure on their creditors and the economy at large can skew their incentives to adopt high leverage. To the extent that leverage is a binding constraint on a given institution, loosening those requirements without counterbalancing adjustments to equity requirements will therefore lead to lower capital levels.

De-supervision – policies that reduce the intensity of stress tests and oversight by examiners – also may lead to increased regulatory arbitrage, including actions geared toward achieving greater synthetic and on-balance sheet leverage. A similar dynamic preceded the 2008 financial crisis, where a rollback in discretionary supervision facilitated firm behaviour that undermined the efficacy of bright-line rules (Menand 2018).

Increased reliance on leverage has been associated with fragility in Treasury markets (Kashyap *et al* 2025). More recently, the bank runs in 2023 were associated with de-supervision and deregulation of mid-sized banks and significant undercapitalisation (Hoenig 2023).

Presidential supremacy over financial regulators also could threaten financial stability over the medium to long term. This is because greater White House control over regulatory policy could favour financial actors seeking to arbitrage rules and, on the margin, could hamstring regulators seeking to prevent evasion.

Enforcement, especially by markets regulators, could drop. More highly resourced and politically favoured actors may benefit disproportionately. Further, the pace of rulemaking is likely to slow, with White House deregulatory goals prioritised.

Consumer and investor protection

Relaxed regulatory standards, as well as the shrinking of policymaking and enforcement capacity at financial regulators, is likely to put consumers and investors at greater risk.

What will happen to the enforcement authority the CFPB previously exercised is, as yet, uncertain. Though the new administration has suggested that these authorities should be transferred to other regulators, it is unclear if they will be and if so, how effectively or efficiently they will be used.

Legal protections, whether they are provided by the CFPB, SEC, CFTC, or others, are intended to provide investors and consumers with assurances that they can make informed decisions free of fraud and misleading information about risks, investments, and products.

Although state regulators are primed to step into part of the breach, history suggests that only rigorous federal enforcement can provide sufficient protection. In the long run, the associated lack of confidence could harm risk appetite and capital formation more generally.

Another key area of focus of changed policy has been regarding crypto assets. The new administration has made clear that it intends to actively promote the development of crypto assets. That may leave investors more exposed to the kind of fraud and abuse revealed in these markets.

Financial crimes, illicit activities, and sanctions

The efficacy of guarding against illicit activities and enforcing sanctions depends upon the use of the dollar as the international key currency. Businesses worldwide use dollars for most large crossborder and domestic payments. That privileged position has allowed the United States and its allies a degree of control over critical nodes in financial payment networks (ie. chokepoints) as well as an invaluable informational advantage (ie. a panopticon; Farrell and Newman 2019).

As a result, in recent decades, financial sanctions have emerged as a key tool for advancing US interests through non-military means (Mulder 2021, Fishman 2025). National security policymakers have used sanctions to bloc problematic transactions, individuals, corporations, and even entire countries from parts of the global economy.

Stablecoins, however, can undermine the United States' ability to guard against illicit activities and promote national security policy (Massad 2024, Rauterberg and Younger 2024)[10]. As transactions involving these tokens settle outside of the banking system and are pseudonymous, stablecoins are well designed to evade authorities.

At the moment they are relatively small – less than half of 1% of the more than $45 trillion in US dollar monetary instruments circulating globally (Gensler 2024) – and, as mentioned, they are mostly used within the crypto trading and lending ecosystem.

Like many digital creations, though, stablecoins have the potential to grow quickly. Already, some cryptocurrency companies are offering a way to hold stablecoins while earning interest (among the biggest competitive disadvantages at present with other monetary instruments).

Secretary Bessent recently cited expectations that stablecoins could grow to more than $2 trillion in just a couple of years (Bessent 2025b). This figure presumably reflects the anticipated effects of the administration's advocacy, including *"promot[ing] the development and growth of lawful and legitimate dollar-backed stablecoins worldwide."*[11]

(A new stablecoin issued by World Liberty Financial, an organisation majority owned by the President's business interests, already exceeds $2 billion.) Previously there were significant hurdles to stablecoins replacing bank deposits and other more traditional forms of currency in international trade and finance.

At the scale suggested by Secretary Bessent, however, in any jurisdictions in which stablecoins (or their affiliates) have the ability to pay interest, they could start to compete (although this introduces additional legal considerations; Birdthistle *et al* 2025). Were that to occur, the use of the global dollar-based banking system for sanctions and guarding against illicit activities could be degraded.

Even if the growth of stablecoins falls short of more enthusiastic projections, the administration is taking other steps that reduce the efficacy of financial sanctions. The US Treasury's recent announcements dropping requirements for new Congressionally mandated entity beneficial ownership reporting, for example, leaves a significant gap in the current tools for financial crimes and sanctions enforcement.

To the extent that this lowers the effectiveness of sanctions, it risks a destabilising shift towards more use of kinetic warfare rather than financial conflict.

Conclusion

The new administration is making policy changes that could pose long-term risks to the US financial system, including the global dollar architecture. Some of these are direct adjustments to financial policy, such as relaxing regulatory standards, reducing enforcement activity, and promoting nonbank stablecoins. Others are facially unrelated to the financial sector.

Most notably, the new administration has called into question traditional economic alliances and relationships and asserted unprecedented control over regulatory agencies. Incidentally, it is these more general changes that may have the biggest effects on the financial sector and by extension the economy. Each of these shifts is still unfolding.

None has yet done lasting damage to the dollar, financial stability, capital markets, consumer protection, or national security. The administration's actual and proposed actions, however, could eventually have significant impacts on each of these financial sector dimensions.

Mark Sobel, a former senior Treasury official, recently warned: *"by weakening America's economic and institutional foundations, by not being a trusted partner, [the United States] is undermining the underpinnings of what has given rise to dollar dominance."*

While there is, at present, no viable alternative to the US dollar, a transition away from key currencies to a more multipolar monetary system is certainly plausible. By its actions and policy goals, the second Trump administration is potentially pushing and accelerating that transition.

Similarly, degradation of our consumer and investor protections, our ability to combat illicit finance, and checks on excessive leverage could contribute to future financial instability and higher cost of capital in the economy. ■

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Endnotes

1. See also https://www.bloomberg.com/news/articles/2025-01-16/the-hidden-history-of-eurodollars-part-3-spinning-out-of-control.
2. The administration has also failed to clarify its stance with respect to lender of last resort activities, which play a critical role in preventing disorderly monetary contractions.
3. The president also has insinuated that Chair Powell is engaged in misfeasance, another recognised removal ground. ("Well, he should lower [interest rates]. And at some point, he will. He'd rather not because he's not a fan of mine. You know, he just doesn't like me because I think he's a total stiff.") It is hard to predict how courts would adjudicate a challenge following a removal by the president for cause, given the lack of recent precedent.
4. Executive Order 14,178, "Strengthening American Leadership in Digital Financial Technology", The White House, 23 January 2025.
5. See also https://www.bloomberg.com/news/articles/2025-01-15/the-hidden-history-of-eurodollars-part-2-defending-the-dollar-system.
6. The key currency view of international monetary systems is often attributed to Charles Kindleberger, its most prominent advocate in the postwar years. This contrasts with a more multilateral approach championed by Robert Triffin and John Maynard Keynes.
7. See also https://www.reuters.com/markets/after-tariff-shock-trump-may-weaponise-finance-against-allies-2025-04-04/.
8. At $13 trillion, the overseas dollar market is too big to rely on the domestic banking system alone (which is at most twice as large) (Gensler 2024).
9. A notable exception is the decision to exempt Treasuries and reserves from the Supplementary Leverage Ratio at both the bank holding and bank operating company levels in 2020. This was, however, done on a temporary basis and was specifically issued "[i]n light of recent disruptions in economic conditions caused by the coronavirus disease 2019 (COVID–19) and current strains in U.S. financial markets" (85 FR 20578, 14 April 2020).
10. Stablecoins threaten to undermine the efficacy of this "economic weapon" (Massad 2023).
11. Executive Order 14,17.

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Europe and its defence

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On the eve of the meeting between Trump and Putin in Alaska, Russian Foreign Minister Lavrov wore a remarkable T-shirt. His jacket was open just enough to reveal the letters CC, along with part of a letter before as well as after them. The full text undoubtedly read: CCCP, the Russian abbreviation for USSR.

This was not merely a nostalgic message but above all a deliberate threat: the current Russian regime seeks to restore dominion over the former 'Eastern Bloc' or, at the very least, over all territories that once belonged to the Soviet Union.

We want to gain control of all of Ukraine, Lavrov thereby (once again) indicated. But regarding Europe as a whole, the message that the Kremlin longs for the old Soviet empire directly affects at least ten current NATO member states: the three Baltic states, six former satellite states in Central and Eastern Europe, and Germany (as it now includes the territory of the former GDR).

Even if the Kremlin's ambitions were limited to reasserting control over the Soviet Union's former borders, the message would still be clear: after Ukraine, the Baltic states will be next. Estonia, Latvia, and Lithuania hardly needed reminding that they are on the Kremlin's 'menu'.

Their centuries-long experience with Russian aggression and the trauma of half a century of communist oppression are deeply etched into their national consciousness. Other NATO members, however, would do well to realize that Putin's hunger for power extends far beyond the Donbas.

Many NATO states do indeed seem to have been awakened – after years of ignoring Putin's clear statements and failing to treat the Russian annexation of Crimea and its military meddling in eastern Ukraine as alarm bells.

It was only the war that Putin and his allies launched against Ukraine in February 2022 that finally opened many eyes. Yet it remains to be seen whether Western politicians truly wish to recognize that Russia's expansionist drive reaches far beyond Ukraine.

An alternative lesson from the USSR era

That the Soviet Union was one of the last colonial powers, and that Russia has never accepted the decolonization that began in 1991. is something protesters in free countries, who demonstrate to incur colonial 'guilt' and 'colonial trauma', systematically ignore.

Russia, for its part, shows no sense of remorse; quite the contrary. But if Lavrov is fond of reminiscing about the 'good old days' of the Soviet Union, he might also reflect on other implications from half a century ago.

Back then, the Helsinki Final Act was signed. In it, the free West and the communist 'Eastern Bloc' agreed on principles such as freedom of conscience, religion, and the exchange of ideas and press.

However, the communist signatories had no intention of honouring these principles. *"We are masters in our own house"*, Soviet foreign minister Gromyko whispered reassuringly to Soviet leader Brezhnev, meaning: we ourselves will decide whether to observe these human rights.

The reason Soviet leaders accepted these (empty) promises on human rights was that they received something significant in return under what was called the *First Basket*: recognition of Europe's post-war borders and the solemn promise that these borders could only be altered peacefully and by mutual consent. This was the grand prize Brezhnev secured in 1975. But it is also an agreement that Putin and Lavrov flagrantly violate to this day.

When the Soviet empire collapsed around 1989-91, most regimes in Central and Eastern Europe underwent change, but borders mostly did not. Czechoslovakia split into two countries, but this was achieved without spilling a drop of blood and with the mutual consent of Czechs and Slovaks.

The three Baltic states regained the independence and freedom violated in 1940, but their borders with the Russian rump state remained unchanged.

By contrast, Putin's violent seizure and annexation of Crimea in 2014 was a unilateral act of aggression, constituting a breach of the Helsinki Final Act.

Any potential 'peace' between Russia and Ukraine that involved recognition of territories seized by the former from the latter – which, as I write this about a week after the Alaska summit, is still unforeseeable – would ipso facto constitute a violation of the Helsinki Final Act. Because it would be a reward for brute aggression.

And it would send a disastrous signal to other nations: that one can get away with waging war against another country and violently seizing its territory, indeed that one can even profit handsomely from it. Aggression pays, that would be the message. A message that would not be lost on eg. Beijing or Pyongyang.

"If Trump truly wants peace, he will at the very least have to commit troops himself. Until he is willing to send American forces to Ukraine, his peace initiative cannot be taken seriously"

What kind of peace?

Trump is right that the further loss of life among Ukrainian and Russian soldiers is extraordinarily tragic. An end to the war would, in that sense, be a good thing. Of course, every war eventually comes to an end. But *how* it ends and *under what peace terms* makes all the difference.

A peace that amounts to surrender for Ukraine may be more unbearable than continuing the fight. Otherwise, the soldiers already killed or maimed will have been sacrificed in vain. Moreover, an independent existence in freedom is far preferable to a life of oppression and servitude.

The Americans, in 1776 and the years that followed, did not choose to continue living as a British colony, even though the rule of King George III was far milder than the predatory regime of Putin and his associates.

Moreover, it is a mistake to believe that such a peace would satisfy Putin. If the Kremlin is rewarded for committing aggression, it will only whet its appetite for more. The Russians will bide their time until a favourable moment arises to strike again, hoping that the Western world will have grown weary of the conflict and cease its support for Ukraine.

It is therefore understandable that Ukraine seeks security guarantees and is not content with mere promises. Promises from the Kremlin are worthless, but paper promises from Western countries are hardly better. The only pledge that carries real weight for Ukraine is boots on the ground. They must come from nations capable of exerting substantial military force.

Several European countries currently seem willing to provide this. Yet it would be unwise if the military force guaranteeing Ukraine's security consisted solely of Europeans. Would this really deter the Kremlin?

Ultimately, only the fear of nuclear retaliation or of conventional superiority will prevent Putin and his circle from launching another attack. Only an American military presence in Ukraine constitutes credible deterrence for the Kremlin.

Without American forces, Europeans would face a grim choice in the event of renewed Russian aggression: stand by passively while Ukraine is attacked and pushed back again, or go to war with Russia themselves. Europe would then be thrust into a situation that has been carefully avoided since February 2022.

If Trump truly wants peace, he will at the very least have to commit troops himself. Until he is willing to send American forces to Ukraine, his peace initiative cannot be taken seriously.

EU ≠ Europe

Trump is also correct that many European countries have shamefully neglected their defence for years. But he is certainly not the first American president to raise this issue; the question of fair 'burden sharing' was already contentious during the Cold War.

At its end, many European nations irresponsibly slashed their defence budgets under the naïve assumption that war on the European continent had become unthinkable. What was dismantled then must now be rebuilt, at far greater effort and expense than if proper defence capacities had been maintained.

At the NATO summit this June, member states committed to spending at least 5% of their GDP on defence in the future, of which 3.5% for the armed forces themselves and 1.5% for related matters such as infrastructure and digital security. Whether all members will honour this commitment remains to be seen.

In the 1970s and 1980s, several members paid scant regard to the obligation to allocate at least 3% of GDP to defence. Even the 2014 Cardiff pledge to spend a minimum of 2% was until recently flouted by a large majority of member states. The fact that notorious free riders such as Spain and Belgium opposed the new requirement right up to the NATO summit in The Hague is also telling.

Although additional defence spending currently enjoys relatively broad voter support, it takes courage for politicians to sustain this in the long term. The commitment made in The Hague will cost most member states tens of billions annually, to be raised either through (even) higher taxes or by cutting social spending or healthcare, as these are typically the largest budget items in most Western countries.

How much support for additional defence spending will remain once the threat from Russia or other hostile states appears somewhat less urgent?

The European Commission in Brussels now seeks to position itself as the willing executor of this new defence agenda. It wants to give the European Union (EU) a strong defence arm. It would be unwise to allow this.

There already exists a streamlined organization responsible for Europe's military defence: NATO. There is no need for duplication.

Moreover, European nations must do everything possible to keep the United States engaged in their security. And some defence tasks cannot be assumed by Europeans – or only after a very long time.

It is also inconceivable that Europe would build a nuclear deterrent comparable to that of the US, regardless of whether such an endeavour would even be desirable. Even if, in the long run, the United States were (unfortunately) to loosen its ties with Europe, it remains of utmost importance that non-EU members such as Canada, Norway, and the United Kingdom – which has Europe's most capable and experienced armed forces – continue to stand militarily and politically shoulder to shoulder with the EU member states.

Europe is much more than the European Union. The EU would do better to focus on core tasks on which it is underperforming: completing the internal market, restoring the health of the eurozone, keeping budget offenders (such as France and Italy) in check, securing external borders against the influx of illegal migrants, and so forth.

European countries must urgently grow up militarily. They should do so within an organization that, over its 75-year existence, has proven not only to be mature but also to operate with unmatched success at deterring the enemies of the free world. This organization is NATO. ■

Building European autonomy

Christine Lagarde is the President of the European Central Bank

One of the defining questions of our time is how can Europe advance its autonomy while remaining committed to multilateral cooperation and the rule of law? There are many ways in which Europe is trying to build its capacity to respond to the major challenges of our era – whether in the area of defence, the economy or technology. Yet I understand that behind these specific issues lie deeper questions that cut across them all.

Three key questions come to mind. First, how is 'European autonomy' defined in EU law in particular? Second, how can the EU's pursuit of geopolitical and geoeconomic autonomy coexist with its commitment to multilateral cooperation? And third, how do rule-of-law norms relate to the independence of central banks in today's world?

The definition of European autonomy

Autonomy can mean many things, and different people use the term in different ways. Most would agree, however, that autonomy is about Europe's ability to act collectively, guided by its own values and interests.

We are at a global juncture where autonomy – or sovereignty, to use another term – is making a comeback as a central organising principle of international affairs. Yet the European model of autonomy seems to me to be distinct from others in two important respects.

First, European autonomy is *collective* autonomy. It is not the autonomy of a single sovereign state, but of a group of member states that have pooled some of their powers and exercise certain public functions together through common institutions. In other words, European autonomy is autonomy without a conventional state-type sovereign. Autonomy exercised through EU institutions under EU law is a form of shared sovereignty projected onto the world stage.

This, of course, poses challenges. In the EU, action on a global scale requires unanimity, or at least broad agreement, in the form of majority voting, which can sometimes be slow and cumbersome. And for some, this might appear to be a weakness.

But Europe's constitutional order is based on checks and balances, and this also applies to autonomy-building. European autonomy is based upon competence-sharing under the Treaties, compromise and a commitment to follow rules that include and balance different perspectives.

Second, the EU – more so than other major powers – has tied its autonomy to commitments made under international law. The Treaty on European Union makes this abundantly clear, stating that in its relations with the wider world, the EU must contribute to *"the strict observance and the development of international law."*

Even in creating space for itself to make autonomous choices on the international scene, the EU and its member states remain bound to their international legal commitments.

In financial and trade matters, this translates into respecting international agreements – whether International Monetary Fund (IMF) programmes or Basel Committee standards – and seeking out cooperative multilateral solutions within established legal frameworks, such as the World Trade Organization.

Squaring European autonomy with multilateralism

But this brings me to my second question: is this definition of European autonomy not increasingly contradictory? At first sight, reconciling autonomy with international law and multilateral cooperation looks like a paradox.

On the one hand, the EU, like other major powers, wants to defend its interests and act decisively. On the other, it wants to remain integrated with an international rules-based system. But I believe that law can align these two central notions, autonomy and cooperation, without compromising either.

First, autonomy can be exercised in a way that is both flexible and bounded. Autonomy-building inevitably involves high-level political judgements. Law in these areas is not always black and white. Rules have exceptions, and their interpretation requires careful attention to their purpose.

Legal advisers know this well: law provides for discretion to policymakers but also sets outer limits. Respecting those limits – the 'red lines' set by EU and international law – is essential if autonomy is to remain anchored in the rule of law.

Second, international law is itself co-determined. In shaping and exercising its autonomy, Europe – or any other jurisdiction – cannot unilaterally define what international law means and expect others to follow. But, where necessary, we can advocate for reforms that reflect new global realities. The key point is that our interpretations must be part of a global conversation.

Engaging with other perspectives is a necessary part of building a truly multilateral order – even one that gives countries more space to pursue 'sovereign' economic policies.

International rule of law, cooperation and central bank independence

Now, since we are a central bank, we have to mention central bank independence! But bringing independence to the table is more than a central banker's reflex. I believe that central bank independence perfectly illustrates the model of autonomy I have been outlining.

Autonomy does not mean unbound power. Independent courts, specialised agencies, a free press – these all belong to the infrastructure of constitutional democracy as the essential checks and balances of public authority. And so do independent central banks.

Independence is, at its core, a rule-of-law guarantee. By committing to independence in law, countries around the world secure credibility for their monetary policy. And as we have seen on several occasions, that credibility ultimately affords greater autonomy to central banks – allowing, for example, policy tools to be adopted during crises without de-anchoring inflation expectations[1].

In Europe, the EU Treaty explicitly protects the ECB and national central banks from political instructions. Beyond the EU, the IMF promotes central bank independence, sometimes making it an explicit component of financial programmes. Independence thus becomes not only a domestic legal rule, but also a feature of the international financial rule of law – a condition for trust among states, markets and institutions.

And this trust is also the basis of cooperation between central banks themselves. Central banks work together on the assumption that each one of them remains mandate-driven and protected from undue political interference.

Of course, independence does not mean immunity from accountability. The rule of law demands transparency, responsibility and clear mandates. In Europe, the Treaties provide mechanisms to ensure that independence goes hand in hand with accountability.

"European autonomy means acting decisively and collectively on the world stage to uphold our values and interests. Multilateralism means doing so in concert with others, under shared rules and through trusted institutions"

Conclusion

European autonomy means acting decisively and collectively on the world stage to uphold our values and interests. Multilateralism means doing so in concert with others, under shared rules and through trusted institutions.

Far from being opposed, the two reinforce one another. Back in 1989, at another critical juncture, Jacques Delors called for Europe to be *"powerful enough to command respect and to promote our values of freedom and solidarity."*[2]

The rule of law is not the enemy of autonomy; it is its foundation. The backbone of autonomy in a civilised world is the rule of law. Consider the ECB: its independence, grounded in treaty law, gives Europe and its currency credibility and strength.

More broadly, the EU can pursue its policy choices effectively precisely because they are framed by legal commitments that others recognise and respect.

The success of European autonomy should not be judged by how much Europe can do alone, but by how much and how well it can build and sustain the multilateral order. If the EU can stand on its own feet – technologically, militarily and economically – it will be a stronger partner. And its commitment to law and cooperation will enhance its legitimacy and impact.

Let us remember that our laws are bridges, not walls. Their purpose is not to isolate, but to bind member states together internally and bind Europe to the wider world externally. The challenge before us is to remain bold yet collaborative, independent yet interdependent. And if we see it like this, the challenge may serve as an opportunity for Europe to grow stronger and more united. ■

Endnotes

1. For a discussion on the interaction between instrument effectiveness and credibility see Nakamura, E, Riblier, V and Steinsson, J (2025), Beyond the Taylor Rule, Federal Reserve Bank of Kansas City, August.

2. "Soyons assez puissants pour nous faire respecter et pour promouvoir nos valeurs de liberté et de solidarité." See Delors, J (1989), "Speech at the opening session of the 40th academic year of the College of Europe", Bruges, 17 October.

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Geopolitical shifts and their economic impacts on Europe

The rules-based international system has fundamentally altered. André Sapir, Jacob Funk Kirkegaard and Jeromin Zettelmeyer examine the short-term risks, medium-term scenarios and policy choices and discuss how Europe can hold its own in a multipolar world

Executive summary

Over the last decade, Europe has suffered from the decay of the post-war international order, economic coercion from both China and the United States, and aggression from Russia. This contribution puts these changes into a historical context, examines their short-term consequences, develops scenarios for 2030-2035 and uses these to draw out the policy implications for the next one to five years.

The short-term output impact of tariff and policy uncertainty since the beginning of the second Trump Presidency is expected to be moderate. However, Europe faces very high risks. Plausible short-term dangers include: a collapse of the US bond market; escalation of Russian military aggression against Ukraine or the European Union directly; a fiscal crisis triggered by a populist election victory in a high-debt euro area member; or a trade shock triggered by increasing tensions between the US and China and/or hostile Chinese actions in East Asia.

We develop three benchmark scenarios for the world in 2035, all of which involve continued US-China rivalry and greater multipolarity than in the past:

1. A further retreat from, or dismantling of, international cooperation, with continuing protectionism in the US and minimal global public goods.

2. A three-bloc world involving China- and US-led blocs alongside a non-aligned set of countries, with the provision of international public goods within, and partially between blocs.

3. A new multilateral order, with international cooperation over the provision of global public goods.

Actual outcomes could consist of combinations of these scenarios or variants of them. Scenario 1 would be least desirable for the EU, most countries individually and countries collectively, while scenario 3 would be most desirable. In scenario 2, Europe's decision to align with the US or to choose non-alignment would depend on whether the US acts in a benevolent or coercive manner.

Short-to medium term policy must both prepare Europe for adverse future scenarios and contribute to greater international stability and cooperation. This requires policies that increase Europe's strategic autonomy from the two superpowers, both for its protection and to increase its bargaining power.

The policy focus should include much greater defence, tech and financial autonomy from the US, a far more resilient and integrated energy system, secure access to critical minerals and a fiscal framework that gives greater flexibility to low-risk countries.

Internationally, Europe should defend and promote the reform of the rules-based international order by forming coalitions with other countries from the Global North and some from the Global South. The two priority areas should be trade policy and climate policy.

1 Introduction

Geopolitical tension and uncertainty are staples of history, even in a period of relative international order and prosperity, as Europe and most of the world have enjoyed since the end of the Second World War. But the rise in tensions over the last decade, and particularly since Russia's invasion of Ukraine in 2022 and the return of President Trump to the White House, seems different from anything that European and other advanced democracies have experienced since the late 1940s. Unlike previous geopolitical episodes, the international order itself is now being challenged.

And unlike the 1971 collapse of the Bretton Woods system, which was also a major challenge to the existing order, today's shift is not a reaction to the economic unsustainability of the previous regime. Rather, it is the manifestation of deeper trends, including the rise of China, the failure of democratic transition in Russia and increasing polarisation in many Western democracies. It is polarisation that has led to a drastic political and policy change in the United States, with profound consequences for the postwar system.

We argue both that the world is at the beginning of a new era that will challenge the foundations of European prosperity, and that the future is wide open and Europe may be able to shape it. We develop three scenarios to give a sense of both threats and opportunities.

In terms of threats, policies that enhance European strategic autonomy must be emphasised to a much greater degree than in the past. But Europe must not just create more autonomy for itself – it should also put it to the best possible use for the global rules-based order.

The remainder of the paper is divided into three parts. Section 2 recalls the main phases in the evolution of the international economic order since 1945, describes the current geopolitical state of affairs and summarises the short-term economic effects on Europe of recent US policy shifts. Section 3 presents three geopolitical scenarios that will confront Europe in 2030-2035. Section 4 describes Europe's policy choices in relation to these scenarios. The paper ends with some conclusions.

2 The geopolitical state of affairs and its economic effects on Europe

2.1 The evolution of the multilateral system, 1945-2008

The postwar economic order, with the International Monetary Fund, the World Bank and the General Agreement on Tariffs and Trade (GATT) as the three central institutions, was created between 1944 and 1947 by the winners of the Second World War to foster postwar economic cooperation and to prevent a return to the economic nationalism of the 1930s. But what was intended as a new global economic order did not become truly global until the collapse of the Soviet Union in 1990.

2.1.1 The Cold War period

During the Cold War, running from 1947 to 1989, the world was divided into two spheres, east and west, which were political rivals with minimal economic relations between them. Countries in both spheres belonged to the global political institutions created after the Second World War under the leadership of the US, the United Nations and its specialised agencies. But only those in the western sphere – and two countries that later founded the non-aligned movement, India and Yugoslavia – joined the new economic institutions[1].

Most developing countries, which were previously colonies of western countries, became and remained non-aligned after independence, maintaining a degree of political distance from the two spheres, while gradually joining the GATT, IMF and World Bank.

During this period, the world was bipolar, with two superpowers: the US as 'leader of the free world' and the Soviet Union as the main country in the communist camp, though increasingly in competition with China. The western camp lived in a 'liberal international order' in which crucial international public goods in trade, finance and defence were provided by the United States acting as its 'benevolent hegemon'.

Multilateralism mostly prevailed within the western sphere, but not when it clashed with US interest, as with the 'Nixon shock' in August 1971, when the US president ended the Bretton Woods system of fixed but adjustable exchange rates by taking the dollar off the gold standard, and introduced a 10 percent tariff surcharge on all dutiable imports[2].

The import surcharge was meant to put pressure on the main US partners to revalue their currencies against the dollar, which they did under the December 1971 Smithsonian Agreement of December 1971, in the hope of preserving the Bretton Woods system. This hope was dashed in 1973, after the US further devalued the dollar, forcing major currencies to float against the greenback and each other.

Another instance of US unilateralism during this period was Section 301 of the 1974 US Trade Act, which allows the US administration to unilaterally (ie. without recourse to the GATT dispute settlement procedure) address 'unfair foreign practices' through investigations, negotiations and, if necessary, the imposition of tariffs or other trade restrictions. Section 301 is the only US statute that permits the US administration to adopt unilateral trade sanctions on economic grounds. Two other statutes – Section 232 of the 1962 Trade Expansion Act and the International Emergency Economic Powers Act (IEEPA) of 1977 – also permit the US administration to unilaterally impose trade sanctions on certain countries, but on national security grounds.

2.1.2 The rise and fall of hyper-globalisation, 1990-2008

With the 1989 collapse of the Berlin Wall and the end of the Soviet Union in 1991, liberal democracy appeared to have *"triumphed as the final form of human government"* (Fukuyama 1992). In geopolitical terms, this meant that all countries could now join the liberal international order.

In 1992, Russia joined the IMF and the World Bank. The next year, it applied to join the GATT but had to wait until 2012 to become member of its successor, the World Trade Organisation (WTO), created in 1995. The People's Republic of

China had already joined the IMF and the World Bank in 1980, and the WTO in 2001.

With China and Russia taking major steps to liberalise their economies, it looked as if Fukuyama's *"end of history"* (Fukuyama 1992) was approaching, not only in an ideological sense but also geopolitically. Economic liberalisation in the former eastern sphere, in India and other large developing countries, together with the rapid introduction of information technologies created 'One World' with opportunities for more people in more places to compete, connect and collaborate more than ever.

This ushered in a period of truly global trade and investment integration – often referred to as 'hyper-globalisation' – dominated by purely economic incentives and global value chains (GVCs), with little or no geopolitical constraints (see, for instance, Antras 2020).

This period has been described as the unipolar world, with the United States commonly viewed as the sole superpower. It worked fairly well for nearly two decades. The US continued to act as a 'benevolent hegemon' and the liberal international order thrived, with democracy spreading around the world, the creation of the WTO as the lynchpin of the rules-based multilateral system, and hyper-globalisation delivering rapid economic growth to old and mostly new parts of the world.

However, according to geopolitical realists such as Mearsheimer (2019), the liberal international order was bound to fail because it contained the seeds of its own destruction. First, the spread of western-style democracy produced a nationalist backlash in some countries, including China and Russia.

Second, hyper-globalisation produced faster growth but also contributed to greater income inequality and financial instability, both of which contributed to a populist backlash in advanced countries, especially the US, after the Great Financial Crisis.

Third, hyper-globalisation was particularly helpful in promoting faster growth in China and other export-oriented developing countries. The *"rise of China…along with the revival of Russian power … brought the unipolar era to a close"* (Mearsheimer 2019, p. 8).

The decline of the liberal international order and the 'return of history' ushered in the third and current phase in the post-Second World War international system. As anticipated by Kagan (2008 p. 4), *"The end of the Cold War did not bring the end of history, but rather a return to a historical norm: competition among great powers."*

2.2 The return of Great Power competition and economic nationalism in the United States

Analysts disagree on how to describe the new era. Kagan's 'return to great power competition' is one way. Others refer to it as the 'post-post-Cold War era'[3], as an 'era of fragmentation' (for instance, Clavijo 2024) or simply as a 'multipolar era' replacing the previous unipolar period[4].

The problem with these labels is that they underplay what (in addition to the rise of China) has emerged as a defining feature of the last decade: the gradual withdrawal of the US from its role as 'benevolent hegemon'. This shift accelerated with President Trump's push to blatantly violate post-Second World War rules and norms, including with his 'reciprocal' tariffs (which are in fact unilateral rather than reciprocal and violate the cornerstone of the GATT/WTO regime, which forbids countries from discriminating between their trading partners).

Trump has also launched assaults against international law, democratic norms and institutions. One way to describe the present United States is as a 'coercive hegemon', though the term 'hegemon' itself does not fit well with the new multipolar age. In fact, the contradiction between the two – multipolarity and hegemony – describes well the current geopolitical situation, which is in a state of flux.

Though the US is not the hegemon it was during the unipolar post-Cold War period, or even the bipolar Cold War era, it retains exceptional features that set it aside from other major powers including China and the European Union.

It is easy to minimise the role of the US in world trade by noting that it accounts for less than 15 percent of global trade in goods and services (excluding intra-EU trade), and that therefore the rest of the world can and should continue to organise itself according to WTO norms and rules, which the US is now disregarding. But the US has demonstrated that it can coerce many of its trading partners, including the EU, to accept bad deals.

Typically, such deals involve accepting unilateral US tariff hikes and also opening up domestic markets and committing to buy products preferentially from the US (against the interests of trading partners and against WTO rules) as the price for keeping US tariffs lower than threatened by President Trump, and, above all, for retaining aspects of US security protection.

This continuing US power derives from its superiority in four areas: economy, finance, technology and military. China is the only country that partly rivals the US in all of these areas, except finance. While the EU has strengths in some of these areas, it is clearly dominated by the US, and increasingly China.

The US remains the largest economy (26 percent of world GDP in 2024 at market exchange rates), which partly explains why it is also the world's largest importer of goods. Also, of course, the US now specialises mainly in the production of services, and therefore tends to export services and import goods – the opposite of China, the world's second largest economy (on par with the EU, both accounting for 17 percent to 18 percent of world GDP at market rates), which specialises in the production of goods and therefore tends to export goods and import services.

Although the US is increasingly challenged by China for the top place in the GDP league (and has already been displaced by China when the comparison is made using purchasing power parity exchange rates), it remains unparalleled in finance. The

US accounts for roughly 50 percent to 60 percent (depending on the exact year) of global equity market capitalisation, and 40 percent of bond market capitalisation, far ahead of the EU and China.

The US dollar continues to occupy a dominant position, accounting for 60 percent of international reserve holdings in currencies, 45 percent of global trade invoicing and 90 percent of foreign exchange transactions, again far ahead of the euro and renminbi.

In technology, although the US share of global research and development spending has been declining for decades, the US retains overall leadership. China is making rapid progress and has overtaken the US in some critical areas. As Draghi (2024) noted, Europe also has major technological capabilities, but is weak in digital technologies, such as artificial intelligence, the internet of things and quantum computing.

US technological leadership rests on the strength of its private sector, which benefits from a strong innovation ecosystem that includes top universities able to attract student and faculty talent from all over the world and easy access to venture capital.

For instance, in 2023, the US had twice as many active unicorns (startup companies valued at over $1 billion) as the EU and China combined. However, the policies of the Trump administration on research and universities threaten to deliver a blow to the US innovation ecosystem and weaken its technological leadership.

In the military field, US dominance comes partly from the fact that it has accounted for roughly 40 percent of global military expenditures for several decades, far more than its share of global GDP. This has allowed the US to finance the research, development and purchase of sophisticated weaponry, to maintain military bases and troops in every region of the world, and to lead alliances such as NATO, making it the 'policeman of the world', even if this role is increasingly contested, especially in Asia by China.

According to Carlough *et al* (2025), the US maintains 31 permanent bases and has access to 19 additional sites in Europe (the EU plus Norway, Turkey and the United Kingdom). Carlough *et al* (2025), citing official sources, also report that, in early 2025, the US had nearly 84,000 US service members in Europe, down from over 100,000 in 2022, after the full invasion of Ukraine by Russia.

All this sums up to an international system in flux and disorder. In trade, the WTO has been greatly weakened by the willingness of the US – the world's largest importer of goods – to openly violate international rules, which have become partly outdated in any case because the role of the state in China, the world's largest exporter of goods, is incompatible with the spirit (but not the letter) of the liberal economic order that the WTO represents.

But, so far, the rules-based multilateral system has held up. Apart from the US, other WTO members have continued to play by the rules, with one major exception, with many, including the EU, granting preferential access to (some) imports from the US, as part of the deals they have struck with President Trump to avoid the imposition of higher reciprocal tariffs.

"Short-to medium term policy must both prepare Europe for adverse future scenarios and contribute to greater international stability and cooperation. This requires policies that increase Europe's strategic autonomy from the two superpowers, both for its protection and to increase its bargaining power"

In money and finance, where there has been no formal international system since the end of the Bretton Woods system in 1973, there is nonetheless a global order. One element is the role of the US dollar in international payments and as a store of value. Some Trump administration policies, such as the promotion of dollar-based stablecoins, could further enhance this role[5].

Others, such as the administration's lack of concern about fiscal sustainability, and words and actions that undermine the independence of institutions such as the Federal Reserve and the Bureau of Labor Statistics, could undermine the dollar's international role (see section 2.3.2).

The other element in maintaining global order has been international organisations including the IMF, World Bank, Bank for International Settlements (BIS) and the Financial Stability Board (FSB), which have played important roles in coordinating international efforts to maintain financial stability or restore it during crises.

Although the Trump administration announced that it would review US membership of the IMF, World Bank and other international organisations, Treasury Secretary Scott Bessent has stated that the role of the US is rather to *"push them to accomplish their important mandates"* and focus on their *"core mission"*[6].

The EU has played a constructive role by setting up the euro and ensuring its stability, but the absence of a *"genuine Economic and Monetary Union"*, as advocated more than a decade ago by Van Rompuy (2012), limits its ability to play a bigger international role.

Finally, in the area of international security, the fragile world order has been greatly damaged by Russia's full invasion of Ukraine in 2022. This is rightly viewed as a painful wake-up call and turning point by Europeans, especially in the context of President Trump's questioning of NATO, though for some others (including China and India), war in Ukraine has been no more damaging to the world order than the 2003 invasion of Iraq by the United States (with the support of the United Kingdom, Australia, Poland and others), which was also not authorised by the UN Security Council.

Meanwhile, in the Middle East, conflict has raged again since 2023, and Taiwan faces continuous threat of an invasion or a severe blockade by China. In all these theatres, the role of the US as 'global policeman' has receded, and no other power has filled its place. The EU, which is struggling with its own security, is not a candidate – except in Ukraine.

One way to compare the new era of armed conflict and economic nationalism with earlier periods is through indices designed to quantify geopolitical risks and policy uncertainty. The global Geopolitical Risk Index (GPR), which focuses mainly on military risk, is currently slightly below its level during the post-Cold War period, despite the Russia-Ukraine war and the latest episode of conflict in the Middle East (Figure 1)[7].

By contrast, the global Economic Policy Uncertainty Index (EPU) and Trade Policy Uncertainty Index (TPU) have moved up since 2017, reaching their highest ever level immediately after so-called 'liberation day' (1 April 2025), when President Trump announced the imposition of 'reciprocal' US tariffs on imports from trading partners (Figures 2 and 3).

2.3 Short-term economic effects on Europe

The acceleration of the shifts described in the last section in President Trump's second term is at time of writing affecting the European economy through three main channels: a sharp rise in US tariffs, policy uncertainty and fiscal policy. These impact the EU directly and indirectly, via their impact on the United States (which will remain the EUs largest trading partner in the foreseeable future, tariffs notwithstanding). Monetary policy on both sides of the Atlantic is seeking to modulate the impact of these policy shocks. In addition to baseline effects, there are substantial downside risks.

2.3.1 Baseline effects

Tariffs. US effective import tariffs have gone from 2.4 percent at the end of 2024 to almost 19 percent in mid-August 2025 (Figure 4). Imports from the EU now face a baseline tariff of 15 percent, with some products (steel and aluminium, copper and cars) facing higher tariffs at the time of writing, and a yet-to-be defined set of 'strategic products', to which lower or zero tariffs will apply[8].

Estimates of the 2025 and 2026 GDP impact of these tariffs on the US are larger than the impacts on the EU, ranging from -0.35 percent to -0.6 percent of GDP (relative to the preexisting baseline), while the impact on the EU is estimated at -0.1 percent to -0.35 percent of GDP (see Annex Table 1). While the US economy is suffering a generalised negative supply shock via import prices, the EU is suffering a negative demand shock that affects about 20 percent of its goods exports (worth 3 percent of EU GDP in 2024)[9].

Furthermore, the 15 percent levy is at the low end of the range of reciprocal tariffs the US has imposed on most other major exporters, implying that it may offer the EU a gain in market share relative to other exporters, which may compensate for some of the losses relative to US producers.

Policy uncertainty. While some of recent rise in policy uncertainty (Figures 2 and 3) is transitory (as the policy regime emerging from the stop-and-go announcements of the US administration becomes clearer), some may be permanent, as erosion of the rules-based order and independent institutions in the US creates more room for executive discretion.

Notwithstanding the recovery in the US stock market after declines when the US tariff hikes were announced on 1 April, there is evidence that policy uncertainty has dampened investment in the US. Greater volatility and weaker growth in the US hurts the EU through the export channel and might strengthen investment in the EU in relative terms.

Fiscal policy. While the Trump administration's so-called One Big Beautiful Bill Act (OBBBA), signed into law on 4 July 2025, is estimated to be roughly neutral over the next ten years compared to an extension of current US fiscal policy (which was and remains on an unsustainable path)[10], it is expansionary in the short term because the spending cuts envisaged in the bill are backloaded. According to IMF estimates, the OBBBA will raise the US deficit by about 1.5 percent of GDP in 2026.

Fiscal policy in the EU has been affected mainly through the impact of policy shifts on defence spending. In March, the European Commission (2025b) announced that EU members during 2025-2028 would be allowed to debt-finance an increase in defence spending by up to an additional 1.5 percent of GDP per year relative to 2021 levels, if they request the national escape clause (NEC) under the EU fiscal rules.

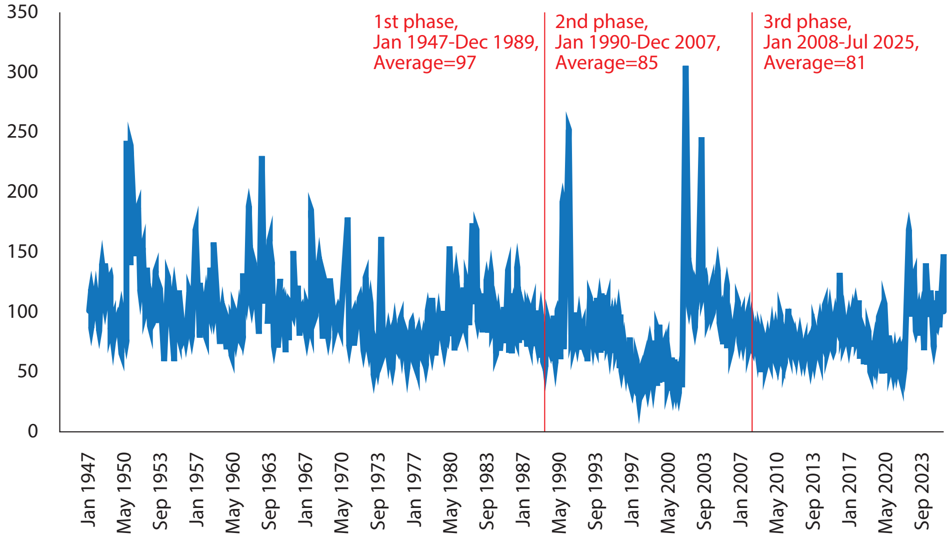
By end-April 2025, 16 EU countries had made such requests[11]. According to the European Commission (2025c), based on *"credibly announced and sufficiently detailed measures"*, additional defence expenditures announced by 30 April 2025 will amount to 0.1 percent of EU GDP in 2025.

The June NATO summit triggered further announcements for 2026 and beyond, while the German medium-term fiscal-structural plan, published in July, envisages an increase in the country's fiscal balance by about half a percent of GDP relative to the European Commission's baseline for both 2025 and 2026. On this basis, the combination of higher defence spending and additional fiscal expansion in Germany could add fiscal stimulus in the order of 0.2 percent to 0.4 percent of EU GDP during 2025-2026.

Importantly, this stimulus is set against a baseline that would otherwise be contractionary, as many EU countries had begun their adjustments under fiscal rules enacted in 2024, leading to net neutral or slightly expansionary fiscal stances in 2025 and 2026.

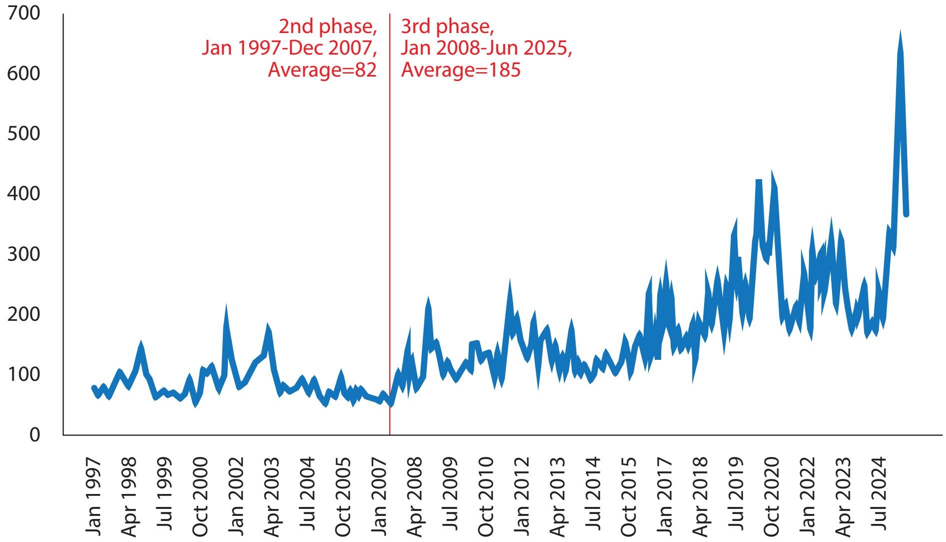
Monetary policy. The combination of higher tariffs and policy uncertainty has created a difficult task for the Federal Reserve, which needs to manage a negative supply shock in an environment of high demand uncertainty. With US inflation

Figure 1. Geopolitical risk index, 1 Jan 1947 to 1 Jul 2025, average by geopolitical phase



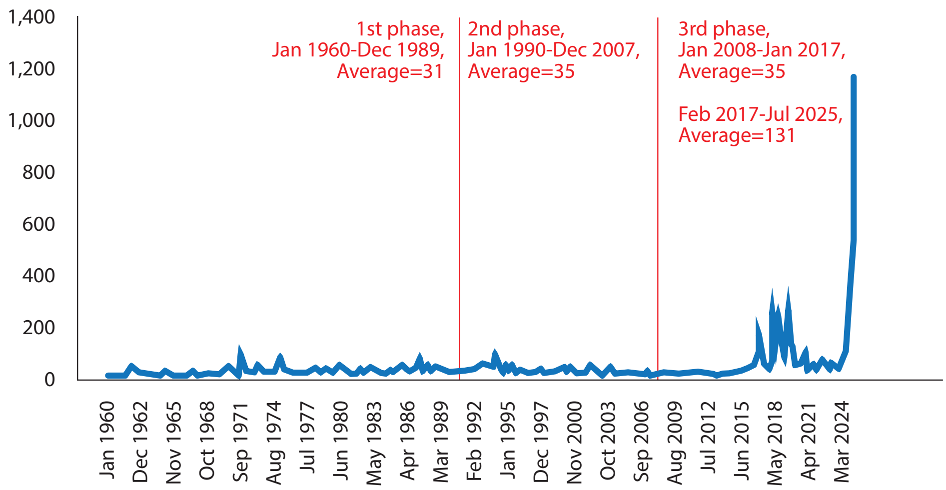
Source: Bruegel based on Caldara and Iacoviello (2022). Data downloaded from https://www.matteoiacoviello.com/gpr.htm.

Figure 2. Economic policy uncertainty index, Jan 1997 to Jun 2025, average by geopolitical phase



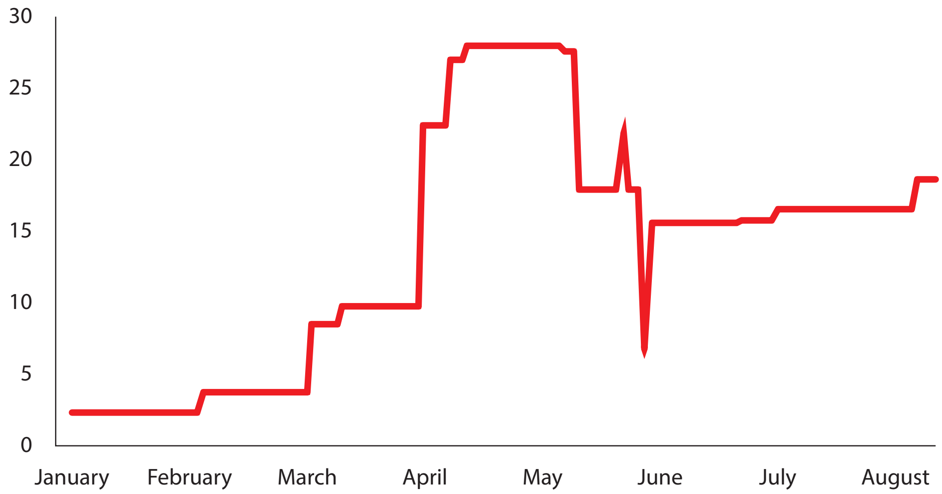
Source: Bruegel based on Davis (2016). Data downloaded from https://www.policyuncertainty.com/global_monthly.html.

Figure 3. Trade policy uncertainty index, Jan 1960 to Jul 2025, avg. by geopolitical phase



Source: Bruegel based on Caldara et al (2020). Data downloaded from https://www.matteoiacoviello.com/tpu.htm.

Figure 4. United States average effective tariff rate



Source: Bruegel based on The Budget Lab (2025).

likely to be above target, it has opted to leave the federal funds rate unchanged at 4.25 percent to 4.5 percent since December 2024.

In contrast, the European Central Bank's task has been comparatively simple: with euro area inflation declining below 2 percent and slowing external demand, because of higher US tariffs and appreciation of the euro-dollar exchange rate, it has lowered its deposit interest rate. However, markets view a Federal Reserve interest rate cut in September as likely and expect a further cut by the end of 2025 and two cuts by mid-2026.

In contrast, markets are currently pricing in no further cuts from the ECB this year and are unsure about a cut in the first half of 2026[12]. The joint impact of policy shocks and policy uncertainty is reflected in short-term output expectations.

Figure 5 shows the evolution of median forecasts of private sector economists surveyed by Bloomberg for both the US (panel a) and the euro area (panel b). The purple lines show forecasts for 2025 real GDP growth; the light blue lines show forecasts for 2026. Dates on the x-axes indicate the time of the forecasts.

Since Trump's second inauguration in January until early September 2025, the 2025 median growth forecast for the US has dropped by 0.50 percentage points, from 2.1 percent to about 1.6 percent, while the euro area median forecast dropped by just 0.1 percentage points, from 1.2 percent to 1.1 percent.

In the interim, forecasts for 2025 have undergone large swings, particularly in the US, where exuberance in the first months of the new administration was followed by a large drop in output expectations in April, when the extent of Trump's tariff hikes became clearer, and eventually a modest recovery. US output expectations for 2026 have gone through a similar cycle, albeit of smaller amplitude (Figure 5, left panel).

For the euro area, the 2025 forecast decline in the first half of 2025 has been more gradual than in the US, while the June-August recovery was steeper, likely reflecting a combination of monetary and fiscal policy easing, and the trade agreement with the US at the end of July.

At time of writing, forecasters expect modestly higher US growth in 2026 than in 2025, perhaps reflecting expected fiscal stimulus and monetary easing. Euro area output in 2026 is expected to be unchanged from 2025.

2.3.2 Risks

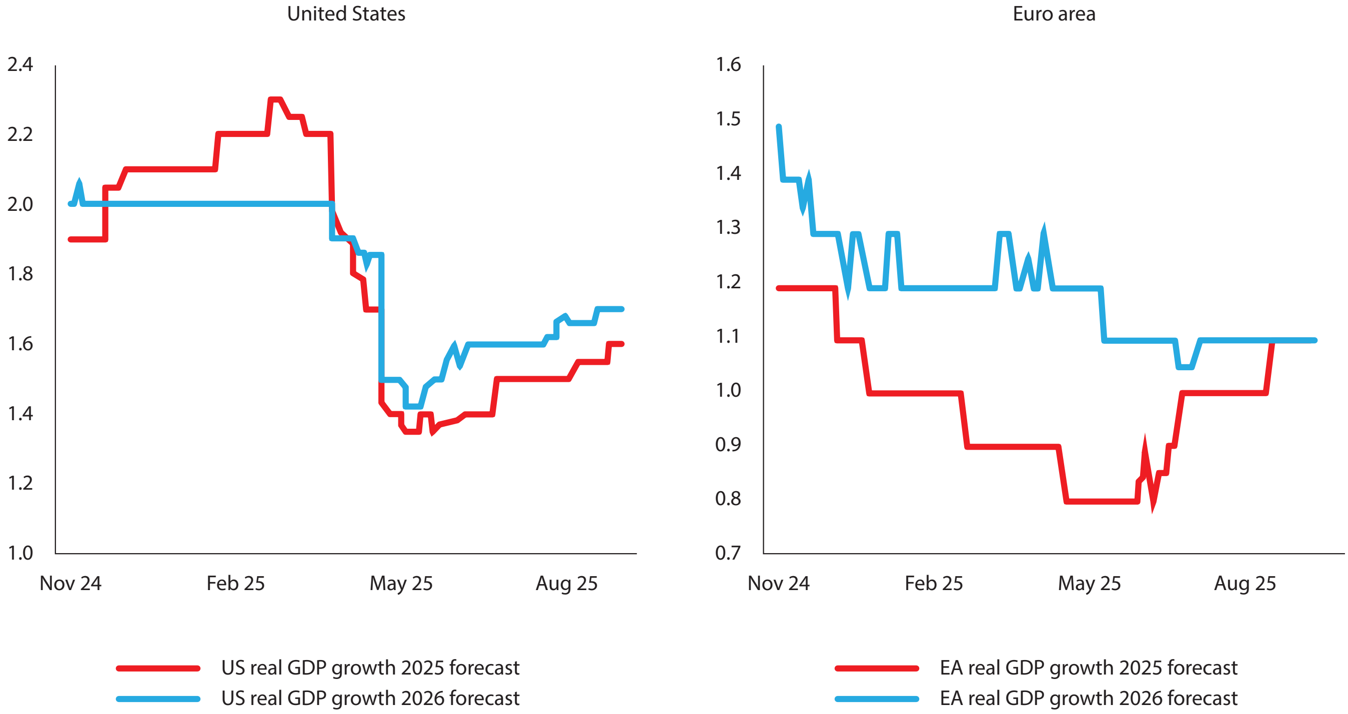
While expected EU and US economic performance for both 2025 and 2026 is sub-par, baseline forecasts remain relatively benign – far from a recession in either the US or the euro area. Nevertheless, it is easy to imagine far worse outcomes, even in the relatively short term (2025-2027). We focus on four.

A collapse of the US bond market, triggered by one or several of the following: (1) a sense that the US deficit is out of control, as political majorities in the US make fiscal adjustment impossible in the foreseeable future; (2) a sharp rise in inflation expectations; (3) a loss of faith in the quality of US economic data, particularly inflation and labour market data, triggered by Trump's assault on institutions.

An escalation of Russian military actions against Ukraine or the EU directly. This could take several forms: significant further loss of territory in Ukraine, leading to a new refugee wave; an acceleration of Russia's hybrid campaign against the EU, targeting EU government institutions, critical infrastructure and other economic assets; or even a direct Russian military attack on one or several EU countries.

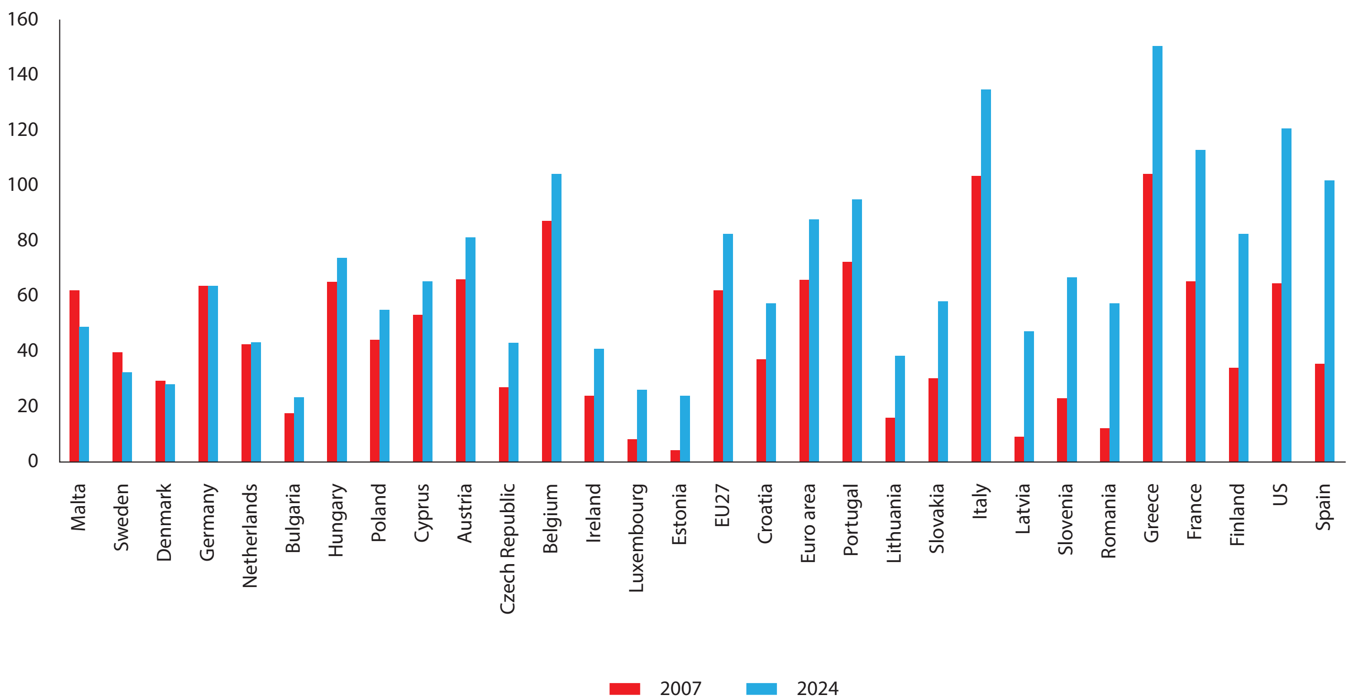
In the case of a direct military attack, the defence of Europe would become existential, testing NATO and EU unity. Russian military or hybrid gains short of a direct attack on the EU, however, may hurt the EU particularly through their political and economic knock-on effects.

Figure 5. US and euro area short-term forecasts of annual real GDP growth (percent)



Note: Latest observation 04/09/2025.
Source: Bruegel based on Bloomberg Economist Survey (median response).

Figure 6. Debt-to-GDP ratio in 2007 and 2024 (percent)



Notes: Solid black line indicates a debt-to-GDP ratio of 100 percent. Countries are ranked in increasing order of the difference between the debt ratio in 2024 and 2007.
Source: Bruegel based on IMF (WEO).

These include nationalist populist backlash in the EU – hurting mainstream parties and eroding the consensus around additional assistance to Ukraine – and sharp drops in EU consumer and investment confidence, depressing output, increasing fiscal stress and possibly prompting a return of the fiscal-banking 'doom loop' in some EU countries.

A fiscal crisis in the euro area triggered by a populist election victory in a high-debt member state. With the government of the country in question unable or unwilling in this scenario to undertake fiscal adjustment in response to a loss in market confidence, EU crisis mechanisms may fail to work. The resulting debt crisis would throw the euro area into turmoil and raise questions about the sustainability of the common currency, as it did during 2010-2012.

A trade shock triggered by increasing tensions between the US and China and/or hostile Chinese actions in East Asia. Global supply chains could be disrupted either by an interruption of shipping linked to hostilities in East Asia, or by export bans on all critical minerals to any nation deemed to take 'hostile economic actions' against China.

All EU countries would be included in China's immediate export ban. The EU would be faced with a prolonged economic downturn from the de facto end of freedom of navigation in the high seas in a vital part of the world and the severance of important global sea lanes, and would be denied access to critical minerals crucial to its industrial economy.

These shocks could be amplified in two ways. First, crisis scenarios may overlap (for example, policy paralysis arising from a populist victory and the priority of repelling Russian aggression). Second, several countries could be pushed to the fiscal and social breaking point.

The accumulation of crises since 2008 has left profound economic, political and social marks on the EU, US and other advanced countries. One measure of this is the level of public debt. In 2007, at the end of the post-Cold War period, debt-to-GDP ratios stood between 60 percent and 65 percent on average for the EU and euro area, with substantial differences between countries. The US ratio was similar.

By 2024, debt-to-GDP ratios had increased by more than 20 points for the EU/euro area, with a big increase in the dispersion between countries. In countries including Denmark, Germany and the Netherlands, the debt ratio remained around or well below 60 percent, while it increased by around 50 percent of GDP or more in Finland, France, Spain and the US (Figure 6).

According to Darvas *et al* (forthcoming), stabilisation of the debt ratio over the long term will require fiscal adjustment of about 6 percent of GDP in the US, 5 percent of GDP in France and about 3 percent to 4 percent of GDP in Italy, Spain and Belgium.

Although they have much lower debt ratios, several central and eastern European countries are also under high pressure to adjust over the medium term on account of very high deficits.

Add to this the additional cost of defence in the face of the new geopolitical reality, plus the costs of ageing populations and climate change (mitigation and adaptation), and it becomes clear that public finances are in a very difficult place in many EU countries and the US.

We assess the policy implications in section 4, after examining three geopolitical scenarios for the period 2030-2035 in section 3.

3 Three geopolitical scenarios for the coming decade

This section discusses three contrasting geopolitical scenarios for 2030-2035 that share two common features: the world will be more multipolar than today, with no country willing or able to play the role of global hegemon providing overall insurance to the system; and the US-China geopolitical rivalry will persist. Multipolarity will increase because the number of major powers will rise. By 2030-2035, there will be a dozen major powers falling into three tiers:

- **Superpowers:** China and the US. There is much speculation among analysts and policymakers about the economic, military and technological trajectories of the two countries over the next five to ten years, and whether the US will retain its lead in some or all of these areas or be overtaken by China[13]. But there is consensus that in this timeframe, China and the US will remain the world's only superpowers.

- **Other (potential) great powers:** Russia, the EU and India. Besides China and the US, only Russia currently qualifies as a great power, mainly (or even only) because of its large nuclear arsenal. But as Mearsheimer (2019) has argued, Russia *"will be by far the weakest of the three great powers for the foreseeable future, unless either the US or Chinese economy encounters major long-term problems."*

  Although it has plenty of economic and soft power, the EU is not currently a great power because it lacks military capability. However, European re-armament is speeding up and in the next five to ten years, EU countries will have substantial military capacity (Burilkov *et al* 2025), especially if reinforced by partnerships with countries including the UK, Canada, Norway and Ukraine.

  Another candidate for great power status is India, the world's most populous country and already one of the five largest in terms of GDP, with the fastest growing economy among the top five. India has also a rapidly growing military footprint. Its 2025 defence budget was the third largest in the world, after the US and China, not counting the EU as bloc.

- **Middle/regional powers:** in Asia (Indonesia, Japan), Africa (Nigeria, South Africa), the Middle East (Turkey, Saudi Arabia) and South America (Brazil). All these seven countries (except Nigeria) belong to the G20 and are already regional powers. Brazil, Saudi Arabia and South Africa also belong to the BRICS, as do China, India and Russia.

The three scenarios we discuss differ with respect to two variables: the degree of intensity in the US-China geopolitical rivalry; and the capacity of other major powers and smaller countries to organise rules-based international cooperation and institutions.

Note that the scenarios are not designed as a typical triad comprising a 'central' or 'base case' scenario, which represents the most likely outcome based on current information, plus upside and downside scenarios that explore more optimistic and pessimistic outcomes. Instead, they are meant to be organising principles that help describe possible states of the world in 2030-2035. Actual outcomes could well consist of weighted combinations of two of these scenarios (or even all three), and of variants within scenarios.

3.1 Scenario 1: collapse of international cooperation

Scenario 1 is defined as a 'bad' (collectively inefficient) non-cooperative equilibrium across the three tiers of powers. By 2030-2035, there are only loose and opportunistic alliances between countries, and a bare minimum of international cooperation. The global public goods created after the Second World War (UN, IMF, World Bank, WTO) have lost relevance or ceased to exist, mainly because of the intense geopolitical competition between the US and China, with neither willing or able to provide or promote international public goods, and both acting coercively towards other countries.

The US continues to maintain substantial tariffs, even if they have not led to the desired results (US reindustrialisation and enhanced economic security), mainly because they raise substantial revenue for the US government, which needs it to help finance its large debt.

The only global public good that continues to be provided in this scenario might be some degree of control of nuclear proliferation, the area with the biggest potential negative global externality. Another area with a very large potential negative global externality, climate change, is one of the victims of the collapse of the international order, propelled by a doom loop involving domestic and international conflict.

Major powers with low social cohesion, high public debts and high levels of support for populist politicians oppose international cooperation and institutions. Meanwhile, nationalist and populist policies reduce economic growth and the ability of countries to deal with the economic consequences of ageing and climate change (Funke *et al* 2023), which further increases domestic discontent and international conflicts.

Scenario 1 closely relates to the 'Kindleberger trap', a term coined by Joseph Nye to warn – a few weeks before the start of the first Trump presidency – of the risk of a situation in which neither the declining superpower, the US, nor the ascending one, China, is able or willing to assume the role of 'benevolent hegemon'[14].

Since Kindleberger (1973), it has been widely agreed that such a role must be played by one of the great powers to sustain a liberal international order, as the US did for the Western sphere during the Cold War period or globally during the much shorter period of hyper-globalisation[15]. Scenario 1 lacks any such hegemon.

3.2 Scenario 2: back to a world of blocs

The defining feature of scenario 2 is that the world splits into three groups: a US-led bloc, a China-led bloc and a non-aligned set of countries. This scenario has two variants, depending on the degree of interdependence between the US and China blocs[16]:

In the decoupling variant, the US-China geopolitical rivalry is intense, and after more than a decade of economic (trade, finance, technology) and political fragmentation, the two blocs are detached from one another, perhaps not as much as was the case between the western and eastern blocs during the Cold War, but far more than is the case in 2025[17].

In the derisking variant, the US-China geopolitical competition is somewhat less intense, and the two blocs remain fairly interdependent, managing the risks of such interdependence with *"intelligent economic security policy"*[18]. This is in line with what President Biden's National Security Advisor, Jake Sullivan (2023), advocated with his *"small yard, high fence"* policy: selective decoupling in areas where national security is at stake.

The first variant is easier to understand. It amounts to a new Cold War, with little relationship between the US-led and China-led blocs, except for security issues handled by the two superpowers. The second variant is probably more realistic, though harder to grasp.

In particular, it is not clear what the exact perimeter of the 'small yard' would be, nor whether it would be possible to really keep it 'small'. After all, what constitutes 'national security' or even 'economic security' is highly subjective. In addition, imports and supplier relationships that pose a risk to economic security are very hard to pinpoint empirically (Pisani-Ferry *et al* 2024).

In both variants, global cooperation would likely be more extensive than in scenario 1. In particular, the two blocs may agree to cooperate not only on nuclear proliferation, but also on climate change. Global economic institutions including the IMF, World Bank and the WTO would retain meaningful roles.

In the decoupling variant, however, these roles would be much reduced, even compared to their already diminished levels in 2024, ie. before the de-facto US exit from the WTO in 2025. In particular, trade governance would probably revert to the pre-WTO days, when GATT members enjoyed more 'policy space' (meaning they could be more protectionist) and there was no Appellate Body to adjudicate disputes, resolution of which was left to diplomats and politicians rather than judges.

This governance structure would include most current WTO members, but might not include the US, unless by 2030-2035 it has re-embraced some form of rules-based trade, particularly the most-favoured-nation (MFN) non-discrimination principle that is enshrined in Article I of the GATT and is one of its cornerstones.

With China and its state capitalist practices now impacting the US-led bloc relatively little, the countries of this bloc may decide to retain WTO-like governance among themselves, including by reinstating the Appellate Body dismantled by US actions during the Obama and first Trump administrations because of rulings related to trade with China[19].

In the de-risking variant, the two blocs should in principle be ready to cooperate more closely than in the decoupling variant, and economic institutions including the IMF, World Bank and the WTO should retain greater roles, with some redefinitions to meet demands from the Global South, which would presumably remain non-aligned with the two blocs.

In terms of membership of the two blocs, it is fair to assume that countries that are likely to remain security-dependent on the US for geographical reasons, such as South Korea or Japan, will be part of the US bloc. It is less clear with which bloc the EU, India and Russia – the three actual or potential 'great powers' – would align.

In view of the EU's lopsided trade deal with the US administration[20], it might seem obvious that the EU has chosen, or felt that it had to choose, the US bloc. However, this was in 2025. By 2030-2035, the EU may have gained sufficient strategic autonomy to be able to make real choices, especially if European military capacities have been strengthened.

In view of India's history since independence in 1947, during which it stayed non-aligned with both the US and the Soviet Union and later Russia, India is unlikely to align itself with the US. However, an opportunistic alliance with America to counter its Chinese neighbour is likely to remain part of its strategy.

Finally, Russia's position is by no means obvious. It has a solid alliance with China, which has been strengthened by the war in Ukraine. However, Russia has gradually become the junior partner in its relationship with China and may seek to reestablish a more balanced relationship by strengthening links with Europe and America.

A crucial factor in the decision of the EU to align itself with, or perhaps behind, the US, or to become non-aligned, will be US behaviour. Will it return to its role of relatively benevolent hegemon, or will it continue to behave as a 'coercive hegemon', as it did by imposing a 15 percent reciprocal tariff on the EU and demanding from the EU concessions for not imposing higher tariffs, which has been described as humiliating?[21]

In the former case, the EU would likely continue to align with the US, though it would seek a better arrangement than it enjoys currently. In the latter case, it would be difficult for the EU to belong to the US-led bloc, pushing it toward the non-aligned.

3.3 Scenario 3: multilateralism reinvented

In scenario 3, the two superpowers, although remaining rivals in some areas, agree to cooperate to provide global public goods in all areas that have potential negative externalities, including nuclear proliferation, climate change, trade and finance, because they have discovered – perhaps after having passed painfully through scenarios 1 and 2 – that not tackling common problems through common efforts and institutions has a high cost, not only for others but also for themselves.

In this idealistic scenario, a new international order would be established. This would involve reforming multilateral global institutions including the UN, the IMF, World Bank and WTO to guarantee a greater role for the Global South, which remained largely non-aligned in scenario 2, and to respond better to their development goals, while ensuring international security and dealing with global warming.

This new order would not depend on the ability or willingness of a superpower to provide global public goods. Instead, the new international order would be managed by a new grouping composed of China, the United States, Brazil, the EU, India, the African Union and maybe one or two more countries. In its most idealistic variant, this new grouping would take over from China, France, Russia, the UK and US as the new permanent members of the UN Security Council.

A less idealistic, though still ambitious, variant of this scenario would assume that the US-China rivalry will preclude the participation of the two superpowers in the reinvention of the multilateral rules-based order, at least initially.

In this variant, a coalition of countries, involving the EU, the UK, Norway, Canada and a small group of like-minded countries from the Global North (including Japan and Korea) and the Global South, would take the initiative, hoping that the US will join them at a later stage. China, however, may already be part of the coalition for some issues (such as climate change) though not for others (such as trade), as we discuss in section 4.

Table 1 summarises the geopolitical situation and the degree of world integration in each of the three scenarios for 2030-2035 (and beyond) and compares them to the conditions that prevailed during the three phases from 1945 to the present.

From the perspective of informing EU policy, the scenario analysis offers two main takeaways. First, the three scenarios can be ranked in terms of their welfare implications for the EU and the world collectively.

Scenario 1 would be least desirable for the EU, most individual countries and countries collectively, because international cooperation on global public goods would be largely absent, armed conflict would likely be frequent, and protectionism would become the norm.

Scenario 2 (multipolarity with strong elements of bipolarity and some multilateralism within each of the two blocs) would be better because it would entail some international rules (strong ones inside the blocs and weaker ones between them) and greater capacity to deal with global issues than scenario 1.

Finally, scenario 3 (multipolarity with multilateralism) would be the most desirable.

Second, the probability of realisation of any of these three scenarios mostly depends on the two superpowers. But the other major powers, including the EU, will also be influential. The EU and its allies may also be able to shape which variant of a scenario becomes reality. As already indicated at the beginning of section 3, all three scenarios have two features in common: continued US-China rivalry for at least a decade, and multipolarity.

In such a setting, the EU may be able to take steps, with other partners, to push the world in the direction of scenario 3; or it may be able to shape scenario 2 by strengthening international institutions and/or by choosing whether to align with the US or be non-aligned in areas other than security (on which Europe will want to preserve NATO).

4 Policy choices for Europe

The discussion in section 3 implies that EU policy and institutional choices must serve two purposes: to influence the world in the direction of greater stability and international cooperation – that is, scenario 3, or the more benign variants of scenario 2 – and to optimally adapt to whichever scenario or scenario combination arises.

This appears to create a dilemma. However hard the EU may try to preserve or restore a cooperative international order, it may fail. If it does, it would then need a different set of institutions and policies than it would need in the case of success. Scenario 3 may justify policy choices that have the same flavour as in the period of hyper-globalisation: low levels of military spending, high levels international specialisation.

In some variants, the US might regain its status as a reliable ally, implying that depending on the US in areas such as defence, technology or digital infrastructure would have a low cost. In contrast, in one variant of scenario 2 and in scenario 1, the EU might be essentially on its own, forcing much higher levels of self-reliance. Military spending would be high, and the argument for much deeper military integration in the EU, including a common army, would be far stronger.

As it turns out, however, identifying the right policies is much simpler than this confusing array of state-contingent possibilities suggests, for two reasons.

First, many policies choices do not involve a trade-off between security and efficiency. These include all reforms that encourage innovation and deepen the single market[22]. Such reforms are not just good for growth, but help the economy weather shocks, including those resulting from economic coercion.

A deeper single market allows the flexible reallocation of services and goods production in the face of external shocks, while deeper and more unified capital markets reduce both financial fragility and dependence on US capital markets.

Second, Europe's policymakers are not called on to make policy choices for 2035. They are called upon to make choices for the next one to five years, both in light of how these choices will impact Europe during this period, and how they will influence Europe's future.

Seen in this light, a dominant strategy emerges. Apart from pursuing policies that are good for both growth and resilience – which should be done anyway – Europe should make policy

Table 1. Geopolitical situation and degree of world integration, by period

Period	Geopolitical situation			Degree of world integration
	World		Europe	
Past and present				
1947-1989	ColdWar	Bipolar	US vassal, by necessity	Low, but high for the West
1990-2007	US hegemony	Unipolar	US vassl, by necessity	Hyper-globalisation
2008-today	Great power competition	Multipolar	'Vassalisation malheureuse'	Increasing fragmentation
Future				
2030-2035	Scenario 1	Multipolar	Autonomous	More fragmentation and disorder than in 2025
2030-2035	Scenario 2	Multipolar		
	With decoupling		Autonomous or US vassal	More fragmentation but more order than in 2025
	With de-risking		Autonomous or US vassal	Relative fragmentation and order, like in 2024
2030-2035	Scenario 3	Multipolar	Autonomous	High, with new international order

Source: Bruegel.

choices that reduce its dependence on the two superpowers and increase its security more broadly.

This would protect it against attempts by the superpowers to exploit this dependency, and it would increase Europe's bargaining power, both to deter bad behaviour – such as arbitrary imposition of tariffs by the US, export embargos by China or aggression by Russia – and to preserve or rebuild cooperative international arrangements.

Such policies are good both in the world as it is currently and is likely to remain in the medium term – a world in which the US is no longer a friendly hegemon. Such policies would also nudge the world in a better direction.

In the remainder of this section, we develop a short-to medium term policy agenda that meets these criteria and covers two areas: EU domestic and international policies.

4.1 The domestic policy agenda

4.1.1 Defence autonomy

An essential element of strategic autonomy is to strengthen the EU's ability (and that of its European neighbours, including Ukraine) to defend itself without help from the United States. The EU and its European allies also have a strong interest in preserving NATO: the North Atlantic alliance has been, and continues to be, a cornerstone of its security. This requires a strategy that satisfies both objectives: preservation of NATO, and much greater defence autonomy from the US.

Over the past year, the EU has started to move in this direction, by accelerating national rearmament, and through modest steps that help members shoulder the financial burden of rearmament and that encourage joint procurement, including SAFE, a €150 billion lending instrument[23], and the use of the 'national escape clause' (NEC) to accommodate higher defence spending under EU fiscal rules[24]. But these steps do not go nearly far enough. Europe needs to go much further, in two respects.

First, it must create a single market for defence equipment. This should include non-EU allies including the UK, Norway, Ukraine and potentially Canada, Switzerland and Turkey. Because such a market will be resisted by national defence-industrial interests, its creation requires a legal commitment device, analogous to EU legislation prohibiting national preferences in procurement and promoting competition within the EU.

In addition to prohibiting discrimination in procurement against companies inside the single market, such legislation should designate areas and modalities for joint procurement and lay the basis for standardisation of defence products.

Europe-wide competition, greater standardisation and joint procurement (where possible) are essential to raise the scale of European defence production, reducing unit costs and ensuring the interoperability of equipment.

Unfortunately, creating such legislation through EU regulations or directives is impossible because Article 346 of the Treaty on the Functioning of the EU (TFEU) exempts national security related industry from single-market commitments.

Hence, the legal framework for creating a single European defence market requires an intergovernmental treaty, with an institutional mechanism to enforce it. One advantage of taking this route is that it would allow non-EU countries to join on an equal footing, and it would not require all EU countries to join.

Second, Europe must jointly develop and owning common defence assets to reduce its dependence on US-provided strategic enablers such as satellite-based intelligence, surveillance and communication infrastructure, strategic airlift (heavy transport aircraft and aerial refuelling systems), military mobility and air defence systems.

While NATO functions well, these can complement US-provided assets and contribute to fairer burden-sharing within the alliance. And if the US were to lose interest, Europe would have an alternative.

Assets of this type must be jointly planned and funded to ensure fair burden-sharing and good incentives. This could be done through a new intergovernmental organisation created by EU NATO members and their European allies (Wolff *et al* 2025; Zettelmeyer *et al* 2025a).

Or it could be done through existing, EU-based institutions and arrangements, with the EU providing funding through dedicated debt issuance financed by service payments by the countries that benefit from the common defence assets (Steinbach *et al* 2025), and planning and technical expertise through Permanent Structured Cooperation (PESCO) and the European Defence Agency.

In either case, operational control would need to be delegated to national or joint control-and-command systems that have the military capacity to run them.

4.1.2 Tech autonomy and AI

Defence autonomy is closely related to technological and, especially today, AI-related autonomy. On this, the EU (and other countries) faces both hardware and software challenges.

In the 2030-2035 timeframe, reunification of Taiwan with China cannot be ruled out, creating a risk that the entire world's supply of state-of-the-art 2 nanometre (or less) chips, important for AI development, will be in Chinese hands.

Medium-term EU technological and AI sovereignty may rest on having such a plant not just outside Taiwan, but inside the EU or in a geographically close and politically reliable trading partner. Appropriate EU measures to sway key firm-level decisions towards meeting this goal will be necessary.

On the software side, US firms have an entrenched dominance over global digital services platforms outside the Chinese market. To successfully dislodge current technology incumbents and secure EU technological autonomy in these areas, entirely new technologies are likely to be required.

EU policies must therefore remain focused on facilitating such disruptive innovation through 'moonshot missions', rather than on supporting EU-based substitutes for existing services offered by US domiciled entities. This will include focusing on several policy areas, with careful consideration given to the probable impact of AI on future technology trends and on broader society.

AI is a powerfully disruptive general-purpose technology (Bresnahan and Trajtenberg 1995; Ding 2021), characterised by a wide and pervasive applicability across many economic sectors, and with the potential for continuing technical improvements and synergies with other innovations. This means skills for the promotion of AI adoption throughout the EU economy will be crucial.

This requires focusing on a wide section of the workforce, rather than just the limited segment needed to pioneer its development. Designing and training innovative AI applications at thousands of large EU firms and SMEs requires a workforce with access to practically focused AI skills, with course certifications recognised across the EU, AI based life-long learning modules and AI courses available at tertiary, professional degree and vocational training educational institutions.

Accelerating adoption by European businesses of AI assisted workflows, task solving and product development further requires flexible labour market regulation and workplace conditions that will facilitate profitable firm-level AI adoption.

AI will meanwhile continue to generate fake online identities and misinformation, frequently promoted by platform-owning intermediaries through algorithms designed to maximise their revenues. It will therefore become, and likely already is, a conduit for destabilisation and hybrid warfare.

To counter this, the EU, with private-sector identity-verification service providers in a public-private partnership to ensure cost and technology standards, should implement a common digital identity and authentication standard.

This should include a common digital EU identity platform to serve as a gateway via which Europeans will access a wide variety of public and private online services.

Working in tandem with current provisions in the Digital Markets Act (Regulation (EU) 2022/1925), the promotion of verifiable human-generated content in the EU will weaken the digital platform network effects currently fuelling the dominance of US-based entities. This will help promote European content providers and reduce the influence of robotised digital information created outside the EU.

4.1.3 Financial autonomy

European citizens, banks and firms depend heavily on the US through several financial channels. These include the payments system (the only EU-wide retail payment service providers are American companies; EU-based competing services are typically nationally based) and dependence on US Treasury Bonds as a store of value and as collateral.

In the current state of US politics, as well as in scenario 1 and some variants of scenario 2, this is a significant problem. A coercive US could threaten to order its companies to disrupt EU payments to gain leverage, impose taxes on capital outflows or even threaten to restructure US Treasury Bonds held by specific institutional holders along the lines described by Miran (2024).

The introduction of the (retail) digital euro is an important step to guard against the first risk but is not sufficient, for two reasons. First, holdings of digital euros are expected to be tightly capped to a few thousand euros. Furthermore, the digital euro will not be usable for payments outside the euro area.

While the digital euro could prove useful to consumers and for safeguarding retail payments inside the euro area, it will not reduce the dependence of EU companies on US-based payment technologies. While private European solutions are emerging[25], it is unclear how reliable they will become, particularly if the providers may themselves be dependent on US technology.

Second, the expected growth of dollar-based stablecoins implies that EU dependence on the US dollar both for payments and as a store of value may be about to become a lot bigger. The US administration is promoting dollar-based stablecoins, backed by US Treasuries, for fiscal reasons. Unless there are EU-based alternatives, US stablecoins might become the payments technology of choice for EU companies, particularly for international transactions.

The EU could respond in two ways. One approach would be for the EU (including the European Central Bank) to actively support the creation of euro-based stablecoins, while ensuring their safety[26]. This could be done by promoting the harmonisation and standardisation of euro stablecoins, and by mitigating systemic risk, including by giving stablecoin issuers direct access to ECB liquidity support.

Second, the EU could maintain the current strategy on stablecoins, which is to provide a regulatory framework but otherwise leave the market to itself. But if this is the choice, the ECB should also provide a digital currency that can compete with stablecoins in providing free and fast payments and settlement services, both wholesale and retail. This would go far beyond the digital euro as currently planned[27].

In either case, the ECB should accelerate its work on improving wholesale digital payments infrastructure, an area in which it has started a pilot project (Appia)[28]. This could be made interoperable with stablecoins, making euro stablecoin transactions faster and more secure and improving the attractiveness of regulated relative to unregulated stablecoins. And the EU needs to accelerate work on capital market union (rebranded the Savings and Investment Union), enabling the emergence of low-cost, diversified investment instruments available to all savers and investors (EU and non-EU).

4.1.4 Energy systems

Europe's reliance on imported energy has proven a strategic vulnerability. Europe's strategy of building a largely electrified energy system powered by domestic resources (European Commission 2024) is the right path to decarbonise and to end dependence on imported fossil fuels. But if the necessary investments, which are substantial, are planned and financed country-by-country, Europe risks locking in avoidably high energy costs.

A predictable, European rules-based market framework, embedded in coordinated long-term system planning, can significantly reduce investor risk and the cost of capital, prevent wasteful duplication and deliver a more efficient geographic and technological mix of generation, storage and demand.

Beyond immediate savings in dispatch and investment, a large and predictable market fosters scale economies, competition and innovation, reducing costs over time (Zachmann *et al* 2024). Equally, a consistent framework enhances resilience by turning Europe's scale and diversity into cost-effective mutual insurance.

The current system is still far from a single market in which price differences point to underlying economic cost differences. The biggest successes in the last two decades have been the common carbon market and the coupling of electricity wholesale markets, which has substantially reduced inefficiencies in dispatch across borders (eg. when the wind is blowing strongly in one country, production from gas-fired power plants in another country can be reduced).

But currently, the system remains characterised by poorly coordinated national electricity system development planning, unaligned national remuneration mechanisms for investments in generation, opaque stacking of national policy-driven pricing-components, leading to idiosyncratic final electricity prices for individual consumers, and insufficient crossborder transmission and its inefficient usage.

An ambitious strategy to put the EU on track to a resilient and affordable integrated electricity system should include:

- Establishment of an EU energy information administration that would providing reliable, relevant and usable data on the current and planned state of the energy system, underpinning informed policy discussions.
- Introduction of real coordination of national system planning, including an independent top-down view serving as a benchmark.
- A European fund to catalyse more crossborder transmission.
- Progress towards a single borderless dispatch market, in which only physical constraints would justify price differences.
- A means of ensuring that capacity remuneration mechanisms are organised, at least at regional level (Holmberg *et al* 2025).

Making this work will require long-term trust, discipline to resist domestic vested interests and a willingness to pool elements of sovereignty. It will only succeed with a credible commitment at the highest political level.

4.1.5 Secure access to critical minerals

China successfully weaponised its critical minerals export-control regime and established trade escalation dominance over the US in retaliation against Donald Trump's tariffs[29]. While the EU is neither in a geopolitical rivalry nor a trade war with China, EU firms were affected by China's export controls on critical minerals.

The urgency of securing EU access to critical minerals in the face of China's continuing global dominance, especially of refining and processing of critical minerals, has risen since the European Critical Raw Materials Act (CRMA, Regulation (EU) 2024/1252) entered into force in May 2024. New policy measures must now be added. Domestic measures should include further incentivising and mandating critical raw materials recycling.

The recently updated EU battery material recovery targets[30], applying 2031 target values of 95 percent for cobalt, copper, lead and nickel[31], should serve as inspiration for all identified critical materials. Target values must be updated frequently to track progress in best commercially available recycling practices.

For rare earths that are used in such small quantities that recycling may not be cost efficient, mandatory minimum stockpiles should be established. EU governments could choose to do this at national or EU level by simply buying and stockpiling the raw materials deemed sufficiently important, or they can incentivise businesses to do it via tax benefits or prescribed firm-level inventory levels.

Significant expansion of public funding for basic materials research at EU public and private institutions, pursuing 'innovative substitution' to make new and cheaper but equally efficient materials available to replace critical raw materials currently sourced from China.

However, the EU should not push for domestic production targets for critical mineral extraction and processing that are costly to implement. It should rely instead on trade with trusted partners (see section 4.2).

4.1.6 A risk-based reform of the EU fiscal framework

The 2024 reform of the EU fiscal framework was a big step in the right direction. It rightly requires high-debt, high-fiscal-risk countries to cut their deficits quickly. But it also suffers from two major flaws.

The costs associated with these flaws, insofar as they guide national fiscal policies in the EU in the wrong direction, were perhaps manageable before the acceleration the geopolitical challenges the EU has faced since the start of the second Trump administration. But they have now been shown to be prohibitive, including in most of the scenarios discussed in section 3.

The first flaw, which was apparent even before the system became fully final (Darvas *et al* 2023) was that EU-endorsed investment spending was not favoured sufficiently relative to other spending. While debt sustainability must remain the primary objective of fiscal rules, there should be no quantitative limits on a debt-financed investment boost within a pre-agreed period (say, seven years), provided that: (1) the criteria of high-quality public investment defined in the current fiscal framework are complied with, and (2) debt remains sustainable at the end of the period.

The latter will generally require adjustment in the non-investment budget while the investment programme is being carried out. However, the adjustment needed to pay for even a large investment programme – provided it is temporary – is limited (Annex 1 of Darvas *et al* 2024).

The second flaw has become obvious only more recently. It is that the rules impose the same standard of fiscal adjustment – to put debt on a declining path with high probability within four to seven years – regardless of whether fiscal risks are high or low. The only exception is for countries with debt below 60 percent of GDP, which do not need to put their debt on a declining path as long as it is projected to stay below 60 percent in the medium term.

The consequence is heavy constraints on the fiscal policies of both countries with debts below but close to 60 percent of GDP, and close to but above 60 percent of GDP, even when those countries could afford an extended period of increasing debt without meaningful fiscal risks (because their debt remains relatively low and the adjustment required to stabilise the debt would remain manageable).

There may be several reasons why no-one worried about this feature of the new rules. First, it relates directly to Article 126 TFEU in conjunction with Treaty Protocol 12, which defines government deficits as excessive if debt is above the 60 percent of GDP reference value unless it *"approaches the reference value at a satisfactory pace."*

Second, the countries that would benefit from greater flexibility without creating fiscal risks – including Germany and potentially the Netherlands – felt that they did not need it. In Germany, a national fiscal rule imposed even tougher constraints than the EU rule. This situation has now changed.

As a result, the EU rules are imposing constraints on German policy and potentially the policies of other countries close to the 60 percent of GDP threshold that are tighter than is good for these countries or for the EU collectively (Zettelmeyer *et al* 2025b).

A solution that gives more fiscal space to low-risk countries could take one of two forms (Steinbach and Zettelmeyer 2025; Pench 2025):

First, define much longer adjustment horizons for countries with debt above but near 60 percent of GDP and low fiscal risks. The latter could be identified using a sovereign risk assessment methodology (such as the IMF's sovereign risk and debt sustainability framework, or using elements of the current EU methodology), perhaps supported by market indicators, including risk premia.

Alternatively, increase the debt reference value outlined in Treaty Protocol 12 from 60 percent to 90 percent. This would not require Treaty change, but it would require unanimity in the Council.

4.2 The international policy agenda

To enhance its strategic autonomy, making significant progress on domestic policy should be an absolute priority for the EU during the next five to ten years. Simultaneously, the EU should develop its international agenda. We focus on two areas: trade and climate.

4.2.1 Trade policy

EU trade policy should have two objectives. First, it should promote trade, thereby contributing to growth and enhanced strategic autonomy. Second, this autonomy should be used to promote a rules-based international trade order that favours gains from trade.

On the first objective, the EU needs to further extend its large network of regional and bilateral trade agreements (already currently covering 74 countries and 44 percent of EU trade)[32] to enhance its economic security, including in critical raw materials.

Here, the EU's strategic emphasis should be on agreements with the Global South, which is already pivotal in many areas and can only increase in importance in the future given its growth prospects.

By 2030, the Global South (defined here as the emerging and developing economies (EMDEs), minus China and Russia) is expected to account for 40 percent of global GDP at PPP, slightly more than the share of the west (defined here as the advanced economies) and double that of China (Table 2).

The EU has already free-trade agreements (FTAs) with important countries in the Global South, including Mexico, South Africa and Vietnam. It should rapidly ratify the FTA with Brazil (and its Mercosur partners) and conclude FTA negotiations with India and Indonesia[33], the three biggest players in the Global South.

The EU also has strategic partnerships on raw materials with 14 countries from the Global North (including Australia, Canada and Norway) and the Global South (including Argentina, Chile and Zambia), complementing existing or future FTAs. These partnerships should be welcomed but also given more resources.

On the second objective, the EU should seek to move the trading system towards our scenario 3, or at least the most benign version of scenario 2. This involves two priorities: ensuring that the EU and most economies continue to adhere to existing WTO rules, despite the Trump administration's behaviour, and seeking effective reform of the WTO.

Table 2. The EU27 and the world: GDP at PPP (% of the world), 2000, 2025, and 2030

	2000	2025	2030	200-2030
EU27	21.7	14.1	13.0	-8.7
US	20.5	14.7	14.0	-6.5
Other advanced	16.0	10.5	9.6	-6.4
Total advanced	58.2	39.4	36.6	-21.6
China	6.7	19.7	20.4	+13.7
India	4.0	8.5	10.0	+6.0
Other EMDEs	31.0	32.1	33.0	+2.0
Total EMDEs	41.7	60.6	63.4	+21.7
World	100.0	100.0	100.0	0.0
Memo item:				
Global South, w/t China & Russia	31.9	37.5	39.8	+7.9

Source: Bruegel based on IMF (WEO).

The EU must decide whether it is politically ready to take the lead and gather a 'coalition of the willing' to redesign international trade rules and institutions without US participation (at least initially). The US does not believe at the moment in a rules-based order, while China's economic system sits oddly with the practices of most other countries.

Sweden's National Board of Trade (Altenberg 2025) has proposed that the EU launch a rules-based trade coalition (RBTC) with like-minded partners, extending Commission President Ursula von der Leyen's June 2025 suggestion that the EU deepen its cooperation with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)[34]. According to President von der Leyen, acting together, the EU and the CPTPP countries would show to the world that free trade with a large number of countries is possible on a rules-based foundation.

Using two main criteria to select RBTC partners – like-mindedness at the WTO, and countries with which the EU already has or is in the process of signing an FTA – Altenberg (2025) came up with non-exclusive list of 56 potential coalition members: the 27 EU countries, 13 non-EU European countries (including Iceland, Norway, Switzerland and Ukraine), 11 CPTPP members (including the UK), and five others[35]. Neither China not the US are on the list of potential RBTC partners (Altenberg 2025).

The coalition would operate outside the WTO institutional framework, but its ultimate goal would be to strengthen the multilateral trading system and the WTO by reforming them. At the same time, the coalition should be ready to cooperate with countries interested in maintaining a rules-based framework. This could be done through open plurilateral agreements with different memberships. For instance, an agreement to cooperate on the trade and climate interface would need to include China, India, Indonesia, Brazil and South Africa (Garcia Bercero 2025).

This and other proposals based on the idea of coalitions of the willing are compatible with scenario 3.

4.2.2 International climate policy

For climate protection, there is no option other than multi- or plurilateralism, to even hope to keep to the goals of the Paris Agreement. Ideally, plurilateral efforts would need to involve the top five emitters – China, the US, the EU, India and Russia – which together account for roughly 60 percent of global emissions, with China responsible for half this figure.

In this area, a coalition of the willing, perhaps led by the EU but leaving out China, the US and Russia, will clearly not work. Assuming that the US and Russia are unwilling to participate at the moment, the coalition would need to include the EU, China and India, and perhaps some other large emitters such as Brazil and Japan.

This coalition would account for a little more than 50 percent of global emissions but would be rather unbalanced in terms of emissions between emerging economies (with China, India and Brazil accounting together for roughly 40 percent of global emissions) and advanced economies (with the EU and Japan accounting together for only 10 percent of global emissions).

What kind of foreign economic policy should the EU put in place to reduce its emissions and promote similar reductions in China and the Global South?

The EU has already decided to implement a carbon border adjustment mechanism (CBAM), which will complement its emissions trading system (ETS) by levelling the playing field for European producers subject to the ETS and encouraging climate action beyond EU borders.

Although potentially very useful to reduce emissions in the EU and elsewhere, CBAM is resented by many emerging and developing economies, which view it as 'green protectionism' and unfair because it imposes the same carbon price on rich and poor countries, irrespective of their ability to pay and degree of responsibility for climate change.

Opposition from the Global South creates geopolitical difficulties for the EU because of the Global South's growing pivotal role in many issues, including climate.

Recognising that global climate outcomes will largely be determined in emerging and developing economies, since they account for two-thirds of current emissions (slightly above their share in global GDP at PPP), Pisani-Ferry *et al* (2025) proposed a climate strategy in line with the economic interests of both developing and advanced countries.

Central to this strategy is the formation of a climate coalition of advanced and emerging market countries committed to tiered carbon pricing based on income level, and underpinned by a common CBAM, which would replace the EU CBAM. This coalition would include China, the EU, India, Brazil, Japan and a few others.

This strategy would also include two other important blocks: formal agreements in which advanced economies and China provide climate financing to the Global South countries in exchange for their commitment to ambitious net zero targets, and green industrial partnerships between the EU, the UK, Norway and resource-rich countries in the Global South with high renewable-power potential, from which Europe would import energy-intensive intermediate products rather than expensive-to-ship green electricity (Pisani-Ferry *et al* 2025).

Like Pisani-Ferry *et al* (2025), we view the EU as pivotal to the formation of these climate coalitions by virtue of its long-established carbon market and regulatory credibility.

5 Conclusion

We derive three main conclusions from our analysis. First, the short-term economic impact in terms of GDP growth of the current geopolitical situation seems relatively modest. We suggest, however, that policymakers should not be complacent for two reasons:

1. It would be a grave mistake to take a short-term view of this new shock to the European economy, rather than consider it as part of a series of shocks that have affected Europe since the start of the Great Financial Crisis in 2008. Though not suggesting that shocks including the Great Financial Crisis, the COVID-19 pandemic and the war in Ukraine have a common cause, one must at least appreciate that these shocks have common economic and political impacts on European (and other advanced economy) countries, of which the increases in political fragmentation and debt levels are just two indicators.

2. Partly related to the previous caveat, there are a number of downside risks, stemming from the situation in the US and elsewhere, which could aggravate the situation in the next year or two, and even provoke a new financial crisis. Vigilance should be top of mind.

Our second main conclusion is that, besides short-term risks, recent geopolitical developments raise important medium- and longer-term risks for Europe. By placing such developments in a historical perspective and envisaging three scenarios for the period 2030-2035, we have sought to alert European policymakers to the huge and very challenging geopolitical shifts that Europe faces, and for which it is ill prepared.

If the EU wants to be a scenario-maker rather than simply a scenario-taker, as it is at the moment, our analysis of a range of scenarios points in the same direction: Europe must work to gain strategic autonomy in key areas including defence, technology, finance and critical raw materials.

Our third conclusion is that strategic autonomy should not be confused with self-reliance or protectionism. Europe is and needs to remain an open economy and society. It is also and needs to remain a rules-based society and the champion of a rules-based international order. The past order, born (like the EU itself) from the ashes of the Second World War, is now being challenged not only by China and Russia, but also by its founder, the United States.

Meanwhile, humanity faces global problems like never before because of increasing nuclear proliferation and more dramatic climate change, issues that require global governance. Because the US has relinquished its role of supporting the global system, and the other superpower, China, is not (yet) able to take over that role, it is incumbent on Europe to work with coalitions of the willing from the Global North and Global South to reinvent the multilateral order. The place to start this journey is with climate and trade. ■

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Endnotes

1. Poland and Czechoslovakia joined the IMF and World Bank in 1945, prior to their absorption into the Soviet bloc, but withdrew in 1950 and 1954, respectively.

2. See Office of the Historian, 'Nixon and the End of the Bretton Woods System, 1971–1973'.

3. Patricia M Kim, 'China's choices and the fate of the post-post-Cold War era', Commentary, 8 March 2022, Brookings.

4. In an extensive study of geopolitical fragmentation, Fernandez-Villaverde et al (2024) found that it started during the 2007-2008 financial crisis, accelerated between 2017 and 2020 because of mounting trade and capital flow restrictions, and has surged to unprecedented levels since 2022, because of the war in Ukraine and the Middle East conflict. Focusing on trade, Carluccio et al (2025) found that the trend toward fragmentation started in 2018, with the US-China trade conflict.

5. Hannah Lang, 'Trump signs stablecoin law as crypto industry aims for mainstream adoption', Reuters, 19 July 2025.

6. See Secretary Bessent's remarks at the Institute for International Finance, 23 April 2025, and at the International Monetary and Financial Committee of the IMF, 23 April 2025. In line with these remarks, the July 2025 Report to Congress from the Chairman of the National Advisory Council on International Monetary and Financial Policies (an US interagency body chaired by the secretary of the Treasury mandated to report on the activities of the IMF and MDBs on an annual basis) reiterated the importance of a US-led IMF (US Department of the Treasury, 2025).

7. The GPR index is by Caldara and Iacoviello (2022) and is regularly updated. Its historical version begins in January 1900.

8. According to the European Commission, "as of 1 August 2025, US tariffs on EU aircraft and aircraft parts, certain chemicals, certain drug generics or natural resources will go back to pre-January levels. This will provide immediate tariff relief for key EU industries, while the EU and US agreed to keep working to add more products to this list". The precise composition of the list remains unclear. For aluminium, steel and copper, a 50 percent tariff continues to apply, but an EU communication claims that "the EU and the US will establish tariff rate quotas for EU exports at historic levels, cutting the current 50% tariffs". See European Commission Questions & Answers of 29 July 2025, 'EU-US trade deal explained'.

9. According to European Commission data, goods exports from the EU to the US amounted to €531.6 billion in 2024, which corresponds to 21 percent of total extra-EU goods exports, or 3 percent of EU GDP. See Eurostat news of 11 March 2025, 'Trade in goods with the United States in 2024'.

10. Based on an overview provided by ING, which combines estimated effects of tariffs and the OBBBA by the Congressional Budget Office (CBO, 2025a; 2025b) over the next ten years (2025-2035). See James Knightly, Dmitry Dolgin and Padhraic Garvey, 'How President Trump's plans will impact the US deficit'.

11. Belgium, Bulgaria, Croatia, Czechia, Denmark, Estonia, Finland, Germany, Greece, Hungary, Latvia, Lithuania, Poland, Portugal, Slovakia and Slovenia. In addition, 18 member states have applied for SAFE, a lending facility to support rearmament offered by the European Commission. See section 4.4.1.

12. Market expectations are based on Bloomberg's 'World Interest Rate Probabilities', which calculates the likelihood of interest rate cuts at central bank meetings. The calculations are based on OIS rates, with data as of 4 September 2025.

13. See, for instance, Edward Luce, 'Trump is the gift that keeps giving to China', Financial Times, 5 August 2025.

14. Joseph S Nye Jr, 'The Kindleberger trap', Project Syndicate, 9 January 2017.

15. Followers of the realist school of geopolitics reject this idea and consider that the liberal global order was either a fantasy (Kagan, 2008) or doomed from the start (Mearsheimer, 2019).

16. Becko et al (2025) considered another variant. They assumed that there are two categories of countries in the world: China and the US, two large countries, which enjoy market power and set their import tariffs to improve their terms of trade; and small countries, which have no market power and set their tariffs at zero. The two large countries trade with each other and the small countries, to which the large countries offer free access if they accept political alignment with them. If they don't, they are charged the optimal tariff that the large countries also apply to each other. Using a stylised model, they found that the US sets an optimal tariff of 12.4 percent when competing with China for allies, while China sets a tariff of 7.0 percent. In their model, China's lower tariff reflects both its smaller economic size and a weaker preference for alignment.

17. Gopinath et al (2025) also assumed a situation in which the world splits in three groups: a US-aligned bloc, a China-aligned bloc and non-aligned countries. They found that this split will have less detrimental effects on trade than during the Cold War, because they assume that non-aligned countries will act as 'connectors' between the two geopolitical blocs, as they have been doing since trade fragmentation started around 2018.

18. Henry Farrell and Abraham Newman, 'The new economic security state: How de-risking will remake geopolitics', Foreign Affairs, 19 October 2023.

19. Wailin Wong, Adrian Ma, Julia Ritchey, Lilly Quiroz and Kate Concannon, 'Why there's no referee for the trade war', NPR, 19 March 2025.

20. Jorge Liboreiro and Peggy Corlin, 'Brussels defiant against persistent criticism of EU-US trade deal', Euronews, 3 September 2025.

21. See, for instance, Ellen Francis and Anthony Faiola, 'To avoid worst of Trump tariffs, E.U. accepted a lopsided deal', The Washington Post, 28 July 2025.

22. See, among others, Letta (2024), Demertzis et al (2024), Draghi (2024), the European Commission's (2025a) Competitiveness Compass and the IMF (2024; 2025).

23. See European Commission, 'SAFE'.

24. See Council of the EU press release of 30 April 2025, 'Coordinated activation of the National Escape Clause'.

25. For example, Wero, a new instant online payments system run by a consortium of EU-based banks.

26. Lorenzo Bini-Smaghi, 'No, la moneta digitale della Bce non è un'alternativa al modello Stablecoin', Il Foglio, 12 July 2025; Lucrezia Reichlin, 'Europe needs a Euro stablecoin', Project Syndicate, 2 September 2025.

27. See European Central Bank, 'Digital euro'.

28. See European Central Bank press release of 1 July 2025, 'ECB commits to distributed ledger technology settlement plans with dual-track strategy'.

29. Ayeshea Perera, 'Why China curbing rare earth exports is a blow to the US', BBC, 17 April 2025. Some US concessions have led China to reduce export controls on rare earths: Darlene Superville, Josh Boak, Paul Wiseman and Didi Tang, 'Trump says US gets rare earth minerals from China and tariffs on Chinese goods will total 55%', AP, 11 June 2025.

30. See European Commission News article, 'Circular Economy: New rules to boost recycling efficiency and material recovery from waste batteries'.

31. Ditto.

32. See European Commission press release of 15 November 2023, 'Value of EU trade deals surpasses €2 trillion'.

33. See Garcia Bercero and Sapir (2025) for a discussion of what the EU-India free-trade agreement should contain and why it should be concluded rapidly.

34. Gerardo Fortuna, 'Let's create a new World Trade Organization - Von der Leyen', Euronews, 27 June 2025. The CPTPP is a free-trade agreement is a free trade agreement between twelve countries: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the UK and Vietnam.

35. Brazil is among these five countries, but India is not. Altenberg (2025) offered no explanation so one can only guess the reasoning. India was probably considered not sufficiently like-minded at the WTO, an issue also raised by Garcia Bercero and Sapir (2025), though they concluded that an ambitious EU-India FTA would be a tangible sign that India's trade policy has evolved towards greater like-mindedness.

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Annex

Table 1. Estimated short-term impacts of US tariffs on GDP growth in the US and EU (annual)

Source	US impact	EA/EU impact	As of/assumptions
The Budget Lab (2025)	-05 pp (in 2025 and 2026)	-	As of/assumptions
Kiel Trade abd Tariffs Monitor	-	-0.1 pp (EU) an -0.11 pp (EA) in real production	As of 28 July 2025
ECB scenario analysis	-	-0.35 pp in 2025 (-0.3 in 2026 and +0.1 in 2027).	As of 14 May 2025, baseline scenario
'The coversation'	-0.36 pp	-0.13 pp	As of 4 August 2025
Bloomberg tariff tracker	-0.62 pp	-	As of 7 August 2025
IW Köln (based on Oxford Economics)	-	-0.36 pp	Latest US-EU trade deal

Source: Bruegel based on The Budget Lab (2025); Kiel Trade and Tariffs Monitor; ECB (2025); Bloomberg, 'Tracking Every Trump Tariff and Its Economic Effect', 21 March 2025; Kolev-Schaefer and Hüther (2025); ECB Eurosystem staff macroeconomic projections for the euro area, Box 2; Niven Winchester, 'Trump tariffs: early modelling shows most economies lose – the US more than many', The Conversation, 4 August 2025.

Booms and busts and the regulatory cycle

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I will discuss one of the most important resources that policymakers have: the lessons of history. In discharging my responsibilities at the Federal Reserve, I have been thinking a lot about history. Its study provides the opportunity to step out of the particular circumstances of today to inform our understanding of the core issues at the heart of financial regulation.

While we must be attentive to new and even unprecedented challenges, experience shows that understanding the lessons of history gives policymakers a great advantage. Many of the decisions we face today have, in some form, been confronted by previous generations of policymakers.

In these remarks I want to discuss a particular pattern in the history of the financial system, which is the relationship between regulatory weakening and the economic and financial cycle of booms and busts. My intent is not to re-hash well-examined facts or to go over past historical episodes chapter and verse. Rather, I aim to offer a perspective on this historical throughline that focuses on the regulatory cycle.

It's widely accepted that the economy and financial system experience cyclical booms and busts. Booms have historically been characterized by a multitude of good things. These can include fast economic growth, workers who had been sidelined entering the workforce and improving their lives, and financial innovations that often make credit or investments more readily available.

At the same time, some of the characteristics of a boom economy, such as rapid increases in credit and in financial market activity, as well as greater risk-taking and leverage, can sow the seeds of busts. In busts, economic activity and lending contract and asset prices decline. This can lead to rapid deleveraging and dislocation throughout the financial system, which worsen the downturn, causing job losses and business closures, homes lost and lives upended.

There are usually multiple causes that drive booms and make busts so terrible, some unique to each individual episode. But one factor that is common to many past cycles of boom and bust is weakening financial regulation. Weakening regulation often drives risk-taking and increases bank fragility during the boom, making the ensuing bust more painful. Indeed, economic research suggests that weaker regulation leads to more bank failures, setting the stage for worse recessions[1].

Moreover, because the financial system evolves so rapidly, regulation must also continuously adjust. Much regulatory weakening occurs simply when regulators fail to keep pace, while at other times, there is a deliberate action to lower regulatory burden that ends up miscalculating the risk involved. Let me be clear here that, when I refer to regulatory weakening, I mean not only direct deregulatory actions by regulators or legislators, but also failure of the regulatory framework to keep up with changing circumstances.

In principle, financial regulation should incentivize banks to engage in responsible risk-taking and build up resources in good times, so that they can deal with times of financial stress and continue their vital role in the economy in bad times. The prosperity that accompanies a healthy economy should allow banks to invest in improved risk management and strong financial resources.

However, a healthy economy can also reduce the effectiveness of regulatory constraints on bank risk-taking. This can occur for a host of reasons, including behavioural biases, political pressure, market dynamics, and the tendency for innovation to move more quickly than regulators.

These dynamics can result in regulatory weakening during boom times. When actively pursued, this weakening often appears justified at the time and may be implemented by well-meaning policymakers who simply miscalculate the long-run effects of their actions.

My purpose in these remarks is to recount several boom-and-bust episodes in American history and identify some lessons that can guide policymakers entrusted with the responsibility of promoting a strong and stable banking system. This history demonstrates the connection between regulatory weakening and cycles of boom and bust.

I don't mean to suggest that more regulation is always better or that repealing and reforming regulations isn't sometimes appropriate to remove obsolete rules and relieve unnecessary burden. But, if we can at least agree that regulation should seek to limit devastating financial crises, then the history that

I will describe offers some lessons for anyone thinking about regulatory policy.

There are, of course, lots of examples to choose from, both in the United States and abroad, but I'll focus on the Great Depression, the Savings and Loan (S&L) Crisis, and the Global Financial Crisis. I will then discuss some possible reasons that similar episodes could recur and conclude with some thoughts on the lessons we can learn.

"It is striking to see the pattern of regulatory weakening during a boom, including the failure of the regulatory environment to keep pace with the evolving financial sector, and how this weakening lays the foundation for a subsequent bust"

The Great Depression

Let's start with the biggest and most widely studied bust in US history, the Great Depression. Scholars continue to debate its causes, which were multiple and complex. One compelling argument focuses on the failure of regulation to keep pace with the innovations of the Roaring Twenties.

As I said, I view such regulatory stagnation as a form of weakening. This weakened regulatory environment played a role in setting the stage for and then exacerbating the bust. Weakened regulation that had failed to keep up with the times left banks unable to weather shocks to the economy. The banking sector's collapse was a significant factor in making the Great Depression the most severe economic crisis that this country has ever experienced[2].

The Roaring Twenties expansion was powered by the post-war recovery and technological advances in transportation, manufacturing, and communications. Stock markets grew quickly to help finance this innovation, while residential and commercial real estate investment surged and swelling demand for consumer durables led in turn to increased demand for financing[3].

As credit needs escalated, there was intensifying competition among banks; savings and loan institutions (S&Ls); and rapidly growing nonbank finance companies, trust companies, and other financial vehicles.

The 1920s were also characterized by high levels of financial speculation, both inside and outside the banking sector. Banks engaged in speculation through nonbank affiliates and supported speculation by lending. At the same time, many banks were relatively thinly capitalized and overly concentrated, especially given the lack of federal deposit insurance at the time.

In addition, many states had prohibitions on branching that prevented banks from diversifying their portfolios and inhibited local competition, keeping many struggling banks alive[4]. The stock market boomed, margin lending grew dramatically, and insider trading and market manipulation were rampant.

As the financialization of the economy increased, the regulatory framework failed to keep up. Outdated branching restrictions remained, failing to reflect the size and dynamism of the modern economy.

Banks gained permission to engage in new activities, such as real estate lending and certain activities in the securities markets; however, capital requirements and other rules were not adjusted to reflect potential increased risks from these new activities[5].

The cumulative effect of these events was a significantly weakened regulatory environment and a substantial buildup in risk, without a commensurate increase in resources to allow the sector to withstand the risks posed.

Looking back, we know that, when the economic shock hit, the banking system magnified that shock. The boom of the Roaring Twenties started to go bust in 1929, when the fast growth of the past decade turned to contraction, followed by a series of financial and banking crises.

In all, approximately 9,000 of the nation's 23,000 banks failed, resulting in major losses to depositors, given the lack of federal deposit insurance, and a significant contraction in credit that deepened and lengthened the economic downturn[6]. Notably, banks in states that had more robust regulatory frameworks—for example, those that applied higher capital requirements—had lower rates of failure[7].

In response to the financial collapse in the Great Depression, Congress adopted reforms aimed at addressing risks that had driven those panics. Among these steps, Congress established the Federal Deposit Insurance Corporation and federal deposit insurance to reduce the risk of bank runs and protect retail depositors.

Congress increased regulatory oversight of banks and separated commercial and investment banking. Congress also enacted strong securities laws and created the Securities and Exchange Commission (SEC). Overall, these steps helped stabilize the financial sector and ushered in a long period of quiescence in banking.

The Savings & Loan Crisis

My second example today is the S&L crisis of the 1980s and early 1990s, which did substantial harm to millions of Americans and the financial system and was extremely expensive to resolve. In this episode, in contrast to the Great Depression, affirmative deregulation led to excessive risk-taking by S&Ls, as well as banks, during a boom period.

As circumstances soured, revealing weaknesses, Congress attempted to bolster the S&L sector by loosening the regulatory framework further. This failed to resolve the underlying stress and instead further fuelled the buildup in risk-taking, worsening the losses in the subsequent bust.

Let me first set the stage. The years leading up to the S&L crisis were characterized by dramatic growth in business credit, in the course of the economic expansion that began in 1982. At the beginning of this period, the S&L sector primarily served the residential real estate market because of restrictions on S&L activities.

These restrictions eased over the 1980s, allowing S&Ls to get significantly larger and engage in new kinds of lending; however, these changes were not accompanied by sufficient regulatory enhancements to account for increased risks. This expansion in S&L activity also presented new competition with commercial banks, which had themselves built up significant risks as they expanded into new activities[8].

At the same time, both S&Ls and banks were increasingly under pressure due to both high inflation and high interest rates, which disrupted their funding models[9]. Competition for customer funds increased dramatically, especially because of the rise of money market mutual funds, which had grown rapidly.

When Congress removed outdated deposit rate caps to allow banks and S&Ls to more effectively compete for funds, it did so without implementing adequate safeguards against these institutions taking on excessive risk. This led many S&Ls to engage in increasingly risky projects to compensate for escalating funding costs. Banks also increased their deposit rates and took on more risk.

As vulnerabilities at S&Ls became evident, Congress, federal regulators, and the states attempted to bolster both sectors with the hope of allowing them to outgrow those weaknesses. For instance, Congress and the states reduced restrictions on S&Ls' ability to invest in commercial and consumer loans[10].

These changes contributed to the boom in commercial real estate lending, which became a key source of vulnerability.

In addition, Congress and the Federal Home Loan Bank Board, the federal S&L regulator at the time, weakened capital requirements and the enforcement of those requirements for the S&L sector[11]. This allowed institutions to become weaker and poorly capitalized entities to stay afloat, leaving S&Ls as a whole badly positioned to weather adverse conditions.

The bust, when it came, was severe. S&L losses continued to mount throughout the 1980s. Many banks also experienced severe stress. These difficulties were amplified by an eventual decline in real estate values and problems in the agricultural and energy sectors.

In 1980, there were just under 4,000 S&Ls. By 1989, that number had fallen to below 3,000, with over 500 of the remaining institutions insolvent as judged by book value. And over 1,600 banks failed between 1980 and 1994.

Regulatory weakening had propped up tottering institutions, allowing zombie institutions to persist, accumulating much greater losses than they otherwise would have. The process of cleaning up the sector began in earnest in the late 1980s and continued into the mid-1990s, with a final cost of $160 billion, roughly 5 percent of gross domestic product at the time[12]. And the cost of resolving insured banks that failed during this period was $36 billion[13].

Congress implemented significant reforms in response to the S&L crisis, including stricter capital and accounting requirements, limits on insured depository institutions' investment powers, and expansions of regulators' enforcement authority. These changes paved the way for stability in the banking sector for some time.

The Global Financial Crisis

I'll turn now to my final example, the Global Financial Crisis, which had devastating effects for the millions of people who lost their livelihoods, their homes, and their businesses.

In the decade leading up to the crisis, America experienced rapid credit growth and a housing boom. There was optimism about the benefits of financial innovation, such as securitization of home loans, and belief in the power of market discipline as a form of self-regulation. Home prices and mortgage debt accelerated in tandem, driven by a mutually reinforcing cycle of optimism, with home prices roughly doubling between 1997 and 2006, and even larger increases in mortgage debt[14].

Amid this boom, lending standards dropped, driven by investor demand for mortgage-backed securities, which were increasingly opaque and risky in their design but still highly rated by the rating agencies. There was substantial growth in the over-the-counter (OTC) derivatives market, including new forms of credit derivatives.

Money market funds boomed, becoming increasingly linked to the off-balance sheet business of banks[15]. These developments led to the emergence of large, short-funded, and interconnected financial entities—both banks and nonbanks.

The regulatory environment failed to keep up with these changes in activity and the increasing complexity of financial institutions and markets, and regulatory weakening heightened vulnerabilities.

The Gramm-Leach-Bliley Act, enacted in 1999, permitted the creation of financial holding companies that could engage in the full range of financial activities; however, the act did not put in place a regulatory framework commensurate with the full range of financial risks and permitted nonbank firms such as investment banks and insurance conglomerates to compete with banks wholly outside its framework.

The Commodity Futures Modernization Act of 2000 exempted OTC derivatives transactions from virtually all regulation and oversight by the Commodity Futures Trading Commission and SEC.

In the lead-up to the crisis, regulators cut oversight further. A striking image from the time featured the head of one financial regulatory agency wielding a chainsaw to demonstrate his commitment to slashing regulations[16].

The competitive landscape and regulatory lacuna led to a race to the bottom in standards for underwriting and issuing mortgage loans and securities, and transactions became increasingly funded by opaque and unstable short-term wholesale funding. Consumers were left unprotected as the subprime crisis grew.

In addition, the largest investment banks, which were overseen by the SEC, increased their leverage with heavy reliance on short-term funding, leaving them increasingly vulnerable to any losses.

These are just a few examples of the widespread failures in financial regulation and supervision that occurred in both the banking and nonbanking sectors in the lead-up to the crisis.

The resulting recession and financial crisis saw the deepest and longest contraction in economic activity since the second world war, the collapse of large financial institutions, significant government support to keep the financial system afloat, and a prolonged period of slow growth.

In response to this crisis, Congress passed the Dodd-Frank Act, a reform package that, among other things, strengthened bank capital, addressed off-balance sheet exposures, and provided for stress testing. Consumer protections were strengthened, and a new Consumer Financial Protection Bureau was established. Supervisors ramped up forward-looking supervision.

In addition, banking regulators adopted capital and liquidity reforms, which substantially improved the resiliency of the banking sector. Studying the role that regulatory weakening played in the crisis provides a powerful reminder of the importance of preserving these regulatory gains.

Lessons for policymakers

Reviewing these three examples together, it is striking to see the pattern of regulatory weakening during a boom, including the failure of the regulatory environment to keep pace with the evolving financial sector, and how this weakening lays the foundation for a subsequent bust. Why do we continue to see these cycles?

Some reasons are psychological, others political. Humans have short memories, especially for experiences we might like to forget. The further we get from a crisis, the more its causes fade from memory and the less likely a recurrence seems.

We become more likely to view regulations as unduly burdensome and place less value on the protection they offer from downside risk. The financial sector itself lobbies hard to weaken regulation, which is often effective when the last crisis seems far away.

Credit cycles, financial innovation, and the evolving needs of the economy are also significant contributors. As the economy changes, so do financing needs. This makes it harder to recognize when things are running too hot.

In addition, regulators are understandably cautious about restraining innovations that have societal benefits, which may hinder their ability to reduce associated risks. Longstanding regulations can be subject to regulatory arbitrage, making them less effective as activities migrate outside the regulated system. These dynamics make the financial sector unstable, feeding the boom-and-bust cycle. How can we do better?

The first lesson is to approach the financial system with a through-the-cycle perspective and avoid thinking 'this time is different'. In each of the booms I have covered, there was a heady confidence that market discipline would control risk-taking, that downside risks were so implausible as not to merit attention, and that easing regulation was justified.

With such confidence, insufficient thought was given to how regulatory weakening might create new vulnerabilities.

A bit of humility would have helped. While it is true that regulation must evolve with the economy and financial system, we need to recognize that relaxing rules can create vulnerabilities. Changes in the markets themselves can also weaken the effectiveness of regulations.

The second lesson is that policymakers should resist the pressure to loosen regulations or to refrain from imposing regulation on new activities during the boom times. With past economic downturns in the rearview mirror, regulations start to be seen as a limitation on growth, rather than necessary protection against vulnerabilities.

As became evident in past episodes, vigilant supervision and prudent rules on risk-taking are important to prevent future crises. While there is a trade-off, it is important to have appropriate protections in place to reduce the risks and costs of the resulting busts.

Third, regulation cannot be static. If regulation fails to keep up with evolution of the financial sector, it can create new risks or hinder growth.

To conclude, an important lesson we can draw from US financial crises is the role that ill-advised weakening of the bank regulatory framework played in those crises. It is well within our ability, and is our duty as regulators, to learn from these episodes to avoid making the same mistakes.

In doing so, we can help to ensure that the financial system is prepared to weather downturns and continue to serve households and businesses. ■

Endnotes

1. For example, see Paul H Kupiec and Carlos D Ramirez (2013), "Bank Failures and the Cost of Systemic Risk: Evidence from 1900 to 1930," Journal of Financial Intermediation, vol. 22 (3), pp. 285–307; and Kris James Mitchener (2005), "Bank Supervision, Regulation, and Instability during the Great Depression," The Journal of Economic History, vol. 65 (1), pp. 152–85.

2. Ben Bernanke (1983), "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," American Economic Review, vol. 73 (3), pp. 257–76.

3. See Arthur E Wilmarth Jr (2003), "Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis? Evidence from the Past Three Decades and the Great Depression," in Benton E Gup, ed, Too Big to Fail: Policies and Practices in Government Bailouts (Santa Barbara: Greenwood Publishing Group), pp. 77–105; and Barry Eichengreen and Kris Mitchener (2003), "The Great Depression as a Credit Boom Gone Wrong (PDF)," BIS Working Papers No. 137 (Basel, Switzerland: Bank for International Settlements, September).

4. National banks received authorization to engage in branching, subject to state law, in 1927 but interstate branching remained prohibited.

5. Before 1900, national banks were prohibited from underwriting, dealing, or investing in securities. However, federal authorities loosened these restrictions by allowing national banks to establish bond departments that could underwrite, sell, and invest in debt securities. Although restrictions on dealing in stock remained, national banks were able to circumvent these restrictions by organizing affiliates that engaged in the full range of activities with regard to both stocks and bonds. Federal regulatory authorities did not interfere with these affiliate activities. Scholars continue to debate the extent to which this underwriting activity was risky for the banks. See Wilmarth Jr, "Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis?" (see note 4); and Eugene Nelson White (1986), "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," Explorations in Economic History, vol. 23 (1), pp. 33–55.

6. See Federal Reserve History (2013), "Bank Holiday of 1933," webpage; Board of Governors of the Federal Reserve System (1934), 20th Annual Report, 1933 (Washington: Board of Governors); and Social Security Administration (n.d.), "Social Security History," webpage; and David C Wheelock (n.d.), "The Great Depression: An Overview (PDF)," Federal Reserve Education.

7. See Mitchener, "Bank Supervision, Regulation, and Instability" (see note 2).

8. Federal regulators, as well as many state legislatures and state banking authorities, expanded the scope of permissible activities for banks during this period.

9. For example, S&Ls made long-term, fixed rate residential mortgage loans, funded with short-term retail liabilities. As rates increased, S&Ls' existing mortgage portfolios decreased in value, because of their fixed rates. At the same time, S&Ls were forced to pay higher rates on their liabilities. This situation threatened their continued viability.

10. Many states simultaneously relaxed their own activities restrictions for state charters to allow for real estate investment.

11. For instance, the Federal Home Loan Bank Board reduced net worth requirements for federally insured S&Ls to allow troubled S&Ls to avoid closure and hopefully recover once interest rates declined.

12. This figure refers to the cost of resolving S&Ls that failed during the crisis. See Alane Moysich (1997), "The Savings and Loan Crisis and Its Relationship to Banking (PDF)," in History of the Eighties--Lessons for the Future, vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s (Washington: Federal Deposit Insurance Corporation), pp. 167–88; and US Bureau of Economic Analysis (2025), Gross Domestic Product, via FRED, Federal Reserve Bank of St Louis, June 26 (accessed July 15, 2025, 1982:Q4 used as gross domestic product reference point).

13. This figure reflects costs associated with bank failures from 1980 through 1994.

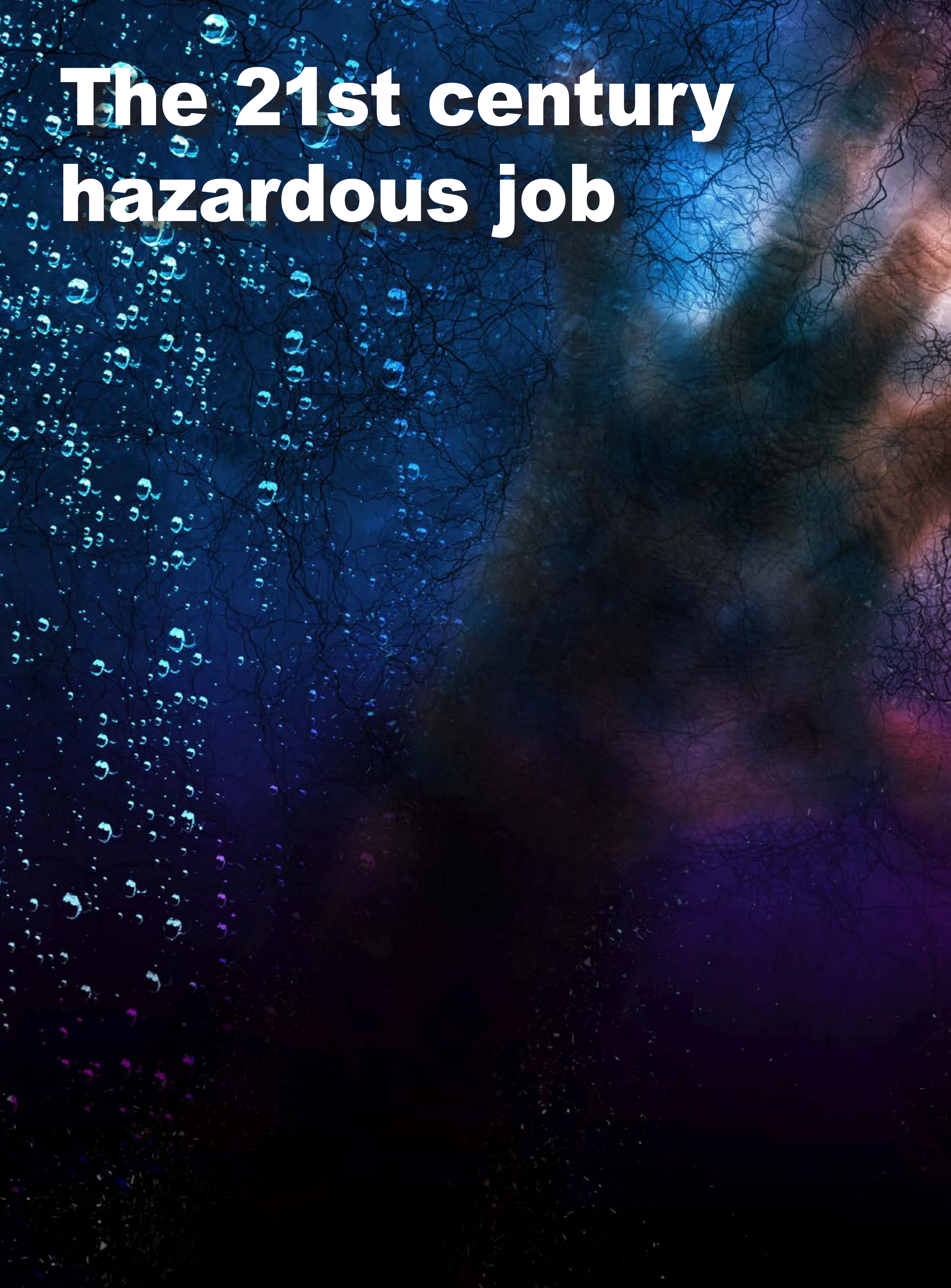
14. See Federal Housing Finance Agency (2025), All-Transactions House Price Index for the United States, via FRED, Federal Reserve Bank of St Louis, May 27 (accessed July 15, 2025); and Board of Governors of the Federal Reserve System (2019), Mortgage Debt Outstanding, All holders, via FRED, Federal Reserve Bank of St Louis, December 12 (accessed July 15, 2025).

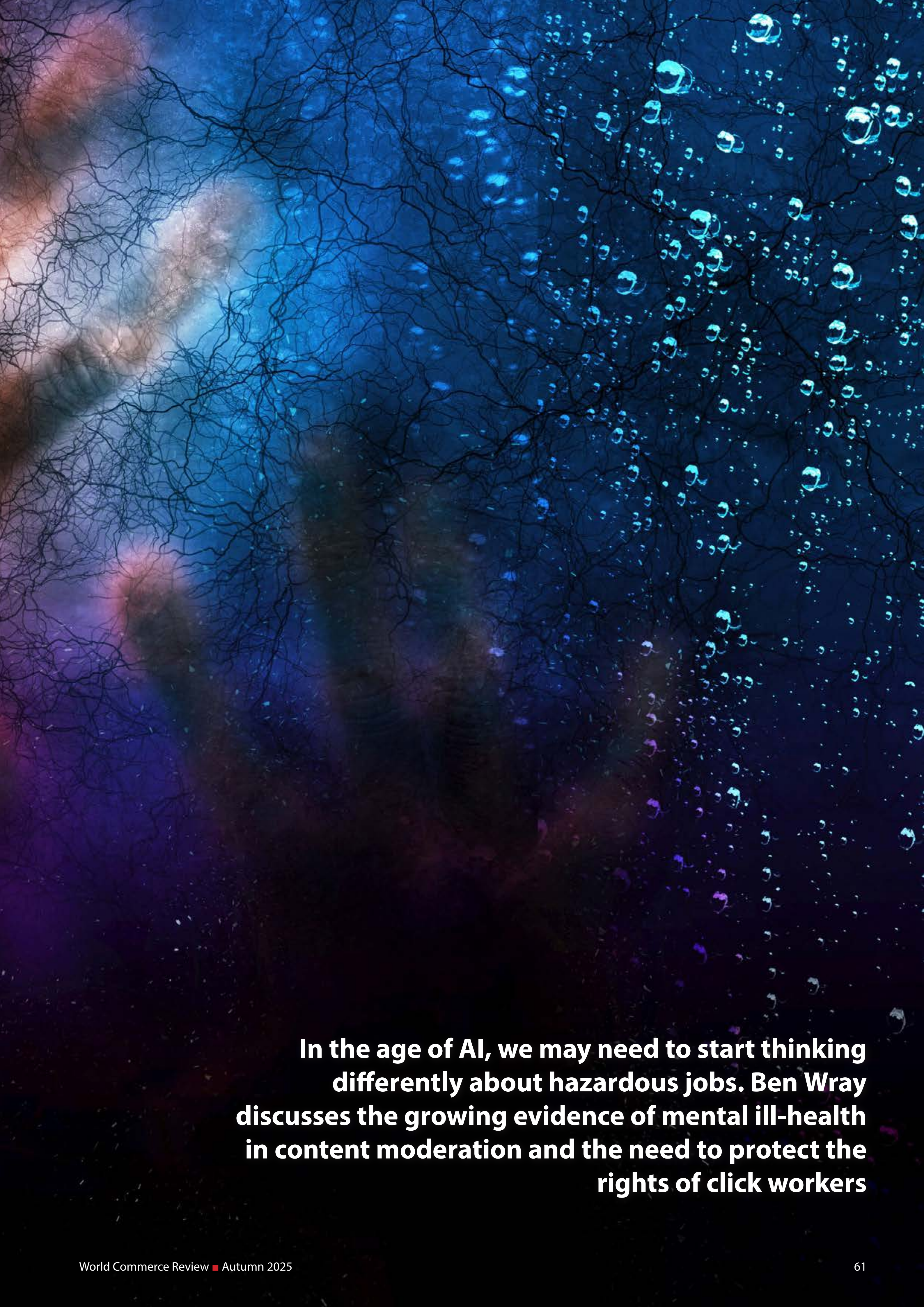
15. For example, many banks created asset-backed commercial paper (ABCP) programs as conduits that allowed them to fund bank assets without bringing them on balance sheet, thereby avoiding regulatory capital treatment. However, this approach created significant risks because the primary holders of ABCP were money market mutual funds, which are ultra-sensitive to payment delays and themselves subject to run risk. Money market funds also similarly funded other parts of banks' balance sheets in the lead-up to the crisis. In addition, other private cash-like instruments, such as auction rate securities, repurchase agreements based on ABCP, and other short-term debt instruments that were treated like money created new vulnerabilities as they grew and subsequently collapsed.

16. Binyamin Appelbaum and Ellen Nakashima (2008), "Banking Regulator Played Advocate over Enforcer," Washington Post, November 23.

The views expressed here are my own and are not necessarily those of my colleagues. This article is based on a speech delivered at The Brookings Institution, Washington, DC, July 2025.

The 21st century hazardous job





In the age of AI, we may need to start thinking differently about hazardous jobs. Ben Wray discusses the growing evidence of mental ill-health in content moderation and the need to protect the rights of click workers

Are hazardous jobs a thing of the past in Europe? In the age of artificial intelligence, we may need to start thinking differently about what such a job looks like, focusing less on the lungs or the heart and more on the mind.

There is a rapidly expanding industry in Europe in which there is growing evidence that mental ill-health is a systemic problem for workers. That industry is content moderation. And a network of workers, researchers and politicians are catching on and fighting back.

"There are surely some content moderators that haven't suffered mental health problems connected to the job, but I haven't met them," says sociologist and computer scientist Milagros Miceli, who has studied the content moderation industry for the past six years. *"I have no doubt that content moderation, like coal mining, is a hazardous job."*

Coal mining, known for the proliferation of 'black lung disease', is a classic example of a hazardous job, but there are only approximately 200,000 coal miners left in the whole of the European Union. There are plenty of other jobs which come with dangers, but few where 'risk to your health' are still written on the job description.

Content moderation may, however, qualify as the new exception. Just as exposure to silica dust caused lung diseases in miners, endless toxic and disturbing content is a threat to the mental health of those employed to engage with it on a daily basis.

Content moderators are essentially the security guards of social media. They are tasked by platforms like Facebook and Tik-Tok to remove content that breaches their guidelines. The posts that they filter out include hate speech, violent, graphic and pornographic content (including child sexual exploitation), content from proscribed organisations such as terror groups, bullying and harassment, and suicide and self-harm.

The content that reaches the screens of content moderators has either been flagged by a user or identified by an AI system as a potential candidate for removal. A big part of what content moderators are doing is labelling the content they see on their screen in order to train the AI to become more proficient in identifying harmful content.

Chris Gray is the first former content moderator to take Meta to court in Europe. He worked in Dublin for CPL, an outsourcing firm for Meta, from 2017 to 2018. It was only years after he was fired that Gray began to come to terms with how the job had affected him.

"I met a journalist who wanted the human-interest angle, she was pushing me to talk about disturbing content," he recounts. *"I hadn't spoken to anyone about that. I didn't speak to my wife about it. The NDA [non-disclosure agreement] had been hammered into me: 'Don't ever talk about the work'."*

"As I started to tell her, I had a complete meltdown, I just lost control of myself completely. I sat in a coffee shop with tears streaming down my face. The journalist insisted I go to a doctor, and it started from there." Gray was diagnosed with PTSD and in 2019 he took a claim against CPL and Meta to the Irish High Court, alleging psychological injuries from repeated exposure to extremely disturbing content. The case is still pending.

In the United States, a similar case involving Meta content moderators was settled out of court, with the workers receiving damages of up to 50,000 US dollars per person. Gray has not been offered an out-of-court settlement yet, and says he wouldn't agree to one if he was. 'As part of the US settlement, they had to accept that no one was harmed to get the pay-out. That's no good to me.

"Content moderation is like where the tobacco industry was in the 1960s. Everyone knows it's harmful but it hasn't been proven yet and there's a huge vested interest in maintaining the fiction that it isn't an issue. I want it to be proven by a court of law that this job is harmful to workers' health. Once we've established that it's harmful, we can start the conversation about how to mitigate the risk."

Bound to secrecy

While the work of content moderators is for the big social media platforms, they are hired almost exclusively through outsourcing firms, companies which are typically called 'BPOs' ('business processing outsourcing'). A veil of secrecy surrounds this industry.

No major platform has been willing to say how many content moderators are hired on their behalf by these firms or even provide a list of the BPOs they work with, but there is little doubt that this is a big and rapidly growing sector: there were three million posts flagged for removal every day on Facebook alone in 2021.

Some content moderation work can be offshored, with the Philippines in particular a major global centre for content moderation. However, Antonio Casilli, an expert in 'click work' (which content moderation is one sub-section of), says that the platforms cannot avoid employing content moderators within the EU.

"Sometimes content moderation has to happen in Europe for legal reasons, because they are managing content and data that is subject to GDPR [the EU General Data Protection Regulation]. Also, there are linguistic reasons. You can't find people in Africa, for instance, who speak specific languages, like Lithuanian or Swedish. Some things can't be outsourced to lower-income countries."

According to Casilli, the European content moderator industry has become highly concentrated in recent years, with a few big firms buying out rivals and dominating the sector. Teleperformance, Appen and Telus are three of the biggest players. These BPOs organise the industry in a call centre-style office environment where surveillance of workers is intensive and secrecy is a top priority.

"Their contracts are extremely strict on non-disclosure agreements, they are really NDAs disguised as work contracts,"

explains Casilli. *"In these contracts, not much is said about the rights that workers have. Basically there is a lot of emphasis on secrecy and confidentiality. And they do not mention the specific health risks that are associated with this work."*

Another typical feature of the content moderator industry is that the workers are migrants. Casilli is one of the authors of *Who Trains the Data for European Artificial Intelligence?*, a new study by the EnCOre Initiative on click workers (including content moderators), commissioned by The Left Group in the European Parliament. The researchers held focus groups with content moderators working at BPO firms Telus and Accenture in Germany (in Berlin and Essen) and at an anonymised BPO firm in Portugal.

At the Portuguese site every worker they spoke to, was a migrant: from Russia, Poland, India and Turkey. At the German sites, most of the workers were migrants, including many from Asia and Africa. *"They are contractually blackmailed because their work status is often linked to their visa,"* explains Casilli. *"So if they stop working for these companies, or if they whistle-blow, they face the risk of deportation."*

From the BPOs to the NDAs to the migrant visas, the big social media platforms are protected from accountability for the working conditions of their content moderators by layers of deniability, secrecy and marginalisation. But behind these walls of opacity there exist real people with real stories, and some of them are determined to be heard, despite the barriers they face in speaking out.

Mental health concerns: 'a little overdramatic'?

Just like Chris Gray, Ayda Eyvazzade, an Iranian former content moderator in Berlin, is also in no doubt about the harms of the job. *"I experienced some really traumatising moments,"* she tells HesaMag. *"I remember watching a child being exploited sexually, and that image has stayed in my mind. You feel yourself very alone and solitary when doing that work; very hopeless and insecure. The quality of my sleep was really damaged. I would see the images in my nightmares. I would wake up more tired than when I went to sleep."*

Eyvazzade was sacked in November 2023 after working for an outsourcing firm for almost five years (which she does not wish to name due to the NDA she signed). She says that the combination of human and digital surveillance intensifies the pressures of the job.

The content moderators have KPIs ('key performance indicators') which they have to meet, and time away from the computer due to the distress of the images and videos that they have witnessed count as 'unproductive' time.

"If something you see is really difficult then you can leave your desk, but at that moment you have to remember to put on your computer that you are on 'wellbeing'," explains Eyvazzade. *"But if the supervisors think you are using 'wellbeing' more than you should, they will intervene. They would say: 'Your 'production' time is a bit lower than expected, you have been on 'wellbeing' a lot.' So you are pressured to increase your time on 'production' by decreasing your 'wellbeing'."*

It's only a matter of time before the content moderator industry is brought out of the shadows and into the light. At that point, platforms like Meta and TikTok will have to answer for why they can have hundreds of pages of guidelines to ensure the safety of their users, but none concerning the safety of their content moderators

After a content moderator in Telus' Essen office committed suicide, the company changed its policy so that workers could have unlimited 'wellbeing' time. However, Milagros Miceli, who has conducted research with content moderators in Essen, says that the pressure to watch a lot of content in a short space of time still exists.

"The content moderators have the right to wellness breaks, but the KPIs that you need to achieve, you won't achieve them if you take too many breaks," she explains. *"KPIs are always the most important disciplining factor for workers managed via algorithmic management."*

The EnCOre Initiative study, which Miceli is also a co-author of, found 'incidents in which workers have fainted, suffered from burnout, experienced psychotic episodes, and, tragically, in at least one instance, committed suicide'. None of this will be news to Meta founder and CEO Mark Zuckerberg.

In a leaked audio recording of a meeting in 2019 he was told by staff that many content moderators were suffering from PTSD. The CEO responded by saying that *"some of the reports, I think, are a little overdramatic."*

Miceli, who has spoken to hundreds of content moderators, believes the exact opposite. *"The problems are much worse than people think,"* she says. *"I've heard a man say his wife has left him because he cannot perform sexually after reviewing paedophilia content. All of these workers have real conditions, certified by real psychiatrists."*

The BPOs say they provide in-house counsellors, but both Gray and Eyvazzade said that most of the counsellors they spoke to were under-qualified. Miceli agrees. *"Quite a lot of the in-house counsellors are not certified therapists. Also, a lot of workers have the suspicion that counsellors inform managers about what they are told from the workers."*

She thinks Ver.Di (*Vereinte Dienstleistungsgewerkschaft* – United Services Union) could have been more assertive in challenging the company, including through the courts.

Miceli also believes that if unions are going to grow in this sector, they need to be better prepared to confront the secrecy and intimidation that dominates content moderation work. *"Definitely part of the issue is unions struggling to adapt to*

new times and struggling to relate to the migrant workers who are leading the organising in these new digitised spaces," she says.

The delicate balance between user safety and worker safety
If unions have work to do in this area, surely regulators should also be taking a close look. The 2022 EU Digital Services Act (DSA) significantly increased the burden on platforms to police content, leading to the content moderator industry burgeoning in Europe, but the DSA paid no attention to the safety of content moderators themselves.

"The Digital Services Act has increased the amount of moderation but it has also increased the centralisation of moderators," Casilli says. *"The market is becoming bigger and bigger but with fewer actors."*

In May, the European Commission announced a new investigation into Meta over potential breaches of DSA in relation to the safety of children using Instagram and Facebook.

A senior Commission official has also questioned how X can be meeting its DSA obligations while hiring significantly fewer content moderators than Meta and TikTok. But the more that platforms hire content moderators to cope with the political pressure from the EU, the more workers will be placed at risk – a tricky balance that needs to be addressed.

"It's totally about what is politically important," content moderator Chris Gray says of the regulatory debate in Europe. *"Everyone who has kids cares about their kids not being exposed to horrible stuff on social media, but how many of those parents care that there's a bunch of people in a room somewhere that has to look at this stuff over and over again to stop your kid seeing it?"*

The content moderator Works Council at Telus in Essen has made a number of proposals to improve working conditions: increased vacation time to alleviate mental stress, access to professional mental health support without fear of reporting to management, fair compensation, recognition of their work as a skilled profession, and recognition that this is a hazardous job through the application of appropriate mitigation measures.

In the German Bundestag (federal parliament), a summit for content moderators was held in 2023 at which the content moderators presented a manifesto and one of the workers from the Essen Works Council gave testimony. But in a clear sign that the BPOs have little appetite to change, this worker was subsequently suspended by Telus for breaching his NDA. The Bundestag has yet to act on the recommendations of the content moderators.

Leila Chaibi, Member of the European Parliament who leads The Left Group's work on AI and work, says the EnCOre Initiative study highlights the need for European regulatory action in this area. *"This report should be a wake-up call to the EU decision-makers to act to protect the rights of click workers, and address their specific needs,"* she tells HesaMag.

Despite the secrecy of the platforms and BPOs, it's only a matter of time before the content moderator industry is brought out of the shadows and into the light. At that point, platforms like Meta and TikTok will have to answer for why they can have hundreds of pages of guidelines to ensure the safety of their users, but none concerning the safety of their content moderators. ■

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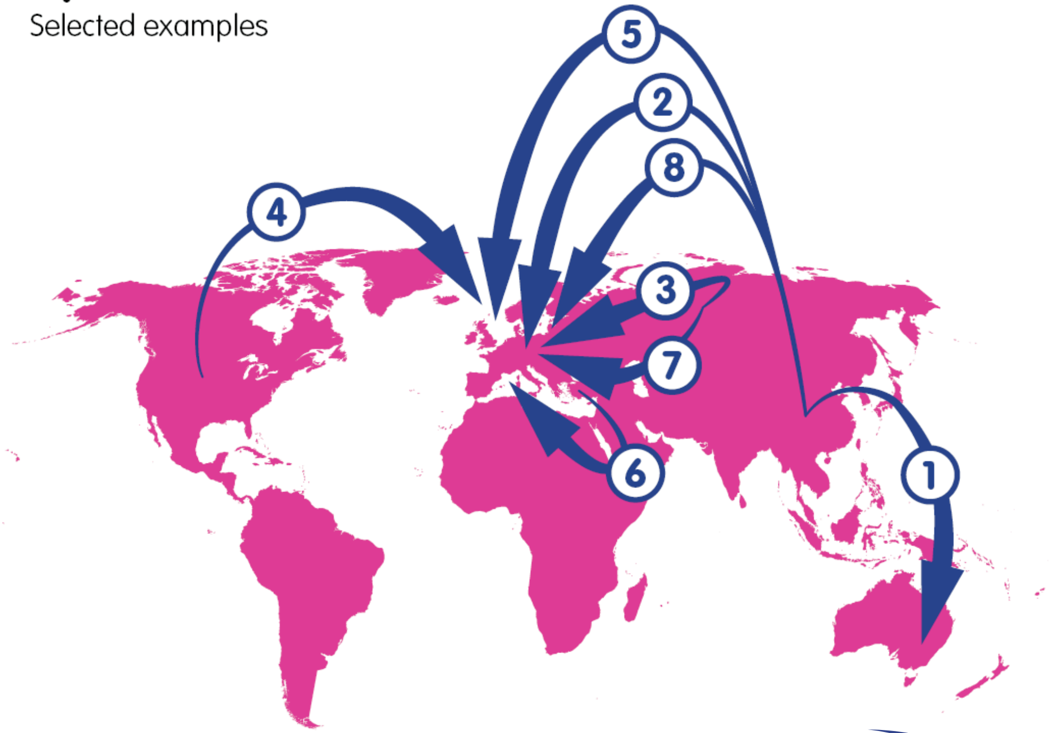
The Power Atlas

The EU is increasingly threatened by economic coercion

Selected examples



1. Chinese curb on Australian exports to push back against an investigation into the origins of covid-19 (2020)
2. Chinese threat of car tariffs to pressure Germany into accepting Huawei's 5G infrastructure (2019)
3. Russian ban on Polish imports of fruit and vegetables following EU sanctions over the war in Ukraine (2014)
4. US threat of section 301 tariffs to prevent France and other European countries from levying taxes on digital services (2020)
5. Chinese 'popular boycott' of EU companies (such as Adidas and H&M) following EU sanctions on Chinese officials involved in human rights violations in Xinjiang (2021)
6. Turkish boycott of French-labelled goods following President Emmanuel Macron's announcement of policies to combat extremism (2020)
7. Russian threat to ban Czech beer imports following Czech government's declaration of links between Russian intelligence services and the 2014 Czech warehouse explosions (2021)
8. Reported Chinese suspension of rail freight to Lithuania and block on export permits for Lithuanian producers in reaction to the announcement that a Taiwanese Representative Office would open in Lithuania (2020)

9

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