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Ignacio García Bercero and Niclas Poitiers consider the next steps for European economic security

The EU must speed up its integration amid mounting geopolitical turmoil, Christine Lagarde warns

Charles Lichfield and Nicolas Véron argue that an EU reparations loan is the right way to help Ukraine

THE EUROPEAN TRADE AND FINANCE PLATFORM

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The next steps for European economic security

The world has changed fundamentally. Ignacio García Bercero and Niclas Poitiers argue that the EU needs a balanced strategy to cut reliance on the US and China while improving its capacity to counter coercive economic threats

Executive summary

The European Union's economic security strategy was initially developed at a time of close transatlantic cooperation and focused largely on risks linked to Chinese dominance of certain parts of global manufacturing. However, given the diminished commitment of the United States to its traditional alliances and to multilateral rules, EU economic security planning now also needs to take into account the risk of US coercive action.

The EU must combine a medium-term strategy to reduce dependencies on both China and the US in critical areas with the capacity to react in the short term to threats of coercion. This requires supply chain chokepoints to be identified. There should also be a political discussion with EU countries on the circumstances in which the EU Anti-Coercion Instrument should be deployed, and the appropriate measures to respond to coercion.

The EU's various tools for responding to urgent threats to its economic security need to be adapted to the new geopolitical context. The EU should prioritise support for research and development in relation to critical technologies and should ensure a more targeted and effective approach to state aid. It should avoid 'buy Europe' policies that contradict its international commitments and limit the scope for partnering with third countries.

On traditional economic statecraft tools, screening of foreign investment needs to be transformed to responding more effectively to economic security threats, while export controls need to be better coordinated. Given the need to de-risk relationships with both the US and China, strengthening economic partnerships has become ever more important.

Moreover, more robust governance structures to manage the use of economic security tools and partnerships with like-minded countries internationally need to be developed.

1 Introduction

In 2023, the European Commission published a European economic security strategy (European Commission, 2023a)[1]. It was conceived at a time when the European Union could rely on close cooperation with the United States and was part of a coordinated transatlantic response to the risk of the weaponisation of economic dependence by China. China's dominant position in several manufacturing sectors, particularly in the processing of critical raw materials, was a particular focus.

The move to a new EU economic security doctrine deserves a broader discussion on how to mitigate risks in the new geopolitical environment

EU-US alignment on economic security justified using the G7 as institutional platform to coordinate responses to economic coercion and, potentially, to develop economic security standards. On the EU side, the 2023 strategy is now being developed into an economic security 'doctrine' that focuses on how different policy tools can contribute towards mitigating economic security risks.

The move to a new economic security doctrine, in addition to EU initiatives on critical raw materials and on industrial policies, deserve a broader discussion on how to mitigate economic security risks in the new geopolitical environment.

The world has changed fundamentally (Sapir *et al* 2025). The administration of US President Donald Trump has shown little interest in coordinating action with allies when it comes to 'de-risking' relations with China. The US has even threatened the EU and its members with coercive action. This threat remains despite the EU-US trade deal inked in July 2025 envisaging cooperation on economic security[2].

All of this is happening in the context of war on the European continent and the major threat from Russia. US weaponisation of economic interdependence, which was thus far mostly wielded in favour of common transatlantic objectives (Farrell and Newman, 2019), might now become detrimental to European interests. Meanwhile, China has shown its readiness to weaponise economic dependencies through its dominance of the processing of the critical raw materials relied on by EU manufacturing.

The 2023 EU economic security strategy triggered risk assessments in four areas[3]:

1. Supply chain vulnerabilities;

2. Critical infrastructure;

3. Technology security;

4. Economic coercion.

The strategy did not clearly define economic security but rather used economic security as an umbrella term for a collection of instruments (Chimits *et al* 2024). Such a lack of conceptual clarity could lead to confirmation bias or confusion about the instruments needed to respond to different types of economic security threat (Pisani-Ferry *et al* 2024).

Some ambiguity can be helpful in providing leeway when deciding on defensive action, but vague risk assessments can be problematic when trying to devise strategies to minimise risks. This implies that while it can make strategic sense to not be too tied down to reactive policies, proactive policies should be based on thorough risk assessments and definitions.

This is particularly the case for measures aimed at reducing supply-chain vulnerability, for which a balance is needed between industrial policies and foreign economic policies. Given the changing external threat environment, the EU economic security doctrine needs to be continuously reviewed and adapted. Since the economic security strategy was published, various steps have been taken as part of its implementation (Table 1).

The challenge now is for economic security is to move beyond a process of risk assessments to risk-mitigation strategies based on the coherent deployment of economic security tools. The foundation for economic security

Table 1. EU policy developments on economic security since 2023

Date	Document	Purpose
June 2023	Communication on an Economic Security Strategy (European Commission, 2023a).	Sets out the Commission's views on the economic security threats to be guarded against and the relevant EU policies for this purpose.
Oct 2023	Recommendation on further risk assessments on critical technologies (European Commission, 2023b).	10 critical technology areas identified for joint risk assessments by member states and the Commission; four to be done urgently.
Dec 2023	Adoption of the Anti-Coercion Instrument (ACI, Regulation (EU) 2023/2675).	Regulation allowing for a calibrated EU response in the event of economic coercion by a third country.
Jan 2024	Commission publishes five initiatives on technology security and research.	Proposal for a revision of the FDI screening regulation (European Commission 2024a); white paper on export controls (European Commission 2024b); white paper on outbound investment; white paper on R&D for dual use technologies (European Commission 2024c); and a proposal for a Council Recommendation on research security (European Commission 2024d).
Apr 2024	Letta report on the single market (Letta, 2024).	Suggests various improvements for economic security, including establishing an Economic Security Council, broadening the scope of de-risking and defining a framework for cooperation with 'rival partners'.
May 2024	Adoption of the Critical Raw Materials Act (CRMA, Regulation (EU) 2024/1252).	Seeks to reduce dependency on single sources (in particular China) for critical raw materials. It includes streamlined permitting and measures to improve recycling and circularity.
July 2024	Political Guidelines for 2024-2029 European Commission (von der Leyen 2024).	Calls for economic security to form one of the three pillars of a new 'foreign economic policy'.

Sep 2024	Draghi report (Draghi 2024).	Section 4 focusses on reducing vulnerabilities to external pressure and dependencies.
	Mission Letter to Commissioner-designate for Trade and Economic Security Maroš Šefčovič[4].	Places economic security under the renamed Directorate General for Trade and Economic Security; calls for the development of a "new economic security doctrine, which outlines the strategic use of our economic security tools within the EU"; calls for the development of economic security standards with international partners for key supply chains.
Oct 2024	Adoption of the Internal Market Emergency and Resilience Act (IMERA; Regulation (EU) 2024/2747).	Aims to reduce impact of crises on the functioning of the single market and to ensure the availability of critical supplies.
Jan 2025	Recommendation on outbound investment screening (Recommendation (EU) 2025/63).	Calls on EU governments to review their companies' outbound investments in non-EU companies in three crucial technology areas, which will inform whether further action at EU level is needed.

Source: Bruegel.

policies has to be a clearly articulated view about the geopolitical positioning of the EU and the relationship between economic security and the EU's overall economic strategy.

In this *Policy Brief* we assess the main threats to EU economic security (section 2) and then analyse and make recommendations on the roles of industrial policies, foreign economic policies and economic statecraft tools in mitigating the economic security risks facing the EU, and for the governance of economic security (section 3).

This is not to suggest that these instruments are the only tools for the mitigation of economic security risks. Horizontal policies that reinforce growth in the European economy, and notably underpin the single market and an open trade policy, are also critical enablers to promote economic security.

2 The main threats to EU economic security

2.1 Import dependency

Overreliance on crucial imports is a clear risk to the EU economy. The ability of countries to restrict access to these imports strengthens their coercive power. Moves by both the US and China to restrict certain exports of chips[5] and raw materials[6] show this risk must be taken seriously.

A particular challenge is that a de-risking strategy for sectors such as the processing of critical raw materials requires close coordination among like-minded countries and substantial investment before dependency can be reduced significantly. An effective strategy to develop alternative sources of supply for critical raw materials, for example, would have to be structural in scope and implemented over the medium to long term[7].

The 2023 European economic security strategy listed various ways to identify dependencies, such as stress tests, and the Commission has developed some metrics already. The Commission's Joint Research Centre has published

a set of economic indicators to capture the EU's trade dependencies on third countries, broken down by exporting and importing countries and sector (Piñero Mira *et al* 2024).

However, both data and analytical challenges make identifying genuine import dependencies very hard (Mejean and Rousseaux 2024). It is difficult to measure substitutability, both intertemporally and cross-product. In other words, it is hard to know which products are genuinely critical to EU production or consumption.

Because of re-exporting and complex supply chains, it is also difficult to capture the EU's ability to produce the products in question in the event of a shock, and to identify ultimate import and export dependencies[8].

Broader import diversification is welcome, especially given the documented churn in the products for which the EU has dependencies (Vicard and Wibaux 2023). Detailed risk assessments and attempts to reduce dependencies should be limited to areas for which weaponisation would lead to greatest macroeconomic or social impacts.

There is broad agreement that de-risking is necessary for a narrow category of goods. These include semiconductors, batteries, critical raw materials and some pharmaceuticals (Pisani-Ferry *et al* 2024). These dependencies relate primarily to China (Figure 1).

The attitude of the Trump Administration means that areas previously overlooked must now also be considered. For instance, a thorough examination of critical defence dependencies should be prioritised (Burilkov and Wolff 2025; Mejino-López and Wolff 2025). Similarly, while energy dependence has generally been associated with Russia, EU dependence on imported liquified natural gas (LNG) from the US since the Russia's 2022 invasion of Ukraine should be considered a potential pressure point (Keliauskaitė *et al* 2025).

Beyond these categories, it is difficult to know exactly where to de-risk. Thus, engagement with the private sector in critical sectors is crucial, especially to identify upstream inputs for which there may be significant bottlenecks. Another important factor is that not all dependencies require the same policy response. For some, the EU might want to diversify imports (eg. LNG), whereas in defence, it could prioritise boosting European production or procurement from close allies such as the United Kingdom and Canada.

More importantly, the fact that many import dependencies can only be reduced in the medium term implies the need to develop strategies to deter coercive action in the short term. More attention should be paid, in close cooperation with member states and the private sector, to the identification of chokepoints based on reverse dependencies (ie. chokepoints under EU control), which could be targeted in attempted economic coercion.

Identifying such chokepoints may be critical if the EU Anti-Coercion Instrument (ACI, Table 1) is to be used in a targeted way – the ACI empowers the EU to react with a broad range of retaliatory measures should it threatened with economic coercion. In such cases, other measures may be more effective than import tariffs because affected countries may be able to diversify or simply absorb the tariff.

2.2 Export vulnerabilities

China has sought to apply economic coercion to the EU through restrictions on imports to its market (McCaffrey and Poitiers 2024). For example, Chinese attempts to sway member state decisions on the imposition of countervailing duties on Chinese electric vehicles included threats to limit access to the Chinese market for Spanish pork[9] and French cognac[10].

While such limitations are not macroeconomically significant, they have the potential to shape political outcomes. In the end, however, Chinese threats did not prevent the adoption by the EU of countervailing duties on electric

vehicles[11]. But these types of threats might be more successful in areas in which the EU can only act on the basis of a positive qualified majority.

Understanding these risks is crucial. It is not always direct exposure that matters, as export restrictions may be applied further down the supply chain (China threatened to restrict imports of EU cars that contained parts from Lithuania in response to the opening of a Taiwanese representative office in Vilnius; McCaffrey and Poitiers 2024).

Such instances have helped firms understand that they may become casualties in this new geopolitical landscape, and firms seem to be diversifying supply chains and, in some cases, building secondary supply chains[12].

The conclusion of new free trade agreements would make a significant contribution to diversifying export markets and could go together with tools to facilitate trade and the integration of value chains, such as negotiation with FTA partners of a common protocol on rules of origin or a supply chain resilience agreement.

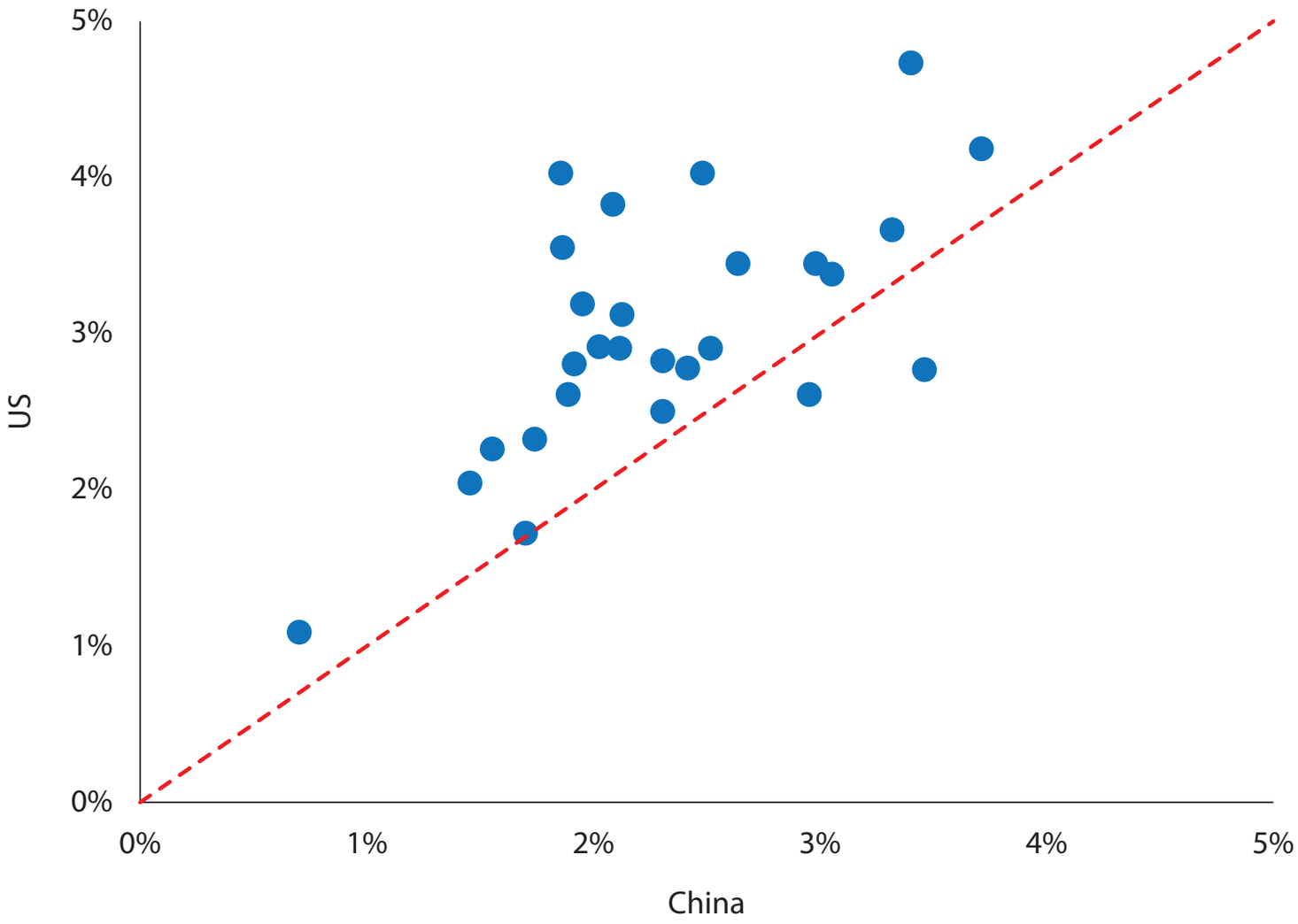
2.3 Foundational technologies

The area of foundational and emergent technologies presents the strongest case for active industrial policies in the name of economic security. These are technologies with the potential to significantly disrupt and reshape the global economy.

A strong presence in the development of such technologies will help ensure the EU's future strategic indispensability. In other words, the EU would be better equipped to hit back at the coercive measures of others and by doing so would change the decision-making calculus of would-be adversaries.

The semiconductor sector is a prime example. The EU does not control the fabrication of semiconductors, but, in ASML in the Netherlands, has a monopoly on the machines used for their production (Poitiers and Weil 2022b).

Figure 1. Dependencies of EU countries on US vs China (% of GDP, 2022)



Note: each dot represents a country and its position on an index that captures the "domestic gross value added generated by the exports of an economy to a trade partner directly and indirectly through third countries. This indicator is built up on domestic value added in exports and domestic value added in foreign final use" (Eurostat).
Source: Bruegel based on Eurostat trading partner exposure index.

This means the EU cannot be easily excluded from semiconductor value chains. On the other hand, allowing other economies to develop monopoly power in critical technologies would tie the EU's hands.

The EU needs to protect its lead in the areas in which it maintains a significant edge, such as the ultraviolet lithography machines produced by ASML. However, given the scale and speed of developments in these sectors, it is equally important to play a pioneering role in the next generation of foundational technologies.

The EU previously held a dominant position in research and development in clean tech, before falling behind China (García-Herrero *et al* 2024). Eulaerts *et al* (2025) have identified emerging critical technologies using a range of techniques and these could be a solid basis for guiding future R&D support.

2.4 Financial and digital dependencies

Given US dominance in finance, there may be a risk of US financial coercion, not only trade coercion[13]. This was a feature of the first Trump administration when, for instance, pressure was put on HSBC over its interactions with Huawei, and on Swift to disconnect Iranian banks. Given the US desire to maintain the dominant role of the dollar and trust in its financial system, it is unclear exactly how far coercion in this sector could go.

However, the record of the first Trump administration and the actions of the second to date imply that this risk should be taken seriously. This is especially important given that finance did not feature in the European economic security strategy and, therefore, preparations in this area may justify a specific new risk assessment[14].

The EU also relies on US digital services in many areas. The US tech giants often enjoy monopolistic power, and there are often few alternatives, apart from Chinese providers. This dependency is a potential EU weakness, especially when it comes to critical digital infrastructure such as cloud services and satellites[15].

European attempts to break these US monopolies and compete in digital services continue to be significant sources of friction in transatlantic relations, resulting in US threats of trade restrictions as a response to the enforcement of EU digital regulations[16].

The EU should, therefore, prioritise reducing its reliance on US digital infrastructure and finding the most effective responses to US threats. As with critical raw materials dependencies, reducing dependencies linked to US digital or financial dominance requires a medium- to long-term strategy and a combination of different EU tools.

3 The development of risk mitigation strategies

3.1 Industrial policies

Economic security is often presented as a justification for more proactive industrial policies, boosting domestic industry, particularly through state aid. Important Projects of Common European Interest (IPCEI) are the main EU-level tool for this. These are large-scale industrial projects using novel technologies and serving a strategic European interest, supported by public subsidies.

The European Chips Act (Regulation (EU) 2023/1781) follows this mould, as a more lenient sector-specific version of an IPCEI. It's state-aid pillar uses the same R&D justification for state aid as ICPEIs and has the same conditionality, with the exception that it not only allows the promotion of completely new technologies, but also supports the introduction of technologies to the EU in the case of chip foundries (Poitiers and Weil 2022b).

For this type of industrial policy, there is a lack of clarity on the criteria for identification of industrial sectors for which an expansion of domestic production is both economically viable and necessary from an economic security perspective.

Whereas much of the focus has been on sectors for which there is an import dependency, not all import dependencies represent an economic security threat; in several sectors, diversification of import suppliers may be a better economic strategy. A better approach may be to subsidise R&D and its deployment in sectors that are at the technological frontier.

Moreover, IPCEIs have not been an unqualified success. Selection of individual large projects for significant subsidies has seen a number of notable failures. The Chips Act's flagship project was to be a semiconductor factory in Magdeburg Germany, slated to receive €10 billion in subsidies.

Meant to promote European high-end manufacturing, the project was halted in 2024[17]. Northvolt, a Swedish battery company that received significant ICPEI subsidies to build a battery supply chain independent of China went bankrupt in early 2025 (Tagliapetra and Trasi 2024).

ICPEIs are not the only policy tool intended to promote economic security by promoting investment in European strategic industries. The Critical Raw Materials Act (see Table 1) and the Net Zero Industry Act (NZIA, Regulation (EU) 2024/1735) introduce standards and procurement rules that seek to promote the diversification of European supply in sectors in which China has a market-dominating position (Le Mouel and Poitiers 2023; Tagliapietra *et al* 2023).

The main economic security tool under the NZIA has been the introduction of resilience criteria, sometimes combined with criteria related to sustainability or protection against cybersecurity risks. Resilience criteria require public buyers to diversify supply sources when procuring strategic technologies (ie. when the EU is dependent on a single supplier for more than 50 percent of its imports).

This approach needs to develop further. While the need to support certain industries through industrial policies (including subsidies) is clear, IPCEIs are not up to the task. The process of agreeing an ICPEI requires significant haggling between national government funders and large companies.

This favours established national industries over areas of import dependency, in which there is a lack of well-connected European industries. Furthermore, its use of an R&D state-aid exemption to support strategic industries makes the process onerous, while political pressure to approve projects under this narrow rule undermines the stringency of state-aid control (Poitiers and Weil 2022a).

Similarly, a better understanding of the problems that these policies try to solve is needed in order to design more targeted policies. The Chips Act's emphasis is on foundries producing high-end chips but this does not address the causes of shortages during the pandemic and the EU's strategic vulnerabilities relative to China.

The European Commission has also published work mapping the EU's import vulnerabilities to its comparative production advantages, a valuable exercise that should help to inform when and how to implement industrial policies (Arjona *et al* 2023; Poitiers *et al* 2024).

Trade and Economic Security Commissioner Šefčovič has been asked *"to develop economic security standards for key supply chains with our G7 and other likeminded partners"* (see footnote 2). As discussed in section 3.4, it is not clear that the G7 is the relevant forum for developing such standards. There is also a need for greater conceptual clarity about the reasons for such standards. For instance, should such standards be met to benefit from certain incentives, or as a condition of market access? So far, the only standard with a clear economic security rationale is the NZIA resilience criteria.

In relation to consumption subsidies for green products or preferences for green procurement, the promotion of lead markets would argue for standards based on well-defined carbon-footprint and circularity requirements, which in cases of high dependency may be combined with resilience standards.

However, the risk of the emergence of an amalgamation of unrelated requirements to establish an ill-defined 'economic security standard' could lead to discrimination and protectionism.

One particular concern is the introduction in the EU's February 2025 Clean Industrial Deal (European Commission 2025) of the concept of 'Buy Europe' or 'minimum European content', under which only products with a certain level of European content will benefit from access to government procurement or other benefits, such as consumption subsidies. Such policies would be incompatible with the EU's international obligations and could also become a major obstacle to developing partnerships as part of the economic security strategy.

Moreover, the introduction of such criteria is not necessary to de-risk from China since China is not a member of the World Trade Organization Government Procurement Agreement and 'resilience' criteria will often be sufficient for de-risking purposes outside of government procurement. A 'Buy Europe' policy could be a major obstacle to partnerships with likeminded countries and for the diversification of supply chains.

A more coherent approach to the deployment of industrial and foreign economic policies for economic security purposes requires a multi-step analysis:

1. Identify the most economically significant economic security risks in terms of supply chain dependencies and risks in relation to critical technologies;

2. Conduct an economic assessment of the extent to which the EU has the capacity to increase production in the EU, or to maintain its lead or develop foundational technologies;

3. Identify the most effective tools to achieve the industrial policy objectives; and

4. Develop partnership strategies for the diversification of external supplies as the most cost-effective approach to reducing vulnerabilities.

The economic security doctrine should contribute towards better governance on the use of industrial policy and its interface with trade and other external policies.

3.2 Economic statecraft instruments

In certain instances, the promotion of economic security justifies the introduction of export or investment restrictions. These are the two most traditional economic statecraft instruments, use of which has intensified in recent years. In the EU, they are managed at member state level, though there have been ongoing attempts to reinforce EU coordination.

The EU has also adopted a specific instrument to respond to economic coercion: the Anti-Coercion Instrument (ACI; Table 1), which empowers the European Commission to retaliate against economic coercion with a variety of coordinated measures. To be triggered, the Council of the EU decides whether an instance of economic coercion has taken place. Once this decision has been taken, the European Commission has broad powers to retaliate against the offending country in a proportionate manner.

At the time of writing, the EU has not yet deployed the ACI, though Chinese responses to the EU countervailing duties on EVs or President Trump's so-called reciprocal tariffs could have fallen within its scope. The unwillingness to deploy the ACI in circumstances of clear coercive threats raises serious questions about its credibility. The EU must be ready to deploy the ACI in case US threats of digital regulation materialise, or if China seeks to weaponise critical raw materials dependencies to influence EU decision making.

The identification of chokepoints and reverse dependencies is crucial in identifying possible response measures. The EU also needs to build the capacity to respond to possible escalation by the coercer. A discussion with EU countries should take place ahead of any invocation of the ACI to identify the appropriate tools to deter or respond to threats linked to digital regulation or the dependency on critical raw materials.

More broadly, the ACI should not be treated only a measure of last resort. The instrument allows targeted responses against measures or threats that seek to influence sovereign choices by the EU or its member states. Not responding to coercion would fundamentally weaken the EU as a geopolitical actor.

Another measure to protect European economic interests against foreign interference is screening of foreign direct investment. This is intended to protect strategic technologies from acquisition by potential geopolitical adversaries.

However, the European Commission plays only an advisory and coordinating role on FDI screening. EU governments decide themselves whether or not to block FDI, based on national-security concerns. The Commission has proposed reinforcing FDI screening (see Table 1) so that all EU countries have the capacity to screen investments in sectors that are critical for economic security; this would improve the coherence of investment screening.

The adoption of the Commission proposal (European Commission 2024a) is the minimum required to ensure adequate protection against risks of technology leakage, or relating to the protection of critical infrastructure.

The US has increased the use of export controls on dual-use technologies, particularly those related to semiconductors. China has introduced controls on critical raw materials exports, potentially causing major economic disruption. For the EU, greater coordination of export controls among member states is critical, in case escalating geopolitical tensions result in tit-for-tat export controls by the US and China.

The economic security framework should propose reinforced coordination of export controls at EU level, including an early warning mechanism under which the Commission and EU governments would be notified when a member state is considering the introduction of new controls.

3.3 Foreign economic policies

The two main foreign economic policies that can be deployed to reinforce economic security are trade policy and development cooperation policy. The EU's vast network of free trade agreements (FTAs) is an essential tool to reduce export dependencies at time when the EU is vulnerable to the combination of US protectionism, and the Chinese focus on exports as the main source of growth.

Of particular importance are trade agreements with emerging economies that are both highly protected and have a substantial growth potential, such as the Mercosur bloc, India and Indonesia. It is also essential that the EU seeks to maintain maximum stability and predictability by leading a broad coalition that prepares the ground for World Trade Organization reform (García Bercero 2025).

Since WTO reform will take time, the EU should also seek ways to reinforce linkages between its bilateral trade agreements. This could be done, for example, through a common protocol on rules of origin, or closer cooperation with likeminded partners on supply chain resilience.

The EU could work with the members of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership as the starting point for such reinforced cooperation. To develop partnerships with third countries, inward-looking economic security policies should be avoided and support for rule-based trade must be maintained.

However, FTAs alone are unlikely to make a decisive contribution to the diversification of imports because WTO-mandated most-favoured nation tariffs for the areas in which the EU is highly dependent on China are often zero or very low[18].

Moreover, FTAs and the WTO often have limited disciplines on export restrictions, or on issues relating to the business environment. Clean Trade and Investment Partnerships (CITPs) such as that signed with South Africa in November 2025[19] could fill this gap. To be successful, such partnerships should bring together all the relevant tools available to the EU to prepare balanced packages that are attractive to developing partners, including:

1. Identification of projects for which EU companies are ready to invest in the green value chain, including financial de-risking tools;

2. Rules relating to the business environment that address the main obstacles to investment in the country concerned;

3. An offer to provide technical cooperation and regulatory dialogue to facilitate compliance with European Green Deal regulations. This could include cooperation on carbon pricing or on the development of national deforestation plans, for instance.

CTIPs could be negotiated as self-standing agreements or in the context of broader FTA or investment facilitation agreement negotiations. For CTIPs to be effective, it is critical to have sufficient EU-level funding to support both financial de-risking and technical-assistance activities. This could be done through an 'external partnerships' window in the new Competitiveness Fund.

3.4 Governance of economic security

The implementation of economic security strategies raises a governance challenge. At EU level, there is a need to coordinate deployment of the various economic security tools, for which different parts of the Commission are responsible, and to ensure a robust framework for sharing information and for the coordination of EU and member state instruments. At international level, the relationship between WTO rules and economic security measures, and whether a new institutional framework is needed to coordinate economic security policies, must be clarified.

The creation of the role of European commissioner responsible for economic security was an important step towards better coordination of the work being done in the Commission, both on risk assessment and on ensuring synergy and coherence in the deployment of the different economic security tools. This would imply a reinforcement of cooperation between the relevant Commission services, with a coordinating role for the trade directorate-general.

At the political level, the Commissioners' Project Group on Economic Security[20] could steer work on risk-mitigation strategies and arbitrate in case of potential conflicts between services.

The Commissioners' Project Group could perform two critical functions. It should agree on the prioritisation of economic security threats and should ask a lead service to coordinate the preparation of risk-mitigation strategies, based on contributions from all relevant services.

Prioritisation of threats should be based on a rigorous analysis of the risk of weaponisation of dependencies, and on the economically efficient means to mitigate such risks. In this context, the Commissioners' group could seek an economic analysis from the Commission's economic and financial affairs directorate-general.

Such risk-mitigation strategies should assess how all available tools that can contribute towards risk mitigation can be deployed coherently. These strategies should then be dis-cussed with member states to encourage consistency between EU and member state actions, and to provide a basis for a 'Team Europe'[21] approach to engage with third countries to develop de-risking partnerships.

At the working level, the Commissioners' group should regularly update risk assessments and review cooperation activities with third countries. There should also be opportunities to consult the private sector when developing sectoral de-risking strategies.

In this context there may also be a need to develop instruments to gather the information needed to underpin economic security. This may require working more closely with those member states and economic operators present in priority value chains, to identify vulnerabilities that need to be de-risked. This work would be particularly relevant to identify reverse dependencies.

It is critical to fully involve member states in the assessment of risks, the development of risk-mitigation strategies and in seeking coordinated responses in areas of national competence, particularly when there is external pressure

to align with the US. The Commission has already established an Economic Security Network to promote integrated advice from member states.

This should be reinforced (Steinberg and Wolff 2023; Letta 2024) through the establishment of a Council Working Group on Economic Security. The group should also evaluate policies relating to investments and export controls, on which most decisions are made at member state level. At the ministerial level, a Council meeting of ministers responsible for trade and industrial policies should be held once a year.

The WTO framework provides a basis for the development of economic security policies, even if there are gaps that should be clarified as part of a plan for WTO reform (Pinchis-Paulsen 2025; Pinchis-Paulsen *et al* 2024). The current rule book provides enough policy space for countries to adopt sanctions in the event of war or other emergencies, or to adopt measures to restrict investments or exports of dual-use technologies. WTO rules are, therefore, no obstacle for the use of traditional economic statecraft tools or sanctions in response to hard security threats.

The WTO rules on subsidies are also sufficiently flexible to accommodate policies that may need to be adopted for economic security purposes, though there may be a need to reinforce these rules to prevent their use to generate dependencies and to clarify when resilience criteria can be applied. In other words, economic security should not become a justification for adoption of WTO-incompatible measures.

The WTO does not at this stage provide a forum in which economic security policies can be discussed. There are also questions about whether the WTO dispute-settlement mechanism is the most appropriate tool to address conflicts arising from the implementation of economic security measures. The WTO framework could, however, be critical role in preventing tit-for-tat escalation by ensuring that any response to measures based on essential security concerns remains proportionate.

For instance, instead of reviewing the legal justification for export controls on dual-use technologies, an arbitration panel could establish the economic impact of the measures and review the proportionality of possible responses. All of these issues could be part of the discussion on WTO reform.

Beyond WTO, the G7 has been important for discussions on economic security. However, it is unlikely that the Trump administration would be ready to enter into a genuine process of consultation on economic security policies and measures. When the US might try to coerce other G7 members, it is difficult to see how meaningful any discussions in a G7 anti-coercion forum would be.

Nevertheless, there may be scope to cooperate on policies aiming at de-risking import dependencies in certain priority areas, such as critical raw materials.

In the absence of effective G7 cooperation, the EU could seek to reinforce bilateral dialogues on economic security issues with likeminded partners, notably the UK, Japan, Canada, Australia and South Korea. This could provide the basis for an informal group to coordinate policies on the de-risking of critical value chains and on responses to coercion.

4 Recommendations and conclusions

Our main policy recommendations arising from the analysis in section 3 are:

- New economic security risk assessments should be started to evaluate risks associated with EU dependencies on digital and financial infrastructure;

- The Commission should accelerate work on the identification of supply-chain choke-points, based on reverse dependencies;

- Medium-term risk-mitigation strategies need to be developed for priority economic security risks, particularly related to dependencies on critical raw materials and digital and financial infrastructures;

- The Anti-Coercion Instrument should be made ready for deployment in case threats related to digital regulation or export controls on critical raw materials are used as a coercive instrument;

- The Commission should propose reinforced coordination on export controls, and the investment screening regulation should be reinforced based on the Commission proposal;

- Any proposal to use industrial policy for economic security reasons should be preceded by a robust assessment of the economic security risks and an economic analysis that establishes the proper balance between industrial policies and foreign economic policies;

- Measures inconsistent with the EU's international commitments should be avoided;

- The EU should include cooperation on economic security in its international trade and investment agreements, and should develop clean trade and investment partnerships as an instrument to support diversification of green value chains;

- A new Council Working Group should be established to discuss priority risk-mitigation strategies and to attend, at least once a year, a ministerial-level discussion on the implementation of the economic security strategy;

- At the international level, the EU should include discussions on economic security in its strategy on WTO reform, while coordinating policies with an informal group of like-mind-ed countries and negotiating a

supply-chain resilience agreement with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

The current geopolitical context implies that the EU needs to de-risk its relationships with China and the US, while facing a major hard security threat from Russia. This challenging environment makes it essential for the EU to develop broad alliances with countries that wish to maintain rules-based cooperation. The EU will need to stay decoupled from Russia economy for as long as it represents a threat.

The objective with China and the US should be to reduce dependencies while maintaining a maximum of mutually beneficial economic engagement. The extensive nature of dependencies implies the need for medium-term de-risking strategies, combined cooperation. However, the EU must also be ready to respond to threats of coercion.

Most economic security measures are preventive: an insurance policy to limit the risk of geopolitical tensions harming economic interests. In most instances economic security is not about responding to hard security threats, so it is essential to have institutional mechanisms that allow for the evaluation of trade-offs.

In particular, trade-restrictive economic security measures need to be balanced against the economic benefits of openness, or of achieving other essential EU objectives, such as the net zero transition. Whenever possible, win-win policies, including reinforcement of the single market, support for R&D, free trade agreements and support for green investment in developing countries, should be preferred over measures that restrict trade. ■

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Endnotes

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2. European Commission, 'The EU-US trade deal: Restoring stability and predictability', undated. Despite the EU-US trade deal, there have been US threats of tariffs as a response to EU digital regulation (see section 2.4).

3. Other economies have also introduced policies and strategies aimed at bolstering their version of economic security. See Chimits et al (2024) for an overview of different countries' measures.

4. Mission Letter from Ursula von der Leyen to Commissioner-designate for Trade and Economic Security Maroš Šefčovič, 17 September 2024.

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SCAN TO DOWNLOAD

Securing strategic autonomy

Europe's lack of defence capabilities leaves it vulnerable to economic and foreign policy pressure. Philipp Hildebrand, Hélène Rey and Moritz Schularick outline key principles for establishing a European Future of Defence Architecture and a framework for its financing

Europe must urgently strengthen its defence capabilities to secure strategic autonomy. The absence of such capacity leaves the continent vulnerable to economic and foreign policy pressure, threatening the survival of the EU and its core values. Europe must also address the overwhelming dominance of US capital markets.

This column outlines key principles for establishing a European Future of Defence Architecture and the common framework for its financing. Such a framework would support the development of a safe and liquid European securities market at a propitious moment, as global investors are actively seeking alternatives to the dollar. It would address a critical and urgent collective security need. It would establish the governance and foundations necessary for the emergence of a European safe asset, which is a critical step forward for the integration of European financial markets.

By Europe, we refer to a coalition of willing EU countries – the 'European Team' – prepared to move quickly, as time is short.

European Future of Defence Architecture

This column does not address traditional expenditures such as personnel, munitions, and tanks. Instead, it focuses on the development of European strategic autonomy in next-generation military technologies such as a European sky shield, hypersonic weapons, strategic enablers such as the cloud, AI infrastructure, advanced software, quantum computing, cyber capabilities, satellite constellations, drones, robotics, and critical-mineral processing technologies.

Security needs and these technologies have a distinctly European dimension. These technologies cannot be deployed efficiently at the national level. Today, fragmented defence spending has produced duplication, inefficiency, and lack of scale. Europe lags in essential fields[1]. To reverse this, the European Team must:

- Pool resources and engage in joint, predictable procurement over extended periods.
- Ensure some competition among the European Team firms for long-term contracts.
- Rely on long-term commitments to build industrial capacity and foster innovation.

The urgency cannot be overstated. Russian aggression, shifting US commitments, and global competition over trade, technology, critical minerals, talent, and intellectual property create a narrow window of political alignment. Europe must seize this opportunity to safeguard its autonomy and to finally develop and integrate its financial markets

Many of these technologies will be dual-use, contributing to both security and long-term productivity growth. Their relative novelty limits the entrenched influence of national champions and lobbies, giving policymakers an opportunity to pursue joint procurement without legacy obstacles. Digital technologies and satellites are prime examples of dual-use technologies, of transcending national borders, and of being crucial for our defence.

Governance of the European Future of Defence Architecture

Article 346 TFEU exempts the defence industry from standard EU Single Market provisions, including non-discrimination in procurement. Hence an intergovernmental treaty among European Team countries is necessary. The intergovernmental treaty should allow the coalition of countries to deliver on their future of defence goals quickly. For this a special attention to the robustness of the decision-making process and its rules will be called for.

Steering Committee of Defence and Technology Experts

This body, transcending national borders, should define forward-looking priorities, allocate resources within a multi-year budget, plan investments, and ensure quality control, scale, and interoperability.

- For its innovation mandate, the committee could draw on the DARPA[2] model of governance.
- The overall multi-year budget should be determined by European Team representatives, taking NATO commitments and other national defence needs into account.
- A Team Europe Military Purchase mechanism should be put in place (similar to US Foreign Military Sales) in order to simplify defence purchases by all European countries and allies (scope to be defined by the steering committee).

Financing

The European Defence Architecture is a joint investment and requires joint financing. Because of past underinvestment in European defence, defence spending needs to be front-loaded to catch up and therefore debt financing in the short run is needed. Individual countries cannot shoulder, nor perform efficiently, the necessary catch up in future of defence technologies, which have a European dimension.
Alongside the Defence and Technology Committee, a Steering Committee for Financing Future Defence should be created. The two steering committees should work in close cooperation.

Mandate of the Financing Committee

- Issue joint European Future of Defence Bonds to minimise financing costs (joint and several liabilities).
- Achieve sovereign status for these bonds[3].
- Ensure eligibility for ECB refinancing operations.

Such a mandate would help accelerate the development of deeper, more liquid capital markets to compete with the growing dominance of the US capital market since the Global Financial Crisis.

Achieving sovereign status likely requires:

1. A predictable issuance calendar enabled by the recurring nature of defence financing.
2. Revenue streams attached to the bonds

3. Minimum issuance scale or predictable growth over time.

4. Transparency and credibility of the European Team's commitments.

Repayment shares using national revenues or the use of common tax resources should be decided by European Team representatives.

Sketch of a possible future of defence spending profile for a catch up

- Spending of 1% of GDP per year for the next ten years, going down to a steady 0.5% thereafter.

- Future of Defence issues 1% of GDP with ten-year maturity, each year for ten years and rolls over the new debt so there are no payments (on principal or interest) for the first ten years.

- The outstanding debt in 2035 would represent about 10% of GDP (at 3% annual interest rate). From 2035 on, the debt would be stabilised with member country fiscal resources. About 1% of GDP would be rolled over every year with member countries fiscal resources covering the interest costs (net of growth) and the flow of 0.5% of current future of defence expenditures.

- After 2035, the contribution of member country fiscal resources would be about 0.6% of GDP for a steady permanent defence spending of 0.5% of GDP and payment of interest to stabilise the debt-to-GDP ratio.

- With a GDP of €15.9 trillion in 2024 (team made of France, Germany, Italy, Spain, the Netherlands, Belgium, Luxemburg, Poland, Ireland, Sweden, Denmark, Finland, Greece, Estonia, Lithuania, Latvia), nominal growth of about 2%, cumulative spending would be about €1.8 trillion for ten years (2026-2035) for the catch-up phase[4].

- If the team consisted of the entire EU, with a GDP of about €17.9 trillion in 2024, nominal growth of about 2%, this gives a cumulative spending of about €2 trillion for ten years (2026-2035) for the catch-up phase.

- Fiscal resources after ten years – for example, VAT receipts of each country could be allocated.

This defence spending profile can be scaled up or down depending on the identified military needs put forward by the Steering Committee of Defence and Technology Experts.

For example, for the team made of France, Germany, Italy, Spain, the Netherlands, Belgium, Luxemburg, Poland, Ireland, Sweden, Denmark, Finland, Greece, and the Baltic countries, a catching up phase spending of 0.5% of GDP per year for the next ten years would lead to cumulated spending of about €900 billion and a debt-to-GDP ratio of about 5% in 2035.

Governance of Future of Defence Bonds

We focus on one possible implementation, but there are several. For concreteness, we take an example where the Financing Committee could be housed within the European Stability Mechanism (ESM). Other possibilities include the European Investment Bank (EIB) or a new agency. If the ESM were used, one would need to create two distinct pillars:

- Pillar I: Current 'European Monetary Fund' functions (crisis management function)

- Pillar II: Financing functions for the European Defence Architecture (common investment function)

Advantages of using the ESM:

- Established via intergovernmental treaty.
- Experienced in bond issuance and well capitalised.
- Crucially, ESM debt is off member-state balance sheets – a key advantage given fiscal constraints and NATO commitments.

The ESM treaty (not yet ratified) should be amended to:

- Authorise lending not only to member states but also to agencies (eg. the Future of European Defence Agency).
- Reflect the creation of the second financing pillar of a very different nature from the first pillar. The second pillar is there to fund a common investment of Team Europe.
- Authorise some non-euro area and some non-EU members to be part of pillar II of the ESM.

One potential disadvantage of using the ESM for this initiative is the fact that the ESM was explicitly designed as a crisis mechanism for the euro area and not a general financing vehicle. For that reason, the creation of a new financing agency could instead be considered.

Composition of the European Team

- The European Team should begin with a subset of EU countries willing to move quickly, prioritising governance quality over size. It would be highly desirable to quickly associate non-EU countries such as Norway, the UK, Switzerland, and Ukraine.

- Once established, the framework should remain open to other volunteer countries.

This inclusiveness should be considered when revising the ESM treaty and building the legal framework or when setting up a new dedicated financing and issuing agency.

Why this approach would work

- Urgency: the geopolitical situation is recognised as critical across European capitals.

- European dimension: defence needs and technologies naturally transcend borders.

- Financing credibility: purpose-driven, efficient joint issuance contrasts with earlier Eurobond proposals.

- Market timing: global investors seek safe alternatives to dollar assets.

- Fiscal flexibility: enables member states to meet NATO commitments despite fiscal constraints.

- Economy: dual-use contributes to both security and long-term productivity growth. Proper governance of a common investment and joint financing helps build up the savings investment union and a European safe asset.

- Institutional blueprints: building on a NATO European branch/DARPA/ESM can help speed up the implementation.

- Historical context: allows Germany to channel large defence commitments into joint European projects, which is a plus given Europe's history.

Time horizon

- Treaty amendments and ratifications: approximately one year.

- Establishment of steering committees: similar timeframe.

- Strategy: begin rapidly with a small group and limited projects, ensuring sound governance, then scale up.

The urgency cannot be overstated. Russian aggression, shifting US commitments, and global competition over trade, technology, critical minerals, talent, and intellectual property create a narrow window of political alignment. Europe must seize this opportunity to safeguard its autonomy and to finally develop and integrate its financial markets. ■

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Endnotes

1. The current initiatives such as the 2023 EDIRPA (€300 million) to subsidise common procurement or the €150 bn loans to EU member states by SAFE (Security Action for Europe) are important and are complementary to this European defence architecture. They are key to address some of the current issues linked to the Ukraine war. But they are too small and insufficiently forward looking to provide incentives for innovation and industrial capacity building for the Future of Defence described in this column.

2. On the innovation side, DARPA is characterised by an agile governance structure – with experts in the relevant technological fields – to allocate funds to multiple research teams pursuing specific objectives, with clearly defined milestones evaluated before further disbursements are made. What characterizes DARPA is precisely this ability to set clear goals, provide incentives and resources, and ensure that those goals are achieved as quickly as possible.

3. The failure to obtain full sovereign status in the past meant that jointly issued debt by European countries or the European Commission has not been included in indices, therefore has more limited demand and less attractive financing terms. The goal of the Steering committee should be to issue Future of Defence bonds at close to zero spread compared to the best euro area bond market performers. Because of the sound institutional set up, Future of Defence bonds should benefit from a convenience yield within a short time horizon, which would decrease the spread of the Future of Defence bonds. Pure defence bonds might exclude some investors due to their investment policies, but that we do not believe this is a significant constraint.

4. If catch up spending of 2% of EU GDP was made during a five-year period (2026-2030) with stabilisation and steady spending afterwards, debt would be stable at 10% of GDP after 2030. Cumulative spending would be €1.9 trillion (2026-2030) for the EU.

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From resilience to strength

The EU must speed up its integration and overhaul a model of export-led growth that has faltered amid mounting geopolitical turmoil. Christine Lagarde warns that the EU is increasingly vulnerable to shocks and is lagging behind in areas that will drive growth such as AI

I would like to start with a quote:

> *"The world around us does not stand still.*
>
> *In recent years, the global environment has been transformed in ways that none of us could have imagined. We have seen the post-war global order fracturing, the rise of new – and some old – powers, rapid changes in technology, and an uncertain outlook for global trade and finance.*
>
> *Uncertainty abounds and conventional wisdom is being challenged, in politics, in diplomacy and in economics. And, unavoidably, this calls on Europe to consider its place in the world and reset its ambitions."*

This may sound like the kind of passage you have heard in many speeches this year. But, in fact, it is from the first speech I gave as ECB President –in November 2019[1].

In that speech, I urged Europe to recognise that its old growth model – built on export-led growth – was coming under strain. And I called for a shift: to focus instead on developing our domestic economy as a source of resilience in an uncertain world. My point was not to argue for protectionism or inward-looking policies.

It was about realism: recognising the world as it is. And it was about acknowledging that the solution was already in front of us: the untapped potential of our own internal market. Six years on, that diagnosis has only become clearer and stronger.

Europe has become more vulnerable, also due to our dependency on third countries for our security and the supply of critical raw materials. Global shocks have intensified, with rising US tariffs, Russia's invasion of Ukraine and stiffening competition from China.

At the same time, our internal market has stood still, especially in the areas that will shape future growth, like digital technology and artificial intelligence, as well as the areas that will finance it, such as capital markets. And yet – as Galileo famously said – *"it moves."* Europe continues to show resilience, revealing sources of strength that could grow if only we allow them to.

So the question I would like to address today is: how do we move from being resilient but vulnerable to being genuinely strong? And what will it take to do so?

Europe's vulnerabilities stem from having a growth model geared towards a world that is gradually disappearing

Vulnerabilities in Europe's growth model

Europe's vulnerabilities stem from having a growth model geared towards a world that is gradually disappearing. We embraced globalisation more than any other advanced economy. In the two decades before the pandemic, external trade as a share of GDP almost doubled in the EU, while in the United States it barely moved[2].

This deep integration brought significant benefits: the number of jobs supported by EU exports[3] rose by 75%, reaching almost 40 million[4] – and for many years, this was a source of resilience. But today, that same openness has become a vulnerability. Exports have become a far less reliable engine of growth, reflecting the changing global landscape.

In mid-2023, for instance, ECB staff expected exports to grow by around 8% by mid-2025. In reality, they have not grown at all. And looking ahead, exports are projected to subtract from growth over the next two years[5]. This has been felt most acutely in countries with large manufacturing sectors, which have faced a prolonged slump in industrial production.

As a result, growth across the euro area has become more uneven. At the same time, this export-led growth model has resulted in a persistent current account surplus, increasing our reliance on other countries to generate our wealth – especially the United States.

Euro area residents now hold nearly 10% of their total equity investments in US stocks, totalling €6.5 trillion – about two times the amount they held at the end of 2015[6]. This has been a rational response: US markets have delivered returns roughly five times higher than Europe's since 2000. But it has created a vicious circle.

As US markets channel European savings into high-productivity sectors, the performance gap between our economies widens – prompting yet more European savings to flow across the Atlantic. The result is stagnating productivity at home and growing dependence on others.

Finally, we now face a new form of vulnerability shared by all major economies: the weaponisation of dependencies on key raw materials and technologies. ECB analysis shows that more than 80% of large euro area firms are no more than three intermediaries away from a Chinese rare earth supplier[7].

Recent supply shocks – for example, the shortage of automotive chips – have shown how a single chokepoint can stall entire sectors. These vulnerabilities do not trigger dramatic crises. Instead, they erode growth quietly, as each new shock nudges us onto a slightly lower trajectory. Over time, the cumulative effect of this 'lost growth' and lost productivity becomes material.

In mid-2023, ECB staff projected that the economy would expand by 3.6% cumulatively by mid-2025. In reality, it has grown by only 2.3% – a shortfall equivalent to an entire year of growth in normal times, and productivity has turned out worse.

Sources of resilience in the domestic economy

Yet even as this changing world has exposed our vulnerabilities, 2025 has revealed Europe's latent strengths. Our experience this year has shown that a resilient domestic economy can shield Europe against global turbulence.

Three sources of domestic strength have helped cushion the impact of global shocks – our *people*, our *potential* and our *policy*.

First, our people. We have benefited from an unusually strong labour market – one that has remained remarkably resilient even as growth has slowed. Typically, employment tends to grow at roughly half the pace of real GDP. Yet since the end of the pandemic, that relationship has been almost one-to-one in Europe[8].

This strength has created a virtuous circle: rising employment has supported consumption, which in turn has sustained services output and created still more jobs – particularly in labour-intensive sectors[9].

Second, our potential. Despite the notion that Europe is lagging behind in AI, European firms are moving quickly through the digital transition – and that is making investment more resilient to global uncertainty.

While tangible investment has fallen in the past two years as manufacturing has weakened, intangible investment has risen sharply[10], keeping overall business investment broadly stable. Firms continue to invest in AI and digital infrastructure because, for any company that wants to stay competitive, these are no longer optional.

Third, our policy. Fiscal policy, in particular, has acted countercyclically, buffering the economy rather than amplifying downturns, as we saw after the financial crisis.

The fiscal packages now being implemented for defence and infrastructure – especially here in Germany – are coming at the right time for Europe and will have a measurable effect on growth.

ECB staff estimate that higher government investment between now and 2027 will offset around one-third of the trade shock[11].The ECB is also playing its part by delivering price stability. We have cut interest rates by 200 basis points from their peak, and this is increasingly feeding through into easier financing conditions, which is helpful to support demand. We will continue to adjust our policy as needed to ensure that inflation remains at our target.

Together, these three sources of resilience will help anchor growth at home. Domestic demand is set to become the main engine of expansion in the years ahead[12]. And this shift should also help narrow Europe's current account surplus, which has already halved since its peak in 2018[13].

The potential of the domestic market

This experience underlines the power of a resilient domestic economy, strengthened by open strategic autonomy. But it also exposes how much potential Europe continues to leave untapped.

Today, despite more than 30 years of the Single Market, trade barriers within the EU remain too high in key areas. ECB analysis finds that internal barriers in services and goods markets are equivalent to tariffs of around 100% and 65%, respectively[14].

Of course, we should not expect these barriers to disappear altogether: not all products are equally tradeable, and national preferences will always play a role. Policy can reduce certain frictions, but it cannot eliminate them entirely[15].

But we should expect two things. First, that barriers are low enough for the sectors that will shape future growth to operate in a truly European market. This is clearly not the case for digital services, which will drive future innovation, and capital markets, which must finance it.

Second, we should expect that being inside the Single Market offers a clear advantage over being outside it – in other words, that internal barriers are lower than external ones.

But this is also not currently the case for services: over the past 20 years, barriers to crossborder trade within Europe have been declining no faster than those faced by international firms seeking to operate here.

This helps explain why, even though services now account for three-quarters of Europe's economy, trade in services within the EU makes up only about one-sixth of GDP – roughly the same as our trade in services with the rest of the world.

This is a vast waste of potential – especially at a time when we must rely more on ourselves than on others. And the key point is that *achieving these gains would not require radical change*.

Our analysis shows that if all EU countries were merely to lower their barriers to the same level as that of the Netherlands, internal barriers could fall by about 8 percentage points for goods and 9 percentage points for services[16]. If we only did a quarter of that, it would be sufficient to boost internal trade enough to fully offset the impact of US tariffs on growth[17]. So the question we must now ask is: why are we not taking these steps?

Towards a new governance

The answer comes down to governance. Fully harmonising all national laws and regulations is not realistic, nor is it always even necessary. But we lack effective tools to overcome barriers in the areas where progress matters most.

I believe that three steps can help us move forward. The first is to revive the principle of mutual recognition – the very engine of liberalisation that powered the Single Market in the 1980s.

Mutual recognition means that if a good or service is lawfully provided in one member state, it should be allowed to circulate freely across the EU without the need to comply with every other country's rules. For example, in the EU there is a system of automatic recognition of professional qualifications for a number of sectoral professions.

Such mutual recognition is also visible in financial services. Today, banks benefit from a passporting system: a single licence granted by the ECB enables them to provide services across Europe. But they still face different rules in foundational elements of the framework they operate in. Completing the banking union and deepening our capital markets would therefore be transformative, accelerating our path towards a truly integrated home market.

The same logic applies to the digital economy. Just as passporting embodies mutual recognition in banking, the mutual recognition of digital identities, trust services and other credentials would dramatically improve interoperability and eliminate hidden costs that are slowing the growth of Europe's digital markets.

The second step is to streamline decision-making – by extending qualified majority voting to the areas on which Europe's future growth depends. While qualified majority voting has been instrumental in driving integration, it has now largely reached its limits. In several critical fields, the continued requirement for unanimity in the European Council still prevents meaningful progress towards completing the Single Market.

Taxation is the clearest example. Reforms such as harmonising VAT rules or establishing a common consolidated corporate tax base remain stuck because of national vetoes, leaving firms to navigate a maze of fragmented tax regimes.

This fragmentation is especially damaging in a world of digital business models and intangible assets, where tax policy cannot be managed within national borders alone. For example, a digital platform providing cloud or

software services across Europe must currently comply with 27 different VAT systems, each with its own definition of where value is created for tax purposes.

This complexity tilts the playing field towards large US firms that can absorb the associated costs – exactly the opposite of what Europe needs if it wants to nurture its own digital champions.

Moving to qualified majority voting, using the passerelle clause where necessary – which allows the European Council to shift specific areas from unanimity to majority voting without changing the Treaties – could help break this deadlock.

The third step is to take a more radical approach to simplification – and I do not mean simply trimming regulations through the Omnibus packages. The fastest way to achieve genuine simplification is not by repealing existing rules, but by creating new '28th regimes' – optional EU legal frameworks that sit alongside national law rather than replacing it.

These frameworks would allow firms to opt into a single European rulebook in specific areas, without requiring full harmonisation across all member states. A prime candidate is company law[18], as proposed in the Letta and Draghi reports.

A European company law regime would provide firms – in particular start-ups and scale-ups – with a simpler path to operate across borders, cutting through the complexity of 27 different national systems.

This approach has worked before. The EU Trademark (1993) and Community Design (2001) were both 28th regimes, offering optional EU-wide intellectual property titles alongside national rights. And both have been widely adopted, especially by firms active across multiple markets.

Their success shows how an optional EU framework can reduce fragmentation and even generate healthy 'systems competition': when firms choose the EU rules, national systems are put under pressure to adapt.

The European Commission is planning to present a 28th regime proposal as part of its renewed and welcome ambition to set clear deadlines for removing barriers identified in the 'Single Market Roadmap to 2028'. But progress will depend on political will.

The first step may be modest – such as creating a digital business identity, giving firms a single trusted profile to register and operate online across the EU – but it could set a powerful precedent for broader reforms to follow.

If we get this right, firms that could grow based on genuinely European regimes would also be best placed to access pan-European financing, helping to channel our vast savings into productive investment.

Completing the Single Market – in the real economy and in finance – is therefore a mutually reinforcing project, strengthening Europe's competitiveness and its capacity to invest in the future.

Conclusion

The world will not slow down for Europe – but we can decide how we move forward. If we make our Single Market truly single, Europe's growth will no longer depend on the decisions of others, but on our own choices. This was my message six years ago. Today, that message has only grown more urgent.

Another six years of inaction – and lost growth – would not just be disappointing. It would be irresponsible. But the experience of this year should also give us confidence. It has shown that our economy has real sources of strength – and that, if we act, those strengths can be multiplied.

The steps we need to take are not beyond our reach. They require no new treaties, no radical rewiring of our Union – only the political will to use the tools we already have. If we can summon that will, Europe can move from being merely resilient to being genuinely strong. ■

Christine Lagarde is President of the European Central Bank

Endnotes

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15. Head, K and Mayer, T (2025), "No, the EU does not impose a 45% tariff on itself", VoxEU column, Centre for Economic Policy Research, 13 November.
16. Bernasconi, R et al (2025), op. cit.
17. According to ECB simulations, this reduction in barriers would raise trade within the EU by around 3%, offsetting the 0.7 percentage point reduction in GDP growth between 2025 and 2027 caused by US tariffs and the related uncertainty.
18. So far, most legal reforms aimed at improving the business environment have relied on soft coordination, voluntary standards or limited harmonisation directives. This approach reflects national sensitivities in certain areas (eg. company law, tax law and labour law) that remain primarily a member state competence. However, previous attempts at soft convergence have only led to modest results.

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The EU should moderate its steel protection plan

There is a steel overcapacity problem. Ignacio García Bercero considers a European Commission proposal for a tight quota and high steel tariffs that risks undermining perceptions of the European Union as a reliable trading partner

On 7 October, the European Commission proposed a 50% tariff on steel imports into the European Union that exceed a certain quota, while cutting the duty-free quota by 47%. The tariff would replace a 'steel safeguard', which was introduced in 2018 and will expire in mid-2026.

The safeguard was a response to the diversion of steel into the EU market because of global incapacity and the introduction by the first Trump administration of a 25% steel tariff. Under the safeguard, the EU sets a quota on steel and levies a tariff of 25% for imports that exceed it. The new proposal would thus significantly increase tariffs and cut back the overall level of imports.

Safeguard measures under World Trade Organization rules are allowed in order to remedy serious injury and facilitate adjustment. There may well be a case for avoiding disruption in steel markets once safeguards expire, but it is questionable whether this justifies substantially increasing the level of protection, or whether high tariffs on all steel imports (regardless of carbon content) are consistent with the objective of promoting the sector's decarbonisation.

Furthermore, increased tariffs might undermine the competitiveness of downstream industries or prompt a broader increase in tariff protection in the EU and elsewhere.

The steel overcapacity problem continues to exist and the Trump administration has now increased the level of protection for the American steel sector by eliminating quotas and product exclusions, increasing US steel tariffs to 50% and applying increased tariffs to products with significant steel content. Canada and Mexico have already responded, introducing tariffs that to a certain extent mirror the US levies.

To ensure consistency with the WTO, the Commission says the EU can rely on Article XXVIII of the General Agreement on Tariffs and Trade (GATT). This allows for an increase in tariffs provided that the balance of mutually advantageous concessions is maintained. Its application is legitimate under the WTO framework, which recognises that as circumstances change, tariff concessions may need to be adapted.

However, the application by the EU of high tariffs to all steel imports, and the intention to cut quotas, suggest that compensation claims will be substantial and negotiations difficult.

At a time when the EU needs to be seen as a reliable trading partner, a decision to ignore its FTA commitments should not be taken lightly

A particularly problematic aspect of the Commission plan is that the new tariffs would apply to countries that have free trade agreements with the EU. GATT Article XXVIII only relates to increases in general tariff rates and provides no justification for departing from duty-elimination commitments under FTAs.

While FTAs include bilateral safeguard provisions, these would not justify automatic application of a quota after the expiry of the WTO safeguard. The Commission proposal therefore implies a breach of all the FTAs the EU has with third-country steel suppliers, and a major obstacle to concluding negotiations with steel exporters such as India.

At a time when the EU needs to be seen as a reliable trading partner, a decision to ignore its FTA commitments should not be taken lightly. This goes to the core of the EU's role in the global trading system and its interest in ensuring that the rule of law is respected.

After all, if the EU ignores its international commitments in a critical sector, what would prevent the EU's FTA partners from increasing tariffs on any sector they consider sensitive? Since many developing countries have high tariff bindings, or agreed ceilings that tariffs will not exceed, they could increase tariffs on EU exports without even following an Article XXVIII procedure. But more fundamentally, what makes Europe an attractive partner is its readiness to play by the rules.

The objective of reducing duty-free steel imports by 47% cannot be reconciled with the objectives of avoiding major compensation claims in WTO negotiations and of respecting FTA commitments. Nor is it necessary to prevent market disruption once the safeguard is lifted.

A more reasonable objective would be to maintain import penetration at the 2024 level, and to justify this as a modification of the tariff binding, so that negotiations can continue between major steel suppliers to reduce overcapacity in a manner consistent with decarbonisation objectives.

The increased tariffs should not apply to low-carbon steel or steel inputs that contribute towards decarbonisation (eg. green iron ore). A further review of the bindings could take place after three years in order to review progress on the elimination of overcapacity.

This approach could be reconciled with safeguard provisions in FTAs and would have the added advantage of relaunching plurilateral negotiations on steel that should cover both capacity reduction and decarbonisation objectives. ■

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This article is based on a Bruegel First Glance.

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An EU reparations loan is the right way to help Ukraine

There will be a post-war reconstruction of Ukraine. Charles Lichfield and Nicolas Véron examine how European Union countries should agree to back a clever financing workaround that would leave Russia's assets untouched but leverage them to support Ukraine

Can the full amount of immobilised Russian sovereign assets be offered to Ukraine, without confiscating the money outright? EU finance ministers discussed the issue on 10 October, with Stephanie Lose, economic affairs minister of Denmark, which currently chairs EU ministerial meetings, saying *"not finding new financing for Ukraine is definitely not an option,"* and that EU countries would continue work on a European Commission plan for a loan to Ukraine based on the Russian assets.

That plan has not been made public but was previewed by European Commission President Ursula von der Leyen a month ago: *"With the cash balances associated to these Russian assets, we can provide Ukraine with a reparations loan. The assets themselves will not be touched. And the risk will have to be carried collectively. Ukraine will only pay back the loan once Russia pays for the reparations."*

Our interpretation of how the plan might work is based on media reporting and conversations with participants. When Russia invaded Ukraine in February 2022, its central bank held securities at Euroclear Bank, the leading international central securities depository, based in Brussels. These were quickly immobilised by sanctions and have mostly come to maturity since then.

Consequently, the Bank of Russia has accumulated deposits at Euroclear Bank, denominated in over ten currencies and estimated at around €180 billion. It cannot move this cash and is not entitled to interest on it, given Euroclear Bank's contractual terms.

For two years after the invasion, Euroclear earned interest income on the trapped Russian cash, with one quarter going to the Belgian state as corporate income tax. Since early 2024, the EU has confiscated nearly all Euroclear's associated after-tax income.

In December 2024, this stream became the basis of the Extraordinary Revenue Acceleration (ERA) loans to Ukraine, totalling $50 billion, raised by the EU with the United States, United Kingdom, Japan and Canada. If the Commission's reparations loan mechanism is implemented, the EU is expected to repay all ERA lenders, including itself.

When Russia invaded Ukraine in February 2022, its central bank held securities at Euroclear Bank, the leading international central securities depository, based in Brussels. These were quickly immobilised by sanctions and have mostly come to maturity since then

The reparations loan – also supported by German Chancellor Friedrich Merz – would involve Euroclear lending an equivalent amount to the immobilised assets, say €180 billion (in the same currencies), to a European entity. This may be the EU itself or an ad-hoc special-purpose vehicle – we refer to it as 'Europe'.

The zero-interest loan would not cost to Euroclear since it no longer gains interest income on the cash. Europe would reimburse the ERA loans and lend the rest – about €135 billion – to Ukraine.

If Russia eventually pays reparations, Europe will use these to reimburse Euroclear. Because this is uncertain, Euroclear's loan would be backed by guarantees from participating member states, ideally all EU countries.

That would represent a significant, albeit contingent, new commitment but is worth the effort. If Ukraine loses the war, the subsequent financial costs – and other tragic consequences – are likely to be far greater for Europe.

State guarantees for the loan would probably require approval from national parliaments. Euroclear would also need assurance that the block on Russia's cash will remain for the duration of its loan to Europe, because otherwise it would be at risk of having to borrow the difference at a loss.

EU leaders have already said Russian assets should stay immobilised until reparations are paid, but putting this reassurance into law would allow the EU to escape the need to renew the immobilisation every six months – a process that requires unanimity.

How the EU will get there is not yet entirely clear, but we assume the willing capitals will find a solution. EU leaders will further discuss the reparations loan at a summit on 23-24 October.

In our understanding, Euroclear will be reimbursed even if future diplomacy results in a settlement in which Russia does not pay reparations. But the loan mechanism would be a powerful incentive to European countries to insist that Russia must pay reparations, and to use their leverage accordingly. This may be why the reparations loan idea has been met with furious pushback from Russian propagandists.

Meanwhile, by guaranteeing the integrity of international reserves held in Europe and of Euroclear as a securities depository, the scheme would avoid undermining the international monetary order. It achieves the best possible balance between the many parameters that have shaped the debate on Russia's immobilised reserves.

If this ingenious scheme fails, there will be alternatives for EU provision of support to Ukraine, but they will be less good. All Europeans should thus support a well-designed reparations loan. ■

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This article is based on a Bruegel First Glance.

The EU's digital deregulation push

The European Commission is seeking to reduce the burden of its digital rulebook. Mario Mariniello discusses a new framework and shows how EU digital reforms must balance efficiency with transparent recognition of distributive consequences

Executive summary

To boost the European Union's digital economy, the European Commission is seeking to reduce the burden of its digital rulebook. However, the Commission's deregulatory strategy lacks a rigorous, evidence-based analysis of the expected effects entailed by proposed burden reductions, is insufficiently transparent and accountable in relation to potential distributive trade-offs and is overly focused on a narrow geopolitical goal of 'catching up' with the United States, which may neglect Europe's distinct social and institutional priorities.

This paper introduces a framework to analyse these issues. It distinguishes between efficiency effects that enhance total societal value, and distributive effects which determine how value is shared within society. The framework explains how total factor productivity (a proxy for competitiveness) may have a complementary and a substitutive relationship with digital regulatory protection.

The Commission's deregulatory initiatives may entail both efficiency and distributive effects, but that the Commission typically only acknowledges the former. This misrepresentation leads to unrealistic goals, such as EU companies matching the same level of data use as US companies without compromising European privacy standards.

Digital regulation can be designed to generate value and can distribute that value in accordance with the goals the Commission intends to pursue. A distinction should be introduced between 'mitigating' distributive effects, in which the proposed initiatives shift the distribution of value among players without fundamentally altering business models, and 'steering' distributive effects, in which proposed initiatives may encourage the development of alternative approaches to technological development.

In pursuing a deregulatory strategy, the Commission should be more transparent about its aims. The Commission should ground reforms in robust impact analysis, without a preconceived goal in terms of the desired amount of reduction in regulatory burden. It should also clearly identify the end goals while detailing potential trade-offs between them, and adopt measurable indicators for efficiency, mitigating distributive effects and steering distributive effects, in order to assess the potential effectiveness of its initiatives and to understand their actual impacts.

The entire EU digital deregulatory strategy hinges on a presumed goal of 'catching up' with the US

1 Introduction: The European Commission's deregulatory strategy

On a number of indicators, European Union technological markets are trailing the United States, particularly in the development of artificial intelligence. In 2024, for example, only four of the world's top 50 technological companies were European.

Also in 2024, European AI startups raised $12.8 billion, compared to $80.8 billion raised by their US-based counterparts[1]. The US ranks first in 'Global AI Vibrancy', a composite index developed by the Stanford Institute for Human-Centred AI (SIHC)[2]. The top EU country according to this index, France, ranks sixth, scoring 22.5 compared to the US's 70.

The EU's lagging performance is seen as worrying because thriving technological markets are considered crucial for future prosperity. Digital technologies play an infrastructural role and increasingly support the production and delivery of public goods, including public services, education, environmental policies and military security (McMillan and Varga 2022). They can significantly boost productivity (Brynjolfsson *et al* 2025). When used effectively, they may foster inclusivity (UNCTAD 2019).

The EU's priorities for the digital economy have typically been framed in regulatory terms. The EU has come to be perceived as a 'referee' of digital markets, rather than a successful, active player[3]. A substantial number of EU regulations directly applicable to digital markets have been introduced.

Among the most important are the General Data Protection Regulation (GDPR, Regulation (EU) 2016/679), the Digital Markets Act (DMA, Regulation (EU) 2022/1925), the Digital Services Act (Regulation (EU) 2022/2065), the Data Act (Regulation (EU) 2023/2854) and the Artificial Intelligence Act (AI Act, Regulation (EU) 2024/1689) but the overall list is much longer (Bruegel Dataset 2023).

The EU digital rulebook is consistent with a traditionally risk-averse regulatory approach enshrined in the EU Treaty[4]. EU digital laws are based on a precautionary approach, imposing limitations on companies ex ante, protecting public interests and preventing possible irreversible harm before it emerges (Draghi 2024). By contrast, in other jurisdictions – most notably the US – regulators tend to intervene only after evidence of harm emerges: a regulatory approach generally considered more innovation-friendly, as companies face fewer regulatory hurdles when launching new products or services[5].

The persistent question for the EU therefore is whether its digital rulebook contributes to the technological gap between the EU and comparable economies? If so, should a deregulatory agenda be pursued to close that gap? The European Commission appears to believe the answer to both questions is 'yes' and is pursuing an approach that involves a structural recalibration of focus from regulation to competitiveness. In other words, it is primarily preoccupied with fostering development and growth of digital technologies, rather than protecting against potential harm.

The Commission's strategy to reduce the EU's digital regulatory burden entails plans to facilitate companies' compliance with existing rules, making compliance less costly. It also includes policies with potentially substantial implications, such as easing regulatory reporting requirements for companies[6].

The Commission is grouping such measures into so-called 'Omnibus' packages. An 'Omnibus IV' proposal in May 2025 was intended to ease GDPR compliance for smaller companies[7]. A 'Digital Omnibus' proposal, published on 19 November 2025[8], meanwhile, seeks to boost AI development by broadening access to data for companies, a vital issue for AI training and operation.

For example, it would expand the definition of 'non-personal' data, putting it beyond the scope of personal data protection. This might be done for pseudonymised data, from which the original data subject supposedly cannot be reidentified by the data processor – though another processor might be able to do so (Henriksen-Bulmer and Jeary 2016). This would create substantial new risks for data subjects.

The deregulatory strategy may also manifest passively, with the Commission choosing to refrain from acting, or abandoning or delaying previously planned proposals. For example, the EU has considered supplementing the AI Act to protect workers from potential misuse of AI in the workplace, but has not yet done so, despite prodding from the European Parliament (2025). In February 2025, the Commission withdrew a proposal to regulate standard-essential patents, despite it having already been approved by the European Parliament[9].

Finally, the strategy also involves implementation delays. There have been many requests for a lengthening of the AI Act's tight compliance timeline[10]. Among other things, the AI Act requires European standardisation organisations to develop standards to help providers and deployers of high-risk AI systems demonstrate compliance. These standards have yet to be developed, and in the November 2025 Digital Omnibus the Commission laid the ground to postpone the enforcement of the obligations from August 2026 to December 2027[11].

The Commission's initiative may have substantive implications and we therefore term it 'deregulatory', rather than the Commission's preferred term of 'simplification' (European Commission 2025a). We use the term 'deregulatory' to describe any action to reduce the burden of EU digital regulation, regardless of whether it involves lowering regulatory standards or is limited to cutting compliance costs without reducing protection. The term 'simplification' can be misleading, implying that the strategy will have no substantive implications.

In fact, the Commission's digital deregulatory strategy has three main shortcomings:

1 .The deregulatory process lacks solid evidence. The Omnibus proposals have not been supported by impact assessments (IA) and have not gone through the structured ex-ante processes normally applied to evaluate the potential economic, social and environmental effects of the Commission's initiatives. The Commission argues that IAs could not be conducted because it would take too long, while the demand for deregulation is urgent (European Ombudsman, 2024)[12]. However, IAs could, for example, recommend that reporting obligations cannot be further reduced, because this might have significant social or environmental repercussions.

2. The process lacks transparency. The lack of empirical evidence makes it difficult to assess whether the Commission's strategy can effectively reduce regulatory burdens for companies. Most importantly, it hampers understanding of whether the strategy might make certain constituencies worse off, because of the proposed changes or because of regulatory inaction. This results in diminished accountability, as the Commission fails to assume responsibility for the distributive choices it implicitly asks EU legislators to make.

3. The entire digital deregulatory strategy hinges on a presumed end goal of 'catching up' with the US and reclaiming lost ground compared to its global competitors (as expressed in Draghi 2024). The urgency of the deregulatory strategy is justified by the technological gap between the EU and the US in terms of, for example, investment in digital infrastructure, such as data centres, funding of AI companies and adoption of digital technologies by traditional industries. The goal itself is not problematic: there is a compelling need to keep pace with the technological frontrunners and to increase the competitiveness of the European economy. However, it is risky to direct the entire strategy solely towards that specific objective, for two reasons:

First, comparing technological markets in the EU and the US is analytically unsound, for instance, because the two systems protect personal rights differently, and it is therefore obvious that markets perform differently.

Second, focusing mainly on imitating US investment strategies risks missing an opportunity to develop alternative approaches to technological development. For example, the Commission might be more concerned with the *amount* of AI innovation produced or adopted, rather than with *which kinds* of innovation gain traction in Europe. Minimising systemic differences with the US, moreover, could be hazardous by making EU technological markets more vulnerable to systemic shocks (such as the potential bursting of an AI bubble). This does not mean that the EU should not attempt to boost competitiveness, including by learning from the US. Rather, this should not be the EU's only strategic goal.

This paper sets out a simple analytical framework to explain why these three problems risk undermining the Commission's overarching digital goals. To address the problems, the Commission should be clear about its goals and should be more transparent on the potential effects of its regulatory and deregulatory initiatives.

The discussion in this paper, however, should not lead to the conclusion that regulation or deregulation can play a pivotal role in ensuring success in the digital economy. Quite the contrary: the roots of Europe's problems are deep and EU regulation is only one potential contributor – and probably not the most important[13]. Regulation is also only one tool that policymakers must pursue to achieve public goals. It should be considered a complement rather than a substitute for industrial policy.

To analyse the effects of regulation alone, an assumption must thus be made that investing economic or political resources in changing the regulatory framework does not imply crowding out other policy instruments (which would be the case, for example, if significant political capital is invested in adopting an Omnibus proposal, reducing

the chances of adopting a new subsidy scheme). This assumption is significant but necessary to evaluate the Commission's deregulatory strategy on a standalone basis.

The next section explains the theoretical foundation of the framework proposed in this *Policy Brief*[14]. Section 3 analyses the scope for efficiency improvements to the EU digital rulebook. Section 4 discusses the distributive choices entailed by regulation. Recommendations are set out in section 5.

2 A model for efficiency and distribution in EU digital regulation

Regulatory changes can have two types of effects: *efficiency* effects and *distributive* effects[15]. Efficiency effects increase the economic value created, while distributive effects determine how that value is allocated within society[16]. Differentiating between them is often challenging, since a regulatory norm can produce both kinds of effects.

For example, a regulation designed to encourage market competition may have efficiency effects (as competition boosts productivity and innovation, while also reducing the risk of abusive conduct that may harm consumers) and distributive effects (by shifting value from sellers to buyers). The efficiency and distributive effects triggered by competition are highly relevant for digital markets, which tend to have a structural tendency towards concentration[17].

The dynamics underpinning efficiency and distributive effects can be more easily understood through a simple economic model. Consider an economy – the EU – with an administration – the European Commission – that aims to maximise its citizens' prosperity. It does so by producing two sets of public goods[18]:

The first relates to competitiveness, to how productive the EU economy is. This can be measured by total factor productivity (TFP), the part of economic growth not explained by increases in labour or capital (TFP thus depends on technological innovation, development and adoption). TFP can be considered a public good because a higher TFP means higher average incomes and tax revenues. It is associated with higher levels of prosperity, from which citizens cannot be excluded (for example, TFP is positively correlated with average wages).

The second set of public goods relates to digital fairness (DF), an umbrella term encompassing the security, safety, resilience and trustworthiness of the EU digital economy. DF includes privacy protection, online safety, cybersecurity, consumer protection, digital inclusion and AI ethical standards. DF is a public good because everyone benefits from reducing the average risk of harm when dealing with digital technologies. DF can be interpreted to include also strategic autonomy, or the EU's ability to develop, adopt and regulate digital technologies independently, without relying excessively on foreign countries' supply chains.

In the model, the Commission can deploy only one production factor: regulation[19]. Depending on how regulation is designed, it results in varying levels of TFP and DF in the economy (for example, a regulation designed to reduce barriers to entry and boost competition can produce more TFP and DF).

From a regulatory perspective, TFP and DF can be complementary but also substitutes: regulatory design may sometimes increase both TFP and DF. However, there can also be a trade-off, with one of the two indicators increasing and the other decreasing.

To illustrate the effects, consider privacy protection. Data privacy may increase overall productivity. For example, it may address market inefficiencies, increase consumer trust and expand and stabilise market demand, particularly in the long term. Lefouili *et al* (2024) showed that, when a sufficiently large proportion of the population is privacy-

conscious, privacy regulation may increase demand among users to such an extent that a company's incentive to innovate and generate additional revenue is enhanced (see also Choi *et al* 2019; Acemoglu *et al* 2021; Niebel 2021; Blind *et al* 2024; Adepeju *et al* 2025).

However, there is also significant evidence that privacy constraints can reduce corporate profitability by limiting their ability to tap into data (eg. Goldfarb and Tucker 2011; Campbell *et al* 2015; Jia *et al* 2021; Frey and Presidente 2024). For example, a rule that forces companies not to use personal data without consent, if binding, necessarily implies a suboptimal choice for the company.

Other examples of such constraints include rules on consumer protection, online safety, digital inclusion, AI ethics and cybersecurity. In all these examples, a case can be made for a potential negative relationship with competitiveness[20]. There may also be a significant trade-off between competitiveness and strategic autonomy (Meyers 2025).

For example, Lysne *et al* (2019) found that banning the use of Huawei telecoms equipment for security reasons increased 5G rollout costs significantly. Thus, while the relationship between TFP and DF is not linear, for the purposes of the model, it is sufficient that they can be negatively correlated, even if only occasionally[21].

Finally, the model assumes that EU citizens have variable preferences related to TFP and DF and want them in differing combinations. A digital company's shareholders may attach relatively more value to TFP than members of a minority population group at higher risk of online discrimination, for example. Thus, within this model, efficiency effects arise whenever, in the wake of Commission regulatory or deregulatory action, the sum of TFP and DF increases, expanding total economic value. Conversely, for distributive effects to arise, it is sufficient that one of the two variables decreases.

Figure 1 represents the model graphically using a typical economic illustration of a production trade-off under resource scarcity. The slopes represent different levels of prosperity (V = economic value). The EU economy is currently at the starting point – S in Figure 1. Through value-enhancing regulation, it can move upwards and/or outwards, until it reaches the maximum value that can be produced with the available resources. This maximum is represented by the purple line, known as the production-possibility frontier.

Figure 1 Panel A shows how the Commission typically presents regulatory initiatives. The Commission might argue that GDPR streamlining proposals will serve a public goal (for example, simplifying compliance and increasing competitiveness) without compromising privacy protection (eg. European Commission 2025d).

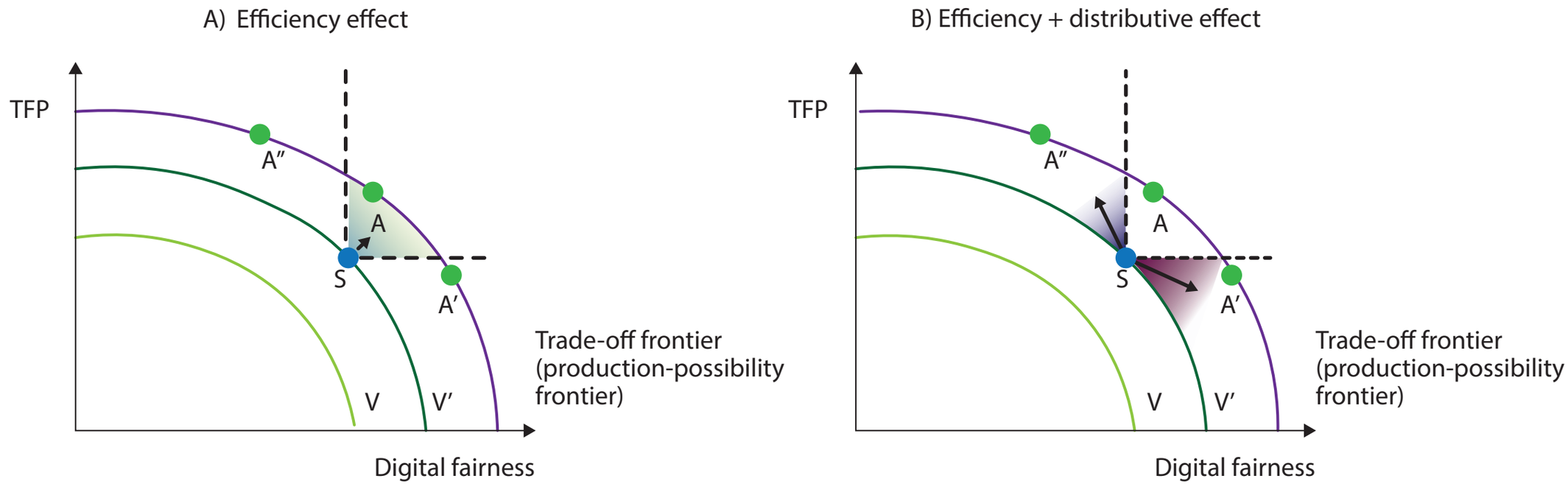
In the November 2025 Digital Omnibus, the Commission has proposed controversial measures that may, for example, allow companies to use pseudonymised data that would have previously considered as personal data and thus subject to stricter protection. This could generate new risks of discriminatory conduct by data controllers[22].

Nonetheless, in the introduction to the Digital Omnibus, the Commission states: *"the measures are calibrated to preserve the same standard for protections of fundamental rights"* (European Commission 2025c).

Conversely, the Commission might assert that introducing stricter privacy rules will not harm competitiveness. For example, the impact assessment accompanying the GDPR proposal more than a decade ago claimed that the new regulatory framework would support innovation and growth in the digital single market (European Commission 2012).

None of the impact assessments accompanying a sample of 14 significant Commission digital regulatory initiatives since 2019 mentions possible negative effects on growth (TFP in the model), instead often anticipating significant net positive effects on competitiveness and innovation[23]. In other words, the Commission generally expects its

Figure 1. Regulation and the production-possibility frontier



Source: Bruegel.

proposals to encourage the EU economy to shift from S to another equilibrium within the area highlighted in green (for example, to point A; Figure 1, Panel A).

But reality is harsher. Even if regulatory initiatives increase economic value, they are likely to also have significant distributive effects. Figure 1 Panel B shows how the economy might move to other equilibria (to A', where TFP is lower – the purple area – or to A", where DF is lower – the blue area – for example). Distributive effects should always be disentangled from efficiency effects and, if possible, quantified.

For example, Aridor *et al* (2021) found that an opt-in requirement in the GDPR for online tracking led to a 12.5 percent reduction in consumers using a major online travel intermediary, lowering advertising revenues (this loss was partly offset by the valuable information that those customers who consented to share their data conveyed to the intermediary).

Similarly, the AI Act obliges providers of high-risk AI systems to ensure that datasets are relevant, representative and free of bias, and to implement procedures to detect, prevent and mitigate discriminatory effects. Von Zahn *et al* (2022) demonstrated that removing gender bias from AI prediction models in e-commerce led to an 8 percent to 10 percent increase in financial costs for model promotors. That is the cost requiring fairness in AI: if companies cannot use gender to predict consumer behaviour, they lose a tool to increase profits (Von Zahn *et al* 2022).

These exercises focused solely on distributive effects: lost profits induced by the AI Act or the GDPR are not the result of inefficiencies in the design or enforcement of the regulatory framework. This is important because many studies that seek to quantify the effects of regulation on productivity are based on comparisons of average productivity in the market with and without regulation.

In such comparisons, it is often unclear whether the productivity effects result from flawed regulatory design (which can be corrected) or to deliberate choices by the legislator, which pursues multiple, conflicting goals.

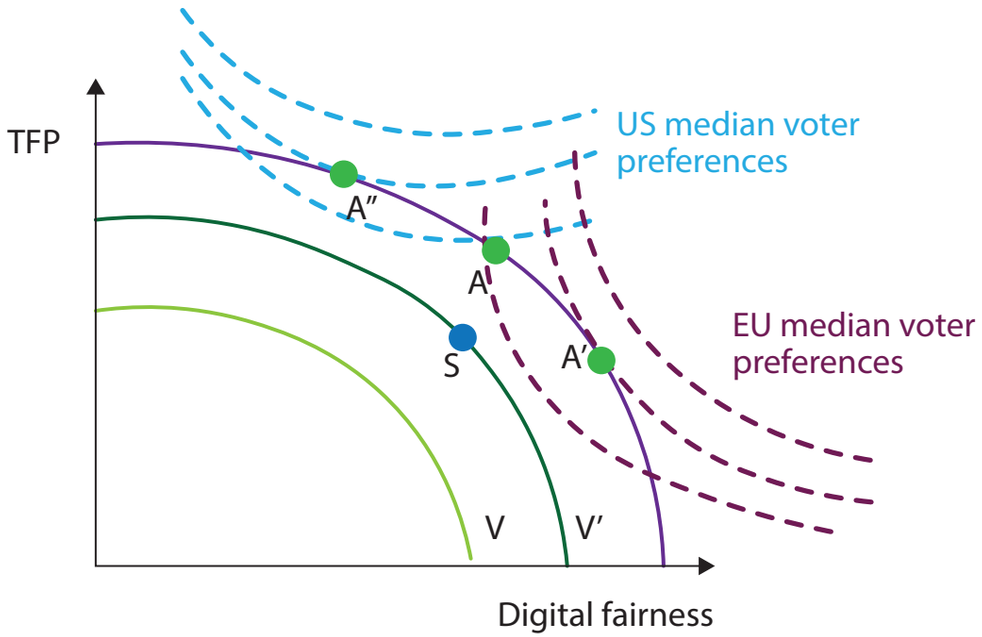
Despite strong evidence of distributive trade-offs, however, the narrative that regulatory or deregulatory actions can pursue incompatible objectives remains firmly embedded in the public debate. For example, Mario Draghi, the former Italian prime minister and author of a major report on competitiveness intended to guide the European Commission, has said that for European companies, *"one of the clearest demands is for a radical simplification of GDPR,"* which has *"raised the cost of data by about 20 percent for EU firms compared with US peers"* (Draghi 2025).

The GDPR, however, increases data costs by design. It includes the principle of data minimisation, requiring data controllers to restrict data processing to what is necessary. US companies that are not subject to the GDPR when operating outside the EU might instead collect and process data without a clearly defined purpose. It thus makes little sense to compare data use in the EU and US and blame lower EU data use on the GDPR's supposed inefficiencies.

Figure 2 illustrates these dynamics. The blue lines are 'indifference curves', or different combinations of TFP and DF that bring the same value to the individual, for US and EU median voters. The US median voter is assumed to have flatter indifference curves than the EU median voter, meaning she values TFP over DF relatively more than her EU counterpart[24].

Survey evidence supports this assumption. Germans, for example, tend to attribute a higher value to privacy when using digital technologies than Americans (Prince and Wallsten 2022; Despres *et al* 2024). Bellman *et al* (2004) demonstrated that cultural preferences influence regulatory approaches, with US internet users generally less

Figure 2. Differences in citizens' preferences entail different equilibria



Source: Bruegel.

concerned than Europeans about online safety. This provides a possible explanation for the EU's precautionary approach and the US's risk-based regulatory approach.

Since the European Commission aims to maximise its citizens' prosperity, it should seek through regulation to reach the point at which the EU median voter's preferences coincide with the trade-off frontier (Figure 2, point A'). At this point, TFP is inevitably lower than at point A", which would be the equilibrium if the EU median voter had the same preferences as the US median voter.

The model shows that failing to distinguish efficiency from distributive effects results entails overlooking the fact that some differences between the economic performances of the EU and the US are structural and cannot be eliminated through better regulatory design. Digital fairness may imply a TFP cost. That cost should be acknowledged. The Commission should dispel the misconception in its deregulatory agenda that, simply by streamlining the EU digital rulebook, protection and competitiveness can always be maximised simultaneously.

3 Efficiency gains: increasing value with EU digital regulation and deregulation

EU digital regulation creates value primarily by expanding digital markets from national to European level. It does this establishing common supranational rules that override national approaches: it fosters the digital single market (DSM). Since digital business models greatly benefit from economies of scale, the value created in a fully developed DSM would exceed the total of the values generated within each EU country, if considered separately. A completed DSM would reduce uncertainty for businesses and boost competition[25].

Therefore, when EU regulation tackles issues such as data use that would otherwise be regulated at national level, it prevents fragmentation and thereby creates value gains. For example, the GDPR and another law, the Regulation for the Free Flow of Non-Personal Data (Regulation (EU) 2018/1807), were designed, taken together, to facilitate

the seamless transfer of data across the EU, overcoming national barriers and expanding the data market from the national to the EU level, with notable efficiency benefits (European Commission 2025b)[26].

The DSM remains incomplete, however. Regulations that appear effective on paper often fail to deliver in practice. The GDPR is not enforced uniformly across the EU as originally intended, for example (Gentile and Lynskey 2022). It is this inconsistency that is likely the main reason for the EU's competitive disadvantage, and lack of digital champions, compared to the less-fragmented US and China (Letta 2024; Draghi 2024).

The EU's fragmented market hinders businesses from starting up, securing funding and expanding. Rather than being a drag on competitiveness, EU regulation, if well designed, has the potential to foster, rather than impede, the emergence of European champions.

But regulation is often not well-designed and for that reason can impose significant compliance costs on companies. Annual compliance costs related to the GDPR have been estimated up to €500,000 for small and medium-sized enterprises (SMEs) and up to €10 million for large organisations (Draghi 2024). Most importantly, regulation can create unwarranted distortions in technological markets. Whenever regulators constrain companies' behaviour, they interfere with natural market dynamics, potentially resulting in inefficient outcomes.

For instance, regulators may reduce competition by (intentionally or inadvertently) erecting barriers to market entry. Alternatively, they may favour companies that do not deserve to be advantaged because they are less efficient than their competitors.

The GDPR, for example, introduced a mandatory data-management process for companies that handle large or highly sensitive datasets. These processes entail high fixed costs and thus larger firms have a comparative

advantage, as the cost of GDPR compliance is relatively lower for them than for SMEs, because of economies of scale. Peukert *et al* (2022) provide evidence that web technology service markets have become more concentrated since the introduction of the GDPR. One aim of the Commission's May 2025 Omnibus IV proposal (European Commission 2025d) is to address this issue.

The risk of distortion can never be entirely eliminated when regulation is introduced. However, it can be minimised by ensuring that regulations are linked closely to the market failure they address. In other words, regulation should not target issues that the market is expected to resolve within a reasonable timeframe. Often, instead, the EU regulates where not strictly needed.

For example, the AI Act obliges that high-risk AI systems with the greatest potential to cause harm to be accurate, robust and cyber-secure. Competition in AI system design is intense (HAI, 2025), and accuracy is one of the principal parameters on which developers compete.

Therefore, one should expect that the market will incentivise and reward more accurate AI systems. The need for accuracy requirements in regulation is thus not obvious.

The potential for value gains through both regulatory and deregulatory digital measures in the EU thus seems significant. The GDPR, for instance, could be improved by streamlining enforcement, ensuring it is more consistent and effective across the single market and emphasising higher-risk use cases. Reporting processes could be streamlined to reduce duplication with overlapping obligations under other regulations, such as the Digital Services Act or the AI Act[27].

Additionally, the GDPR could incorporate greater automation in processing users' consent for their personal data and could standardise consent requirements, easing compliance for low-risk data controllers. The November 2025 Digital Omnibus proposal requires automated privacy signals from browsers to overcome cookie consent fatigue, and this is no doubt a good step towards a more efficient regulatory framework.

4 The distributive effects of regulation

Fixing market failures (such as correcting the lack of market competition) entails both efficiency and distributive effects. Regulation, however, can also be designed primarily to have distributive effects (ie. to move along the efficiency frontier in Figure 1), without targeting a specific market failure. This is often true in the digital economy for three reasons.

First, correcting market failures takes time and is often outpaced by technological progress. The Digital Markets Act, for example, contains norms to enhance competition structurally, such as reducing the costs of switching between large online platforms (Article 6(6) DMA), and also fairness measures, such as preventing large platforms from exploiting non-public commercial data obtained from their business users in order to compete against those users (Article 6(2) DMA)[28].

EU lawmakers assumed rightly that, even if the DMA Article 6(6) increases competition in digital markets by correcting the market failure arising from low levels of competition, ultimately reducing the likelihood of abuse, it will take a considerable amount of time to see results[29]. Therefore, Article 6(2) was also needed to prevent exploitation directly.

Second, perfectly functioning markets exist only in theory, and given the highly dynamic nature of digital markets, it would be naive to expect regulation to resolve all potential market failures indefinitely. The third reason is that

even if markets did not fail and the economy was permanently at the efficiency frontier, it would not necessarily mean a distribution of value considered fair by society's members, even if those members operate and manifest their preferences via the economy's markets[30].

Consider, for example, economic discrimination, or the practice of treating comparable economic actors differently to extract value from them. The data economy is based on the idea that users' information can be used to generate value. The more producers know about their customers, the better they can tailor their offerings.

Online e-commerce platforms, for instance, can set higher prices for buyers who are more willing to pay (Borreau and de Streel 2018). On an aggregate level, this might be efficient because the supplier (the e-commerce platform) sells to everyone and maximises sales (in other words, price discrimination can get you closer to the efficiency frontier).

However, most of that overall value is captured by the discriminating platform. In the extreme case of first-degree price discrimination[31], the economy may be at the efficiency frontier but buyers are left only with the value of their consumption. They gain no 'surplus', ie. the potential difference between what they are willing to pay and what they actually pay. Since all pay different prices, buyers might feel they are being treated unfairly.

The EU digital regulator opposes discrimination, as demonstrated by several explicit regulatory provisions. For example, Article 10(2) of the AI Act requires data-governance measures to mitigate discrimination by high-risk AI systems. Article 26(3) of the Digital Services Act forbids the use of sensitive information, such as sexual orientation or political beliefs, for targeted advertising.

Such provisions reflect a distributive-oriented choice by the regulator because, on pure efficiency grounds, discrimination could in theory be justified[32]. Discrimination might expand the economic value produced in the economy.

4.1 Mitigating vs. steering distributive effects

Regulation can have different types of distributive effects. In the analytical framework outlined in this paper, mitigating distributive effects, in which proposed laws shift the distribution of value among players without fundamentally altering business models, should be distinguished from steering distributive effects, in which proposed laws may encourage the development of alternative approaches to technological development.

The DMA contains an example of a potential mitigating distributive effect, as it prohibits large platforms from favouring their own services (prohibition of self-preferencing, Article 6(5)). This principle does not aim to change the business model, but rather to prevent abuse. However, it has distributive effects because it shifts value from platforms to their rivals, and this is not necessarily value-enhancing. In fact, self-preferencing may be pro-competitive, increasing consumer welfare (Katz 2024).

The GDPR, meanwhile, generates steering distributive effects, as it pushes companies to develop more privacy-friendly businesses and to adopt technologies that minimise data use (GDPR Article 25). Martin *et al* (2019) showed that the GDPR steers innovation in startups in data-intensive sectors towards privacy-preserving software.

Steering distributive effects are particularly important for the digital economy because they enable regulation to influence systemic choices. Through steering distributive effects, regulation can establish the foundation for alternative technological development paths, rather than those dominated by the US or China.

The need for systemic choices is urgent given the nature of digital technologies, which are increasingly deeply embedded in EU society and the economy. AI is progressively becoming the 'infrastructure of infrastructures'[33].

However, systemic choices are only feasible at an early stage of development. Once the economy has adapted to a new technological system, it can be extremely difficult to change it through regulation. David (1985) and Arthur (1989), for example, described this as technological path dependency: early coordination on a technology (cars, VHS) commits society to a specific trajectory that is hard to change.

Furthermore, significant risks are associated with the implicit decision to match the EU's digital deregulatory agenda with the US. First, it is unlikely that the US's technological lead can be matched, given its strong first-mover advantage. This is evident in how large US AI firms can utilise extensive data and computing facilities and thus benefit from substantial economies of scale (Krakowski *et al* 2023).

Second, as shown in the model described in section 2, bridging the EU-US divide would inevitably involve compromising the EU's approach to technology, which is grounded in applying regulation to promote a human-centric digital economy (European Commission 2022). Aping the US would diminish the EU's comparative advantage. By lowering safety or security standards, the EU could, for example, become less attractive to foreign talent.

Third, steering distributive effects can be beneficial for strategic autonomy goals, as they can support the development of technologies for which foreign powers lack a comparative advantage. The more these technologies become widespread, the greater the EU's bargaining power. For instance, the principle of privacy by design enshrined in the GDPR might favour data-processing technologies that handle data closer to data subjects[34].

Adoption of such technologies has been underwhelming so far but with support from complementary industrial policies, they could become more significant, exerting competitive pressure on the cloud market, enabling local, sovereignty-preserving alternatives that make centralised services less necessary.

Finally, by focusing its efforts on joining the AI gold rush, the EU maximises its exposure to potential systemic risks affecting the AI system. AI may be nearing an investment bubble. If the bubble bursts, the economic impact would be less severe if the EU had diversified its technological investments and prioritised a long-term perspective, taking into account AI's ethical, societal and environmental impacts (Floridi 2024).

Regulation alone cannot compel systemic choices; however, it can support them. For instance, regulation can offer a strategic edge in technologies that may follow AI as the next major trend, such as quantum technologies. It could establish interoperability standards, design faster assessments of safety, security and regulatory compliance of quantum systems, or introduce public procurement rules, such as cybersecurity requirements, that promote the adoption of quantum technologies. By boosting demand for quantum, regulation would assist in directing investment towards it.

Regulation can likewise potentially prompt radical changes in digital business models or directly prohibit certain harmful uses. The Digital Services Act, for instance, could be enforced in a manner that brings about fundamental changes to social network business models, reducing addiction or doomscrolling by requiring adjustments to recommendation algorithms and engagement-driven design features.

Labour-market regulation could steer technological progress by boosting workers' bargaining power and shaping incentives so that innovation focuses on augmenting labour rather than just replacing it; this implies banning or heavily restricting the use of monitoring or surveillance AI-enabled applications (Acemoglu and Johnson 2023).

5 Recommendations for a transparent and effective digital deregulatory strategy

The European Commission's deregulatory digital strategy: 1) lacks an evidence base; 2) lacks transparency, and the Commission is not accountable for the distributional choices it makes; 3) is implicitly aimed at the unrealistic goal of catching up with the US while maintaining the EU's level of protection from harm caused by digital technologies (section 1).

The Commission should not ignore the potential for distributive effects, assuming that its deregulatory strategy will only have efficiency effects. The Commission may use regulation or deregulation to pilot the economy to generate more value (section 3) and to distribute that value according to the goals it intends to pursue (section 4). But to be effective, it must acknowledge trade-offs and be transparent about the cost its initiatives entail.

The Commission's deregulatory strategy should therefore:

1. Design an effective methodology to support any future regulatory or deregulatory initiatives with solid economic evidence. The claim that the urgency to take action prevents the carrying out of impact assessments overlooks the potential for substantial distributive effects[35].

2. Relatedly, the Commission's strategy should not specify from the outset fixed goals for the level of regulatory burden it aims to cut. The strategy's efficiency target must be to maximise the value generated by the EU digital economy. Reducing the compliance burden is a means to achieve that aim but not a goal in itself.

3. Whenever a full impact assessment is not feasible, the Commission should still accompany initiatives with broad analyses of the potential effects. Analyses need not be detailed, but must be thorough and sound,

highlighting all relevant dynamics, at least at the theoretical level[36]. The public goods involved should be identified clearly and whether they are in a complementary or substitutive relationship should be explained.

For example, if the Commission proposes to exempt AI companies from the ban on using sensitive personal data to train algorithms, it should clearly outline all academic literature indicating that using sensitive data for AI training may jeopardise human rights. Similarly, the Commission must establish the theoretical basis that supports the expected efficiency effects.

4. The Commission should state clearly the ultimate purpose of its deregulatory strategy. If the aim is solely to narrow the gap between EU and US tech markets, it should state this explicitly and outline the kinds of distributive decisions that will be needed to achieve that aim.

Conversely, if the goal is to help bridge the EU-US gap while also allowing for different visions of technological development to emerge, it should recognise that, in some areas, the EU-US gap might never be fully closed. For example, access to data in Europe will always be more costly (and, therefore, lower) than in the US, if the EU maintains higher privacy standards.

5. Finally, the Commission should establish metrics to assess the potential effectiveness of its initiatives ex ante and to validate them ex post. In this respect, technology can also be considered an enabler, rather than just the target of Commission proposals: large language models can speed up data analysis and improve its quality, and it is increasingly hard to justify regulatory proposals that lack quantitative backing. The Commission should propose:

- Indicators to measure efficiency effects, such as: total reduction of compliance costs; lower exposure of personal data to potential abuse; increase in investment in technological infrastructure; increase in private and public adoption of digital services; reduction of cybersecurity risk; increase in online safety; quantitative increases in technological innovation.

- Indicators to measure mitigating distributive effects, such as: changes in the balance of expected revenues between different kinds of market players (of different sizes or operating in different sectors); loss of established rents in relation to the creation of new safeguards from online harm; gains of new rents by specific market players in relation to loss of established consumer protections.

- Indicators to measure steering distributive effects, such as: relative changes in the balance of different kinds of technological innovation (for example, the ratio between safety-oriented and monitoring-oriented AI-powered applications in the workplace); shifts in investment between different kinds of technologies; creation of new technological business models.

Proponents of deregulation, such as the European Commission, often assert that deregulation will cause no harm. Conversely, opponents tend to argue that boosting trust in digital technology through regulation reinforces the sustainability of tech business models. Neither claim is fully convincing, and a polarised debate may impede EU efforts to improve its regulatory framework and support the growth of European tech markets. The Commission should therefore adjust its deregulation strategy by increasing transparency about its aims and taking full responsibility for its actions. ■

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Endnotes

1. See Statista, 'The 100 largest companies in the world by market capitalization in 2024', 30 May 2025, and Dealroom (2025).

2. See the Global AI Vibrancy Tool. The composite index includes metrics such as research output, investment, infrastructure and policy.

3. Guntram Wolff, 'Europe may be the world's AI referee, but referees don't win', Politico, 17 February 2020.

4. As seen in the EU approach to environmental policy; Art. 191(2) of the Treaty on Functioning of European Union.

5. This, however, is not necessarily true when also considering the qualitative aspects of innovation. See Klinke and Renn (2002), for example.

6. A move to simplify sustainable finance rules has been criticised for its potential to distort sustainable-finance markets by significantly reduce companies' reporting; see Sylvia Merler, 'Streamlining or hollowing out? The implications of the Omnibus package for sustainable finance', First Glance, 3 March 2025, Bruegel.

7. European Commission, 'Omnibus IV', 21 May 2025.

8. See European Commission press release of 19 November 2025, 'Simpler EU digital rules and new digital wallets to save billions for businesses and boost innovation'.

9. Francesca Micheletti and Mathieu Pollet, 'EU's red tape bonfire stokes tech patent rows', Politico, 12 February 2025.

10. The AI Act is a comprehensive framework governing the development, market placement, deployment and use of AI systems within the EU. It entered into force in August 2024, but its full applicability is being phased in.

11. See European Commission press release of 16 September 2025, 'Commission collects feedback to simplify rules on data, cybersecurity and artificial intelligence in the upcoming Digital Omnibus'. The 19 November 2025 Digital Omnibus gives the option to the Commission to decide to delay enforcement.

12. Drafting an impact assessment can take more than a year (European Commission, 2009). In relation to the Omnibus proposals, the results of impact assessments in any case may have been predetermined to some extent: Commission President Ursula von der Leyen has said that she considers necessary a reduction in reporting obligations for large

corporates of at least 25 percent, and for small and medium enterprises, of at least 35 percent. See Ursula von der Leyen, 'Mission Letter Valdis Dombrovskis, Commissioner-designate for Economy and Productivity, Commissioner-designate for Implementation and Simplification', 17 September 2024.

13. Most of European companies' compliance costs originate in EU countries' national legislation. In addition, European companies do not consider regulation as the main obstacle to investment (EIB, 2024).

14. This paper draws extensively from, and expands on, Mariniello (2025).

15. This classification is broadly consistent with the mainstream economic literature on regulation. See, for example, Joskow and Rose (1989) and Baldwin et al (2011).

16. Value is an all-encompassing concept used to indicate how prosperous an economy is. It is equivalent to total welfare or total utility. It can include measurable quantities (such as domestic output) and less objectively quantifiable benefits (quality and accessibility of services).

17. Digital services, for instance, tend to benefit from scale and network externalities, which naturally lead to market concentration.

18. A public good is a good defined by two properties: non-rivalry (one person's consumption of the good does not reduce its availability to others) and non-excludability (individuals cannot easily be excluded from benefiting once the good is provided).

19. This is a drastic simplification, of course. TFP and DF depend on many other factors, and the Commission has many different policy tools to produce them. The purpose of this model is, however, to isolate the effect of regulation. The model thus assumes that all the other factors or policy tools affecting TFP and DF are given.

20. Consumer protection increases liability risks and may deter innovation or market entry for new technologies; online safety may divert resources to moderation and compliance; digital inclusion may imply pricing constraints and reduced profitability; AI ethics limits companies in using sensitive data to optimise pricing strategies; cybersecurity increases operational costs.

21. Researchers have attempted to explain that the dichotomy regulation vs competitiveness does not necessarily hold (see, for example, Bradford 2024). However, this does not imply that such a dichotomy never holds.

22. Mario Mariniello, 'The European Commission's Digital Omnibus could increase risks, not growth', First Glance, 13 November 2025, Bruegel.
23. The examined initiatives are: the Digital Services Act, Digital Markets Act, AI Act, Data Act, Cyber Resilience Act, NIS2 Directive, European Digital Identity Regulation (eIDAS 2.0), Data Governance Act, Platform Work Directive, European Health Data Space, Gigabit Infrastructure Act, Interoperable Europe Act, European Media Freedom Act and the revision of the Product Liability Directive.
24. The flatter the indifference curve, the more units of the good on the X-axis are needed to compensate for a reduction of one unit in the good on the Y-axis, for the individual to be indifferent when two bundles of goods are compared.
25. EIB (2024) found that uncertainty was considered a major obstacle to investment by 44 percent of European companies, while regulation was considered an obstacle by 32 percent.
26. The Digital Omnibus repeals Regulation (EU) 2018/1807 because it has been de facto superseded by the Data Act.
27. The Digital Services Act establishes an EU regulatory framework for online intermediaries, attempting to enhance transparency, accountability and user protection, reducing the spread of illegal and harmful content online.
28. The DMA requires online platforms with significant market power to make some of their services compatible with others. Without this regulation, competition in those markets would remain low because the major platforms benefit from large network effects, giving them a significant advantage over potential challengers. By opening markets to competition, the DMA aims to unlock their potential and encourage the creation of more value for the economy than they currently generate.
29. Increasing market competition reduces the ability of incumbent players to abuse their market power. In the extreme (and theoretical) scenario of perfect competition, no abuse is possible because no market player has the power to commit it.
30. What 'fairness' amounts to is a matter for political philosophy. See, for example, Rawls (2001) and Rawls (2005).
31. First-degree price discrimination occurs when a supplier has full information about its customers' willingness to pay for its products. For an overview, see Mariniello (2022).

32. There are many reasons why discrimination can reduce or increase efficiency. It depends on the context. For an analysis, see Papandropoulos (2007).
33. Robin Berjon, 'Infrastructure Shock', 23 September 2024.
34. 'Fog' computing, for example, moves cloud capabilities closer to end devices by processing data locally within a network. 'Edge' computing processes data directly on or near devices, minimising latency and bandwidth use.
35. Draghi (2024) may have been the catalyst for the Commission's strategy, but lacks granularity to justify specific regulatory design choices.
36. The 207-page European Commission Staff Working Document accompanying the November 2025 Digital Omnibus proposals dedicates just slightly more than one page to measuring the distributional impact of the proposed GDPR amendment on pseudonymised data. See European Commission (2025e), pages 54-55.

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Trade wars and central banks: lessons from 2025

Christine Lagarde states we can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations, but warns we must remain alert to possible new shocks that may still lie ahead

The idea that economics cannot be separated from geopolitics is hardly new. During the early 1990s, as the Soviet Union collapsed, Finland lost more than 10% of its GDP when trade with its eastern neighbour suddenly evaporated[1]. Few countries know better the costs of ignoring geopolitical realities.

Today, the rest of Europe is facing a similar reckoning. We find ourselves in a new world – one where policymakers can no longer confine themselves to traditional economic and financial variables. Now, we must factor 'geoeconomics' into our analyses. The term was coined in 1990 by Edward Luttwak, who described geoeconomics as *"the admixture of the logic of conflict with the methods of commerce."* It is not protectionism in the old sense of sheltering vulnerable industries. Instead, it is trade deployed as a tool of power, a strategy of influence and dominance.

This approach has been around for some time, most visibly during the US-China trade disputes that unfolded during the first Trump Administration. The unjustified war in Ukraine and the sanctions that followed have also reshaped the European landscape. But 2025 marks the first year in which Europe itself has been on the receiving end.

We currently face the highest tariffs since the days of Smoot-Hawley in the 1930s, imposed by our largest trading partner. Global trade is being reshaped as other countries respond to tariffs directed at them. And in the span of just a few months, we have seen a surge in trade uncertainty and sharp swings in exchange rates. So now is a good time to take stock of what we have learned so far, and what this implies for monetary policy.

Trade wars: expectations versus reality

A year ago, most would have assumed that US tariffs rising from 1.5% to 13% would trigger a major adverse shock to the euro area economy. Indeed, most trade models judged the imposition of tariffs to be, on net, negative for euro area growth and likely positive for inflation, at least in the short run.

This was broadly our internal assessment in December of last year, albeit surrounded by considerable uncertainty. Three channels were usually seen as decisive in producing such an outcome. First, retaliation. Reciprocal tariffs were expected to raise import costs and reverberate through supply chains. In most models, this retaliation channel was by far the largest driver of higher short-term inflation[2].

This is an unusual time to be a monetary policymaker. We can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations. And yet, we must remain alert to the possibility that not all the consequences are visible today – and that new shocks may still lie ahead

Second, the exchange rate. Tariffs were expected to trigger a depreciation of the euro against the dollar – driven by expectations of higher US rates and a smaller US trade deficit – thereby amplifying imported inflation[3].

Third, uncertainty. Elevated trade policy uncertainty was expected to weigh heavily on business investment and growth, often more than the direct effect of tariffs on exports themselves. This was expected to be the largest negative force on growth. Yet some of these assumptions have not been borne out. This is because the tariffs were not an isolated economic event, but a symptom of a broader geopolitical shift – one that triggered political economy dynamics beyond the reach of standard models.

Start with retaliation. In Europe and globally, it has so far been limited. In response to the US tariffs on steel and aluminium, the EU announced counter-tariffs on around €26 billion worth of American goods, but suspended them once a deal was struck in July. Pressure from major industrial groups to avoid a prolonged cycle of tit-for-tat measures, as well as concerns about jeopardising US support for the war in Ukraine, ultimately outweighed pure economic calculus.

As a result, we have not yet seen significant supply chain disruption. Global supply chain pressures remain contained, and in the euro area, bottleneck indicators are close to historical averages. If anything, rather than blocked supply chains, the euro area is facing rising imports. The euro area's trade deficit with China has risen by around 10% this year, although this was driven more by weaker Chinese demand than by diverted trade flows.

The exchange rate has also not behaved as expected. Rather than depreciating, the euro has appreciated substantially. Since the start of this year, it has risen by 13% against the US dollar, while the nominal effective exchange rate has increased by 6.5% and the real effective exchange rate[4] by 5%.

This reflects the fact that the imposition of US tariffs coincided with a broader re-evaluation of the country's position in the global financial system. Investors began to question whether the US dollar would continue to warrant its status as the ultimate safe-haven currency – another political-economy factor that narrow, tariff-focused models excluded by assumption.

The international role of the euro has helped insulate us from the resulting exchange rate volatility, with 52% of our imports invoiced in our own currency. But many key imports, especially commodities, are still priced in dollars. The euro's appreciation has therefore contained imported inflation from supply chains, while at the same time placing an additional drag on growth.

The effects of uncertainty have been more in line with expectations. The expected cumulative impact of tariffs and uncertainty on growth is around 0.7 percentage points between 2025 and 2027, compared with our projections last December. Still, these effects have not been as strong as we anticipated. For example, only about a quarter of the downward revision for next year, compared with December last year, is due to uncertainty.

This is partly because trade policy uncertainty fell faster than we expected once the deal with the United States was concluded. It is also because the euro area has taken internal measures to boost growth that have helped counter external weakness.

In particular, governments in Europe have committed to the largest increase in rearmament in decades, with some reversing years of underinvestment. Government investment is now expected to add 0.25 percentage points to growth[5] between 2025 and 2027, offsetting around one-third of the trade shock[6].

The EU has also pushed ahead with new trade agreements, which will support growth. The Mercosur and Mexico deals now being adopted cover more than 3% of extra-euro area goods exports, while agreements currently under negotiation account for a further 6%[7]. This is another example of a response that models could not capture beforehand: trade pressures have led European governments to re-evaluate their broader trade and security relationships, prompting an endogenous investment response.

All in all, with no retaliation and an appreciating exchange rate, tariffs have had little inflationary impact so far, with their adverse effects mainly limited to growth. Those effects, however, have been relatively moderate thanks to the domestic response.

Evaluating the balance of risks

In an environment of high uncertainty, understanding the nature of shocks is a precondition for getting the baseline projection right. But capturing the balance of risks is just as crucial, so that we are prepared for a situation in which the baseline may prove obsolete and can act pre-emptively, if necessary.

This was a key conclusion of our recent strategy review: to emphasise more risks and uncertainty in our decisions, not just central projections. Initially, we viewed the risks to growth from US tariffs as tilted to the downside. This assessment was informed by extensive scenario analysis, including escalation scenarios and possible offsetting forces – notably the growth impact of a sustained increase in defence and infrastructure spending.

Overall, these scenarios have consistently shown that the most salient risks – those that could push growth furthest from its current path – lie on the downside rather than the upside.

For example, ECB staff find that severe escalation in trade tensions could lower growth cumulatively by about 1 percentage point over the projection horizon[8]. The potential boost from higher defence spending would not be sufficient to offset this, even if all countries were to deliver fully on their NATO commitments.

This tilt in the risk balance remains in place today. But at our last meeting, we judged risks to growth to be more balanced, because the likelihood of major tariff-related downside risks materialising had fallen owing to the new trade deal.

Meanwhile, we judged inflation risks to be two-sided, with plausible scenarios that could push inflation off track in either direction. But as new information has come in, the range of risks on both sides has also narrowed. In particular, the absence of significant EU retaliation has reduced the risk that higher import tariffs might drive inflation above the baseline. Our scenario analysis also points to inflation risks that remain well contained.

If trade tensions were to reignite, staff project only moderately lower inflation in 2027, reflecting weaker growth. Higher spending on defence equipment, by contrast, would only modestly raise inflation, given its relatively small weight in the consumption basket.

Staff have also examined scenarios that would affect prices more directly: on the downside, Chinese export prices being lowered further as a strategic response to tariffs; and on the upside, more pronounced bottlenecks in global supply chains.

In both cases, however, the impact would be limited under reasonable assumptions, with inflation in 2027 differing by only 0.1-0.2 percentage points[9].

Policy implications

So what does this imply for our monetary policy? I have said that we are in a good place. This was largely a reference to the fading of the large inflation shock we faced in recent years, which is now essentially over in the euro area.

But there are also three additional reasons why it applies to the current situation. First, because trade shocks are not creating new inflationary pressures, we are not confronted with the classic policy trade-off where the central bank faces stalling growth and rising inflation. This has already allowed us to cut policy rates by 100 basis points since December – cushioning the impact while keeping medium-term inflation on track.

Second, insofar as we can model the future, the risks to inflation appear quite contained in both directions.

Third, with policy rates now at 2%, we are well placed to respond if the risks to inflation shift, or if new shocks emerge that threaten our target.

At the same time, we are navigating a far more difficult environment than before – beset by war, tariffs and uncertainty – which we must also factor into our policy. If we consider the 'known knowns', the risks appear well bounded.

But there are also 'known unknowns' – above all, how euro area companies will adapt to this new setting. Firms are still running down inventories and absorbing the shock in margins, so the full effects of US tariffs have yet to become clear[10].

Finally, there are the 'unknown unknowns': in a world of geoeconomics, new trade and geopolitical shocks will remain a constant feature of our environment.

How these forces play out will have unavoidable effects on monetary policy – not only through their impact on growth, but also on potential growth. If firms interpret the new environment as a lasting confidence shock, we could see investment shift out of the euro area[11]. Preliminary staff analysis suggests that, all else being equal, tariffs are likely to weigh negatively on potential growth.

Lower potential growth would, in turn, put downward pressure on real rates and reduce the policy space available. But other paths are possible if governments act decisively and give firms new reasons to be confident.

One factor often overlooked in the tariff debate is that our internal market is far more important for trade than the global market. Staff analysis shows that an increase of just 2% in intra-euro area trade would be enough to offset the loss of exports to the United States caused by higher tariffs[12].

This is a compelling reason to implement the reforms identified in recent reports from Mario Draghi and Enrico Letta, in particular simplifying burdensome regulation, completing the Single Market and building a genuine European capital market. The same reforms would also help European companies adopt artificial intelligence more rapidly[13]. This would result in a positive shock for potential growth, helping to balance the negative forces coming from abroad.

In short, nothing about our future is fate – and there is no room for complacency by any party. For our part, we cannot pre-commit to any future rate path, whether one of action or inaction. We must remain agile, and ready to respond to the data as they come in.

Conclusion

This is an unusual time to be a monetary policymaker. We can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations. And yet,

we must remain alert to the possibility that not all the consequences are visible today – and that new shocks may still lie ahead.

As we look to the future, we do so mindful of Finland's long tradition of *sisu* – courage and inner strength in the face of uncertainty. *Sisu* is not a show of fleeting bravery, but rather a fierce determination and perseverance to continue fighting even when times get tough. We are in a good place today, but that place is not fixed. Our task is to sustain it with agility, humility and a firm grounding in the data. ■

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Endnotes

1. Analysis finds that the trade shock alone can explain between 4.7 and 5.9 percentage points of the loss in GDP. See Gulan, A (2021), "Can large trade shocks cause crises? The case of the Finnish-Soviet trade collapse", Blogs – Bank of Finland Bulletin, Bank of Finland, 5 May.

2. Gnocato, N et al (2025), "Tariffs across the supply chain", VoxEU Column, CEPR, 30 May.

3. Jouvanceau, V, Darracq Pariès, M, Dieppe, A and Kockerols, T (2025), "Trade wars and global spillovers. A quantitative assessment with ECB-global", Working Paper Series, No 3117, ECB, Frankfurt am Main, September.

4. Deflated by consumer price inflation.

5. This estimate also includes wages, government consumption and transfers.

6. Government investment as a ratio to GDP is expected to be cumulatively almost 0.6 percentage points higher over the period from 2025 to 2027 than projected in December last year.

7. With South Korea, India, Australia, Malaysia, Thailand, Indonesia and the Philippines.

8. European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, June 2025", Frankfurt am Main, June.

9. European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, September 2025", Frankfurt am Main, September.

10. Organisation for Economic Cooperation and Development (2025), OECD Economic Outlook Interim Report September 2025: Finding the Right Balance in Uncertain Times, OECD Publishing, Paris, September.

11. European Central Bank (2025), "The outlook for euro area business investment – findings from an ECB survey of large firms", Economic Bulletin, Issue 4.

12. The United States accounts for 10% of total euro area exports, and the new tariffs are expected to reduce euro area exports to the United States by approximately 9%, translating to a 0.9% decline in overall euro area exports – roughly €66 billion. Making up for this shortfall in direct trade would require a 2% increase in intra-euro area trade.

13. European Investment Bank (2025), Investment Report 2024/2025: Innovation, integration and simplification in Europe, March.

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