Under Construction:

Europe's Economic Repositioning in a Fragmented International Order

by **Marie Krpata**

"Under Destruction" – this was this year's motto at the Munich Security Conference. A motto that applies both to security and economy in an increasingly fragile international system. In 2024, Mario Draghi's report on the EU's competitiveness rang the alarm bell: Europe is slipping behind the US and China, European companies struggle with Brussels' bureaucracy, and the internal market is too fragmented. However, two years later only about 15% of his recommendations were implemented: the wake-up call was not heard.

In fact, the situation is getting tougher for the EU as fiscal room is scarce, and energy costs have been rising. In addition, huge investments are needed in the EU's defense industry to supply Ukraine with weapons, while investment needs in the digital and energy transitions are also huge. Moreover, the EU, whose economic model is based on free trade, is now confronted with increased protectionism from its main trade partners, with tariffs, export controls, market access restrictions that divert trade flows and restructure value chains. In the past years, the EU has been responding through various strategies, policies and instruments largely focused on increasing the EU's resilience and reducing one-sided dependencies, thereby reflecting the growing nexus between economy and security.

Geopolitical Shocks Must Serve as Opportunity for Europe

There seems now to be an understanding of a sense of urgency. The time has come for middle powers to unite, as Canada's Prime Minister Mark Carney suggested at the World Economic Forum in January 2026. This was echoed by the President of the European Commission, Ursula von der Leyen, in her speech in Davos. The moment has come to be clear-eyed: "Geopolitical shocks can and must serve as an opportunity for Europe." An "independent Europe" is now emerging, one that takes action on securing energy, critical raw materials, and defense, and speeding up efforts in the digital realm; one that chooses

> "The EU tends to reform only when its back is against the wall."

"partnership instead of isolation" through free-trade agreements; one that would strive toward the deepening of the internal market so that companies can benefit from the extent of an area gathering 450 million people.

The French President, Emmanuel Macron, in February this year, warned that Europe is facing a "geopolitical and geo-economic state of emergency" and risks being "swept aside" if staying passive to evolutions in the US and China. Europe must reckon with the gravity of the stakes and take action. In line with Ursula von der Leyen, Emmanuel Macron insisted on the EU's assets, such as a predictable regulatory environment where the rule of law applies.

The EU's Economic Outlook: Between a Rock and a Hard Place?

The EU's economic outlook is sobering. This is obvious when looking at the EU's biggest economy and manufacturing power – Germany. According to Peter Leibinger, the president of the Federation of German Industries (BDI), Germany is facing the "deepest crisis since the founding of the Federal Republic." The chemical industry, the machine tool and steel as well as the automotive industries are facing "a structural decline" and the fear of deindustrialization is looming. In Germany bad news hits the media every day between crumbling infrastructure, soaring energy prices, layoffs and a skills shortage. Since 2019, the German automotive industry has been hit by 110,000 job losses. The transition from the internal combustion engine toward the electric vehicle (EV), where Chinese car makers are more competitive than their European counterparts, risks driving these figures up even more while German car makers are also considering moving part of their production from Germany to the US to circumvent tariffs put into place by Donald Trump.

As tensions are mounting with the US, including on economic topics, the use of the European "trade bazooka", the so-called Anti-Coercion Instrument (ACI), has been discussed. Notably, ahead of the Turnberry trade deal or amidst the tensions over Greenland. However, countries particularly exposed to the US decided against it, raising questions over the ACI being a mere "paper tiger." Donald Trump can easily play out Europe's dependence on US security and defense that gives the US leeway in trade negotiations, while the EU's energy dependence on the US is also increasing as it transitioned away from Russian energy.

The EU Facing the 2nd China Shock

China accounts for 35% of the world manufacturing production and the EU is faced with massive exports of Chinese overcapacities. Moreover, the Renminbi's undervaluation further decreases the competitiveness of European products as compared to Chinese products. The EU's bilateral trade deficit ballooned to over €350 bn in 2025. In the past decades, China had been benefiting from technological transfer from Western companies which concluded joint venture (JV) agreements with Chinese companies to get access to the Chinese market. >

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Guangzhou, Guangdong, China: 26 September 2025: Electric cars are displayed in a showroom at the GAC Aion Intelligent Ecological Factory.

> As long as divisions persist between European capitals, third countries can drive a wedge between them."

Now that Chinese companies master these technologies, Western companies are squeezed out from China. Increasingly, Chinese products, which are not only cheaper but increasingly also reaching the same quality level – or above – their European counterparts, compete both, with European products on the European market but also on third markets. That is what is considered the second "China shock."

It is notably the case in the EV sector where Chinese car manufacturers benefited from state subsidies, thereby leading to unfair competition. After an investigation by the European Commission (EC) the EU put into place countervailing duties against these Chinese EV manufacturers. However, discussions over the use of trade defense instruments display divergences among EU member states. Germany, particularly exposed to trade, fears retaliation and therefore was reluctant to sanction Chinese EVs. France, on the contrary, which is less exposed to trade, defends an offensive European approach. In response to the countervailing duties, China hit back, targeting cognac and dairy products with retaliatory measures, thereby showing it could play out the exposure of European – and more specifically French – sectors to the Chinese market. Beijing also knows how to astutely use its European counterparts' import-dependence on goods originating from China, for instance critical raw materials or semiconductors, where export restrictions led to shortages causing nervousness within the EU and among European companies.

The EU's New Economic Orientations

The saying goes that the EU has proven resolve to reform only with its back against the wall and, in these particularly challenging times, discussions on the way forward have intensified, perhaps helping to advance on key economic areas.

First, the new geoeconomic reality needs to be recognized: trade is increasingly weaponized and dependencies may be used to coerce trade partners and blackmail them. Acknowledging this is already a change in DNA for an EU that believes in economic liberalism, free trade, international division of labor based on comparative advantages and the availability of factors of production and economic efficiency. Economists, many of whom have doubted this, may need to adapt their view, and confront it with the analyses of political scientists looking at things from another lens.

Second, in some areas where there is consensus processes may be sped up. On the need of simplification of rules applying to European companies there is overall agreement within the EU. There is also convergence on diversification, meaning the multiplication of trading partners to increase the number of suppliers and clients and thereby reduce the EU's dependence on single states such as the US or China. Alternatives and possibilities of substitution are key to avoiding chokepoints and shortages. Trade agreements with Mercosur, India, and Australia were recently finalized.

Current Discussions on European Preference, the Internal Market, Mergers, Financing…

Third, European preference is now discussed within the Industrial Accelerator Act (IAA), which should boost investments, productivity in the industrial sector and the EU's competitiveness. While there is discussion on local content rules and on the scope of "Made in Europe" or "Made with Europe", the IAA should also contain increased conditionality to Foreign Direct Investments (FDIs) directed toward the EU including JV requirements, the investor's limitation of capital takeover and of controlling rights and a job guarantee in the EU.

Fourth, deepening the internal market has become a priority. European entrepreneurs face difficulties in securing funding as the European capital market is too fragmented. The Draghi report criticized that €300 bn of European savings each year fuel the US economy and could be better used to fund companies in Europe. A Savings and Investment Union (SIU) should help companies access capital in the EU. In parallel the "28th regime" is discussed: a truly European company structure with a single and simple set of rules facilitating doing business and raising financing seamlessly across Europe just as in uniform markets like the US or China. That would help EU companies grow and attract foreign investment.

Fifth, European merger rules are currently discussed with the prospect of furthering the creation of "European champions" to withstand global competition. For a long time, the EU favored consumer protection and was reluctant to allow mergers. Now the EU's approach is changing: mergers are also considered in the interest of consumers from the perspective of security of critical input supply, enhancing supply-chain resilience. Moreover, mergers enable the mutualization of costs and R&D, accelerate innovation and focus procurement budgets.

Finally, it always comes down to the financing. Mario Draghi evaluates the financing needs at €1 200 bn per year to invest in cleantech, quantum computing and artificial intelligence (AI), the steel, the car and the chemical and defense industries, to ramp-up with the US and China. Berlin, which is reluctant to European debt, points at other Member States' responsibility to improve their public finances. In this controversy, Mario Draghi in 2025, explained that public money is only considered a trigger to leverage private capital. "The more we push reforms, the more private capital will step up – and the less public money we will need."

Overcoming National Interests to Avoid Divisions

On many of these aspects national interests are in the way, for instance on European preference, Eurobonds or the SIU. Europe does have coordination tools to work on common industrial projects that help achieve scale, such as Important Projects of Common European Interest (IPCEIs). But member states spend a greater deal on state aid: In 2023, EU countries spent nearly €190 bn on state aid – five times more than has been allocated to IPCEIs since 2018. A truly European way of thinking would enable to increase synergies among Member States and their industries. As long as divisions persist between European capitals, third countries can drive a wedge between them such as China circumventing countervailing duties against its EV manufacturers. Thinking in terms of European interests could also include the pooling of costs to compensate for asymmetric retaliation from third countries.

Even though there has been great progress on joint strategies, policies and instruments in the economic realm within the EU, there is still room for improvement on the path to integrating a truly European reflex in the interest of a strong EU economy.

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