EUROFI Regulatory Update

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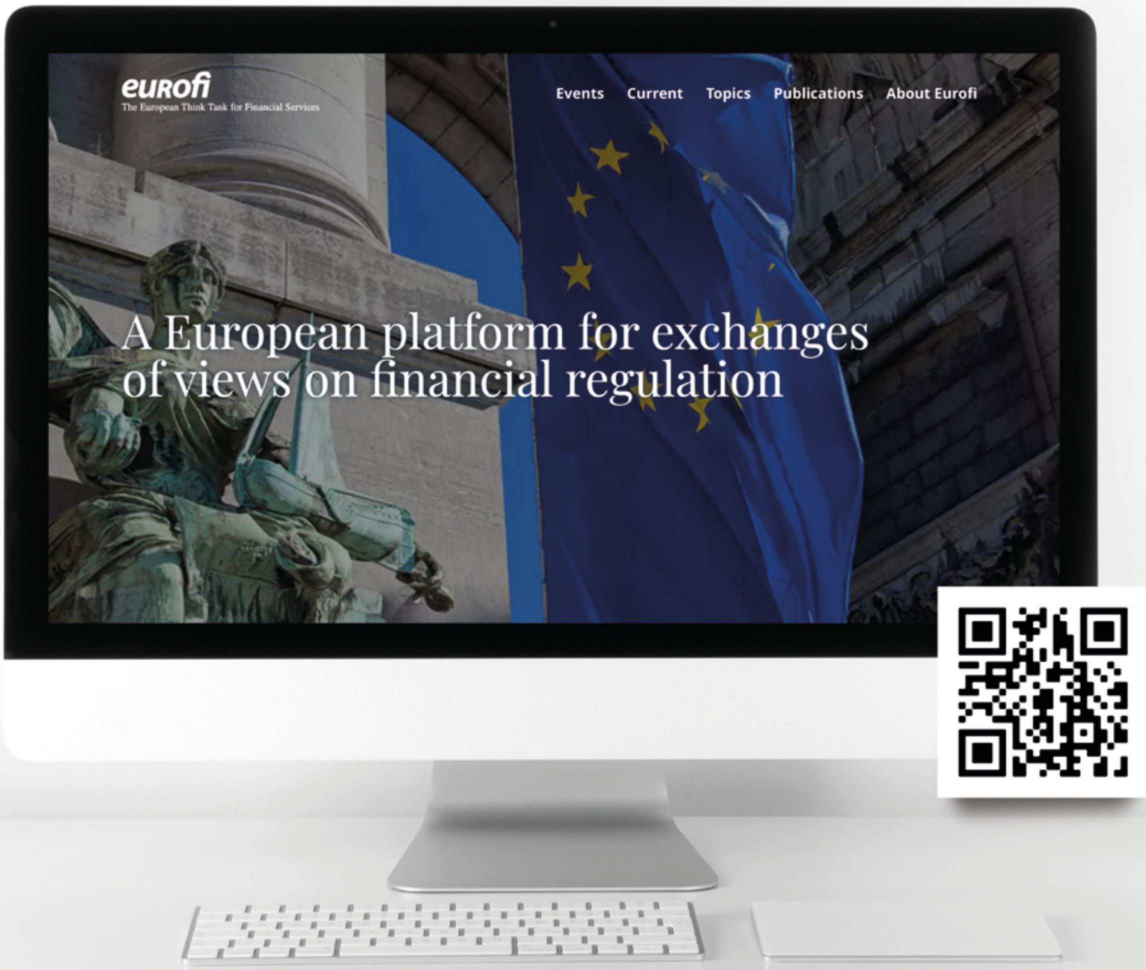

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The Monetary Policy Dilemma

Note written by Jacques de Larosière[1]

The world is shocked from the war launched against Iran by the United States and Israel.

This war was supposed to be local and quick: the missile strikes on Iran were intended to destroy that country's military capabilities in a matter of weeks.

However, due to Iranian resistance and reactions, the conflict is set to drag on. Iran has sought to "internationalize" this war by setting the entire Middle East ablaze. The situation has taken on global proportions, with rising hydrocarbon prices and disruptions to trade. According to observers, this situation portends serious stagflation on a global scale.

The U.S. leadership now appears, after more than three months of war, to be facing a conflict whose complexity and full international implications it does not seem to have fully grasped. Furthermore, the new administration in Washington is pursuing its agenda of dismantling the multilateral order that has ensured global prosperity since 1945.

Has this crisis – whose full international consequences have not yet been assessed – disrupted financial markets? The answer is no: markets have remained calm and efficient, and monetary policy has not shifted.

Let us examine this strange convergence: that of a potential severe global crisis that the markets do not seem to care about.

I will structure my remarks around three questions:

1. Can the resilience of financial markets last?
2. What can we expect from monetary policy in such a context?
3. What should we make of developments in digital currencies and market fragility?

1. The Resilience of the Markets is Surprising. Can it last?

A resident of Sirius who knew nothing about the war in Iran and the Middle East and followed only the movements of the financial markets would have a calm and positive view of our planet's prospects.

1.1 Stock markets have been calm and resilient since the start of the war in Iran (February 28, 2026)

Stock markets have been on the rise for years, but the uptrend continued after the start of the war in Iran. One reason for this strong market performance is the hope that the conflict will not drag on. The markets have "voted" for an end to hostilities before the end of June 2026, which demonstrates remarkable confidence in their ability to predict and influence the future.

This chart shows that since the start of the conflict with Iran (February 28, 2026), the S&P 500 has gained – after a brief dip in March – a maximum increase of 7% on May 10, 2026. Stock markets soared from record to record in April and May.

In the bond markets, there has been a certain rise in rates. But optimists note that these movements are in line with the trend in inflation, which is on the rise, even though it was, until April 2026, fairly close to the official target of 2%.

1.2 Foreign exchange markets have been relatively calm despite a turbulent environment, but certain exchange rate distortions have worsened:

The euro has remained stable over the past year.

The dollar has weakened slightly, but only modestly (-2.7%) given the scale of the macroeconomic imbalances in the United States.

The yen has plummeted. But this is the result of a long-standing, systematic policy of lowering interest rates.

As for the yuan, it has lost 7% against the euro over the past year. In terms of relative competitiveness (in purchasing power), according to the IMF, the yuan is undervalued by 16% relative to the

1. Speech delivered by Jacques de Larosière at the Global Official Institutions Conference (GOIC) on 18 June 2026.

CHART 1.
Stock Market

Source: Zonebourse.com

Eurozone, thereby giving Beijing a considerable export advantage.

But, overall, nothing is disrupting the calm in the markets, which continues to hold.

1.3 Government pressure on central banks to lower key interest rates continues. But not any more intensely than usual

Admittedly, President Trump has continued his pressure. But the Fed has not really given in (the Fed did, admittedly, cut rates by 0.25% in December 2025, but it cited the weakness of the labor market to justify this move).

The pressure will continue. But a man like Kevin Warsh (whom I know personally and hold in high regard) will never do anything he considers contrary to his country's interests.

To the question: "How long will the calm in the financial markets last?" the answer will depend heavily on the U.S. authorities. If they appear mired in a war with no obvious way out, and the conflict continues, it seems possible – if not probable – that the markets will eventually react to the crisis and, in particular, to the prospect of the conflict continuing indefinitely.

Since the start of the war in Iran, long-term bond yields have been rising (see chart), highlighting the uncertainty surrounding inflation expectations. But the higher oil prices get, the higher long-term rates climb, reflecting households' concerns about the future of inflation.

Since January 2023, 10-year rates have risen:

In the U.S., from 3.5% to 4.2%.

In France from 3% to 3.5%.

In Japan from 0.5% to 2.2%.

Stock and bond markets are dependent on the basic assumption that the conflict will end before July. If, on the contrary, it appears that the conflict is likely to drag on, a market downturn would be all the more plausible given the looming threat of stagflation.

It is important to understand that this is a "vicious cycle".

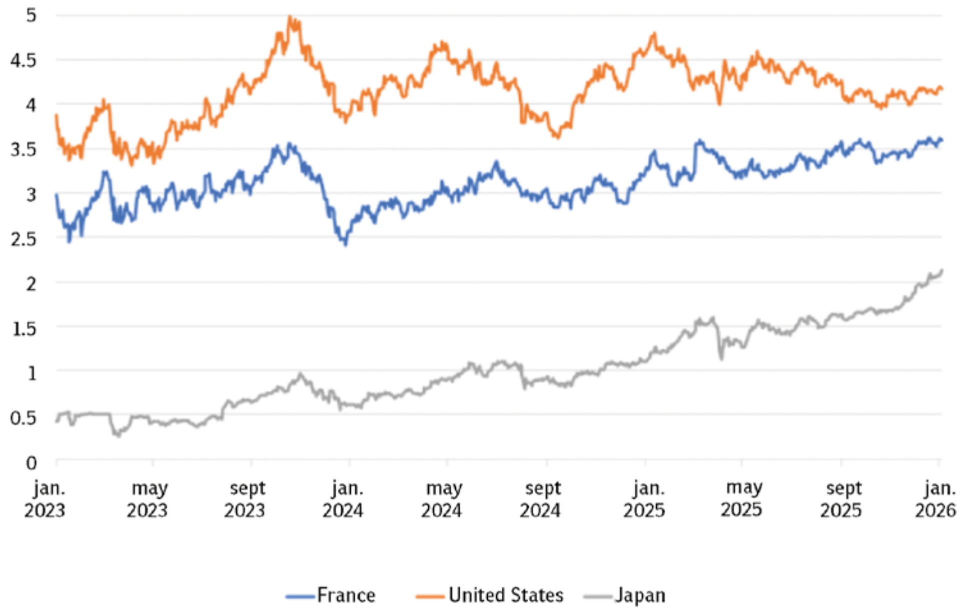
The markets are operating on the basic assumption that the conflict with Iran will be resolved by June 2026[2]. If it appeared that the war were to continue indefinitely, the markets would be forced to adopt an alternative – and necessarily pessimistic – scenario. The markets would turn downward, and after an initial wave of selling, the "Minsky Moment" could emerge...

All major international organizations are saying it: stagflation is just around the corner.

The IMF, in particular, offers an **interesting analysis** in its "Global Stability Report" (April 2026) **of the**

2. Given the significant decline in oil inventories, severe supply disruptions could occur if the conflict drags on and/or the Strait of Hormuz remains closed, as strategic hydrocarbon reserves appear increasingly insufficient.

CHART 2.
Interest rate on 10 years sovereign bonds



Source: BLOOMBERG

"**systemic** vulnerabilities" that could emerge should tensions escalate with a prolonged conflict in the Middle East.

- **The sharp rise in debt – both private and public – is a concern for the IMF.** As governments are forced to roll over their debt at higher rates, the risk of market destabilization intensifies. In turn, these tensions risk exacerbating the vicious cycle between sovereign risk and banking risk.
- Regarding **private credit**, the report highlights a rise in defaults. For now, these defaults are generally low in number and are being resolved through selective renegotiations or new debt without immediate interest payments. But if these defaults were to multiply and spread more widely among companies, there would be cause for concern about contagion (though the scale of the problem is still limited).
- **Lending to emerging markets** has largely been carried out by "non-bank" entities that could reverse their positions and drag the countries in question into episodes of acute crisis with adverse macroeconomic effects, as well as a surge in capital outflows aimed at unwinding positions.
- **The responsiveness and fiscal flexibility of many governments have diminished**. And massive calls by governments to the markets to finance their debt could widen spreads and increase tensions.
- **The foreseeable rise in inflation** could prevent monetary policy from supporting the markets. The foreseeable rise in key interest rates could slow the cycle of massive investments planned in artificial intelligence, as these increasingly rely on debt. Such a reversal could trigger a correction in stock markets dependent on AI.
- **Option sellers** could turn the market against itself, as they are sensitive to fluctuations in the underlying stocks and would thereby trigger increased stock market volatility and downward spirals.

2. What Can We Expect From Monetary Policy in the Current Context?

Inflation, driven by rising energy prices, has returned with a vengeance.

Often, episodes of rising oil prices are temporary and followed by declines. We therefore tend to look "through" energy prices, which do not have the power to structurally alter the inflation curve. But the current situation is complex.

Rising oil prices (which have climbed from $60 per barrel at the start of the war to $110 today) have already seeped into consumer price indices. In the United States, these have just risen to 3.5% over a three-month period, well above the 2% target set by central banks.

So, even if oil prices were to fall and return to their pre-Iran conflict levels, consumer prices would still have risen in the meantime. However, we see that these prices, once incorporated into overall inflation, do not tend to return entirely to their pre-crisis levels. Experience shows, in fact, that **after the crisis subsides**, the **price level will remain higher than it was before the price hike**. It is this relative inelasticity of the price level that poses a problem and leads us to the conclusion that the current sharp increases affecting consumer price indices cannot be fully reversed (see the Elias Krieff study on this subject).

This relative inelasticity of the price level is often overlooked, but it is a key element of the problem.

2.1 Stagflation, stemming from the conflict, is beginning to emerge and poses a real threat

It is well known that, among the effects of the Iran war, **the impact on production processes is among the most severe.**

With the unrest in the Middle East and disruptions to passage through the Strait of Hormuz, **we are witnessing significant supply disruptions**. There are numerous examples of this. One can cite agriculture, particularly in Asia (in India, Vietnam, etc.), which has been hit hard by difficulties in securing fertilizer supplies. Part of the spring planting season has already been affected. The Philippines have been seriously affected and have been declared a "disaster area".

However, these disruptions to the production system cannot be fully overcome, and production losses will reduce GDP in 2026. The same applies to supplies as diverse as medicines, semiconductors, and aluminum packaging...

In all these areas, the decline in production has already occurred, and growth forecasts are beginning to be revised downward.

It is too early to assess the exact extent of this emerging stagflation. This will depend, to a large extent, on the duration of the conflict. Disruptions in production chains could, of course, be partially resolved, but that will take time. Such uncertainties (Rogoff calls it the most serious threat of stagflation ever seen) are not good for productive investment, which is, however, a prerequisite for future growth.

2.2 Not all countries are equally affected

The countries most affected are obviously those that are most dependent on hydrocarbon imports. And among this group of countries, the most vulnerable are those with high levels of public debt and little remaining fiscal leeway. Implementing "mitigating measures" to reduce the loss of purchasing power caused by rising energy prices requires a minimum of fiscal leeway. A country like France no longer has such leeway and is forced to increase its borrowing to cover these increased subsidies.

The lower-left quadrant of the attached chart (countries that are both dependent on hydrocarbon imports and heavily indebted) shows just how severely a country like France is affected.

It is therefore impossible, based on this analysis, to assert that the effects of the conflict will be "reversible". The most likely scenario is that the world will fall prey to high stagflation (in 2026-27) and that the markets will have been hardly vigilant in foreshadowing this development.

2.3 What can central banks do in such an environment?

So far, with the exception of Norway, which has just raised its key interest rate, central banks have remained inactive. The Fed was, as always, torn between the duty to control inflation and the need to prevent rising unemployment. As for the ECB, it is still seeking the lowest possible key rates. (Its latest cut, in May 2026, allowed it to return to a zero key rate in real terms despite the harmful effects – increasingly recognized as such – of this strategy).

Central bank governors have therefore procrastinated... But the situation is becoming uncomfortable.

In a context of abundant liquidity, with inflation at 3.5% heading toward 4% – and QT virtually nonexistent (at least in the US) – it seems difficult for central banks to remain inert, unless they want to give the impression that the fight against inflation has now been abandoned[3].

Furthermore, **the macroeconomy still rests on a dual foundation: monetary policy and public finances**. Both must play a role in the fight against inflation. The situation in France could be characterized as follows. Inflation is trending above the 2% target set by the central bank. Given the two major factors – namely, the looming threat to public debt and public finances on the one hand, and the sheer volume of liquidity on the other – I believe we must understand that doing nothing today risks having consequences that we might regret later. To call a spade a spade, I think it is very difficult to

3. Producer prices in the United States, linked to the conflict in Iran, have risen by 6% over a 12-month rolling period (statistics as of mid-May 2026). This increase is the sharpest since 2022.

imagine that we would do nothing under these circumstances. Given the abundance of liquidity, it would be a salutary gesture of warning and vigilance for the future if we signaled an interest rate hike very soon. Doing nothing, turning a blind eye – standing idly by – would be a monetary policy move that would be difficult to explain.

Monetary policy cannot be conducted in isolation from fiscal policy. If fiscal policy remains lax – which it is – monetary policy must be all the more restrictive. If, on the other hand, fiscal policy were to restore a certain degree of discipline, then monetary policy would face less pressure. The two are therefore inextricably linked. And, if within this pair, fiscal policy continues to go off the rails without reform, what should monetary policy be? In principle, it should be tighter than it would be if the fiscal side demonstrated a greater sense of responsibility. However, I do not see this sense of responsibility materializing on the fiscal side. I do, however, see two major factors: on the one hand, the slide into debt, and on the other, the impact of the war in Iran on oil prices. I would feel very uncomfortable if I heard someone say: "Well, these things are important, but we don't yet see a strong influence on current inflation indices (the CPI). Therefore, we shouldn't do anything." In reality, since the ECB's monetary policy is less restrictive than in the U.S. and the U.K., it would be normal for Europe to raise interest rates.

There is, moreover, an interesting debate in the US regarding **the desirable size of the Fed's balance sheet.**

Until last year, the Fed was making progress in its effort to reduce its balance sheet through QT. By not reinvesting maturing securities, the Fed managed to reduce its market presence by $2 trillion (or 7% of GDP).

However, for some time now, the Fed's balance sheet has been growing again (+$200 billion since December 2025). The central bank's securities purchases are intended to keep reserves at a high level to better control short-term rates.

Mr. Kevin Warsh views a very large central bank balance sheet as an aberration and a way for the Fed to intervene in the fiscal sphere, which is not its domain.

Mr. Stephen Miran, a close advisor to the President, also believes that the Fed's presence in the market must be reduced as much as possible to avoid encouraging the distortions for which the government is responsible. Ultimately, a smaller balance sheet will better protect the boundaries between monetary and fiscal policy.

Miran wants to end the Fed's "regulatory dominance" and dismantle the incentives given to banks to increase their reserves with the Fed.

These views are set to be debated. Should the balance sheet be reduced in the traditional manner (through securities sales) or adapted to the new regulatory framework à la Miran?

To be continued...

I would add that in his Senate hearing on April 21, 2026, the new Fed Chair gave the impression that he was a strong personality.

He emphasized that the Fed's independence would be central to his role as Fed Chair;

He confirmed that he intended, over time, to lower key interest rates and gradually reduce the institution's balance sheet;

He was highly critical of the monetary policy pursued between 2021 and 2023, which he believes was ineffective in containing inflation.

Finally, a Fed Chair who is leaving the beaten path of "unconventional policy"!

3. But at the Same Time, Significant Changes Are Emerging Both in the Realm of Digital Innovation and in the Area of Excessive Leverage in Financial Markets

While some senior political leaders are bent on starting wars and undermining the multilateral free-trade system that has been in place since 1945, significant monetary and financial developments are taking place without much attention being paid to them.

3.1 The age-old dilemma. Can a national currency also be an international currency?

This is the age-old – and ever-present – dilemma.

How to preserve the dollar's international role while avoiding its appreciation, which risks undermining the competitiveness of American industry; despite the damage the United States inflicts upon itself (and in particular through sanctions that undermine the dollar's acceptability), the fact remains that the existence in the United States of the world's largest financial market – broad, deep, and liquid – keeps the dollar in its preeminent position. No one can compete with this market.

Despite its growing budget deficits, U.S. Treasury bonds remain the dominant benchmark.

The global market for government bonds is \$140.7 trillion, of which \$55.3 trillion is issued by the U.S. (39% of the total), with 31% held by non-residents and 14.6% by the Fed.

The worsening fiscal trajectory of the U.S. has hardly altered these figures, although the announcement of President Trump's tariff policy was accompanied by a 40-basis-point widening of spreads on U.S. sovereign debt.

In contrast, Eurozone countries issued €10 trillion (of which 35% is held by the ECB and 22% by non-residents).

Japan has issued \$7.8 trillion worth of debt, equivalent to 250% of its GDP. The Bank of Japan holds 52% of these bonds.

In summary, the general deterioration of fiscal policies raises questions about the quality of the securities issued and explains the rise in gold, a safe-haven asset that now accounts for 15% of reserves held by central banks.

The Chinese sovereign bond market – \$21 trillion – though large, is issued primarily by local and illiquid entities. The portion that is, in principle, "marketable" amounts to approximately \$2 trillion, which is relatively negligible.

A slow erosion of the dollar's share in global reserves is certainly worth noting (the dollar's share in central bank reserves has fallen from 72% to 58% since 1999), but there is no sign of a "replacement" for the dollar, whose market remains dominant and is characterized by its liquidity and depth.

Nevertheless, the international "system" is crumbling.

Settlements of commercial transactions are increasingly taking place in the currencies of the contracting states. And settlement platforms centered on the renminbi are multiplying.

These advances in instant payments are driven by the desire to reduce transaction costs and be less subject to the volatility of exchange rates for a few major currencies.

This transition to the Instant Payment System (IPS) is developing rapidly. More than 100 countries are now moving in this direction (see Hung Tran: "The global push for local-currency cross-border payments is intensifying" – Econographics, May 20, 2026).

These advances are intended to improve the efficiency of the payment system, not to replace the dollar as an international currency. However, inevitably, these new settlement methods will tend to reduce the dollar's role as an intermediary currency in international trade.

3.2 The rise of stablecoins

These instruments are developing under the influence of the U.S. "Genius Act" of July 2025.

The market capitalization of these assets, fully backed (one-to-one) by the U.S. dollar, is growing rapidly. It reached \$317 billion in April 2026. This figure could rise to \$3 or \$4 trillion by 2030, as noted in a recent study by Hung Tran[4].

Stablecoins are payment methods that can be used at low cost on the blockchain 24 hours a day. As such, these payment methods represent an improvement over traditional solutions.

From a monetary perspective, stablecoins increase the velocity of money compared to the slower turnover of bank deposits.

In principle, this increased velocity has inflationary implications. However, the requirement for issuers to hold 100% of the value of stablecoins in dollars makes this system similar to "narrow banks". These new payment methods are not covered by deposit insurance and, as a result, are not included in the M aggregates.

While stablecoins are purchased with cash, the fact remains that these payment methods are not included in M0, even though they are a tokenized form of currency in circulation.

Currently, stablecoin issuers hold \$182 billion in U.S. Treasury bills – representing 57% of their reserves – with the remainder held as bank deposits or certificates of deposit.

This \$182 billion still represents only a small percentage of the total T-Bills, which amount to \$6.3 trillion. It is possible that, in the future, if demand for stablecoins increases, the Treasury will issue more T-Bills.

The acquisition of stablecoins using bank deposits does not change the amount of deposits. The concern is rather that the foreseeable growth of stablecoins could lead to some disintermediation of the banking system: indeed, stablecoin users might well transfer their bank deposits into stablecoins.

The risks associated with stablecoins can be analyzed as follows:

4. See Hung Tran's article: "Stablecoins' Potential Effects on the Monetary System", Policy Center for the New South, PB26/26. I drew inspiration from this article in the text above.

- stablecoins introduce – in the realm of payments – the risk of cyberattacks;
- the risk of a loss of collateral ("depegging"). There have been 9 instances where collateral fell below 100%;
- The risk of dollarization of foreign payment systems appears relatively low given the $16 trillion held by banks outside the U.S. However, the proliferation of stablecoins points toward an increased role for the dollar internationally and a decline in interest rates on Treasury bills.

3.3 The ECB is continuing its painstaking work on the issuance of a central bank digital currency

The digital euro is supposed to have all the characteristics of a central bank currency, just like the banknotes and coins it is not meant to replace but to complement.

This highly technical issue is progressing slowly in Frankfurt. But I would tend to side with the opinion of Mr. Bailey, Governor of the Bank of England, who finds it strange that certain central banks want to become operational themselves on a technical issue concerning digital means of payment. Why not leave this matter to the private sector?

The central goal of this push toward a central bank digital currency is driven by the desire to restore the sovereignty of the payment system – sovereignty that has been compromised for 22 of the 27 European countries, which are exclusively dependent on the American systems Visa and Mastercard.

Before taking a stance on complex issues and questionable solutions, it would seem wise to pause the process and ask independent bodies to conduct comparative analyses.

3.4 Excessive market leverage. Several risk-laden phenomena are currently emerging

a) Leverage increases when retail investors make greater use of margin debt.
These investors borrow from brokers using their existing investments as collateral.
The amount of margin debt in use reached a record $1.2 trillion by the end of December 2025. Added to this is an additional $250 billion in leveraged exchange-traded funds (ETFs).
Overall, the high degree of leverage that characterizes these retail investments can cause their valuations to swing both up and down. But at the expense of the system's stability.

b) **Hedge funds** are betting with less and less of their own money and are increasing their debt, particularly with banks.
The value of Treasury bill swaps (long cash positions combined with short futures positions to exploit small valuation differences) has risen significantly in recent times. When interest rates and the value of instruments move contrary to expectations, hedge funds incurring losses are forced to unwind their positions and sell assets, which creates new tensions in the markets.

c) The rise of private credit introduces new vulnerabilities.
The market has grown from $500 billion in 2010 to $1.3 trillion by the end of 2025, and the trend continues to expand. (It is expected to reach up to $5 trillion in the near future).
Private credit is predominantly accompanied by "covenant-lite" contracts, as was the case before the 2007–2008 crisis.
Private credit funds are investing more in collateralized loan obligations (CLOs) to improve their performance. However, transparency and quality suffer as a result.
There is also a surge in "continuation deals," which allow "non-banks" to sell debt to themselves. The cash generated by these debts is then re-lent to companies whose already very high debt levels are rising (these "continuation deals" have grown from $4 billion in 2024 to $15 billion in 2025).

d) **Non-bank debt[5] is increasingly linked to banks**
The amount of bank loans to various types of non-banks (CLOs, asset-backed securities, insurance companies, private equity firms, hedge funds, etc.) has grown at an accelerated pace. The outstanding balance of these loans is high, reaching $2.5 trillion.
For their part, banks have accumulated $1.5 trillion in leveraged loan exposures (a 12% increase since 1997).
The Fed's report on financial stability at the end of 2025 notes that the financial system's leverage is "significant".

However, experience shows that excessive debt is a source of vulnerability.

The risks highlighted above – which are partly linked to the uncertainties surrounding President Trump's policies – should serve as a warning to authorities if we are to avoid a recurrence of the tensions that led to the 2007-2008 crisis.

5. "Non-banks" accounted for 41% of the European Union's financial sector assets at the end of 2023.

In conclusion, I believe it is worth noting that despite the resilience and calm of the markets, vulnerabilities are evident.

The wave of stagflation stemming from the war in Iran is very real (inflation is projected to reach 4% in 2026–27, with growth expected to decline by at least 1%, based on current estimates).

A global economy whose lifeblood – *i.e.*, trade – is disrupted is an economy whose very foundations are threatened.

That said, the dollar will remain the international currency for a long time to come. This is due to the power, liquidity, and size of the U.S. financial market.

A number of vulnerabilities that predate the Middle East conflict must be addressed if we are to avoid a debt crisis.

Overly Indebted Euro Area Sovereigns: More at Risk Than International Peers?

Note written by Didier Cahen & Elias Krief with Kiann Conlon

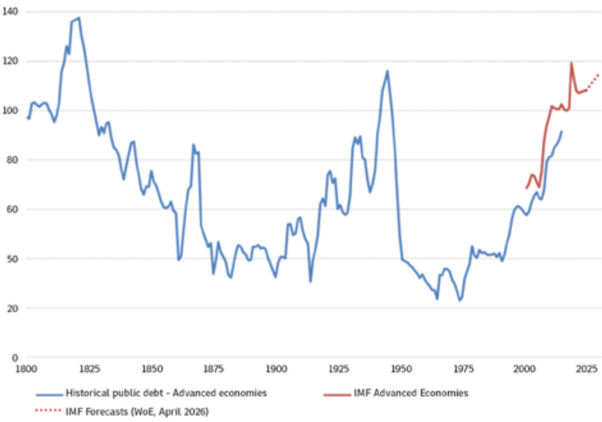
INTRODUCTION

The sovereign debt debate needs to be reframed

Public debt has become a defining feature of advanced economies. It rose from an average of around 40% of GDP in the 1980s to over 120% by 2025 (*see Chart 1*). Yet the assessment of sovereign debt sustainability continues to focus predominantly on debt-to-GDP ratios. This paper argues that such an approach has become increasingly insufficient. While several advanced economies now carry historically high debt burdens, sovereign vulnerabilities are far from evenly distributed. Our analysis suggests that some highly indebted Euro area Member States are structurally more exposed to a deterioration in financing conditions than other advanced economies carrying comparable – or even substantially higher – levels of public debt, including the United States and Japan.

This apparent paradox reflects differences not simply in fiscal positions, but in monetary sovereignty, economic growth, institutional architecture, financing structures and market resilience. In the current macro-financial environment, these structural characteristics increasingly determine whether high public debt remains manageable or becomes a source of financial vulnerability.

CHART 1.
Advanced economies, gross government debt, % of GDP

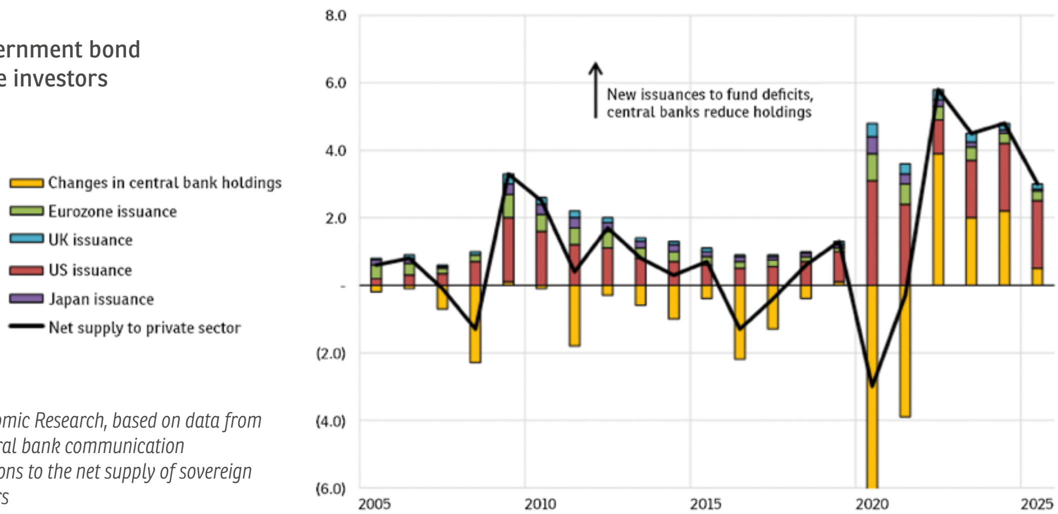


Source: Ekonomics, *based on data from the Historical Public Debt Database (Abbas, Belhocine, El-Ganainy & Horton, 2010). World Economic Outlook, April 2026*

A fundamentally different macro-financial environment

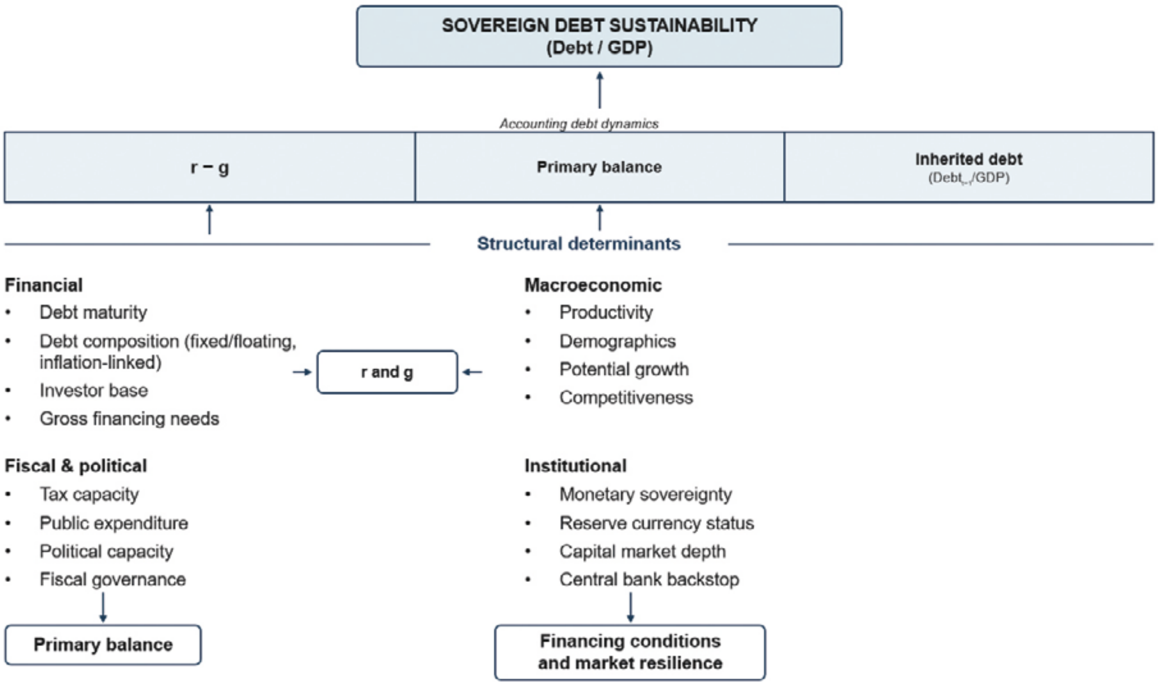
The pre-pandemic period, characterised by exceptionally low interest rates, quantitative easing and abundant central bank liquidity, has ended. Higher interest rates, quantitative tightening, demographic pressures, defence spending and weaker productivity growth have fundamentally altered sovereign debt dynamics. As central banks

CHART 2.
Net supply of government bond issuance to private investors



Source: Berenberg Economic Research, based on data from Haver, IMF, various central bank communication
Notes: in $ tn, contributions to the net supply of sovereign bonds to private investors

CHART 3.
A multidimensional framework for assessing sovereign resilience



Macroeconomic: *r-g, potential growth, productivity, demographics, competitiveness.*
Fiscal: *debt-stabilising primary balance, fiscal capacity, taxation, expenditure quality.*
Financial: *gross financing needs, maturity, creditor base, external balances, private debt.*
Institutional: *monetary sovereignty, political capacity, reserve currency status, capital market depth.*

gradually withdraw from sovereign bond markets, record gross financing needs must now be absorbed by increasingly price-sensitive private investors – a structural shift that raises both the cost and the volatility of sovereign borrowing (*see Chart 2*).

The consequences are unlikely to be uniform. Sovereigns combining credible fiscal trajectories, stronger growth, deeper domestic capital markets and greater monetary autonomy are likely to prove significantly more resilient than countries lacking these characteristics.

Why debt-to-GDP ratios no longer discriminate sufficiently between sovereign risks

Ten advanced economies had public debt above 90% of GDP in 2025, five of which were in the Euro area. However, they do not face equivalent risks. Countries displaying similar debt ratios may differ substantially in their ability to absorb future shocks because resilience depends on the interaction between macroeconomic performance, fiscal dynamics, financial structure and institutional arrangements. This observation is particularly relevant when comparing France, Italy and Belgium with the United States and Japan. Although the latter display higher debt ratios, their monetary sovereignty, market depth and investor base provide important stabilising mechanisms unavailable to Euro area sovereigns.

A multidimensional framework for assessing sovereign resilience

Existing analytical frameworks developed by the IMF, the European Commission, the BIS and the OECD have considerably improved sovereign debt surveillance. This paper builds on these approaches rather than challenging them. Its contribution lies in integrating their principal determinants into a single comparative framework centred on sovereign resilience.

None of these indicators alone determines debt sustainability. Their interaction explains why countries with similar debt ratios may exhibit markedly different levels of vulnerability.

The dynamics of public debt is, at its core, an accounting phenomenon: the change in the debt-to-GDP ratio from one period to another is governed by the interaction of three fundamental determinants – the interest rate-growth differential (r–g), the inherited debt stock, and the primary budget balance. Any deviation of the primary balance from its debt-stabilising level mechanically translates into a change in the debt ratio, upward or downward.

Yet these three proximate determinants are themselves endogenous to a broader set of structural and institutional forces. The debt service burden is shaped not only by prevailing market interest rates but by the composition of the debt stock itself – notably its average maturity profile, the share of inflation-indexed or floating-rate instruments, and the structure of the investor base, in particular the relative weight of foreign versus domestic holders and of private versus official creditors, each carrying distinct implications for rollover risk and market sensitivity.

Potential growth, in turn, reflects long-run supply-side fundamentals – above all total factor productivity dynamics and demographic trajectories whose deterioration in most advanced economies structurally compresses the denominator effect that historically helped contain debt ratios.

The primary balance is conditioned by the prevailing degree of political stability, which governs both the capacity to sustain fiscal adjustment over time and the willingness to enforce the expenditure restraint and revenue mobilisation that consolidation requires.

A comprehensive assessment of debt sustainability must further account for private-sector leverage. Countries combining elevated public and private debt are disproportionately exposed to a higher-for-longer interest rate environment, as the simultaneous deleveraging pressures on both balance sheets can amplify contractionary dynamics, erode the tax base, and ultimately impair the sovereign's capacity to generate the primary surpluses on which long-run sustainability rests.

Purpose of the paper

While the macro-financial environment is deteriorating for indebted economies more broadly, exposure to debt sustainability risk – understood as the capacity to generate sufficient resources to service public debt – is far from uniform. Two countries carrying comparable debt levels can face radically different sustainability trajectories depending on their primary balance, growth outlook, debt structure, institutional framework and political capacity for adjustment, making it difficult to identify a single threshold beyond which debt becomes unsafe.

Rather than asking whether a sovereign debt crisis is imminent, the objective is to understand why apparently similar debt ratios may conceal fundamentally different degrees of resilience, and which indicators deserve the closest attention from policymakers and financial markets in the years ahead.

This note assesses vulnerability along several dimensions: debt arithmetic, debt structure, private sector leverage, and supply-side fundamentals. The arithmetic alone already points to divergent – in some cases unsustainable – trajectories for the United States, France and Belgium, while fiscal effort puts several southern European countries on a more credible path.

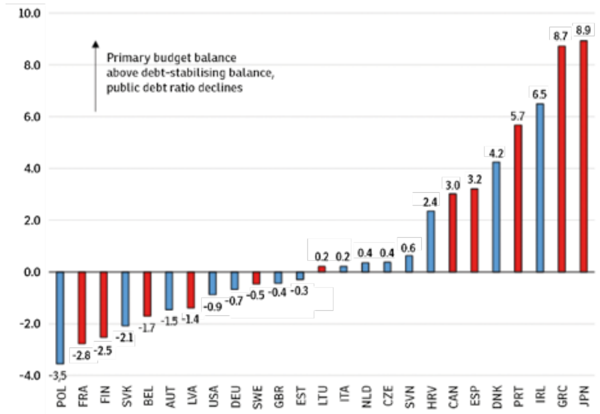
Main findings

Applying the multidimensional framework developed above to the most highly indebted advanced economies leads to five main findings.

First, debt arithmetic already points to markedly different debt trajectories despite similar debt ratios. While fiscal adjustment is gradually stabilising debt dynamics in countries such as Italy, Portugal and Greece, persistent primary deficits leave the United States, France and Belgium on increasingly difficult-to-stabilise debt paths.

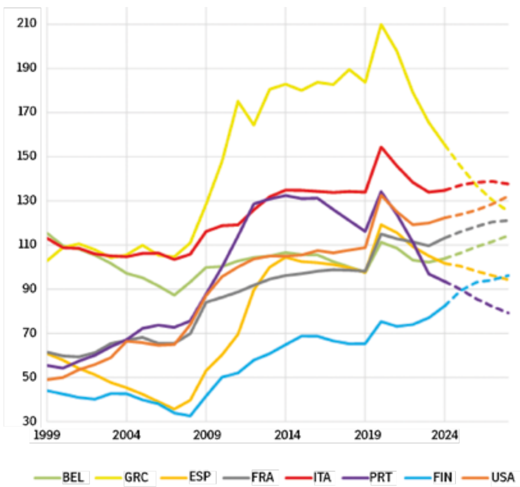
CHART 4.
Fiscal gap and public debt prospects

Chart 4a : Fiscal gap* in 2025, pts points



Source: Ekonomics, *based on data from the IMF (WoE, April 2026)*
*Notes: *Gap between the primary balance and the debt-stabilizing primary balance. A negative gap indicates that the primary balance falls short of the level required to stabilize the debt ratio, implying an increase in the public debt-to-GDP ratio relative to the previous year. Red bars are countries with debt to GDP close or above 90% of GDP in 2025*

Chart 4b : Gross public debt, % of GDP



Source: Ekonomics, *based on data from the IMF (WoE, April 2026)*

TABLE 1.
Heatmap of debt sustainability risk – Key indicators across the most heavily indebted advanced economies, 2025

Variable group	Variable	Unit, year	France	Belgium	Italy	Spain	Portugal	Greece	Finland	United States	United Kingdom	Japan	Canada
Arithmetics of public debt	Public debt	% of GDP, 2025	116,0	106,3	137,1	100,4	89,9	145,7	89,3	123,9	102,3	206,5	113,5
	Primary Balance	% of GDP, 2025	-3,1	-3,5	0,5	-0,4	2,1	4,4	-3,5	-3,2	-2,8	-0,9	-2,1
	Stabilizing Primary Balance	% of GDP, 2025	-0,4	-1,8	0,3	-3,6	-3,5	-4,3	-1,0	-2,3	-2,3	-9,8	-5,1
	Fiscal gap	% of GDP, 2025	-2,8	-1,7	0,2	3,2	5,7	8,7	-2,5	-0,9	-0,4	8,9	3,0
	Projected Public debt	% of GDP, 2031	120,7	122,3	136,1	90,4	74,4	110,9	100,8	142,1	102,6	192,8	103,5
Debt structure	Non-resident holders	% of public debt, 2025	54,3	63,4	34,3	48,9	47,2	76,4	61,1	36,0	33,4	11,8	41,0
	Central Banks hodings	% of public debt, 2025	19,2	18,6	18,1	24,4	27,1	10,1	22,4	14,6	18,5	46,3	17,0
	Average weighted Maturity	Years, 2025	8,4	9,9	6,8	7,7	7,6	9,6	7,7	5,8	13,4	9,3	6,7
	Variable, Inflation-indexed debt and T-Bill	% of public debt, 2025	19,0	8,0	21,0	11,0	6,0	10,0	10,0	30,0	26,0	12,0	23,0
Supply-Side structure	Long-term Real GDP growth	%, 2031	1,1	1,3	0,7	1,7	1,6	1,6	1,2	1,8	1,4	0,6	1,8
	Dependancy Ratio	2024	40,2	35,7	42,0	34,9	42,5	41,6	42,8	30,8	34,0	54,9	33,2
	Public pensions expenditures	% of GDP, 2025	14,2	13,1	16,1	13,7	12,8	13,2	13,2	5,3	8,2	9,1	7,2
Private debt	Level	% of GDP, 2025	215,4	174,7	94,3	119,3	128,1	97,4	177,4	140,3	132,6	175,1	218,9
	Change 2013-25	pts	32,6	-29,5	-28,7	-88,7	-91,2	-37,4	0,2	-11	-33,8	16,6	29
Government Spending and taxation	Gov. Expenditures	% of GDP, 2025	57,5	38,9	51,1	44,7	43,7	49,7	57,6	37,7	43,6	36,9	44,0
	Interest payment	% of tax burden, 2025	4,8	5,0	8,9	6,3	4,9	7,6	3,7	17,5	9,1	3,6	12,2
	Tax burden	% of GDP, 2025	46,3	44,3	43,2	38,2	37,3	41,6	42,7	26,6	37,3	33,2	14,7

Source: Ekonomics, *based on data from the IMF, World Economic Outlook (April 2026); European Commission/ECB; OECD; national authorities*
Note: The fiscal gap measures the distance between the observed primary balance and the debt-stabilising primary balance (i.e. the primary balance that would, given the prevailing interest rate-growth differential, hold the debt-to-GDP ratio constant). A negative fiscal gap indicates that the observed primary balance exceeds the stabilising threshold, putting the ratio on a declining path; a positive fiscal gap indicates an insufficient primary balance, consistent with a rising debt ratio. Colour coding follows a traffic-light scale (green: comparatively favourable; red: comparatively unfavourable) applied independently to each across the sample

Second, these accounting dynamics are themselves shaped by deeper structural factors. Italy and the United States remain exposed to refinancing risk because of relatively short debt maturities, whereas France and Belgium are more vulnerable to shifts in investor sentiment owing to their heavy reliance on non-resident investors. High private-sector indebtedness adds a further layer of vulnerability in Belgium, Japan and France, although only France continues to experience rising private leverage. Demographic ageing and weak productivity further aggravate debt dynamics in Italy, are only partly offset by automation in Japan, weigh increasingly on France and Belgium, and remain considerably more favourable in the United States.

Third, several highly indebted Euro area Member States appear structurally more vulnerable than the United States despite carrying comparable – or even lower – public debt ratios. The United States benefits from reserve-currency status, monetary sovereignty, deep and integrated capital markets, stronger long-term growth, energy self-sufficiency and a lower tax burden. By contrast, Euro area sovereigns borrow in a currency they do not individually control, operate within fragmented capital markets and cannot rely on an unconditional central bank backstop. Debt sustainability in the Euro area must therefore be assessed primarily at the level of individual Member States rather than through aggregate Euro area indicators.

Fourth, France emerges as one of the most exposed large Euro area sovereigns. Although its debt ratio remains below Italy's, several forward-looking indicators point to greater vulnerability: a much larger share of debt held by non-residents, the absence of a primary surplus since 2002, a persistent external deficit, substantially higher private-sector indebtedness and weaker productivity performance. By contrast, Italy has returned to primary surpluses and is pursuing sustained fiscal consolidation despite its much higher inherited debt stock.

Finally, France's fiscal trajectory raises a broader question about the resilience of the Euro area's institutional framework. An economy growing by around 1% cannot indefinitely sustain interest payments approaching 3% of GDP while continuing to run large primary deficits. Rising sovereign yields, increasing market concerns and persistent political difficulties in delivering durable fiscal consolidation suggest that, absent credible adjustment, France's fiscal position could progressively undermine market confidence and generate wider implications for financial stability within the monetary union

1. Debt Arithmetic Suggests Increasingly Difficult to Stabilise Debt Dynamics in the United States, France and Belgium, While Fiscal Efforts Are Putting Some Southern European Countries on a Credible Fiscal Path

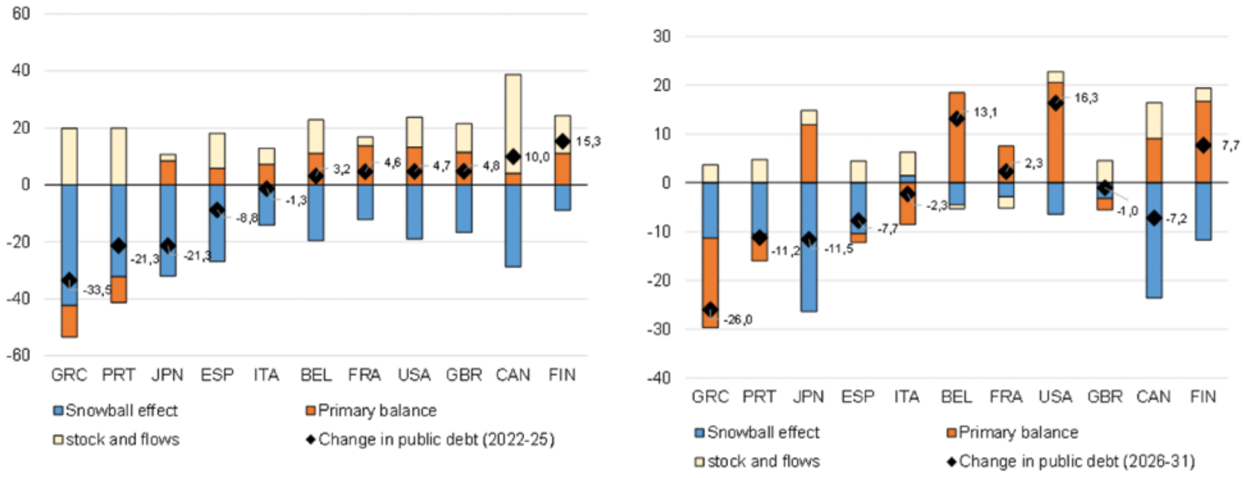
Public debt dynamics is an accounting phenomenon. Its variation over time reflects the interaction of three key inputs: the interest rate–growth differential (r–g), the inherited level of public debt, and the primary budget balance. The first

CHART 5.

Gross public debt dynamcs and drivers across the most indebted countries

Chart 5a : Change in gross public debt between 2022 and 2025

Chart 5b : Projected change in gross public debt between 2026 and 2031



Source: Ekonomics, *based on data from the IMF*

of these, commonly referred to as the **snowball effect**, captures the mechanical tendency of a debt ratio to rise when the GDP growth rate falls below the interests paid on government debt. From this snowball effect, a debt-stabilising primary balance can be derived analytically – the level of the primary balance that would exactly offset the snowball effect and hold the debt ratio constant. Any primary balance below this stabilising threshold is associated with a rising debt ratio; and where r exceeds g, that threshold is set higher still, since both the inherited stock and the unfavourable differential push the ratio upward.

The sign of the r–g differential determines the level of the primary balance required to stabilise the debt ratio.

- A **negative** r–g differential (r<g) implies a deficit-stabilising balance: public debt can be reduced despite a primary deficit, provided that the primary deficit is lower than the stabilising deficit.
- Conversely, a **positive r–g** differential (r>g) implies a surplus stabilising balance. To reduce public debt, the primary balance must therefore be in surplus and greater than the stabilising balance.

While the r–g differential has been negative and is projected to remain so in most heavily indebted economies – albeit on a narrowing path – several of them are running primary deficits well above the debt-stabilising level, such that their debt ratio continues to rise. Chart 5 decomposes the cumulative change in the gross debt-to-GDP ratio of the eleven most indebted advanced economies into its three proximate drivers – the snowball effect, the primary balance contribution, and a residual stock-flow adjustment[1] – over the realised period 2022-25 and the projected period 2026-31. The exercise reveals a striking degree of heterogeneity, which can be organised into five broad archetypes:

1. **Persistent deficits incompatible with debt stabilisation: Belgium, France, the United States, and Finland.** In all four cases, the rise in the debt ratio is overwhelmingly attributable to primary deficits that remain incompatible with stabilisation even where the snowball effect is only mildly favourable: France (+4.6 points of GDP over 2022-25), the United States (+4.7 points), Belgium (+3.2 points) and Finland (+15.3 points – the largest increase in the sample). Projections suggest this pattern is set not merely to persist but to intensify: the United States is projected to accumulate a further +16.3 points and Belgium +13.1 points over 2026-31, with France (+2.3 points) and Finland (+7.7 points) continuing to deteriorate more moderately.
2. **Italy illustrates a contrasting archetype: fiscal consolidation undermined by weak growth and rising debt-servicing costs.** Having

1. The stock-flow adjustment (SFA) captures the difference between the change in the gross debt-to-GDP ratio and the sum of the snowball effect and the primary balance contribution. It reflects transactions that affect the debt level without passing through the deficit – notably financial transactions (acquisitions of financial assets, loan disbursements), valuation effects (exchange rate movements on foreign-currency-denominated debt), and statistical reclassifications. Source: European Commission/Eurostat, AMECO methodology.

returned to a primary surplus in 2024, Italy's primary balance reached 0.8% of GDP in 2025, and is projected to keep rising, to around 1.3% of GDP by 2027. Yet this strengthening fiscal effort has so far delivered only a near-stabilisation of the debt ratio over 2022-25 (–1.3 pts of GDP): with potential growth structurally weak and the cost of debt servicing still rising as the stock of low-yielding debt issued before 2022 is progressively refinanced at higher rates, the snowball effect is projected to roughly neutralize the additional fiscal effort over the near term, leaving debt on a slightly declining path of -2.3 pts over 2026-31 before the consolidation gains take fuller hold. This is consistent with the projected approach of Italian public debt towards 140% of GDP by 2027, overtaking Greece as the most indebted sovereign in the Euro area.

Italy nevertheless remains exposed to the combination of a very high inherited debt stock, weak potential growth and one of the highest interest burdens in Europe. As a result, sustained primary surpluses will need to be maintained over many years before public debt can be placed on a clearly declining trajectory.

3. **Strong nominal growth cushions persistent primary deficits: Japan.** Despite a chronically negative primary balance, its debt ratio fell by –21.3 pts of GDP over 2022-25 and is projected to fall by a further –11.5 pts over 2026-31, as a highly favourable r–g differential – reflecting the post-pandemic resurgence of inflation against a still-contained cost of debt service – performs the consolidation work that the primary balance does not. This lay out illustrates the risk that a benign snowball effect can mask, rather than resolve, an underlying structural deficit problem, leaving debt dynamics vulnerable to any normalisation of the interest rate-growth differential.
4. **Fiscal adjustment compounded by strong growth, on a clearly downward path: Portugal and Greece.** Portugal (–21.3 pts over 2022-25; a further –11.2 pts projected for 2026-31) and Greece (–33.5 pts; –26.0 pts projected) post by far the largest declines in the sample. In both cases, sustained primary surpluses combine with above-average nominal growth to durably outweigh any residual drag from the snowball effect, placing these two countries – paradoxically among the most heavily indebted in the Euro area at the start of the period – on the most credible deleveraging path within the group.
5. **Spain** (–8.8 pts over 2022-25, with a further –7.7 pts projected), the **United Kingdom** (+4.8 pts, reversing to –1.0 pt projected), and Canada (+10.0 pts, reversing to –7.2 pts projected) **occupy intermediate positions**, combining elements of fiscal effort, supportive growth, and – for the United Kingdom and Canada in particular – an anticipated easing of the snowball effect expected to arrest the recent deterioration in their debt ratios.

Taken together, this decomposition confirms that the level of public debt alone is a poor predictor of sustainability risk. Countries with comparable, or even lower, debt ratios – France and Belgium chief among them – face a markedly less favourable trajectory than some of the currently most indebted economies, owing to the combined effect of high primary deficits and an adverse interest rate-growth differential.

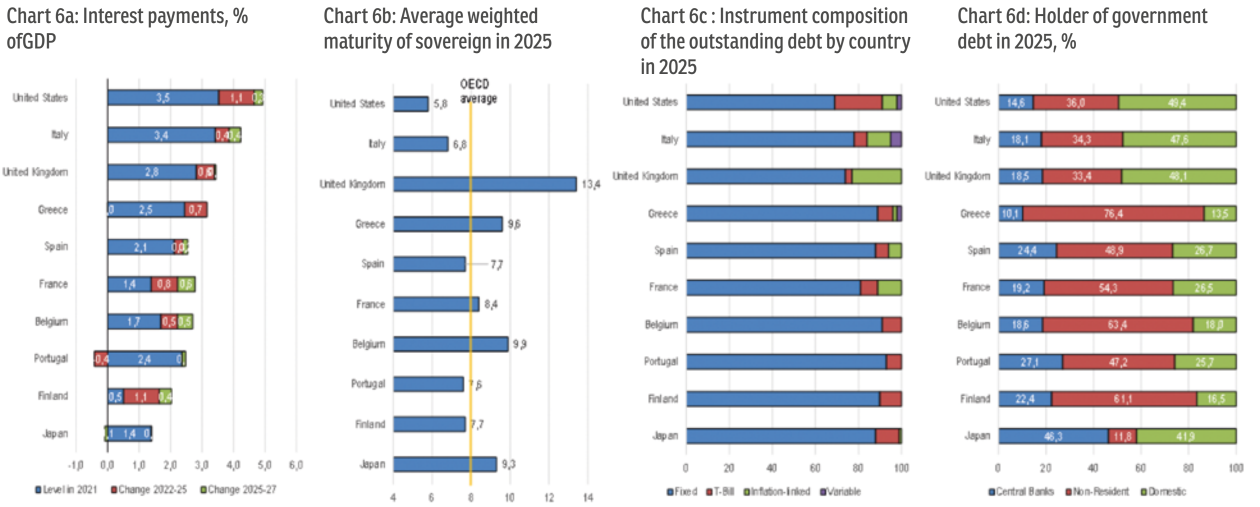
2. Institutional, Financial and Supply-Side Structures Amplify Vulnerability for Italy, France and Belgium – But Provide Japan, Portugal and Greece with a Structural Buffer

The three proximate determinants of public debt dynamics – the r-g differential, the debt stock, and the primary balance – are shaped by a broader set of structural forces that influence how quickly a shock is transmitted to borrowing costs, and how much fiscal capacity a sovereign retains to absorb it. The four categories of factors that matter are: the composition of the debt stock, which determines how quickly a rate shock is passed on to servicing costs; private-sector leverage, which creates contingent fiscal liabilities that materialise precisely when public balance sheets are under the most strain; supply-side fundamentals, such as productivity and demographics, which reduce both potential growth and revenue capacity; and institutional architecture, which determines the conditions under which debt is financed and how resilient market access is under stress. Examining these factors together reveals a markedly different distribution of vulnerability to that suggested by the headline debt ratio alone.

2.1 Debt structure, private-sector leverage and supply-side fundamentals shape the degree of financial vulnerability across highly indebted sovereigns

As specified earlier, public debt sustainability cannot be assessed from the headline debt-to-GDP ratio alone. The dynamics governing debt accumulation – captured analytically by the

CHART 6.
Debt structure and interest payment across selected indebted economies



Source: OECD, IMF, ECB, Federal Reserve

interest-growth (r–g) differential and the primary balance – are themselves shaped by a wide set of underlying macroeconomic, financial and institutional factors. The BIS Annuel Economic Report (BIS AER2026)[2] frames this multi-dimensionality precisely: "whether fiscal pressures will prove manageable depends on how borrowing costs evolve, which is determined by two factors – the structural demand for government bonds, itself shaped by demographic trends, productivity growth and household saving behaviour; and the capacity of the financial system to intermediate that demand, which can shift rapidly in response to shocks and compress fiscal space well before any limit implied by long-run fundamentals is reached."

2.1.1 Italy and the United States are rendered vulnerable by their debt maturity, France and Belgium by their debt holders

The structure of public debt – defined by the residency and institutional nature of its holders, the maturity profile of outstanding securities, and the share issued at variable or inflation-linked rates – conditions how quickly and how forcefully a given interest-rate shock passes through to the cost of debt service.

Three channels operate jointly. (I) The maturity structure determines the pace of rollover: a high share of short-term debt forces a government to refinance a larger fraction of its stock at prevailing market rates each year. (II) Floating-rate and inflation-linked instruments remove the buffer that fixed-rate, long-maturity debt normally provides, repricing automatically with policy rates or inflation outturns. (III) And the composition of the investor base shapes the stability of demand: while a large non-resident holder base signals market access and reduces the adverse feedback loop between sovereign and domestic-bank balance sheets, non-resident holders – particularly non-bank asset managers – are typically more sensitive to global liquidity conditions, making the holder base more prone to sudden stops in periods of stress.

The BIS AER2026 adds a further dimension to this last channel: "the same deterioration in fundamentals can compress fiscal space far more severely" when the financial system's intermediation capacity is constrained – a risk that has grown as NBFIs, with their "highly leveraged and funding-dependent strategies", have replaced central banks as the marginal holder of sovereign debt.

Against this framework, the most heavily indebted advanced economies display markedly different vulnerability profiles.

Italy, the United States and the United Kingdom stand out for the level and continued rise of their interest burden, even though they reach it through different channels. Italy's interest payments rose from 3.4% of GDP in 2021 to a projected 4.2% by 2027, driven by a short average maturity (6.8 years) and a meaningful inflation-linked component. The US shows an even sharper increase (3.5% to close to 4.9%), reflecting the shortest maturity in the group (5.8 years) and an instrument mix tilted toward T-bills, which forces continuous rollover at prevailing rates. The UK reaches a comparably elevated burden (2.8% → roughly 3.4%) through the opposite channel: its maturity is the longest in the sample (13.4 years), but its 24-25% inflation-linked share drives the increase.

2. BIS, Annual Economic Report, June 2026.

France and Belgium sit at the other end of the maturity spectrum (8.4 and 9.9 years) with a far smaller indexed component, which has so far kept their interest burden lower and its increase more contained (1.4% → 2.8% for France; 1.7% → 2.7% for Belgium).** Their vulnerability lies elsewhere: both rely heavily on non-resident holders (54.3% and 63.4% of public debt respectively), well above the OECD norm, leaving debt service exposed to shifts in foreign investor sentiment. In the BIS AR2026's framing, this matters beyond the yield level itself: "fiscal risk repricing can tighten financial conditions quickly and weigh on demand, especially if amplified by NBFI deleveraging" – precisely the channel to which France and Belgium are most exposed given the dominance of price-sensitive foreign holders, especially hedge funds, in their creditor bases.

Greece, Japan and Spain show comparatively favourable headline structural metrics, but for reasons that are partly mechanical rather than durable. Greece combines the highest non-resident share in the sample (70.8%) with the longest average maturity (~18 years); however, much of that foreign holding is concessional official-sector lending rather than price-sensitive market debt, keeping its interest bill on a declining trajectory (3.5% in 2019 → 3.3% projected by 2027). **Japan's** long maturity (9.5 years) and very low non-resident share (14%) delay rate pass-through despite a debt ratio above 200% of GDP, but the BIS AR2026 characterises this cushion as temporary rather than structural, flagging that "debt maturity influences the balance between channels: shorter maturities speed up the pass-through to fiscal costs" – a mechanism that will reassert itself as Japan's legacy low-yielding debt progressively rolls over.

Across nearly all these economies, one common factor partially offsets country-specific pressures: central banks retain a meaningful footprint in sovereign debt markets despite quantitative tightening. Eurosystem PSPP/PEPP holdings still cover a comparable order of magnitude across France, Belgium and Italy (17–19% of general government debt), and notably higher shares in Spain (24%), Finland (22%) and Portugal (27%). This residual footprint continues to provide a common, if diminishing, cushion against the upward pressure on long-term yields that would otherwise compound each of the channels described above.

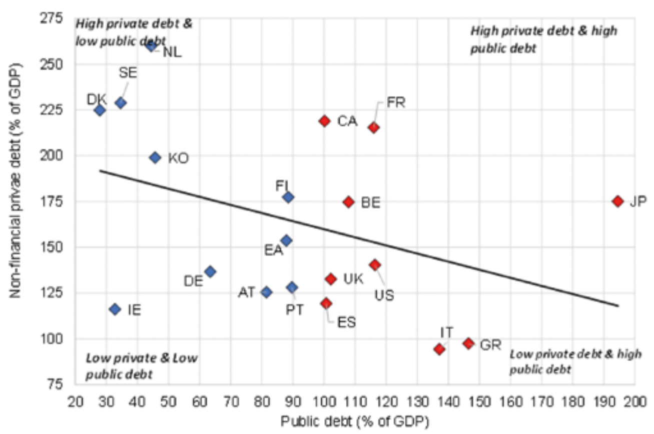
2.1.2 Belgium, Japan and France combine public and private leverage above prudential thresholds – but only France's is still rising

Excessive private debt poses risks to public debt sustainability through several channels. When private debt becomes unsustainable, the state typically absorbs the shock through bank recapitalisation and automatic stabilisers, effectively converting private liabilities into public ones; a high pre-crisis public debt level leaves far less fiscal space to play this lender-of-last-resort role (Jordà, Schularick and Taylor, 2016)[3]. Even absent an acute crisis, rapid household and corporate debt buildup tends to predict slower growth three to four years later as deleveraging compresses consumption (Mian, Sufi and Verner,

CHART 7.

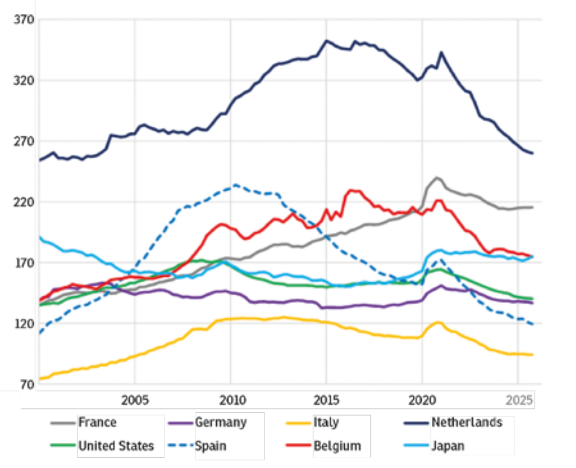
Private and public debt across indebted economies

Chart 7a : Private debt v. public debt across advanced, as of Q4-2025



Source: Ekonomics, *based on data from the Bank for International Settlements*

Chart 7b : Non-Financial Private sector debt, % of GDP



3. Jordà, Ò., Schularick, M., & Taylor, A. M. (2016). Sovereigns versus banks: credit, crises, and consequences. Journal of the European Economic Association, 14(1), 45-79.

2017), mechanically eroding the denominator of the debt ratio[4]. The BIS AER2026 formalises this link explicitly, noting that "public debt may increase due to the fiscal costs of future financial crises, which tend to be linked to the scale of private non-financial sector debt" – and while private debt has fallen slightly since the GFC across advanced economies as a whole, it "remains historically high in several AEs."

This vulnerability maps unevenly across the sample and can be organised into three groups defined by the level of private debt.

A first group – Spain, Italy, Portugal and Greece – carries private debt below 130% of GDP and has seen sustained deleveraging since 2013: Spain's ratio fell by roughly 88 points to 119.3% of GDP by end-2025, Italy's by 29 points to 94.3%, Portugal's by 91 points to 128.1%, and Greece's by 37 points to 97.4% – all four now within or below the Euro area average of 153.6%, despite public debt ratios of 81-147% of GDP.

A second group – the United States and the United Kingdom – carries private debt in the 130-150% range, also on a declining trajectory: US private debt fell by roughly 11 points between 2013 and 2025 to 140.3% of GDP, and the UK's by 34 points to 132.6%. Both combine this moderate and receding private leverage with elevated but comparably contained public debt (116% and 102% of GDP respectively), limiting the scope for private-sector stress to compound their sovereign burden – though the US remains exposed through the sheer scale of its refinancing needs and the structural rather than cyclical nature of its deficit.

A third, more acute risk category comprises France, Belgium, Finland and Japan, all carrying private debt above 170% of GDP. Their recent trajectories diverge, however. Belgium's private debt fell by roughly 30 points from 204.2% in 2013 to 174.7% by end-2025, and Finland's remained broadly flat at 177.4% (up only 0.2 points). France and Japan stand apart: France's private debt rose by approximately 26 points to 215.4%, and Japan's by 16 points to 175.1%. France's trajectory is particularly notable – at 215.4% of GDP, it now converges toward the Netherlands (260%), one of the advanced economies with the highest private debt in the world, whose own ratio nonetheless fell by 77 points over the same period. Unlike the Netherlands, however, France combines this still-rising private leverage with a public debt ratio of 116% and weak potential growth, placing it in the most exposed quadrant of the public-private debt matrix.

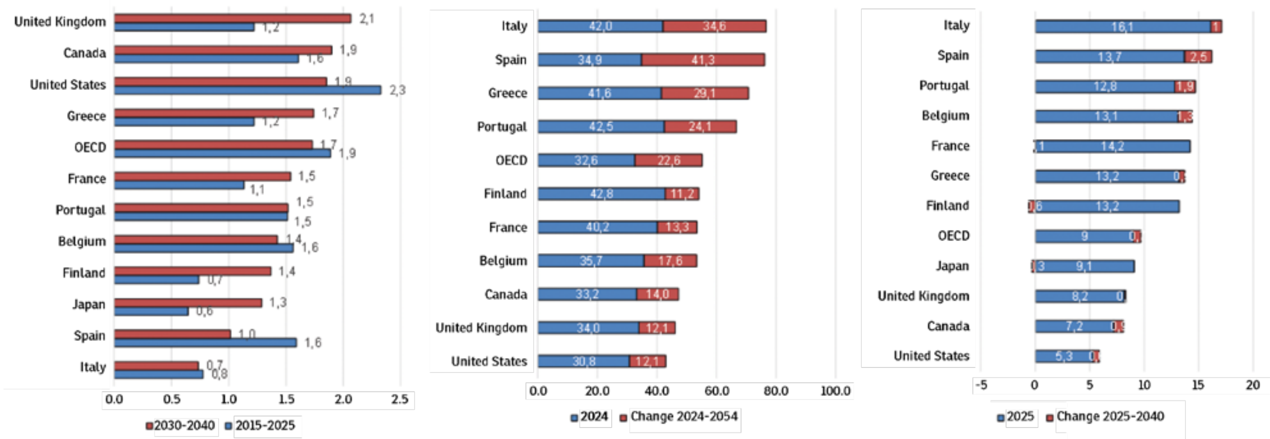
2.1.3 Demographics and productivity worsen the debt arithmetic in Italy, are partly mitigated by automation in Japan, represent an unresolved structural challenge in France and Belgium, and still favour the United States

Population ageing and weak productivity growth have implications for public debt sustainability. On the growth side, a declining working-age share mechanically reduces labour input and potential output, widening any positive r–g gap and raising the primary surplus required merely to stabilise the debt ratio; productivity weakness compounds this by lowering g independently of demographics. The BIS AER2026 identifies both as structural forces reshaping long-run borrowing costs: "as populations age and shift from saving to dissaving,

CHART 8.

Demographics, pensions costs and potentiel growth's long-term prospects among indebted economies

Chart 8a: Average annual potential growth, % | Chart 8b: Old-age dependency ratio (65+ / 20-65) | Chart 8c: Public pensions expenditures, % of GDP



Source: OECD extracted from "Pensions at Glance", 2025 and OECD global long-run economic scenarios: 2025 update

4. Mian, A., Sufi, A., & Verner, E. (2017). Household debt and business cycles worldwide. The Quarterly Journal of Economics, 132(4), 1755-1817.

while also demanding more health and social services, aggregate saving may fall, putting upward pressure on real interest rates" – a dynamic whose "timing and scale are highly uncertain" but whose direction is not. On the primary balance side, higher dependency ratios raise age-related expenditure – pensions, healthcare and long-term care – and the BIS projects these to "continue to exert upward pressure on pension and healthcare expenditures in many countries", with demands for higher public investment in infrastructure, defense and renewable energy "intensifying" simultaneously. OECD-wide projections point to an average increase in fiscal pressure of close to 6¼ points of GDP by 2060, of which ageing accounts for more than 40%, absent corrective action[5].

Exposure across the sample is markedly uneven. **Japan and Italy stand out as the most demographically advanced, both having experienced a roughly fivefold increase in their old-age dependency ratio since 1960 to around 55%, but their growth responses diverge sharply.** Italy's potential growth has remained the lowest in the OECD (0.7-0.8%), compounding a dependency trajectory set to push the ratio from 39 to as much as 70 per 100 working-age people by 2050. Japan, despite comparable demographic compression, has used sustained investment in automation to lift potential growth from 0.6% to a projected 1.3% – a partial offset whose durability the BIS itself questions, given the exposure of Japan's debt dynamics to any normalisation of the r–g differential.

Spain, Greece and Portugal form a second cluster, also characterised by dependency ratios above the OECD average in 2024 (around 42-43% for Italy-comparable for Greece and Portugal, and a lower starting point but the steepest projected increase for Spain, which is set to overtake Italy by 2054 at roughly 76%). Unlike Italy, however, all three show meaningful, if uneven, improvement in potential growth: Greece and Spain are projected to see potential growth rise from around 1.0-1.2% to 1.6-1.7%, while Portugal remains flat at a moderate 1.5%. This relative growth resilience only partially mitigates the fiscal channel, since ageing-related expenditure remains on a steep path regardless of the growth outlook: Spain's public pension spending is projected to rise by 2.5 points of GDP by 2040 to around 16%, among the highest in the EU, while Portugal's is set to climb from 12.8% of GDP in 2025 to 15.1% by 2045, the third-highest ratio in the EU. For this group, the primary-balance channel via ageing costs therefore dominates the growth channel as the principal sustainability risk, even where productivity prospects are improving.

France, Belgium, Finland, the United Kingdom and Canada hold an intermediate position, differentiated chiefly by the trajectory of ageing-related costs. France's pension spending, already as high as 14.6% of GDP across 42 distinct regimes, faces renewed pressure following the suspension of the 2023 pension reform until January 2028. Belgium faces a comparable challenge: pre-reform projections pointed to a 4.7 point rise in total age-related expenditure by 2070, well above the 1.3 point EU average, though a March 2026 draft reform is expected to reduce the projected increase by 1.3 points. Finland, by contrast, benefits from strong innovation fundamentals and favourable AI-complementary employment, consistent with potential growth more than doubling from 0.7% to 1.4%.

The United States anchors the opposite end of the spectrum – with the lowest dependency ratio in the sample (31% in 2024, projected to rise to only 43% by 2054) and potential growth supported by technology investment – but two caveats temper this structural advantage: potential growth is expected to decelerate from 2.3% to 1.9% as the investment impulse normalises, and public healthcare spending (8.5% of GDP federally, close to 10% with state and local outlays) constitutes a structural primary-balance risk not captured by the dependency ratio alone.

2.2 Fragmented markets, weak productivity, faster ageing and the absence of a unified fiscal authority leave indebted Euro area Member States more exposed to adverse financing conditions than the United States

One might argue that concerns over European public debt are exaggerated: after all, the United States carries a debt burden exceeding 120% of GDP, set to rise to 143% by 2035, and is widely regarded as the world's anchor sovereign. Such comparisons, however, risk conflating fundamentally different economic realities – and European leaders who invoke them to reassure markets and citizens risk underestimating the structural divergence between the two sides of the Atlantic. The United States therefore illustrates that reserve-currency status considerably increases fiscal space but does not remove the need for long-term fiscal adjustment when structural primary deficits remain exceptionally large.

The United States combines elevated public indebtedness with robust growth dynamics, sustained productivity gains and unparalleled innovative capacity. Since the pandemic, the US

5. OECD (2025), Pensions at a Glance 2025: OECD and G20 Indicators, OECD Publishing, Paris, https://doi.org/10.1787/e40274c1-en

economy has grown materially faster than the Euro area, driven by leadership in high-value sectors – digital technologies, artificial intelligence and advanced services. Its deep and unified capital markets, reserve currency status, full monetary sovereignty and fiscal unity further distinguish its structural position. Crucially, the US tax burden remains in the 25-27% of GDP range, significantly below the 40%-plus levels typical across the European Union and above 45% in France – a lower ratio that reflects not only political choices and differing welfare-state models, but also a structurally different incentive environment for growth and private investment. And unlike most European economies, the United States has in recent years re-attracted large-scale industrial investment: industrial investment surged by 32% over 2025 to reach USD1,800 billion[6], pointing to a productive-base expansion that materially underpins its debt trajectory.

Several European economies, by contrast, face high and rising debt in a context of weaker productivity growth, fragmented capital markets, heavy compulsory levies and limited technological dynamism. To equate the two situations is therefore misleading: debt sustainability cannot be assessed in isolation from growth potential, institutional architecture, fiscal structure and innovation capacity. Aggregate Euro area indicators, to which European leaders often refer, obscure deep structural divergences between Member States – and the Euro area itself does not rest upon a fully unified fiscal authority, a deeply integrated capital market or a single political executive accountable for macroeconomic stabilisation.

The contrast in institutional architecture is, in this respect, the most consequential distinction. The United States issues the world's reserve currency, borrows in a deep and unified sovereign bond market, retains full monetary sovereignty and benefits from an implicit central bank backstop unconstrained by supra-national governance. Euro area Member States enjoy none of these advantages: they borrow in a currency they do not individually control, rely in several cases heavily on non-resident and price-sensitive investors, and operate within a bank–sovereign nexus that can amplify shocks rapidly – as the 2011–2012 sovereign debt crisis demonstrated.

The ECB can act as a backstop through the TPI and OMT mechanisms, but its support is conditional, bounded by its mandate, subject to Governing Council decisions and eligibility requirements: it cannot be viewed as an unconditional liquidity guarantee of the kind implicitly available to the US Treasury. This institutional fragility is compounded by the economic fragmentation of the union itself – a context that fosters divergence rather than coordination and sustains a climate of mutual distrust that makes collective responses to fiscal stress both slower and less credible[7].

2.3 France's fiscal trajectory is more concerning than Italy's – and could jeopardise the long-term viability of the monetary union

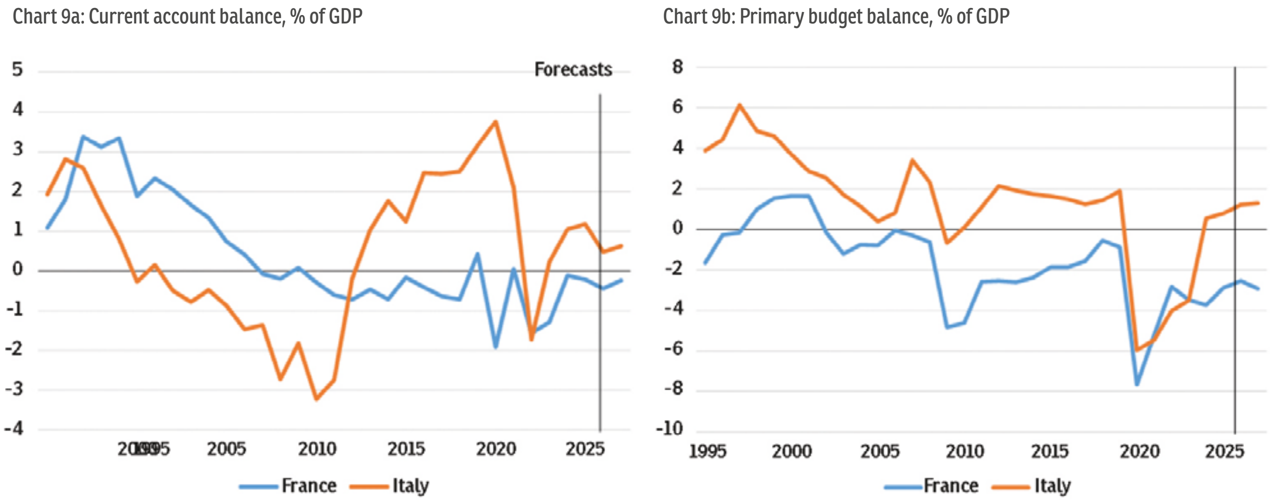
France carries a lower headline debt ratio than Italy, yet its fiscal position appears more vulnerable on several forward-looking sustainability indicators. France appears to have lost control of its public finances" – a judgment supported by four structural divergences that distinguish the French situation from that of its Italian peer.

1. **The primary balance.** France has not recorded a primary budget surplus since 2002 – more than two decades of uninterrupted primary deficits, regardless of the economic cycle. Italy, despite a far higher headline debt ratio, returned to primary surplus in 2024 (+0.4% of GDP against a deficit of 3.6% the previous year) and is projected to maintain and deepen that surplus to around 1.1% of GDP by 2026. The contrast is stark: Italy's consolidation is driven partly by necessity – rated BBB by S&P, one notch above non-investment grade, a downgrade would trigger forced selling by institutional investors bound by investment-grade mandates – while France's still high-grade rating (AA- from S&P, six notches above the speculative threshold) has removed the market-imposed urgency that typically compels adjustment. The consequence is visible: France's primary deficit widened in 2024 relative to 2023, moving in the opposite direction to every other major indebted Euro area sovereign.
2. **The trade performance**. France runs a structural trade deficit – averaging around €23 billion per year since 2007, when it last recorded a surplus – while Italy has posted a trade surplus averaging over 2% of GDP annually since 2012. This divergence reflects fundamentally different productive structures: the share of industry in value added fell from 16% to 10% in France between 1999 and 2024,

6. Guichard Guillaume, "Les Etats-Unis de Trump continuent d'attirer un déluge d'annonces d'investissements industriels", Les Echos, 23 February 2026.

7. Diverging fiscal interests have repeatedly prevented meaningful agreements, with the euro becoming a permanent source of issues to negotiate and "regularly a source and a manifestation of some discord among Member States. When mutual trust in adherence to common fiscal rules weakens, the architecture becomes more fragile still – and for the most indebted and fiscally exposed Member States, that fragility cannot be offset by pointing to the aggregate debt ratio of the bloc. Debt sustainability in the Euro area is ultimately a Member State-level phenomenon; and it is at that level – not the aggregate – that the risks identified in this note must be assessed.

CHART 9.
Fiscal and external performances of France and Italy



Source: Ekonomics, *based on data European Commission (Spring Forecasts of May 2026)*

while remaining stable at around 20% in Germany and recovering in Italy. France's de-industrialisation, compounded by one of the highest tax burdens in Europe, has shifted the economy toward services with structurally lower productivity – and it is productivity, ultimately, that generates the tax revenues a state needs to service its debt.

3. **Private sector leverage.** Private non-financial sector debt in France reached 215.4% of GDP by end-2025 – more than double Italy's 94.3% and well above the Euro area average of 153.6%. As discussed in Section 2.2.2, this dual exposure of both the public and private balance sheets is the configuration that leaves the state least equipped to absorb a private-sector shock, since it would be called upon to recapitalise banks and support the economy at the very moment its own fiscal space is most constrained.
4. **The creditor base.** More than half of France's public debt is held by non-residents, compared with around 30% in Italy. Whilst the presence of foreign investors traditionally signals trust and creditworthiness from the market, too heavy a reliance on non-domestic private investors may constitute a structural vulnerability, as identified in Section 2.2.1. Most foreign investors are private and price-sensitive. For instance, the *Banque de France*[8] noted a stark increase in transactions operated by hedge funds on the secondary European sovereign markets including France, doubling between 2019 and 2023. This heavy reliance on price-sensitive foreign investors exposes the sovereign risks in a rush for exits, herd behaviour, and sudden stops in funding during crises – precisely the moment when domestic fiscal pressures are most acute.

Assembling these four factors, the arithmetic of France's fiscal trajectory is revealing. France's primary deficit in 2026 is projected at 2.7% of GDP, against a debt-stabilising balance of only 0.3% – a gap of more than 2 points that places the debt ratio on an unambiguously rising path. As a result, public debt is set to rise from 116% of GDP in 2025 to approximately 118.4% in 2026 and 120-122% by 2027-2031 depending on the source.

The underlying debt arithmetic raises a fundamental sustainability question: How can a country sustain interest payments equivalent to 3% of GDP when its economy is growing by only 1%?

Interest payments, which rose from €36.9 billion in 2019 to €66.6 billion in 2025, are projected to reach €88.2 billion by 2027 (close to 2.9% of GDP) according to the EU Commission forecasts dating from May 2026, surpassing education spending and becoming the single largest item in the national budget. As of mid-August 2026, France's 10-year yield was already surpassing 4% against a potential growth rate barely exceeding 0.7-0.8% in 2026-2027, a configuration that makes the r–g differential structurally debt-increasing absent a decisive primary balance adjustment. Between 2019 and 2024, total factor productivity in France declined by 2.6%, against an increase of 18.5% in Germany over 1999-2024 and only 0.1% in Italy over the more recent period – a structural competitiveness gap that directly erodes the government's capacity to generate the revenues necessary to service a rapidly rising debt.

8. Banque de France, Financial Stability Report, June 2026.

The market is beginning to price this divergence. Since June 2024, the French 10-year government bond yield has successively risen above those of Portugal, then Spain from October 2024, and Greece from June 2025. By mid-August 2026, it stood some 40 to 50 basis points above the yields of all three countries. More recently, the French yield has also edged above Italy's by a few basis points, making France the country with the widest spread over Germany among the economies that were at the epicentre of the 2011–12 sovereign debt crisis – a clear signal of growing investor unease.

France is replacing Italy at the focal point for market concerns about debt sustainability in Europe. As J. de Larosière states in his article for the *Eurofi Magazine* (September 2026), some bond market investors appear to consider that French public finances will somehow benefit from largesse via a bail-out from the European Central Bank. Otherwise, it is difficult to understand why yields on French 10-year bonds are trading at only 0.8 percentage points over German government bonds. This 'spread' is up from a range largely below 0.5 points in the decade to mid-2024. But it compares favourably with a yield spread of 1.8 points for the UK, whose public finances, although far from healthy, are in a less poor state than France's.

An effort is needed to reduce the primary French deficit from 2,9% of GDP to a stabilising level of around +0,1% and could be achieved over several years. The problem cannot be resolved in its fundamental aspects by a mere support by the ECB. If the ECB were to indulge in buying the public debt that cannot be absorbed by markets anymore, this would not change the basic structural weaknesses that lie at the heart of France's adjustment problems. The worse of all scenarios would be to see the ECB throwing unconditional money at problems that require reforms more than financing. Such a scenario would lead to more inflation and less growth.

As D. Cahen (2025) warns[9], the structural factors contributing to France's deteriorating fiscal position "are already in place, though their effects are unfolding gradually."

Beyond a certain threshold, the gradual drift in sovereign spreads could accelerate sharply; a sharp rise would trigger contagion to other highly indebted, low-growth economies within the Euro area. The end-state of a failure to adjust, D. Cahen (2025) concludes, is not merely a French fiscal crisis: it is a scenario that "could have significant implications for financial stability within the Euro area and test the resilience of the institutional framework established since the sovereign debt crisis."

Conclusion

The analysis confirms that sovereign debt sustainability cannot be inferred from the public debt ratio alone. The transition from exceptionally low interest rates and large-scale central bank purchases to higher financing costs, quantitative tightening and record sovereign issuance has increased the importance of fiscal flows, growth capacity, debt structure, investor composition and institutional credibility. The relevant distinction is therefore not simply between countries with high and low debt, but between sovereigns whose economic and institutional frameworks can absorb adverse shocks and those whose vulnerabilities may reinforce one another.

The comparative assessment also points to an important asymmetry. The United States and Japan face substantial and, in several respects, rising fiscal risks; reserve-currency status, monetary sovereignty or a stable domestic investor base do not eliminate the need for adjustment. Nevertheless, in the current macro-financial environment, several highly indebted Euro area Member States appear structurally more exposed to adverse financing conditions than some advanced economies carrying even higher debt ratios. This reflects the interaction of weaker potential growth, persistent primary deficits, more fragmented capital markets, greater dependence on non-resident investors and the absence of full national monetary sovereignty.

Italy illustrates a different configuration: despite credible fiscal adjustment, its exceptionally high inherited debt stock and weak potential growth imply that maintaining debt on a firmly declining path will require sustained primary surpluses over an extended period.

These findings should not be interpreted as a prediction of an imminent sovereign crisis or as a mechanical ranking of countries. They identify relative vulnerabilities that may evolve with policy choices, growth outcomes and market conditions. The policy implication is that fiscal consolidation alone, while necessary in the most exposed countries, will not be sufficient: strengthening sovereign resilience also requires productivity-enhancing reforms, deeper and more integrated capital markets, credible medium-term fiscal frameworks and an institutional architecture capable of containing destabilising feedback loops.

9. D. Cahen, The Euro Is in Danger, Odile Jacob, 2025.

Breaking the Banking Union Deadlock: Challenges and Paths to a Holistic Solution

Note written by Didier Cahen with C. Dupérat et H. Moulaoui

Abstract

More than a decade after its establishment, the Banking Union remains institutionally incomplete, while its prudential and supervisory framework has become increasingly complex and fragmented, with a growing reliance on supervisory judgement, making it more difficult to operate efficiently. Despite numerous legislative initiatives and technical reforms, progress has remained limited. This paper argues that the persistence of the Banking Union deadlock reflects not a lack of technical solutions, but an incomplete understanding of its underlying institutional causes.

The prevailing debate treats banking market fragmentation, regulatory complexity, prudential proportionality, the implementation of international standards and the competitiveness of European banks as separate policy challenges. This paper develops an original perspective by showing that these issues are different manifestations of the same institutional dynamics. Supervision and resolution have been Europeanised without fully aligning the incentives of authorities that continue to bear largely national financial stability and fiscal responsibilities. Combined with persistent economic and fiscal divergences across Member States, this institutional asymmetry undermines the mutual trust required to relax national safeguards and perpetuates the home-host dilemma.

The resulting institutional equilibrium creates incentives for ring-fencing, solo prudential requirements, supervisory conservatism and the progressive accumulation of regulatory safeguards. While individually justified, these measures collectively reduce the efficiency of cross-border banking groups, increase regulatory complexity and hinder financial integration, thereby reinforcing the very conditions that sustain the Banking Union deadlock.

Building on this diagnosis, the paper argues that breaking the deadlock requires a comprehensive and indivisible political package combining completion of the Banking Union with improvements to its prudential and supervisory framework. Only such a holistic approach can resolve the main issues by addressing the concerns and aligning the incentives of all stakeholders, demonstrating that a genuine Banking Union can generate tangible benefits for each of them.

The package combines stronger common safeguards – including a European Deposit Insurance Scheme (EDIS), a credible European liquidity framework in resolution and legally enforceable intragroup support mechanisms – with operational freedom for cross-border banking groups. It also advocates a simpler and more proportionate prudential framework that better reflects the diversity of Europe's banking sector, including a periodic reassessment of cumulative prudential requirements, a review of the growing reliance on Pillar 2 measures, the establishment of a Prudential Efficiency Review Panel, and a more effective implementation of international standards that better reflects the specificities of the European economy.

Finally, the paper argues that durable progress also depends on continued fiscal responsibility and greater economic convergence among Member States, thereby strengthening the mutual trust on which a genuine Banking Union ultimately depends. Only such a comprehensive package can credibly break the Banking Union deadlock by aligning incentives, restoring mutual trust and enabling genuinely integrated European banking groups to emerge. Reaching such an agreement, however, will ultimately require the political willingness of Member States to allow the common European interest to prevail over national interests.

Introduction

The Banking Union is one of the European Union's most ambitious integration projects since the creation of the euro. Yet, unlike the Economic and Monetary Union, it was not considered by the Maastricht Treaty. It emerged only in response to the sovereign debt crisis of 2010-2012, when the close interdependence between sovereigns and domestic banking systems threatened the stability of the monetary union[1]. The crisis demonstrated that a single currency could not function sustainably without a common framework for banking supervision and crisis management.

In little more than a decade, the European Union has made remarkable progress. The Single Supervisory Mechanism (SSM) has centralised the prudential supervision of the Euro area's largest banking groups under the European Central Bank, while the Single Resolution Mechanism (SRM) has created a common framework for managing bank failures and preserving financial stability. Together, they have significantly strengthened the resilience of the European banking system and enhanced the consistency of banking supervision across participating Member States.

Recent policy discussions, notably the European Commission's Communication on the Competitiveness of the Banking Sector and the Single Market in Banking, have considerably broadened the debate. The Communication rightly recognises that banking market fragmentation, regulatory complexity, prudential proportionality and the competitiveness of European banks are closely interconnected challenges. This paper shares that diagnosis but proposes a broader interpretation. It argues that these challenges are not simply parallel policy agendas but different manifestations of the same institutional asymmetry that continues to shape the Banking Union.

More than fifteen years after its creation, the Banking Union therefore remains both incomplete and institutionally constrained. Important building blocks – including a common European Deposit Insurance Scheme (EDIS) and a fully operational framework for liquidity in resolution – are still missing. At the same time, the prudential framework relevant to the Euro area's largest banking groups has progressively become more complex. The cumulative interaction between minimum capital requirements, Pillar 2 requirements, macroprudential buffers, resolution requirements and supervisory expectations has generated **a gradual accumulation of prudential safeguards.**

While each individual measure may be justified when considered in isolation, the framework has proved considerably more effective at introducing additional safeguards than at periodically reassessing whether the cumulative stock of requirements remains coherent, proportionate and consistent with Europe's broader objectives of financial integration and competitiveness. The growing importance of institution-specific supervisory requirements, particularly under Pillar 2, illustrates this broader evolution. Although supervisory judgement is an essential component of effective supervision, its increasing role raises legitimate questions about transparency, predictability, international comparability and the cumulative impact of prudential requirements on banks' capacity to compete and allocate capital efficiently across borders. As a result, European banks continue to operate within a regulatory environment that remains largely shaped by national considerations despite the existence of common European institutions.

This apparent paradox reflects a deeper institutional asymmetry. Unlike the Eurosystem, which functions as a genuinely integrated federal system in which national central banks operate as constituent parts of a single institutional framework, the Banking Union has developed according to a different model. European supervisory and resolution authorities coexist with national competent authorities, national resolution authorities and national governments, which continue to bear significant responsibilities for financial stability, crisis management and, ultimately, potential fiscal consequences. Supervision and resolution have therefore been Europeanised without fully Europeanising the incentives under which public authorities continue to operate.

This institutional asymmetry lies at the heart of the Banking Union's defining challenge: the home-host dilemma. Home authorities naturally seek to supervise banking groups on a consolidated basis and to allow capital and liquidity to circulate efficiently within integrated groups. Host authorities, by contrast, remain responsible for protecting domestic financial stability, depositors and, ultimately, national public finances. As long as these responsibilities remain predominantly national, nationally oriented behaviour – including ring-fencing, solo prudential requirements and the gradual accumulation of additional prudential safeguards – remains a rational response to nationally borne risks. Individually, such safeguards often represent prudent supervisory responses. Collectively, however, they generate an accumulation of prudential requirements that progressively overburdens the regulatory framework, constrains the efficient management of cross-border banking groups and contributes to increasing regulatory complexity.

1. In response to the EU sovereign debt crisis of 2011-2012, the European Union launched the Banking Union project in 2012 with four foundational objectives: "to safeguard financial stability, deliver a safer banking sector, reduce the sovereign-bank nexus and protect taxpayers from the cost of bank failures." Originally conceived to break the vicious circle between sovereign and banking risk, the Banking Union sought to create "a more integrated and resilient financial system" and to enable "the emergence of truly pan-European banks, while also weakening the entrenched link between national fiscal positions and domestic banking sectors." The Banking Union currently covers 21 Eurozone countries and remains open to other EU Member States.

This diagnosis also changes the way the Banking Union should be understood. Its objective is not, by itself, to create a fully integrated European banking market. Such integration will continue to depend on broader progress in areas such as insolvency law, taxation, company law, consumer protection and economic convergence. Rather, the Banking Union should create the institutional conditions under which supervisors, resolution authorities and governments can progressively move away from nationally driven safeguards towards a more coherent, proportionate and integrated regulatory framework. Resolving the home-host dilemma would therefore not automatically eliminate market fragmentation. It would, however, fundamentally transform the regulatory environment in which European banks operate, making greater cross-border integration, prudential simplification, more effective implementation of international standards and stronger competitiveness institutionally and politically achievable.

The prolonged stalemate of the Banking Union should therefore not be interpreted simply as a failure of political will. It reflects the legitimate concerns of all stakeholders. Host Member States seek credible safeguards before accepting greater integration. Home authorities wish to preserve the integrity and efficiency of cross-border banking groups. Smaller, cooperative and mutual banks seek reassurance that deeper integration will continue to respect the diversity of European banking models and the principle of proportionality[2]. Banking groups themselves seek a framework that allows them to allocate capital and liquidity more efficiently while ensuring that prudential requirements remain coherent, proportionate and predictable over time. Lasting progress will therefore require more than completing the Banking Union's missing institutional building blocks. It will require a political compromise capable of changing the incentives of all stakeholders while strengthening both financial stability and mutual trust.

This perspective also changes the relationship between the Banking Union and Europe's broader banking agenda. Banking market integration, prudential simplification, proportionality, the implementation of international prudential standards, the competitiveness of European banks and the objectives of the Savings and Investments Union should no longer be regarded as separate policy agendas. They are all influenced by the same institutional incentives. None of these objectives can be fully achieved as long as the home-host dilemma continues to encourage the accumulation of prudential safeguards. Conversely, addressing that asymmetry would create the institutional conditions for a more coherent prudential framework and unlock meaningful progress across all these policy areas.

Against this background, this paper argues that the priority is not to pursue a succession of isolated legislative initiatives but to negotiate a comprehensive political package capable of restoring mutual confidence among Member States. Such a package would combine stronger common safeguards – including the completion of EDIS, a credible European liquidity framework in resolution, effective intragroup financial support mechanisms and appropriate governance reforms – with freedom for cross-border banking groups to manage capital and liquidity, together with a more coherent, proportionate and periodically reassessed prudential framework. These reforms should not be viewed as independent initiatives but as mutually reinforcing components of a single political compromise capable of reducing fragmentation, reversing the cumulative accumulation of prudential safeguards where no longer justified, and strengthening the competitiveness of the European banking sector.

Ultimately, the Banking Union should not be judged solely by whether its institutional architecture is formally complete. Nor should it be expected, on its own, to deliver a fully integrated European banking market. Its success should instead be measured by its ability to transform the regulatory environment in which European banks operate reducing the structural incentives for regulatory fragmentation, allowing prudential requirements to evolve in a more coherent and proportionate manner, facilitating the efficient management of cross-border banking groups and thereby strengthening the competitiveness of Europe's banking sector and its capacity to finance the continent's long-term economic ambitions.

1. The Banking Union: The Common Thread Across Europe's Banking Challenges

More than a decade after the establishment of the Banking Union, the European banking sector has become significantly more resilient. Banks are better capitalised, supervision and resolution have been profoundly strengthened, and financial stability has improved considerably. Yet European banks continue to face a number of major structural challenges that constrain their ability to finance the European economy and to compete internationally.

2. Proportionality means adapting the intensity and complexity of prudential and supervisory requirements to the size, risk profile, business model, complexity and degree of international activity of an institution, while preserving financial stability and the integrity of the Single Rulebook.

These challenges are generally analysed separately. They include the incomplete nature of the Banking Union, the persistent fragmentation of the European banking market, the growing complexity of the prudential, supervisory and resolution framework, and the need to ensure that the implementation of international prudential standards better reflects the specific characteristics of Europe's predominantly bank-based financial system.

This chapter argues that these four challenges are closely interconnected. Rather than constituting separate policy agendas, they reflect different dimensions of the same underlying issue: the incomplete integration of the European banking market. It also argues that the Banking Union has progressively become the common thread linking these challenges. Completing the Banking Union is therefore no longer simply an institutional objective; it has become an essential condition for reducing fragmentation, simplifying the regulatory framework, better adapting prudential standards to European specificities and, ultimately, strengthening the competitiveness and financing capacity of the European banking sector.

1.1 The four main challenges facing European banks

European banks currently face four major structural challenges that are often analysed separately but are closely interconnected. The first is the incomplete Banking Union. The second is the persistent fragmentation of banking activities along national lines. The third is the growing cumulative complexity of the prudential, supervisory and resolution framework. The fourth concerns the implementation of international prudential standards, which does not always sufficiently reflect the structural characteristics of Europe's predominantly bank-based financial system.

Taken together, these challenges increasingly determine the ability of European banks to compete internationally, to finance households and businesses efficiently, to support the Savings and Investments Union and, more broadly, to contribute to Europe's strategic autonomy. Their importance therefore extends well beyond the banking sector itself. They directly affect the competitiveness, resilience and long-term growth potential of the European economy.

1.1.1 An incomplete Banking Union

The three-pillar architecture: what exists, what is still missing

The conception of the Banking Union relied on three pillars: "the first one is supervision, the second one is resolution, and the third one – which is still a matter of discussion among Member States – is the creation of the European Deposit Insurance Scheme (EDIS)[3]."

What exists. The first pillar is the Single Supervisory Mechanism (SSM), fully established in November 2014, "a system of banking supervision comprising the ECB and national authorities, directly supervising the most significant banks of the Euro area[4]." The second pillar is the Single Resolution Mechanism (SRM), operational since January 2016, "which objective is to protect financial stability and the taxpayer by planning for and managing bank failures[5]." The Single Resolution Fund (SRF) is now fully built up at approximately EUR80 billion and is backstopped by the European Stability Mechanism (ESM). As D. Laboureix, Chair of the Single Resolution Board, recalls: "In the last ten years Europe has built strong common supervision and a solid resolution framework. Resolution plans have been developed for all major European lenders, the Single Resolution Fund has reached EUR80 bn, banks have built substantial loss-absorption buffers and, importantly, resolution in Europe has been shown to work across different Member States[6]."

What is missing. The third pillar, the European Deposit Insurance Scheme (EDIS), remains unrealised. As H. Ettl puts it: "the transition from national fragmentation to a real European banking market remains incomplete, for which the missing third pillar, EDIS, will play a decisive role. Intended to complement the SSM and SRM, completing the Banking Union's architecture, EDIS still remains unrealised[7]."

Beyond EDIS, two additional elements are missing: the liquidity backstop to the Single Resolution Fund and the arrangements for liquidity in resolution.

Indeed, although the Single Resolution Fund provides a common mechanism to support bank resolution, the revised ESM Treaty – which would enable the common fiscal backstop to the Single Resolution Fund – has still not entered into force, as it remains subject to ratification by Italy.

Similarly, the Banking Union still lacks a comprehensive European framework for providing

3. *Ibid.*
4. *Ibid.*
5. *Ibid.*
6. D. Laboureix, "Internal barriers, resolvability and banking union integration", in Breaking the Banking Union deadlock, Eurofi Nicosia, Magazine 2026.
7. H. Ettl, "From achievements to next steps: completing the vision of the banking union", in Breaking the Banking Union Deadlock, Eurofi Nicosia, Magazine 2026, p. 144.

liquidity to banks in resolution. While there is broad agreement on the need for such arrangements, designing them remains challenging because of unresolved questions regarding the allocation of financial risks, the respective roles of central banks and fiscal authorities, the availability of eligible collateral and the appropriate institutional framework for providing temporary liquidity in resolution. These remaining gaps continue to weaken the credibility of the resolution framework and reinforce the incentives of national authorities to rely on domestic safeguards.

What does a true Banking Union really mean?

According to many banking professionals, there is a fundamental difference in perspective between the banking sector and public decision-makers regarding what the Banking Union is ultimately expected to deliver[8]. Public authorities have traditionally focused on completing its institutional architecture through the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the missing deposit insurance pillar. By contrast, banking practitioners argue that the objective should be to create the conditions for a more integrated European banking market by enabling cross-border banking groups to allocate capital and liquidity more efficiently across the Union and to operate on a genuinely pan-European basis. From this perspective, completing the institutional architecture, while necessary, would not in itself remove the remaining prudential, legal and economic barriers that continue to fragment the European banking market.

The success of the Banking Union should therefore not be assessed solely by the completion of its institutional architecture, but also by its ability to reduce unnecessary fragmentation, enable cross-border banking groups to operate more efficiently across the Union and deliver the economic benefits expected from a more integrated European banking market. Completing the Banking Union will therefore require not only the establishment of its missing third pillar (*see Chapter 4*), but also the removal of the remaining legal, prudential and operational barriers that continue to prevent banking groups from functioning as genuinely European institutions.

Only by combining institutional completion with effective economic integration will the Banking Union achieve its original purpose: enabling European banking groups to operate seamlessly across the Union while strengthening financial stability, improving the financing of the European economy and enhancing the quality and diversity of banking services available to households and businesses.

1.1.2 *A fragmented European banking market*

Despite the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism, the European banking market remains largely fragmented along national lines. Banking groups continue to organise much of their capital, liquidity and business activities at national level, cross-border consolidation remains limited, and the concentration that has taken place has occurred primarily within national markets rather than across borders.

This fragmentation stems from two distinct but mutually reinforcing sources. The first is prudential fragmentation, resulting from domestic ring-fencing practices. The second is the structural fragmentation, reflecting the absence of harmonisation of the legal, fiscal and consumer protection frameworks governing retail banking markets.

The first driver of fragmentation is ring-fencing. Ring-fencing materialises when host authorities take regulatory and supervisory action in order to secure resources within their own jurisdictions. National ring-fencing policies[9] are applied to capital, liquidity, the output floor, leverage ratios and MREL liabilities Although the SSM has centralised prudential supervision for significant institutions, national authorities continue to exercise important supervisory, macroprudential and crisis-management responsibilities. Consequently, the distinction between home and host interests – and the influence of national considerations – has not disappeared and continues to shape supervisory, prudential and resolution practices across the Banking Union. In such a context, subsidiaries of cross-border groups operating in the banking union are mainly governed by national rules.

This ring-fencing is both a consequence of the incompleteness of the Banking Union and an obstacle to its deepening: as long as Member States do not fully trust the common mechanisms of supervision, resolution and deposit insurance, they will continue to protect their national interests, holding back the realisation of a genuine single banking market. Banks must furthermore deal with a patchwork of national authorities' different views on macroprudential rules and conduct[10].

8. D. Cahen; The euro is in danger, Odile Jacob, September 2025.
9. Ring-fencing policies occur when host countries take regulatory and supervisory action in order to secure bank financial resources within their own jurisdictions.
10. D. Cahen and A. Valroff, "Banking Union: what way out of the current deadlock?", Eurofi Regulatory Update, February 2024, p. 107.

These gaps are not merely technical; they reflect a deeper political deadlock. Some Member States are reluctant to share financial risks without further progress on risk reduction; others argue that greater integration is impossible without concrete mutual support mechanisms. This persistent tension has led to years of stalemate, weakening both the credibility and the effectiveness of the Banking Union.

The second driver of fragmentation is the absence of harmonisation of the non-prudential framework, which fragments the retail market even where no supervisor intervenes. Banking products themselves remain largely national: banks in Spain, Italy and Germany predominantly offer variable-rate mortgages and are therefore directly affected by rising ECB rates, whereas French banks mostly offer fixed rates; markets differ in consumer preferences for mortgage types, in legal requirements on consumer protection and collateral enforcement, and in national credit reference schemes[11]. As the European Commission explains, "differences in taxation, borrower protection, or anti money laundering provisions at Member State level result in bank-specific entry and adjustment costs that discourage cross-border banking"[12], and there is no single EU-wide loan registry as in the United States. These differences prevent banks from sharing processes and systems across borders and deny them scale advantages when entering new European markets.

As P. Montagner observes, "consumer protection frameworks, insolvency regimes, tax systems, labour regulations and banking product structures differ significantly across member states. As a result, retail banking remains fundamentally local because the underlying legal and economic infrastructure is still national"; such differences also prevent banks from leveraging their European presence efficiently[13]. The distance to a single banking market is thus considerable, and the national practice of ring-fencing illustrates the very lack of cooperation that stands in the way of a True Banking Union, making progress towards the single market harder still. Ring-fencing and the absence of harmonisation together produce the fragmentation of the EU banking landscape; the cost of the first, and the remedies to both, are examined in the chapters that follow.

Consequently, the level of cross-border deposits and loans remains negligible, a little above 1%, a figure that has barely moved since the single supervision was established in 2014; direct cross-border loans to non-financial corporations, at 10% in May 2023, have edged up to about 16% today, an evolution that remains extremely slow for a banking union[14]. Savings collected in one Member State are still overwhelmingly intermediated in that Member State: for households and firms, the Banking Union has not yet changed the geography of banking.

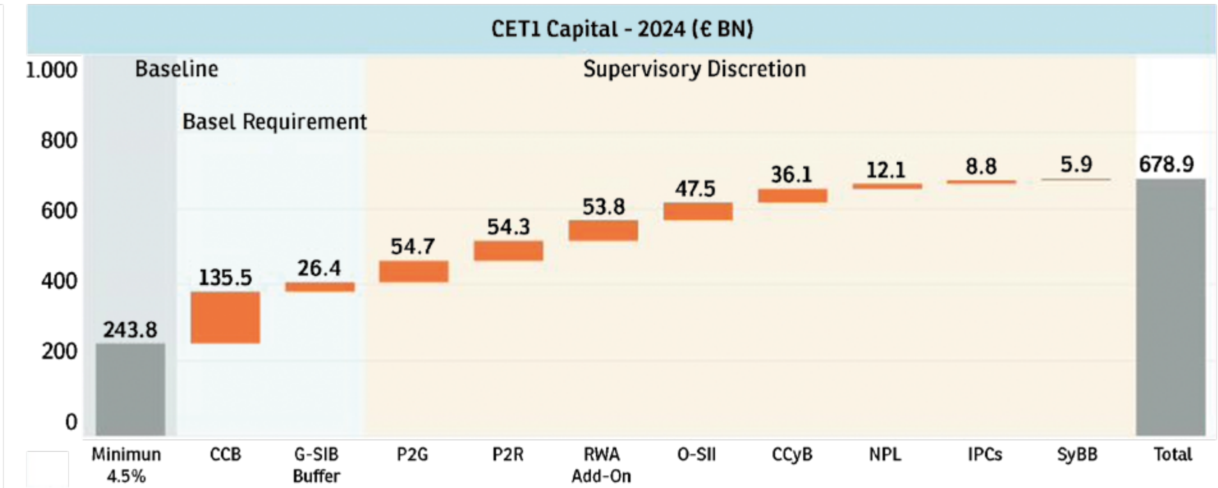
1.1.3 An increasingly complex prudential and supervisory framework

The fragmentation of the European banking market is not the only source of inefficiency in the EU banking sector. It is compounded by a second, closely related challenge: the cumulative complexity of the prudential, supervisory and resolution framework itself. While each regulatory reform introduced over the past decade has pursued legitimate public policy objectives and contributed to strengthening financial stability, their successive accumulation has progressively made the overall framework more difficult to understand, implement and supervise. Today, complexity stems less from individual prudential rules than from their cumulative interaction.

This growing complexity is no longer only an academic or regulatory concern. In recent years, several leaders of Europe's largest banking groups have publicly questioned the evolution of the EU supervisory framework, particularly the expanding role of institution-specific Pillar 2 requirements. While fully recognising the importance of supervisory judgement, they argue that Pillar 2 requirements have become less transparent, less predictable for both banks and investors and increasingly disconnected from internationally agreed prudential standards. They also point out that, unlike Pillar 1 requirements, **Pillar 2 measures tend to accumulate over time and are only rarely reduced when banks' capital positions, governance or risk profiles improve,** creating the perception of a one-way prudential ratchet. This debate has also revived comparisons with the United States, where supervisory judgement remains an essential tool but Pillar 2-type capital requirements play a significantly more limited role within the overall prudential framework. Some banking leaders therefore question whether the current balance between harmonised regulation and institution-specific supervisory requirements remains appropriate for Europe.

11. D. Cahen and A. Valroff, "Banking Union: what way out of the current deadlock?", op. cit., p. 107; D. Cahen and A. Valroff, "Banking fragmentation issues in the EU", op. cit., p. 16.
12. European Commission, quoted in D. Cahen and A. Valroff, "Banking Union: what way out of the current deadlock?", op. cit., p. 107.
13. P. Montagner, speech at the SSM Senior Forum organised by A&O Shearman, Kronberg im Taunus, 24 June 2026.
14. *Ibid.*, p. 14-15 (cross-border loans and deposits of households a little above 1%; direct cross-border loans to non-financial corporations at 10% in May 2023); European Commission, draft Communication on the competitiveness of the EU banking sector, 2026, citing ECB data (approximately 16% for non-financial corporations).

CHART 1.
Incremental impact on required CET1 capital from Basel and supervisory items, 2024 (EUR bn)



Source: GBI and GARP, EBF Capital Demand Study, 2025 (15 large EU banks).

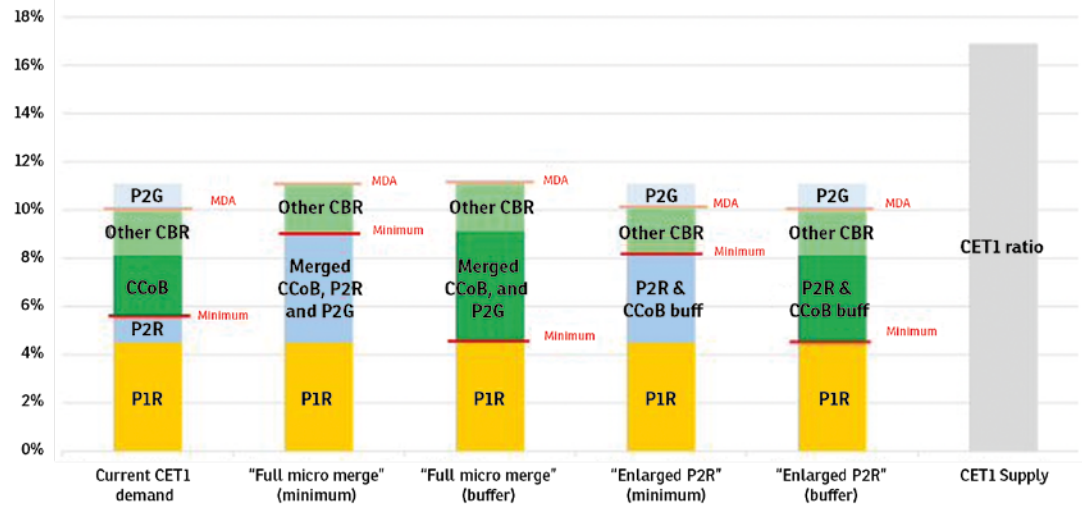
This evolution is particularly noteworthy because, despite the significant strengthening of banks' capital positions and profitability since the creation of the Banking Union, institution-specific supervisory requirements have not followed the same downward trajectory. This has fuelled the perception that Pillar 2 requirements increasingly operate as a cumulative supervisory overlay rather than as a genuinely risk-sensitive instrument. Beyond its prudential implications, this evolution also has consequences for market valuations. Because Pillar 2 requirements are determined through the annual supervisory review process and depend on supervisory judgement, investors cannot anticipate with the same degree of certainty the capital requirements that will apply in future years. This reduces the predictability of banks' future capital positions, distributable profits and capital management policies. By contrast, Pillar 1 requirements are largely rule-based and therefore more transparent and predictable. The comparatively greater reliance on supervisory judgement in the European framework may therefore contribute to a higher degree of regulatory uncertainty than in jurisdictions such as the United States, where institution-specific supervisory capital requirements play a more limited role.

This complexity has two complementary dimensions. The first is vertical, reflecting the progressive layering of prudential requirements. The CET1 requirement alone combines the Pillar 1 minimum requirement, institution-specific Pillar 2 Requirements (P2R), the capital conservation buffer, G-SII or O-SII buffers, the systemic risk buffer and the countercyclical capital buffer, with Pillar 2 Guidance (P2G) expected on top. Depending on their profile, institutions may simultaneously face as many as ten distinct regulatory constraints, including the risk-based capital stack, the leverage ratio, TLAC, MREL and subordinated MREL requirements. These layers are established for different purposes, by different authorities and with different legal consequences in the event of non-compliance. As a result, the same underlying risks may be addressed several times through different prudential instruments.

This issue is illustrated by the interaction between supervisory initiatives and Pillar 2 requirements. Following the ECB's Targeted Review of Internal Models (TRIM), changes to banks' internal models resulted in higher risk-weighted assets and therefore stronger Pillar 1 capital requirements for a number of institutions. However, market participants have questioned whether the corresponding Pillar 2 requirements were always reassessed to fully reflect this strengthened Pillar 1 coverage. Whether or not this was justified in individual cases, the example illustrates a broader governance challenge: when prudential requirements evolve through different regulatory and supervisory channels, there should be a systematic mechanism to assess whether the same underlying risk continues to be addressed more than once. **Yet no authority today has an explicit mandate to assess the cumulative interaction of the overall framework, to determine whether successive prudential measures have rendered earlier overlays redundant, or to ensure that unnecessary overlaps are systematically identified and removed.**

The cumulative effect of this layering is measurable. For the fifteen large EU banking groups participating in a recent industry benchmarking study, the minimum CET1 requirement of 4.5% represented

CHART 2. Average CET1 stack in the EU currently and impact of merged approaches



Source: Supervisory reporting. Size-weighted averages of EU banking sector (2689 institutions at highest level of consolidation in EU/EEA). Layers in green are buffer requirements subject to MDA. "Other CBR" refers to O-SII/G-II CCyB and SyRB buffers which are assumed to remain unchanged. The CET ratio is after deduction of parts of T1 and TC minima not met by AT1/T2

EUR243.8 billion of capital in 2024. Basel capital buffers increased this requirement by 66%, to EUR405.7 billion, while supervisory and discretionary adjustments increased it by a further 67%, bringing the overall CET1 requirement to EUR678.9 billion. Particularly striking is the growth of the discretionary component, which increased from EUR171 billion in 2021 to EUR273 billion in 2024, whereas the Basel minimum requirements remained broadly unchanged.

The second dimension of complexity is horizontal, reflecting the multiplicity of institutions involved in designing and calibrating the framework. The SSM and the national competent authorities determine Pillar 2 Requirements and Guidance; national designated authorities calibrate macroprudential buffers; the Single Resolution Board and national resolution authorities determine MREL; the European Banking Authority and the European Systemic Risk Board develop methodologies and technical standards; while the European co-legislators regularly add new legislative requirements, often accompanied by national options and discretions. Each authority understandably focuses on its own mandate and calibrates its own layer of the framework.

However, no institution is currently responsible for maintaining a holistic view of the cumulative interaction between the microprudential, macroprudential and resolution frameworks. As the EBA itself has observed, the European framework has become considerably more complex than those of other major jurisdictions, notably the United States, Switzerland and Japan, where several EU-specific components – such as P2R, P2G, the systemic risk buffer and the generalised use of MREL – either do not exist or play a much more limited role.

These two forms of complexity are not independent; they reinforce one another. A significant part of today's cumulative complexity results directly from the incomplete nature of the Banking Union itself. National discretions, divergent macroprudential requirements, home-host considerations and the continued application of prudential and resolution requirements at solo or sub-consolidated level inevitably generate additional layers of capital, liquidity, reporting and supervisory obligations. Fragmentation therefore does not simply coexist with complexity; it actively contributes to creating it. As discussed in the previous chapter, the persistence of the home-host dilemma encourages ring-fencing practices and nationally based prudential safeguards, which in turn increase the number of requirements applicable to cross-border banking groups.

At the same time, complexity also reflects broader governance issues. Successive reforms have strengthened individual components of the prudential framework without always considering their cumulative interaction. While each authority is responsible for safeguarding financial stability within its own mandate, no institution currently has explicit responsibility for assessing whether the overall framework remains coherent, proportionate and free from unnecessary overlaps. The challenge is therefore no longer simply to simplify individual prudential requirements, but to ensure that the prudential, macroprudential and resolution frameworks operate as a coherent whole.

Meaningful simplification cannot therefore be reduced to removing individual rules or lowering prudential standards. Rather, it requires improving the overall governance of the regulatory framework, strengthening proportionality, reducing unnecessary overlaps and addressing the structural sources of complexity, including the fragmentation of the Banking Union itself. Completing the Banking Union would not, by itself, eliminate all regulatory complexity. However, by reducing national discretions, limiting ring-fencing practices and allowing a more genuinely group-based application of prudential and resolution requirements, it could significantly contribute to a simpler, more coherent and more proportionate regulatory framework. The remaining sources of complexity – notably those stemming from the coexistence of multiple European and national authorities and from the cumulative layering of prudential requirements – would nevertheless require additional governance reforms and a more holistic approach to future regulatory design.

The growing complexity of the banking prudential framework should also be assessed against the broader evolution of the financial system. Over the past decade, the prolonged period of exceptionally low interest rates encouraged a significant expansion of non-bank financial intermediaries (NBFIs), as investors increasingly searched for yield outside the banking sector. This has diversified sources of finance and strengthened market-based intermediation, but it has also shifted an increasing share of financial activity towards entities operating under prudential frameworks that differ substantially from those applicable to banks. This evolution suggests that prudential policy should increasingly adopt a system-wide perspective. Strengthening the resilience of banks remains essential, but the cumulative calibration of banking requirements should also be assessed in light of developments across the wider financial system, so as to preserve both financial stability and the competitiveness of Europe's bank-based financing model.

1.1.4 An implementation of Basel standards that does not always sufficiently reflect Europe's bank-based financial system

More than fifteen years after the global financial crisis, Basel III remains the cornerstone of the international prudential framework for banks.

The Communication of the EU Commission recognises that international prudential standards may not always sufficiently reflect the structural characteristics of the European financial system and that their implementation should better take account of EU specificities. Unlike the US, where capital markets play the dominant role in financing the economy, the EU remains predominantly bank-based, with a much higher share of unrated corporates, SMEs, residential mortgage lending, infrastructure and project finance, and trade finance.

European banks therefore play a much larger role in financing households, SMEs, unrated corporates and infrastructure projects, while also remaining key intermediaries in supporting the development of European capital markets. This raises the question of whether prudential standards calibrated primarily around globally active banking systems and market-based financing adequately capture the characteristics and financing needs of the European economy.

Where international prudential standards do not adequately reflect these structural differences, they may unintentionally constrain the capacity of European banks to finance the sectors that are most important for the European economy. Higher capital requirements on activities such as lending to unrated corporates, SMEs, residential mortgages, infrastructure or project finance may increase the cost of financing these sectors or reduce banks' incentives to develop them. At the same time, European banks compete internationally with institutions operating in financial systems that rely much more heavily on capital markets and whose business models are therefore less affected by these calibrations. Ensuring that the implementation of international standards appropriately reflects the specific characteristics of the European financial system is therefore not only a question of regulatory consistency but also of maintaining a level playing field and preserving the international competitiveness of European banks.

More fundamentally, the issue goes beyond the competitiveness of the banking sector itself. In a financial system where banks remain the principal providers of credit to households and businesses, the calibration of prudential requirements directly influences Europe's capacity to finance investment, innovation, the green and digital transitions, defence and strategic autonomy. Better reflecting the specific characteristics of the European financial system in the implementation of international prudential standards is therefore also a question of supporting the competitiveness and long-term growth of the European economy.

Basel III should not, be viewed solely as a constraint imposed on Europe's bank-based model. It continues to function as a common international floor from which national authorities and supervisors may depart in either direction. The relevant question is therefore not only whether the Basel framework should better reflect European specificities, but also how much of today's cumulative prudential burden originates from

Basel itself, as opposed to decisions taken within the European Union's own multi-layered prudential architecture. From this perspective, better reflecting Europe's bank-based financial system cannot be achieved solely through adjustments to Basel III. It also requires addressing the national and supervisory sources of divergence that continue to arise within the EU's prudential framework, not least because the Banking Union remains institutionally incomplete.

1.2 Why the Banking Union has become the common thread

The four challenges presented above are frequently discussed as distinct policy issues. Yet they increasingly appear to be different manifestations of the same underlying problem: the incomplete integration of the European banking market and the persistent lack of mutual trust between Member States.

This section argues that the Banking Union has progressively become the common thread linking Europe's wider banking reform agenda. The improvement of the efficiency of the Banking Union’s framework and its completion is no longer simply one objective among others. It has become an enabling condition for addressing banking market fragmentation, reducing unnecessary regulatory complexity, better reflecting European specificities in the implementation of international prudential standards and, ultimately, strengthening the competitiveness and financing capacity of the European banking sector.

1.2.1 The competitiveness imperative

More than a decade after its launch, the completion of the Banking Union has acquired renewed urgency. Originally conceived as a response to the sovereign debt crisis and as a means of strengthening financial stability, it has progressively become a central element of Europe's broader competitiveness agenda. The debate is no longer confined to banking supervision or crisis management. It now affects Europe's capacity to build internationally competitive banking groups capable of financing investment, innovation, the green and digital transitions, defence and strategic autonomy. This evolution also reflects changes in the international environment. European banks now compete with institutions operating in much larger and more integrated domestic markets, particularly in the United States, where the combination of a genuine single banking market, deeper capital markets and recent deregulatory initiatives provide significant competitive advantages.

This renewed focus on competitiveness reflects a changing international environment. Although European banks have become significantly more resilient since the global financial crisis, they continue to lag behind their main international competitors in terms of scale and market valuation. As of May 2026, no Euro area bank ranked among the world's ten largest banks by market capitalisation, whereas four of the top ten were US institutions, led by JP Morgan Chase with a market capitalisation of approximately USD811 billion. Over the past decade, US banks have also gained around 10 percentage points of global market share at the expense of European banks, including both EU and UK/Swiss institutions. This performance reflects not only differences in business models but also the advantages of operating within a vast, deep and genuinely integrated domestic financial market supported by a single legal framework. Recent deregulatory initiatives in the United States may further reinforce these competitive advantages.

Overall, the competitiveness of the EU banking sector depends on the strength of the European economy itself, including its growth, productivity and investment performance. Macroeconomic conditions further shape the divergence between the performance of US and EU banks. Europe’s growth outlook remains structurally weaker than that of the United States, with lower productivity growth and fewer large-scale, high-growth investment opportunities. Interest-rate dynamics, including differences in pass-through mechanisms and the prevalence of variable – versus fixed-rate lending models, also influence profitability patterns and the distribution of “profit pools” across Member States.

These structural features may impose limits on scale and returns that regulatory reform alone cannot overcome. However, a genuine Banking Union would improve the competitiveness of EU banks (*as explained in Chapter 2*).

1.2.2 The interdependence between the Banking Union and Europe's other banking reforms

At first sight, the major challenges currently facing European banks may appear largely independent. Completing the Banking Union, reducing the fragmentation of the European banking market, simplifying the prudential and supervisory framework, and ensuring that the implementation of international prudential standards adequately reflects the specific characteristics of Europe's predominantly bank-based financial system are generally discussed as separate policy agendas.

These challenges are closely interconnected. They all ultimately depend on the same underlying political condition: a greater willingness of Member States to cooperate, to share risks and to place greater trust in common European institutions.

The incompleteness of the Banking Union illustrates this relationship most clearly. As long as Member States remain reluctant to mutualise certain financial risks, host authorities will continue to rely on national safeguards and ring-fencing practices, preventing banking groups from operating efficiently across borders. The resulting fragmentation not only limits the emergence of a more integrated European banking market but also contributes to the growing complexity of the prudential, supervisory and resolution framework by encouraging the multiplication of national discretions, solo-level requirements and overlapping prudential safeguards.

The same logic extends beyond the Banking Union itself. A meaningful simplification of the European prudential framework requires supervisors and public authorities to be confident that reducing unnecessary overlaps or granting greater flexibility at group level will not weaken financial stability. Similarly, adapting the implementation of international prudential standards to better reflect the characteristics of Europe's bank-based financial system requires Member States to reach a common assessment of risks and to accept that European specificities can legitimately be taken into account within the Basel framework. Without sufficient political trust, governments are unlikely to support reforms that could be perceived domestically as weakening prudential safeguards or favouring banks.

These four structural challenges therefore ultimately converge towards a common economic outcome: the international competitiveness of the European banking sector. Banking fragmentation reduces economies of scale and limits the emergence of pan-European banking groups; excessive regulatory complexity increases compliance costs and constrains managerial resources; and an implementation of international prudential standards that does not always sufficiently reflect Europe's bank-based financial system may weaken the capacity of European banks to finance the economy while competing on equal terms with institutions operating in other major jurisdictions. Together, these factors affect not only the efficiency and profitability of European banks but also their ability to support investment, innovation and long-term growth across the European economy.

The Banking Union has therefore become much more than one reform among many. It has become the common thread linking Europe's wider banking agenda. Completing the Banking Union is no longer simply about finalising its institutional architecture. It has become a prerequisite for reducing fragmentation, simplifying the prudential framework, enabling a better adaptation of international prudential standards to European specificities and, ultimately, strengthening the competitiveness, resilience and financing capacity of the European banking sector.

The central question is therefore no longer simply how to complete the Banking Union itself. It is whether Europe can realistically achieve any of these broader objectives without first restoring the mutual trust and political cooperation between Member States that remain the essential preconditions for deeper banking integration.

2. The Benefits of the Banking Union: Realised Achievements and Potential Gains

The Banking Union is often assessed through the reforms that remain incomplete. This chapter adopts a different perspective. It first examines what the Banking Union has already delivered before analysing the economic, regulatory and strategic benefits that remain unrealised because the project itself remains unfinished. A fundamental distinction must therefore be drawn. Some benefits are already observable and directly attributable to the institutional architecture established since 2014. Others remain potential because they depend on the completion of a True Banking Union. The gap between the two represents the opportunity cost of the current institutional settlement and provides the rationale for the comprehensive political package proposed in Chapter IV.

As J. Mejino-López and N. Véron observe in a study for the European Parliament, capital and loss-absorption requirements "are very complex in the EU and particularly in the Euro area, primarily because of the awkward coexistence of national and European decision-makers beyond the SSM, not least in the macro-prudential area[15]."

2.1 Benefits already delivered by the Banking Union

More than a decade after its establishment, the Banking Union has already delivered substantial and largely undisputed benefits. Although its architecture remains incomplete, it has profoundly transformed the governance of banking supervision

15. J. Mejino-López and N. Véron, "EU Banking Sector & Competitiveness: Framing the Policy Debate", study requested by the ECON Committee of the European Parliament, PE 764.188, May 2025, executive summary.

and crisis management in the Euro area and has significantly strengthened the resilience of the European banking sector. These achievements constitute the institutional and prudential foundations upon which any further deepening of the Banking Union must build.

2.1.1 Institutional achievements

The first tangible achievement of the Banking Union has been the establishment of a genuinely European framework for banking supervision and crisis management. The creation of the Single Supervisory Mechanism (SSM) in 2014 and the Single Resolution Mechanism (SRM) in 2016 represented an unprecedented transfer of supervisory and resolution responsibilities from the national to the European level, constituting one of the most significant advances in European economic integration since the creation of the euro.

Today, 110 significant banking groups are directly supervised according to common prudential standards under the responsibility of the European Central Bank[16], while bank failures are managed through a common European resolution framework supported by the Single Resolution Fund and its common public backstop. These reforms have substantially reduced supervisory fragmentation, strengthened consistency in supervisory and resolution practices and reinforced confidence in the stability of the European banking system.

As Dominique Laboureix, Chair of the Single Resolution Board, has underlined, Europe has now built "strong common supervision and a solid resolution framework."[17] Resolution plans have been prepared for all major banking groups, banks have accumulated substantial loss-absorbing capacity, the Single Resolution Fund has reached approximately EUR80 billion and the European resolution framework has demonstrated its operational credibility across several Member States. These institutional achievements are no longer reversible; they constitute the bedrock upon which any assessment of the Banking Union's remaining shortcomings must be built.

2.1.2 Greater resilience and financial stability

The second major achievement of the Banking Union has been the remarkable strengthening of the resilience of the European banking sector. Since the establishment of the SSM, European banks have substantially improved their capital, liquidity and governance positions while significantly reducing legacy vulnerabilities inherited from the global financial crisis and the sovereign debt crisis.

Recent data published by the European Banking Authority confirm that European banks continue to operate from a position of considerable strength despite an increasingly uncertain geopolitical and macro-financial environment. Capital ratios remain close to historical highs, liquidity buffers remain well above regulatory minima and profitability has remained resilient. These figures are more than prudential indicators; they describe a banking sector that is structurally more resilient than at any point since the Banking Union was established.

As Claudia Buch, Chair of the ECB's Supervisory Board, has emphasised, this resilience is both financial and operational[18]. It reflects not only banks' strengthened capacity to absorb shocks through higher capital and liquidity buffers but also their increasing ability to withstand cyber threats, operational disruptions, sanctions-related risks and financial crime.

Most importantly, this resilience has been demonstrated in practice. The European banking system successfully weathered the Covid-19 pandemic, the energy crisis following Russia's invasion of Ukraine and the banking turmoil experienced in the United States and Switzerland in 2023 without experiencing systemic disruption within the Euro area. Legacy vulnerabilities have also been substantially reduced. Greece, for example, has reduced its non-performing exposure ratio from almost 50% in 2016 to just above 3% today[19]. These developments illustrate the extent to which the Banking Union has contributed to restore confidence in the European banking sector and strengthening financial stability.

These achievements should not be underestimated. They demonstrate that the Banking Union has largely fulfilled its original objective of strengthening financial stability and reinforcing confidence in the European banking system. Yet they also highlight the limits of what has been achieved so far. Most of the economic, regulatory and strategic benefits originally associated with the Banking Union depend on a degree of market integration that the current institutional framework has not yet delivered. These unrealised benefits represent both the opportunity cost of an unfinished Banking Union and the rationale for completing it.

16. The ECB directly supervises around 110 significant banking groups, representing approximately 82% of total banking assets in the Euro area. Around 1,900 less significant institutions remain under the day-to-day supervision of national competent authorities, under the oversight of the ECB.
17. D. Laboureix, "Internal barriers, resolvability and banking union integration", in Breaking the Banking Union Deadlock, Eurofi Nicosia, Magazine 2026, p. 145.
18. ECB Annual Report on supervisory activities 2025, March 2026, as presented by C. Buch, Chair of the Supervisory Board of the ECB.
19. Y. Stournaras, "Banking and financial outlook for Greece and Europe in 2026", speech, February 2026.

2.2 The unrealised benefits of a true Banking Union

2.2.1 Economic benefits

A True Banking Union generates economic benefits through three mutually reinforcing channels: better risk sharing, better allocation of capital, more integrated banking markets. Together these three mechanisms strengthen the SIU and European competitiveness.

A better functioning Economic and Monetary Union through stronger private risk sharing

One of the most important economic justifications for completing the Banking Union lies in its contribution to the functioning of Economic and Monetary Union itself. In a monetary union, where fiscal stabilisation remains largely national, private risk sharing through integrated banking and capital markets constitutes the principal mechanism for absorbing asymmetric economic shocks.

This objective was already central to the original rationale of the Banking Union. As J.-M. Andrès, D. Cahen and M. Truchet explain[20]: "The Banking Union should contribute to a stronger and better functioning Economic and Monetary Union by improving the transmission of monetary policy, fostering a more efficient allocation of financial resources across the Euro area and strengthening private risk sharing in a monetary union that lacks a genuine supranational fiscal stabilisation capacity."

The comparison with the United States illustrates the scale of the challenge. Around 80% of asymmetric shocks are absorbed through integrated banking and capital markets in the United States, whereas only around 20% are smoothed through private financial channels in the European Union, the remainder being absorbed mainly through national fiscal stabilisers. Despite the progress achieved since the creation of the Banking Union, empirical evidence continues to show that a large proportion of regional shocks in the Euro area remains unsmoothed, illustrating the persistence of financial fragmentation and the limited capacity of private financial markets to absorb country-specific shocks.

The economic mechanism is straightforward. As as D. Cahen and A. Valroff explain, banking integration complements capital market integration by allowing cross-border banking groups to delink local credit supply from local economic conditions[21]. Losses incurred in one Member State can be compensated by profits generated elsewhere in the Union, allowing banks to continue lending to sound borrowers even during local downturns. By contrast, nationally fragmented banking systems tend to amplify economic shocks because domestic banks frequently reduce lending precisely when financing needs are greatest.

Progress towards deeper and more integrated securitisation markets in Europe would facilitate the transfer and diversification of credit risks across Member States, thereby strengthening the ability of the European financial system to absorb asymmetric shocks. At the same time, by transferring part of the credit risk to capital market investors, securitisation could release regulatory capital and create additional lending capacity for banks, supporting the financing of households, businesses and the green and digital transitions. Banking Union and the Savings and Investments Union should therefore be seen as mutually reinforcing components of a more resilient and integrated European financial system (*see also 2.23*).

A True Banking Union would therefore considerably strengthen one of the principal adjustment mechanisms of Economic and Monetary Union. By increasing private risk sharing, it would reduce the dependence of Member States on public intervention during crises while weakening the bank-sovereign nexus that has historically amplified financial instability in the Euro area.

A more efficient allocation of capital, liquidity and savings across Europe

The second major economic benefit concerns the allocation of financial resources across the European economy.

Today, despite more than ten years of Banking Union, Europe's banking market remains remarkably fragmented. Cross-border household deposits and lending still represent little more than 1% of total banking activity within the Euro area, while direct cross-border lending to non-financial corporations has increased only gradually, from around 10% in 2023 to approximately 16% today. Savings collected in one Member State continue overwhelmingly to finance investment in that same Member State.

These figures reflect the persistence of national ring-fencing practices. Cross-border banking groups continue to operate largely as collections of national subsidiaries rather than as genuinely integrated European banking groups. Capital, liquidity, MREL resources, leverage constraints and increasingly the Basel output floor continue to be managed at solo or sub-consolidated level under the influence of host authorities.

20. J.M. Andrès, D. Cahen & M. Truchet, "Optimising the Banking Union", Eurofi Regulatory Update, April 2018.
21. D. Cahen (with A. Valroff), "Banking fragmentation issues in the EU", Eurofi Regulatory Update, Santiago, September 2023, p. 38.

The economic cost of this fragmentation is substantial. Resources that could otherwise finance investment remain trapped within individual legal entities. Several ECB analyses estimate that tens of billions of euros of capital and liquidity remain immobilised within national subsidiaries because of prudential constraints and ring-fencing practices. Under an appropriate framework combining legally enforceable intragroup support, effective group supervision and credible safeguards for host jurisdictions, a significant proportion of these resources could be redeployed towards productive investment across the Union.

Fernando Restoy summarises the problem particularly well[22]: "In an environment where technology amplifies economies of scale in banking, insufficient consolidation hampers efficiency, profitability and the ability of European banks to compete globally. Ring-fencing prevents banking groups from realising efficiency gains through centralised management of capital and liquidity."

The benefits extend well beyond banking groups themselves. A more integrated Banking Union would improve the allocation of Europe's abundant savings by allowing surplus savings accumulated in one Member State to finance productive investment opportunities elsewhere in the Union.

Evidence provided by several large European cross-border banking groups confirms that these costs are not merely theoretical. Some institutions report having abandoned local expansion projects or acquisition opportunities because the additional capital and liquidity requirements imposed by host authorities rendered such investments economically unattractive.

Towards a more integrated banking market supporting Europe's competitiveness

The economic benefits of a True Banking Union would extend far beyond banking groups themselves. By reducing prudential fragmentation and facilitating cross-border integration, it would promote greater competition, stronger economies of scale and more efficient banking intermediation throughout the Union. Larger and better integrated banking groups would be better positioned to finance households, SMEs, infrastructure projects, innovation, defence and the green and digital transitions.

A completed Banking Union would not, by itself, establish a genuine Single Market for banking. Important non-prudential barriers – including differences in insolvency law, taxation, consumer protection, anti-money laundering frameworks and mortgage legislation – would continue to fragment retail banking markets but significant progress towards a genuine Banking Union would contribute to a virtuous dynamic toward this goal.

The Banking Union also constitutes a necessary foundation for the Savings and Investments Union. Without sufficiently integrated European banking groups capable of operating efficiently across borders, Europe's considerable savings will continue to be intermediated predominantly within national markets or increasingly by non-European financial institutions.

The strategic implications are significant. Today, European banks account for less than half of investment banking activities carried out in Europe, while the growing role of non-European intermediaries exposes the European economy to the risk of capital outflows during periods of market stress. Strengthening genuinely European banking groups would therefore contribute not only to financial integration but also to Europe's strategic autonomy and long-term economic resilience.

Ultimately, the economic benefits of a True Banking Union converge towards a single objective: improving the capacity of the European financial system to allocate savings more efficiently, finance productive investment wherever it is most needed and support sustainable long-term growth across the Union. These benefits would extend well beyond the banking sector itself. They would strengthen Economic and Monetary Union, reinforce the Savings and Investments Union, improve Europe's strategic autonomy and contribute directly to the competitiveness of the European economy.

2.2.2 Regulatory benefits

A simpler and more coherent regulatory and supervisory framework

One of the least recognised but potentially most significant benefits of a True Banking Union would be a simpler, more coherent and more proportionate EU regulatory and supervisory framework.

As discussed in Chapter I, the current framework has become increasingly complex through the cumulative interaction of the microprudential, macroprudential and resolution regimes. Institutions must simultaneously comply with multiple layers of capital requirements, leverage constraints, MREL, liquidity requirements, the Basel output floor and various distribution restrictions. These requirements are calibrated by different European and national authorities, often independently of one another, and are further complicated by numerous national options and discretions.

22. F. Restoy, "The role of the banking union in the current geopolitical context", in Breaking the Banking Union Deadlock, Eurofi Nicosia, Magazine 2026, p. 146.

However, an important part of this complexity is not inherent to prudential regulation itself. It reflects the incomplete nature of the Banking Union. As long as Member States remain reluctant to rely fully on European supervision and common crisis-management arrangements, national authorities have strong incentives to maintain additional safeguards at solo or sub-consolidated level through ring-fencing practices, national discretions and overlapping prudential requirements.

Completing the Banking Union would therefore simplify the framework not through deregulation but through integration. A greater reliance on consolidated supervision, legally enforceable intragroup support mechanisms and freer movements of capital and liquidity within cross-border banking groups would reduce the need for many of today's duplicated prudential constraints. Greater trust between Member States would also allow a gradual reduction in national discretions and facilitate a more coherent articulation between the microprudential, macroprudential and resolution frameworks.

This would also create the political conditions for a more proportionate prudential regime. A comprehensive political agreement on the completion of the Banking Union could combine deeper integration for large cross-border banking groups with a more proportionate regulatory framework for domestic, cooperative, mutualist and smaller institutions, while preserving key national specificities such as Institutional Protection Schemes. In this respect, integration and proportionality should not be regarded as competing objectives but as two complementary components of the same political package.

Such simplification should not, however, be confused with a weakening of prudential standards. As Claudia Buch has repeatedly stressed, any simplification of the regulatory framework must preserve the resilience of the European banking system. The objective is therefore not less regulation, but better regulation: a framework that is simpler, more coherent, more proportionate and less fragmented while maintaining a high level of financial stability.

The remaining sources of complexity – particularly those resulting from the cumulative interaction between the microprudential, macroprudential and resolution frameworks – would nevertheless require additional governance reforms. Completing the Banking Union would therefore not eliminate every aspect of regulatory complexity, but it would remove one of its principal structural causes and create the conditions for a more holistic and coherent approach to prudential regulation.

2.2.3 Strategic benefits

A Necessary Foundation for the Savings and Investments Union

The completion of the Banking Union has become a strategic priority not only for the banking sector itself but also for the success of the European Union's broader Savings and Investments Union (SIU).

A fragmented banking market inevitably fragments banking groups. Conversely, a True Banking Union would create the conditions for the emergence of genuinely European banking groups capable of competing globally, accompanying European companies throughout the Single Market and internationally, and financing the large-scale investments required for Europe's green and digital transitions, defence and strategic autonomy.

Although the SIU seeks to mobilise Europe's abundant private savings towards productive investment, its success cannot rely exclusively on deeper capital markets. Europe remains a predominantly bank-based financial system in which banks continue to play the central role in collecting household savings, financing businesses and supporting the development of capital markets themselves.

As Vítor Constâncio already argued when discussing the synergies between Banking Union and Capital Markets Union[23], the two projects are complementary rather than competing. A Banking Union strengthens the resilience of the banking sector, facilitates cross-border consolidation, enhances cross-border credit markets and reduces intermediation costs, while integrated capital markets diversify sources of finance and strengthen private risk sharing. Together they create a more integrated European financial system capable of allocating savings more efficiently across the Union.

More recently, the Savings and Investments Union has explicitly recognised this complementarity. The objective is no longer simply to develop capital markets but to create an integrated financial ecosystem capable of transforming Europe's considerable stock of private savings into productive investment supporting innovation, digitalisation, defence, decarbonisation and strategic autonomy. This objective cannot be fully achieved if Europe's banking market remains fragmented along national lines.

23. V. Constâncio, "Synergies between banking union and capital markets union", keynote speech at the joint conference of the European Commission and the European Central Bank on European Financial Integration, Brussels, 19 May 2017.

A True Banking Union would therefore constitute one of the institutional foundations of the SIU. Better integrated banking groups would facilitate the cross-border mobilisation of savings, complement capital markets, improve the allocation of financial resources and strengthen the financing capacity of the European economy.

Strengthening Europe's strategic autonomy

A second strategic benefit concerns Europe's financial sovereignty. The fragmentation of the European banking market has limited the emergence of banking groups able to compete globally and support European strategic priorities. Consequently, a growing share of financial intermediation within Europe is undertaken by non-European institutions, particularly in wholesale and investment banking activities.

This dependence creates strategic vulnerabilities. During periods of financial stress, internationally active non-European institutions may naturally reallocate capital and liquidity towards their domestic markets or other jurisdictions, reducing their capacity to support the financing needs of the European economy. A stronger network of genuinely pan-European banking groups would therefore reinforce Europe's financial resilience and reduce its dependence on external financial intermediaries. Completing the Banking Union would thus contribute not only to financial integration but also to Europe's broader objectives of strategic autonomy, economic security and resilience.

Strengthening the international competitiveness of European banks

Finally, a True Banking Union would strengthen the international competitiveness of European banks by removing one of the principal structural disadvantages that distinguishes Europe from other major jurisdictions.

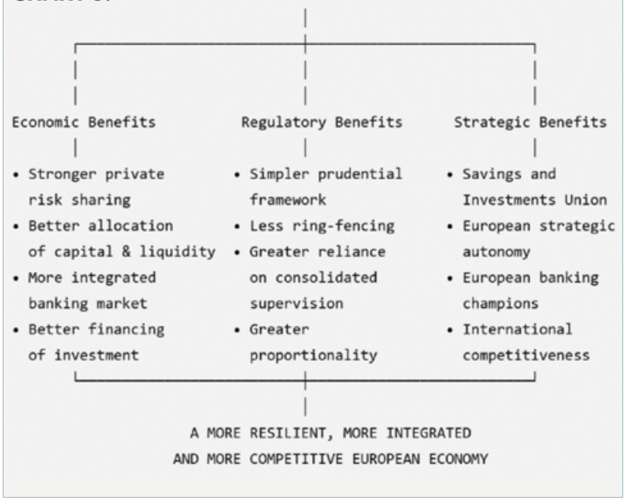
As discussed in Chapter I, the competitiveness gap between European and US banks reflects several structural factors. However, one important handicap is specific to Europe: the fragmentation of prudential requirements, the persistence of ring-fencing practices and the duplication of capital and liquidity constraints across national subsidiaries.

Progressively, removing internal capital and liquidity barriers within cross-border banking groups would improve efficiency, competitiveness and private risk sharing across the Union.

The issue is therefore not primarily one of deregulation. Recent ECB analysis suggests that stronger capitalisation does not necessarily reduce banks' efficiency or competitiveness. Europe's competitive disadvantage instead stems largely from the fragmentation of its banking market and the incomplete nature of the Banking Union. Completing the Banking Union would therefore represent Europe's principal structural response to growing international competition, while targeted adaptations of the Basel framework to European specificities would constitute an important complementary reform rather than a substitute.

The economic, regulatory and strategic benefits discussed above should not be viewed as separate or competing outcomes. They are closely interconnected and reinforce one another. A True Banking Union would simultaneously strengthen the functioning of Economic and Monetary Union, simplify the prudential framework and reinforce Europe's strategic capacity to mobilise savings, finance investment and compete internationally. Together, these mutually reinforcing effects explain why completing the Banking Union has progressively become one of the central pillars of Europe's broader competitiveness agenda.

CHART 3.



2.3 Who benefits from a true Banking Union?

The benefits of a True Banking Union would not accrue uniformly. They differ according to the characteristics, responsibilities and interests of the various stakeholders involved. Understanding this distribution of benefits is essential for identifying the conditions under which a comprehensive political agreement could eventually emerge.

A successful Banking Union is therefore not a zero-sum game between home and host countries, large and small banks, or European and national authorities. Properly designed, it can generate benefits for all stakeholders, provided that deeper integration is accompanied by credible safeguards addressing their legitimate concerns.

2.3.1 Large cross-border banking groups

Large cross-border banking groups would be the primary operational beneficiaries of a True Banking Union. Greater freedom to allocate capital and liquidity within the group, legally enforceable intragroup support mechanisms, reduced ring-fencing practices and greater reliance on consolidated supervision would improve balance-sheet management, reduce funding and compliance costs and facilitate cross-border expansion. These gains would strengthen profitability, increase lending capacity and improve the ability of European banking groups to compete internationally.

2.3.2 Host Member States

Host Member States are often perceived as the principal losers from deeper banking integration because they fear losing control over capital and liquidity held within their jurisdictions. In reality, a properly designed Banking Union could also generate substantial benefits for host countries.

A credible framework combining legally enforceable intragroup support, a European deposit insurance dimension, effective liquidity arrangements in resolution and stronger European crisis-management mechanisms would provide host authorities with greater assurance that local subsidiaries would continue to receive adequate financial support during periods of stress. Better diversified cross-border banking groups would also improve the financing of local economies while strengthening private risk sharing within the Monetary Union. The objective is therefore not to eliminate safeguards for host countries, but to replace national safeguards with credible European safeguards.

2.3.3 Domestic, cooperative, mutualist and smaller banks

Domestic, cooperative, mutualist and smaller institutions would benefit from a different set of reforms than large cross-border banking groups. For these institutions, whose activities remain primarily domestic and relationship-based, the principal gains would come less from greater cross-border integration than from a more proportionate, predictable and business-model-sensitive prudential and supervisory framework.

The diversity of the European banking sector constitutes one of its structural strengths. The coexistence of large commercial banks, cooperative and mutualist groups, regional and local institutions, specialised banks and digital players contributes to financial stability, competition, financial inclusion and the financing of households, SMEs and local economies. It also reduces concentration risk by allowing different ownership structures and business models to coexist within the European financial system. Completing the Banking Union should therefore reinforce this diversity rather than unintentionally encouraging the convergence of all institutions towards a single shareholder-owned banking model.

This implies that a comprehensive political agreement on the Banking Union should be accompanied by meaningful progress on proportionality. Prudential, supervisory, reporting and resolution requirements should better reflect differences in size, complexity, ownership structure and business model. Supervisory practices should also become more sensitive to the specific characteristics of cooperative and mutualist institutions, whose governance arrangements, capital formation mechanisms and profitability objectives differ fundamentally from those of listed commercial banks. Lower shareholder-driven profitability should not automatically be interpreted as evidence of weaker business models, nor should supervisory benchmarks systematically reflect the characteristics of listed commercial banks.

The preservation of Institutional Protection Schemes (IPS) should remain an essential component of any political agreement. IPS have demonstrated their contribution to financial stability and represent a cornerstone of several national banking systems. Likewise, the costs associated with deeper integration should not fall disproportionately on institutions that derive only limited direct benefits from greater cross-border banking integration.

More fundamentally, deeper European integration and greater banking diversity should not be regarded as competing objectives. On the contrary, they should reinforce one another. A True Banking Union should enable large cross-border banking groups to operate more efficiently across Europe while allowing cooperative, mutualist, regional and smaller institutions to continue fulfilling their distinctive economic role under a genuinely proportionate supervisory framework. In this sense, integration and proportionality should form two complementary pillars of the same political agreement rather than two separate policy agendas.

2.3.4 Supervisory and resolution authorities

European and national supervisory and resolution authorities would also benefit from a more coherent institutional framework. Greater reliance on consolidated supervision would reduce the need for overlapping prudential safeguards, facilitate a more consistent interaction between the microprudential, macroprudential and resolution frameworks and allow authorities to focus more effectively on risks at group level rather than on the protection of individual legal entities. Resolution planning would also become more credible through clearer intragroup support arrangements and improved liquidity management in resolution.

2.3.5 Member States and public finances

Member States collectively would benefit from stronger private risk sharing within Economic and Monetary Union. By enabling cross-border banking groups to absorb shocks across jurisdictions, a True Banking Union would reduce the reliance on national fiscal intervention during financial crises, weaken the bank-sovereign nexus and improve the resilience of the Euro area as a whole. Better financial integration would therefore complement, rather than replace, sound national fiscal policies.

2.3.6 European households, businesses and the wider economy

Ultimately, the main beneficiaries would be European households, businesses and the wider economy. A more integrated banking market would promote greater competition, improve the quality and diversity of banking services, foster innovation and facilitate access to more diversified sources of finance for households and firms. Better allocation of savings and capital across borders would strengthen investment, productivity and long-term growth throughout the Union.

More broadly, a True Banking Union would reinforce the Savings and Investments Union, support Europe's strategic autonomy and strengthen the international competitiveness of the European financial system. Its benefits would therefore extend well beyond the banking sector itself.

2.3.7 A common interest requiring differentiated safeguards

Recognising that these benefits differ across stakeholders is essential for understanding why completing the Banking Union has proved politically difficult. The issue is not whether a True Banking Union creates value – it clearly does – but how that value is distributed and under which institutional safeguards.

A comprehensive political agreement should therefore ensure that each category of stakeholders perceives tangible benefits while seeing its legitimate concerns adequately addressed. For host Member States, this requires credible European safeguards able to replace national ring-fencing. For domestic, cooperative, mutualist and smaller institutions, it requires a genuine proportionality agenda together with the preservation of Institutional Protection Schemes. For large cross-border banking groups, it means allowing genuine group-based supervision and the freer movement of capital and liquidity within banking groups.

Completing the Banking Union should therefore not be viewed as a choice between deeper European integration and the preservation of national banking diversity. A well-designed Banking Union should deliver both: greater integration where scale creates value, and greater proportionality where diversity strengthens financial stability and the financing of the European economy. This balance lies at the heart of the comprehensive political package discussed in Chapter 4.

2.4. The opportunity cost of an unfinished Banking Union

The previous sections have distinguished between the benefits already delivered by the Banking Union and those that remain unrealised. These unrealised benefits are not merely hypothetical. Their absence already imposes measurable economic, regulatory and strategic costs on European banks, on the European economy and, ultimately, on financial stability itself.

The cost of an unfinished Banking Union should therefore not be measured solely by the reforms that have yet to be adopted. It should also be assessed through the resources that remain immobilised, the duplication of prudential requirements, the business opportunities that are forgone and the reduced capacity of the European banking system to respond efficiently during periods of stress. In this sense, the Banking Union deadlock already has a tangible opportunity cost.

2.4.1 Trapped capital and liquidity

The most visible manifestation of this opportunity cost concerns the immobilisation of capital and liquidity within national subsidiaries.

The Banking Union currently operates in a hybrid institutional framework in which supervision and resolution have largely been centralised while capital and liquidity continue to be managed largely within national legal entities. The result is not excessive prudence but duplicated prudence: similar prudential safeguards are applied simultaneously at consolidated, sub-consolidated and solo levels because Member States are not yet prepared to rely fully on common European mechanisms.

The clearest illustration concerns liquidity. At Eurofi in Ljubljana in 2021, Andrea Enria[24] estimated that, of the EUR418 billion of high-quality liquid assets held by non-domestic subsidiaries of significant institutions, around EUR221 billion were immobilised by solo Liquidity Coverage Ratio requirements and a further EUR34 billion by host-country limits on intragroup large exposures. In total, approximately EUR250 billion of liquid assets remained trapped within national subsidiaries. Even if all existing regulatory waivers were fully used, almost EUR140 billion would remain trapped because several Member States continue to apply national large-exposure constraints.

More recently, the European Commission, relying on ECB estimates, concluded that approximately EUR230 billion of high-quality liquid assets could potentially be released if these structural constraints were removed. The order of magnitude therefore remains remarkably consistent across successive analyses.

Capital mobility is affected in a similar way. The joint non-paper published by France, Italy and Spain estimates that approximately EUR225 billion of regulatory capital, including around EUR180 billion of CET1, is currently held within cross-border subsidiaries. The issue is not that this capital is economically unproductive, but rather that it cannot be reallocated efficiently within banking groups according to changing financing needs.

2.4.2 Higher regulatory and funding costs

The opportunity cost of fragmentation extends well beyond trapped resources. It also generates significant regulatory and funding costs.

Large cross-border banking groups must comply simultaneously with multiple national prudential constraints governing liquidity, capital, leverage, MREL and large exposures. Internal MREL requirements frequently require each material subsidiary to issue loss-absorbing instruments subscribed by the parent institution, multiplying issuance programmes, legal structures, operational teams and compliance costs throughout the group. European MREL requirements often exceed the international TLAC standard while remaining fragmented across legal entities.

Large-exposure limits also continue to constrain the circulation of liquidity within groups. In many jurisdictions, intragroup exposures remain subject to national limits that differ across Member States and across financial products. Banking groups consequently report that several billions of euros of liquidity remain idle each year solely because of these prudential constraints.

Macroprudential requirements further reinforce these costs. Similar risks are often addressed simultaneously through Pillar 2 requirements, systemic risk buffers, countercyclical buffers and other national macroprudential instruments. Differences in national calibrations may therefore produce materially different prudential outcomes for institutions with otherwise comparable risk profiles.

These additional costs do not primarily reflect higher prudential standards. They result from the fragmented application of those standards across multiple legal entities and jurisdictions.

2.4.3 Lost business opportunities

Fragmentation also carries a less visible but equally important economic cost by discouraging investment, expansion and cross-border consolidation.

Several major European banking groups report having abandoned local development projects or acquisition opportunities because additional capital and liquidity requirements imposed by host authorities significantly reduced their expected profitability. Ring-fencing therefore not only immobilises existing resources; it also discourages future investment and limits the emergence of genuinely European banking groups.

As Fernando Restoy has observed, this fragmentation prevents banks from realising the efficiency gains associated with integrated balance-sheet management at a time when technological investment increasingly rewards scale. The cost is therefore measured not only in trapped capital but also in lost opportunities for innovation, digitalisation and cross-border expansion.

2.4.4 Lower resilience in periods of stress

Perhaps the greatest cost cannot be measured through static balance-sheet indicators. It materialises precisely when banking groups need flexibility most.

During periods of financial stress, integrated banking groups should be able to transfer capital and liquidity rapidly towards subsidiaries facing losses or liquidity outflows. Under the current architecture, however, fragmentation often prevents such reallocations. Resources remain trapped within national entities precisely when they are most needed elsewhere within the group.

Paradoxically, arrangements originally designed to protect national financial stability may therefore

24. A. Enria, "How can we make the most of an incomplete banking union?", speech at the Eurofi Financial Forum, Ljubljana, 9 September 2021.

reduce the resilience of the European banking system as a whole. The true cost of fragmentation lies not in the level of prudential requirements themselves but in the absence of mutual trust allowing these resources to be managed efficiently at consolidated level.

The opportunity cost of an unfinished Banking Union extends well beyond trapped capital and liquidity. It encompasses higher compliance and funding costs, forgone investment opportunities, less efficient balance-sheet management and a reduced capacity to absorb economic shocks. More fundamentally, it reflects Europe's inability to exploit the full economic potential of its banking sector. Resources remain fragmented, banking groups continue to operate largely along national lines, and the European economy forgoes efficiency gains, stronger private risk sharing and better financing of investment. Completing the Banking Union is therefore not simply about finalising an institutional architecture. It is about removing one of the principal structural obstacles to a more integrated, more competitive and more resilient European financial system.

3. Why the Banking Union Remains Incomplete: A Hierarchy of Five Problems

The persistent incompleteness of the Banking Union is often attributed to a lack of political will or to protectionist reflexes among Member States. This chapter adopts a different perspective. It argues that the current deadlock is largely the rational consequence of an incomplete institutional architecture operating in a context of persistent fiscal and economic divergences.

The five problems analysed below do not constitute an independent list of obstacles but successive links in the same causal chain. At its origin lies the sovereign-bank nexus that the Banking Union was originally designed to break. Yet this nexus continues to be sustained by divergent fiscal trajectories across Member States, which undermine mutual trust and make risk-sharing politically difficult. This lack of trust is reflected institutionally in a Banking Union that remains only partially federal, where supervision has been Europeanised while legal responsibility for financial stability remains largely national. The resulting solo approach encourages ring-fencing and other forms of market fragmentation, which ultimately prevent the emergence of a genuinely integrated European banking market.

Understanding this chain is essential because problems reinforce each other. The Banking Union therefore remains incomplete not because one reform is missing but because each unresolved issue perpetuates the others. This diagnosis also explains why isolated technical reforms are unlikely to succeed and why the comprehensive political package proposed in Chapter IV has become necessary.

3.1 The sovereign-bank nexus

The Banking Union was launched explicitly to break the doom loop between banks and their national sovereigns that had amplified the 2011–2012-Euro area crisis. That founding objective, recalled in Chapter I, was the original raison d'être of the project, not market integration or the creation of a single retail space; and it is on this primary test that the Banking Union has only partially succeeded.

The numbers tell a clear story. According to the EBA's Risk Assessment Report of December 2025, EU/EEA banks reported about EUR4 tn of sovereign exposures as of June 2025, a 14% increase year on year, with the ratio of sovereign exposures to CET1 reaching 226%, the highest level since the onset of the pandemic; in several jurisdictions banks report sovereign exposures exceeding 300% of their capital[25].

The domestic intensity of the sovereign-bank nexus remains significant. ECB C33 data at end-2025 show that domestic general government exposures held by banks in their home jurisdiction amount to approximately 1.8 times CET1 capital in Italy, 1.3 times in France and 0.7 times in Germany[26]. The directional trend is one of partial and uneven diversification: 45% of EU/EEA banks' sovereign exposures were still allocated to their home country as of June 2025, down from 53% in June 2018, while exposures to other EU/EEA sovereigns rose from 25% to 31%[27]. As C. Buch observes, the relative home bias of the large banks under European supervision has declined over the Banking Union's first decade[28]; the aggregate figure, however, conceals national realities that remain very

25. European Banking Authority, Risk Assessment Report - December 2025, p. 11 and p. 24. EU/EEA banks reported about EUR4 tn of sovereign exposures as of June 2025 (a 14% year-on-year increase); the ratio of sovereign exposures to CET1 stood at 226%, the highest level since the onset of the pandemic.

26. ECB, C33 statistical data on banks' holdings of domestic general government debt, end-2025, cited separately from the EBA aggregate. Domestic general government exposure equivalent to about 1.8 times CET1 in Italy, about 1.3 times in France and about 0.7 times in Germany.

27. European Banking Authority, 2025 EU-wide Transparency Exercise, published 4 December 2025 (119 banks, 25 EU/EEA countries, reference date 30 June 2025); EBA, Risk Assessment Report - December 2025, p. 23-24.

28. Eurofi High Level Seminar 2026, summary of the session "Breaking the Banking Union deadlock".

TABLE 1.
Domestic sovereign exposure and fiscal position, selected Member States

Member State	Domestic sovereign / total assets	Domestic sovereign / CET1	Public debt (% of GDP)
Italy	c. 10.8%	c. 180%	c. 138%
France	c. 6.5%	c. 130%	c. 114%
Germany	c. 3.6%	c. 70%	c. 66%

Source: ECB, C33 statistical data (sovereign exposures), end-2025; Eurostat, government debt, Q1 2025. Figures preceded by "c." are approximate. The intensity of the nexus tracks the fiscal position. EU/EEA total sovereign exposures stood at about EUR4 tn, or 226% of CET1, as of June 2025 (EBA).

different, as the ECB C33 data above show, and the nexus binds precisely where it is strongest.

This relative progress coexists with deterioration in absolute terms. Strongly rising public debt, in Germany where 2025 issuance is projected to exceed EUR143 bn[29], and the high-debt trajectories of Italy and France, mechanically increase the volume of sovereign exposures on domestic balance sheets. The geographical concentration of the loop, moreover, remains a structural reality.

The ECB's Financial Stability Review of November 2025 warns that investors' perceptions of risk have focused on the deteriorating trajectory of fiscal fundamentals in France[30], whose ten-year OAT-Bund spread widened to about 80 basis points in September 2025, the highest reached since the dissolution of the National Assembly in June 2024[31], a striking convergence with Italian levels. As D. Cahen and A. Valroff observe, the persistence of the loop is "not the result of a dysfunction of the SSM or the SRB, but the consequence of fiscal slippage in some countries that have been exacerbated by the Covid-19 crisis[32]." Crucially, a bank that holds its own sovereign's debt is only as safe as that sovereign's public finances: the danger of the nexus is a direct function of fiscal trajectories. The founding mission of the Banking Union has therefore not been achieved, and the fiscal divergence that drives the nexus is the subject of Problem 5.

3.2 The central bank-sovereign nexus

The 2% inflation target pursued by central banks has pushed them to maintain very accommodative financing conditions, and asymmetric monetary policies over the past 20 years. Central Banks, and the ECB in particular, have not tightened monetary conditions when the crisis was over, between 2015 and 2022. The massive increase in central banks' total assets and the expansion of the monetary base in non-crisis times illustrates this asymmetry.

We reminded previously that the sovereign-bank nexus decreased between 2015 and 2019. The counterpart of such decrease has been an increase of the Eurosystem balance sheet due to the QE policy of the ECB. Thus, there is a stronger central bank-sovereign nexus. From January 2015 to early March 2020, a total of EUR2.66 tn of public and private securities were purchased by the Eurosystem, corresponding to nearly 20% of the 2019 Eurozone's GDP. This brought the value of the ECB's balance sheet to EUR4.7 tn, *i.e.*, 39.1% of the 2019 GDP. Between 2014 and mid-2022, the ECB's balance sheet increased from 21.2% of the Eurozone's GDP to 73.8% (*see Chart 15*). That is a EUR6.8 tn rise towards the record of EUR8.83 tn as of end-May 2022. When the pandemic struck in March 2020, the key financing rate of the ECB could not be lowered further, leaving little room for maneuver. Substantial monetary policy accommodation was emphasized over the course of 2020 and 2021 to counter the negative impact of the pandemic on the inflation outlook. Thus, as one can see on Chart 15, the size of the Eurosystem's balance sheet as a share of the Eurozone's GDP more than doubled compared to its size after the GFC and the EU sovereign debt crisis.

Considering the ECB's action, the Governing Council decided in March 2020 to launch the Pandemic Emergency Purchase Program (PEPP) of up to EUR750 bn until the end of 2020, on top of the EUR120 bn in extra purchases as part of the already existing APP. Following the end of the net purchases under the PEPP in March 2022, the Eurosystem continued buying securities as part of the APP. Since March 2023, the ECB has been reducing its sovereign bond holdings. From March to June 2023, the APP portfolio decreased by an average of €15 billion per month, as the Eurosystem did not reinvest all the principal payments from maturing

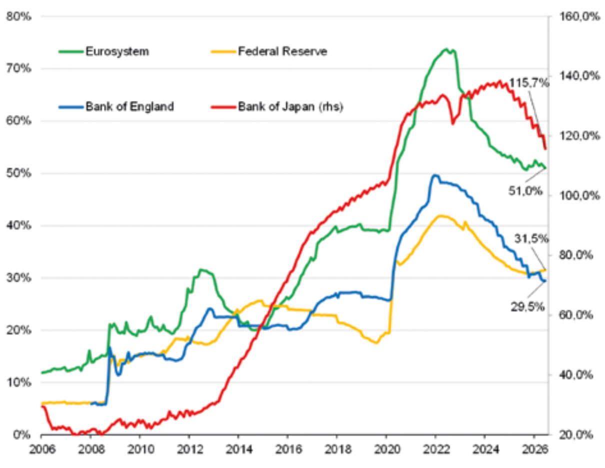
29. EBA, Risk Assessment Report - December 2025, p. 18, citing the German Federal Ministry of Finance: German borrowing in 2025 projected to exceed EUR143 bn by year-end.
30. European Central Bank, Financial Stability Review, November 2025.
31. Eurostat, government debt data, Q1 2025; OMFIF, "Putting a price on French political turmoil", October 2025; MarketAxess data on the OAT-Bund spread, reaching approximately 80 basis points in early September 2025.
32. D. Cahen and A. Valroff, "Banking Union: what way out of the current deadlock?", Eurofi Regulatory Update, February 2024, p. 106.

securities. From July 2023 onwards, the Eurosystem decided to stop reinvesting redemptions under the APP. This has accelerated the reduction in securities holdings to an average of €25 billion per month. Since July 2024, the stock of bonds held under the PEPP has fallen by an average of €12 billion per month.

The ECB started to slow down the pace of asset purchases in March 2022. Indeed, net purchases under the APP ceased on 1 July 2022. The Eurosystem has then had a leading role in public debt monetization during the Covid-19 crisis, as its government securities purchases amounted to most of government debt issuance (*see Chart 12*). Charts 13 and 14 show the growing share of government debt held by National Central Banks (NCBs). The latter has been increasing continuously since 2015, when the ECB started its APP. Between January 2015 and December 2019, the share of public debt held by the Eurosystem grew from 4.4% to 19.5%.

The purchase of sovereign bonds since 2015 has led the Eurosystem to hold more than a third of the Euro area's public debt outstanding in 2022. More than two and a half years after quantitative tightening began in March 2023, the Eurosystem's share of Euro area public debt has fallen by 10 percentage points to reach 23% in December 2025. Despite this recent decline, the Eurosystem still holds a larger share of public debt than before the pandemic (19.5% in December 2019), retaining a meaningful footprint in Euro area sovereign debt markets that attests to the persistence of the Central Bank-sovereign loop. In December 2025, the Eurosystem held 19.2% of French government debt and 18.1% of Italian government debt. More than 25% of Portuguese (27.1%), German (28.6%) and Dutch (33.3%) government debt remained on the Eurosystem's balance sheet.

CHART 4.
Central Banks' Total Assets Relative to GDP, %



Source : Ekonomics, *based on national central banks data*
Notes : Last data are from December 2025; the ratio is calculated on the basis of the 2019 nominal GDP for all the data since 2019. Last observation from June 2026.

Most importantly, it highlights that the linkages between governments and banks are now extended to central banks. This sheds a special light on the independence of central banks, as NCBs own a growing and significant share of the national government debts and have de facto become the agents of fiscal policies.

3.3 A structural institutional asymmetry: a federal Eurosystem and a non-federal Banking Union

3.3.1 A structural institutional asymmetry

If the home-host dilemma persists, it is not for lack of European ambition at the level of the SSM or the SRB. Both institutions function effectively within the mandates conferred upon them, and national competent authorities (NCAs) participate fully in their governance, through the SSM's Supervisory Board, where each Member State is represented, and through the SRB's plenary and executive sessions. The dilemma persists because the European supervisory architecture rests on a non-federal foundation: national authorities retain their own legal mandates, so the home-host tension cannot be dissolved by supervisory cooperation alone.

The persistence of the home-host dilemma is therefore not primarily a supervisory issue but an institutional one. It reflects a structural asymmetry between a federal Eurosystem and a non-federal banking supervisory and resolution framework.

In the field of monetary policy, the Eurosystem operates as a fully integrated, federal system. National central banks (NCBs) are conceived as integral parts of the Eurosystem: when implementing the single monetary policy, they act on behalf of the European Central Bank and may receive direct instructions from its Executive Board. Their national mandates are subsumed into the Eurosystem's framework, and the Treaty itself organises this federal integration.

The architecture of European banking supervision and resolution is, by design, different. As the ECB's own legal staff have observed, "the SSM appears to be a less integrated system than the Eurosystem since the NCAs do not legally form its 'integral parts'"[33]. National competent authorities are not

33. C. Zilioli and K.-P. Wojcik, "The Eurosystem and the Single Supervisory Mechanism: institutional continuity under constitutional constraints", ECB Legal Working Paper Series No 17, June 2018: "the SSM appears to be a less integrated system than the Eurosystem since the NCAs do not legally form its 'integral parts'."

branches or operational arms of the ECB; they remain national authorities with their own legal mandates, accountability frameworks and supervisory responsibilities extending well beyond the SSM. The same observation applies, mutatis mutandis, to the relationship between the SRB and national resolution authorities.

This is not an institutional flaw to be condemned: in many respects it reflects the legitimate distribution of competences in a Union of Member States. But it has direct operational consequences. Two authorities with overlapping but distinct mandates, one acting in the European interest, one accountable to a national jurisdiction, will inevitably overlap, produce additional layers of requirements and, in stress situations, trigger ring-fencing reflexes. As S. Cappiello observes, the home-host tensions that perpetuate this fragmentation are not the result of bad faith but of a structural misalignment: "More than a decade after its launch, the Banking Union remains incomplete. The persistent stalemate is rooted in enduring home-host tensions and a broader sense of insufficient trust in EU-level governance, even though the SSM and SRB have demonstrated their effectiveness. At its core, the home-host dilemma reflects a structural misalignment: EU-level responsibilities have expanded, yet the national legal frameworks that ultimately shape critical decisions on capital, liquidity and crisis management remain largely unchanged[34]."

The economic rationale behind a genuine Banking Union is therefore not limited to improve the efficiency of banking groups. It is to create the conditions for capital and liquidity to circulate more freely across the Euro area, strengthen private risk-sharing, reduce financial fragmentation and improve the financing of the European economy. These objectives cannot be fully achieved as long as the institutional asymmetry between a federal monetary union and a non-federal banking framework continues to encourage nationally based supervisory and resolution responses. As J.-M. Andrès, D. Cahen and M. Truchet emphasised already in 2018, the emergence of transnational banking groups "would notably help Eurozone excess savings to circulate across borders to parts of Europe where the most attractive investment opportunities exist[35]" and would "increase private risk sharing[36]" within the Union.

The Banking Union did not form part of the original architecture of Economic and Monetary Union. It was created only after the Euro area sovereign debt crisis had exposed the weaknesses of a monetary union operating without an integrated framework for banking supervision and crisis management. However, unlike Monetary Union – which rests on genuinely federal institutions – the Banking Union was constructed as a hybrid system in which European responsibilities coexist with nationally anchored legal mandates. This institutional asymmetry continues to shape the functioning of the Banking Union and remains one of the fundamental explanations for the persistence of the home-host dilemma.

This institutional distinction also shapes the incentives under which supervisory authorities operate. While members of the Supervisory Board and the SRB are required to act in the European interest when exercising their responsibilities within those bodies, national competent authorities continue to perform important functions under national law, including preserving domestic financial stability and supervising institutions outside the scope of the Banking Union. As a result, European and national perspectives inevitably coexist within the overall supervisory architecture. This is not a question of conflicting loyalties but a consequence of the legal allocation of responsibilities.

Institutional design matters because it shapes incentives. As long as supervisory and resolution responsibilities continue to combine European decision-making with nationally anchored legal responsibilities, authorities will naturally remain inclined to take domestic financial stability considerations into account alongside European objectives.

3.3.2 The solo approach: the operational consequence

The third problem is the architecture of the prudential framework itself: the solo approach, under which cross-border groups are treated not as single entities but as a sum of separate subsidiaries. Its mechanism was set out in Chapter I and its cost quantified in Chapter II: each subsidiary meets liquidity, capital, MREL and output-floor requirements on its own, so the sum of solo constraints exceeds the consolidated level, and resources cannot move to where they are needed.

The solo approach is therefore not simply a prudential technique. It is the operational consequence of a Banking Union whose institutional architecture remains only partially federal. As long as capital and liquidity continue to be managed primarily through nationally supervised legal

34. S. Cappiello, "Two key underpinnings for the Banking Union", in Breaking the Banking Union deadlock, Eurofi Nicosia, 2026, Magazine.
35. J.-M. Andrès, D. Cahen and M. Truchet, op. cit., Annex, p. 2.
36. D. Cahen and A. Valroff, "Banking fragmentation issues in the EU", op. cit., p. 39.

entities, ring-fencing will remain the rational response of national authorities.

3.4 Market fragmentation, ring-fencing and government interference

The institutional architecture described in the previous section has direct operational consequences. As long as financial stability, crisis management and fiscal responsibilities remain largely organised at national level, national authorities have strong incentives to protect their domestic banking systems. This national bias manifests itself in two complementary ways. First, through prudential fragmentation, reflected in ring-fencing practices that restrict the free movement of capital, liquidity and loss-absorbing resources within cross-border banking groups.

Second, through political fragmentation, whereby governments continue to intervene in, or seek to influence, major cross-border banking transactions in order to safeguard national economic and financial interests. These two forms of fragmentation are not isolated deviations from the spirit of the Banking Union; they are the operational consequences of an institutional framework in which supervisory responsibilities have been partly Europeanised while financial risks and political accountability remain largely national.

3.4.1 Ring-fencing: subsidiaries of cross-border groups are mainly governed by national rules

As D. Cahen and A. Valroff put it, "ring-fencing is when host authorities take regulatory and supervisory action in order to secure resources within their own jurisdictions. There are no host supervisors anymore in the banking union, but the distinction between home and host authorities and the 'national bias' still exist for banks operating across borders[37]."

Indeed, "national regulators still fear that capital and liquidity could be trapped in individual Member States or inadequately allocated from their own viewpoint if a pan-European banking group fails. This perception is particularly acute in countries that are strongly dependent on banks part of groups headquartered in other countries for the financing of their economies[38]."

Ring-fencing policies are applied to capital, liquidity and MREL liabilities. The obstacles to the integrated management of bank capital and liquidity within cross-border groups remain persistent and fragment banking markets: recognised in 2013 by CRD4, capital and liquidity waivers remain at the discretion of national supervisors, which are most often reluctant to use them, so that in practice all capital and liquidity ratios are applied at both solo and (sub-)consolidated levels, notwithstanding the possibility of waivers allowed by the legislation[39]. Ever more funds must moreover be pre-positioned at subsidiaries: internal MREL is now required for all institutions and financial holding companies with a balance sheet exceeding EUR5 bn, so that pre-positioned resources are not available for re-allocation within groups if and when necessary; several host authorities submit dividend distributions from subsidiaries to their approval; and host countries can, most of the time successfully, obtain increased Pillar 2 Requirements for subsidiaries of the same European banking group[40].

The root causes of these practices have been identified and continue to exist. First, ring-fencing is deeply rooted in a general lack of trust, mainly due to the economic and fiscal divergences between the largest Member States, which also prevent the creation of an EU safe asset that would enhance the diversification of risks. Second, the bad memories of the EU sovereign debt crisis in several Member States, such as Belgium, where foreign banks took over national leading banks. Third, host authorities are concerned with ensuring the financing of their national economic activities, and for some of them especially their public deficits[41]. Beneath these causes lies a governance grievance: host countries consider that their concerns regarding burden-sharing and the way cross-border resolutions would be handled are often dismissed, and they ring-fence to protect themselves[42].

3.4.2 Government interference: a political fragmentation by Member States

To ring-fencing must be added a second, distinct mechanism that has come into sharp focus: direct political interference by Member States in cross-border transactions, well-illustrated by the UniCredit-Commerzbank case of 2025-2026. Having built a stake of just under 30% in Germany's second-largest listed lender, UniCredit launched in May 2026 an all-share offer for the remainder, valuing the bank at more than EUR35 bn. The German Chancellor and Commerzbank's management fiercely opposed the tie-up, the former describing the approach as "hostile" and "aggressive" and

37. D. Cahen and A. Valroff, "Banking fragmentation issues in the EU", op. cit., p. 14-15.
38. D. Cahen and A. Valroff, "Banking fragmentation issues in the EU", Eurofi Regulatory Update, September 2023, section 1.1.2, p. 15-16.
39. *Ibid.*, section 1.1.2, p. 16.
40. *Ibid.*, section 1.1.2, p. 16.
41. *Ibid.*, section 1.1.3.
42. *Ibid.*, section 3 ("Host countries concerns are often dismissed, leading them to ring-fence in order to protect themselves").

adding that, while Germany needed larger banks, "this does not mean that every type of takeover is welcome"[43]. The ECB criticised the position publicly. As L. de Guindos declared in May 2026: "It's very difficult for governments to argue that they are in favour of the savings and investments union if they then say 'Well, no, we are against this specific transaction'. (...) It's not only relevant in this specific example, it's happening everywhere. Such moves go against the spirit of a single market and undermine the credibility of the savings and investment union[44]."

On the doctrinal level he formulated, almost word for word, the conceptual cornerstone of a True Banking Union as defined in Chapter I: "we recommend considering the Euro area as a single jurisdiction, with free movement of capital and shares, and a common deposit guarantee[45]"; and on the economic rationale he added that "a real European large bank could compete with the American ones. Valuations would be much higher, and cheaper funding would become possible[46]."

At first sight, the resistance looks like protectionism, and in part it is. But beneath it lies a rational core that the single-market discourse tends to obscure. To absorb a systemically important national bank into a group headquartered in another Member State is to tie that bank, and the deposits it holds, to the home sovereign of the acquiring group. Through the home-host nexus, a future deterioration of that sovereign's public finances would reach the acquired subsidiary and the host economy, which would be left to manage the fallout with no binding assurance of group support and no European deposit guarantee. A State that hesitates before letting its second-largest bank pass under the control of a group domiciled in a far more heavily indebted State is therefore not acting irrationally: it is responding to a risk that the incompleteness of the Banking Union leaves unaddressed. The fiscal mechanism behind this is developed as Problem 5.

What must be named here is the political fact it produces: a genuine deficit of cooperation between Member States, and it should be stated plainly. The economics point towards integration; the practice defends national perimeters, because governments do not trust that, in a crisis, resources will flow and burdens will be shared. Ring-fencing by supervisors and interference by governments are, in the end, two faces of the same rational distrust, and it is that distrust, rather than any shortage of technical solutions, that keeps the Banking Union incomplete. How trust might be rebuilt, through fiscal convergence and binding European safeguards, is the subject of Chapter IV.

3.5 Economic divergences and differences in banking-system structures

The fifth problem is both economic and structural. Unlike the preceding sections, which examined the institutional and operational mechanisms through which fragmentation is maintained, this section focuses on the underlying conditions that shape Member States' preferences and their willingness to deepen integration. Fiscal divergences, differences in banking-system structures and heterogeneous macroprudential frameworks do not directly create fragmentation; rather, they sustain the lack of mutual trust that makes fragmentation a rational outcome. They explain why completing the Banking Union ultimately requires not only institutional reforms but also a political agreement capable of reconciling risk reduction, risk sharing and respect for legitimate national specificities.

3.5.1 Fiscal and macroeconomic divergence: the deep driver

The most fundamental obstacle to a fully integrated Banking Union remains the divergence of fiscal trajectories across Member States. Several countries continue to combine high public debt with persistent budget deficits, while others have maintained comparatively stronger fiscal positions. Italy's public debt remains around 138% of GDP, France's around 118% and Belgium's above 100%, whereas Germany and the Netherlands maintain significantly lower debt ratios[47]. Even more important than the stock of debt are current fiscal trajectories: while Italy has significantly reduced its annual deficit despite its high debt ratio, France remains subject to the Excessive Deficit Procedure because of its persistently large fiscal deficit.

These divergences have two direct implications for the Banking Union. First, they perpetuate the sovereign-bank nexus. High public deficits require continued sovereign debt issuance, a significant share of which continues to be absorbed by domestic banks. Second, they prevent the emergence of a genuinely European safe asset. As long as Member States differ substantially in their fiscal positions, they remain reluctant to mutualise sovereign risks,

43. O. Storbeck, "Top ECB official attacks German opposition to UniCredit's bid for Commerzbank", Financial Times, 11 May 2026.
44. L. de Guindos, interview with the Financial Times, 11 May 2026.
45. *Ibid.*
46. *Ibid.*
47. Eurostat, government debt data, Q1 2026.

leaving banks dependent on their domestic sovereign debt as the principal risk-free asset.

Fiscal divergence therefore explains why the sovereign-bank nexus analysed in Problem 1 continues to generate concern and why the resistance to deeper cross-border banking integration described as Problem 4 remains rational. The mechanism can be illustrated through a deliberately simplified scenario. If a highly indebted Member State were to experience acute fiscal stress, its domestic banking system would immediately be affected through its holdings of national sovereign debt. Within an integrated cross-border banking group, this shock could then be transmitted through capital and liquidity links to subsidiaries located in other Member States. Host authorities would consequently find part of their own financial stability exposed to fiscal risks over which they exercise no control. From their perspective, maintaining prudential safeguards and exercising caution towards cross-border consolidation is therefore a rational response rather than a rejection of European integration.

This diagnosis has two important implications. First, restoring trust between Member States cannot rely exclusively on further risk reduction nor exclusively on greater risk sharing. Both must advance together. Second, fiscal convergence remains an essential condition for completing the Banking Union, but it cannot by itself resolve the current deadlock. Without credible European safeguards able at reassuring both home and host authorities, greater fiscal convergence alone is unlikely to generate the degree of trust required for deeper banking integration. The comprehensive package discussed in Chapter IV is designed precisely to reconcile these two dimensions.

3.5.2 Structural diversity of European banking systems

A second factor shaping national preferences is the structural diversity of European banking systems. Banking markets differ considerably across Member States in terms of ownership structures, business models and the role played by cooperative, mutual and savings banks. In several countries, these institutions remain major providers of credit to households, SMEs and local communities and therefore constitute an essential component of the domestic financial system.

This diversity should not be regarded as an obstacle to European integration. On the contrary, preserving a diversity of business models contributes to the resilience, competitiveness and financing capacity of the European banking sector. However, it also shapes national regulatory preferences and helps explain why some Member States attach particular importance to proportionality, the preservation of institutional protection schemes and the continued recognition of individual legal entities within banking groups.

Distinguishing between legitimate structural diversity, which should be preserved, and unnecessary market fragmentation, which should progressively be removed, is therefore essential when designing and applying the European prudential framework. The Commission has recognised that, despite existing proportionality provisions, many prudential and supervisory requirements continue to apply with insufficient differentiation according to institutions' size, complexity and business model, generating unnecessary complexity and administrative burdens.

This issue is particularly acute for cooperative and mutual institutions. These institutions have distinctive ownership, governance and capital-formation features. They are not driven by external shareholder remuneration in the same way as listed commercial banks; they rely heavily on retained earnings; many are organised through decentralised or federated structures; and their business models are often based on long-term customer relationships, local anchoring and member value.

Many of these institutions therefore argue that supervisory expectations, SREP peer-group methodologies, profitability benchmarks, cost-efficiency assessments and governance standards should be better adapted to their specific characteristics, as these frameworks still often reflect, explicitly or implicitly, the features of shareholder-owned commercial banks. Similar concerns have been raised in earlier Eurofi discussions, notably in relation to profitability measurement, governance, digitalisation and resolution planning for cooperative and mutual banking models.

3.5.3 Macroprudential divergence as an additional source of fragmentation

Over the past decade, the EU macroprudential framework has significantly strengthened the resilience of the European banking sector. Within this decentralised framework, national authorities are responsible for setting macroprudential measures to reflect the specificities of their banking sectors and economic cycles, using a range of instruments including capital buffers, risk-weight measures and borrower-based measures. Among these instruments, capital buffers have become the cornerstone of the framework, increasing banks' loss-absorbing capacity and helping preserve the supply of credit during periods of severe stress.

Over time, however, the framework has become increasingly complex, with a growing number of instruments, heterogeneous national implementation and significant differences in calibration across Member States. Part of this diversity is legitimate: national authorities calibrate certain instruments, notably countercyclical and systemic risk buffers, to reflect genuine differences in financial structures and systemic risk across Member States, and some degree of differentiation is therefore both expected and desirable. Yet, it has also raised questions about transparency, proportionality, comparability and the overall coherence of the framework. As the Commission itself notes, the current framework suffers from limited predictability and consistency, owing not only to differences in national calibration but also to the absence of a harmonised EU methodology and to a multilayered governance involving both EU and national authorities.

The difficulty arises when national methodologies, supervisory practices and the cumulative interaction of prudential instruments lead comparable institutions to face materially different capital requirements. Differences in the calibration of Pillar 2 measures, systemic buffers and other macroprudential instruments, combined with the cumulative stacking of prudential requirements, contribute to de facto capital ring-fencing and reinforce the fragmentation previously analysed.

TABLE 2.
Sources of the increase in CET1 requirements for 15 banks (2021–2024)

Required CET1 (EUR bn)	2021	2024	Change
Basel minimum	229.4	243.8	+6%
Supervisory & macroprudential components	c. 170	c. 280	c. +65%

Source: GBI, EBF and GARP Capital Demand Benchmarking Study (2025)

Industry benchmarking illustrates this phenomenon. Between 2021 and 2024, the increase in required CET1 capital for major European banking groups resulted overwhelmingly from supervisory and macroprudential add-ons, while the Basel minimum requirements remained broadly stable.

The issue is therefore not national differentiation as such but the absence of a sufficiently coherent European framework ensuring that each risk is captured once, calibrated consistently and without generating unnecessary overlaps or de facto ring-fencing. Completing the Banking Union would not eliminate macroprudential policies, but it would create the conditions for a more coherent, proportionate and genuinely European application of prudential requirements.

3.6 Cross-cutting factors reinforcing the deadlock

Several additional factors reinforce the five structural problems analysed above.

First, the current framework still lacks a legally enforceable intragroup support mechanism. The optional arrangements provided by the Bank Recovery and Resolution Directive have proved largely ineffective in practice because their application ultimately depends on national legal frameworks. As long as host authorities cannot rely on legally binding commitments ensuring the transfer of capital and liquidity within cross-border groups during periods of stress, they have strong incentives to maintain ex ante ring-fencing.

Second, despite the Europeanisation of supervision and resolution, the legal framework governing company law, insolvency, creditor hierarchies and several aspects of crisis management remain largely national. This supervisory-legal asymmetry limits the practical effectiveness of European decisions and constrains the free movement of resources within banking groups even where supervisors agree on the appropriate course of action.

Finally, questions continue to be raised regarding several aspects of the governance of the SSM and the SRB. Host authorities participate fully in their governance structures, yet several Member States remain unconvinced that their concerns regarding burden-sharing, liquidity in resolution and the practical management of cross-border crises are sufficiently reflected in European decision-making. These concerns should not be dismissed as a simple lack of trust. They identify concrete governance issues that a comprehensive Banking Union package should explicitly address.

Taken together, these five structural problems, reinforced by the institutional and legal gaps described above, explain why the Banking Union remains incomplete. They do not reveal a lack of political ambition or an unwillingness to cooperate. Rather, they describe the rational equilibrium of an institutional framework in which supervision has been partly Europeanised while fiscal responsibility, financial stability and political accountability remain largely national. Under such conditions, nationally oriented behaviour – including ring-fencing, solo-level prudential requirements and caution towards cross-border banking integration – remains the rational response to nationally borne risks.

This diagnosis also explains why isolated technical reforms are unlikely to succeed. Completing the Banking Union requires changing the institutional incentives that currently encourage national protection rather than European integration. The comprehensive package proposed in Chapter IV is designed precisely to address these structural causes simultaneously by combining stronger risk reduction, credible risk-sharing mechanisms, greater proportionality and a governance framework capable of restoring mutual trust between Member States.

4. The Way Forward: A Comprehensive and Indivisible Package

The analysis developed in the previous chapters points towards a clear conclusion. Since the different sources of fragmentation reinforce one another, no isolated reform can resolve the deadlock. What is required is a comprehensive legislative package capable to simultaneously address the institutional, prudential, legal and political dimensions of the home-host dilemma.

That's why such an agreement must address the concerns of host states and be built on the tangible benefits that a completed banking union would bring them. Beyond stronger financial stability through more credible European safeguards, these benefits should include more efficient financing of their economies, a broader and more competitive banking offer for households and businesses, greater availability of cross-border banking services, improved financing capacity for investment and growth, and stronger private risk-sharing across borders.

The proposed package is not designed as a single institutional objective. It is designed around political acceptability. Every stakeholder must obtain a tangible benefit while seeing its principal concern addressed. This is the only way to overcome the equilibrium of mutual distrust analysed in Chapter III. Indeed, since large cross-border banking groups are absent in most Member States, the agreement must guarantee real proportionality for small and medium-sized banks and preserve Europe's diversity of business models. Without these safeguards, these states will not come on board.

The objective of this EU agreement is the free movement of capital and liquidity within cross-border banking groups, which is another way of saying that those groups must be recognised in European law and treated as operating in a single jurisdiction rather than as a sum of national subsidiaries. The objective cannot be reached without resolving the home-host dilemma, and the home-host dilemma cannot be resolved piece by piece.

It requires the comprehensive legislative package that D. Cahen proposed in 'The Euro is in Danger', to be put by the European Commission to the Council of Finance Ministers on the basis of a detailed analysis of the benefits of a completed Banking Union and of the costs of inaction, and resting on three components: an unconditional and legally binding internal support mechanism for cross-border banking groups; a European Deposit Insurance Scheme, conditional on the full legal recognition of those groups; and the settlement of the questions that remain open, foremost among them liquidity in resolution, the ratification of the ESM backstop to the Single Resolution Fund and the completion of the crisis management framework[48].

Completing the package successfully depends on three inseparable conditions. The first is that it must address the concerns of the host Member States completely, since their fear of being left without resources in a local crisis is the true engine of ring-fencing and therefore of fragmentation. The second is that it must offer something to the banks that are not among the hundred or so groups supervised by the SSM, in the form of a proportionality that is effective rather than declaratory. The third is that it must not cross the lines that should not be crossed: the institutional protection schemes are preserved, the diversity of European banking models is reaffirmed, and the costs of integration are not loaded onto institutions that would not benefit directly from it.

One condition governs all the others. Risk sharing on this scale will not be granted, and would not be sound if it were, unless the overindebted Member States restore sustainable public finances and the economies of the Union converge. Without that convergence the package remains a wish, and it is on this point, far more than on any technical difficulty, that completion has repeatedly failed.

The stakes are broader than completing Banking Union. Europe currently pursues three major objectives in banking policy that may appear as separate agendas – completing the Single Market for banking, simplifying the prudential framework,

48. D. Cahen, The Euro is in Danger: Key priorities for rebuilding a Europe focused on growth, p. 281-282.

and strengthening the competitiveness of European banks. All three depend on the same political precondition: greater cooperation and mutual trust between Member States.

As long as Member States remain reluctant to share risks, host authorities will continue to rely on national safeguards and ring-fencing practices, supervisors will have limited incentive to reduce prudential requirements or simplify the regulatory framework, and governments will remain politically cautious about reforms that could be perceived domestically as weakening financial stability or favouring banks. The same lack of political consensus constrains efforts to adapt international prudential standards to the specific characteristics of the European banking system.

Without genuine cooperation among Member States, the single banking market, the Savings and Investments Union, regulatory simplification and the recalibration of Basel standards will all remain out of reach. However, securing this agreement would set a virtuous dynamic in motion across the wider European banking agenda. The Banking Union deadlock is therefore not a secondary issue – it is the priority for the future of the EU banking sector.

4.1 An EU comprehensive legislative package to break the deadlock

To address this impasse, the European Commission should propose a comprehensive legislative package to the Council of Finance Ministers (Ecofin).

Three principles should govern any attempt to complete the Banking Union. First, cross-border banking groups should be recognised as genuinely integrated European entities rather than as a collection of national subsidiaries. Second, no component of the Banking Union can be completed in isolation; the package must remain indivisible because every concession is conditional upon another. Third, further risk sharing must continue to progress together with risk reduction and fiscal convergence.

The starting point of this package must be the recognition of transnational banking groups as integrated entities operating in a single jurisdiction. **They would no longer be regulated and supervised as a sum of subsidiaries subject to different rules and operating in different jurisdictions, but treated as single entities from an operational, regulatory, and prudential perspective.**

Building on this recognition, the package should include three components:

- **An unconditional and legally binding internal support mechanism for cross-border banking groups.** Parent companies would be required to support subsidiaries in distress using internal group funds, as specified in their recovery plans. These plans would include predefined triggers (*e.g.* if a subsidiary's liquidity ratio falls below X%, the parent company would inject Y billion in liquidity) and would be approved by the European supervisor, ensuring the parent holds adequate capital.
- **A European liquidity backstop for the Single Resolution Fund.** Crucially, Italy must also ratify the revised treaty enabling the European Stability Mechanism (ESM) to act as a safety net for the Single Resolution Fund (SRF), which intervenes when a failing bank exhausts its own resources. Furthermore, a comprehensive **European framework for providing liquidity to banks in resolution** must be set up.
- **A European Deposit Insurance Scheme (EDIS), to be implemented in so far as – and if and only if – it is accompanied by the full legal recognition of cross-border banking groups**. This would ensure that prudential regulation and supervision are carried out on a consolidated basis, and that capital can circulate freely within banking groups.

In other words, banks will only support a shared European deposit guarantee scheme if they are assured that internal capital mobility within their group will be safeguarded. EDIS[49] should neither intend to weaken effective national mechanisms such as Institutional Protection Schemes (IPS)[50], nor impose premature mutualisation of losses. Rather, it would serve as a last-resort safety net, activated only when all prior lines of defence – including IPS – have been exhausted. This approach ensures that all Member States – including those with robust systems like Germany – can be confident that European solidarity will not come at the expense of their institutional autonomy.

This balance only holds if the package is adopted as a whole: each component loses the very safeguard that makes it acceptable to the others once taken separately. This indivisibility is not a drafting

49. Guaranteed deposits in the Eurozone are estimated at around 7,000 to 8,000 billion euros. However, the institutions directly supervised by the SSM, whichaccount for roughly three quarters of these deposits, are subject to the European resolution framework, including bail-in requirements, MREL and the Single Resolution Fund. Consequently, the design and target size of a European Deposit Insurance Scheme should reflect not only the volume of covered deposits but also the significantly lower probability that deposit insurance would be called upon for institutions benefiting from this comprehensive resolution framework. Banks' contributions could continue to be phased in over a period of eight to ten years on a risk-based basis.

50. Institutional protection schemes are contractual arrangements, often within the same cooperative or mutual group, whereby credit institutions support one another to ensure their solvency and liquidity.

preference – it follows directly from the mapping above. Each concession is conditional on the others: host countries lift ring-fencing only because they obtain binding support, a backstop and EDIS; banks accept contributions only because they obtain the lifting of ring-fencing and the end of duplication; creditor states accept risk-sharing only because it is matched by fiscal discipline; smaller banks accept the framework only because their proportionality and protection schemes are guaranteed. Remove any one component and a party's concern goes unanswered, its red line is crossed, and it blocks the rest. A partial Banking Union is not a smaller version of the whole; it is a broken bargain.

As EU leaders have stated that the Banking Union is vital to financial stability and to the smooth functioning of the Economic and Monetary Union (EMU), adopting this proposal would send a strong political signal. It would mark renewed consensus in favour of deeper financial integration and greater European financial sovereignty.

4.2 What the package offers to the banks that are not under the remit of the SSM and the SRB

Most Member States have no large cross-border banking group of their own. For them, the package's core promise – the free movement of capital and liquidity within cross-border groups – delivers no direct benefit. Their support is nonetheless indispensable, since the package requires unanimity among finance ministers. It can only be secured if the package offers these states, and the smaller and non-complex banks that make up the bulk of their banking sector, guarantees of their own: real proportionality, and a supervisory framework that reflects their business models rather than penalising them for not fitting a template built for large shareholder-owned groups.

4.2.1 Improving proportionality to facilitate the adoption of such an agreement

For small and non-complex banks, the concern is one of scale: compliance costs designed for large, internationally active banks fall disproportionately on institutions with far smaller balance sheets, and the incremental adjustments granted over the years have not corrected this asymmetry. The Commission itself now presents the diversity of the European banking sector as a competitive advantage that requires a proportionate application of the framework and calls on authorities to explain how proportionality relieves the administrative burden borne by small and non-complex banks[51]. Proportionality is therefore not a concession appended to the package. It is one of the conditions of its adoption.

The Commission's Communication of 17 July 2026 proposes a dedicated CRR regime allowing small and less complex banks to be more clearly identified within the regulatory framework, irrespective of their legal and organisational structure – a formulation that implicitly targets cooperative and network-based banking groups, whose structure currently complicates their qualification as small and non-complex institutions (SNCIs). The Commission has also signalled a likely revision of the current SNCI thresholds, which several Member States consider too low and insufficiently adjusted to inflation.

The Commission's regime would extend across the prudential, macroprudential and resolution dimensions simultaneously, while explicitly preserving risk-based requirements rather than replacing them. The proposal would also extend to Level 2 and Level 3 measures, tasking the EBA with reducing the number of technical standards, guidelines and processes applicable to small and less complex banks – directly addressing concerns that supervisory soft law has become a de facto fourth layer of regulation. Finally, the Commission has committed to pursuing its dialogue with the SSM and the SRB on the practical application of proportionality to institutions that meet the default significance criteria under the SSM Regulation, but whose individual circumstances might justify remaining outside direct European supervision.

In any case, a credible proportionality agenda should not come at the expense of financial stability. Institutions whose failure could have significant consequences for national financial stability should continue to comply with appropriate prudential and resolution requirements, including adequate MREL where justified. Access to the Single Resolution Fund should also remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF): taxpayers and DGSs should not subsidize banks that do not have sufficient MREL, and the moral hazard issue caused by "free riders" must be avoided[52].

Lastly, proportionality should focus on eliminating unnecessary complexity and administrative burdens for genuinely smaller and less risky institutions, while preserving a high level of resilience across the banking sector.

51. See the Commission Communication on the competitiveness of the banking sector and the Single Market in banking. The Commission is expected to invite regulators, supervisors, resolution and macroprudential authorities to embed proportionality more clearly and to explain how it relieves the administrative burden on small and non-complex banks, and on other banks with relatively simple and prudent business models.

52. D. Cahen and A. Valroff, "Banking fragmentation issues in the EU", Eurofi Regulatory Update, September 2023, section 3.2.1.

4.2.2 Regulatory and supervisory measures to demonstrate the commitment to business model diversity in Europe

This attachment to business model diversity reflects a European asset, not an untidiness to be resolved: diversity increases the resilience and financing capacity of the system and serves customers that a single standardised model would not reach. Sufficient profitability is essential to every bank, but profitability cannot be the sole compass of supervision. On both counts the principle is the same, and it is what makes the package acceptable to institutions that will not benefit directly from cross-border integration: the costs of that integration must not be loaded onto them.

Cooperative and mutualist banks have consistently raised the same concern: that a framework designed for shareholder-owned commercial banks is applied to them by default, rather than adapted to what they are. Cooperative and mutualist groups do not remunerate external shareholders; they build capital primarily through retained earnings; they are organised in decentralised or federated structures; and their business rests on long-term customer relationships, local anchoring and member value.

This is not a marginal concern: it runs through supervisory expectations, SREP peer groups, profitability benchmarks, cost-efficiency assessments and governance standards, all of which continue to reflect, explicitly or implicitly, the characteristics of shareholder-owned commercial banks. The consequence is direct: a lower return on equity is liable to be read as a business-model weakness, when it is in fact the mechanical result of an ownership structure that does not remunerate external shareholders in the same way.

The package answers this concern by committing to recalibrate supervision itself, rather than asking cooperative and mutualist banks to conform to a template that does not fit them. SREP peer groups, profitability benchmarks and JST judgement should be redesigned to reflect different ownership and governance models. The indicators used to assess these institutions should include their capacity to generate retained earnings, the stability of their deposit base, their capacity to lend to local economies and their resilience through the cycle – evidence that cooperative and mutualist banks are best placed to provide, and that justifies differentiated supervisory treatment without amounting to preferential treatment or a lowering of prudential standards.

The same holds for the digital transition, where the scale required to invest in cloud infrastructure, cyber security, artificial intelligence and payments pushes towards standardisation, and where the ability of cooperative and mutualist networks to mutualise those capabilities while preserving local autonomy and member-based governance will determine whether digitalisation renews the diversity of European banking or erodes it.

TABLE 3.
How the package answers each party

Party	Concern or red line	What the package provides
Host countries	Resources may not flow in a local crisis; fear of being left alone	Binding intragroup support; European liquidity backstop; EDIS; meaningful association in governance
Home countries of large groups	Capital, liquidity and internal MREL immobilised by ring-fencing	Progressive lifting of sub-consolidated requirements once the safeguards are credible
Large cross-border banks	Capital, liquidity and MREL trapped and duplicated	Single-jurisdiction recognition; removal of duplicated requirements; free movement of resources
Smaller, cooperative and mutualist banks	Loss of proportionality; supervisory benchmarks built for shareholder-owned banks; threat to institutional protection schemes	A simpler regime for small and non-complex banks; supervision that reflects cooperative and mutualist models; IPS maintained as a prior line of defence; costs of integration not loaded onto them
Creditor Member States	Underwriting the fiscal slippage of others	Fiscal-discipline precondition; treatment of sovereign exposures if convergence fails
Supervisors and resolution authorities	Fragmented view; overlapping requirements; contested governance	Clarified SSM and SRB governance; simplification; an authority for the aggregate stack ("Prudential Efficiency Review Panel")
Depositors and the EU economy	Uneven depositor protection; fragmented market; lost competitiveness	EDIS; single banking market and merger synergies; the Savings and Investments Union

4.3 A package that answers everyone's concerns

The components above are not a series of concessions to one camp. Taken together they form a balanced settlement in which every constituency identified in this paper obtains an answer to its central concern and a guarantee on its red line. The mapping is set out below.

Two red lines deserve emphasis, because the whole settlement turns on them. The first is the host countries' assurance that they will not be left alone in a local crisis: the intragroup support mechanism, the liquidity backstop and EDIS exist precisely to provide it, and the clarified governance ensures their authorities are meaningfully associated with the decisions that affect them. The second is the proportionality of the framework for smaller, cooperative and mutualist banks and the preservation of their institutional protection schemes: the package must not load the costs of integration onto institutions that would not benefit directly from it. A settlement that respects both red lines is one that every party can sign.

4.4 Establishing a prudential efficiency review panel

The growing accumulation of microprudential, macroprudential and resolution requirements stemming either from both Pillar 1 and Pillar 2, national or EU levels, illustrates the need for a more holistic assessment of the European prudential framework outcomes. While each authority pursues legitimate objectives within its own mandate, no institution is currently responsible for assessing the cumulative impact of prudential and resolution requirements on banks' resilience, competitiveness, market integration and their capacity to finance the European economy.

The European Commission, supported by the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), should therefore establish a small and independent **Prudential Efficiency Review Panel** composed of highly respected former supervisors, central bankers, academics and market practitioners. Such a panel could include former Chairs of the ECB Supervisory Board, former EBA Chairs, former central bank governors and other recognised experts with extensive supervisory, regulatory and financial market experience.

In particular, the Panel could:

Ex post:

- assess the cumulative impact of microprudential, macroprudential and resolution requirements and its added value and efficiency regarding the EU prudential framework.
- identify overlaps, inconsistencies and obsolete requirements across the different regulatory pillars.
- recommend simplifications or recalibrations where different measures address broadly similar risks.
- assess regularly the impact of the EU prudential and supervisory framework on the competitiveness of European banks, both within the Single Market and internationally, and report publicly on developments affecting the level playing field.

Ax ante : develop a **Prudential Efficiency Check**, to be systematically applied before any significant new prudential or resolution measure is introduced. Under such a **Prudential Efficiency Check**, every significant regulatory initiative should be required to answer a limited number of questions:

- what new prudential or financial stability risk does the measure address?
- is this risk already covered, in whole or in part, by existing microprudential, macroprudential or resolution requirements?
- what is its cumulative impact on banks' capital, liquidity, reporting obligations, operational complexity and lending capacity?
- could an existing requirement be simplified, recalibrated or removed to offset the additional burden?

This would introduce a genuine **"one in, one review"** principle into European banking regulation, ensuring that regulatory complexity is actively managed rather than continuously accumulating.

The Panel would not interfere with day-to-day supervisory decisions or institution-specific capital requirements, which should remain the responsibility of the competent supervisory and resolution authorities.

Rather, it would provide an independent, system-wide assessment of the overall coherence of the prudential framework individual and system-wide outcomes and advise the Commission on the cumulative impact of significant regulatory initiatives before they are adopted.

And rather than allowing the cumulative prudential stack to grow without an explicit benchmark, the Panel could periodically assess, using supervisory stress tests and other forward-looking risk assessments, the aggregate level of capital necessary to ensure a high degree of resilience. This assessment would not constitute a binding cap on institution-specific requirements but would provide a system-wide benchmark against which the cumulative impact of microprudential, macroprudential and resolution requirements could be evaluated. Where the aggregate prudential stack materially exceeds this benchmark, particularly because several layers of requirements address broadly similar risks, the Panel could recommend recalibrations or simplifications in order to avoid unnecessary overlaps, while fully preserving financial stability and banks' capacity to finance the economy.

The Panel's recommendations should be made public. The European Commission, together with the relevant European banking authorities, should be expected to respond within a reasonable period, indicating whether and how the recommendations will be implemented or, where appropriate, explaining the reasons for not doing so.

By introducing an independent assessment of the cumulative impact of prudential regulation across all regulatory pillars, such a mechanism would strengthen the efficiency and consistency of European banking regulation and help ensure that future reforms enhance financial stability without unnecessarily increasing complexity or undermining the competitiveness and integration of the European banking sector.

4.5 The condition that governs the package: Sound public finances

The restoration of sustainable public finances in the overindebted Member States is the keystone on which the entire package rests. As S. Cappiello stresses, fiscal discipline and macroeconomic convergence remain a precondition for any genuinely European banking integration[53]; and as D. Cahen argues, fiscally virtuous countries will not, in the current context, additionally incur the risks of others' slippage[54]. Indeed, without sustainable adjustment, neither EDIS nor the intragroup support mechanism nor any backstop can fully break the sovereign-bank loop, because in those cases the loop runs through fiscal fundamentals that no banking architecture can neutralise. Sound policy is, in the end, the best way to break the nexus, and breaking it is what lets every other part of the package work. The point bears stating plainly, because it conditions everything else: without the correction of excessive imbalances and a symmetrical convergence of the economies of the Union, risk sharing on the scale this package requires will not be granted, and the completion of the Banking Union will remain a wish.

Baron Louis, Minister of Finance in France said to his government around 1820: "Faites-moi de la bonne politique et je vous ferai de la bonne finance", which can be translated as "Make good policies, and I will bring you good finance." We could say under his tutelage and inspiration: "Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you Banking Union."

Conclusion

The analysis developed in this paper suggests that the future of the Banking Union depends less on identifying additional technical reforms than on changing the institutional incentives that continue to shape supervisory and political behaviour. As long as the home-host dilemma remains unresolved, the rational response of public authorities will continue to be the gradual accumulation of prudential safeguards, regulatory fragmentation and constraints on the efficient management of cross-border banking groups. The Banking Union will therefore remain caught in a cycle where each new risk tends to generate additional safeguards, while the conditions for periodically reassessing the cumulative stock of prudential requirements remain limited.

The challenge is therefore not simply to complete the Banking Union by adding its remaining institutional building blocks. It is to create the conditions under which trust between Member States can progressively replace the need for nationally driven safeguards. Only under these conditions can the prudential framework evolve towards greater coherence, proportionality and predictability while preserving the high standards of financial stability that the Banking Union has successfully established over the past decade.

As Jean Monnet understood from the outset of European integration, durable progress is built through cooperation between Member States around concrete objectives that gradually create mutual confidence and align national interests. The Banking Union should follow the same method. Rather than pursuing a comprehensive federal blueprint or relying on successive isolated legislative initiatives, policymakers should seek a negotiated package that combines stronger common safeguards with greater operational freedom for cross-border banking groups. Such a compromise would not eliminate national concerns,

53. S. Cappiello, op. cit.
54. D. Cahen, The Euro is in Danger, op. cit., p. 282.

but it could progressively transform them into a shared European interest.

This also explains why the different policy debates currently shaping the European banking agenda should not be treated in isolation. The completion of the Banking Union, prudential simplification, proportionality, the implementation of international prudential standards, the competitiveness of European banks and the objectives of the Savings and Investments Union are often presented as distinct policy agendas. In reality, they all depend, to a significant extent, on the same institutional precondition: resolving the home-host dilemma and creating a framework in which supervisors and public authorities can progressively rely less on nationally driven safeguards and more on common European mechanisms.

At the same time, institutional integration cannot be entirely disconnected from economic realities. The greater the convergence of Member States' economic structures, fiscal positions and financial systems, the easier it becomes to mutualise risks and deepen financial integration. Conversely, persistent economic divergences inevitably reinforce national preferences, increase reliance on domestic safeguards and reduce the willingness to share responsibilities. Institutional reform and economic convergence must therefore continue to advance together.

The Banking Union should therefore not be regarded as an end, nor should its success be measured solely by the formal completion of its institutional architecture. Nor, on its own, can it create a fully integrated European banking market, which will continue to depend on broader legal, fiscal and economic convergence across Member States. Its essential contribution lies elsewhere: in its capacity to transform the regulatory environment in which European banks operate. By progressively resolving the home-host dilemma, Europe can move away from the cumulative accumulation of prudential safeguards towards a framework that is more coherent, more proportionate and more predictable, while preserving financial stability.

Such a transformation would not solve every structural obstacle to banking market integration. It would, however, remove one of the most important institutional barriers that today constrains the efficient allocation of capital and liquidity, limits cross-border banking activity, increases regulatory complexity and weakens the international competitiveness of European banks. In doing so, it would create the institutional conditions under which Europe's broader objectives – stronger competitiveness, a simpler prudential framework, a more effective Savings and Investments Union and a deeper Single Market for financial services – could progressively reinforce one another rather than remain parallel policy ambitions.

Ultimately, the Banking Union should be judged not simply by whether it is completed, but by whether it succeeds in changing the incentives that shape supervisory, regulatory and political behaviour across Europe. If it achieves that objective, it will not only strengthen financial stability but also provide the institutional foundation for a more integrated, more competitive and more resilient European banking sector capable of supporting the Union's long-term economic ambitions.

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In his comments on this paper, Jacques de Larosière raised a fundamental question underlying this analysis: **if a genuine Banking Union is both possible and beneficial, why has it still not materialised?** His observation points to a central conclusion of this paper: the forces encouraging national particularism continue to prevail over the willingness to pursue a common European objective.

Two obstacles appear particularly important.

The first is **ring-fencing**. By constraining the optimal allocation of banking resources and compartmentalising capital and liquidity requirements along national lines, ring-fencing fundamentally obstructs the emergence of genuinely integrated European banking groups. Yet these practices do not result simply from national protectionism. They reflect legitimate concerns about financial stability, depositor protection and the potential fiscal consequences of banking crises, particularly among smaller host Member States. The experience of previous crises has reinforced these concerns and the resulting lack of mutual trust.

Overcoming them therefore requires credible European safeguards. The package proposed in this paper – combining stronger loss-absorbing capacity, EDIS, effective liquidity arrangements in resolution, credible intragroup support mechanisms and greater freedom for capital and liquidity to circulate within banking groups – is intended precisely to rebuild that confidence. In an exceptional systemic crisis, however, a broader question would inevitably arise if private loss-absorbing capacity and all existing European resolution resources had been exhausted. Ultimately, a fully credible European banking framework may require the capacity to mobilise European public resources as a genuine last resort. Whether Member States would be prepared to accept such an ultimate European backstop is itself a measure of their political willingness to achieve a genuine Banking Union.

The second obstacle is the **progressive accumulation and complexity of banking regulation and supervision.** Successive requirements originating from different European and national authorities have created a framework in which individually justified measures can accumulate without sufficient reassessment of their combined effects. The result is a prudential architecture whose complexity can reduce predictability, constrain banks' capacity to allocate resources efficiently and increasingly weigh on their international competitiveness.

The objective should not be deregulation. The strengthening of European banks' capital, liquidity and resilience since the global financial crisis is a major achievement that must be preserved. The challenge is rather to simplify the framework intelligently: removing unnecessary overlaps, periodically reassessing accumulated requirements, improving the predictability of supervisory measures and ensuring that the prudential framework remains proportionate to risks and adapted to the diversity of European banking models, without compromising financial stability or the level playing field.

This requires going beyond useful but incremental simplification initiatives. The Prudential Efficiency Review Panel proposed in this paper could contribute to that objective by providing an independent assessment of the cumulative impact of prudential and supervisory requirements, regularly reviewing their implications for the competitiveness of European banks within the Single Market and internationally, and identifying requirements that have become redundant or disproportionate. Its recommendations should be public and should receive a formal response from the Commission and the relevant European banking authorities.

The diagnosis of this paper is therefore **fundamentally optimistic.** The principal obstacles to a genuine Banking Union have been identified, and the instruments required to overcome them largely exist or can be created. The difficulty is no longer primarily to identify additional technical solutions, but to generate the political willingness to address the underlying institutional incentives and accept the corresponding sharing of responsibilities.

In this respect, the broadly supportive response of banking institutions, across different sizes and business models, to the analysis and proposals developed in this paper is encouraging. A genuine Banking Union should not be conceived as benefiting one category of Member States or banks at the expense of another. Its political sustainability ultimately depends on demonstrating that a more integrated, simpler and more efficient framework can provide tangible benefits to all participants while preserving financial stability.

The remaining question is therefore not whether a genuine Banking Union is possible, but whether Europe is willing to make the institutional and political choices required to achieve it.

Europe Is Awake. But Is It Ready to Act?

European integration has progressively produced common instruments, but not common interests

Note written by Didier Cahen and Kiann Conlon

Abstract

President Trump's return, China's industrial rise and Washington's gradual military disengagement from Europe have confronted the European Union with its most demanding geopolitical environment since the end of the Cold War. Contrary to the widespread perception that Europe lacks the means to respond, this paper argues that the Union has progressively developed an increasingly sophisticated set of common instruments in fields ranging from economic governance and defence to industrial policy, trade and technological sovereignty. Yet these initiatives have delivered only mixed results.

Their effectiveness is constrained less by institutional shortcomings than by widening economic, fiscal, industrial and strategic divergences among Member States, which increasingly undermine trust and cooperation within the Council. Examining six policy areas, the paper shows that the Commission has sought to compensate for these divisions through a growing number of ad hoc initiatives, but that no European instrument– however innovative – can permanently substitute for the political consensus and economic convergence on which durable European cooperation ultimately depends. Ultimately, a stronger Europe requires stronger, more resilient and more convergent Member States.

Introduction

The current geopolitical environment is dominated by two giants: the United States and China. Their growing strategic rivalry has profoundly reshaped the international economic and political order, confronting the European Union with an environment in which economic interdependence is increasingly subordinated to geopolitical competition. The European Union must contend with the reality that neither of these powers is benevolent and that both place their own interests above all else – whether those interests align with the EU's or not. Europe is therefore no longer operating in a rules-based international environment alone, but in one where market access, technology, energy and security are increasingly used as instruments of power.

Europe is waking up to a world where allies and rivals alike put their own interests first

The re-election of President Donald Trump illustrated this dynamic. Trump has consistently pursued an "America First" doctrine across multiple policy areas. On trade, he succeeded in bringing the EU to the negotiating table in order to correct what he views as a long-standing asymmetry in the relationship. On defence, he has pursued a gradual reduction of American military presence in Europe as part of a revamped NATO framework. Moreover, he has also made some deeply concerning comments – that go against all the established diplomatic rules of decorum – such as threatening to seize Greenland by all means necessary. More broadly, the United States has progressively redefined its alliances through the prism of national interest, signalling that European security and prosperity can no longer rely on assumptions that prevailed during the post-Cold War period.

China, meanwhile, has successfully upgraded its manufacturing base into increasingly sophisticated sectors, directly challenging industries in which EU Member States have traditionally excelled, such as automobile manufacturing, pharmaceuticals, chemicals and capital goods. Since mid-2025, China has exported more capital goods to Germany than it has imported from it. The EU has not merely opened its market to Chinese industry. It has, in effect, offered it up, allowing China to redirect part of the exports displaced by US sanctions towards Europe. For years, European private capital voluntarily financed a foreign industrial policy without ever imposing a condition of reciprocity. At the same time, China's growing technological capabilities, industrial planning and control over critical supply chains increasingly expose the structural vulnerabilities created by Europe's dependence on external production ecosystems.

Awake, but still fragmented

European Member States thus find themselves caught in an uncomfortable position which revives an important question: is Europe finally awakening to the realities of power politics? Security and trade shocks have undoubtedly forced European leaders to confront their dependence on both the United States and China. Yet while the discussions surrounding sovereignty, strategic autonomy and coordination have intensified, concrete action remains far more limited. Europe, it would seem, has finally opened its eyes – but it has yet to get out of bed.

Yet this diagnosis only captures part of the current European reality. Over the past decade, and particularly since the Covid-19 pandemic and Russia's invasion of Ukraine, the European Union has progressively equipped itself with an increasingly sophisticated set of common instruments. From the Recovery and Resilience Facility and common borrowing, to the European Defence Fund, the Chips Act, the Industrial Accelerator Act, new trade-defence instruments and initiatives supporting technological sovereignty, the Union has demonstrated a growing willingness to intervene collectively in areas that were once considered almost exclusively national competences.

The central question is therefore no longer whether Europe is capable of acting collectively. Increasingly, it is. Rather, the question is why these increasingly ambitious instruments often struggle to produce the transformative economic, industrial and geopolitical effects that policymakers expect from them.

There is no federal European State, no federal budget, no federal army, no common foreign policy, nor any common industrial policy. While these powers were never conferred to the EU in the treaties, their absence need not be an obstacle to cooperation. The European Treaties nevertheless provide sufficient legal bases for significant coordination in many strategic fields, provided that Member States are willing to use them. Yet, Member States are currently incapable of producing a common strategic vision for the EU. European leaders have repeatedly favoured their own national interests, or that of their industrial base. European cooperation is too often considered as a means to pursue national objectives, rather than as a platform to construct common goals – whether they be economic or political in nature. The result is a recurring paradox that runs throughout this paper: the Union has progressively developed common instruments, while the political, economic and industrial convergence required to maximise their effectiveness has evolved far more slowly.

Economic divergences among the EU's major Member States and political uncertainty hinder European cooperation

The current inertia is not caused by a lack of awareness. On the contrary, the diagnosis is widely shared across Member States: the European Union is falling behind its peers in terms of competitiveness and productivity. Over the last 20 years, the annual rate of GDP growth in the US was 1.9% against 1% in the Euro area. Over the same period, labour productivity increased by 1.2% annually in the US against 0.35% in the Euro area. The annual rate of investment in equipment (in terms of volume) has increased by 2.6% annually in the US against 0.9% in the Eurozone. This data is only an introduction to the broader diagnosis developed throughout this paper: Europe is progressively losing ground economically, industrially and technologically relative to its principal competitors.

The objective of this paper is not to argue that the European Union lacks policy instruments. On the contrary, many of the initiatives developed in recent years demonstrate that European integration continues to evolve. Rather, it argues that these instruments remain constrained by increasingly divergent fiscal positions, industrial structures, political priorities and strategic cultures among Member States. Europe therefore faces a convergence challenge at least as much as an institutional one.

The solutions to the current challenges are not limited to the creation of additional European programmes. They also require Member States to restore the conditions that make deeper integration both economically sustainable and politically acceptable. Member States must return to the path of economic convergence. First, Member States must put their house in order and address their own shortcomings. They must enhance productivity and stimulate innovation through productive investment. Public finances must align with the rules laid out in the Stability and Growth Pact (SGP). Tax and regulation burdens must also be reduced. A business-friendly environment is a sine qua non condition of Member States' individual successes. Only economically resilient Member States can sustain ambitious collective European policies over the long term. Only once these conditions are met can Member States return to the path of economic convergence and start cooperating more effectively on common strategic priorities.

This phenomenon is compounded by an unfavourable electoral calendar and political context. Italy and Poland are expected to hold general elections in the coming years, France remains in political deadlock ahead of the 2027 presidential election, and Germany faces growing speculation over the durability of its governing coalition. Member States are therefore even more unlikely to pursue genuine good-faith cooperation for fear of losing political power. In order to save face, European leaders might wish to appear "tough" and present themselves as the protectors of national interests. Being too pro-EU can be seen as weakness for a certain portion of national electorates. Domestic political constraints therefore continue to shape European decision-making, often encouraging short-term national calculations over longer-term collective objectives.

The neoliberal turn of the 1980s, when the European Community embraced a more market-oriented approach and grew increasingly sceptical of state intervention

This is not the first time that attempts to revitalise European cooperation have fallen short over the past quarter century. The objectives set out in both the Lisbon Strategy and the Europe 2020 Strategy were never effectively translated into national policies. A significant gap emerged between these ambitions and the Community instruments designed to achieve them. The governance mechanisms relied primarily on intergovernmental coordination and produced few legally binding obligations for Member States. This permissive framework provided little incentive for governments to undertake the reforms necessary to meet common objectives.

At the same time, the market-oriented turn of the 1980s profoundly reshaped the European approach to economic policy. Industrial strategies centred on "national champions" gradually gave way to policies prioritising the completion of the Single Market, deregulation and the promotion of competition. This shift reflected the growing influence of market-oriented economic thinking. Confidence in the state's ability to steer industrial development steadily declined, as public intervention increasingly came to be viewed as liable to distort competition, misallocate resources and hinder innovation through bureaucratic inefficiencies. In this context, European integration contributed to delegitimising attempts to develop a coordinated industrial policy, as such initiatives were often perceived as disguised efforts to advance national interests. Public policy consequently focused on removing barriers to competition rather than shaping industrial structures or supporting strategic sectors.

More broadly, European integration gradually moved away from a model based on negotiated cooperation, compromise and Community preference towards one centred on the rules of the Single Market and enforced by the European institutions. State aid rules were progressively strengthened, significantly restricting governments' ability to support strategic industries. Competition policy came to prioritise consumer welfare and market efficiency over the emergence of European industrial champions. Consequently, major industrial projects such as Airbus were developed outside the Community framework rather than through it. This evolution gradually weakened the political legitimacy of coordinated industrial policies and reinforced mutual distrust among Member States. Many of the debates examined throughout this paper – from European preference and defence cooperation to artificial intelligence and industrial policy – can be understood as attempts to rebalance this model without abandoning the benefits of the Single Market itself.

This shift has produced an uncomfortable paradox: while Member States publicly praise the benefits of European integration, they continue to prioritise national interests and resist the economic convergence on which deeper integration ultimately depends.

Indeed, the failure of Member States to design and implement a coordinated long-term strategy stems largely from nationally driven political and economic choices. Some Member States have adhered far more closely than others to the commitments laid down in the Stability and Growth Pact. The result has been growing economic divergence and increasingly distinct industrial structures, making the alignment of national interests ever more difficult. When countries face different constraints, they inevitably pursue different priorities. What appears as a necessary adjustment for one Member State may be perceived as an unacceptable concession by another. The same logic extends well beyond fiscal policy. Differences in industrial structures, energy mixes, defence priorities, financial systems and exposure to global trade all shape the willingness of Member States to support common European initiatives.

These divergences also raise an important question of timing. European decision-making relies on compromise, consensus-building and lengthy negotiations between Member States and the European institutions. Under normal circumstances, these procedures strengthen the legitimacy of collective decisions. Yet the geopolitical and economic environment is evolving far more rapidly than the Union's traditional decision-making process. The longer Member States take to reach common positions, the more vulnerable the Union becomes. The challenge is therefore not simply to accelerate European decision-making, but to reduce the underlying divergences that make consensus increasingly difficult to achieve.

If left unaddressed, these divergences pose a growing risk to the European project. European integration has long rested on the assumption that cooperation would naturally follow convergence.

Over the past decade, however, this dynamic has weakened considerably. France faces mounting fiscal challenges, while Germany must reinvent its economic model in response to higher energy costs and increasing competition from China. Other Member States face different combinations of demographic pressures, industrial restructuring or geopolitical exposure, further complicating the emergence of shared priorities.

A strong Europe requires strong Member States. European cooperation cannot compensate for persistent national weaknesses. Nor can European instruments fully achieve their objectives when the economic and political conditions required for their success differ fundamentally across the Union. European leaders have yet to demonstrate convincingly the added value of collective action in areas where European cooperation would clearly deliver better outcomes than purely national approaches.

In this context, it becomes imperative to re-establish a clear political narrative: the benefits of collective action must outweigh the costs of compromise. Europe should not be perceived as a relinquishment of sovereignty, but as a strategic platform – one to which powers are delegated in order to amplify collective influence in an increasingly competitive and fragmented global environment. The purpose of deeper European cooperation is therefore not to replace Member States, but to enable them collectively to exercise a degree of influence that none of them can realistically achieve alone.

The central argument developed throughout this paper is that Europe's principal challenge no longer lies in the absence of common instruments. Over the past decade, the European Union has progressively equipped itself with an increasingly sophisticated policy toolbox in fields ranging from economic recovery and industrial policy to defence, trade, energy and technological sovereignty. What remains insufficient is the degree of political, economic, financial and strategic convergence required for these instruments to operate at their full potential. The Union has become increasingly capable of acting collectively; Member States have proven far less capable of converging around the common priorities necessary to maximise the effectiveness of that action.

This paper examines this paradox of an increasingly aware but still fragmented Europe across six areas where the gap between rhetoric and action is most visible. Rather than assessing each policy area in isolation, the paper seeks to identify the common structural factors that repeatedly constrain European action despite the growing sophistication of Union-level instruments.

It first turns to economic governance, assessing whether NextGenerationEU, Europe's flagship instrument of solidarity, has delivered on its ambitions or merely postponed the reckoning with structural weaknesses and incomplete economic convergence among Member States (I).

It then examines how internal divisions among Member States have weakened Europe's response to external economic pressure, from the negotiations with the United States to the Mercosur deadlock (II), illustrating how differing national economic interests continue to shape the Union's common commercial policy.

The paper subsequently turns to energy, where national choices continue to generate collective vulnerabilities despite a functioning internal market (III). Although the Union has progressively constructed an ambitious Energy Union and significantly expanded its common policy instruments, divergent national energy mixes and investment strategies continue to constrain the emergence of a genuinely integrated European energy market.

It then assesses the state of European defence cooperation, a policy area still shaped primarily by national frameworks rather than a common strategic vision (IV). Here too, the Union has considerably expanded its financial and industrial instruments, yet differences in fiscal capacity, industrial organisation and strategic culture continue to limit the development of a truly integrated European defence ecosystem.

The paper further revisits the long-standing debate over European preference, arguing that China's industrial rise makes the case for a coordinated European response more urgent than ever (V). The emergence of instruments such as the Industrial Accelerator Act illustrates that the European Union is progressively reintroducing elements of industrial policy and economic preference. Nevertheless, the effectiveness of these initiatives ultimately depends on Member States' willingness to reconcile divergent industrial and commercial interests.

Finally, it considers Europe's missed technological revolutions, from artificial intelligence to robotics, as the clearest illustration of what is at stake should Europe fail to translate its awakening into common action (VI). The technological challenge demonstrates particularly clearly that Europe does not primarily lack scientific talent, financial resources or policy initiatives. Rather, it struggles to concentrate resources, accept geographical concentration, mobilise patient capital and converge around a limited number of shared technological priorities.

Taken together, these six chapters point towards a common conclusion. Europe has entered a new phase of integration in which the question is no longer simply whether common action is possible, but whether Member States are prepared to create the conditions under which such action can succeed. The future of European competitiveness, strategic autonomy and industrial resilience will therefore depend less on the creation of additional instruments than on the political willingness to use existing ones more coherently, more rapidly and with a greater degree of economic and strategic convergence.

1. Next Generation EU: Strong Ambitions but Limited Results Thus Far

1.1 An unprecedented response to unprecedented times: an example of cooperation and solidarity

On the 21st of July 2020, in response to the unprecedented Covid-19 pandemic, the European Council agreed on a large-scale recovery instrument: Next Generation EU (NGEU). The programme pursued two main objectives. First, it aimed at supporting the recovery of Member States most affected by the pandemic. Second, it sought to strengthen the EU's long-term growth potential by fostering investment and structural reforms, thereby enhancing resilience to future shocks.

It also marked a major institutional innovation: for the first time, the European Union engaged in large-scale common borrowing on capital markets. While loans remain the responsibility of beneficiary Member States, the grant component is financed through EU-level borrowing and ultimately serviced via the EU budget, thereby introducing a form of partial fiscal solidarity across Member States.

NGEU mobilises around €723 billion[1] in 2018 prices, including approximately €385.8 billion in loans and €338 in grants primarily channelled through the Recovery and Resilience Facility (RRF). Given its scale and ambition, the programme was widely expected to trigger a durable improvement in productivity and growth, particularly in weaker economies. Some commentators even called it a potential Hamiltonian Moment for Europe[2].

1.2 The largest recipients of NGEU, Spain and Italy, have thus far shown contrasted results

Whilst the first assessments remains preliminary due to implementation lags, the current NGEU data allows for a preliminary analysis. Indeed, a significant share of funds has already been disbursed (68% as of June 2026), and forward-looking indicators offer a first look into the effects of NGEU on recipients' economies.

Six years after the outbreak of the Covid-19 pandemic, and following the disbursement of a substantial share of NGEU funds, one would expect to observe the first signs of a structural improvement in economic performance. Yet the available evidence suggests that such a transformation has yet to materialise. Growth projections for 2026 and 2027 remain modest across the main beneficiary countries, with little indication of a lasting improvement in their growth potential.

Italy and Spain, the largest recipients of NGEU funds, illustrate these limitations. Spain is allocated approximately €79.8 billion in grants and €83.2 billion in loans, while Italy receives around €54.1 billion in grants and €99.1 billion in loans. Both economies experienced a strong rebound in 2021 and 2022, largely driven by post-pandemic reopening effects. However, this rebound has not translated into a sustained strengthening of their long-term economic performance.

TABLE 1.
Real GDP growth dynamics (%)

Year	Spain	Italy
2021	5.0%	6.5%
2022	5.8%	3.7%
2023	2.5%	0.9%
2024	2.4%	0.7%
2025 (f)	2.1%	0.6%
2026 (f)	2.3%	0.5%
2027 (f)	1.9%	0.5%

Source: IMF World Economic Outlook, April 2026

While Spain continues to outperform Italy in the short term, both economies are projected to converge towards modest growth rates. Italy's growth is expected to remain at around 0.5% in both 2026 and 2027, underscoring the absence of meaningful acceleration despite the scale of NGEU support.

1. European Commission. (2021). Recovery plan for Europe. European Commission. https://commission.europa.eu/strategy-and-policy/recovery-plan-europe_en
2. A Hamiltonian moment for Europe? Demystifying Next Generation EU and the EU's recovery funds. (2022, March 25). EUROPP. https://blogs.lse.ac.uk/europpblog/2022/03/25/a-hamiltonian-moment-for-europe-demystifying-next-generation-eu-and-the-eus-recovery-funds/

Productivity developments reinforce this assessment. In Spain, labour productivity increased only modestly – around 0.5–0.7% on an annual basis between 2019 and 2024 – while it remained broadly stagnant or slightly negative in Italy over the same period.

Spain has been comparatively effective in translating EU funds into short-term economic activity, supported by faster implementation and strong employment growth. Italy, by contrast, has faced more difficulties in disbursing its funds due to its complex multi-layered administrative framework. In neither case, however, is there yet convincing evidence that NGEU has fundamentally altered the underlying drivers of long-term growth.

More fundamentally, these results highlight a core weakness of the programme. Financial transfers, even at significant scale, cannot substitute for domestic reforms or compensate for weak administrative capacity, structural rigidities and an unfavourable business environment. Recent evidence, particularly in the case of Italy, suggests that a significant share of post-pandemic fiscal resources has been deployed towards temporary support measures rather than productivity-enhancing investments, thereby limiting their long-term impact on growth. The effectiveness of NGEU ultimately depends on national implementation capacity, the quality of investment, and the political willingness to undertake reforms.

1.3 Delayed absorption and reform delivery on the behalf of Member States.

Beyond the specific cases of Spain and Italy, the implementation of NGEU as a whole has been slower than initially envisaged. A recent analysis conducted by the European Parliament's Research Service[3] estimates that up to €95 billion of available funds may ultimately remain unused, thus reflecting persistent absorption challenges across several Member States. As of today, approximately €360 billion[4] in grants and €217 billion[5] in loans have been disbursed. At a time when Europe faces pressing investment needs in competitiveness, artificial intelligence, defence and energy, such implementation delays represent a significant opportunity cost.

An interim assessment[6] conducted by the European Court of Auditors (ECA) in 2024 identified several factors behind these delays. While external shocks such as the inflation episode and supply-chain disruptions caused by Russia's invasion of Ukraine together with an excessively accommodative monetary policy have complicated implementation, many obstacles are of domestic origine. These obstacles include administrative capacity and delays linked to public procurement and state-aid procedures. However, the ECA highlights in particular that "the cause of these delays is not the rules themselves but rather underestimation of the time needed to apply them when selecting the measures to be included in the RRPs." In several cases, measures initially included in national plans proved difficult to complete within the RRF's timeframe.

Beyond the scope of NGEU, the ECA's analysis reveals a broader structural weakness within the Union. The current capacity of several national administrations to design, implement and sustain ambitious reforms appears increasingly constrained. Rather than exposing the shortcomings of the European framework alone, NGEU has highlighted the declining implementation capacity of a number of Member States. The slow pace of implementation suggests that governments underestimated both the administrative complexity and the political commitment required to deliver large-scale reforms. More broadly, the repeated postponement of necessary reforms raises questions as to whether European governments have fully internalised the scale and urgency of the challenges they face.

1.4 The mitigated results of NGEU raise uncomfortable political questions: that of repayment

From a European perspective, NGEU also raises important questions regarding fiscal burden-sharing. While loans remain national liabilities, the grant component is financed collectively through the EU budget[7], effectively creating a system of partial fiscal transfers.

The question of long-term repayment remains only partially resolved at the political level. While the servicing of common debt is expected to rely on future EU budgets and proposed new own resources, the composition and adoption of those revenue sources remain subject to ongoing political agreement among the Member States and EU

3. Binder, E., Destin Bobková, B., Mileusnic, M., Monda, M., & Prinz, H. (n.d.). IN-DEPTH ANALYSIS. https://www.europarl.europa.eu/RegData/etudes/IDAN/2025/765765/EPRS_IDA(2025)765765_EN.pdf
4. European Commission. (2023). NextGenerationEU. Commission.europa.eu. https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/nextgenerationeu_en
5. *Ibid.*
6. Special report 13/2024: Absorption of funds from the Recovery and Resilience Facility. (2024). European Court of Auditors. https://www.eca.europa.eu/en/publications?ref=sr-2024-13
7. European Commission. (2023). NextGenerationEU. Commission.europa.eu. https://commission.europa.eu/strategy-and-policy/eu-budget/eu-borrower-investor-relations/nextgenerationeu_en

institutions. As a result, the financial legacy of NGEU may become a source of tension between Member States, particularly if the expected gains in growth and convergence fail to materialise.

The programme raises a more fundamental question: can financial solidarity, in the absence of deeper economic convergence and aligned national policy choices, deliver the economic transformation it was designed to achieve? The limitations of NGEU point to a broader problem: shared financial instruments cannot, by themselves, overcome diverging public finance trajectories and patterns of industrial specialisation.

The experience of NGEU suggests that European solidarity cannot compensate for the absence of domestic reforms. Common borrowing and financial transfers can facilitate investment, but they cannot substitute for national responsibility. The success of any European initiative ultimately depends on Member States' willingness and capacity to undertake the structural reforms needed to strengthen their own economies.

In the end, the reimbursement of common borrowing requires an extension of the European budget – the instrument for intra-European solidarity – due to the higher sovereign rate environment compared to the start of NGEU. However, in order to extend the European budget, one must first as the question: are European Member States willing to do so?"[8]

2. Internal Divisions and Lack of Cooperation in the Face of External Economic Pressures

2.1 The weak response to American trade demands: a reflection of national divergences and differing industrial profiles

In June 2025[9], President Trump, considering that the US was receiving the short end of the stick in terms of global trade – and in line with his campaign promises – threatened to impose up to a 30% tariff on a variety of imported EU goods.

Unlike the United States or China, the European Union does not pursue a single national economic interest. While trade policy is formally an exclusive EU competence, industrial structures, export exposure and political incentives remain overwhelmingly national. As a result, trade negotiations inevitably become an aggregation of national preferences rather than the expression of a genuinely European economic strategy.

The European Union is comprised of economies with differing industrial profiles, each with their own specialisations and varying levels of exposure to foreign markets. These differences became particularly visible during the negotiations with the United States. Rather than pursuing a strategy of escalation, the Commission opted for a negotiated settlement that broadly reflected the preferences of several export-oriented Member States, anxious to avoid a prolonged trade conflict. Commission President von der Leyen agreed to meet President Trump in Scotland mid July of 2025.

The agreement ultimately reached on 19 May 2026 remained considerably closer to the initial American position than many observers had anticipated[10]. The US agreed to reduce its planned tariffs on EU goods to 15%, down from an average of 30%[11]. The EU not only accepted the removal of tariffs on most US goods – thereby giving it nearly unimpeded access to EU markets – it also committed to purchase $750 billion worth of US energy and invest an additional $600 billion in US infrastructure.

When faced with American demands, European states proved unwilling to weaponise what may be the Union's greatest source of leverage: access to the world's largest affluent consumer market. With more than 450 million inhabitants and some of the highest purchasing power globally, the European market is essential for American technology giants such as Google, Apple, Meta, Amazon, and Microsoft. It is estimated that the US has a €180 billion digital services surplus with the EU[12]. In theory, the EU could have used regulatory pressure or the threat of restricted market access as a bargaining tool in negotiations with Washington. Yet such measures were never seriously considered. Part of this restraint reflected concerns that a broader confrontation could jeopardise access to critical digital infrastructure and technological services upon which European economies and public administrations have become deeply dependent.

The EU's weak response is all more striking considering that the Union possesses a purpose-built instrument for exactly this scenario. The Anti-

8. J. de Larosière. European common debt : is this Europe's Hamiltonian moment? Eurofi regulatory update, March 2026.
9. Dlouhy, J. A., Woodhouse, S., & Nardelli, A. (2025, May 23). Trump Threatens EU, Smartphones as Tariff Rhetoric Escalates. Bloomberg.com; Bloomberg. https://www.bloomberg.com/news/articles/2025-05-23/trump-threatens-a-50-tariff-on-eu-goods-starting-in-june
10. Commission welcomes political agreement on implementation of EU-US trade deal. (2026). European Commission - European Commission. https://ec.europa.eu/commission/presscorner/detail/en/ip_26_1103
11. (2025). Vie-Publique.fr. https://www.vie-publique.fr/en-bref/299692-accord-sur-les-droits-de-douane-entre-lue-et-les-etats-unis
12. Bickenbach, F., Holger Görg, & Liu, W.-H. (2026). Services at the Core: The Missing Piece of Transatlantic Trade Talks? Intereconomics. https://www.intereconomics.eu/contents/year/2026/number/1/article/services-at-the-core-the-missing-piece-of-transatlantic-trade-talks.html?utm_source=chatgpt.com

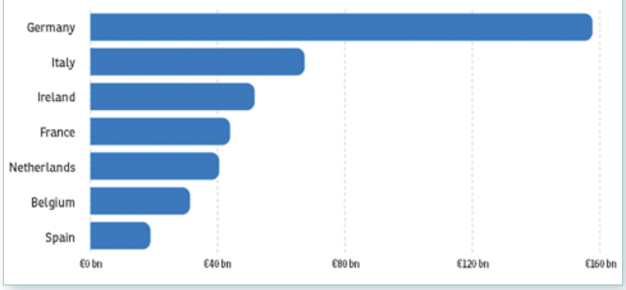
Coercion Instrument[13], adopted in December 2023, grants the Union authority to impose countermeasures against any third country using economic pressure to interfere with EU policy choices – the precise situation the Trump tariffs represented. There were calls from within the European Parliament and certain Member States to activate it. The Commission chose to not activate it however, wary of escalating the dispute and facing pressure from export-dependent economies such as Germany or Italy, afraid of possible retaliation[14].

The credibility of a deterrent depends entirely on the willingness to use it. By leaving the instrument dormant when circumstances most clearly warranted its activation, the EU signalled to partners and adversaries alike that its legal toolkit and its political will are not necessarily aligned. This stands in contrast to China's approach. Beijing demonstrated a far greater willingness to use its economic leverage during negotiations with Washington, notably through export restrictions on rare earths[15] and other critical inputs. Whatever the ultimate outcome of the negotiations, China showed that economic interdependence can also be used as an instrument of geopolitical influence

Part of the EU's unwillingness to provide a strong response to US demands stems from its security depends on its transatlantic ally. The US provides critical aid and infrastructure to Ukraine against Russia through intelligence[16] and internet infrastructure thanks Elon Musk's Starlink satellites[17]. The EU's choice to outsource the defence of its home continent to the US exposes the Union to the whims and demands of its allies as well as limits geopolitical manoeuvrability.

Cracks quickly started to form in the European ranks, precisely due to the different industrial profiles of the Member States. This led them to pursue different objectives and outcomes from this deal, all in order to protect their own national industries. As shown in Chart 1, Germany and Italy are the largest European exporters of goods to the US, representing €157.7 billion and €67.3 billion respectively.

CHART 1.
EU goods exports to the United States by Country (2023)
Selected EU members states exporting goods to the US, based on Eurostat figures cited by Euronews.
In € billions



France, in contrast, only exports $43 billion to the US despite being a larger economy than Italy. This data easily explains each party's position. These differences help explain the contrasting political positions adopted during the negotiations. Germany and Italy favoured a pragmatic and conciliatory settlement in order to minimise disruption to their export-oriented industries. France, by contrast, criticised the agreement as incompatible with European strategic autonomy and sovereignty. Ex Prime Minister François Bayrou openly criticised[18] the deal and expressed his concerns to Commission President Von der Leyen. Critics also argued that the agreement disproportionately protected the interests of Germany's automotive and pharmaceutical industries.

The trade war was the opportunity for Member States to show and demonstrate the strength and credibility of the Union as an institution, but more importantly, as a political project. Instead, internal divergences and nationally-focused decision frameworks undermine the Union's ability to present a united front and to project power internationally. Instead, the negotiations exposed how divergent national interests continue to constrain Europe's ability to transform its economic weight into geopolitical influence.

The negotiations with the United States were not an isolated case. Similar divisions have characterised the Union's approach to other major trade negotiations, most notably the long-running Mercosur agreement.

13. The European Union's Anti-Coercion Instrument (Regulation (EU) 2023/2675) entered into force on 27 December 2023 to deter and respond to economic coercion by third countries. Although conceived partly in response to China's economic pressure on Lithuania in 2021, the mechanism had not yet been formally activated as of May 2026.
14. Corlin, P., & Tadeo, M. (2026, January 18). What is the EU's anti-coercion instrument, and how does it work? Euronews; euronews.com. https://www.euronews.com/my-europe/2026/01/18/what-is-the-eus-anti-coercion-instrument-and-how-does-it-work
15. Jackson, L., Lv, A., & Onstad, E. (2025, April 4). China hits back at US tariffs with rare earth export controls. Reuters. https://www.reuters.com/world/china-hits-back-us-tariffs-with-rare-earth-export-controls-2025-04-04/
16. Deprez, F., Miller, C., Foy, H., Fisher, L., & Hall, B. (2025, March 5). US cuts off intelligence sharing with Ukraine. @FinancialTimes; Financial Times. https://www.ft.com/content/c58fccea-00c4-4fad-bc0a-0185b7415579
17. SpaceX, USAID deliver 5,000 satellite internet terminals to Ukraine. (2026, June 4). Euronews; euronews.com. https://www.euronews.com/next/2022/04/06/us-ukraine-starlink
18. Monde, L. (2025, July 28). Droits de douane : François Bayrou dénonce une "soumission" après l'accord commercial entre Donald Trump et Ursula von der Leyen. Le Monde.fr; Le Monde. https://www.lemonde.fr/economie/article/2025/07/28/droits-de-douane-l-accord-entre-les-etats-unis-et-l-ue-apporte-une-stabilite-temporaire-mais-est-desequilibre-affirme-le-ministre-charge-de-l-europe_6624820_3234.html

2.2 The Mercosur deadlock: an example of Franco-German disagreement

The Mercosur deal deadlock is another example that highlights the growing rift between France and Germany. Both countries hold differing positions with regards to the agreement which can also trace its origin to diverging economic realities.

Germany's support for the agreement follows a clear strategic logic. As Europe's foremost industrial and export-dependent economy, Berlin views South American markets as a valuable outlet for its automotive, chemical, and machinery sectors. It is also an opportunity for Germany to diversify its supply chains.

In contrast, the Mercosur negotiations **exposed longstanding weaknesses within French agriculture that successive governments have struggled or refused to address.** French farms remain relatively small compared with large agricultural exporters outside Europe and are generally less consolidated than those in some highly competitive agricultural economies such as Denmark and the Netherlands[19]. Economies of scale achieved in several neighbouring countries have contributed to France's relative loss of competitiveness. French agriculture is also burdened by high labour and production costs, dense administrative regulation, and slower modernisation than in many of its international competitors. In contrast, South-American producers benefit from lower costs and are not subject to the same stringent environmental regulations as European producers are. This explains why many farmers viewed the agreement not simply as a trade deal, but as a direct threat to the viability of their economic model.

The result is that the Union's two anchor states approach the same negotiating table with genuinely incompatible interests. This is partly explained by two decades of diverging economic trajectories have left them with fundamentally different stakes in the global trading order.

The Mercosur negotiations illustrate a broader structural challenge facing the European Union. As domestic political pressures intensified, national governments increasingly prioritised short-term electoral considerations over longer-term European strategic objectives. While France emphasised the protection of its agricultural sector, Germany focused on securing export opportunities for its manufacturing industry. Both positions reflected legitimate national interests, yet together they made the emergence of a common European trade strategy considerably more difficult.

More fundamentally, the Mercosur debate demonstrates that trade policy cannot be dissociated from the underlying economic structures of Member States. Countries that specialise in different sectors inevitably perceive the costs and benefits of trade agreements differently. In the absence of greater economic convergence, these divergent interests are likely to persist, making consensus increasingly difficult to achieve.

The Mercosur deadlock therefore illustrates a broader trend: whenever domestic political constraints become sufficiently important, European cooperation tends to give way to nationally driven decision-making. Such dynamics may be politically rational at the national level, but they weaken trust between Member States and make the emergence of a genuinely common strategic vision increasingly elusive.

Europe's challenge is therefore not the absence of economic power, but the absence of a sufficiently convergent economic base from which common strategic interests can emerge. The Union already possesses one of the world's largest markets and an increasingly sophisticated economic toolbox. Yet European strategic cohesion cannot simply be proclaimed; it must be built upon greater economic convergence among its principal Member States. As long as national economies face different constraints and pursue different priorities, national interests will continue to outweigh European ones, preventing the Union from fully translating its economic power into geopolitical influence.

3. Energy: National Choices and Collective Vulnerability[20]

3.1 The internal electricity market works – even if further integration is still required

The progressive coupling of national electricity markets is one of the most tangible successes of European integration. Market coupling allows electricity to flow towards the highest-value use across borders, aligning prices between bidding zones and allowing Member States to draw on one another's generation rather than each maintaining costly reserves in isolation. According to ACER (Agency for the Cooperation of Energy Regulators),

19. The decline of French agriculture in Europe. (2026). Robert-Schuman.eu. https://www.robert-schuman.eu/en/questions-d-europe/822-le-declassement-europeen-de-l-agriculture-francaise

20. The authors thank Jean-Marie Andrès for his insightful comments on this section.

the welfare gains delivered by cross-border electricity trade amounted to roughly €34 billion in 2021 alone. Estimates by the Regulatory Assistance Project put the annual benefit of fully integrating European electricity markets at some €43 billion by 2030.

Indeed. Wind, solar, hydro and demand patterns do not peak at the same time across the continent. Iberian solar, Nordic and Alpine hydro, French nuclear and North Sea wind are complementary rather than competing assets. With sufficient interconnection, hours of low renewable output and high demand in one country can be covered by cheap surplus generation in another. Interconnection is, in this sense, the cheapest form of storage Europe possesses, and the cheapest form of security of supply. It is also the mechanism by which the renewable investments made by any one Member State generate returns for all of them.

The problem is that Europe has not built enough of it. The European Council set a target for Member States to reach an electricity interconnection level of at least 10% of installed generation capacity by 2020, raised to 15% by 2030 under the Governance Regulation of 2018. At the beginning of 2026, sixteen Member States had already exceeded the 2030 target. Nine remained below the threshold that was supposed to have been met six years earlier. The internal energy market is, in physical terms, still incomplete – and the gap is concentrated precisely in the regions where integration would deliver the most.

The Iberian Peninsula remains an electricity island, and the reasons for it are not purely technical

Spain is the clearest case. Its interconnection ratio stood at 3.62% in 2025 according to Commission calculations, the lowest in continental Europe and barely a third of the target Spain was meant to have met in 2020. Exchange capacity between the Iberian Peninsula and France is around 2.8 GW, for a Spanish system with more than 130 GW of installed capacity. Spain and Portugal have built large renewable fleets that they cannot fully export, while the rest of Europe cannot access cheap Iberian electricity at scale. Both sides lose.

The principal remedy, the Bay of Biscay interconnection, illustrates the difficulty. This partially submarine link between Gatika and Cubnezais, developed jointly by Red Eléctrica and RTE, will raise exchange capacity from 2.8 GW to 5 GW. It is a Project of Common Interest, co-funded by the Connecting Europe Facility to the tune of €578 million since 2018 and backed by a €1.6 billion European Investment Bank loan signed in June 2025. Its cost has been reassessed at €2.85 billion with a further €250 million provisioned for risk. It is expected to become operational in 2028 – some fifteen years after the project was first identified as a European priority.

Spain has for years accused France of slowing the pace. The accusation is not without foundation: France has a commercial interest in limiting the flow of cheap Iberian solar into a market where its nuclear fleet is the price-setting incumbent, and Paris has consistently prioritised interconnection projects to its north and east over those across the Pyrenees.

But the French objection has always had a second component. A synchronous grid is only as stable as its least well-managed constituent part. Interconnection does not merely transmit electricity, it also transmits disturbances. On 28 April 2025, mainland Spain and Portugal suffered the most severe blackout in Europe in over two decades, and the Iberian system lost synchronism with the continental grid within seconds.

The final report of the ENTSO-E (European Network of Transmission System Operators for Electricity) expert panel, published in March 2026 is unambiguous on where responsibility lies, As the chair of the ENTSO-E board put it, the problem was not renewable energy but voltage control. The panel identified deficiencies in voltage and reactive power management in the Spanish system, and an absence of real-time monitoring. It also noted that distribution system operators had no visibility over output from generators below 1 MW, and that the investigation itself was hampered by incomplete data.

Two conclusions follow. The first is that France's stated concern about importing instability was not a pretext invented to protect its market position: grid management capability genuinely varies between Member States, and the 2025 blackout demonstrated the consequences. The second is that this is an argument for cooperation, not for isolation. Among the factors the panel identified were differences in voltage regulation practices between systems. ENTSO-E has committed to developing a guideline of good practice on voltage support, and Spain has since revised its own operational procedures to allow renewable generation to contribute to voltage control, a reform completed in March 2026.

This is precisely where European action would be both legitimate and useful. Harmonised technical standards for voltage and reactive power management, common real-time monitoring obligations, mandatory data-sharing between transmission and distribution operators, and a genuine European framework for grid operating practice would raise the floor across the Union and remove the most defensible objection to deeper interconnection. None of this requires transferring the choice of energy mix to Brussels, and none of it amounts to federalising energy policy. It requires Member States to accept that if their grids are to be joined, the standards to which those grids are operated cannot remain a purely national matter.

3.2 Individual choices that need to be owned up to

The choice of national energy mix remains a core sovereign competency of Member States, as enshrined in Article 194 of the Treaty on the Functioning of the European Union. Yet there are a number of specific instances where national decisions bear consequences for the Union as a whole in terms of security and climate credibility.

The first example in that respect is Germany's energy trajectory over the past two decades. Following the Fukushima disaster in 2011, the German government made the sovereign decision to accelerate the phase-out of its nuclear fleet, removing a stable, low-carbon and dispatchable source of electricity from its energy mix. To compensate for the intermittency inherent in the renewables it championed, Germany turned to gas-fired power plants as a balancing mechanism. This choice was made on domestic political grounds, and it was entirely within Germany's legal rights to make it. But its consequences were felt beyond Germany's borders.

The immediate consequences of Germany's reliance on gas are geopolitical. Not only was Germany strongly dependent on gas, it was especially dependent on Russian gas. This rendered Germany particularly vulnerable to political pressure from Moscow, and by extension, inhibited the Union's collective response to Russian foreign policy. An article by the Guardian dating from 2022 showed how Germany's gas dependency had been used as a tool of political and economic coercion by Russia. When Russia invaded Ukraine in 2022, the depth of Germany's exposure translated into a hesitancy that complicated the EU's ability to respond with the cohesion and speed that the moment demanded. Since then, Germany has made significant efforts to diversify its gas supply, but in doing so, it has to a considerable degree substituted Russian liquefied natural gas for American LNG. Given the current volatility in transatlantic relations, the question of whether this represents genuine strategic autonomy or merely a change of dependency is a legitimate one.

Another consequence is the climate issue. Germany's reliance on gas as a bridging fuel has measurably diminished the environmental benefits of its considerable investment in renewables. The greenhouse gas emissions profile of the German electricity sector remains substantially higher than that of France, which retained its nuclear capacity. France emits on average 50 gCO2e/kWh for its energy production as opposed to Germany's 329 gCO2e/kWh. This is not an argument for one energy model over another; both approaches carry legitimate costs and risks. It is, however, a reminder that the speed and manner of the transition matter, and that decisions made with primarily domestic considerations in mind can have lasting consequences for the Union's collective credibility on climate.

Italy demonstrates that this is a pattern rather than a German peculiarity

The second example is Italy, and it matters because it shows that the problem is structural rather than attributable to any single government. Italy abandoned nuclear power following a referendum held in 1987, in the aftermath of Chernobyl, and shut its last reactors shortly afterwards. As with Germany, the decision was democratically taken and legally unimpeachable. As with Germany, the gap was filled by gas.

The results are visible in every relevant indicator. Natural gas fuels roughly 44% of Italian electricity generation, close to three times the EU average, and more than 90% of the gas Italy consumes is imported. Italy's overall energy import dependency stands at approximately 75%, the highest of any major European economy – against roughly 68% for Spain, 66% for Germany and 45% for France. Having reduced its exposure to Russia after 2022, Italy has concentrated its supply on Algeria, which provided around a third of its gas imports in 2024, and Azerbaijan. The vulnerability has been relocated rather than removed.

Because gas is so often the marginal generator setting the wholesale price, Italian industry pays for this structure directly. Over the first four months of 2025, Italian wholesale electricity prices averaged around €136/MWh, against approximately €113 in Germany, €95 in France and €81 in Spain. An Italian manufacturer competes against a Spanish one while paying some two-thirds more for electricity. This is not a failure of the internal market; it is the internal market faithfully transmitting the consequences of a national decision. And when Italian competitiveness is invoked in Brussels as grounds for softening European climate instruments, the pattern is explicit rather than incidental: Italy led a ten-Member-State push for weaker EU ETS[21] (European Union Emissions Trading System) rules ahead of the July 2026 review, after Prime Minister Meloni had called in February for the system's outright suspension, and Rome joined Berlin in December 2025 in a formal declaration seeking to weaken the 2035 combustion-engine phase-out on behalf of its automotive sector. In each case, the Union is being asked to absorb the cost of a choice – the energy mix that makes Italian electricity so gas-price-sensitive in the first place – that it did not make.

The pattern is consistent across both cases. Large Member States have made energy mix decisions on domestic political grounds, entirely within their competence, and the Union has absorbed the consequences: weakened leverage against Russia, degraded climate credibility, elevated industrial energy costs, and a persistent political constituency for diluting common instruments. Article 194 allocates the decision nationally. It allocates none of the consequences.

3.3 When common instruments start to take effect, Member States dilute them

The third dimension of the problem is the most recent and, arguably, the most damaging, because it concerns the instruments the Union has actually built.

The strategic case for electrification is not only environmental. Electricity is the only major energy vector Europe can produce domestically at scale. Every barrel of oil and every cubic metre of gas that Europe does not consume is a unit of leverage removed from possible adversaries. Electrification is an industrial and security policy that happens also to be a climate policy. The Commission has recognised this, proposing in July 2026 an electrification target of 46% by 2040, against roughly 23% today. Meeting it would do more for European strategic autonomy than most of what is currently discussed under that heading.

The record of the past year runs in the opposite direction. In March 2023, the Union legislated that new cars and vans sold from 2035 would have to emit no CO_2 – a 100% reduction against 2021 levels. The measure was demanding by design: its purpose was to give European manufacturers a fixed, credible horizon around which to organise investment. On 16 December 2025, following sustained pressure from Germany, Italy and the European automotive industry, the Commission proposed replacing the 100% requirement with a 90% one, with the residual to be offset through EU-produced low-carbon steel, e-fuels and biofuels. Plug-in hybrids, range extenders and conventional engines may continue to be sold beyond 2035. The Commission's stated rationale was technological neutrality and flexibility. The effect is that a deadline which had been fixed for twelve years became negotiable at the point at which it began to constrain behaviour.

Carbon pricing has followed the same trajectory. ETS2, extending emissions trading to buildings and road transport, was due to begin in 2027. In November 2025, during Environment Council negotiations on the 2040 climate target, a group of Member States secured its postponement to 2028, a delay confirmed in trilogue on 10 December. The same negotiation raised the permissible contribution of international carbon credits to the 2040 target from the 3% the Commission had proposed to 5%. Then, on 17 July 2026, the Commission published its review of the ETS itself. The proposal slows the rate at which the emissions cap declines; extends free allocation and carbon leakage protection for energy-intensive industries through 2040; reduces the annual benchmark tightening rate from 2.5% to 2% from 2030; adds, through a separate fast-tracked instrument, some €6 billion in additional free allowances for the 2026–2030 period; and halves the rate at which the Market Stability Reserve absorbs surplus allowances, from 24% to 12%.

Not all of this is retreat. From 2031, free allocation becomes conditional: 80% of a firm's allowances are released on approval of a verified decarbonisation investment plan, and the remaining 20% only once the resulting emissions reductions are demonstrated. The Commission has also proposed an Industrial Decarbonisation Bank with a €100 billion envelope, and – significantly – a requirement that at least half of future ETS revenue be ring-fenced for industrial decarbonisation. That last measure is a direct response to Member State behaviour. The ETS has raised over €270 billion since 2013, of which roughly three quarters flowed to national treasuries, and by the Commission's own accounting only around 5% has gone to industrial decarbonisation in sectors such as steel, chemicals and fertilisers. Member States treated a decarbonisation instrument as a revenue stream. The Commission is now obliged to legislate against that behaviour, which is itself an admission of how the system has been used.

The underlying dynamic will be familiar from the discussion of Next Generation EU. There, common borrowing was intended to finance transformation, and instead too often substituted for the domestic

21. The EU ETS is the European Union's cap-and-trade system for greenhouse gas emissions, under which regulated firms must hold tradable allowances covering their emissions, with the overall emissions cap decreasing over time to drive decarbonization.

reforms it was meant to accompany – an accommodating framework read as permission to defer rather than as an opportunity to reform at lower cost. The same mechanism is now operating on climate instruments. Each softening is individually defensible: European carmakers face genuine Chinese competition, energy-intensive industry faces genuine cost disadvantages, and households in lower-income Member States face genuine affordability constraints. But the cumulative signal to every regulated actor is that European deadlines move when they become expensive. That expectation is corrosive in a way no single amendment is, because it prices in future concessions and therefore reduces the incentive to invest ahead of them. The carbon price works: the Commission's own analysis attributes measurable abatement to it. Its efficacy is precisely why it is politically contested, and precisely what is diminished each time it is loosened.

A competence structure that guarantees externalities

The pattern across this section is not one of Member States behaving badly, though at times they have. It is a structural misalignment between how energy and emission decisions are taken in the Union and how their consequences are distributed.

Article 194 reserves the determination of the national energy mix to Member States, and there is a coherent political logic to that reservation. But nothing in the Treaty reserves the consequences. When Germany replaced nuclear with gas, the Union inherited the strategic exposure to Moscow. When Italy did the same, the Union inherited an industrial cost base that is now routinely invoked as grounds for diluting common instruments. When Spain's grid management proved inadequate to the generation mix it had built, the whole synchronous area was exposed within seconds. When France protected its market position by slowing interconnection across the Pyrenees, the Union forwent gains that ACER measures in tens of billions annually. And when European deadlines began to constrain national industries, those same Member States sought and obtained their relaxation.

The Union has built genuinely valuable common instruments in this domain: a coupled electricity market, a functioning carbon price, a body of infrastructure planning. What it has not built is any mechanism that obliges Member States to bear the collective consequences of their sovereign choices, or that prevents them from unwinding shared commitments the moment those commitments become costly. The remedy is not to federalise energy policy, which is neither achievable nor obviously desirable. It is more modest and more difficult: to harmonise the standards to which interconnected systems are operated, to make common instruments genuinely resistant to renegotiation, and to accept that a sovereignty exercised without regard to its externalities is not sovereignty at the European level but its opposite.

The same tension, expressed through a different competence, structures European defence.

4. Fragmented Defence Architecture: When National Thinking Frameworks Win Over a Common European Vision

President Donald Trump has fundamentally reshaped the rules of global geopolitics. Nicolas Baverez[22] argues in his opinion piece that the President's destabilisation of NATO, his threats to seize Greenland militarily, his strategic meanderings in Iran, and the broader dismissive, condescending tone adopted by the United States toward its long-standing allies have finally awakened the Old Continent. Yet despite the urgent necessity for Europe to unite, increase its independence vis-à-vis the United States, European countries remain more fragmented than ever. Diverging economic conditions and the inability of some Member States to adhere to commonly agreed upon fiscal commitments have rendered the alignment of interests particularly difficult.

4.1 Defence remains a national competency by design

Unlike trade, where the Treaties conferred the Union genuine supranational authority, defence was never transferred to Brussels in the same way. Under Article 42 of the Treaty on European Union, Member States retain primary responsibility for defence planning and capability development[23]. The European Union is not a federal state, and consequently does not hold the regalian prerogatives that a genuine common defence policy would require: the power to tax for defence purposes, to raise or command armed forces, or to bind Member States to a single procurement decision.

The practical consequence is that there is no common EU defence budget. Procurement choices, spending levels and equipment selection remain entirely national. According to the European Parliament's Research Service, EU Member States do not allocate defence resources through a single,

22. Baverez, N. "Il était encore une fois l'Union Européenne", Le Point, April 2026.
23. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.

centralised framework: budgets are determined and implemented by 27 national governments, generating fragmentation, duplication of capabilities, and lower efficiency in spending[24]. The scale of the resulting diversity is considerable: EU armed forces collectively field more than 150 different weapons systems, compared with a few dozen in the United States, depending on the definition and categorisation used[25].

The current European defence industrial base suffers from a high degree of segmentation, with multiple competing national programs. For example, France continues to produce the Dassault Rafale independently, whilst Germany, Spain and Italy collaborate on the Eurofighter Typhoon. In addition, there are 12 main battle tank models in Europe[26], which illustrates the lack of standardisation in defence equipment.

This segmentation runs through the industry as much as through the equipment itself. Europe has no shortage of capable manufacturers such as Rheinmetall, Dassault, Thales, Leonardo. However, each remains geographically anchored to its own country, producing a wide range of competing national products rather than a small number of shared, continent-wide platforms. Certain segments have partially consolidated across borders: Airbus has become a genuinely multinational aerospace group, and MBDA[27] now integrates missile development across several countries. But this remains the exception rather than the rule. Much of the industry stays organised along national lines[28]. The contrast with the United States is striking: where EU armed forces operate over 150 different weapons systems, the US relies on a much smaller, standardised set of platforms, which simplifies logistics, training and operational coordination[29].

As a consequence, this diversity of weapons systems creates real interoperability challenges and complicates joint operations, logistics, maintenance and training. It also limits economies of scale and weakens Europe's collective bargaining power as a buyer, contributing to higher unit costs across the board[30].

Because defence planning, procurement and industrial policy remain overwhelmingly national, Member States naturally continue to define their security priorities through national rather than European lenses.

4.2 The consequences: Europe's strategic dependence on the United States

The fragmentation of the defence industrial base along national lines also has a further unintended consequence, that of dependency on the US

The European Parliamentary Research Service (EPRS) is specific about where the gaps between EU and US defence industries lie. Despite having a broad industrial base in terms of capability, the EU currently offers no domestic solution in several critical segments. These are medium-altitude long-endurance drones (MALE UAVs), tactical ballistic missiles, and long-range artillery rockets[31]. European air forces field capable "4.5-generation" platforms such as the Eurofighter Typhoon, the Rafale or the Gripen, but none reach full fifth-generation status, which is why a growing number of Member States have turned to the American F-35 instead[32].

In 2025, thirteen European countries have acquired F-35 fighter jets, an aircraft whose operational autonomy remains dependent on US-controlled systems. While this dependence is partly operational and logistical rather than absolute, it nonetheless raises significant questions regarding long-term strategic autonomy and decision-making independence. More broadly, American technological supremacy remains close to total in key enablers of modern warfare in the field of intelligence, surveillance and reconnaissance, especially in space-based capabilities.

According to the EPRS, with sufficient political commitment and investment, Europe could develop most of these strategic enablers within roughly five years. Space-based intelligence, surveillance and reconnaissance is the exception, requiring five to ten years. The US operates 246 military satellites against 49 for European NATO members combined. The previous example underlines how important the gap is between the EU and the US is. This disparity is compounded by Europe's limited launch capacity and the absence of a continental spaceport[33].

This gap partly explains why according to recent

24. *Ibid.*
25. *Ibid.*
26. IFRI STUDIES Main Battle Tank: obsolescence or renaissance? Léo PÉRIA-PEIGNÉ SECURITY STUDIES CENTER No. 130 FOCUS STRATÉGIQUE. (2025). https://www.ifri.org/sites/default/files/2026-02/ifri_peria-peigne_main_battle_tank_2025.pdf?
27. French Defence Industrial Company
28. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.
29. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.
30. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.
31. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.
32. Clapp, S. (2026, June). EU joint defence capability development. EPRS, European Parliament.
33. EPRS, op. cit., p.4.

data, around 60% of European defence imports have been sourced from the United States[34]. Despite a growing the growing rhetoric of seeking strategic autonomy amongst certain Member States, EU countries are simply unable to distance themselves from the US, who remains a keystone in the defense strategy of many Member States.

Against this backdrop, the United States has started to reduce its military presence on European soil. On 26 May 2026, Der Spiegel revealed that a Pentagon envoy, Alexander Velez-Green, had briefed senior NATO officials in Brussels on plans to significantly cut the military assets Washington makes available to the alliance in a crisis[35]. The cuts were significant: fighter jets available to NATO would fall by a third, strategic bombers would be halved, fewer destroyers would be set aside for European contingencies, and most strikingly, zero submarines and no reconnaissance drones would be provided at all, leaving European states to supply this hardware themselves[36]. The briefing came alongside the withdrawal of roughly 5,000 US troops from Europe and the cancellation of a planned armoured brigade rotation to Poland. This constitutes the most substantial revision of American defence doctrine on the European continent since the end of the Cold War[37].

Washington has given two main reasons for its decision. European allies, many only now approaching the spending targets agreed at the 2025 Hague Summit, are told to convert new budgets into real capability rather than lean indefinitely on American hardware. At the same time, Pentagon planning is visibly reorienting toward a potential confrontation with China in the Indo-Pacific, where submarines, long-range bombers and carrier groups are the priority. US Secretary of State Marco Rubio made the shift explicit at a NATO foreign ministers' meeting in late May 2026, stating that fewer American troops would eventually be based in Europe than has historically been the case[38].

The matter of fact is that the EU is dependant on the US, both for military equipment, but also operational capacity. This makes the old continent vulnerable to the whims and changing interests of its historic ally. The shifting stance of the US regarding NATO is a case in point of why strategic autonomy is a must, that the EU should pursue now rather than later.

4.3 Europe has developed ad hoc financial instruments to promote a European approach in defence industry and procurement

New financial and institutional mechanisms have been established to foster greater coordination between member states. The European Defence Fund (EDF) is such an example. It is a programme with a budget of around €8 billion for 2021–2027, with €2.4 billion having already been disbursed. Funding is taken directly from the EU budget. The European Defence Fund operates by providing grants to multinational consortia of companies and research organisations engaged in defence research and capability development. The selected projects target priority areas such as AI, cyber, and naval systems. The initiative aims at fostering innovation and promote cross-border cooperation, thereby reducing fragmentation in the European defence industrial base. Most of the projects funded are part of multinational consortia or multinational projects.

Beyond collaborative research, the Union has also sought to strengthen Europe's defence innovation ecosystem. Following the commitments made in the 2022 Versailles Declaration and reaffirmed in the Strategic Compass, the Commission has progressively developed initiatives to accelerate the development and commercialisation of emerging defence technologies. Particular emphasis has been placed on artificial intelligence, quantum technologies, cyber and space capabilities, while encouraging greater participation by start-ups and SMEs. Alongside the European Defence Innovation Scheme and the European Defence Agency's Hub for European Defence Innovation, the Commission proposed the AGILE pilot programme in 2026 to accelerate the transition of innovative technologies from research to operational deployment. Together, these initiatives seek to reduce Europe's technological dependencies and ensure that the Union is able not only to finance defence capabilities, but also to generate them domestically.

The clearest sign that Brussels is moving beyond research funding and into the harder territory of joint procurement is the European Defence Industry Programme (EDIP). With a budget of €1.5 billion, EDIP is the first EU instrument explicitly designed to reach the downstream stages of the capability cycle, namely procurement and production. Thus far, a significant amount of its funding effort was

34. Global arms flows jump nearly 10 per cent as European demand soars. (2026, March 9). SIPRI.
35. US plans significant reduction of military provisions to NATO, Spiegel reports. (2026, May 26). Reuters, cited in Defense News. https://www.defensenews.com/global/europe/2026/05/26/report-us-to-cut-strategic-bombers-and-warships-available-to-nato-in-a-crisis/
36. *Ibid.*
37. US NATO Force Cuts: Implications for European Security. (2026). GLOBSEC. https://www.globsec.org/what-we-do/commentaries/hollowing-out-shield-us-strategic-defence-equipment-reductions-and
38. GLOBSEC, op. cit.

focused on research and development[39]. EDIP ties funding to origin-of-content rules and establishes European Defence Projects of Common Interest, cooperative industrial initiatives intended to support capabilities the Union considers essential to its collective security[40]. In March 2026, the Commission approved a €1.5 billion EDIP work programme: more than €700 million to expand production of missiles, ammunition and counter-drone systems, €260 million earmarked for rebuilding Ukraine's own defence industrial base, €325 million for collaborative European projects, and €240 million specifically to fund joint procurement by Member States and Norway, with a further €100 million reserved for defence start-ups and SMEs[41].

The EU also puts funds directly at the disposition of Member States. The Security Action for Europe (SAFE) for example, is a much larger EU financial instrument providing up to €150 billion in support to Member States for defence investments. It offers long-term, low-cost loans to countries that submit national plans and typically engage in joint procurement of defence equipment with other EU partners, in order to reduce fragmentation. The initiative is funded through EU-level borrowing, with the European Commission issuing EU bonds on capital markets. The loans have a maturity of up to 45 years and are to be disbursed over the 2025-2030 period. It is important to note that SAFE works as an opt-in program. Consequently, countries like Italy with higher borrowing costs than that of the EU, chose to participate because the program represents an advantageous financing opportunity. For countries like Germany that have access to lower rates than the EU, they simply choose to opt out. As a result, cooperation remains limited and defence development capabilities largely follow national lines, which may limit the overall impact of the measure.

The International Monetary Fund (IMF) has specifically called for joint public procurement, warning European countries of the risks of pursuing rearmament independently. The IMF argues that European-level procurement is the most viable path to achieve Europe's strategic objectives, enabling capabilities that would be difficult, if not impossible, to attain individually. Common procurement would also lower financing costs, reduce reliance on imported goods, and could even boost European GDP by 0.9%, should countries increase their defence spending by 1.3% of GDP by 2030.

As in the case of NGEU, the European Union has progressively developed an increasingly sophisticated financial toolbox to encourage cooperation. Yet these instruments remain incentives rather than substitutes for political coordination. Because defence planning and procurement remain national competences, European funding cannot by itself create a genuine European defence market.

On 8–9 June 2026, at the ILA Berlin air show, Chancellor Merz and President Macron jointly confirmed the end of FCAS (Future Combat Air System), the flagship Franco-German-Spanish programme for a sixth-generation fighter jet[42]. Nine years after its 2017 launch, and with an estimated €100 billion in projected costs, the programme had produced no prototype and no flying demonstrator. The cause was primarily managerial: an unresolved dispute between Dassault Aviation, which sought as much as 80% of the workshare on the core fighter, and Airbus, which represented both German and Spanish industrial interests and refused to accept a subordinate role[43]. A German-led mediation process launched after a Macron-Merz dinner in Brussels in March 2026 concluded in April that a jointly built crewed fighter was no longer feasible. Germany's response, formalised the same week in a new national aviation strategy, was to commit to keeping Airbus at the centre of any future combat aircraft programme, while leaving the door open to joining the rival UK-Italy-Japan Global Combat Air Programme instead.

Barely two weeks later, however, the two governments moved to show that Franco-German defence cooperation had not collapsed along with FCAS. On 22 June 2026, Paris and Berlin agreed that Germany would acquire a 40% stake in KNDS, the Franco-German land-systems group behind the Leclerc and Leopard tanks, matching a reduced French stake of 40% (down from 50%), with the remaining 20% floated to institutional investors ahead of a dual Paris-Frankfurt listing[44]. In their joint statement, the two governments framed the deal as consolidating their shared sovereignty over European land-systems manufacturing, rather than merely settling a corporate ownership dispute[45]. Defence Minister Boris Pistorius called KNDS indispensable to the operational readiness of Germany's land forces.

39. EPRS, op. cit., pp.7–8.
40. *Ibid.*, p.7.
41. *Ibid.*, p.7.
42. Germany, France abandon joint FCAS fighter after industry deadlock. (2026, June 8). Aerotime; Germany Kills €100 Billion FCAS Fighter at ILA Berlin. (2026, June 10). TechTimes.
43. *Ibid.*
44. France and Germany commit to equal shareholding in KNDS as potential IPO nears. (2026, June 22). Breaking Defense; Tank maker KNDS plans stock market listing, Germany to buy 40% stake. (2026, June 24). Defense News.
45. Breaking Defense, op. cit.

A similar dynamic is visible in the space sector. In October 2025, Airbus, Thales and Leonardo signed a memorandum of understanding to merge their satellite and space-systems businesses into a single pan-European space champion, aiming to end years of the three companies competing against one another while SpaceX's dominance grew[46]. The European Commissioner for Defence and Space, Andrius Kubilius, has since publicly called on the EU's 27 Member States to work together toward genuine space independence, framing Europe's historically fragmented approach as a self-inflicted handicap[47].

None of this amounts to the governance structure a genuine common defence policy would require. But it does suggest that, even where flagship programmes fail publicly and expensively, the underlying political will to cooperate has not disappeared.

On 2 March 2026, in a speech delivered at the Île Longue submarine base in Brittany, President Macron announced France’s new policy of “dissuasion avancée” or “advanced deterrence”, describing it as an evolution of French nuclear doctrine. President Macron expanded on the concept of “les intérêts vitaux de la France” or “France’s vital interests”, to which he gave a European dimension[48] The idea itself is not new. Indeed, French presidents since François Mitterrand have periodically gestured toward it, and Macron himself first raised it in a 2020 speech.

Concretely, but this announcement went further, offering concrete steps: inviting willing European partners to take part in French strategic-deterrence exercises, envisaging the occasional deployment of French strategic air assets on allied territory, and opening the door to allied conventional forces supporting French nuclear-deterrence activities[49]. Germany, Macron said, would be a key partner in this effort.

The French President did lay out some limitations to this new doctrine. There will be no shared decision-making regarding nuclear weapons, and no sharing of the definition of France's vital interests. Both remain the President of the Republic's alone[50]. What Emmanuel Macron offered was signalling and presence.

By late May 2026, nine countries had responded favourably: the United Kingdom, Germany, Poland, the Netherlands, Belgium, Greece, Sweden and Denmark, joined by Norway on the 27th of May[51].

The initiative is explicitly presented as an extra guarantee, rather than a replacement of NATO deterrence. As the French Ministry of the Armed Forces has put it, the European dimension of French nuclear deterrence cannot replace NATO's extended deterrence[52]. In practice, the new “European dimension” of France’s vital interests changes nothing about ownership and use of nuclear weapons, nor about Europe's continued reliance on the American nuclear guarantee delivered through NATO.

4.4 Despite good intentions, European defence cooperation still falls short

4.4.1 Diverging fiscal capacities limit a common rearmament effort

Germany's rearmament highlights one of the structural constraints facing European defence integration: Member States do not possess the same fiscal capacity to finance the unprecedented military effort now required. While the deterioration of Europe's security environment has generated a broad political consensus on the need to strengthen defence capabilities, the ability to translate this consensus into sustained investment varies considerably across the Union.

The scale of the challenge is substantial. Over the past three years, defence expenditure across the EU-27 has increased by approximately 40–50% in nominal terms, reaching around €381 billion annually in 2025. At the NATO Summit held in The Hague in 2025, Allies further committed to increasing defence-related expenditure to 5% of GDP by 2035, including at least 3.5% dedicated to core military capabilities and 1.5% to broader security and resilience objectives. Meeting this commitment would require an additional effort estimated at around €250 billion per year for the European Allies.

Yet this common objective masks fundamentally different national budgetary realities. Germany, benefiting from decades of fiscal discipline and comparatively strong public finances, enjoys significantly greater room for manoeuvre than most of its European partners. Under Chancellor

46. Forming a Pan-European Space Champion. (2025, October 23). GAM. https://www.gam.com/en/our-thinking/european-equities-blog/forming-a-pan-european-space-champion
47. Space defence: How is the EU boosting its military space capabilities? (2026, April 7). Euronews.
48. Discours du Président sur la dissuasion nucléaire. (2026, March 2). France Diplomatie. https://uk.diplomatie.gouv.fr/fr/discours-du-president-sur-la-dissuasion-nucleaire
49. *Ibid.*
50. *Ibid.*
51. Dissuasion nucléaire : quelle doctrine française ? (2026, May 28). Touteleurope.eu.
52. Touteleurope.eu, op. cit.

Friedrich Merz, Berlin is expected to mobilise an additional €500 billion over the next twelve years for defence, making Germany by far the largest contributor to Europe's rearmament effort. In 2022, Germany's military budget stood at €50 billion. By 2026, it will exceed €108 billion – double the French defence budget[53]. Such financial capacity naturally places Berlin in a central position to shape the future direction of European defence.

Several European partners welcome Germany's renewed military commitment, which also responds to longstanding American calls for a more balanced sharing of the NATO burden. Nevertheless, the emergence of Germany as Europe's dominant military power also raises broader political questions. A rearmament programme of this magnitude inevitably influences the strategic orientation of the continent. The question is therefore not merely whether Germany should spend more on defence, but whether these decisions are sufficiently embedded within a genuinely European framework of consultation and capability planning. Without such coordination, Europe's largest military investment risks reinforcing national rather than European defence structures.

The contrast with France illustrates how divergent fiscal situations translate into divergent strategic possibilities. France has consistently advocated greater European strategic autonomy and remains one of the principal political promoters of a stronger European defence. In the economist C. Antonin's view, France increasingly appears to Germans as a country in a state of collapse – unable to control its public finances, to raise its educational standards, or to halt its deindustrialisation[54]. Yet its financial position substantially limits its capacity to match these ambitions. Public debt now stands at approximately 118% of GDP, the budget deficit remains above 5% of GDP, while interest payments alone are expected to approach 3% of GDP by 2028. Although recent reforms of the Stability and Growth Pact provide temporary flexibility for defence expenditure, they do not fundamentally alter the country's deteriorating fiscal trajectory. Meeting NATO's 2035 spending objective would require France to increase its annual defence budget from approximately €57 billion today to around €95 billion, an objective that appears increasingly difficult to reconcile with the country's broader public finance constraints.

Italy illustrates that France's situation is not exceptional. With public debt approaching 135% of GDP and economic growth remaining subdued, Rome also faces severe limitations in financing higher defence expenditure. Despite recognising the strategic necessity of rearmament, Italy even chose not to activate the EU's National Escape Clause because of its fiscal position. Like France, it therefore possesses the strategic imperative but lacks the budgetary capacity to sustain the level of defence investment that the new security environment requires.

The consequence is that Europe's rearmament effort is increasingly shaped not only by strategic choices, but also by unequal fiscal capacities. While all Member States formally share the same security objectives, they do not possess the same financial means to pursue them. This growing asymmetry inevitably complicates efforts to coordinate procurement, industrial planning and long-term capability development at European level. As in the field of economic governance, national budgetary realities continue to determine the scope of national policy choices. Greater European defence integration therefore requires not only common financial instruments, but also a greater degree of economic and fiscal convergence among the Union's principal Member States.

4.4.2 Diverging industrial strategies prevent the emergence of a genuine European defence market

Beyond fiscal disparities, European defence integration also remains constrained by fundamentally different national industrial strategies. Although recent EU initiatives such as the European Defence Fund, EDIP and SAFE encourage cross-border cooperation, procurement decisions ultimately remain national. Governments continue to view defence industries not only as providers of military capabilities but also as strategic national assets that support employment, technological sovereignty and industrial competitiveness. As a result, defence procurement continues to be driven primarily by domestic political and industrial considerations rather than by the objective of building a genuinely integrated European defence market.

Germany's ongoing rearmament illustrates this dynamic. While Berlin has become the principal financial engine of Europe's military build-up, its procurement strategy remains overwhelmingly national. Much of the additional defence spending is expected to benefit Rheinmetall, which has rapidly emerged as Europe's largest defence manufacturer. Beyond supporting its domestic industrial base, Germany has also continued to rely heavily on American and Israeli suppliers for major capability acquisitions. The acquisition of the F-35 Lightning II is particularly illustrative. Although the aircraft guarantees interoperability within

53. C. Antonin, Challenges, "Ce que la crise de l'automobile allemande dit de l'aveuglement industriel européen".
54. C. Antonin, Challenges, "Ce que la crise de l'automobile allemande dit de l'aveuglement industriel européen".

NATO and provides immediate access to fifth-generation capabilities, it also reinforces Germany's dependence on American defence technology at a time when the European Union is seeking to strengthen its strategic autonomy. Meanwhile, one of France's few globally competitive industrial sectors remains largely absent from Germany's rearmament effort, with French defence products accounting for only a marginal share of German procurement. As C. Antonin puts it: "The word 'France' has completely disappeared from the defence discourse of strategists on the other side of the Rhine[55]." Overall, Berlin's procurement choices continue to prioritise national capability development and transatlantic interoperability rather than the emergence of genuinely European industrial champions.

The collapse of the Future Combat Air System (FCAS) programme further illustrates the structural difficulties of reconciling national industrial interests. Initially launched in 2017 as the flagship Franco-German-Spanish programme to develop a sixth-generation combat aircraft, FCAS was expected to become a cornerstone of European defence integration. Instead, after nearly a decade of negotiations and an estimated programme value approaching €100 billion, the project effectively collapsed in 2026 following irreconcilable disagreements over industrial leadership and workshare. Dassault Aviation insisted on maintaining control over the future fighter aircraft, while Airbus, representing German and Spanish interests, rejected any subordinate role. The dispute ultimately reflected far more than corporate rivalry: it exposed the persistent difficulty of reconciling competing national industrial priorities, even when governments formally share the same strategic objective.

Yet the failure of FCAS should not be interpreted as evidence that European industrial cooperation is impossible. The restructuring of KNDS demonstrates that Member States remain capable of building genuinely integrated industrial structures when political interests sufficiently converge. In June 2026, France and Germany agreed on a new ownership structure for KNDS, placing both governments on an equal footing while reaffirming their joint commitment to preserving European sovereignty in the field of land systems. Similarly, the decision by Airbus, Thales and Leonardo to consolidate parts of their space activities into a common European space champion reflects an increasing recognition that industrial fragmentation has become strategically unsustainable in sectors characterised by intense global competition. These initiatives suggest that European industrial integration remains possible, but only when governments are willing to accept compromises over national ownership and industrial leadership.

This tension between national interests and European integration is perhaps best captured by Franziska Brantner's call for ***Nie wieder allein*** ("Never again alone"). Writing in 2026, F. Brantner[56] argues that Germany's growing military and industrial power inevitably generates unease among its European partners for historical reasons. A German rearmament conducted primarily through national procurement channels and centred on domestic champions risks creating not a stronger European defence, but a stronger German defence. Her response is not to limit Germany's ambitions, but rather to embed German power more deeply within irreversible European structures, ensuring that future capability development, procurement and industrial decisions are genuinely shared. In her view, post-war Germany's traditional commitment to restraint must evolve into a commitment to integration: German power should never again be exercised alone, but always within binding European frameworks.

Ultimately, the evolution of Europe's defence industry confirms a broader pattern already observed in economic governance and trade policy. The European Union has progressively developed financial instruments capable of encouraging industrial cooperation, yet these instruments cannot override national industrial preferences. As long as defence industries remain closely tied to national economic interests and governments continue to regard procurement primarily as an instrument of domestic industrial policy, European defence cooperation will remain constrained by competing national priorities. The principal obstacle is therefore no longer the absence of European instruments, but the persistence of divergent national industrial strategies.

These industrial divergences are themselves rooted in deeper political differences regarding the purpose of European defence. Beyond procurement choices and industrial policy, Member States continue to hold fundamentally different conceptions of Europe's strategic role.

4.4.3 Diverging strategic cultures continue to shape national defence policies

Even if Europe were to overcome its fiscal and industrial fragmentation, a more fundamental obstacle would remain. European defence cooperation ultimately depends not only on common capabilities, but also on a common

55. C. Antonin, Challenges, "Ce que la crise de l'automobile allemande dit de l'aveuglement industriel européen".
56. Brantner, F. (2026, June 4). L'Allemagne doit sortir du déni | Le Grand Continent. Le Grand Continent. https://legrandcontinent.eu/fr/2026/06/04/allemagne-plus-jamais-seuls-brantner/

understanding of the threats facing the continent and of the political objectives that military power should serve. On this point, Member States continue to hold profoundly different strategic cultures, reflecting their geography, historical experience and foreign policy traditions.

France has long been the principal advocate of greater European strategic autonomy. As discussed in the previous section, President Emmanuel Macron's proposal to give France's nuclear deterrent a stronger European dimension illustrates an ambition to strengthen Europe's capacity to act independently whenever its vital interests are at stake. Although carefully presented as complementary to NATO rather than a substitute for the American nuclear guarantee, the initiative nevertheless reflects a longstanding French conviction that Europe should progressively acquire the means to ensure its own security rather than relying indefinitely on external protection.

This vision is not universally shared across the Union. For many Central and Eastern European Member States, particularly Poland and the Baltic States, the Russian threat remains immediate and existential. Their strategic culture has been shaped by decades of Soviet domination and reinforced by Russia's invasion of Ukraine. Consequently, NATO – and above all the American security guarantee – remains the indispensable cornerstone of European security. From their perspective, greater European defence cooperation is desirable only insofar as it strengthens the Atlantic Alliance rather than providing an alternative to it. Strategic autonomy is therefore often perceived less as a strategic necessity than as a potential source of uncertainty regarding continued American engagement.

Germany occupies an intermediate position. While successive governments have gradually embraced the need for a stronger European defence capability, Berlin has traditionally defined its security policy within a firmly Atlantic framework. This partly explains Germany's continued reliance on American military equipment, including the acquisition of the F-35, and its emphasis on interoperability within NATO. Even as Germany becomes Europe's leading military spender, its strategic outlook remains closely linked to the transatlantic alliance rather than centred on the pursuit of autonomous European military power.

These differences extend well beyond relations with Russia or NATO. They also shape Member States' broader foreign policy choices. The reactions to the 2025–2026 crisis involving Iran provide a revealing illustration. While Spain openly criticised the United States' intervention as contrary to international law, Germany adopted a considerably more Atlanticist position. Such divergences demonstrate that Member States frequently interpret the same geopolitical event through different political, legal and strategic lenses.

NATO's own institutional structure further reinforces these national approaches. European countries participate in the Alliance as sovereign states rather than through a consolidated European pillar. Defence planning, operational commitments and strategic decision-making therefore continue to be exercised primarily at national level. Although the European Union has considerably strengthened cooperation in defence research, industrial policy and financing, it still lacks a genuinely common strategic culture capable of guiding collective decisions in times of crisis.

Ultimately, these divergent strategic cultures help explain why European defence integration remains inherently more complex than cooperation in many other policy areas. Even where financial instruments encourage common investment and industrial cooperation progresses, Member States continue to define their security interests through different historical experiences, geographical priorities and alliance preferences. As a result, Europe does not simply face a deficit of military capabilities or defence financing; it also lacks a sufficiently shared strategic outlook. Until Member States converge not only economically, but also in their perception of threats and their conception of Europe's role in the international system, national defence policies will continue to prevail over a genuinely common European strategy.

The evolution of European defence therefore confirms the broader argument developed throughout this paper. Over the past decade, the European Union has progressively equipped itself with an increasingly sophisticated set of financial, industrial and procurement instruments designed to foster cooperation among Member States. Yet these instruments cannot compensate for the absence of convergence among Europe's principal economies. Fiscal capacities remain uneven, industrial priorities continue to diverge, and defence planning and procurement are still overwhelmingly determined at national level.

More fundamentally, Member States do not share a common strategic culture. They do not perceive the same threats nor attach the same importance to NATO, or even assign the same political purpose to defence policy itself. The Franco-German relationship illustrates this divergence particularly well. Whereas France has traditionally approached defence primarily as an instrument of political sovereignty, strategic autonomy and geopolitical influence, Germany has increasingly viewed it through the prism of industrial policy, economic competitiveness and transatlantic integration.

These approaches are not mutually exclusive, but they reflect different conceptions of what European defence is ultimately intended to achieve. Similar differences can be observed across the Union, where Eastern Member States understandably prioritise territorial deterrence against Russia, while others place greater emphasis on crisis management, the Mediterranean neighbourhood or the preservation of the international legal order.

Europe therefore lacks not only a more integrated defence industrial base, but also a shared understanding of the political purpose of European defence. Financial incentives can encourage cooperation, industrial consolidation can reduce fragmentation, and joint procurement can generate economies of scale. None of these developments, however, can by themselves produce a genuinely common defence policy in the absence of agreement on the threats Europe faces, the interests it seeks to protect and the political objectives that military power should ultimately serve.

Ultimately, Europe does not primarily lack defence instruments, industrial capabilities or financial resources. It lacks the degree of economic, political and strategic convergence required to transform national rearmament efforts into a genuinely common European defence capability. As this paper has argued in the fields of economic governance, trade policy and defence alike, the principal obstacle to deeper European integration is no longer the absence of common instruments. It is the persistence of divergent national interests. Until Member States converge not only on how to invest, but also on why they invest and for what strategic purpose, European defence will remain the sum of twenty-seven national policies rather than the expression of a genuinely common European strategy.

5. European Preference: Reviving and Old Warning to Meet a New Threat

5.1 European industrial decline and the early calls for European preference

5.1.5 Completing the Single Market without appropriate protections might benefit foreign exports more than it promotes domestic industries in the EU

In 2025, the IMF called for a further deepening of the Single Market, noting that the barriers that persist between Member States function as a form of invisible internal tariff. The IMF estimated to be equivalent to a levy of around 45% on manufactured goods and far higher on services[57]. Removing those barriers is, in principle, one of the surest ways to raise European competitiveness.

Yet completing the Single Market today carries a risk that would not have existed twenty years ago. In a number of the sectors where internal barriers still bite, the firms best placed to capture the newly integrated market are not European but foreign, and Chinese in particular. The Union has few genuine "European champions" of continental scale, and it runs a substantial and widening goods deficit with its main trading partner. Tearing down internal walls without external perimeter would, in effect, hand the enlarged market to the most competitive outside supplier.

In 2025, total EU-China goods trade reached $828 billion[58], making the EU China's second-largest trading partner, while China is by far the EU's largest single source of imports, accounting for 22.3% of all EU imports in 2025. The trade relationship has become deeply asymmetric: the EU ran a goods deficit of roughly €360 billion with China in 2025[59], or €1 billion a day, putting a potential of 29 million jobs at risk, stated European commissioner Stéphane Séjourné[60].

Europe is directly threatened by China's industrial capacity. The very situation Maurice Allais warned would arise under limitless free trade sixty years ago. The Single Market is ripe for the picking. The task is therefore twofold: remove the internal barriers that hold European firms back, while building an external perimeter high enough to equalise the playing field without tipping into outright protectionism all the whilst deepening industrial and financial integration (Banking Union, the Savings and Investments Union) that would give European firms the scale to compete.

5.1.2 Allais's early warning: open the European market, but don't offer it up

The intellectual roots of European preference long predate the current regulatory debate. Maurice Allais, French recipient of the Nobel Prize in Economics (awarded in 1988), was one of its most consistent and prescient advocates. His trajectory on this question is, however, frequently misunderstood. Allais began as a convinced European federalist: in his 1960 work *L'Europe Unie, route de la prospérité*, he championed the removal of internal tariff barriers and the free movement of goods, capital and persons between Member States,

57. International Monetary Fund. (2025). Europe needs to build on its Single Market to boost growth. IMF Regional Economic Outlook / staff analysis.
58. China-EU – international trade in goods statistics. Eurostat, Statistics Explained.
59. *Ibid.*
60. Johnston, I. (2026, May 28). EU to broaden import quotas and tariffs against China. Financial Times.

viewing economic integration as a precondition for prosperity. Yet his position evolved substantially from the 1970s onwards. As global trade liberalisation accelerated, Allais grew increasingly alarmed at what he saw as the perverse consequences of unrestricted openness to economies operating under radically different cost structures. He attributed the persistent rise in European unemployment directly to the liberalisation of trade with low-wage countries, arguing as early as 1974 that competition from economies where wages were a fraction of European levels amounted to an unfair structural distortion, one that conventional comparative advantage theory failed to account for.

For M. Allais, the solution was not autarky, but what he termed reasonable protection: a moderate external tariff shield allowing Europe to maintain the conditions for a genuine internal free market whilst preserving its social model and industrial base. He was explicit that European preference should not be confused with protectionism in the pejorative sense. As S. Rakotoarison[61] noted, Allais believed the European Community had an obligation to protect its economic security, "not by establishing itself as a fortress, but by surrounding itself with a reasonable level of protection." He also insisted that monetary union and political union had to advance in parallel. The error, in his view, was that the Maastricht Treaty had locked in economic convergence without the political architecture to manage its consequences. On this basis, he criticised the Treaty in 1992 not out of hostility to European integration, but because he feared the monetary union was being constructed on foundations that would generate exactly the kind of economic fragmentation this paper describes.

Despite drawing criticism from many a commentator, his warnings in hindsight about the social consequences of unchecked trade liberalisation, and the need for political integration to precede monetary union, appear accurate. The situation described in the preceding section, namely a European market open to an industrial competitor operating under fundamentally different rules is, in many ways, the precise outcome he spent decades warning against.

5.1.3 A shift in economic doctrine occurred in the 1980's and contributed to the current situation

Antonin Bergeaud explains in his book La prospérité retrouvée the reasons behind Europe's current industrial weakness. According to the author, the success of post-war European industrial policy rested on "an effective articulation between three elements[62]": a highly qualified scientific workforce, a long-term logic of major strategic projects, and clear public leadership, often expressed through public procurement. This combination helped create the conditions for the emergence of internationally competitive industries and technological capabilities across a range of sectors.

The author argues that a decisive shift occurred during the 1980s. In his account, "the famous policies of national champions gradually disappeared in favour of horizontal policies centred on the single market, deregulation and the promotion of competition[63]." This evolution reflected the growing influence of liberal economic ideas and an increasingly widespread belief that governments were poorly positioned to direct industrial development. The role of public authorities consequently evolved away from sector-specific intervention and toward the maintenance of a neutral legal framework, market openness, and support for generic research activities. Industrial restructuring was expected to follow market signals rather than strategic public direction.

This transformation was, in the author's view, reinforced by European integration itself. He argues that "the construction of Europe contributed to reinforce mutual distrust between Member States and delegitimising any attempt at coordinated industrial policy[64]," often because such initiatives were perceived as disguised instruments for advancing national interests. This climate of distrust encouraged the development of European rules that strictly limited state intervention in the economy. Under Article 107 of the Treaty on the Functioning of the European Union, state aid is in principle prohibited unless it falls within narrowly defined exceptions and receives approval from the European Commission. As a result, governments found it increasingly difficult to provide large-scale support to firms or sectors deemed strategically important without demonstrating a broader objective of common European interest[65].

The author acknowledges that this approach helped modernise the business environment and preserve competition within the European market. However, he contends that it also led to "a gradual abandonment

61. Maurice Allais, protectionniste raisonnable et physicien d?raisonnable. (2010, October 19). AgoraVox. https://www.agoravox.fr/actualites/economie/article/maurice-allais-protectionniste-83095
62. Bergeaud, Antonin. La prospérité retrouvée : les leviers de la croissance au XXIe siècle. Paris : Odile Jacob. 2026. p.105.
63. Bergeaud, op. cit., p.108.
64. *Ibid.*
65. Bergeaud, op. cit., p.109.

of any structured industrial strategy[66]." The decision of the European Commission to block the proposed merger between Alstom and Siemens is presented as a particularly illustrative example. Although the companies argued that the merger would create a European "Airbus of rail" capable of competing with major Chinese firms, competition concerns ultimately prevailed.

More broadly, the author argues that the European Union adopted what might be described as a predominantly negative conception of public intervention in the economy. Public authorities were expected primarily to correct market failures rather than define long-term technological or industrial priorities. Within this framework, support was largely confined to fundamental research and "pre-competitive" innovation, upstream from commercial deployment and often weakly connected to concrete industrial objectives. In the author's assessment, this orientation ultimately resulted in chronic underinvestment in industrial capabilities, fragmented initiatives across national and European levels, and the absence of a common governance structure capable of carrying major strategic projects.

The consequence of such policies today is that European industry is playing by fundamentally different rules to that of China. European industrial policy remains in the hands of Member States. The EU may promote coordinated initiatives and set up additional funds, but it does not have the authority to create and pursue a unified industrial policy. It is neither legally able to territorially plan industrial capacity, nor promote and subsidise industrial efforts that could be considered of European sovereign interest. Whilst industrial planning and development relies nearly entirely on market efforts in the European Union, China plays an active role in setting national priorities and developing industrial capacity.

5.1.4 Europe's cautious turn towards preference

The current European preference debate is, in many ways, an institutional recognition of the concerns Allais first articulated half a century ago. On 4 March 2026, the Commission put forward a regulation proposal titled the "Industrial Accelerator Act" (IAA), which is intended to enshrine the concept of European Preference into European law. While the proposal marks a significant shift in the Union's economic approach its effectiveness will likely be hampered by persistent divergences between Member States.

The European Commission has nonetheless taken a cautious step forward. In her 2025 State of the Union address, Commission President Ursula von der Leyen formally committed to introduce "made in Europe" criteria in public procurement. This represents a significant departure from the Union's traditional posture of non-discrimination and open competition. This commitment was formalised in the Single Market Strategy adopted in May 2025, and subsequently anchored in a concrete legislative initiative: the IAA, published on 4 March 2026, with key material procurement provisions targeted to apply from 1 January 2029.

Concretely, European preference reshapes the incentive framework when granting subsidies or awarding public contracts in certain strategic sectors. The IAA is not a protectionist instrument in the traditional sense. It does not outright prohibit non-European firms from bidding on public contracts. Rather, it incentivises public authorities to favour firms operating in Europe that respect certain selected criteria. In this sense, it bears a closer resemblance to the "reasonable protection" Allais advocated: not a fortress, but a selective and calibrated tilt of the playing field in favour of European producers.

5.2 European Preference, a first attempt at addressing industrial decline

5.2.1 The IAA legislative proposal seeks to fulfil four key objectives

The IAA in its current version would only apply to selective industries. The Commission has chosen to support industries that are in its view currently facing significant competitiveness pressures. These mainly include energy-intensive manufacturing (steel, cement, aluminium, chemicals), "net zero" technologies and the creation of automobile components. There are multiple strategic reasons that underpin the Commission's thought process.

First, there is an urgent imperative to reduce strategic dependencies. The Commission has come to recognise, in the wake of the Covid-19 crisis and the energy shock triggered by Russia's invasion of Ukraine, that many of its industries are acutely reliant on foreign suppliers at some point in their value chain. This is particularly acute in defence and in clean energy technologies, sectors where supply disruption carry more than mere economic consequences.

Second, a need to support the clean transition. Public procurement represents a significant share of demand in sectors central to decarbonisation, such as energy, transport, and infrastructure. By favouring suppliers that meet higher environmental

66. *Ibid.*

standards, the EU can reduce the carbon footprint of public spending while creating incentives for firms across the value chain to invest in cleaner production processes.

Third, the IAA is a response to the asymmetric competitive conditions that European producers face vis-à-vis their American and Chinese counterparts. The United States Inflation Reduction Act of 2022 introduced massive subsidies and preference rules for US-made clean energy products, directly disadvantaging European manufacturers. China operates a fundamentally closed procurement system in many sectors, with European firms facing systematic discrimination. As the IAA's proponents (notably France) have argued: what Europe is proposing is not exceptional; it is simply what others are already doing.

Fourth, the EU is pursuing an objective of reindustrialisation. The current ambition is to raise manufacturing's share of EU GDP from around 14.3% today to approximately 20% by 2035. In this context, instruments such as public procurement are seen as demand-side levers to stabilise and expand industrial production within Europe, by providing predictable markets for firms operating in strategic sectors.

5.2.2 The IAA will affect public procurement by implementing Union-origin rules in certain key sectors

In its current proposed form, the IAA would introduce minimum requirements relating to "low-carbon" production and, in certain cases, to "Union-origin" content for products benefiting from public support or procurement. These requirements are calibrated differently across the three sectors identified below.

In energy-intensive industries – including steel, cement, aluminium, chemicals and related materials – contracting authorities would be required to allocate a defined share of procurement to a minimum share of "low carbon" products. The proposal envisages thresholds in the order of 25% for steel and aluminium. For materials such as cement and concrete, lower initial thresholds (around 5%) are combined with Union-origin requirements. For net-zero technologies, such as solar photovoltaic systems, wind turbines, batteries, heat pumps and electrolysers, the mechanism operates primarily through component-based origin requirements. Projects benefiting from public funding would need to incorporate a minimum number of key components manufactured within the Union, with the requirement tightening over a transition period of several years. In the automotive sector, and in particular for electric vehicles, vehicles would need to be assembled within the Union and meet a minimum share of EU-origin value, estimated at around 70% of the ex-works price, excluding certain components in the early stages[67].

5.2.3 Early disagreements and diverging interests between Member Sates risk watering down the proposal

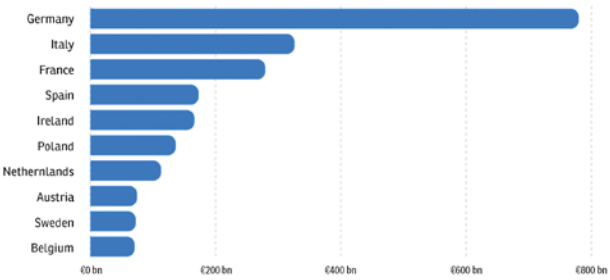
The discussions surrounding the European preference proposal have not been smooth. There have been over 40 draft versions of the IAA, generating heated debates both within the Commission and across the EU-27. The fault lines that have emerged in this debate are, fundamentally, a reflection of the same divergences that run through this paper as a whole.

The leading advocate for European preference has consistently been France, whose industrial tradition and longstanding commitment to strategic autonomy make it a natural champion of the concept. Paris has pushed for a strict "Made in EU" interpretation of origin rules, to maximise direct support for European production and employment. Opposition, however, has been significant and comes from structurally different directions. Export-oriented industrial economies, such as Germany, the Netherlands, and to a degree the Nordic states, are the most reluctant. Their concern is straightforward: as large exporters to the United States, Asia and beyond, they fear retaliatory measures if the EU is perceived to be closing its own procurement markets. Germany has argued for a "Made with EU" model that would include trusted trade partners. This approach would significantly dilute the preferences France is pushing for.

Smaller Member States without significant domestic industrial bases (many Eastern European countries, the Baltic states) face a distinct concern. For them, the risk is not retaliation but supply contraction: if European preference criteria reduce the pool of eligible suppliers, these states may find themselves with fewer options, higher costs, and reduced access to best-in-class technology. They have no domestic champions to protect, and their interests lie in keeping procurement markets as open and competitive as possible. These divisions echo the EU–Mercosur debate, with France favouring strong internal preference and protection, while Germany and other export-driven states push for openness and broader market access.

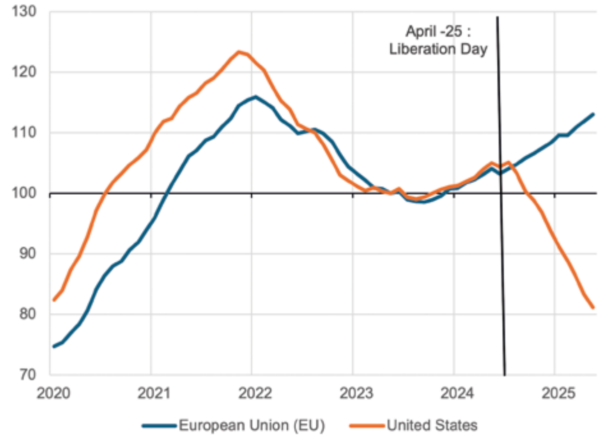
67. Industrial Accelerator Act Proposal, COM(2026) 100 final. See the summary table in the Annexe of this paper.

CHART 2.
Manufacturing value added in the EU by country
Estimated manufacturing gross value added for selected EU countries



Source : Eurostat national accounts / ESTAT nama 10_a_10 dataset values in € billions

CHART 3.



Source: Ekonomics, *based on IMF data*

5.2.4 A firm step forward, yet insufficient on its own

The Industrial Accelerator Act is a step in the right direction, and it should be recognised as such. It represents a meaningful, if cautious, advance: a first institutional acknowledgement that Europe must act if it is to remain an industrial power, and that the European Union can bring added value by acting on a supranational level. Yet its impact risks being significantly undermined by the timeline of its implementation. With full entry into force only scheduled for 2029, and given the Union's well-documented tendency toward delays, its effectiveness may be substantially diluted in practice. In the context of Europe's relative industrial decline and the increasingly urgent need for reindustrialisation, such a protracted timeline is difficult to justify.

Yet it would be a serious mistake to treat the IAA as a solution to the challenges facing European industry. The underlying problems run deeper than procurement rules can address. Industry represents an ever-decreasing share of European GDP, and European firms struggle to attract capital in a business environment still characterised by high tax burden, regulatory complexity, and energy costs that remain structurally elevated compared to American and Chinese competitors. The urgency, therefore, is not only to deploy instruments like the IAA, but to mend public finances and return to the path of economic convergence – the product of decades of divergence and the absence of the political union which was a prerequisite for sustainable integration, as underlined by M. Allais. A strong European Union cannot be built on weak Member States.

5.3 China: industrial competition, strategic dependence and the limits of European coordination

5.3.1 China enters potential trade negotiations from a position of considerable strength

Over the past quarter century, China, as the "factory of the world", has risen to become a core trading partner of the EU, while simultaneously emerging as one of the principal competitors of European industry. When Washington imposed tariffs of up to 145% on Chinese goods in April 2025, it contributed to a partial redirection of Chinese goods from the US to the EU. Despite the October 2025 truce, US tariffs ran at an average of roughly 34%, which is more than ten times the 2-3% rate Europe applies to Chinese goods[68]. Recent trade data are consistent with a partial redirection of exports: Chinese exports to the United States fell by approximately 20% over the course of 2025, whereas exports to the European Union increased by around 8%. This shift cannot be attributed solely to US tariffs, however. It also reflects China's considerable production capacity and the growing efforts of Chinese firms to expand their presence in international markets.

5.3.1.1 A case study of Chinese industrial strength: the automobile industry

The automotive industry illustrates this dynamic vividly. China-made vehicles accounted for 6.4% of EU car sales in 2025. In 2005, China accounted for 8% of global automobile production; twenty years later, that share had reached 41% China exported over 922,000 passenger cars to Europe in 2025, up 29% year-on-year[69]. The speed of this advance is

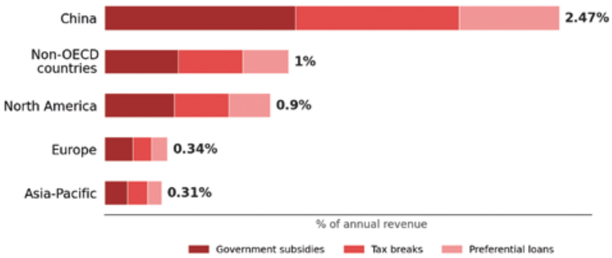
68. World Trade Organization. (2025). WTO Tariff and Trade Data.
69. Reuters Staff. (2026, June 2). China's carmakers expand their presence in Europe. Reuters.

without contemporary precedent: unlike Japanese or Korean carmakers, Chinese firms are entering simultaneously, at massive scale, and with the full backing of state industrial policy. In 2025, close to 20% of EVs sold in Europe were built in China[70]. This rapid increase in imports of China-made electric vehicles is partly connected to the substantial gap between China's domestic sales and its total production capacity. Chinese domestic car sales amounted to approximately 23.9 million vehicles, compared with estimated production capacity of up to 50 million vehicles. Although estimates of overcapacity vary, this imbalance creates a strong incentive for manufacturers to develop export markets[71].

China's industrial advance cannot be attributed solely to state support. It also reflects the scale of its domestic market, highly integrated supply chains, rapid innovation cycles and intense competition among Chinese producers. Public intervention has nevertheless accelerated this development and reinforced China's position in several strategic industries.

National subsidies also have a role to play in the dominance of Chinese industry. According to OECD data, Chinese industrial subsidies (direct grants, tax relief and preferential-rate loans) averaged around 2.5% of company revenue across strategic sectors between 2004 and 2025, against roughly 0.9% in North America and just 0.34% in Europe[72]. Chinese firms therefore compete in the European market while benefiting from a level and combination of state support that European producers generally cannot access on comparable terms. Such assistance does not entirely explain their competitiveness, but it reinforces their ability to invest, increase production and absorb lower margins during periods of international expansion.

CHART 4.
Massive public support for Chinese companies
Industrial subsidies* received between 2005 and 2024, as % of annual revenue



** Average for 15 key industrial sectors, by location of company headquarters*
Source: OECD

5.3.1.2 China plays by its own rules: the WTO framework is facing growing challenges

Europe increasingly finds itself trapped between a rules-based ideal and a geopolitical reality in which the rules no longer inhibit the major powers' ambitions. The paralysis of the WTO dispute settlement system since 2019 has hollowed out the enforcement mechanism that once underpinned confidence in multilateral trade governance. At the same time, China's economic model has moved further away from the liberal assumptions embedded in the WTO framework. The WTO's own 2024 Trade Policy Review noted growing state encouragement for import substitution in high-tech sectors, while the US Trade Representative's 2024 report characterised China's approach as a "predatory" non-market system that mobilises state power to secure dominance in strategic industries. Europe continues to anchor its industrial policy within multilateral trade rules, while China's economic model exposes the difficulty of applying disciplines designed for a less state-directed global economy.

5.3.1.3 Rare earths: China's leverage in the trade war

In the context of growing global trade tensions, China's dominant position in critical raw-material supply chains gives Beijing significant economic leverage and could influence the final design of the IAA's provisions on foreign investment. China extracts around 60% of global rare earth elements, separates and processes around 90% of them, and manufactures around 94% of the magnets containing rare earths used in clean energy, electric vehicles, and a wide range of other industries. For Europe, the exposure is almost total: the EU sources 98%[73] of its rare-earth magnet demand from Chinese suppliers, with similar dependencies extending to magnesium, gallium, and germanium – metals vital for semiconductors and defence technologies. Economists at the European Central Bank estimate that over 80% of large European firms are no more than three intermediaries away from a Chinese rare earth producer. In response to US tariffs, and citing national security grounds, Beijing introduced two waves of export controls on rare earth elements in April and October 2025. When Beijing tightened export licences, magnet exports to Europe fell by three-quarters, forcing several European carmakers to halt production. The second wave has since been suspended until November 2026.

70. Kana, I. (2026, May 22). The European cars made in China. Financial Times. (Draft figure: reconcile the 19% in the source with the 20% cited in the plan).
71. *Ibid.*
72. OECD, Quantifying industrial subsidies, cited in Les Echos.
73. Draghi, M. (2024). The future of European competitiveness Part A. European Commission.

These measures highlight how the existing concentration at critical stages of production can give the dominant supplier the capacity to use export restrictions as an instrument of economic pressure. European industrial resilience therefore requires not complete self-sufficiency, which would be unrealistic, but greater diversification, strategic inventories and the development of alternative processing capacity.

5.3.1.4 The cost of inaction could erode the last of Europe's industrial capacity

In S. Keynes' view[74], China's huge export machine is not just producing cheap goods for European consumers, it is also weakening Europe's industrial base, particularly in Germany, where manufacturing output has struggled as Chinese exports have surged. Keynes argues that this creates several risks at once: the loss of industrial jobs, greater dependence on Chinese supply chains, and a reduced ability for Europe to scale up production in a geopolitical or military crisis. For that reason, tariffs are increasingly being viewed not simply as protectionism, but as tools to reduce overdependence and encourage companies to diversify supply chains. She also acknowledges the downsides – higher prices, disruption for businesses, and the risk of Chinese retaliation – but argues that refusing to act may ultimately make the European economy weaker and more vulnerable to coercion in the long run.

5.3.1.5 The European Union wishes to achieve meaningful advances on the dossier by October 2026

The IAA does not arrive on a blank page. Faced with the surge in Chinese imports, the Union has already deployed a handful of conventional trade-defence instruments. The clearest example is the automotive sector. In October 2024, following a thirteen-month anti-subsidy investigation, the Commission imposed definitive countervailing duties on Chinese-made battery electric vehicles, on the grounds that the Chinese EV (electric vehicle) value chain benefited from unfair state subsidies[75]. These duties are levied on top of the standard 10% car tariff and vary by manufacturer according to the degree of subsidy and cooperation: 17.0% for BYD[76], 18.8% for Geely, and 35.3% for SAIC[77], with a 20.7% rate for other cooperating producers and 7.8% for Tesla vehicles exported from China[78].

Set against comparable measures elsewhere, these rates are strikingly moderate. The United States quadrupled its tariff on Chinese EVs from 25% to 100% in 2024; Canada matched the 100% figure the same year[79]. Even at the top of the EU's range, a SAIC vehicle faces a combined duty of around 45% which is less than half the American and Canadian rate. Rhodium Group analysts had estimated that duties would need to reach 40–50%, and higher still for vertically integrated manufacturers such as BYD, merely to offset the Chinese cost advantage; the definitive 17% imposed on BYD falls well short of that threshold. The measures were also politically fraught: when Member States voted in October 2024, only ten backed the Commission, twelve abstained, and five – including Germany – voted against, wary of Chinese retaliation against their own exporters. Beijing duly retaliated, opening anti-dumping investigations into EU brandy, pork and dairy that targeted France, Spain, the Netherlands and others. The European response – imposing tariffs on Chinese battery-electric vehicles in 2024 – has had a real but limited effect. Chinese manufacturers simply pivoted toward plug-in hybrids, which are not subject to the taxes.

The episode illustrates the central difficulty facing European trade policy. The economic benefits of protection and the costs of retaliation are not distributed evenly among Member States. Countries with substantial automotive exports to China assess the risks differently from those whose industries compete directly against Chinese imports. A common instrument therefore produces different national calculations even before it is implemented.

Beyond the automotive file, the Union has tightened its defences elsewhere. A new Steel Overcapacity Regulation, in force from 1 July 2026, cuts tariff-free import quotas by roughly 47% relative to 2024 levels and doubles the out-of-quota duty from 25% to 50%, explicitly to counter global overcapacity and the trade diversion that follows from restrictions imposed in other markets[80]. Yet even here the direct effect on China is limited, precisely because years of pre-existing anti-dumping and countervailing duties have already compressed direct Chinese steel exports to the EU to only 3–5% of China's total flat-steel exports.

74. S. Keynes. (2026, May 28). Why Europe must embrace tariffs. Financial Times.
75. Commission Implementing Regulation (EU) 2024/2754 of 29 October 2024. See also: EU imposes duties on unfairly subsidised electric vehicles from China. European Commission, 29 October 2024.
76. Chinese automobile manufacturer.
77. Chinese automobile manufacturer.
78. Commission Implementing Regulation (EU) 2024/2754; S&P Global Mobility (2024); Cleary Foreign Investment and International Trade Watch (October 2024).
79. The European Union's countervailing duties on electric vehicles from China: disputes and prospects (2025); on the US Section 301 review of May 2024 and Canada's October 2024 measure.
80. Regulation (EU) 2026/1384; Council of the EU press release, 13 April 2026; Crowell & Moring client alert, July 2026.

5.3.1.6 China has a colossal investment footprint In the EU and the IAA is the EU's attempt to combat it

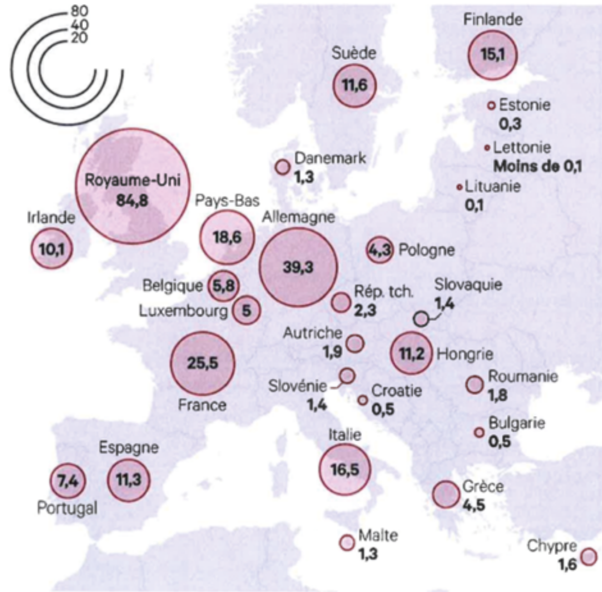
The challenge is not limited to trade flows. On the investment side, Chinese FDI into Europe rose 67% in 2025 to reach €16.8 billion, with Europe absorbing nearly a quarter of all Chinese outbound investment globally, much of it directed at precisely the technology and infrastructure sectors that European policymakers are now trying to protect[81].

Such investment creates a complex policy dilemma. Chinese investment can bring capital, employment and additional production capacity to Europe. At the same time, local assembly does not by itself ensure that technological control, research activities, key components or high-value decision-making are located within the Union. A purely geographical "Made in Europe" criterion could therefore be satisfied without significantly reducing Europe's underlying technological dependence.

The Commission's answer to the industrial imbalance is embedded in the IAA. Beyond the reforms to public procurement rules, the IAA proposes a targeted foreign direct investment screening. The IAA would explicitly limit foreign ownership and investment in critical industries, such as battery technologies, electric vehicles, solar photovoltaic technologies and critical raw materials. More specifically, large foreign investment tickets (circa €100 million) coming from countries that control over 40% of a critical industry's global capacity would require additional authorisation from public bodies[82]. The purpose of the IAA is therefore to ensure that investments benefiting from access to the European market contribute meaningfully to European industrial capacity rather than functioning primarily as final-assembly operations dependent on imported technology and components. The logic behind this measure is straightforward: procurement rules alone are insufficient because they can be circumvented through ownership. Indeed, a Chinese firm that acquires or establishes a European production facility would satisfy "Made in EU" origin requirements while preserving full industrial and technological control. The IAA's FDI provisions are designed to close that loophole.

Beijing's response was swift and unambiguous. On April 24, 2026, China's Ministry of Commerce declared that the IAA's restrictive requirements on foreign investment and "EU-origin" clauses constitute significant investment barriers and institutional discrimination[83]. The Ministry officially expressed concerns and openly threatened countermeasures should the EU adopt the draft law unchanged. Beijing's specific legal objection is that by subjecting countries with more than 40% of global production capacity to stricter rules, the IAA creates a discriminatory category that effectively targets China and China alone, in violation of the WTO's most-favoured-nation principle. This dispute illustrates a broader institutional problem. Measures designed to respond to extreme concentration in strategic sectors will often have a disproportionate effect on the country responsible for that concentration. The EU must therefore demonstrate that its criteria are objective, proportionate and linked to identifiable economic-security risks rather than to the nationality of investors alone.

CHART 5.
Chinese Investment in Europe
Cumulated Chinese FTI, by country, in €bn, between 2000 and 2025



** Only transactions above 5 million dollars are taken into account.*
Sources: Les Echos (2026), Rhodium Group

The irony, noted by EU Trade Commissioner Šefčovič, is that the WTO rules Beijing is invoking were written in 1995 for a world that no longer exists.

5.3.1.7 Complementary tools to the IAA

The IAA is only one component of the nascent European strategy. Beyond foreign investment screening and procurement restrictions, the Commission is also examining more direct instruments. Internal discussions have reportedly

81. Chinese investment rises to 7-year high – Chinese FDI in Europe: 2025 Update. (2026, May 20). Merics.
82. Industrial Accelerator Act Proposal, COM(2026) 100 final, Chapter IV, Arts. 17–21.
83. MOFCOM Spokesperson's Remarks on the EU's Proposed Industrial Accelerator Act. (2026). Mofcom.gov.cn.

considered requiring supplier-dependent firms in strategically sensitive sectors to diversify their sourcing: companies could be required to source critical inputs from at least three distinct suppliers, while capping purchases from any single provider at roughly 30 to 40 per cent of total supply[84]. In parallel, the Commission is seeking to mobilise the EU's network of more than seventy free trade agreements to deepen industrial partnerships and redirect investment towards alternative supplier countries, and has floated using existing safeguard mechanisms and tariff-rate quotas more aggressively by reallocating preferential access towards "trusted partners"[85].

This approach reflects a broader shift from complete autonomy towards "de-risking": the objective is not to sever economic relations with China, but to reduce excessive concentration by constructing a more diversified network of suppliers and industrial partners. Such a strategy also underlines the importance of defining which countries qualify as trusted partners and what degree of reciprocal market access Europe should require in return.

Alongside these proposals, the Commission wishes to reexamine the current merger guidelines in order to take into account geopolitical realities. Historically, the Commission's assessment focused primarily on the European dimension of competition, often overlooking global market dynamics – the approach that led it to withhold authorisation for the Alstom-Siemens merger, aimed at ensuring the ability to rival the Chinese giant CRRC. The case illustrates the tension between two legitimate objectives. Competition policy seeks to protect European customers against excessive market concentration, while industrial policy increasingly seeks to create firms of sufficient scale to compete against state-supported global rivals. A revised framework could give greater weight to innovation, future market developments, global competition and economic security without assuming that every cross-border merger automatically serves the European interest. Considering the economic threat posed by China, a reviewed guideline on mergers could be conducive to the creation of more European Giants. Commission President von der Leyen explicitly stated last February[86] that the EU needs more "champions". Whilst the current Director-General of DG COMP – the Irishman Anthony Whelan – appears close to Ursula von der Leyen and thus more likely to favour European Champions, given the leeway afforded to the authorities in interpreting and applying the text, no one can be certain how effective this impetus will be.

Negotiations enter a decisive phase as Member States remain divided over the appropriate responseThese structural instruments are being assembled against the clock. In July 2026, the EU and China launched a China–EU Trade and Investment Consultation Mechanism, with Trade Commissioner Maroš Šefčovič setting an October 2026 deadline for "tangible results" on the three issues Brussels considers most pressing: the bilateral trade imbalance, Chinese export controls on critical raw materials, and intellectual-property protection[87]. Analysts remain sceptical that Beijing has offered any binding commitment, and the mechanism risks becoming a forum for managing tensions rather than resolving them.

The Union has nonetheless paired dialogue with concrete action. The steel measures already described (the 47% quota cut and the 50% out-of-quota duty in force from July 2026) are the clearest example of trade defence rather than mere talk. But the more revealing development concerns European unity, or the lack of it. In the run-up to these measures, five Member States (France, Spain, the Netherlands, Italy and Lithuania) pushed for a tougher line against China. Germany declined to cosign, calling instead for deeper industrial ties with Beijing[88].

Germany's position should not simply be interpreted as a refusal to defend European industry. It reflects the structure of an economy whose major industrial firms remain deeply dependent on exports, and supply chains linked to China. Measures likely to provoke retaliation consequently impose particularly visible costs on German manufacturers. France and several other Member States, by contrast, place greater emphasis reducing strategic dependencies and preserving the Union's capacity to act independently.

This is the same structural pattern identified throughout this paper. On issues where a united European position would carry the greatest weight, divergent national economic models produce divergent assessments of the costs and benefits of collective action.

The challenge posed by China therefore confirms the broader argument developed throughout this paper. The European Union has progressively equipped itself with trade-defence instruments,

84. Bounds, A. (2026, May 18). EU plans to force companies to buy parts from non-Chinese suppliers. Financial Times.
85. *Ibid.*
86. Statement by President von der Leyen with President Costa following the informal EU leaders' retreat. (2026). European Commission.
87. (Draft placeholder - to be finalised with a primary source closer to drafting, as this is the most fast-moving material in the section).
88. (Draft placeholder - to be finalised with a primary source, e.g. Financial Times/Politico reporting on the five-state démarche.

investment conditions, procurement criteria and policies intended to reduce strategic dependencies. Yet the effectiveness of these instruments remains constrained by divergent national economic interests. Member States do not assign the same weight to industrial sovereignty, consumer prices, export access or the preservation of commercial relations with Beijing.

As economist Céline Antonin puts it: "Faced with this reality, three urgent priorities present themselves to Europe. The first: to articulate trade policy with industrial policy. Tariffs are only a useful tool if they accompany an offensive strategy to upskill in electric and software technologies. The second: to make Sino-European industrial agreements conditional on genuine reciprocity. The third: to give itself a clear horizon. China has just adopted a five-year plan for 2026–2030, while Europe still debates whether to maintain the 2035 deadline for electric vehicles."

6. Europe's Missed Revolutions: From AI to Robotics

Europe is falling behind in several of the technologies that are increasingly determining economic competitiveness, industrial leadership and strategic power. This is not the first time the Union has struggled to convert scientific excellence into firms capable of competing at global scale. As the United States and China consolidate their positions across computing infrastructure, foundational AI models and industrial applications, Europe risks becoming increasingly dependent on technologies designed, financed and controlled elsewhere. Financing is as much part of this challenge as technological capability itself: deep and integrated capital markets are indispensable if innovative firms are to grow from laboratory breakthroughs into globally competitive companies.

6.1 Europe is losing the AI race due to less R&D spending and fewer financing opportunties

6.1.1 A widening R&D and investment gap between Europe and its economic rivals

The most straightforward measure of Europe's lag is investment. Although the following figures refer to overall research and development expenditure rather than AI-specific investment alone, they provide a useful indication of the resources available to sustain technological innovation. American dominance in R&D is overwhelming, China's spending is growing rapidly, while Europe has progressively fallen behind. In 2024, R&D expenditure represented approximately 3.5% of GDP[89] in the United States, 2.7% in China and only 2.1% in the EU-27.

According to CaixaBank Research[90], the United States accounts for around two-thirds of the world's AI-related computational capacity, while China accounts for roughly 20%. The European Union accounts for just 5%.

This investment gap translates directly into technological output. Between 2021 and 2025, the United States produced 331 notable AI models, China 108 and the European Union only 44. The United States hosts approximately 5,427 data centres compared with 1,461 across the EU. These figures should nevertheless be interpreted with caution, as the number of data centres does not necessarily reflect the amount of computing power available. Increasingly, competitive advantage depends on access to hyperscale facilities equipped with advanced AI accelerators rather than on the simple number of installations.

Europe's greatest weakness lies not in semiconductor manufacturing as a whole, where firms such as STMicroelectronics, Infineon and NXP remain globally competitive in several market segments, nor in semiconductor equipment, where ASML occupies a world-leading position. Rather, Europe is almost entirely absent from the design of the most advanced AI accelerators and high-performance graphics processing units (GPUs), which have become the critical hardware underpinning frontier artificial intelligence. Europe retains a strong scientific base, with AI publications broadly comparable to American levels on a per-capita basis, but it continues to struggle to translate scientific excellence into industrial leadership and globally competitive firms.

6.1.2 The gap exists as much in financing as it does in research

The shortfall is not confined to public R&D spending. European venture capital deployed €66.2 billion in 2025 – only 22% of the amount invested in the United States that year, despite the two economies being of comparable size. Between 2014 and 2023 the cumulative gap was even more striking: €89 billion invested across the EU compared with more than €1 trillion in the United States.

The disparity is particularly acute at the stage that matters most for scaling AI and deep-tech companies:

89. OECD overall R&D growth stable; government R&D budgets decline and reorient towards defence. (2026). Oecd.org. https://www.oecd.org/en/data/insights/statistical-releases/2026/03/oecd-overall-rd-growth-stable-government-rd-budgets-decline-and-reorient-towards-defence.html
90. Monthly Report. (2026, May 14). CaixaBank Research https://www.caixabankresearch.com/en/monthly-report/511/may-2026/present-and-futures-new-aiconomy

late-stage and growth financing, where the pool of large European investment funds capable of writing nine-figure cheques remains limited.

The consequence is visible at the very top of the market. As the Draghi Report on European competitiveness observed, no EU company with a market capitalisation above €100 billion has been created from scratch during the past fifty years, whereas all six American companies valued above €1 trillion emerged during the same period.

European institutional investors – notably pension funds and insurance companies, which collectively manage some of the world's largest pools of long-term savings – remain comparatively underrepresented in venture and growth capital, reflecting a combination of prudential regulation, institutional investment practices and the continuing fragmentation of European capital markets. As a result, many of Europe's most promising firms raise their largest financing rounds, list on foreign stock exchanges or are ultimately acquired outside the Union, with a corresponding transfer of intellectual property, value creation and future returns.

This financing gap illustrates one of the broader themes developed throughout this paper. Europe does not lack savings; it lacks the institutional mechanisms capable of transforming those savings into long-term investment in innovative firms. The challenge therefore concerns not only the quantity of available capital, but also its mobilisation and allocation across the Union.

6.1.3 The United States and China have developed two distinct models of technological leadership

The United States has built its leadership through a combination of structural advantages that are difficult to replicate rapidly. As CaixaBank Research notes, the country benefits from "an innovative ecosystem based on elite universities and a concentration of STEM and international research talent," complemented by sustained public support through civilian agencies such as the National Science Foundation and defence institutions such as DARPA. This ecosystem is reinforced by exceptionally large technology companies possessing substantial financial resources, global platforms and a high tolerance for risk.

Equally important, American capital markets provide abundant financing at every stage of corporate development, from venture capital to public equity markets. This allows firms not only to innovate, but also to scale rapidly while remaining headquartered within the United States.

Relatively favourable tax conditions and a regulatory environment characterised by limited intervention during the early phases of technological development have further contributed to this dynamic. The result is an integrated AI ecosystem spanning computing infrastructure, semiconductor design, foundation models and downstream applications, with American firms occupying leading positions throughout the value chain.

China has adopted a markedly different – but equally effective – model. Whereas the United States relies primarily on private entrepreneurial dynamism supported by deep financial markets, China has pursued a strategy based on long-term state coordination. Where Europe thinks in terms of fragmented value chains, China has built a complete ecosystem coordinated by the state over the long term. Artificial intelligence has been identified as a strategic national priority, with subsidies, preferential financing, tax incentives and public procurement all directed towards accelerating technological development.

As CaixaBank Research notes, China's objective is not simply to compete at the scientific frontier, but to strengthen "key links in the global industrial value chain, technological self-sufficiency and national security." This approach is particularly evident in manufacturing. China installed approximately 276,300 industrial robots in a single year, compared with 50,300 across the entire European Union and 37,600 in the United States.

China's technological rise cannot, however, be attributed solely to state intervention. It also reflects the scale of its domestic market, highly integrated industrial ecosystems, rapid innovation cycles and intense competition among Chinese firms. Public support has accelerated this process, but it has done so on the basis of an industrial system already capable of achieving substantial economies of scale.

6.1.4 Europe possesses strong scientific assets but continues to struggle with fragmentation and risk aversion

Europe's difficulties are both structural and political. The European Union possesses genuine strengths: world-class universities, internationally recognised research institutions, highly qualified scientists and a large internal market.

However, as CaixaBank Research observes, Europe suffers from "insufficient supranational coordination and limited prioritisation of its framework programmes." Its financial system remains considerably less oriented towards high-risk investment than its American counterpart, while the continuing fragmentation of capital markets limits firms' ability to scale rapidly across the continent.

Beyond financing, fragmentation also affects entrepreneurship itself. A company seeking to expand across Europe must still navigate multiple legal, tax and administrative frameworks before achieving the scale that an American firm can access within a single domestic market. Europe's difficulty therefore lies less in generating innovation than in transforming innovation into continent-wide industrial champions.

The regulatory environment may compound these structural challenges. The AI Act, while pursuing legitimate objectives relating to safety, transparency and fundamental rights, introduces obligations at an earlier stage of market deployment than the more decentralised American approach.

The issue is not regulation per se. Appropriate safeguards are indispensable if public confidence in AI is to be maintained. The challenge is to ensure that compliance requirements remain proportionate and do not discourage experimentation, investment and commercial deployment, particularly among smaller firms with limited administrative capacity. The central question is therefore whether Europe can combine effective regulation with sufficiently rapid innovation and industrial scaling.

Unlike the United States, where regulatory intervention has generally occurred ex post and remains relatively fragmented, or China, where regulation focuses primarily on politically sensitive uses while leaving industrial development comparatively unconstrained, the European Union has chosen to establish a comprehensive regulatory framework at an early stage of market development.

This approach reflects Europe's broader preference for shaping markets through regulation. While such a strategy can establish global standards, it cannot by itself compensate for lower levels of investment, fragmented capital markets or insufficient industrial scale. As in the fields of energy, defence and industrial policy, Europe has progressively developed sophisticated regulatory instruments. The central question is whether these instruments are accompanied by the financial resources, political choices and industrial concentration necessary to compete with the United States and China.

6.2 Behind the ambition of technological sovereignty, Europe remains dependant on foreign technological ecosystems

6.2.1 Europe's digital infrastructure continues to rely heavily on non-European technologies

Europe's dependency on non-European technology is pervasive. Google accounts for around 90% of European internet searches. Amazon Web Services, Microsoft Azure and Google Cloud together represent approximately 70% of cloud computing services in the European Union. Nvidia controls roughly 80% of the global market for advanced graphics processing units (GPUs), the specialised processors that have become indispensable for training and deploying frontier AI models.

These figures illustrate that Europe's dependence extends across several layers of the technological stack: digital platforms, cloud infrastructure, advanced semiconductors and computing capacity. The issue is therefore not simply one of software or hardware, but of control over the critical infrastructures on which artificial intelligence increasingly depends.

This dependence extends even into sectors where Europe has deliberately sought to strengthen its technological sovereignty. The JUPITER supercomputer, developed under the European High Performance Computing Joint Undertaking (EuroHPC JU) and frequently presented as evidence of Europe's technological ambition, relies extensively on Nvidia[91] for its computing capacity. Although the project represents a major European investment in high-performance computing, it also illustrates the continuing dependence of European public infrastructures on non-European suppliers for the most advanced AI hardware.

When Nvidia substantially increased prices for advanced AI accelerators, European public projects immediately faced higher acquisition costs, highlighting the strategic vulnerability created by dependence on a limited number of suppliers. Europe's sovereign computing ambitions therefore remain constrained by technologies largely designed and manufactured elsewhere.

6.2.2 The European Union has progressively developed instruments to strengthen technological sovereignty

As in the fields of defence, industrial policy and trade, the European Union has not remained inactive. Over the past few years it has progressively assembled an increasingly comprehensive set of instruments intended to strengthen Europe's technological capabilities.

The European Chips Act, launched with the explicit objective of increasing Europe's share of global semiconductor manufacturing to 20% by 2030, represents one of the most ambitious industrial initiatives ever undertaken by the Union.

Nevertheless, achieving this objective has proved

91. Boone, J. (2026, January 17). IA, quantique, défense... Les supercalculateurs Eviden, dernier bastion européen de souveraineté numérique. Les Echos. https://www.lesechos.fr/tech-medias/hightech/ia-quantique-defense-les-supercalculateurs-eviden-dernier-bastion-europeen-de-souverainete-numerique-2210257

considerably more difficult than initially anticipated. A 2025 audit by the European Court of Auditors concluded that the financial resources directly mobilised under the Chips Act, together with the existing governance arrangements, were unlikely on their own to place the European Union on a credible trajectory towards the 20% objective[92]. Europe's structural dependence on non-European semiconductor ecosystems therefore remains substantial.

The lesson is not that the Chips Act has failed, since its principal target remains 2030, but rather that the scale of the challenge exceeds the resources currently available under the programme.

The picture is therefore sobering – but the race is not over. As CaixaBank Research argues, artificial intelligence remains "in its early stages", and technological leadership is not necessarily determined during the first phase of a technological revolution. Europe retains internationally recognised scientific institutions, advanced industrial capabilities and a large internal market. The question is whether these assets can be mobilised sufficiently rapidly and coherently to remain competitive.

6.2.3 The Commission's response: from the Chips Act to the AI Continent Action Plan

The Commission's most recent response is the AI Continent Action Plan, unveiled in April 2025.

The strategy rests on five pillars: computing infrastructure, access to data, sectoral adoption, digital skills and regulatory simplification. It is supported by InvestAI, presented as a €200 billion mobilisation of public and private investment.

Taken together, these initiatives demonstrate that the European Union has progressively expanded its technological policy toolkit. Europe therefore does not lack initiatives or policy instruments. Rather, the question is whether these initiatives provide sufficient financial concentration and industrial prioritisation to compete with the scale of American and Chinese investments.

The infrastructure component illustrates this challenge particularly well.

Thirteen AI Factories, built around existing national supercomputers, are already operational and provide computing resources for researchers and start-ups.

The more ambitious AI Gigafactories, intended to host hyperscale computing infrastructures capable of training frontier AI models are still in the project implementation phase. More than seventy expressions of interest have reportedly been submitted by sixteen Member States, yet, more than a year after the announcement of the initiative, no final selection has been made.

This delay illustrates one of the recurring characteristics of European industrial policy. While Member States broadly agree on the objective of strengthening Europe's technological capabilities, agreement becomes more difficult when decisions require concentrating very large investments in a limited number of locations.

The Commission has subsequently complemented the infrastructure agenda with the Apply AI Strategy, designed to accelerate AI deployment across strategic sectors such as healthcare, manufacturing and defence, as well as with the Digital Omnibus Package, which seeks to simplify certain compliance obligations under the AI Act.

Taken together, these initiatives constitute a coherent framework for coordination, infrastructure development and technology diffusion. However, they remain closer to an enabling strategy than to a fully integrated industrial policy. Unlike the United States or China, the European Union has not yet combined concentrated technological priorities, large-scale new budgetary resources, sustained public demand and long-term financing around a limited number of strategic technological champions.

A further difficulty is that Europe cannot simply assume that the dominant US technology companies will behave as neutral infrastructure providers. As C. Cafarra shows[93], US tech giants have shown themselves incapable of playing "nice" over the past decades. Their business models and market power give them strong incentives to preserve dependence on their platforms and ecosystems. Regulation can constrain some of these practices, but it cannot by itself create European alternatives. The more durable response is therefore to build domestic EU capabilities and infrastructure – in cloud computing, AI, data, robotics, semiconductors and software – so that European firms and governments have credible alternatives to the US platforms on which they increasingly depend.

6.2.4 France illustrates both Europe's strengths and its structural limitations

Within the European Union, France has emerged as one of Europe's most dynamic AI and deep-tech ecosystems.

92. NEWS-SR-2025-12. (2025). European Court of Auditors. https://www.eca.europa.eu/en/news/NEWS-SR-2025-12
93. C. Caffara (2026, August, 18) "L'Europe doit commencer à reconstruire", Le Grand Continent.

It is home to Mistral AI, currently valued at approximately €6 billion and one of the very few European companies developing competitive frontier large language models. Beyond Mistral, France has also developed a particularly strong ecosystem in quantum technologies, with firms such as Pasqal, Alice & Bob, Quandela, Quobly and C12 positioning themselves among Europe's leading innovators.

Public investment has followed. Between 2021 and 2025, France committed approximately €1.8 billion through the France 2030 programme to artificial intelligence and deep technologies[94]. In May 2026 President Emmanuel Macron announced an additional €1.5 billion investment package.

These investments illustrate that several Member States are pursuing ambitious national strategies. France is not unique in this respect: Germany, the Netherlands, Sweden and others have also developed significant national programmes. The broader challenge is that these initiatives remain primarily national rather than genuinely European.

Mistral AI itself illustrates both the strengths and limitations of Europe's technological landscape. The company demonstrates that Europe remains capable of producing globally competitive firms. At the same time, its financing requirements also highlight the exceptional scale of capital now required to remain competitive in frontier AI, reinforcing the importance of integrated European capital markets capable of supporting firms throughout their growth cycle.

6.2.5 Battery gigafactories illustrate the difficulty of transforming public support into industrial scale

The development of battery gigafactories reflects many of the broader challenges confronting European technological sovereignty.

Global lithium-ion battery production capacity exceeded 2,500 GWh in 2025, with China accounting for more than three quarters of global capacity and over 80% of production. European capacity is projected to increase significantly – from approximately 238 GWh in 2025 to around 773 GWh by 2030 – but remains well below Chinese industrial scale, supply-chain integration and cost competitiveness.

Chinese battery production costs remain more than 30% lower than those observed in Europe.

The collapse of Northvolt illustrates these structural challenges. Once regarded as Europe's battery champion, the Swedish company entered bankruptcy proceedings in March 2025 after experiencing production delays, rising costs, supply-chain disruptions and changing market conditions.

Northvolt's failure should not be interpreted solely as evidence of shortcomings in European industrial policy. The company also faced firm-specific operational and manufacturing difficulties, particularly in scaling production to commercial levels. Nevertheless, the episode illustrates the extraordinary financial, technological and managerial challenges associated with building entirely new industrial ecosystems capable of competing with long-established global leaders.

Europe has not lacked public support. The European Union allocated approximately €643 million to five battery gigafactory projects, while France provided €659 million in state aid and facilitated up to €600 million in European Investment Bank financing for a single facility in Dunkirk.

These figures nevertheless remain modest when compared with the scale of public support mobilised in China or with the investment incentives created by the United States' Inflation Reduction Act.

More than half of Europe's planned battery factories are now considered at risk of delay, downsizing or cancellation.

The broader lesson extends well beyond batteries. Building globally competitive technological industries requires sustained investment over long time horizons, tolerance for failure and the capacity to continue supporting firms after initial construction. The European Union has progressively developed financial instruments to encourage these investments. Yet the effectiveness of those instruments remains constrained by fragmented financing, dispersed industrial strategies and the absence of sufficiently concentrated technological priorities. Artificial intelligence is only the first stage of a broader technological transformation. Increasingly, the strategic value of AI will depend less on large language models alone than on its integration into physical production systems, advanced manufacturing and autonomous machines. In that sense, robotics may become the next decisive test of Europe's ability to translate technological capabilities into industrial leadership.

6.3 Robotics is the next test of Europe's sovereignty

Artificial intelligence is not limited to large language models, generative applications or digital services. Its most consequential economic effects may ultimately arise from its integration into

94. Boone, J. (2026, May 22). L'Etat dégaine 1,5 milliard d'euros d'investissements dans le quantique et les semi-conducteurs. Les Echos. https://www.lesechos.fr/tech-medias/hightech/letat-degaine-15-milliard-deuros-dinvestissements-dans-le-quantique-et-les-semi-conducteurs-2232899

physical systems: factories, logistics networks, vehicles, medical devices and autonomous machines. Robotics therefore represents a natural extension of the AI revolution and a particularly important test of Europe's ability to transform scientific and industrial capabilities into technological leadership.

Unlike in frontier AI models or advanced GPUs, Europe does not enter this competition without significant assets. The continent retains internationally competitive capabilities in automotive engineering, industrial automation, machine tools, sensors, embedded systems and advanced manufacturing. European firms and research institutions therefore possess many of the industrial foundations required to compete in robotics. The strategic challenge is whether these capabilities can be combined rapidly enough with artificial intelligence, semiconductors, batteries and advanced materials before non-European platforms establish dominant positions across the entire technological stack.

6.3.1 Humanoid robotics illustrates the convergence of AI and industrial production

The development of humanoid robots capable of performing complex physical tasks in industrial environments has attracted growing interest from automotive manufacturers, logistics companies and technology investors.

Several major industrial groups are already experimenting with humanoid or mobile robotic systems in factories and warehouses. These trials remain at an early stage and should not be interpreted as evidence that mass deployment is imminent. They nevertheless indicate the direction of technological development: increasingly capable AI systems are moving from purely digital environments into physical production processes.

This shift matters because the commercial value of artificial intelligence may increasingly depend on its capacity to interact with the physical world. A firm that controls the software, computing infrastructure, sensors and operating systems used by industrial robots could acquire a strategic position comparable to that of the dominant digital platforms during the first internet revolution.

The scale of the potential market remains highly uncertain. Current estimates value the humanoid robotics market at only a few billion dollars, while some projections suggest that it could reach several tens of billions by the middle of the next decade and considerably more over longer time horizons.

Such estimates should be treated with caution. Long-term forecasts extending to 2050 depend on uncertain assumptions regarding technological progress, production costs, safety, energy consumption, labour-market acceptance and regulation. Their significance lies less in their numerical precision than in the possibility that robotics may become a general-purpose technology affecting manufacturing, logistics, healthcare, defence and household services.

As the automobile helped structure industrial development during the twentieth century, robotics could become one of the technologies around which significant parts of twenty-first-century production are organised.

6.3.2 Robotics could reinforce Europe's existing industrial strengths

This technological transition is particularly relevant for Europe because robotics is closely connected to sectors in which the continent retains a substantial industrial base.

European manufacturers remain competitive in automotive production, industrial machinery, factory automation and precision engineering. These capabilities provide a potential advantage that Europe does not possess to the same extent in consumer digital platforms or frontier AI infrastructure. Robotics may therefore represent a field in which European industrial experience can complement, rather than merely follow, advances developed elsewhere.

Europe's objective should not necessarily be to reproduce every component of the American or Chinese technological ecosystem. It could instead concentrate on areas where the interaction between AI and advanced manufacturing creates a comparative advantage: industrial robotics, collaborative robots, medical robotics, autonomous logistics, agricultural machinery and specialised systems operating in demanding professional environments.

Such a strategy would also be consistent with the structure of the European economy, which remains more industrial than that of the United States and is characterised by a large number of specialised manufacturing firms. The diffusion of robotics and AI through these firms could generate productivity gains even if Europe does not produce the world's dominant general-purpose AI model.

6.3.3 Robotics would create demand across strategic technological value chains

The importance of robotics extends beyond the production of robots themselves. Advanced robotic systems require high-performance processors, sensors, electric motors, batteries, specialised materials, secure cloud infrastructure and large quantities of industrial data.

A credible European robotics strategy could therefore create demand across several strategic value chains in which Europe is currently seeking to reduce its external dependencies. It could support investment in semiconductors, battery technologies, edge computing, industrial software and advanced materials while providing a concrete market for European research and manufacturing.

This demand-side dimension is particularly important. European industrial policy has often focused on subsidising production capacity without ensuring that firms will subsequently benefit from sufficiently large and predictable markets. Coordinated public procurement, common standards and large-scale deployment programmes in areas such as healthcare, defence, transport and critical infrastructure could provide the initial demand required to scale European technologies.

Robotics could therefore serve as an organising industrial objective rather than simply as another sector eligible for dispersed European funding. It would connect existing initiatives in AI, semiconductors, batteries and advanced manufacturing around a concrete set of applications.

6.3.4 Europe still faces important structural constraints

Europe's industrial strengths do not guarantee technological leadership. Many of the most advanced AI models, GPUs, cloud services and robotic software platforms remain controlled by American or Chinese companies.

European robotics firms may consequently become dependent on foreign suppliers for the most valuable layers of the technology, even when the final machines are assembled within the Union. As in the case of batteries or electric vehicles, geographical production alone does not necessarily amount to technological sovereignty if the software, processors, intellectual property and critical components remain controlled elsewhere.

The sector also faces the financing difficulties identified throughout this chapter. Developing and commercialising complex robotic systems requires substantial investment, long testing periods and the capacity to absorb repeated technical failures before reaching industrial scale.

These characteristics make robotics particularly dependent on patient capital. European venture-capital markets remain poorly equipped to finance companies through the long and capital-intensive transition from prototype to mass production. Promising firms may therefore face the same trajectory observed in other deep-tech sectors: early-stage research in Europe, followed by foreign financing, relocation or acquisition when substantial growth capital becomes necessary.

Market fragmentation raises an additional obstacle. Differing safety rules, labour-market practices, liability regimes and procurement procedures can make the deployment of a robotic system across several Member States more difficult. A genuinely European robotics market would therefore require not only research funding, but also common standards, regulatory coordination and cross-border demand.

The main risk is not that Europe lacks technological capabilities, but that it fails to combine them

Europe missed much of the first digital-platform revolution and is struggling to keep pace in frontier artificial intelligence. Robotics, however, remains a more open field in which the Union retains meaningful scientific and industrial assets.

The risk is therefore not simply that Europe will fail to invent competitive technologies. It is that its capabilities will remain divided among national research programmes, industrial clusters and financing systems that are individually too small to shape global markets.

A European robotics strategy would require the Union and its Member States to agree on a limited number of common priorities, concentrate resources around the strongest industrial ecosystems and create shared markets through procurement and deployment. It would also require accepting that the principal production sites and research clusters cannot be distributed equally across all Member States.

Robotics thus anticipates the political problem examined in the following section. The central obstacle to European technological sovereignty is not a lack of talent or industrial expertise, but the difficulty of making collective choices about where to invest, which technologies to prioritise and how to share the benefits of geographically concentrated success.

Artificial intelligence is the most obvious field in which Europe is facing technological competition today. Robotics may be the next. If Europe fails to connect its existing industrial strengths with AI, semiconductors and patient capital, it risks becoming dependent not only on foreign digital platforms, but also on the machines and operating systems that will increasingly organise physical production.

6.4 Europe lacks the capacity to make concentrated technological bets

The core problem is not that Europe lacks scientific talent, private savings or technological ambition. It is that the Union and its Member States remain structurally unable to transform these assets into a limited number of collective industrial priorities. France, Germany, the Netherlands, Sweden and several other Member States have developed ambitious national programmes in artificial intelligence, quantum technologies, semiconductors, batteries and robotics. Yet these programmes follow their own path, are insufficiently coordinated and remain subscale relative to the investments mobilised in the United States and China.

Frontier technologies require more than the broad distribution of research grants. They require continent-wide strategies, patient capital, large and predictable markets, and the political capacity to concentrate resources on a limited number of technological trajectories. In other words, they require the ability to choose.

6.4.1 The European Union has developed instruments, but not yet a fully integrated technological strategy

The European Union already possesses a substantial range of instruments intended to support research and innovation. These include Horizon Europe, the European Research Council, the European Innovation Council, EIC Pathfinder, EuroHPC, InvestEU, the Joint Undertakings and the Important Projects of Common European Interest.

These instruments should not be dismissed. They finance scientific excellence, support high-risk projects and have helped build European capabilities in areas such as high-performance computing, quantum technologies, hydrogen, microelectronics and batteries. The Union therefore does not lack programmes or institutions.

The difficulty is that these instruments do not yet form a coherent system capable of supporting a technological priority from fundamental research to industrial deployment and global scale. Responsibilities remain divided between the Commission, Member States, national promotional banks, private investors and multiple European programmes, each operating under different objectives, timelines and selection procedures.

The Union continues to perform most effectively in areas where it has clear legal authority: establishing common rules, coordinating national policies and distributing funds through negotiated programmes. The AI Continent Action Plan reflects this institutional logic: multiple pillars, several financing channels and a broad framework for coordination.

What it does not yet provide is a concentrated industrial strategy based on a small number of clearly defined technological missions, large-scale new resources, integrated procurement and long-term support for firms capable of reaching global scale.

The problem is therefore not simply that the Union regulates too much or spends too little. It is that regulation, research funding, industrial support, demand creation and capital-market policy remain insufficiently integrated.

6.4.2 Europe needs capabilities closer to the DARPA model

What Europe lacks is often described as a European DARPA.

The United States Defense Advanced Research Projects Agency has supported some of the most consequential technological developments of the past seventy years. Its significance lies not only in the amount of money it distributes, but in the institutional model it applies.

DARPA organises funding around clearly defined technological missions. Its programme managers are given substantial autonomy, projects are selected for their potential strategic impact, and funding can be redirected or terminated rapidly when results prove insufficient. The agency also operates within a broader American ecosystem that connects research funding with defence procurement, private investment and large domestic markets.

The European Union already possesses institutions that incorporate some elements of this approach. The European Innovation Council finances high-risk innovation, EIC Pathfinder supports emerging technologies, the European Research Council funds frontier science and the Joint Undertakings coordinate public and private investment in strategic sectors.

None of these institutions, however, fully reproduces the DARPA model. They do not simultaneously combine empowered programme managers, clearly defined technological missions, flexible contracting, the rapid termination of underperforming projects, sustained public procurement and the ability to concentrate resources over long periods on a small number of objectives.

Creating a new agency would not, by itself, resolve this problem. A European DARPA without substantial resources, political backing, procurement mechanisms and the authority to make selective choices would risk becoming another layer within an already complex institutional landscape. The objective should therefore be less to copy an American institution formally than to reproduce the capabilities that make it effective.

6.4.3 Technological leadership requires concentration rather than geographical balance

Frontier technologies exhibit strong agglomeration effects. The most successful ecosystems combine universities, specialised researchers, suppliers, testing facilities, investors and large industrial customers within a limited number of locations.

It is therefore neither economically realistic nor technologically efficient to distribute every strategic investment equally among twenty-seven Member States. An AI gigafactory, a semiconductor cluster or a quantum-computing ecosystem cannot be divided into twenty-seven equivalent national components without losing many of the benefits created by concentration.

Several European research programmes are formally based on scientific excellence rather than geographical quotas. Nevertheless, the broader political economy of EU expenditure frequently encourages broad participation, multinational consortia and a visible distribution of benefits across Member States.

These objectives are politically understandable and can promote cohesion. Yet they may conflict with the speed, scale and concentration required to compete at the technological frontier. The result is often a compromise in which resources are distributed widely enough to secure political agreement, but not concentrated sufficiently to produce global leadership.

The dilemma is therefore not simply whether Europe should spend more. It is whether Member States are prepared to support investments whose principal laboratories, factories and employment effects may be located elsewhere in the Union.

6.4.4 The gains from concentration must be made collectively acceptable

A more concentrated European technological policy would inevitably produce unequal geographical outcomes. Some regions would host the main research centres, manufacturing facilities and high-value employment, while others would benefit more indirectly.

This does not mean that the benefits must remain exclusively national. Europe could combine concentrated production with shared ownership, access and financial returns.

Projects financed through common European borrowing or a genuinely European investment fund could give all participating Member States a financial interest in their success. Common procurement could guarantee that technologies developed in one region are deployed throughout the Union. Cross-border supply chains, shared research infrastructures and open access to computing capacity could distribute some of the benefits beyond the principal host territory.

The political compromise should therefore not be geographical equality in the location of every asset, but a credible system for sharing the strategic and economic returns generated by concentrated investment.

Without such arrangements, national governments will continue to evaluate European industrial initiatives primarily through the question of where the factory, laboratory or headquarters will be located: As long as success elsewhere in Europe is perceived as a national loss rather than a shared European gain, the Union will remain unable to make the selective investments required by technological competition.

6.4.5 Fragmented capital markets reinforce fragmented industrial policy

The same fragmentation characterises private financing. European venture-capital and growth-equity markets remain substantially smaller than those of the United States, particularly for the large financing rounds required by deep-tech firms.

National institutions such as Bpifrance, KfW, the Tibi initiative and WIN provide valuable support, but they continue to function primarily as parallel national pipelines rather than components of a single continental financing market.

A European company may therefore receive early-stage support within its home Member State, but still struggle to finance industrial expansion across the Union. When the largest investment rounds become necessary, American or other non-European investors frequently provide the capital, often accompanied by pressure to relocate activities, list abroad or accept foreign acquisition.

The proposed 28th regime, or EU Inc., seeks to create a single optional European corporate status and could reduce some of the legal and administrative barriers encountered by firms operating across borders.

This would represent a meaningful step towards a more integrated entrepreneurial environment. It would not, however, resolve the underlying scarcity of large European growth funds, nor would it create by itself a unified capital market capable of financing strategic firms from laboratory research to industrial scale.

Europe has therefore built neither a fully integrated institutional system for selecting technological missions nor a sufficiently deep continental capital market for financing the firms that emerge from them. The two weaknesses reinforce one another: fragmented public strategy produces fragmented demand, while fragmented private finance limits the capacity of firms to respond at scale.

6.4.6 The principal obstacle is political rather than technical

The political obstacle is well understood. A genuinely effective European industrial policy would require directing substantial resources towards the ecosystems most capable of transforming them into technological and industrial leadership.

This means that some Member States, cities and regions would benefit more directly than others. National governments accountable to domestic electorates have little incentive to support such concentration unless they can demonstrate that the resulting gains will be shared more broadly.

The result is a recurring European compromise: a large number of priorities, programmes and participating institutions, but insufficient concentration around any one objective.

This is not merely a technical problem of programme design or a budgetary problem of insufficient expenditure. It is a problem of political convergence. Member States have not yet agreed on which technological capabilities Europe must control, where investment should be concentrated, how much risk should be accepted, or how the resulting benefits should be distributed.

The inability to answer these questions explains why European technological sovereignty often remains more declaratory than operational. The Union can announce strategies and create financing instruments, but their effectiveness remains limited when Member States continue to protect national industrial priorities and resist common decisions with unequal territorial consequences.

6.4.7 Technological sovereignty ultimately depends on Europe's capacity to choose

Artificial intelligence is the most visible test of whether the Union can overcome this pattern. Robotics, quantum technologies, semiconductors and future computing systems will present the same challenge.

Europe does not need to dominate every technological value chain. It does, however, need to identify the capabilities that are indispensable to its economic security and strategic autonomy, and then mobilise sufficient resources to build or preserve them.

That requires a limited number of clearly defined technological missions; large-scale and patient financing; closer integration between research, industrial policy and public procurement; a genuinely continental market for venture and growth capital; and political mechanisms capable of sharing the returns from geographically concentrated investment.

The technological challenge therefore confirms the broader argument developed throughout this paper. Europe does not primarily lack talent, savings or policy instruments. It lacks convergence on the strategic choices required to use them effectively.

Until Member States accept that shared strategic gains may require unequal national outcomes, Europe will remain rich in scientific expertise and financial resources but dependent on technologies financed, scaled and governed elsewhere. Such dependence is incompatible with the strategic autonomy the Union claims to pursue.

Conclusion

The European Union has demonstrated a remarkable capacity to adapt to successive crises. Confronted with challenges for which the Treaties provide only limited competences, the European Commission has progressively developed a growing number of ad hoc instruments in fields such as industrial policy, defence, energy, trade and technological innovation. While these initiatives have strengthened the Union's capacity to respond collectively, they cannot fully compensate for the absence of deeper political consensus and the widening economic divergences among Member States.

Ultimately, Europe's competitiveness and strategic autonomy will depend less on the multiplication of common instruments than on the ability of Member States to strengthen their economic, financial, industrial and political convergence. A stronger Europe requires stronger Member States, but it also requires a renewed commitment to collective action. Only by reconciling national interests with a shared European vision will the Union be able to transform its growing institutional capacity into lasting economic resilience and geopolitical influence.

No European instrument, however innovative, can permanently substitute for the economic convergence and mutual trust on which European cooperation ultimately rests.

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A formidable explosion of new or renewed inventions has been taking place for decades.

We have to acknowledge it: Europe has not been at the origin of these innovations. The train has passed without Europe moving.

In past technological revolutions – and in particular those involving the steam engine, electricity, and the telephone – Europe was at the heart of inventions and industrial achievements. The United States was certainly very active, but Europe was very much present. Yet this was a Europe that was not united: Germany, the United Kingdom, and France developed their production and investment according to their own particular strengths and capabilities.

The question that arises – and it is an uncomfortable one – is this: would Europe be more present if, as in the 19th century, it remained a Europe of sovereign states?

We must dare – as this paper does – to ask the question: is an institutionally unified Europe a better vehicle for innovation? The reader of this paper will judge for themselves, but the diagnosis is not optimistic.

If we want – and there are many good reasons to do so – to maintain the European approach, because unlike the steam engine, interconnection is now at the heart of success, and breakthrough innovations are extremely costly, then states must change their attitude. The paper above sets out the direction that should be taken.

Will we be capable of doing so? That is the fundamental question being raised. But generalizations and additional European funding are not the key to the problem. The key is to accept the concentration that is inherent in the existence of large companies in innovative sectors.

We have shown that we are capable of successfully competing with Boeing in the aerospace sector – but we did so outside the European institutions. Why, then, should we not be capable of creating Airbuses for artificial intelligence, robotics, the Internet, etc.?

Why not?

The reader of this paper will find no valid reason to conclude that we are incapable of doing so. But we need to change our mindset.

If we fail to make the fundamental changes required by this new economy, we will continue to lose ground year after year.

Notes

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