EconPol Update

One year after Draghi's wake-up call

Europe between meeting the challenge and hitting snooze

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Draghi in Rimini: Transforming Europe from a spectator into a protagonist.

One year ago, Mario Draghi presented his **Report on the Future of European Competitiveness**, offering a comprehensive analysis of the main challenges and concrete recommendations for action. In response, the European Commission launched its **Competitiveness Compass** as an economic policy agenda with a special focus on closing the **innovation gap**, streamlining **red tape**, removing **internal market barriers**, reducing one-sided **dependencies**, driving **decarbonisation**, and deepening **capital markets**. Since then, **geo-economic fragmentation** has intensified, and **geopolitical risks** have increased. One year after Draghi's wake-up call, the question remains: **Has Europe truly awakened or is it still sleepwalking towards political irrelevance and economic decline?**

The Compass was followed by a **Single Market Strategy** targeting ten "terrible" barriers, while the **Startup and Scale-up Strategy** is supposed to improve access to capital and introduce a 28^{th} regime. The **Union of Skills** addresses labour shortages, and the **AI Continent Action Plan** aims to promote the commercial use of **artificial intelligence**. A key priority is reducing **red tape**, particularly for SMEs by 25-35%, supported by **Omnibus proposals** to ease requirements. In terms of **external resilience** and **economic security**, the EU aims to reduce strategic dependencies in key sectors like chips and rare earths. Trade agreements with **Mercosur** and **Indonesia** are moving forward, while talks with **Mexico, Australia, India, Thailand**, and the **Philippines** are being accelerated. The **ReArm Europe Plan (Readiness 2030)** proposes to leverage over €800 billion in defence spending through national fiscal flexibility, while the **Preparedness Strategy** intends to boost crisis readiness in areas like energy, health, and supply chains. The **Clean Industry Deal**, **Affordable Energy Action Plan**, and **Industrial Decarbonisation Accelerator** are focused on aligning the green transition with industrial competitiveness. Finally, the **Savings and Investment Union** and the proposed €2 trillion **Multiannual Financial Framework** are designed to unlock capital.

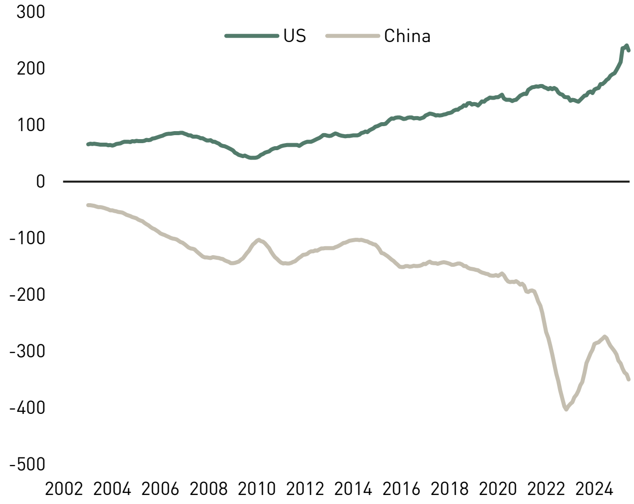
Europe is not short on strategies or action plans. However, success will depend on **translating these ideas and initiatives into measurable progress** in a **timely manner**. In his most recent **keynote speech in Rimini**, Draghi pointed out that Europe is ill-prepared for a world where **global competitiveness** is shaped more by **geopolitics**, **security**, and **robust supply chains** than by **economic efficiency**. The United States' introduction of tariffs and military spending as tools of **strategic pressure on the EU** has exposed Europe's illusion that economic power alone can secure geopolitical **influence** and **leverage** in international trade. To strategically **transform the European economy** and increase its geo-economic power, Draghi continues to advocate for **common European debt** - one of his few demands that were not adopted in the Commission's Competitiveness Compass. In Rimini, he emphasised the distinction between **good and bad debt**. While bad debt funds current consumption and burdens future generations, good debt finances strategic investments that **boost productivity and growth**, enabling repayment. However, at the national level, some good debt investments no longer achieve the necessary scale and are scattered across countries with diverging industrial priorities. Therefore, according to Draghi, common European debt is essential to **support large projects in defence, energy, infrastructure, and technology**, where collaboration can **overcome fragmented national efforts** and **mitigate high risks**.

While Draghi's ideas found broad resonance across Europe, his calls for a **common debt instrument** and a reform of the EU's **governance structures** to enhance its **decision-making capacity** have not (yet) passed the test of political reality. This reflects the complex political dynamics within the Union, as well as differing national approaches to **fiscal policy** and **governance**. At the same time, the challenges Europe faces, from **global power shifts** to **technological disruptions**, continue to grow in **scale** and **urgency**.

Indicators to watch

EU trade balance with the US and China

In € billion



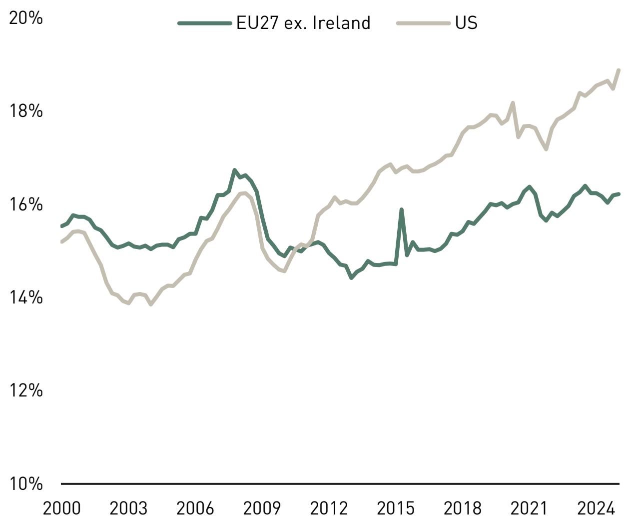
Source: IMF World Economic Outlook, April 2025.

The EU faces a two-front trade war

One of Draghi's main criticisms of European economic policy is that the EU has long relied on external demand to drive growth. This dependency has become even more acute over the past year, as both of the world's largest economies have sought to curb imports. Following a substantial rise starting in 2023, the EU's trade balance with the US has recently deteriorated, due to the US imposing high tariffs on several trading partners, including the EU. The situation with China is equally worrying: EU exports to China fell to a six-year low in June, and the bilateral deficit now exceeds €1 billion per day. As neither of these trends is likely to end soon, the EU will have to stimulate growth internally via the single market if it wants to avoid the 'slow agony' of stagnation that Draghi warned about, while continuing to advocate for a rules-based global trading system.

Productive investment in the EU and the US

In % of GDP, real GFCF minus residential investment



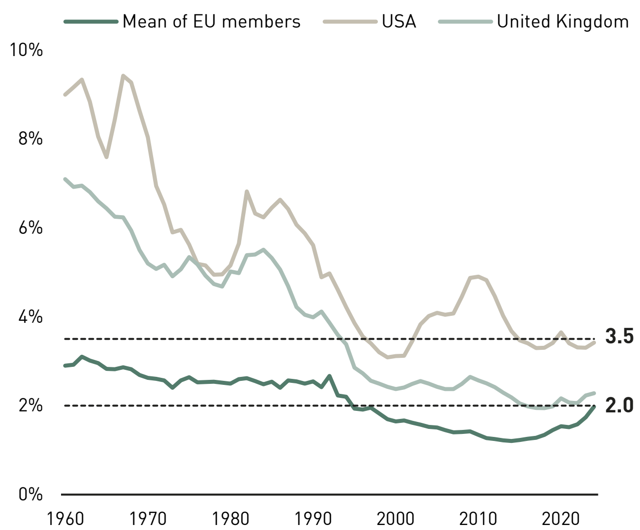
Source: Eurostat, OECD, note: GFCF = gross fixed capital formation.

Europe's investment gap with the US continues to widen

Productive investment in the EU, as measured by gross fixed capital formation excluding residential investment, has stagnated since the pandemic and remains below pre-2008 levels when expressed as a share of GDP. In contrast, investment in the US has surged amid the Biden-era boom, widening the investment gap with the EU to almost 3 percentage points of GDP. Europe's stagnation comes at a time of mounting investment needs as climate risks are materialising faster than anticipated, the AI boom is driving demand for digital infrastructure, and increased defence spending is required in response to Russian aggression. According to Draghi, higher investment in the US is driven above all by the tech sector, where US companies spend twice as much as their EU counterparts on R&D, while EU investment remains focused on mature technologies and traditional industries.

Defence expenditure

In % of GDP



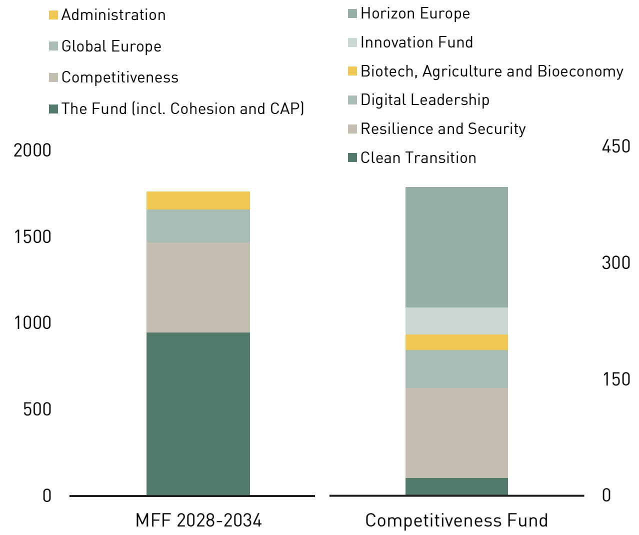
Source: SIPRI.

EU defence spending has almost doubled in 10 years

The Russian occupation of the Crimean Peninsula in 2014 marked a turning point in the steady decline of defence expenditure in Europe since the end of the Cold War. Since then, EU Member States have, on average, nearly doubled their defence spending relative to GDP. To meet their new NATO commitment of allocating 3.5 % of GDP to defence, they will need to spend an additional €2 trillion by 2031. While defence spending represents a cost of insurance, it also offers an opportunity for industrial renewal: defence programmes are unusually R&D-intensive compared with other areas of public spending, generating spillovers to innovation, private R&D, and productivity. Unlocking this potential depends not only on how much is spent but on how it is spent. Stronger EU integration and cooperation will be essential to transform rearmament from a financial burden into a driver of growth.

Commission proposal for the next EU budget

In € billion, 2025 prices



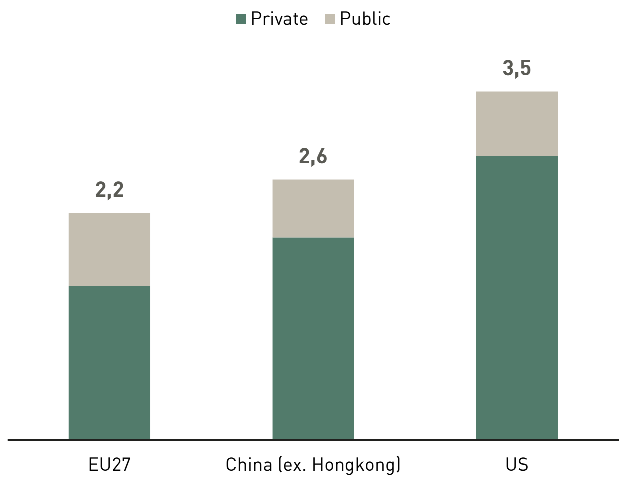
Source: European Commission, note: "the Fund" aims to consolidate 14 programmes and reorganises the EU's CAP and Cohesion Policies.

The budget proposal would represent a genuine reform

According to Draghi, the EU budget has long required greater flexibility and increased spending on shared EU-level priorities, as well as reform of cohesion and agricultural policies. In line with the idea that an institution's budget reflects its priorities, the Commission's proposal to allocate more funds to competitiveness, economic resilience and defence in the next EU budget is a positive step. The share of EU spending on shared priorities is set to almost double, rising from 17% to 30%. At the same time, the proportion of the budget returned to Member States in the form of farm subsidies and regional funds is projected to drop from around two-thirds to just over half. Efficiency is set to improve further by combining most Commission-managed funds into a single Competitiveness Fund. Alongside Horizon Europe, it will form the financial backbone of the emerging EU industrial policy framework.

R&D by sector

In % of GDP



Source: Eurostat.

Europe's R&D gap: why EU innovation falls behind

The EU has two major weaknesses when it comes to R&D spending: a lack of private sector spending and insufficient project scale. As the chart shows, the EU invests about 2.2 % of GDP in R&D – below China (2.6 %) and well behind the US (3.5 %) – with most of the gap stemming from lower private investment. Furthermore, although public sector spending is relatively high in the EU, it delivers less bang for the buck. As Draghi notes, only a small fraction is deployed at EU level and funds are spread thinly across many fields. The result is fragmentation and small project size. The semiconductor industry illustrates this challenge: while the US has channelled support into a handful of megafabs worth tens of billions, Europe continues to rely on smaller, mostly national projects in the low single-digit billions, dispersed across countries with differing priorities.

TAKE: Since the publication of **Mario Draghi's report on European competitiveness** one year ago, the **EU has made notable progress**. The European Commission has launched a variety of initiatives to address the challenges highlighted in the report, as the **underlying issues** have only become more acute. Donald Trump's return to the White House signals a broader shift away from **multilateral rules** towards a system in which **economic power alone no longer ensures geopolitical influence**. As Draghi argues, the **EU's current governance model** leaves it ill-equipped for this environment, exposing it to marginalisation in the US-China rivalry. Ukraine is a case in point: despite being the deadliest land war in Europe since World War II, the EU has struggled to secure a consistent role in US-led diplomatic efforts or to persuade China to curb exports sustaining Russia's war economy. We agree with Draghi that if Europe wants to be a **key player**, it must adapt to this emerging order. Fortunately, it already has a **roadmap for boosting productivity and investment** in the form of the Competitiveness Compass and the proposed budget reform. **The task now is execution** – delivering on these proposals in a way that meets Draghi's call for radical change.

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