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For European Economic Policy, the New World Has Yet to Be Born

As Europe revisits its economic strategy – spurred by calls to "make Europe competitive again" – it must move beyond stylised contrasts and ask what it takes to build and scale technological capacity today. That requires a sharper research agenda: one that explores how mid- and high-tech sectors reinforce each other, how industrial ecosystems function, and how Europe's competition policy fits into a world shaped by the large-scale industrial strategies of China and the United States. For three decades, the EU externally anchored its trade and industrial policy. It implemented the Washington Consensus with vigour: pursuing open trade and imposing strict limits on state aid. A stringent – at least on paper – competition policy followed: EU firms became leaner through global competition, and domestic markets more competitive via imports.

European producers thrived, especially in industrial exports – cars, planes, machinery – thanks to a well-functioning internal market for goods. The single market gave firms scale at home, enabled value chains stretching from Germany and Sweden to lower-wage member states, and allowed production to be unbundled: design and engineering in high-skill regions, components in Central and Eastern Europe. But in services, especially digital, Europe fell behind. As Draghi warns, the continent is stuck in a "mid-tech trap". While big tech drives US R&D, most private R&D in Europe is concentrated in autos, pharma and machinery – just as it was 20 years ago. Europe overdid openness: selling industrial gems like robot maker Kuka to China and letting promising IT firms get scooped up by US tech. But the deeper problem lies in fragmented services and capital markets.

Debate over Europe's response is muddled by false choices. Some argue Europe cannot compete with China in capital- and scale-intensive sectors and should retreat to tradable niches. Others insist the old playbook still works: liberalise labour and product markets, deepen capital markets and let R&D-intensive firms emerge on their own. But in a world where the US and China tilt markets through subsidies, protected demand and scale advantages, Europe cannot remain agnostic about sectoral structure. It needs industrial policy – not just for start-ups, but for strategic sectors under pressure – and commensurate competition policy.

First, Europe must rethink trade policy and align it with industrial strategy. The EU is using its traditional trade deal smarts to clinch deals with Mercosur and is even considering joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). But new free trade agreements (FTAs) have limits. The US still drives half of global trade deficits and remains the critical source of end demand for surplus economies like Europe. As the US turns inward, Europe must boost internal demand for growth – raising questions about how to target fiscal tools.

This is no longer a Ricardian trade world. Comparative advantage assumes countries shift into areas where they are relatively best and stop producing what others do better. But China climbs the tech ladder while clinging to low-end manufacturing, shutting out emerging markets. Comparative advantage now stems less from natural endowments than from industrial policy and investment. China is willing to run long-term losses to dismantle others' advantages and build its own. And it does not share demand with trading partners: its imports of manufactured goods relative to GDP have fallen since its 2001 WTO accession, aided by local content rules and subsidies.

Chinese firms can produce over 50 million cars annually, with global demand at 85-90 million. Domestic demand is 25 million; exports are six million. The idle capacity will be pushed abroad. This

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goes beyond cars. China dominates global output in crude steel, solar wafers, battery chemicals, shipbuilding and active pharmaceutical ingredients. It is climbing into robotics, industrial machinery and aerospace. Scaling regardless of demand causes deflationary pressure and premature deindustrialisation elsewhere. This threatens sectors where Europe still leads – and the ecosystems on which its high-tech future depends. Chip tool maker ASML may be a crown jewel, but it depends on suppliers like Zeiss (lenses) and Trumpf (lasers) with business beyond semiconductors. If those firms lose scale, shift production to China or see margins eroded, Europe's chip tool ecosystem could unravel.

Europe needs tougher trade defences. Exports to the US and China together account for just over 4% of EU GDP – important, but less so than Europe's internal market. Higher public investment from Germany and other low-debt countries can lift demand, and Europe – exporting over €300 billion in savings annually – can afford it. But to prevent this demand from leaking to Chinese firms, the EU must deploy safeguards. With China's US $1.1 trillion trade surplus and its exports increasingly redirected from the US to Europe, that risk is rising. Industrial policy with European preferences can help raise returns and reduce risk for EU firms. The challenge is to do this while preserving EU competition and keeping markets and industrial policy incentives open to allies.

The second challenge is to better understand the interplay between mid-tech and high-tech sectors. Over the past two decades, IT and manufacturing have delivered the highest productivity growth in Europe. Yet the debate often falls into a false dichotomy: bet on high-tech start-ups or accept mid-tech decline. Europe lacks capacity in chip design, enterprise software and AI – where R&D intensity is highest. But Europe retains global strengths in mid-tech – pharma, cars, clean tech, aviation and machinery – even against Chinese state-backed rivals. Aerospace exports exceed €100 billion a year. Clean tech exports are 4% of German GDP. The idea that only venture capital-backed firms drive innovation ignores how ecosystems work. Even Tesla relied heavily on US subsidies. R&D in machinery, chemicals and transport can generate broader productivity gains than R&D in IT or finance. Manufacturing innovation creates tangible tools other sectors depend on. These sectors seed the next generation. ASML emerged from Philips, which began as a lightbulb maker; Airbus came from national aerospace champions. Siemens helped build Germany's clean tech base. Understanding how "the old births the new" should be a focus of research.

The third challenge is to redesign EU competition policy. In China's decentralised model, many firms are supported in emerging sectors, and fierce competition selects winners. In the US's centralised model, the state backs a few flagship projects, with private capital helping winners scale. Europe sits awkwardly between, with decentralised state aid lacking clear priorities or sufficient funds and no EU-level pooling of research. Europe risks spreading resources too thin to move the needle. To compete, Europe needs the best of both models: strategic focus and EU-level pooling, with space for national experimentation.

EU industrial policy must also reflect global dynamics and internal market gaps. In sectors where global competition tends towards oligopoly and the single market functions well, fostering European champions can strengthen the bloc. In such cases, industrial policy can support scale without undermining competition. This does not apply to digital and other services, where the single market remains fragmented. There, national champions risk becoming sharks in small ponds.

In conclusion, Europe suffers from the persistent illusion that tweaking "framework conditions" will fix productivity and innovation, and sectoral composition will sort itself out. But if over-reliance on low-R&D sectors is part of the problem, how can it be solved without sectoral policy when the US and China actively distort global markets? Europe still has time – but only if it abandons the idea that markets alone will deliver. China's industrial policy has been remarkably successful. Europe can protect its mid-tech R&D base, modernise industry, and build high-tech capacity – but only if it acts decisively. That requires a sharper research agenda to map sectoral ecosystems, track spillovers and scale, and guide industrial and competition policy.

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