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Strategic Direction for Europe in the New Economic Geography

Due to Trump Administration policies, Europe faces a new economic geography. In essence, European economies have lost insurance of various types previously provided by the U.S. The European Union has more agency to shape its new environment and more opportunities for gains than is commonly realized. Pursuing U.S. and Chinese type of industrial and trade policies, however, will fail.

The United States Government has crossed the Rubicon in its economic and security relationship with the European Union. What began with Vice President JD Vance's remarks in Munich in early 2025 was confirmed by President Trump's threats over Greenland and speech at the World Economic Forum (WEF) in Davos in January 2026. There is no going back to the levels of trust and interdependence that characterized EU-U.S. relations for the preceding 80 years, either by member governments or by European investors and businesses. The loss of the peace dividend, which French President Macron sounded the alarm about in 2025, has now been recognized and felt. This peace dividend should not be thought of as just a loss in narrow fiscal terms. It should be thought of instead as more broadly the order which we have had eroded.

Now that European decision-makers have left denial or even wishful thinking about the U.S. behind, they must accept that just like after an earthquake, there has been damage and permanent shifts in the landscape. Their quality of life going forward depends on how they rebuild. Europe has a lot more agency than people often think it does. While it cannot step in and replace the better previous version of the U.S. that the international economics was accustomed to, Europe can, through an attainable set of policy choices, make things meaningfully better both for itself and in so doing also for the

majority of people in the world. Yet for that agency to be effective, Europe must set off down a path that is different from that which the Chinese and U.S. governments are now pursuing.

The new economic geography

Persistently higher uncertainty due to the withdrawal of the U.S. may be less conducive to comfortable growth, but the economic landscape Europe faces is knowable. As argued in Posen (2025b), the U.S. was essentially the insurance provider for almost every actor in the world economy – governments, businesses, investors – for the last 80 years, and it is no longer. This is a fundamental change. This is not something that will be rectified even if Trump is out of office in 2028. In a sense, the irony of the alliances, as I put it, is that the more integrated or dependent you were on the U.S. in this situation, the worse off you are due to the change. The United Kingdom, Japan, South Korea and Canada are among those countries most directly harmed; the EU is in the next tier down. Until the rest of the world economy self-insures and cuts back its international economic exposure where self-insurance is infeasible, the Trump Administration is just going to keep renegotiating the extraction for whatever protection it offers. And arguably, it has become a “protection racket” akin to that in U.S. gangster movies or actual U.S. history in which organized criminals approach someone and say, “You have a nice little business here. It would be a shame if something were to happen to it. You should buy insurance.” And the “insurance” is paying them not to harm you. This essentially is where the Trump Administration is going in terms of not only its trade policy but in the security and financial spheres as well.

This has several economic implications. There is an ongoing rise in uncertainty (Bloom et al., 2026). President Trump follows what President Nixon and his administration called the “madman theory” of foreign policy, characterized by destabilization for economic purposes (Posen, 2024a), which ripples out through the world economy. While there is great focus on trade, this also importantly affects interest rates and deficits. A key point made in Posen (2008) and Eichengreen et al. (2019)

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is that – particularly on the monetary and financial fronts – security relationships and economic relationships reinforce each other. Part of the reason that the dollar was dominant is its role in security relationships. There was already a shortage of safe assets available for all the savings in the world. But currently, many of what were thought to be safe assets are becoming less safe. This also affects migration and FDI flows, the diffusion of technology, and the reach of standards and brands.

Despite all of this, there is a consistent worldview from Trump Administration officials that the U.S. had been getting ripped off by providing insurance for globalization and had to renegotiate and withdraw coverage, as Lutnick (2026) repeated at the latest WEF in Davos. It is very odd to believe this argument because insurance can actually be a very profitable business. In fact, the U.S. had a particularly good business model as an insurer for decades on both security and economics fronts, because when it extended insurance, it would sometimes meaningfully reduce the risks and therefore the chances it would have to pay out for claims.

The macroeconomic implications for Europe

Politicians and the popular press are obsessed with the trade picture but lose sight of the important financial results of the new economic geography. There was always a question as to why the U.S. dollar was so dominant when the U.S. share of world GDP was declining and its share of world trade was declining even more rapidly, not to mention various domestic problems. And if one explains this dominance only in terms of network effects, one is essentially labeling a residual.

There were two open secrets about what was keeping the dollar central: the first was of course the lack of viable alternatives, i.e. it was winning the least ugly contest. The U.S. dollar was arguably getting uglier over time, but the euro, unfortunately, and certainly the Chinese yuan were not getting more attractive. As a result, even when there would be bad news for the U.S. economy or security, money would generally flow into the U.S. after an initial adjustment. Investors believed that whatever else happened, the Fed would be able to react effectively, and investors would be safer in the U.S. than elsewhere. The second pillar of the U.S. dollar's relative attractiveness was that it was disproportionately used and held by countries in alliances or military relationships with the U.S. (Posen, 2008; Eichengreen et al., 2019). Countries like Taiwan, Saudi Arabia and Panama were not picking the dollar for economic reasons but for security reasons. The Vance (2025) speech at the 2025 Munich Security Conference and the Trump (2026) speech in Davos 2026 caused a loss of faith in those alliances.

Obstfeld (2025) and Rey (2025) have shown econometrically the impact of these pillars eroding. On multiple occasions since the April 2, 2025 tariff announcements, there has been

an emerging market-style dynamic in the dollar intraday and intraweek response to bad news. The dollar has not crashed, nor has it ceased to be a reserve currency. But when there has been negative news, instead of interest rates and the dollar declining simultaneously on the assumption that the Fed will step in while attracting inflows, what has been observed is interest rates rising as the dollar falls. This is what happens to most currencies, but it has not historically happened to the dollar since the start of the 1980s. Now imagine that Europe starts taking more responsibility for its own security, spending more on defense, creating alliances of its own – with Ukraine, with places in southeastern Europe and potentially in the Mediterranean; one could foresee a reversal of this pattern (Kirkegaard & Posen, 2019; Kirkegaard, 2026).

Additionally, there is a real divergence emerging between European and American approaches to financial supervision (Posen, 2025c). People are understandably, but mistakenly, overly focused on the inflation risks associated with the central bank's diminished independence. Yet, curtailed Federal Reserve independence creates financial stability risks as well (Cochrane et al., 2026). Europe and the European system of central banks and supervisors to their credit are not going to indulge in the same kinds of lacking supervision that the Fed is already on the way to encouraging (Lagarde, 2025). For Europe, though, this divergence must be taken seriously both for the dangers and for the opportunities it presents.

Obviously, but still importantly, the global role of the euro should rise rapidly in this situation – particularly if the euro area remains a region of relative financial stability, open to foreign capital inflows during a period when the U.S. induces financial instability at home.

Utilizing but not falling in love with industrial policy

On the real goods and services side, the new economic geography describes a world where, in addition to the other forces that lead to fragmentation of production and trade, divergent standards emerge. This includes spillovers into additional areas where security-linked industrial policy is of dubious relevance. Just ten years ago, EU and U.S. trade representatives were repeatedly attempting to negotiate a broad mutual recognition of standards in various industries for the sake of trade and investment, one in which even agriculture might have been brought to the table. Now the divergence in standards includes data privacy and ownership. This encompasses obviously widening transatlantic divergences in green tech usage and environmental regulations as well as carbon pricing.

Reinforcing all of this, however, is the sense that Europeans do not want to be reliant on Americans or Chinese for various critical products and inputs, insofar as avoiding that is possible. This feeling is a general wave in the world following the Rus-

sian invasion of Ukraine, the shortages of medical equipment and vaccines during the COVID-19 pandemic, and evidence of backdoors (technological and political) that the major powers embed in civilian network infrastructure. While an understandable impulse, the momentum gathering in some quarters for large scale industrial policy, perhaps as a means to achieving the scale economies for competitiveness advocated in the Draghi (2024) report, is ill-considered.

It is now widely accepted, and should be, that there was too little regard for the concentration risk of suppliers – and for national security needs – in trade practice after the Cold War. That recognition, however, is that a handful of specific markets need a different approach – it is not that overly ambitious attempts at self-sufficiency, let alone economic nationalism, are wise. In fact, the worry about resiliency should make governments more aware of the dangers of import substitution programs absent strategic stockpiling, diversification and alliances (Posen, 2022; 2025a). Put differently, overuse of industrial policy is not merely a sacrifice of a little efficiency for security. Overused industrial policy can put an economy at greater risk of shortages, including by creating domestic “champions” which self-interestedly create additional vulnerabilities for the nation as a whole. Moreover, waste of substantial resources and disruption of pre-existing production networks can deprive national defense of critical technologies.

The first thing to do, which to some degree Europe has done, and the U.S. certainly has not, is to create a genuine technocratic publicly available log of the vulnerabilities to concentrated suppliers abroad. The defense and intelligence communities in the U.S. never wanted to specify the vulnerabilities or even their criteria, let alone delegate such judgements to some experts publicly. They, and the Commerce Department, want to control who they give funding to, and to always be able to declare something as important for national security without being challenged. But not everything is a semiconductor – in the sense of being truly critical, truly concentrated with production choke points, truly dangerous in terms of dependence on China and truly relevant to national security needs.

In making Europe’s assessment of what is truly a matter of national security requiring industrial policies, one should realize that foreign dependence is not necessarily better than self-sufficiency in terms of ultimate resilience. This became evident in the rush for medical supplies during the COVID-19 pandemic. If a country tries to be self-sufficient in production in a given sector, even if it is capable of being so, it would still be subject to what happens if there is a military or terrorist attack on the domestic source. What would happen if there were an earthquake or a nuclear accident, as Japan recently experienced? What would happen if there were a potato blight, as in Ireland 175 years ago? The goal is resilience, and that requires diversification – not just from foreign but also domestic choke points.

Even in as diverse and large an economy as the EU, U.S. or China, self-sufficiency is impossible; attempts to achieve it are very costly and, in the end, will not deliver resilience.

More broadly, the question that always comes up is who depends on whom for what? While the geostrategic attention should be on certain imported materials with low elasticity of substitution in the short run, some believe that Europe depends upon the U.S. as a market. That is not the same thing. The latter is just a matter of money, not of dependency on specific inputs or being caught in choke points. Any pain points from restricted exports can be spread over the whole economy and adapted to. Trump’s capitulation to Xi over rare earths demonstrates the general principle: the country that only has exports to lose in a conflict, in this case China, has greater leverage over the country that depends on that country for specific imports, in this case the U.S. (Posen, 2025a). Ultimately, countries export in order to be able to import. Small developing countries need to export because they do not have scale, but even more because they need to catch up to global technology and production practices, gain access to financing, and discipline the business from local political dominance. None of that applies to Europe today. It is a mistake to let the export-oriented companies drive the economic agenda, let alone the national security agenda. It is a real and costly thing to have exporters deemed too big to fail, as Boeing and Volkswagen demonstrate (Posen, 2022).

So, while there is a security reason to make sure you are not dependent on one hostile place outside of Europe for all of your chips, there is also an economic reason to make sure you have engineers who know how to apply and use chips. And with ASML, Europe already does. There is not a pressing need to make sure that there is a European competitor with Samsung or TSMC. There is not a pressing need to make sure that there is a European competitor even with Google. It is not required that Europe have a national or European champion in every industry.

Europe’s best self is its best way forward

Europe should not try to beat the Chinese and the Americans at their own misguided game of manufacturing obsession and bullying. There is a temptation to say, “Look what the Americans are doing. Look what the Chinese have succeeded with. We need to have this kind of industrial policy. We need to have this kind of pseudo empire.” That is a mistake. Europe cannot compete in a bullying war with either China or the U.S. for a whole host of reasons. Europe will do better by leaning into what it already does well – and what the world wants, and the U.S. has ceased to adequately supply.

Europe’s way forward is to be itself, to reach out in what I would call principled plurilateralism (Posen, 2025c). As with

EU-India and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, Europe should make deals in trade in a multilateral spirit – rules-based, open admission to those who meet the standards, transparent – but not wait for every veto player at the World Trade Organization or elsewhere. Avoid the arms race in industrial policy. No one should care that Chinese producers have 90% of the world solar panel market. Solar panels are the transistor radios of this decade. They are just a cheap output. Within three years, given adequate investment and purchase guarantees, it will not matter that China currently has 90% of rare earths, which are ultimately just a dirty mined product.

Trade deals are not made to create export markets, no matter how many times politicians tell that lie. The reason to have trade agreements with rules limiting subsidies or tariffs is not to create jobs and export markets. That nostalgia for old low-end industries does not prove justified in the data (not even when including the Chinese experience) in terms of providing good employment outcomes in the face of technological progress (Lawrence, 2024; Posen, 2020). The reason to have trade agreements is to manage commerce better and avoid future problems in pre-existing economic relationships. One can see this with Brexit: the main losses for UK business (and employment allocation, not level) have come from the loss of a dependable framework for managing the UK-EU relationship.

Now again this is two-sided. A world where the U.S. is not only ceasing to encourage common standards or is behaving in a very self-interested way (in both the normative and literal sense) is a world where Europe can play a bigger role in setting standards. Europe is well positioned to take advantage of the need for fair rules-based global standards in the face of the U.S. retreat and the similar untrustworthiness of Chinese commitments. Yet, the opportunity requires repeated restraint by Europe in terms of trying to engage in self-dealing via over-used industrial policies. If the U.S. is going away from widely used green technologies or food ingredient rules or privacy protections that are not the way the rest of the world's consumers (including Chinese and some Americans) want to go, then there is more room for Europe to gain from becoming a largely fair and open standard setter. In turn, this will enable the global diffusion of EU technologies.¹ There is recurrent potential for a win-win where Europe advances development through promoting the diffusion of cheaper green technology by opening itself up and making its standards accessible, as

well as limiting some of its nationalist trade and investment policies. This is especially likely to hold in a world economy where the U.S. throws up all kinds of protectionist and variable restrictions, and the rest of the world may not want to depend on Chinese tech with its conditions, either.

Europe will gain from its relative advantages which are now different from both the U.S. and China – being more open and rules-based than either. Europe will reap enormous benefits from the gains made in talent, investment, variety, diversification and soft power. Some European leaders fail to appreciate how little sentiment there is for Chinese or American services, brands and standards in third countries, and the opportunities that gives Europe. It saddens me greatly, but I completely understand given the sense of loss and feeling that the U.S. has let us all down. Europe can determine how much that being let down matters.

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¹ This is not to say that the U.S. or any economy was ever selfless in setting standards, without advancing some parochial interests. It is to say that the chairman of the club does get benefits from being in the chair, but that tenure only lasts so long as the self-dealing is kept well within limits, and the process of self-dealing is not contrary to the bulk of the rules. If a government truly becomes transactional and even extractive, it can give up a lot more in return. Hence, the foolishness of the post-American world economy (Posen, 2018).