

Navigating turbulence: challenges for Europe and the path ahead*

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Introduction

It is a privilege to be here in Tallinn to deliver this lecture in memory of Professor Ragnar Nurkse. Widely regarded as one of the intellectual fathers of the post-war Bretton Woods system, his work showed how external shocks and structural imbalances can shape the trajectories of open economies. Those insights remain profoundly relevant in today's increasingly turbulent world.

The successive crises since the pandemic have tested the euro area in ways that few could have anticipated. Tallinn is an apt place to reflect on this – Estonia has perhaps experienced the impact of these shocks more acutely than most, notably the energy price surge sparked by Russia's invasion of Ukraine and the unprecedented inflation that reached its all-time high of 25% in August 2022, just two years on from a period of deflation.

Estonia, and the euro area economy as a whole, has shown resilience in navigating these shocks. Over the course of 2025, the euro area grew by 1.5% on the back of higher domestic demand, with low unemployment and rising real incomes supporting consumer spending, coupled with buoyant investment in research and development, software and databases.^[1] Survey data ahead of the war in the Middle East suggest that this growth continued into the beginning of 2026.

Strikingly, this resilience has been achieved amid profound uncertainty and geopolitical transformations that have by no means run their course. Over the past year, we have witnessed major shifts in US trade and foreign policy, and a serious erosion of the multilateral system that has long underpinned global trade and supported European prosperity and stability. A new paradigm has emerged, where the rule of law is challenged by the rule of power. High uncertainty and geoeconomic fragmentation are here to stay.

This is the context in which we must view the war in the Middle East. It represents an acute materialisation of geopolitical risks that have figured prominently in economic

* Speech by Vice-President of the ECB, at the Ragnar Nurkse Memorial Lecture organised by Eesti Pank - 26 March 2026

analysis and as a key threat to financial stability. Approximately 20% of the world's oil and liquefied natural gas travels through the Strait of Hormuz. With shipping now virtually at a standstill, we are facing a supply shock that will likely have far-reaching repercussions for the global economy and financial stability. The scale of the impact and the implications for price and financial stability will depend on how much the war spreads, and how long it lasts.

Spillovers to the euro area financial sector have so far remained contained. Direct bank exposures to the region are limited, and the banking system is well positioned with strong profitability and robust capital and liquidity buffers. EU market infrastructures, including central counterparties whose services are focused on energy markets, have managed margin requirements effectively despite the volatility. More generally, markets broadly expect the war to be relatively short-lived.

However, amid already elevated global uncertainty, this conflict could trigger the unravelling of interconnected vulnerabilities and cause systemic stress. It threatens to derail market sentiment at a time when asset valuations are high, potentially leading to a sharp repricing of risk for leveraged borrowers and sovereigns and amplifying stress in the non-bank financial sector.

Current outlook for growth and inflation

The outbreak of the war in the Middle East has made the growth and inflation outlook significantly more uncertain. The sharp increase in energy prices observed over the past few weeks poses upside risks for inflation and downside risks for economic growth. ECB staff now expect annual growth in the euro area to drop below 1% [average 0.9%] this year and to then hover above 1% in the coming years, following significant downward revisions. The energy shock is expected to weigh on short-term growth prospects by eroding household purchasing power and weakening business and consumer confidence.

However, we are well positioned to navigate this uncertain period. Inflation has been at around our 2% medium-term target for about a year, longer-term inflation expectations remain well anchored, there are no pronounced demand-supply imbalances in the euro area economy and our monetary policy stance is broadly neutral.

Against this backdrop, last week the ECB's Governing Council decided to keep the three key ECB interest rates unchanged. Our data-dependent and meeting-by-meeting approach allows us to respond in an agile manner to the evolving outlook and ensure that inflation stabilises at our 2% target over the medium term.

Looking ahead, the war is expected to push up energy prices and drive inflation above 2% in the near term. Projections for inflation have been revised up considerably

compared with December last year. Annual inflation is expected to average 2.6% this year before subsequently converging to our 2% target.

As I said earlier, the medium-term implications of the war will depend on how much the war spreads and how long it lasts, and on the intensity and duration of the energy shock, as well as its propagation to consumer prices and the economy via indirect and second-round effects. Therefore, in line with our monetary policy strategy, the Governing Council considered a range of additional scenarios around the baseline to illustrate the potential impact of the war on the euro area economy. This scenario analysis suggests that, if the energy shock proves more persistent than currently anticipated, it may result in higher inflation and lower growth compared with the baseline projections.

We are closely monitoring the incoming information to assess the evolving effects of the war on the outlook for growth and inflation. We will follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance, and we are unwavering in our commitment to ensuring that inflation stabilises at our 2% target in the medium term.

Strengthening European resilience

As an open economy deeply integrated into global trade and financial markets, the euro area is highly exposed to external shocks. The current war in the Middle East and continued dependence on fossil fuels underscores the EU's vulnerability to energy shocks, while other recent developments, including tariffs and supply chain disruptions, have highlighted the risks of relying heavily on external trade.^[2] Dependence on third countries applies to digital payments too, with non-European companies processing almost two-thirds of card transactions in the euro area.^[3]

Besides limiting the EU's ability to shape its own future, these vulnerabilities expose our economy to demand and supply shocks that harm its growth potential and could complicate the conduct of the ECB's monetary policy. And the ongoing fragmentation of the EU's internal market compounds these challenges by holding back investment and innovation. All this is gradually eroding competitiveness at a time when Chinese competition in Europe – in both the domestic and export markets – is encroaching on sectors historically dominated by European companies, while Europe lags behind in the global race to lead in AI and critical technologies.

The current geopolitical turmoil adds to a series of overlapping crises that require a unified European response. It is a call for the EU to focus on its circle of influence by reducing internal fragmentation, standing up for its values, addressing its external

vulnerabilities and building strengths to face emerging challenges. Let me now look at four priorities for strengthening Europe.

First, **completing the Single Market**. Despite enjoying the largest consumer market among advanced economies, the EU remains deeply fragmented, especially in the services sector. Services account for three-quarters of the EU's economy, yet intra-EU trade in services remains underdeveloped. ECB analysis shows that if internal barriers were as low across all Member States as they are in the best-performing ones, intra-EU trade in services could expand by almost 15%, with effects on GDP roughly four times greater than the estimated losses from US tariffs.^[4] A true single market for goods and services would present more attractive opportunities and incentives to invest in the EU. Creating a 28th regime as proposed by the European Commission last week – allowing businesses to operate across the EU under a single harmonised rulebook – would be a transformative step, fostering investment and facilitating the scaling up of EU companies across the EU.

This brings me to EU capital markets and the second priority – building a genuine **savings and investments union**. Owing to the EU's high saving rate, which reflects its persistent current account surplus, Europe has a vast amount of capital that could be channelled into productive investments in an economy that urgently needs to fund its own transformation. Harmonising regulatory frameworks and removing national divergences in tax, insolvency, labour and corporate law are essential to reduce frictions for cross-border investment. More integrated capital markets supervision would level the playing field, enhance the resilience of the system over the cycle and help remove barriers to capital market integration.^[5] The European Commission's market integration package is an important step in this direction.^[6]

The third priority is to secure **technological sovereignty**. At present, no single EU country has the resources required to develop critical technologies at scale. The EU needs to promote EU initiatives in critical technologies by seeking new forms of integration. In parallel, targeted EU policies can bolster strategic autonomy by supporting key sectors, thereby enhancing resilience in supply chains. The same logic applies to the financial sector. If the EU were to lose control of its financial and payment infrastructure, it would have a strategic vulnerability that could be leveraged by competing powers. The digital euro will provide a European public option, built on European infrastructure, ensuring that citizens and businesses can always pay digitally without depending on foreign intermediaries. The digital euro can enhance inclusion, reduce fragmentation in our payments market and strengthen Europe's resilience in an increasingly uncertain global environment.

And the fourth and final priority is **regulatory simplification**. The resilience of Europe's financial sector rests on the rules framework that has been established since the global financial crisis. That resilience must be preserved. That said, we acknowledge that the same resilience can be achieved with simpler rules. There is scope to reduce undue complexities which may otherwise unnecessarily hamper the euro area financial sector's competitiveness and ability to finance the real economy. The ECB contributed to this debate by publishing Governing Council recommendations for simplifying the European regulatory, supervisory and reporting framework for banks, basing it on the principles of maintaining resilience and effectiveness in meeting prudential objectives, fostering European harmonisation and financial integration, notably completing the Banking Union, and upholding international cooperation.^[7]

Conclusion

Let me conclude. Ragnar Nurkse dedicated his career to exploring how countries could remain stable and prosperous while navigating forces beyond their borders. Although he was looking at a different group of countries, the challenge he grappled with resonates with the challenges Europe faces today.

To strengthen Europe's growth prospects and reduce its vulnerability to current and future shocks, the only viable path forward is to focus on what we can achieve together and foster deeper integration within Europe. To uphold its core values, prosperity and inherent stability, the EU must focus on addressing its vulnerabilities while strengthening long-term growth and resilience.

Thank you.

1. ECB (2025), [Eurosystem staff macroeconomic projections for the euro area](#), December.
2. External trade as a share of GDP is 43% in the EU compared with 26% in the United States.
3. European Central Bank (2025), [Report on card schemes and processors](#), February.
4. Bernasconi, R., Cordemans, N., Gunnella, V., Pongetti, G. and Quaglietti, L. (2025), "[What is the untapped potential of the EU Single Market?](#)", *Economic Bulletin*, Issue 8, ECB.

5. Ceh, A.M., Daly, P., Evrard, J., Grill, M., Martino, A., Wedow, M. and Weistroffer, C. (2026), “[Why we need an EU perspective in the supervision of large asset managers](#)”, *The ECB Blog*, 13 February.
6. European Commission (2025), “[Market integration package](#)”, 4 December.
7. European Central Bank (2025), [Simplification of the European prudential regulatory, supervisory and reporting framework](#), December.