

The follow up to the report on Europe's competitiveness¹

by Mario DRAGHI²

Thank you. It's a real pleasure to be back here in the European Parliament to discuss the follow up to the report on Europe's competitiveness. The input of elected representatives was vital in the preparation process of the report, and many members of the European Parliament and national parliaments have reached out to me since its release. Your reactions have been invaluable in helping refine the proposals and build the momentum for change.

Your engagement underscores the strength of European democracies and how we need all actors working together to transform Europe. Since the report was published, the changes that have taken place are broadly in line with the trends that were outlined there. But the sense of urgency to undertake the radical change that the report advocated has become even greater.

First, the pace of progress in artificial intelligence, AI, has accelerated rapidly. We've seen frontier models achieving almost 90% accuracy on benchmark tests for scientific reasoning, outperforming human expert scores. We've also seen models becoming much more efficient, with training costs falling by a factor of ten and inference costs by a factor of over 20. For now, most progress is still happening outside of Europe.

Eight of the current top ten large language models have been developed in the United States, with the other two originating from China. Every day we delay, the technology frontier is moving away from us. But falling costs are also an opportunity for us to catch up faster.

Second, natural gas prices remain highly volatile, rising by around 40% since September, and margins on LNG imports from the United States have increased

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significantly since last year, to over 100%. Power prices have also generally risen across countries and are still two-three times higher than those in the United States. And we've seen the type of internal tensions that might arise if we do not act urgently to address the challenges created by the energy transition.

For example, during the severe *Dunkelflaute* in December last year, when solar and wind power fell close to zero, German power prices rose by more than ten times the yearly average price. That, in turn caused major price spikes in Scandinavia, with countries having to export energy to fill the gap, leading some of them to consider postponing interconnector projects. In parallel, increasing threats to critical undersea infrastructures, underscoring the security imperative to develop and protect our grids.

Third, when the report was written, the main geopolitical theme was the rise of China. Now the EU will face tariffs by the new US administration in the coming months, coming weeks, probably. Hindering our access to our largest export market. Moreover, higher US tariffs on China will redirect Chinese overcapacity into Europe, further hitting European firms. Indeed, larger EU companies are more concerned about this effect than loss of access to the US market.

We may also face policies devised to attract European companies to produce more in the United States based around lower taxes, cheaper energy and deregulation. Expanded industrial capacity in the United States is a key part of the government's plan to ensure that tariffs are not going to be inflationary. And if recent statements outline our future, we can expect to be left largely alone to guarantee security in Ukraine and in Europe itself.

To cope with these challenges. It's increasingly clear that we need to act more and more as if we were one state. The complexity of the policy response involving research, industry, trade and finance will require an unprecedented degree of coordination between all actors, national governments and parliaments, the Commission and the European Parliament.

The response must be fast, because time is not on our side. With the European economy stagnating, while much of the world grows. The response must be commensurate with the size of the challenges, and it must be laser focussed on the sectors that will drive the growth. Speed, scale and intensity will be essential. We must create the conditions for innovative companies to grow in Europe, rather than

staying small or moving to the United States.

That means bringing down internal barriers, standardising, harmonising and simplifying national regulations and pushing for a more equity based capital market. We are often our worst enemy in this regard. We have an internal market that is of a similar size to that of the United States. We have the potential to act at scale.

But the IMF estimates that our internal barriers are equivalent to a tariff of around 45% for manufacturing and 110% for services. And we have chosen a regulatory approach that has prioritised precaution over innovation, especially in the digital sector. For example, the GDPR is estimated to have increased the costs of data by 20% for EU companies. We also have a lot of savings in Europe that we could use to finance innovation.

But with a few notable exceptions, our countries mostly rely on bank lending that is generally not suited for this task. That leads us to send more than €300 billion every year in savings overseas, because investment opportunities are lacking here. We must help our leading firms to catch up in the air race by channelling more investment into computing infrastructure and digital networks.

The recently announced EU AI champions initiative is a good example of how the public and private sector can work together to help close the innovation gap faster. If we act decisively and make Europe an attractive place for innovation. We have an opportunity to reverse the brain drain that has pulled many of our best scientists across the Atlantic.

The report identifies several ways to expand our research capacity, and if we do so, our tradition of academic freedom, an absence of cultural orientation in government funding can become our comparative advantage. Next, we have to bring down energy prices. This has become imperative not only for traditional industries, but also for advanced technologies. It's estimated that power consumption by data centres in Europe will more than triple by the end of the decade.

But it is also increasingly clear that decarbonisation itself can only be sustainable if its benefits are brought forward. The report identifies a host of reasons for Europe's high energy prices, beyond the fact that the EU is not a major natural gas producer. In these reasons are the limited coordination of national gas procurement, the

functioning of the energy market, delays in installing renewable capacity, underdeveloped grids, high taxation and high financial margins.

These and other factors are all of our own making, and therefore they can be changed if we have the will to do so. The report proposes several measures in this regard reform of the energy market, much greater transparency in energy trading, more extensive use of long term power contracts and long term purchases of natural gas, and massive investment in grids and interconnection.

It also calls not only for faster installation of renewables, but also for investment in clean baseload generation and flexibility solutions that we can draw on, where renewables are not generating power. At the same time, we must ensure a level playing field for our nobody clean tech sector so that it can benefit from the opportunity of the transition.

Decarbonisation cannot mean that we lose green jobs because firms in countries with more state support can capture market share. Finally, the report addressed several vulnerabilities in Europe, one of which is our defence system, where fragmentation of industrial capacity along national lines prevents the necessary scale. Even if we are collectively the third largest spender in the world. We would not be able to satisfy a ramp up in defence expenditure through our own productive capacity.

Our national defence systems are neither interoperable nor standardised. In some key parts of the supply chain, this is one of the many examples where the European Union is less than the sum of its parts. Alongside acting to modernise the European economy, we need to manage the transition for our traditional industries. These industries remain important in Europe.

Since 2012, the top ten sectors with the fastest growing productivity have consistently most entirely of so-called meat tech sectors like automotives and machinery. The manufacturing sector also employs around 30 million people, compared with 13 million in the United States. And in this world where geopolitical relationships are fastly evolving and protectionism is rising, retaining industries like steel and chemicals that provide inputs to the whole economy and are critical for defence, has become strategic.

Supporting traditional industries is often depicted as a binary choice. We can either

choose to let them go and allow resources to move to new sectors, or we can sacrifice the development of new technologies and ultimately resign ourselves to permanently low growth. But the choice doesn't have to be so stark. If we carry out the reforms to make Europe more innovative, will relax many of the trade offs between these goals.

For example, if we exploit the economies of scale of our EU market and integrate our energy market, it will lower production costs everywhere. Then we will be better placed to deal with the potential spill-overs of say providing low cost energy to energy intensive industries. If we offer a more competitive rate of return in Europe and in more efficient capital markets, our savings will naturally stay home.

Then we will have a deeper pool of private capital to finance both new technologies and established industries that retain a competitive edge. And if we remove our internal barriers and raise our productivity growth will help increase our effective fiscal space. That will give us more capacity to finance projects that serve the public good, but that the private sector is unlikely to touch such as the decarbonisation of heavy industry.

To give an illustration, the report estimated that increasing total factor productivity by just 2% over the next ten years would reduce the fiscal costs for governments, so financing necessary investments by one third. At the same time, removing internal barriers will make the fiscal multipliers of these investments higher. There is a robust evidence that fiscal multipliers decrease with trade openness, as part of a fiscal impulse will be matched by higher imports.

And Europe's economy is very open to trade. More than twice the level of the United States, which is a symptom of our own internal, high internal tariffs. With expansion in our domestic market, effectively capped, EU companies have looked abroad for growth opportunities, while imports have become relatively more attractive as external tariffs have fallen. And if we take to lower these internal barriers, we would see a large rerouting of demand back into our market.

Then trade openness would naturally decline and fiscal policy would become commensurately more powerful. The commission has recently launched its Competitiveness Compass, which embraces this agenda. The aims of the compass are fully in line with the recommendations of the report, and they signal a much needed reorientation of key European policies.

It's now important that the Commission is given all the necessary support, both in the implementation of this programme and in its financing. The financing needs are massive, 750 800 billion is a year, is a conservative estimate. To increase financing capacity, the Commission is proposing a welcome rationalisation of EU financing instruments, but there are no plans for new EU funds.

The method being proposed is to combine EU instruments with more flexible use of state aid, coordinated by a new European tool. While we hope that this contraction will deliver the financial backing required, success will hinge on member states using the fiscal space they have available and being prepared to act within a European framework

But the Commission is only one actor. It can do a lot to ensure areas of exclusive competence, such as trade, competition policy. But it cannot act alone. The European Parliament, national parliaments and national governments must stand by its side. The Parliament has a key role in play in making EU decisions faster. If we follow our usual legislative procedures, which often take up to 20 months, our policy responses may be outdated as soon as they are produced.

We also rely on the Parliament to act as a protagonist, to build political unity, to create momentum for change, to hold policymakers to account for hesitation, and to carry out an ambitious action programme. We can revive the novel, the spirit of our continent. We can regain our capacity to defend our interests, and we can give our people hope.

The national governments and the parliaments of our continent, and the European Commission and the European Parliament are called to be the guardians of this hope at the turning point in Europe's history. If united, we will rise to the challenge and succeed. Thank you.