Opinion **EU trade**

Forget the US – Europe has successfully put tariffs on itself

High internal barriers and regulatory hurdles are far more damaging for growth than anything America might impose

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Europe is also being held back by its tolerance of persistently weak demand © Dreamstime

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The writer is a former president of the European Central Bank and was prime minister of Italy. He oversaw a report on the future of European competitiveness

Recent weeks have provided a stark reminder of Europe's vulnerabilities. The eurozone barely grew at the end of last year, underlining the fragility of the domestic recovery. And the US began imposing tariffs on its major trading partners, with the EU next in its sights. This prospect casts further uncertainty over European growth given the economy's dependence on foreign demand.

Two major factors have led Europe into this predicament — but they can also lead it out again if it is prepared to undergo radical change.

The first is the EU's long-standing inability to tackle its supply constraints, especially its high internal barriers and regulatory hurdles. These are far more damaging for growth than any tariffs the US might impose — and their harmful effects are increasing over time.

The IMF estimates that Europe's internal barriers are equivalent to a tariff of 45 per cent for manufacturing and 110 per cent for services. These effectively shrink the market in which European companies operate: trade across EU countries is less than half the level of trade across US states. And as activity shifts more towards services, their overall drag on growth becomes worse.

At the same time, the EU has allowed regulation to track the most innovative part of services — digital — hindering the growth of European tech firms and preventing the economy from unlocking large productivity gains. The costs of complying with GDPR, for example, are estimated to have reduced profits for small European tech firms by up to 12 per cent.

Taken together, Europe has been effectively raising tariffs within its borders and increasing regulation on a sector that makes up around 70 per cent of EU GDP.

This failure to lower internal barriers has also contributed to Europe's unusually high trade openness. Since 1999, trade as a share of GDP has risen from 31 per cent to 55 per cent in the eurozone, whereas in China it rose from 34 per cent to 37 per cent and in the US from 23 per cent to just 25 per cent. This openness was an asset in a globalising world. But now it has become a vulnerability.

The paradox is that while internal barriers remained high, external barriers fell as globalisation accelerated. EU companies looked abroad to substitute for lack of domestic growth and imports became relatively more attractive.

For instance, since the mid-1990s, trade costs in services are estimated to have dropped by 11 per cent within the EU but by 16 per cent for non-EU imports. This helps explain why trade in services inside and outside the EU is about the same today as a share of GDP — unthinkable in a fully integrated large economy.

The second factor holding Europe back is its tolerance of persistently weak demand, at least since the global financial crisis of 2008. This has exacerbated all the issues caused by supply constraints. Until the crisis, domestic demand as a share of GDP in the eurozone was near the middle of the range of advanced economies. Afterwards, it fell to the bottom and stayed there. The US has remained at the top throughout.

This widening demand gap has helped turn high trade openness into high trade surpluses: the eurozone current account has shifted from broadly balanced until 2008 to persistent surpluses thereafter.

And weak demand has fed back into exceptionally weak total factor productivity growth after recessions, a pattern not seen in the US. This can partly be explained by the effect of demand on the innovation cycle. Research finds that policy-driven demand shocks have a significant effect on R&D investment, especially for disruptive technologies.

While the demand gap has different drivers, the most significant has been the relative stance of fiscal policies. From 2009 to 2024, measured in 2024 euros, the US government injected over five times more funds into the economy via primary deficits — €14tn versus €2.5tn in the eurozone.

Both these shortcomings — supply and demand — are largely of Europe's own making. They are therefore within its power to change. An unyielding drive to remove supply constraints would help innovative sectors to grow and, by redirecting demand back into the domestic market, reduce trade openness without raising trade barriers. The European Commission's new Competitiveness Compass provides a road map to achieve this.

At the same time, more proactive use of fiscal policy — in the form of higher productive investment — would help lower trade surpluses and send a strong signal to firms to invest more in R&D.

But this path calls for a fundamental change in mindset. Up to now, Europe has focused on either single or national goals without counting their collective cost. Conserving public money supported the goal of debt sustainability. The spread of regulation was designed to protect citizens from new technology risks. Internal barriers are a legacy of times when the nation state was the natural frame for action.

But it is now clear that acting in this way has delivered neither welfare for Europeans, nor healthy public finances, nor even national autonomy, which is threatened by pressure from abroad. That is why radical change is needed.