5. ARE FRANCE AND GERMANY THE SICK MEN OF EUROPE?

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The original "Sick man of Europe" was the Ottoman Empire; subsequently the phrase was used again to refer to another Empire on its way to downfall, the Austrian one. In more recent history, it's been used time and again to refer to a country going through a rough growth patch, with social discontent and a clouded outlook. France and Germany clearly do not meet the first definition—apart from not being Empires, they remain peerless and unchallenged in the EU in terms of dominant economic size and attractiveness to FDI, among other metrics. But they earned themselves the "sick man" label before, and again the question is being asked, not without reason: indeed, since the pandemic, both been have facing economic, social and political challenges. This being said, many if not all of these challenges are shared with a number of other European economies; and both stand a good chance of tackling these challenges in the next 5 years. Naturally, the efforts underway across Europe to address common weaknesses—weak productivity growth, aging populations, lagging innovation, high energy costs, along with the renewed impetus of rearmament efforts, will also benefit its two largest economies. Indeed, they are particularly well placed to benefit disproportionately from the rearmament effort owing to the scale of their respective defense industries.

1. FRANCE AND GERMANY HAVE BOTH UNDERPERFORMED SINCE THE PANDEMIC

From 2019 to 2024, Germany's GDP grew by just 0.3% and France's by 3.6%, below the average of 5.2%. Poverty increased in both countries—up 2.3 percentage points in France and 0.7 in Germany since 2019. Productivity growth has been particularly

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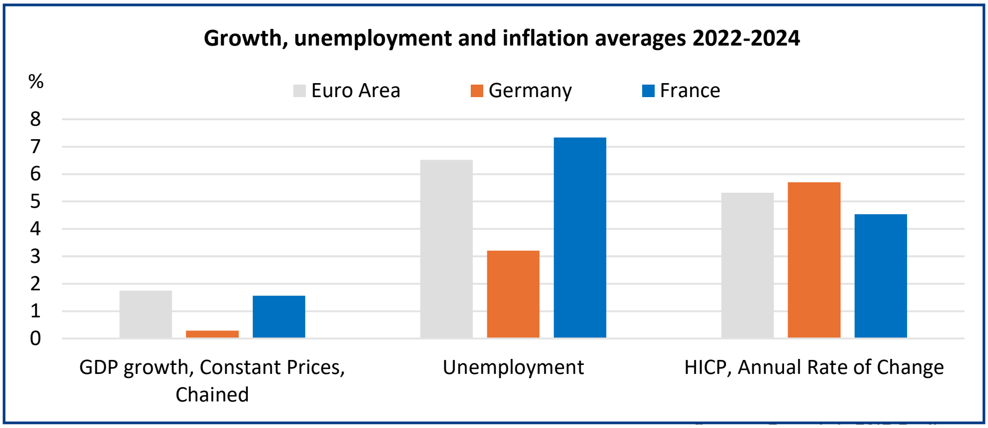
weak in France. The growth potential of both countries has weakened markedly and is now estimated to be just between 1 and 1 ¼% in France and only around 0.5% in Germany.

In terms of "misery index", France and Germany have been afflicted by a different mix: Germany has kept a low unemployment rate, but its inflation has been higher than the Eurozone average, averaging 5.15% from 2021 to 2024, 45 basis points above the eurozone and 115 above France. It peaked at 10.9% in Q3 2022, surpassing the eurozone's 9.9% peak (see chart 1). By contrast, inflation in France has been markedly better behaved than in most of the Eurozone; but its unemployment rate remained relatively high, never falling below 7%–albeit this is an historically low rate for France. This point to another specific French weakness, namely relatively high structural unemployment.

Perhaps unsurprisingly then, both countries have seen a rise in the popularity and vote share of anti-system populist parties from both sides of the political spectrum. In the 2025 German federal election, the far-right AfD party came in second with 20.8% of the vote, double its share in the previous election in 2021. The left-wing Die Linke and far-left Bündnis Sahra Wagenknecht (BSW) parties won a combined total of 13.8% (8.8% and 4.97%, compared with 4.9% in 2021). In France, the Rassemblement National (RN) came out on top in the 2024 European elections with 31.4% of the vote. The RN and its allies won 33.22% of the votes in the 2024 legislative elections, the highest score ever achieved by the party, nearly twice as high as in the previous legislative elections, and ahead of the presidential coalition.

Chart 1.



Source: Eurostat, BNP Paribas.

But France and Germany retain strong economic foundations that should ensure their continued economic dominance within the EU.

France and Germany together account for just over 1/3 of EU population and 40% of its GDP. Thus, it is no surprise that they should have an outsize weight in the EU's economy. But in some important ways, they outperform these two key metrics.

France and Germany dominate the European large corporate landscape, together accounting for 2/3 of the companies listed on the EUROSTOXX 50. They are also the EU's top two destinations for foreign direct investment, with France leading in recent years, and have been among the top recipients for many years. Germany has one of the highest R&D investment to GDP ratio in the OECD and is responsible for 11% of patents granted in Europe. It is also the top investor in AI R&D. While less active in R&D overall, France is also a leader in AI in the EU. This bodes well for the two economies' ability to position themselves as leaders in the industries of tomorrow.

Both countries enjoy high living standards. In 2023, Germany's GDP per capita reached $63.2k (PPP), compared to $54k in France and $53.8k across the EU. In terms of household adjusted disposable income, Germany ranks second in the EU, while France ranks 6th and stands over 10% above the EU average. Life expectancy stood at 82.9 years in France and 80.5 in Germany as of 2024. Reflecting the combination of high income and high savings rates in both countries, their households also hold substantial savings—EUR 573 billion in Germany and EUR 326 billion in France in 2024, together about half of the EU total.

Both have large, healthy and well-capitalized banking systems. France, in particular, is home to 4 of the 5 largest banks by assets in the EU and hosts four global systemically important banks (G-SIBs). As of Q4 2024, Germany's total financial assets amounted to EUR 4 trillion, while France's reached EUR 8.6 trillion, together representing nearly half of the euro area's total financial assets. The IMF recently delivered a clean bill of health to the French banking system, writing that "banks' solvency and liquidity positions are robust, with adequate buffers. Sound prudential measures are mitigating housing market risks as property prices stabilize, while risks to the banking sector from corporate indebtedness and sovereign exposures remain manageable. Notwithstanding high uncertainty, financial stability risks remain contained, with French banks showing resilience under severe geopolitical and recessionary stress test scenarios, applied in the context of the IMF's 2025 Financial Sector Assessment Program (FSAP)."[2] German banks, admittedly, continue to suffer from low profitability and associated vulnerabilities, reflecting limited progress in consolidating its over 1400 banking institutions.

Germany, unlike most advanced economies, has remained an industrial powerhouse in recent decades. At 18.3%, its employment share in manufacturing is the highest in the G7 (tied with Italy), and it has resisted better than most to the rise of China since the turn of the century. This has helped it generate steady large current account surpluses over recent decades; notably, it recently took over from Japan the spot of world's first creditor with net foreign assets worth USD 3.95 Trillion at end 2024.

True, France and Germany are both afflicted with adverse demographics, with Germany in particular expected to have by far the fastest shrinking working age population of any G7 country in the coming decade. But demographic headwinds are a problem shared with a majority of fellow EU member states. Immigration has been helping contain the natural shrinkage of the workforce, particularly in Germany. However, the po-

[2] France: Staff Concluding Statement of the 2025 Article IV Mission, IMF, May 2025.

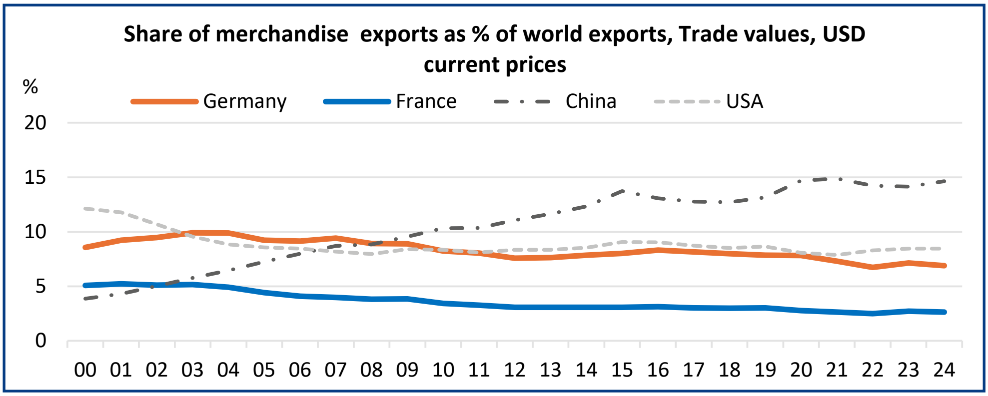
litical climate is not favorable to further expansion. In fact, the opposite is the case, nearly everywhere across the EU.

2. GERMANY'S PROBLEMS ARE STRUCTURAL IN NATURE, BUT NEW POLITICAL MOMENTUM PROVIDES AN EXCELLENT OPPORTUNITY TO FIX THEM.

Against the relative strengths identified above, Germany has 3 main challenges: a high exposure to global trade shocks; an energy-intensive, medium-tech heavy economic structure, combined with a fossil-fuels heavy energy mix; and a depleted public capital stock.

The German economy has historically been very dependent on foreign trade. Exports represented 42% of GDP in 2024, making it vulnerable to a slowdown in global demand such as the one expected to result from the recent US tariff rise. Compared to other large EU economies, it also has relatively high exposure to trade with the US. What's more, Germany has been losing global export market share in recent years: from 8,6% in 2000 to 6,9% in 2024, mostly to the benefit of China (see chart 2).

Chart 2.

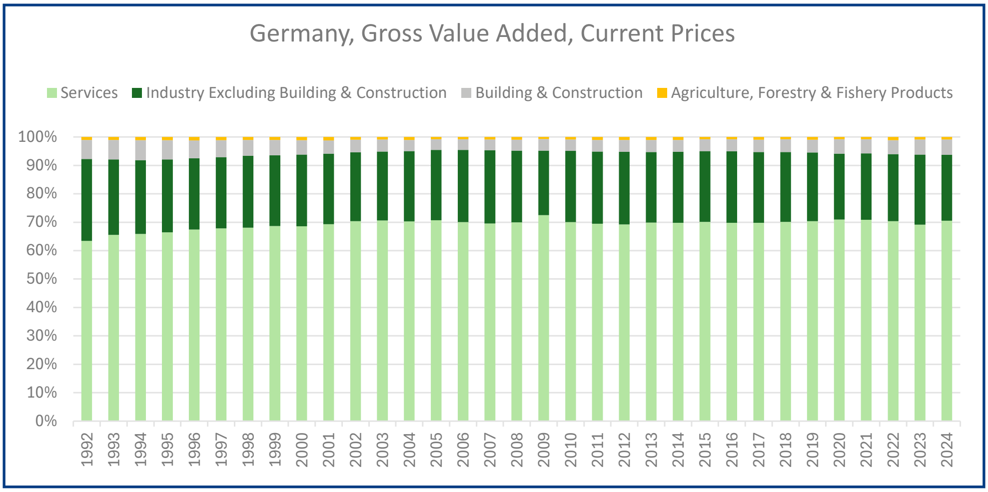


Source: WTO, BNP Paribas.

Germany suffered disproportionately from the energy price hike in 2022 because of its high dependence on fossil-fuels. Germany had strongly been dependent on Russian gas in comparison to other countries. When looking at energy PPI, prices rose by 100% during the summer of 2022 y/y. Since then, prices have slowly decreased but remain 54% higher than in the summer 2021. As the German economy relies heavily on energy-intensive industries (chemicals, metals, wood and paper, plastic products) and the automobile sector, industrial production has been struggling. Those sectors respectively account for 28.6% and 20.8% in 2022 (latest data available). The weight of energy-intensive industries is comparable between France, Spain and Italy but these—

especially France and Spain—can rely on a much higher share of renewable and, in the case of France, nuclear energy. Regarding the weight of the automobile sector, Germany is in a league of its own. That sector has been facing particularly strong headwinds owing the rise of Chinese automakers, particularly competitive in the EV segment (see chart 3).

Chart 3.



Public investment has been notoriously weak in Germany for the last few decades, placing it near the bottom of the EU league table. In fact, since the 1990s, public investment has been barely sufficient to offset depreciation.[3] This is likely to have played a significant part in Germany's weak productivity growth and decaying growth potential.

But the winds have started to turn more favorable and more dramatic changes lie ahead. The 2022 terms of trade shock has largely been absorbed. Energy intensive industries are still struggling, but positive employment creation has resumed in other parts of German industry. While attracting less attention than the old industries Germany is famous for, Germany is an emerging global leader in several high growth sectors, notably sustainability and climate tech, digital health, and industry 4.0 (e.g., 3D printing and other advanced manufacturing and supply chain technologies). It is well positioned in the upstream parts of advanced semi-conductors supply chains. Further, an old industry like Defense, another German stronghold, is having a strong revival. Even automobile production resumed rising in 2023. And the largest two German car makers accounted for 10% of global EV sales in 2023.[4] GDP growth surprised very positively in Q1 2025 (+0.4% q/q in Q1 2025). Industrial production over six months seems to be stabilizing, consumer confidence is improving, and economic indicators overall are encouraging

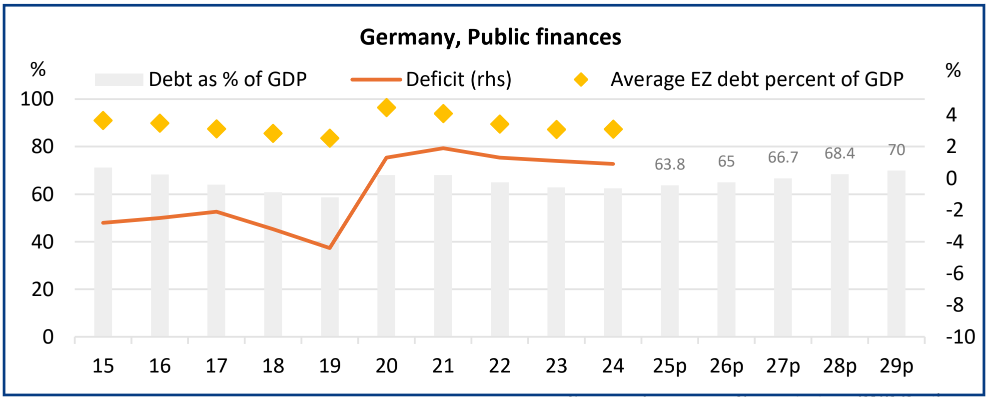
[3] A European Public Investment Outlook - 3. Public Investment in Germany

[4] Germany's Real Challenges are Aging, Underinvestment, and Too Much Red Tape, IMF, 2024.

(composite PMI at 50.1, gradual recovery in the manufacturing PMI and construction PMI at a two-year high; IFO which has been improving since last December).

Against this already encouraging background, the investment plan approved by the new governing coalition elected in March 2025 is set to be a game-changer. This plan, made possible by a constitutional reform of the "debt brake", provides for EUR 500 bn to be invested in infrastructure over the next 12 years, plus at least another EUR 500 bn to be invested in defense. This latter amount is not capped, however, and could in fact end up significantly larger in light of the emerging goal to bring Germany's defense spending to 5% of GDP rather than the initial goal of 3.5%. This is set to be the largest increase in public investment since the German reunification. Importantly, this reform also creates fiscal space for measures targeted to reducing the cost of energy. The German government under Friedrich Merz plans to tackle high electricity prices by reducing the electricity tax to the European minimum and capping grid fees. The goal is to lower the electricity bill by at least five cents per kilowatt-hour for households and businesses. Additional relief measures have also been announced for energy-intensive industries, though details remain vague. In the medium and long term, Chancellor Merz aims to accelerate the deployment of renewable energy and build 20 GW of gas-fired power plants by 2030, which should help stabilize prices and ensure supply security.[5]

Chart 4.



Source: European Comission, BNP Paribas.

By our estimates, consistent with those of the European Commission, German GDP could be 1.5% higher by end 2029 and up to 2.5% higher by 2035.[6] Thanks to a relatively low initial debt to GDP ratio, Germany should be able to finance this investment

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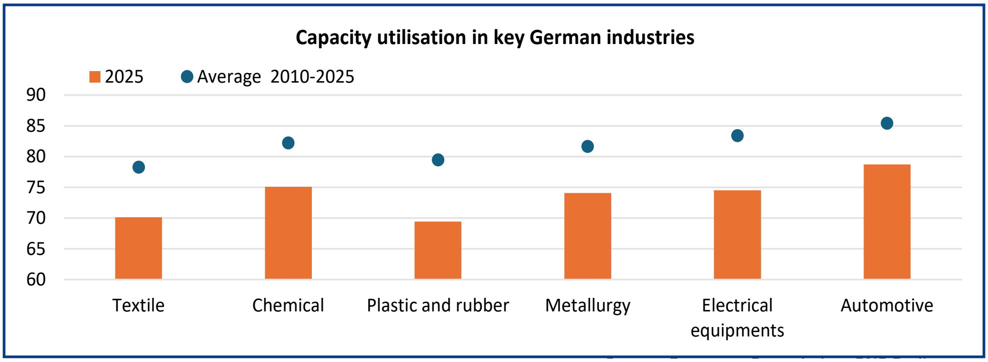
[5] While Chancellor Merz has also signaled greater open-mindedness to nuclear power, notably in the EU regulatory context, there is no intention to reopen the former German nuclear power stations shut down in 2011. Rather, the emphasis is on exploring new technologies: Small Modular Reactor (not yet developed in EU and with relatively limited usage), fusion (a very long-term objective before it becomes operational).

[6] The potential economic impact of the reform of Germany's fiscal framework - European Commission, May 2025.

surge without meaningful crowding out effect; on the opposite, this investment should help boost the productivity of private investment, generating a lasting increase in Germany's growth potential. As a result, we estimate Germany's debt to GDP ratio would reach only 70% by 2029 (See chart 4).

Will this investment plan prove inflationary? This concern exists but should not be overestimated. The impact of Germany's new public investment plan on inflation should, in itself, remain limited. This plan comes at a time when production capacity remains underexploited in several strategic sectors, providing headroom (see chart 5). Indeed, the German auto industry has already started converting idle capacity towards Defense production. The additional public spending will therefore mainly offset weak private demand. However, given a parallel increase in military spending at the European level, we could see rising input costs (raw materials, supply chains) and labor market tensions, particularly for skilled workers in strategic sectors. Despite these risks, upward pressure on prices should remain contained thanks to positive medium-term effects, with public investment expected to boost the productivity of productive capacity. As a result, we anticipate inflation of 2.3% in 2025 and 2% in 2026 in Germany. That said, Germany's cost competitiveness has eroded in recent years due to sustained wage growth and higher inflation than the average for other European countries. This trend is expected to continue, and as a result, Germany's real effective exchange rate is likely to continue to appreciate slightly in the coming years. This should contribute to further rebalancing of intra-EU external positions.

Chart 5.



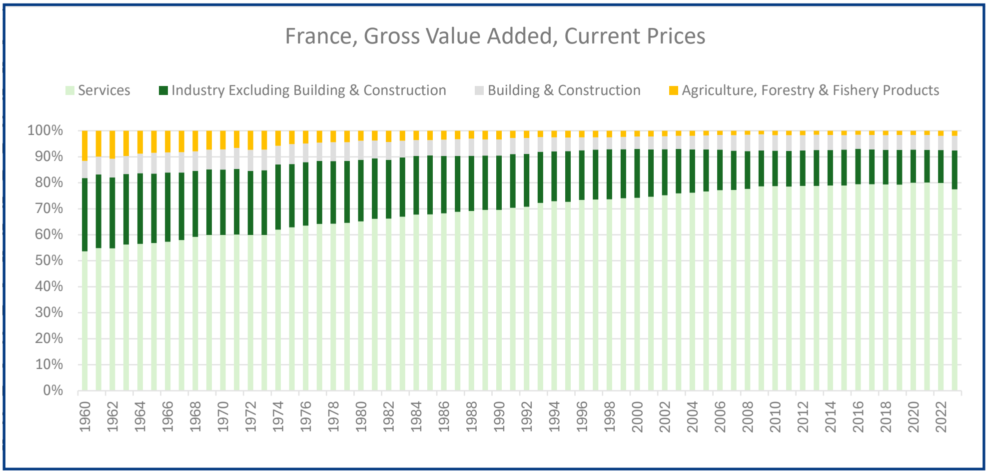
Source: European Comission, BNP Paribas.

Political dynamics are conductive to broader structural reforms that should help boost growth. The new German government has been elected for a five-year term. The two-party coalition (down from 3 in the previous parliament) facilitates compromise and allows for smoother coordination. The new government's economic platform emphasizes modernization and strengthening competitiveness. Beyond the public investment plan, other measures include tax reforms, incentives to foreign investment, reduction of bureaucratic red tape, and the relaxation of certain labor market rules.

3. FRANCE'S PROBLEMS ARE MAINLY FISCAL, HENCE "TECHNICALLY" EASIER; BUT THE POLITICAL CONTEXT MAKES IT HARD TO SOLVE THEM PROMPTLY.

France's economy has real structural strengths. Unlike Germany, France suffered severe de-industrialization in the last two decades, with its employment share in manufacturing falling by a record in the G7. But what is left of it (11% of GDP, roughly 5 pp below 2000) is highly competitive and high value-added (luxury, pharma, aeronautics). Moreover, France has a strong and vibrant service sector, driving growth through exports, investment and consumption (see chart 6). This service-heavy makeup of the economy reduces France's vulnerability to trade wars. France also benefits from low cost of energy thanks to early investment in nuclear power and large investment in renewables. As EU energy markets become more integrated, the French energy sector is likely to benefit.

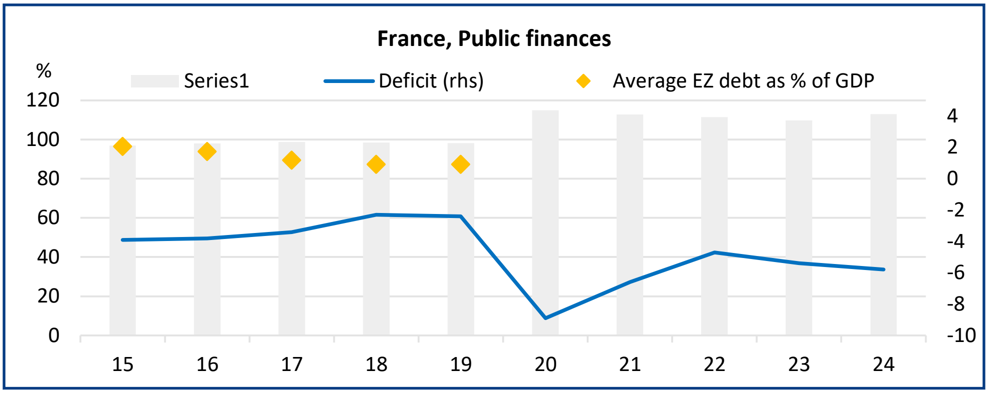
Chart 6.



Source: Insee, BNP Paribas.

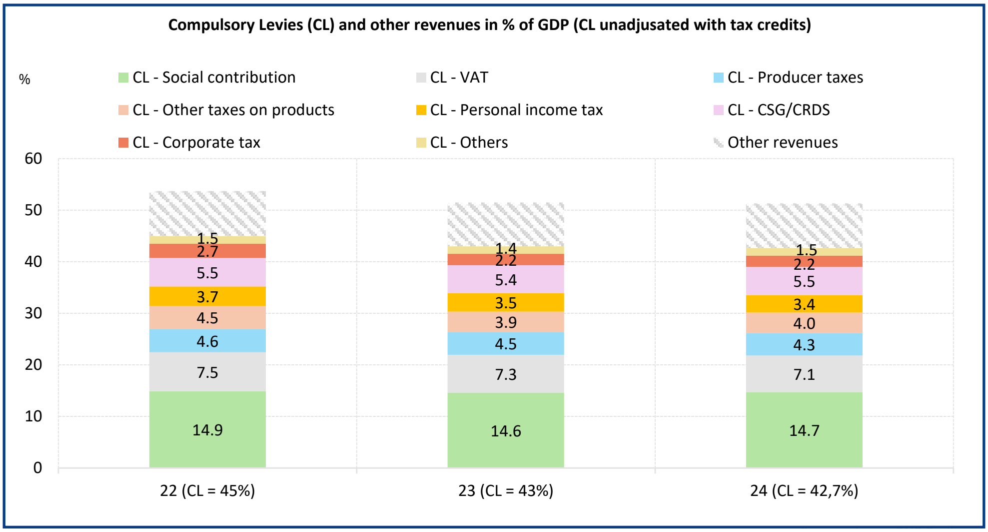
However, France has a fiscal problem. France is the only large country in the EU that hasn't managed to rein in its public debt to GDP ratio or its fiscal deficit in the post-pandemic period. The fiscal deficit increased significantly in 2023 and 2024, due to a decline in the public revenue-to-GDP ratio and a public expenditure-to-GDP ratio that still remains above its pre-COVID level. Alongside other reasons, (notably the impact on revenues of the slowdown in household consumption and the decline in real estate transactions on revenues), the decision to fully offset inflation through de facto indexation measures on revenues (indexation of income tax brackets) or expenditures (indexation of social spending) differs from that taken in other European countries. As a result, the public debt-to-GDP ratio returned to its 2021 level (113% of GDP) in 2024, while it declined elsewhere in Europe (see charts 7 and 8). There are now clear signs of crowding out effects on both consumption and investment owing to high taxation and fears that it is about to get even higher.

Chart 7.



Source: European Comission, BNP Paribas.

Chart 8.

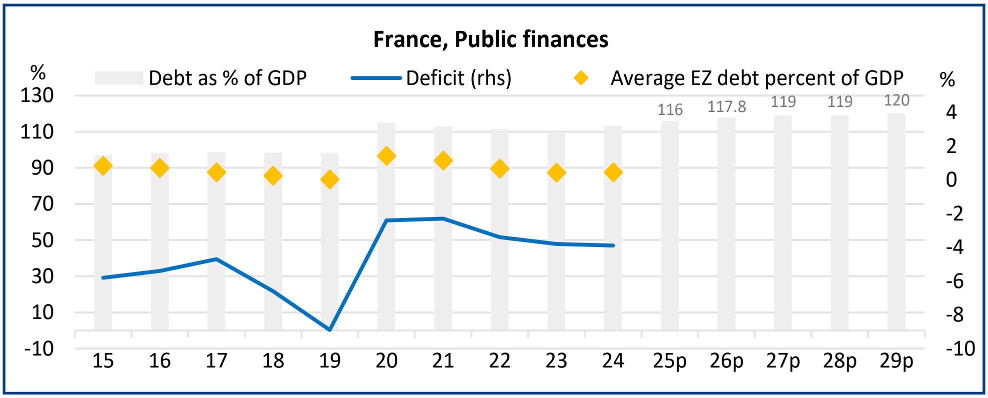


Source: Insee, BNP Paribas.

The 2025 budget should enable consolidation to resume (reducing the deficit from 5.8% to 5.4% of GDP). An increase in revenue is likely: end of the "gifts" of the inflation period; stabilization of real estate transactions; "exceptional" increase of taxes (corporate tax, tax on high incomes). However, the public spending-to-GDP ratio is expected to remain high.

In the medium term, fiscal consolidation should remain gradual in order to blunt its impact on growth and because two additional costs will weigh on the deficit: interest expenditure and military spending: +0.5pp per year on average between 2025 and 2029). To reach the government's target (3% of GDP in public deficit in 2029), an adjustment of 0.5 percentage points of GDP would be necessary per year, i.e. a primary effort of 1 percentage point of GDP per year (taking into account additional interest payments and military spending). Taxes on labour and production are both very high compared with peers. This means France needs to contain the growth of its public spending. Containing the growth of transfers to a sub-GDP rate and increasing the productivity of the public sector workforce would be the most growth-friendly ways to proceed (See chart 9).[7]

Chart 9.



Source: European Comission, BNP Paribas.

A particular challenge is that France's employment rate remains relatively low particularly among the youth and seniors, and it has a significant proportion of NEETs ("not in education, employment or training"). However, reflecting recent labour market reforms, the employment rate has been on a rising trend and reached an all-time high (since data records began in 1975) in Q1 2025. Budget consolidation will therefore benefit from reforms of incentives to work and hire. These issues are now all on the table, which allows hope for progress in coming years.

There is a risk that unforeseen factors could complicate this pace of consolidation. However, we believe that meaningful consolidation will take place over time, as long as a recession can be avoided, because there is now a wide consensus in the French society that public debt is too high and something must be done about it. Local government spending already appears to have slowed. State spending has already been cut. The most difficult point will be to slow down social spending, whose weight in GDP accounts for most of the increase in public spending compared to pre-Covid levels (1% of GDP). As wages are now rising more steadily than inflation, under-indexing social spending

[7] For further details see French Budget: The Hardest Part is Yet to Come, Stephane Colliac, May 2025.

to inflation could now be considered (a return to a policy that contributed to the fiscal consolidation implemented between 2012 and 2017).

French politics have been a complicating factor since last year's dissolution of Parliament, but the seriousness of the problem should not be overestimated. France's government lacks a majority in Parliament, a situation that is likely to persist until the next presidential election in May 2027. This makes it impossible to push through draconian reforms. However, discussions for the 2026 budget have been kicked off early this year, across all political forces, in the hope of forging a consensus acceptable to a wide majority. Could we see a "Liz Truss moment" in France? No, since there is wide consensus across political forces, and in public opinion, that fiscal consolidation is needed. Views differ only about the means to deliver it. Thus, even though a new no-confidence motion against the government cannot be ruled out, and it would be likely to generate some market volatility, any new government would need to remain committed to fiscal consolidation to have Parliament's backing.

4. WHAT DOES THIS ALL MEAN FOR EUROPE?

Inflation. Germany accounts for 27.6% of the HICP calculation for the eurozone in 2025, and France accounts for 19.1%. As we expect inflation in France to continue to undershoot the 2% target in coming years, and Germany to overshoot it slightly, our central scenario envisions inflation broadly at target from H2 2025 onwards, with ECB cutting its main deposit rate to 1.75% by end 2025, with rate rises resuming in H2 2026.

Interest rates. Bund yields have risen and are set to rise further as a result both of higher issuance volumes and higher growth expectations. While this trend will also affect other European countries, spreads with other member states should narrow slightly given a stronger overall growth outlook, particularly for countries showing progress in consolidating their public finances (as has been the case for the last few years already). Spreads could be further contained by further recourse to joint borrowing alongside national one to finance rearmament efforts, and even more in the event of conversion of part of the stocks of national debt into Eurobonds, an old idea that has burst back onto the stage lately[8]. At the same time, as ever, EU yields will be impacted by developments in US Treasuries yields. Historically, particularly since the 2008 Global Financial Crisis, the correlation between US and German government bond yields has been highly positive and often close to 1[9]. However, since the onset of the broad-based US tariff offensive and other US policy steps that have led global investors to question the safe haven status of the dollar, we have seen a partial decorrelation, seemingly caused by a partial redirection of safe haven flows toward European government bonds (EGBs).

Euro. During the sovereign debt crises of the early 2010s, the euro proved unexpect-

[8] See for example: Now is the time for Eurobonds: A specific proposal | PIIE ; How Europe should respond to the erosion of the dollar's status ; Now is the time to reopen the Eurozone bond debate

[9] See Growth is local, bond yields are global: why does it matter?, William de Vijlder, March 2025

edly resilient. This was because investors dumping periphery country sovereign debt tended to reinvested in core-EZ countries, leaving the overall demand for euros largely unchanged. That said, it could be argued that a sovereign debt crisis in France would be seen to threaten the existence of the euro itself and as such might lead to capital outflows from the EZ at large. This is very much a gray swan in our view, and a far more likely scenario is that as the EZ's 2 largest economies regain health and dynamism, more global capital is drawn into the region, and the euro appreciates as a result.

Financing of European public goods. Germany's rearmament carried out through a national initiative does not in any way hinder the pursuit of joint projects at the European level. The decision to favor national deficit spending over financing through European mechanisms is based on cost considerations, as Germany benefits from more favorable financing conditions. In any case, Chancellor Merz's has explicitly indicated being open to discussing more financing of European public goods. From the French perspective, the more European public goods can be financed at EU level, the easier it will be to reconcile its own fiscal consolidation needs with its undaunted aspiration to strengthen European sovereignty. Were Euroskeptic parties to take power in 2027 following the Presidential and legislative elections, it is conceivable that they would press for a reduced French contribution to the EU budget negotiations on the 2028-2034 multi-annual financial framework should be substantially completed by mid-2027. As a result, the earliest opportunity to press for a smaller EU budget would not come until negotiations about the 2035-41 budget. However, given the timing and pluri-annual nature of the EU budget process, they earliest opportunity to press for a smaller EU budget would not come until negotiations about the 2034-2040 budget.

5. IN SUM

While France and Germany have both being going through what may be described as a rough patch, the conditions are ripe for their convalescence, which has begun, to gather momentum. This trend will both support and be supported by broader EU-level efforts to seize the opportunity created by the historic pivots in US domestic and international policies and execute on plans to rearm Europe and on the full set of EU-level reforms identified last year in the Letta and Draghi reports: deepen the Single-Market, boost productivity and innovation, complete the capital markets union, complete the EU's energy transition.

pean firms when competing abroad, because they play with home rules (the so-called "Brussels effect"). This might be true, but it depends crucially on whether foreign regulators adopt EU standards or develop more lenient local rules. In the field of banking, for instance, there is certain evidence that EU banks, being under EU laws in their activities overseas because of consolidated regulation and supervision, compete with stricter rules than their local competitors in many emerging economies, in what we may call "self-defeating extraterritoriality".

In the field of financial services, the asymmetry of EU data sharing regulation like Open Banking and more recently Open Finance (under discussion in the Financial Data Access Regulation, FiDA) implies a competitive disadvantage for banks, in the sense that specific financial sector regulations impose more demanding data sharing rules vis-à-vis non-financial players than horizontal regulations affecting all sectors. This approach penalizes EU banks vs non-EU Bigtechs. This is probably an unintended consequence of policies aimed at enhancing competition in the financial sector. The implementation of the Digital Markets Act, DMA, which develops rules for data sharing for gatekeepers, may attenuate this asymmetry.[6]

In the new regulatory frontier on Artificial Intelligence, the AI Act imposes more demanding requirements on AI systems in order to mitigate potential negative impacts in citizens' health, security and fundamental rights, reflecting also the EU concern with privacy and intellectual property protection. Although the AI Act approach is in line with European values, its interaction with previous regulations like GDPR complicates the use of AI in many fields and is leading some of the main AI players like Meta and Apple to declare that they will not deploy global AI systems in the EU, or will delay their implementation. The underlying problems point to GDPR requirements like the limit in the consent on the use of data by consumers to one specific purpose, or the data minimization principle, which are incompatible with the nature of AI systems. This restriction in the adoption of new technologies in the EU (which anyway has very little domestic capacity to develop such systems) may put EU companies and consumers at a disadvantage in the global context.

In the field of cryptoassets, the development of EU regulation (MiCA) in parallel to the work of global standard setters may consolidate the backwardness of the EU compared to the US. In contrast with previous examples, this may reflect a deliberate policy choice of regulation, given the mistrust of EU regulators towards cryptoassets.

To sum-up: although the lack of Bigtech champions in the EU cannot be attributed exclusively (not even mainly) to the impact of regulation, it may be a limiting factor. And in recent regulations concerning what is arguably the most important transformation in the world economy in recent years (AI), the combination of well-intended regulations with very strict privacy rules may leave Europe outside crucial forthcoming transformations.

[6] See Fernandez de Lis (2024): "European leadership in digital finance regulation: Pros and cons", in Duckbucks, Regulation in the age of digital finance, September 2024. www.duckbucks.com

5. COMPETITIVENESS, SIMPLIFICATION, DEREGULATION

The Draghi Report on European Competitiveness underscored the need for financial sector reforms, advocating for regulatory simplification and enabling mergers to foster dynamism. However, as I analyzed in a previous article[7], a stark contrast emerges between this vision and the stance of the ECB's Supervisory Board Chair, Claudia Buch, who, around the same time of the publication of the Draghi report, stated in the European Parliament that the SSM's mandate is strictly financial stability, not competitiveness. This divergence is further highlighted by Commission President Ursula von der Leyen's mission letter to the new Financial Services Commissioner, María Luisa Albuquerque, emphasizing competitiveness and sustainable finance as core priorities.

The UK's recent financial reforms, particularly the Financial Services and Markets Act 2023, explicitly integrates competitiveness into regulatory objectives. Section 3(2)(e) states that regulatory actions should "facilitate the international competitiveness of the UK economy and its medium- to long-term growth." Applying this new approach, Rachel Reeves, the Labor Chancellor of the Exchequer, noted in her first Mansion House speech that "these changes [the reform following the global financial crisis] have resulted in a system that sought to eliminate risk-taking. That has gone too far… the UK has been regulating for risk, but not for growth… We have sent letters on their growth-focused tasks to the Financial Conduct Authority (FCA), the Prudential Regulation Authority (PRA), the Monetary Policy Committee (MPC), the Financial Policy Committee (FPC), and the Payment Systems Regulator (PSR). These letters make clear that I expect them to fully support this government's ambitions for economic growth". Around the same time the Chancellor forced out the Chair of the competition authority (CMA) on the grounds that she wants pro-business decisions to drive prosperity and growth, and appointed a former BigTech executive as new Chair. And in another move to simplify the regulatory framework, the UK decided to include the Payments System Regulator under the FCA.

In the aftermath of the Draghi and Letta reports, the debate on whether and how to incorporate objectives in terms of competitiveness or growth in EU financial regulation has gained momentum, triggered also by the delay and watering down of the finalization of Basel III in the UK and the US. The Trump presidency also appointed Elon Musk for a special agency in charge of deregulation: the Department of Government Efficiency (DOGE). In the EU deregulation seems to be a bad word, but the EU Commission has put forward a Competitiveness Compass[8] and announced a simplification of regulation focusing initially on sustainability (where an Omnibus Directive has been presented), but that could (and should) also reach other files.

[7] Fernández de Lis, Santiago (2024): Competitiveness as an Objective of EU Financial Regulation, The International Banker, November 27, 2024.
https://internationalbanker.com/tag/santiago-fernandez-de-lis/

[8] EU Commission: A Competitiveness Compass for the EU, 29.1.2025
https://commission.europa.eu/document/download/10017eb1-4722-4333-add2-e0ed18105a34_en

The Competitiveness Compass elaborates on the three transformational imperatives to boost competitiveness identified in the Draghi report: (i) innovation, (ii) decarbonisation and (iii) strategic autonomy and security. In a characteristic European approach to deregulation and simplicity, instead of eliminating regulations currently in the pipeline whose need is not obvious (like FiDA en the Retail Investment Strategy, RIS), the Compass envisages 11 Acts and numerous strategies, initiatives, guidelines, plans, packages, frameworks… Among the potentially most powerful ideas is the 28th regime, a new streamlined EU-wide regime for innovative companies covering labor, bankruptcy and tax rules. It remains unclear whether Member States will support this proposal. A related proposal is the Competitiveness Lab, a procedure suggested by the Spanish government that allows a sub-group of EU countries to go ahead in terms of integration, to which other Member States may join in a future stage. However, some Member States, especially small ones, have criticized this two-speeds approach, and it is difficult to assess whether it may gather sufficient support. Another criticism is that the Compass focus on 'scaling up' start-ups risks worsening the threshold effects that keep European firms small.[9]

Shortly after the publication of the Compass the Commission made public the Omnibus initiative, focused on sustainability, with amendment proposals to several pieces of legislation. The Corporate Sustainability Due Diligence Directive (CSDDD) is postponed one year and the review clause for financial institutions is eliminated. The transition plans requirements are aligned with the Corporate Sustainability Reporting Directive (CSRD), which in its turn reduces by 80% the scope of companies covered, and a future revision to reduce data points is foreseen. A consultation was open regarding the taxonomy regulation, where the definition of Do Not Significant Harm (DNSH) and the reporting templates are simplified, but the Green Asset Ratio (GAR), which was the main concern of the financial industry, is not eliminated. These changes are not definitive and the process may be long, since the proposal will now enter a negotiation process.

Simplification is becoming a buzzword in EU regulatory debates. But complexity is to a certain extent embedded in EU Multi-Layered Governance System, which needs detailed and binding rules to prevent regulatory arbitrage inside the Single Market (see table 1 for a ChatGPT summary of the reasons why Europe regulates so much). The EU legislative process involves multiple layers of rule-making, interpretation, and enforcement (Level 1, Level 2 and Level 3 regulation, plus supervision) which implies that regulatory adaptation becomes a continuous process rather than a one-time compliance effort.

In the exercise of simplifying EU regulation there are a series of trade-offs that it would be better to avoid:

- Less European regulation should not be achieved in exchange for more national regulation. The simplification exercise should be done without creating addi-

[9] For a critical view of the Competitiveness Compass see Garicano and Garicano (2025): 20 thoughts on the Competitiveness Compass,
https://www.siliconcontinent.com/p/20-thoughts-on-the-competitiveness

tional fragmentation in the single market. Indeed, the simplification exercise perhaps requires reducing regulation mostly at the national level.

- Less Level 1 regulation should not lead to more Level 2 regulation. Broadening the scope of independent agencies without strengthening their accountability and clarifying the overlaps in their mandates risks increasing (instead of reducing) complexity (see section 6).
- For similar reasons, less regulation in exchange for more supervision does not look like the best approach. Supervision is probably the source of the most restrictive interpretations of the regulation. Extending their scope of action would reduce the predictability of the regulation and exacerbate the uncertainty under which EU banks operate.

Part of the problem of the simplification process in the EU is that the institution in charge of carrying it out (the European Commission) is a bureaucracy created to regulate and whose main purpose is to develop rules that ensure the level playing field in the single market. The Commission needs to run against its instincts in simplifying regulation.

Table 1. 10 reasons why Europe regulates so much.

1. Historical Experience with Crises
2. The European Model of Social Market Economy
3. Fragmented Political Landscape & the EU's Need for Harmonization
4. Precautionary Principle
5. Strong Public Support for Regulation
6. Influence of the European Parliament & Bureaucracy
7. Geopolitical and Economic Competitiveness Strategies
8. Legal Traditions Favoring Rules Over Market Solutions
9. Risk Aversion & Stability Prioritization
10. Digital & Financial Sector Oversight

Source: ChatGPT

6. THE OBJECTIVE(S) OF INDEPENDENT AGENCIES AND DEMOCRATIC ACCOUNTABILITY

The scope for simplification of regulation is closely related to the regulatory architecture, the role played by different stakeholders and the dividing line between regulation and supervision. The ideal scheme should be based on (i) high-level international standards, (ii) principles - based regulation (level 1) and (iii) more technical and detailed regulation and supervision in charge of independent agencies (level 2) with appropriate accountability.

Over recent years international standards have become increasingly detailed, but their enforcement is increasingly weaker, which suggests a certain inconsistency in the whole process. We should move towards less detailed standards and reinforce their application through peer reviews and similar exercises. To facilitate the operation of international banks, regulation should avoid extraterritoriality and rely more on equivalence and substituted compliance.[10]

Regarding the balance between level 1 and level 2 legislation, it is important to ensure that banking regulation is in accordance with legislators' objectives and at the same time based on sound technical analyses, which requires a clear mandate to the agencies and accountability on their part. This is more or less the UK model (reinforced after the 2023 reform) and was the US model before the Trump 2.0 Presidency, which has put into question the independence of the agencies.

Accountability is very limited in the EU, in particular in the supervisory field. The SSM has inherited the independence of the ECB, in what is probably an excessive interpretation of the Treaty. The rationale for the ECB independence is clear in the monetary policy domain, to avoid decisions based on short-term political objectives (for instance, a reduction in interest rates to stimulate growth and favor the reelection of an incumbent government) that may undermine the long-term objective of price stability (the so-called time inconsistency problem). But the rationale of extending this independence to the banking supervision field is not obvious.

This debate is related to the coexistence of multiple objectives in an independent institution. Accountability is easier with agencies that have a single objective. But over recent years the ECB has expanded its array of objectives to include, on top of price stability, banking supervision, payment systems efficiency or contributing to climate change objectives, to name a few. At the same time, other institutions have been created with narrow mandates (like the SRB in the area of resolution, AMLA in money laundering or the ESRB in macroprudential policies) that tend to overlap with that of the ECB.

To sum up, in Europe we have a weak government (as compared to Member States), a weak parliament (as compared to national parliaments), a strong bureaucracy tasked with developing regulation as its main purpose (the Commission), a very powerful in-

[10] See Fernández de Lis, S. (2017): Towards More Selective and Enforceable International Regulatory Standards, International Banker, December 11, 2017. https://internationalbanker.com/banking/towards-selective-enforceable-international-regulatory-standards/

dependent supervisor (the ECB/SSM) and a series of new regulatory agencies with narrow mandates and very limited accountability, focused on only partial objectives, without a broader picture. These new institutions tend to defend their territory by being more orthodox than the other agencies. It is not surprising that we overregulate, and it is certainly challenging to instill regulatory simplification in this architecture, a review of which should be a priority.

7. STRENGTHENING THE IMPACT ANALYSIS OF REGULATIONS

The EU carries out Impact Analysis (AI) of its regulation that scrutinizes legislative and non-legislative initiatives, delegated acts and implementing measures, with significant economic, environmental or social impacts. It was recently reviewed in the Better Regulation Communication of 2021. It comprises several steps: (i) problem definition and objective setting; (ii) identification of policy options; (iii) elaboration of an impact assessment report; and (iv) check by the Regulatory Scrutiny Board (RSB).

Impact Assessments must serve as honest evaluative mechanisms, identifying flaws and areas for improvement, to determine if a legislative proposal is the best policy option to achieve the intended objectives. The current process looks rather as a mechanism to confirm the appropriateness of the Commission's initiatives, as illustrated by the low and decreasing number of withdrawn or rejected Commission proposals. A negative IA should have the ability to halt proposals that have been deemed unnecessary.

The current static IA process, which focuses only on the pre-legislative stage, must be enhanced with dynamic IAs that incorporate systematic ex-post evaluations. This would ensure continuous monitoring and adjustment of policies based on real-world impacts and stakeholder feedback during the legislative process as well as after the legislation has been implemented. These should then lead to changes in the legislation themselves.

The IA process should prioritize competitiveness checks to ensure that new policies do not inadvertently harm economic growth or the competitiveness stance of EU companies. These checks must go beyond mere formalities and should be weighted significantly in the evaluation process and avoid "tick the box" exercises.

The current governance mechanisms, such as the Regulatory Scrutiny Board (RSB), need to be more effective. The absence of a significant number of final negative opinions from the RSB raises concerns about its ability to effectively evaluate the quality of IAs. Elevating the authority of the RSB by making its opinions binding would ensure higher quality and accountability in IAs before advancing the legislative proposals. Additionally, the composition of the RSB should include more external experts to objectively evaluate the IAs. Introducing stricter oversight measures and strengthening the RSB governance could improve the credibility and robustness of the IA process.

Other ideas that can be explored to improve the IA process are the following: broadening IA analyses to include factors like competitiveness, simplicity, cross-sectoral impacts, and broader economic implications, not just compliance costs; explaining more clearly IA methodologies, including assumptions, data used and calculations, to allow industry stakeholders to replicate and validate findings; include third-country impacts on the subsidiaries of EU companies, especially for industries like banking, where global competitiveness is critical; extend IAs to critical level 2 regulations and national transpositions, to ensure more clarity and predictability in implementation and less fragmentation; and improving industry data collection to ensure IAs are based on accurate, real-world inputs.

8. CONCLUSIONS AND SPECIFIC PROPOSALS

The European financial regulatory framework has grown increasingly complex, raising concerns about its impact on bank competitiveness. This note outlines a few proposals to streamline regulation, strengthen institutional accountability, and promote efficiency:

1. Clarify the scope of EU vs national competences.

- To avoid a rush to regulate when competences are unclear, it would be helpful to delineate more clearly ex ante the national vs EU competences, especially in the digital domain.

2. Embed Competitiveness into Regulatory Mandates.

- EBA and ESMA already include in their mandates the efficiency of the financial system, which is taken into account in their analyses of risks and vulnerabilities. There is no need to change these mandates, but perhaps reinforce the competitiveness/efficiency element in their impact analyses (see below)
- The SSM currently lacks a competitiveness goal and does not even consider it an implicit objective. A legislative "quick fix" could integrate efficiency/ competitiveness in the SSM mandate, mirroring the UK's 2023 reform.

3. Strengthen the SSM Accountability

The accountability of the SSM towards the European Parliament should be enhanced. The SSM should publish annual competitiveness or growth reports, detailing the impact of its policies on these objectives.

4. Create Better Avenues for Challenging SSM Decisions

- A senior-level dialogue between the industry and the SSM should help escalate technical issues that affect banks' competitiveness.
- The Administrative Board of Review (ABoR) should include independent experts, increase its transparency, and play a challenging role.

5. Reform the EBA Governance

- The EBA's board should include more independent members and less rep-

resentation of national authorities. This would help making the consultation process of level 2 regulations more open.
- The European Commission should improve the oversight of EBA by assessing more systematically whether delegated acts stay within the legal mandates.

6. Enhance Impact Assessments
- Regulatory proposals should include evaluations focusing on economic and competitiveness impacts. Impact Assessments should be done also ex post (for instance 4-5 years after adoption), to ensure that the intended effects have been reached.
- The Regulatory Scrutiny Board of the Commission should include more independent experts.

7. Eliminate Redundant Authorities
- Every time an EU institution is created an analysis on whether the corresponding national authorities are still relevant should be carried out. The burden of proof should be on the need to maintain these national agencies.

8. Expand ESMA's Role
- In support of a deeper Savings and Investment Union (SIU), ESMA should supervise systemic market infrastructures and manage cross-border asset managers through harmonized oversight structures.

9. Simplify Capital Requirements
- Regulations like MREL should be simplified to reduce the compliance burden.
- The buffer structure of banks' capital requirements should be simplified, to avoid overlapping requirements decided by different authorities, with a special focus on the Systemic Risk Buffer, the Countercyclical Buffer and the Pillar 2 Buffers.
- EU banks should go further in the simplification of internal models, moving as a rule towards the standard model, as the US did a few years ago.