

THE DRAGHI-REPORT

EU INDUSTRY BETWEEN A ROCK AND A HARD PLACE



THE DRAGHI REPORT: EU INDUSTRY BETWEEN A ROCK AND A HARD PLACE

The Draghi-report on the widening gap in competitiveness of European industry is an impressive read and wake-up call. The report is giving an official name to many developments that are neither recent nor unexpressed. The corona crisis and the war in Ukraine and the subsequent inflation have sharply revealed the extent of the ailments and imbalances in the EU economy, which have been festering since 2008/2009 or even before. With the report now on the table, it is important to assess the implications of this macro- and in part meso-economic analysis.

The focus on energy in the report is not surprising. The energy crisis of 2022 and after, in combination with the cost of the energy transition running ahead of the benefits, has structurally changed the price tag of energy for users in the EU. The EU is a resource and energy (carrier) poor group of countries, relying on global markets to source the economy with necessary inputs. Energy is a major input into the economy, for industry, mobility, offices and houses. Industry is an important contributor to job security and productivity. De-risking trade relations with state capitalist countries is complicated. China has strategically invested in resource production around the world and is the main processor of these resources. Russia was a main supplier of energy and energy products. The significant dependency on Russian energy has been replaced with dependency on the US. Both Russia and China focus on converting their main export products into more value-added products which are not yet curbed by trade measures or sanctions. China is rapidly outpacing our renewable manufacturing on scale, price and market penetration.

The report calls for a lot more Europe, which opens the door to a fundamental and arduous debate about the organisation of the EU economic structure, its financing and the direction of European integration. The report deserves a wide public and political debate, not only in Brussels but also in the member states. The plethora of recommendations, ranging from overarching to detailed interventions, deserve such a debate because they will determine the direction of the EU for years to come. The current reality check could lead to a more realistic approach to the issues on the table, rather than the recent REPowerEU ambitions, which may lead to organised frustration and obfuscates the successes.

The national discussion of the report is complicated because the EU-wide approach may not address the more regional or local issues. International competing industries are clustered in certain parts of the EU, while other industries serve regionally relatively captive markets. Moreover, the socio-economic consequences of previous steps to deepen and widen integration are typically never part of analysis of this sort of EU-wide

study. This may prevent the EU to learn important lessons, and again, propose to jump into a direction which may or may not address the current competitiveness issues.

Energy, both traditional and new, plays an important role in the analysis. The recent increase in energy costs for industry in combination with the organised cost of bureaucracy of the energy transition is creating a lot of regulatory risk. The 2030 emission reduction targets may become too ambitious to achieve because the ability to mitigate the investments risks are insufficient in the current policy-setting. The report exudes urgency because the window of opportunity is very small for many EU industries. The report, without saying it out loud, declares the Lisbon agenda, in which the EU aimed to become the most competitive economy in the world, void. A new and realistic agenda takes time to negotiate. The current political mood in many member states may not help to navigate the many pitfalls ahead.

THE END OF EU INDUSTRY?

The EU runs the danger of turning the current wait-and-see posture of industry towards investments into a let's-pick-up-and-move-elsewhere assessment. Already, some of the 2030 energy transition targets are slipping out of reach, even though a lot of progress has been made towards reaching parts of the ambitious Green Deal targets. Some targets are merely delayed with a few years, although it remains unclear in how far closing industrial production units contribute to this achievement. Reading the report oozes urgency to do things less bureaucratically and create more space for businesses to find solution spaces than currently offered in the thousands of pages, sometimes contractionary, exhaustive regulations. Some of these regulations befit an economy post-2040/2050, when network bottlenecks may have been solved, and not the infant industry stage of some of the technologies nor the state of current network capacities and capabilities.

THE ROLE OF ENERGY

Energy is playing an important role in the current analyses of the widening competitive gap with the US and China. The energy transition is not questioned, also because some of the success stories in offshore wind and solar, and the promise of hydrogen is still alive. The bureaucratic burden of the energy transition policy combined with the implicit lack of Green Deal policymakers' understanding of industrial dynamics and value chain creation, may require a different approach to keep progress going. Already, China is catching up fast with new end-user products that may thwart local EU production, while the competitive energy sector in the US may offer cheaper routes for the energy transition efforts of EU industries, if they dare to commit to this premium product. The proclaimed leadership of the EU in energy and climate does not translate into sufficient technological or green energy economic success.

The EU and its member states may have fallen asleep due to the lower energy prices in the period 2014-2021, thinking that the buyer's market of that period was the new normal. Moreover, the introduction of the internal EU energy market (power and natural gas) was often heralded as the main proponent of this new normal, until it was not. These were politically convenient truths, not economic ones. The Draghi-report also forgets to mention the impact of the expansion of US shale production (and the early abolishment of such activities across the EU before the technology was improved), while also the impact of the introduction of the chosen model of monetary union and enlargement on the economic imbalances of the EU economy would have deserved some attention. If

urgency is needed to stop the erosion of the competitive position of industries in the EU, the EU and its member states should act without delay to create a business environment that is noticeable, consistent over time and substantially reduces the non-commercial risk of investments.

PRODUCTIVITY

The weaker productivity of labour growth in the EU, the deficiency of innovation compared to the US and China, the higher gas prices (impacting industry and electricity prices) since the supply of Russian spot deliveries were reduced in the fall of 2021, and the lack of coordinated responses and bureaucracy are viewed as the main reasons for the EU's relative decline in competitiveness. The recommendations, presented in box 1 of the A-report *Key principles for trade policy in a European industrial strategy*, are logical and should have been embraced at the start of the monetary union. However, the comparative sectoral breakdown of labour productivity growth in the report is based on the pre-2004 member states (minus the UK) and does not include all member states.¹ Excluding *tech*, productivity in the EU set of member states is in line with that of the US, concludes the report. Apart from the incomplete set of member states, this may also point to productivity imbalances in the US, where only a few sectors (energy and *tech*) drive the numbers. *Tech* development has been a longstanding issue in the EU, predating 2000, and due to more risk averse capital markets. It is also argued that the diffusion of technology was faster and larger in the US than the EU. A regular traveller to the US may beg to differ with this broad statement on this deeper diffusion, but the likes of Google, Amazon, Tesla, Apple, Microsoft, Meta, Nvidia, Airbnb, Uber and others, offering new generation platform-based services (AI), did originate in the US and changed international communication and mobility. China is following suit with its own versions of social media, platform products and online shops, competing head-on with the US companies.

When it comes to innovation, the comparison is only to the US and not China, perhaps because the state-capitalist system employed different instruments to rapidly innovate rather than the market-based American ones. Implicitly, a choice is made not to question the market-based organisation of the EU economy, while for all intents and purposes, the EU is a mixed economy, with a greater government-intervention level in the economy than in the US. This particularly applies to the climate-side of policymaking, where micro-management of the energy sector and the desired course of the transition must be one of the largest sources of bureaucracy for industry. Although, the Inflation Reduction Act also has its difficulties, the time and effort to gain approval appears fundamentally easier and quicker than the European regulations. The state capitalist industrial strategy of China is also left aside in the analysis, even though a future EU industrial strategy must take this as much into account as the American one.

REGULATORY HUBRIS

One consequence of the EU energy transition policy toolbox was the conception of a long international regulatory arm, which may clash with EU security of supply and affordability in the lengthy transition period due to mismatches with other countries. Network bottlenecks reduce transition options for up to ten or fifteen years in some parts of the

¹ On a side note, in a table presented by the Dutch Ministry of Economic Affairs, the top ten countries in labour productivity in hours worked, Luxemburg, Norway, Denmark, Switzerland, Belgium, Sweden, score higher than the US, while Austria, Germany and the Netherlands score below the US. The EU scores much lower. <https://www.bedrijvenbeleidinbeeld.nl/kern>

EU, while the EU is throttling supply of traditional fuels for a variety of reasons. The current international complaints about the long arm of the methane² directive is a good example of the EU's attempt to export its regulatory might to the rest of the world. But this regulatory muscle could result in shunting the EU as a viable export market for LNG long before the EU's import dependency has been remedied with alternative low-carbon fuels. The same may happen to low-carbon fuels, such as ammonia, hydrogen and methanol. We do not read about this possibility in the report. The growing regulatory compliance burden keeps adding compliance costs. Only when the administrative costs can be priced in and other premium markets become less attractive or demand similar reporting, exporters may contemplate complying, but the EU has a proven track record of squeezing supplies out of its energy system. In the alternative, the EU may have to swallow its pride and be forced to accept spurious data to allow energy to flow into the market. The chapters on the impact of high energy costs on competitiveness of EU industries since the escalation of the Ukraine war, are a case in point that policy measures developed in the pre-energy crisis Green Deal time have not been adapted to the new realities for the EU. **Instead, regulation has been tightened further, creating a precarious energy security of supply and energy cost issue for the coming years. No federalist type of capital market can remedy this regulatory risk and promote Final Investment Decisions in EU industries with an increasingly short and uncertain window to carve out a business case for their investments.**

INTEGRATION OF DIVERSE ECONOMIES

The impact of the chosen type of monetary union and enlargement is also left unspoken. For some member states, the interest rate is too low, creating a permanent situation of overheating, while for other it is too high, draining them of labour and capital. The stabilisation pact worked maybe a few years but that was already a long time ago. The fiscal pressures in the member states are mounting with also the previously strong economies beginning to suffer. The influx of cheap labour from new member states, with constructions unfitting a social EU, may also have put a serious break on productivity and innovation, allowing inefficiencies to persist. The growing pains of the EU internal market (or perhaps better: the perils of integration of unequal economies) are serious, and the social-economic consequences may be one of the causes for the current political commotion. Competition moved from quality competition to price competition in economies like Germany and other NW European member states. The new normal of overheating some parts of the EU created pressure on public sector services like health care, education and housing. The period of high inflation and subsequent wage-inflation still needs to be absorbed in the analyses. None of these internal issues are addressed. More EU will probably drown out these regional or local concerns for the greater good. Hence, the core of the current discussion focusses on how to remedy the competitive gap and the EU governance shortcomings today.

indicatoren/arbeidsproductiviteit#anker-3-vergelijking-nederland-met-vs-en-eu

² <https://energy.ec.europa.eu/news/news-eu-methane-regulations-reduce-harmful-emissions-fossil-fuels-europe-and-abroad-2024-05-27>; Ben Cahill and Hatley Post, EU Methane Rules: Impact for Global LNG exporters, CSIS, 3 May 2024, <https://www.csis.org/analysis/eu-methane-rules-impact-global-lng-exporters>; and Kim Talus, Gunnar Steck, James Atkin, EU Methane Regulation and its impact on LNG imports, *Journal of World Energy Law and Business*, 2024, 00, 1-15, <https://doi/10.1093/jwelb/jwae022>.

GREEN DEAL OR GREEN BOG

The decarbonisation agenda³ is increasing the costs for industry (competing in international markets) in the EU because of mismatches in time, type of interventions and targets, compared to the US and China. **While fossil fuels may be increasingly squeezed off EU markets on paper, they reappear in the form of semi-finished or finished goods (like cars, fertilizers, equipment, clothes, etc.), undermining the outlook for many EU companies to successfully complete their energy transition and survive.** The EU is in a dire predicament because most of the counter measures are slow or too late due to entangled corporate structures (like in the car industry). Particularly the German industrial strategy, based on cheap Russian gas and cheap labour of their Chinese counterparts, has been exposed in recent years to geopolitical repositioning.

After years of successfully increasing the supply of solar, wind and other sustainable energy supply, the sector is beginning to struggle with a lack of (industrial) demand for their product. Industrial demand is not forthcoming due to grid bottlenecks and to a lack of a plausible strategy or market organisation to deliver reliable energy for continuous production units. The electricity market model is blamed for many of the ills, as the marginal source of power production sets the price, often natural gas. The increased price volatility since the energy crisis, when a large chunk of supply from Russia had to be replaced by spot-market LNG, drove up power prices, is a serious external event and is hard to digest in any type of market organisation. The expected oversupply in the years after 2025 may help to stabilise gas prices, but the EU will remain dependent on international LNG markets for a substantial number of years. The suggested remedies in the report, some very interesting indeed, deliver some short but mostly medium to long term solutions for industry. A serious round of industrial restructuring in many industries seems unavoidable in the period to 2030.

In the Netherlands, industry is sometimes seen as a source of flexible demand. This may be the case for some, non-continuous production type of industries, but for the (bio)refining and chemical sector, and other energy-intense industries, like steel, fertilizers and cement, this is not an option. In general, costly capital stock needs maximum utilization and cannot exist competitively in a global market environment when their operational hours are limited due to periods of scarcity of electricity. In addition, operational safety is also important, and processes are less flexible than sometimes assumed. They also need large volumes of reliable power, bringing the importance of dispatchable power to the fore. Maybe in future, hydrogen (carriers) or batteries may provide the necessary power system stability, but currently these technologies, nor the network, are there for them at a competitive cost to commit to largescale electrification. The CO₂ costs, taxes and levies on energy in the EU are much higher than in competing countries and, also vary a lot among the member states. At the same time, the EU-PPA market for wind and solar remains immature.

Bringing hydrogen and perhaps hydrogen carriers under the natural gas market regime may not help in building or importing these new capacities because not all risks along the value chain can be mitigated in the current market organisation structure. Already, many hydrogen (carrier) projects for the European market are stuck in study-land and fail to reach FID due to definition uncertainties, other regulatory or policy risks at the national,

³ Decarbonization should be called re-carbonisation because without carbon many products cannot be manufactured, so we are talking about circular or neutral carbon sources.

EU or third country level. In the absence of a liquid market, price marker and uncertainty about future electricity prices, market and price formation is too unclear for investments to materialise

The energy and critical material chapters (also in part B of the report) paint an already well described dilemma of Chinese dominance of many of the value chains in energy transition technologies. China's dominance was established in the past 20 years when EU investments in raw materials and minerals declined. At the same time, the emission (GHG-emission and other legislation impacting on power and industry) space for domestic mining and processing of critical raw materials shrank in the EU, counting on international markets to source materials. What is often overlooked is that the EU appears better positioned in creating value chains for sodium batteries than the predominant ion-lithium batteries, where China has taken the lead. These opportunities should be promoted and may help the battered chemical industry in Europe to carve out new markets for their output. At the same time, without strategic support and a willingness to facilitate mining and processing within the framework of the Green Deal, the competitive questions and pressure to import green products from elsewhere persist.

In the new geopolitical environment, international sourcing has become more complicated and strategic dependencies have developed. Japan has countered this dominance by creating a collective investment strategy, with organisations representing Japan Inc., while such a strategy has not been successful (yet) in the EU in gas and hydrogen. The report offers some remedies, but they may take some time to develop, given the political and economic diversity among the member states.

WAITING FOR BRUSSELS?

Much depends for the energy-intense industry on the success of CBAM to create space for EU industry to successfully complete its transition in the short span of time defined for them. The report is worried about the administrative burden on this product-based system (the ETS is installation-based) and the ease with which it may be circumvented. The report also recommends contemplating “to postpone the reduction of free ETS allowances if CBAM’s implementation proves ineffective” and “to simplify, accelerate and harmonise subsidy allocation mechanisms. Adopt common instruments across Member States, such as the European Hydrogen Bank and Carbon Contract for Difference” (p.105) as much needed short to medium term measures. The report also pleads for possibilities to approve permitting for a cluster of projects or integrated permitting for industry and infrastructure ecosystems. Moreover, the report also recommends changing the focus of the European Commission with some very interesting ideas for DGCOMP, the role of national parliaments and simplifying rules without formulating a new Treaty. Instead, the report recommends refocussing policymaking on some key areas, use subsidiarity smartly, less bureaucracy and stay more in touch with daily reality and seek (temporary) solutions for certain competitive or investment issues. At the same time, the report acknowledges that a market-based competitive economy is crucial. These are but a few of the many proposals put forward in the report.

The number of recommendations is, however, large and wide ranging and could take years to debate and implement. Financing the plans is but one of the issues. Moreover, the Central and East European member states already complained that too few of their organizations and experts have been consulted. Smaller member states may follow suit. With the last enlargement and the current plans for another enlargement of the EU, the

point of gravity is moving away from the pre-2004 member states. The latter indeed feature more in the list of consulted parties. The EU would become rather unworkable when economic diversity grows further, and the institutions would not adapt. Perhaps this has also inspired some of the suggestions to centralise some policies, simplify decision-making, become more strategic on competition policy issues and allow for more subsidiarity on other issues.

The many recommendations and ideas to unlock the energy transition without throwing the EU industry overboard could easily get stuck in the Brussels' clay. The problems are very complex, vary among the member states while time appears short. A new agenda requires a new mindset of the EU Commission, EU legislators and member states and, importantly, public support. This support is not a given. Earlier efforts to simplify were not very successful and have sapped confidence. In energy, the regulatory burden has increased substantially. Earlier approaches, for instance in the Netherlands, to other dossiers which seemed reasonable twenty or more years ago and now interact with the energy transition plans, have created a nearly Kafkaesque gridlock for all sorts of investments. Is then a reset possible under the recommendations put forward in the Draghi-report or must member states stay in their often-self-dug policy holes?

GOING DUTCH?

The discussion of the report in the Netherlands has so far been rather muted, while bridging the non-commercial gap between climate change objectives and securing the industrial base is important for the Dutch economy. Many of the proposals on capital markets may sit uneasy with the Ministry of Finance, while the pan-EU solutions for energy may not gel with the national 2030 plans, nor save our industry from restructuring. The recent PBL assessment that some of the 2030 targets are moving out of reach, while the subsequent additional measures could lead to more frustration rather than lifting the regulatory burden and other issues identified by the impressive Draghi-report. A reason to publicly discuss the recommendations of the report and what would and would not work for Dutch energy and energy-intense industry, depends, on the one hand, on the speed with which some of the recommendations can be translated into policymaking, while on the other hand, space for more tailor-made solutions may be needed to address specific local or regional issues. And this is just the energy part of the discussion.

The Draghi-report sets out the work for EU and Dutch policymakers, but the reality is that many companies cannot wait for the Draghi-dust settling down in new policies. In the Netherlands, discussions with the 15 largest CO₂-emitting companies have so far not led to the necessary breakthroughs for companies to take FID on their projects. These projects are usually competing for capital in international portfolios and potential new opportunities elsewhere, where the business environment is less risky. The government should seriously weigh the importance of securing those investments for the Netherlands and offer meaningful reductions in the non-commercial gap. In the alternative, investments will not materialise, and energy-intense industries may restructure and relocate. The window of opportunity is very narrow, and the industries may require a bold step by the government to save the industrial jobs and the innovative transition approaches, they and the ecosystems around them can offer for our future economic activity. The Draghi-report demands that we take the current woes of industry serious in a hurry and come up with integrated remedies.

Coby van der Linde, senior fellow CIEP

CENTRE FOR INTERNATIONAL ENERGY POLICY | [CIEP](#)

ADDRESS

Breitnerlaan 299 +31 70 374 67 00
2596 HA The Hague, ciep.energy
The Netherlands contact@ciep.energy