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Balancing economic efficiency and national security: Industrial policy at the nexus of geopolitics and globalisation

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Abstract
This article examines the resurgence of industrial policy in the EU, with a particular focus on its evolving rationale in the context of geopolitical fragmentation and economic security concerns. It explores how recent global events, including the Covid-19 pandemic and Russia's invasion of Ukraine, have intensified debates about government intervention in the economy and led to a renewed focus on strategic autonomy. The paper analyses the key EU industrial policy initiatives and their implications, particularly in sectors such as energy, defence and critical technologies. Special attention is given to the challenges and opportunities presented by Ukraine's reconstruction, including potential adaptations to EU state aid rules. The article concludes by proposing principles for effective industrial policy design and implementation, emphasising the importance of maintaining single-market integrity, ensuring transparency and accountability, and balancing interventions with sound macroeconomic policies.

Keywords
Industrial policy, State aid, Strategic autonomy, Reconstruction of Ukraine

Introduction

Industrial policy has experienced a strong resurgence in recent years, following a period of disfavour in the 1980s and 1990s. This earlier decline was due to criticism of failed initiatives and the predominant ideology of market liberalisation. More recent literature

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(Rodrik 2008; Mazzucato et al. 2015; Juhász et al. 2023) has highlighted both the broader scope and the generally positive impact of industrial policies while underlining the importance of implementation practicalities for the efficacy of such policies.

Industrial policy refers to government efforts to shape the economy through targeted measures on specific domestic industries, firms or economic sectors to achieve certain economic or strategic objectives (McDonald et al. 2024, 1). Although governments, particularly in developed countries, have traditionally used industrial policy interventions in pursuit of growth (Rodrik 2010), they increasingly use subsidies, fiscal incentives and other industrial policy instruments not just to improve the competitiveness of industry but to overcome modern challenges, such as climate change, impediments to technological progress and geopolitical fragmentation.

Due to the rise of industrial policy interventions, a number of researchers at the IMF (Evenett et al. 2024) introduced the New Industrial Policy Observatory dataset to document emergent patterns of policy intervention during 2023. The dataset counted more than 2,600 industrial policy measures across the world, with around half introduced by the US, China and the EU. These measures cover about one-fifth of world trade.

One of the important features of the new industrial policy is the evolving rationale for government intervention. Historically, industrial policy measures have been associated with the industrialisation or structural transformation of certain sectors, addressing competitiveness issues. More recently, however, the rationale has expanded to include the green and digital transitions, resilience of supply chains, job creation and national security. Evenett et al. (2024, 7) find that just over a third of the measures surveyed in 2023 address strategic competitiveness concerns, while climate change and supply chain resilience account for the rationale of 28% and 15% of the measures, respectively. Notably, national security and geopolitical tensions have been the motivation behind around 20% of the measures, and military and civilian dual-use sectors have been targeted in 26% of the cases.

Within the EU specifically, several major initiatives have reflected the industrial policy renaissance. In March 2020 the European Commission presented *A New Industrial Strategy for Europe*, aimed at supporting Europe's industry in the green and digital transitions and strengthening Europe's competitiveness and strategic autonomy (European Commission 2020). In the wake of the consequences of the Covid-19 pandemic, the Commission updated the strategy with a focus on the resilience of the EU single market, the EU's dependencies in key strategic areas, and support for small and medium-sized enterprises and start-ups (European Commission 2021).

A flurry of industrial policy acts have been adopted since 2022, following the invasion of the Russian Federation into Ukraine and the need to ensure energy and economic security and the resilience of supply chains, but also in response to active industrial policy interventions elsewhere. Notable measures include the 2023 European Chips Act, aimed at mobilising investment into the semiconductor ecosystem; the Net Zero Industry Act and Critical Raw Materials Act, which aim to boost the EU's production capabilities for strategic clean technologies and the raw materials required to produce them; and the Strategic Technologies for Europe Platform to provide financial support for clean technologies and defence manufacturing capacities. More interventions have been announced for the future, such as the Carbon Border Adjustment Mechanism, which will impose a levy on products imported from countries with less stringent climate legislation from 2026.

Geopolitical fragmentation and economic security

A number of factors have contributed to the renewed interest in industrial policy, especially within the EU. One key driver has been the conviction that market forces alone may be inadequate to address issues like climate change, digitalisation and building resilient supply chains for critical goods after the Covid-19 pandemic. As highlighted by Mazzucato and Rodrik (2023), strategic government coordination is needed to provide directionality, incentivise research and investment, and catalyse structural transformations in areas of systemic importance.

Geopolitical tensions have significantly intensified debates about government intervention in the economy, leading to a renewed focus on strategic autonomy and efforts to mitigate risks associated with excessive foreign dependency. An impetus has been the challenge posed by China's state-capitalist economic model and its strategic use of subsidies and other non-market forces to gain competitive advantages in key high-tech sectors such as renewables, semiconductors and artificial intelligence. This has sparked concerns about the loss of technological leadership and productive capabilities in Europe and other advanced economies. In fact, Evenett et al. (2024) find that measures set out in industrial policy are correlated with past measures by other governments in the same sector, and warn about the negative effect of tit-for-tat interventions.

The invasion of the Russian Federation into Ukraine has significantly impacted EU industrial policy, triggering a range of strategic shifts. One of the first and key focus areas was to enhance energy security by reducing the dependency on Russian fossil fuels and accelerating the transition to renewables. In May 2022 the EU introduced the REPowerEU Plan, mobilising around €300 billion in investments and reforms to enhance energy security, followed by a number of Green Deal tools, such as the Net Zero Industry Act mentioned above. The war has also led to increased efforts in research and innovation, particularly in energy-efficient technologies, and prompted a reassessment of trade relationships. Additionally, the EU has had to address economic challenges such as inflation and energy price volatility while also considering measures to ensure food security.

Importantly, in March 2024 the European Commission presented its first-ever European Defence Industrial Strategy (European Commission 2024), alongside a legislative proposal for a European Defence Industry Programme, to support competitiveness and industrial readiness in the EU. The €1.5 billion investment mobilised by the Defence Industry Programme will not only finance increased production capacities in the defence industries, but also address issues related to the security of defence supply chains and industrialisation of research products, and encourage defence cooperation between member states.

However, estimated financing needs far exceed the current budget. The strategy therefore calls for a review of the European Investment Bank's lending policy to include defence projects. As a result, defence industry policy measures are expected to expand significantly.

Beyond energy and defence, geopolitical fragmentation has spurred EU industrial policy initiatives across numerous sectors. These initiatives include efforts to achieve digital sovereignty, secure critical raw materials, boost semiconductor production, strengthen pharmaceutical supply chains, advance the space industry, promote smart manufacturing and lead in biotechnology—all aimed at reducing strategic dependencies and enhancing the EU's competitive position in key industries.

The future of industrial policy in the context of the reconstruction of Ukraine

Ukraine and its partners have already started the strategic planning for reconstruction, viewed as an element of wartime resilience (Greene et al. 2024). This reconstruction presents significant challenges and considerations for EU industrial policy. The massive scale of Ukraine's reconstruction needs will likely test the limits of the EU budget and state aid rules (Milakovsky and Vlasiuk 2024). The EU will need to consider how to allow for substantial financial support without undermining its competition principles. This complex issue intertwines economic, geopolitical and regulatory aspects, requiring a careful balancing act from EU policymakers as well as effective coordination with multiple stakeholders.

The amount of financing needed for the reconstruction of Ukraine is staggering. The third joint Rapid Damage and Needs Assessment, undertaken jointly by the World Bank, the Government of Ukraine, the European Commission and the United Nations and supported by other partners, estimated that as of 31 December 2023, the total cost of reconstruction and recovery in Ukraine is $486 billion over the next decade (World Bank Group 2024, 14).

Reconstruction presents an opportunity to integrate Ukraine into EU supply chains, potentially enhancing the Union's strategic autonomy. Moreover, rebuilding Ukraine's energy infrastructure offers a chance to accelerate the transition to renewable energy, aligning with EU climate goals, as well as to integrate it into the European energy network. As Ukraine is a candidate for EU membership, the alignment of reconstruction efforts with EU standards and regulations could further strengthen the Union in areas such as research and innovation, defence and dual-use technologies, energy efficiency, environmental protection and digital infrastructure.

However, this must be balanced against existing EU industrial strategies and the interests of current member states. Moreover, the reconstruction process will inevitably be influenced by broader geopolitical factors, including relations with Russia and strategic partnerships. EU industrial policy and state aid decisions will need to account for these complex dynamics. Traditional restrictions on government support may need to be reassessed to accommodate the extraordinary circumstances.

The Anti-Monopoly Committee of Ukraine has noted that Ukraine's Recovery Plan includes state aid measures, yet current EU legislation lacks specific guidelines for state aid to compensate for war-related damages. The Committee argues that special approaches to state aid should be developed for Ukraine. These could include new conditions for admissibility (and subsequently, exemptions), such as

- the direction of state aid to a clearly defined goal of solving social and economic problems related to the military aggression of the Russian Federation against Ukraine;
- clear justification by the provider of the need for state intervention;
- proportionality of state aid, that is, limiting the amount of state aid to the minimum necessary to achieve the stated goal; and
- transparency of state aid; in particular, information about it should be publicly available (Anti-Monopoly Committee of Ukraine 2023).

One of the measures identified as important for the economic recovery and reconstruction of Ukraine is regulation on local content in public procurement, which would allow Ukrainian manufacturers to recover from war-caused market failures, such as CAPEX expenditures on repairs or relocating production, power cuts, blockaded ports, and mobilised or displaced workers (Milakovsky and Vlasiuk 2024, 15). Ukraine may also require an exception or transition period on the application of the Carbon Border Adjustment Mechanism. Ukraine's metallurgy industry association, GMK Center, estimates that the Adjustment Mechanism's tariffs could lead Ukraine's iron and steel sector to lose $1.4 billion in export revenue, leading to a 25%–35% decrease in output (GMK Center 2024, 21).

Including Ukraine in the European Defence Industrial Strategy, on the other hand, could help Ukraine benefit from the EU's industrial policy and contribute to the country's economic growth (Milakovsky and Vlasiuk 2024). Ukraine will be included in joint procurement initiatives, and its defence companies will receive support for capacity building and collaboration with European counterparts. The strategy also proposes a dedicated budget to bolster Ukraine's defence industry, potentially funded by frozen Russian assets, subject to EU Council approval.

The EU's industrial policies related to the reconstruction of Ukraine will play an important role for both the country's recovery and the Union's own economic security. Developing a clear legal and regulatory framework for reconstruction aid that aligns with EU state aid rules while providing necessary flexibility will be essential. This may require temporary derogations or new legal instruments.

Managing the trade-offs: a balancing act

The EU's policy shift reflects a global trend of resurgent industrial strategies, prompted not only by market failures but increasingly by strategic competition and national security concerns. Geopolitical tensions are set to remain a primary driver of EU industrial policy, shaping priorities in energy security, digital sovereignty and access to critical raw materials. These tensions, coupled with supply chain vulnerabilities, will likely intensify interventionist approaches.

The EU faces significant challenges in navigating this new landscape: balancing strategic interventions with fair competition principles, reconciling divergent national interests in an increasingly fractured global order, securing adequate funding for large-scale initiatives, and developing flexible governance mechanisms to address rapidly evolving technological and geopolitical realities. This geopolitically driven industrial policy raises complex questions about optimal design, democratic accountability and the changing role of the state in economic development.

Therefore, it is important for the research and debate on industrial policy to focus less on whether interventions and measures should be introduced and more on how they should be designed and implemented. Although the literature on the effectiveness of industrial policy does not give clear-cut answers on optimal design (Rodrik 2019), some key principles and criteria resulting from existing analysis are presented in what follows.

Maintain unity and cohesion to strengthen the Union and the single market.

Preserving the integrity of the EU single market is paramount when crafting and executing industrial policy interventions. The single market, a cornerstone of European integration, provides economies of scale; enhances competition; and facilitates the free movement of goods, services, capital and labour across member states (Czermińska 2016). As the EU pursues more active industrial policies in response to geopolitical challenges, it must carefully balance national and Union-wide interests to avoid fragmentation of this unified economic space.

This requires effective coordination with member states as well as between the different policies and portfolios of the EU. Although the combination of competition and cohesion policies has limited the dependency of Central and Eastern European members on large foreign players, disconnected from domestic production and innovation systems, the effective utilisation of these policies depends on domestic state capacities (Medve-Balint and Scepanovic 2020). Consequently, a more active industrial policy, without active inclusion measures, may leave some states or regions behind.

The European Council on Foreign Relations proposed a number of measures to improve coordination between portfolios and to implement a more proactive economic security policy, including creating the position of vice-president of geoeconomics for the

Commission, who can serve as a single access point for member states, allies and the private sector (Gehrke and Medunic 2024).

Ensure transparency and accountability mechanisms.

These principles ensure that policy measures are subject to public scrutiny, guaranteeing the accountability of bureaucrats and fostering trust and legitimacy in government interventions (Rodrik 2008). Transparent processes allow for informed debate among stakeholders, including businesses, civil society and the general public, potentially leading to more robust and widely accepted policies. Accountability mechanisms, such as regular reporting, independent evaluations and clear performance metrics, are essential for assessing the effectiveness of industrial policy measures and enabling timely adjustments. They also serve as safeguards against the potential misuse of public resources or regulatory capture by vested interests. Preventing rent-seeking is particularly important in the context of the reconstruction of Ukraine, supporting the country's rule of law and anti-corruption reforms.

For the EU, transparency and accountability take on added importance due to the multi-level governance structure and the need to balance national and Union-wide interests. Moreover, in an era of heightened geopolitical tensions and strategic competition, transparent and accountable industrial policies can demonstrate the EU's commitment to fair practices and rules-based governance, potentially reducing international frictions and setting a positive example for global economic cooperation.

Ensure continuous learning and adaptation in an evolving context.

Learning and adaptation are vital in industrial policy design and implementation (Mazzucato et al. 2015; Rodrik 2008). As economic and geopolitical landscapes rapidly evolve, policymakers must remain agile. Continuous learning enables the identification of successful strategies and less-effective approaches, allowing for real-time policy adjustments. Regular evaluation of outcomes and stakeholder feedback can inform iterative improvements. Learning from international experiences while contextualising to local conditions provides valuable insights. The ability to experiment, analyse results and scale successful initiatives while phasing out ineffective ones is key to maximising policy impact. This approach builds institutional knowledge and capacity, creating more refined, flexible and effective industrial policies over time.

Combine new investment with responsible monetary and fiscal policies.

Past experience shows that effective industrial policy requires a holistic approach that integrates targeted investments with sound macro-level economic management and responsible monetary and fiscal policies (Cimoli et al. 2009; Kapstein 1984). While direct investments in strategic sectors are often the most visible aspect of industrial policy, their success is heavily dependent on the broader economic environment. Appropriate macro-level policies create a stable foundation for industrial growth, enhancing the effectiveness of targeted interventions. Responsible monetary policy, maintaining price stability and managing inflation, provides a predictable environment for long-term industrial planning and investment. Prudent fiscal policy ensures sustainable public finances, enabling consistent support for industrial initiatives without jeopardising economic stability.

Moreover, well-coordinated fiscal measures can complement industrial policy goals through targeted tax incentives, public procurement and infrastructure development. The interplay between these policy domains is crucial: for instance, overly expansionary monetary or fiscal policies could undermine industrial competitiveness through currency appreciation or crowding out private investment. Conversely, excessively tight policies might stifle growth and innovation. Therefore, policymakers must carefully calibrate the mix of industrial investments, macroeconomic management, and monetary and fiscal policies to create a synergistic effect. This balanced approach not only enhances the efficacy of industrial policy but also contributes to overall economic resilience, which is particularly important in navigating the complexities of global economic integration and geopolitical uncertainties.

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