SPEECH

Strengthening economies in a stormy and fragmenting world

Speech by Christine Lagarde, President of the ECB, at the ninth Annual Research Conference “Economic and financial integration in a stormy and fragmenting world” organised by the National Bank of Ukraine and Narodowy Bank Polski in Kyiv, Ukraine

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It is an honour to be here in Kyiv – a city that has come to symbolise resilience, dignity and the enduring spirit of freedom. Kyiv stands not only as the heart of Ukraine, but as a beacon of what it means to hold fast to democratic values in the face of immense challenge.

As the great Ukrainian poet Taras Shevchenko once wrote, “In your own house – your own truth. Your own strength and freedom.” Ukraine’s fight today reminds all of Europe of this powerful truth: our security and prosperity rely on unity, on integration with our neighbours.

In the face of Russia’s unjustified war of aggression, Ukrainians have demonstrated extraordinary courage and resilience in defence of their country.

In my remarks today, and in keeping with the theme of this conference, I would like to reflect on the historical lessons we have learned about strengthening and integrating economies in an increasingly stormy and fragmented world.

Experience shows that closer ties with the European neighbourhood can provide a strong foundation for Ukraine to rebuild and emerge stronger. And as geopolitical tensions rise and global supply chains fragment, the case for deeper regional cooperation has never been clearer.

Europe’s own long history of integration offers valuable insights that can help guide Ukraine’s path forwards. Two key lessons stand out.

First, while deeper integration increases the potential rewards, it also raises the risks if not managed wisely. Sound domestic policy frameworks are essential to maximise growth and safeguard stability.

Second, the benefits of integration are neither automatic nor permanent. Maintaining them depends on continuous reform – but reforms must also deliver tangible improvements for people’s lives, and do so relatively quickly.

The benefits of integration in a fragmenting world

During the Cold War, the Iron Curtain fractured the European economy. Trade between East and West fell by half. This division was like imposing a 48% tariff – leading to immense welfare losses and isolating the

Eastern bloc from global markets.[1]

But the transformation since Europe's eastern enlargement has been nothing short of remarkable. On average, countries that joined the EU in 2004 have nearly doubled their GDP per capita over the past two decades.

Critically, this was not just about catching up from a low base. Between 2004 and 2019, the EU's new Member States saw their GDP per capita grow 32% more than comparable non-EU countries.[2] The difference was deeper economic integration – and those that were already highly embedded in the regional economy gained the most.

While all new members experienced gains, countries with stronger integration into regional value chains recorded nearly 10 percentage points higher GDP per capita growth compared with less integrated peers – regardless of geographic proximity.[3]

This difference was driven mainly by technology and productivity spillovers. ECB research shows that a 10% increase in productivity among western EU firms translated into a 5% productivity gain for central and eastern European firms linked to their supply chains.[4]

The case for regional integration is therefore clear – and in today's increasingly fragmented geopolitical landscape, it has become even more compelling.

First, regional integration underpins growth.

European economies are highly open, which means a world splintering into rival trading blocs poses clear risks to prosperity. Yet Europe's most important trading partner is Europe itself: around 65% of euro area exports go to other European countries, including the United Kingdom, Switzerland and Norway. For Ukraine too, Europe is the principal trading partner, accounting for over 50% of its goods trade in 2024.

By deepening economic ties – more closely linking neighbouring economies – we can reduce our exposure to external shocks. Rising trade within our region can help offset losses in global markets.

Second, regional integration strengthens resilience.

One consequence of geopolitical fragmentation is the realignment of supply chains toward trusted partners. Nearly half of firms involved in external trade have already revised their strategies – or intend to do so – including relocating parts of their operations closer to home.[5] While this trend reduces strategic dependencies, it can also raise costs.

Yet large integrated regions can mitigate these costs by replicating many of the benefits of globalisation at the regional level. Supply chains can be reorganised regionally, allowing each country to specialise based on its comparative advantage within regional value chains.

Ukraine stands to benefit significantly from expanding these networks across the region – and the EU stands to benefit, too, from having Ukraine as a partner.[6]

In the automotive sector, for example, Ukrainian firms already produce around 7% of all wire harnesses used in EU vehicles.[7] As the industry shifts towards electric vehicles, which require more complex wiring systems, Ukraine's manufacturing base is well positioned to scale up and play a larger role in the EU value chain.

Equally transformative is Ukraine's drone industry, which has become one of the most advanced in the region. Drones are not only a critical component of modern warfare, but also a technology with substantial spillover effects and far-reaching dual-use applications.

Indeed, the country's ambitious goal of producing 4.5 million drones by 2025 has accelerated innovation in materials science, battery technology and 3D printing. These advances are already finding civilian applications in sectors such as logistics, agriculture and emergency response.

In short, for both existing EU members and neighbouring countries like Ukraine, regional integration is both a path to prosperity and a strategic anchor in an increasingly fragmented world.

Managing the risks of integration

But examining the experience of countries that have used regional integration as a platform for growth and reform reveals two important lessons.

The first is that if integration is not accompanied by appropriate reforms, it can create new vulnerabilities – especially in the financial sphere.

Financial integration often brings volatile capital inflows, which can make it difficult to distinguish sustainable growth from unsustainable excesses in real time.

One way this can happen is when productivity gains in tradable sectors, such as manufacturing, drive up wages in those sectors, which then spill over into higher wages in non-tradable sectors and push up overall inflation.[8]

While this effect is a normal feature of catching-up, it can make it easy to mistake genuine convergence for economic overheating. If foreign capital is in fact driving financial imbalances – such as unsustainable real estate booms – countries may exhibit the same patterns of rising wages and inflation, masking underlying vulnerabilities.

Another potential distortion is that capital inflows can significantly affect government fiscal positions by boosting tax revenues and creating the illusion of permanently greater fiscal space. This often leads to procyclical fiscal policies, with governments increasing spending or cutting taxes during boom periods – only to face fiscal stress when inflows reverse or growth slows.

Both dynamics have been visible during Europe's recent experience with regional integration.

After the eastern enlargement, financial integration accelerated rapidly. Between 2003 and 2008, the new Member States experienced an extraordinary surge in capital inflows, averaging over 12% of GDP annually – twice the typical level for emerging markets globally.[9]

Initially, this rapid financial integration brought clear benefits: it expanded access to credit, fuelled growth and enabled much-needed development. However, in many countries, foreign capital was disproportionately channelled into consumption and construction booms, while tax revenues rose sharply on the back of property transactions and buoyant domestic demand.[10] This led to widespread misallocation of private capital and inefficient public spending.

Capital flows then reversed sharply when the global financial crisis struck, exposing these imbalances. Between December 2008 and May 2013, external bank liabilities in non-euro area central and eastern European countries declined by an average of 27% – with some countries experiencing drops of more than 50%.[11]

Yet the risks associated with financial integration can be avoided. Not all countries in the region were affected equally. Those that performed better typically shared two key features.

First, they had clear policies to channel foreign investment into productive sectors. Strong industrial strategies, a skilled workforce and integration into global supply chains helped direct capital towards manufacturing and tradable services – sectors that drive export growth and are less prone to unsustainable booms and asset bubbles.[12]

Second, they maintained robust financial policy frameworks. Tighter capital requirements, active macroprudential measures and countercyclical buffers strengthened domestic banking sectors and curbed excessive mortgage lending. These tools enabled those countries to absorb large capital inflows without creating destabilising imbalances.[13]

The lesson is clear: as countries integrate into the region, strong domestic policy frameworks are critical to ensuring that capital inflows support long-term growth rather than generating financial instability or inefficient allocation.

This insight is especially relevant for Ukraine today as it charts its path towards recovery. If reconstruction proceeds as planned, the country could attract significant capital inflows over the next decade. But without the right safeguards, that capital risks being misallocated – undermining long-term productivity instead of strengthening it.

There are encouraging signs. The EU–Ukraine Association Agreement and Deep and Comprehensive Free Trade Area have already driven significant reforms in the financial sector. Ukraine’s banking regulation now aligns with more than 75% of EU standards, covering critical areas such as capital adequacy, governance and auditing.[14]

The National Bank of Ukraine has adopted a risk-based supervisory model inspired by the Single Supervisory Mechanism – the system of banking supervision in Europe – markedly improving oversight. Despite extremely challenging circumstances, Ukraine is also modernising its capital markets – consolidating exchanges, upgrading settlement systems and strengthening regulatory enforcement to attract long-term investors.

These reforms are already delivering results: in 2023, Ukraine's banking sector remained profitable and well capitalised despite the ongoing war – an outcome that would have been unthinkable a decade ago.

Still, further progress is essential, especially in fiscal governance. Strengthening public investment management will be critical to ensure that reconstruction funds are allocated transparently and efficiently.

This is not just about meeting external standards. It is about ensuring that every euro, and every hryvnia, delivers real returns for the Ukrainian people.[15]

Making integration sustainable

However, reforms cannot be treated as a one-time effort.

So, the second key lesson is that the benefits of regional integration are neither automatic nor permanent. Sustaining them requires continuous reform – and, just as importantly, it requires citizens to see visible, tangible improvements in their daily lives.

In this context, there are two risks to watch out for.

The first is that institutional reform momentum can fade if economic benefits do not follow quickly.

Deeper regional integration typically begins with aligning framework conditions, such as legal systems, regulation and public administration. These areas often improve rapidly. But for the economic gains to materialise, domestic entrepreneurs and foreign investors must respond to the new incentives created – and this takes time.

In the long run, evidence shows that countries with initially weaker institutions benefit the most from adopting higher standards.[16] But in the short run, if people only see the effort and not the payoff, public support for further reforms can weaken, putting long-term convergence at risk.

The second risk is that structural shifts in the economy may weaken the link between integration and economic convergence over time.

The integration of goods markets has traditionally driven convergence almost automatically, as foreign direct investment flows to countries with lower land and labour costs, supply chains relocate and lower-income countries benefit from technology transfers.

As I mentioned earlier, this will remain an important mechanism even in an era of supply chain reshoring. But countries cannot rely on it as heavily as in the past. Future growth in intra-EU trade is expected to depend increasingly on services – particularly digital services.

However, research shows that services sector activity tends to concentrate in larger, more affluent urban areas that exhibit the hallmarks of a knowledge economy: high tertiary education rates, strong technology and science sectors and robust digital infrastructure.[17]

This means that deeper integration alone will not guarantee broad-based convergence across all regions. Over time, countries will need to invest more in education, skills and digitalisation to ensure they can build high levels of human capital.

Maintaining the path of convergence is therefore not easy. But slowing down reform efforts is not the answer – especially in the shock-prone world we face today.

There is a clear link between strong institutions and economic resilience. ECB research indicates that, during the pandemic, regions with lower institutional quality experienced – all else equal – an additional decline of around 4 percentage points in GDP per capita compared with the ten regions with the highest quality of government.[18]

As our economies are increasingly buffeted by global turbulence, institutional backsliding therefore risks creating a vicious circle: repeated shocks can undermine economic convergence and further erode public confidence in the reform process.

The best way for countries to sustain reform momentum is to recognise the importance of maintaining public support and, as far as possible, pair governance improvements with a focus on sectors where they have a clear competitive edge – and where deeper integration with the region can unlock significant and rapid growth opportunities.

This way, the benefits of reforms will be felt more quickly and more widely.

Ukraine is well positioned to put this into practice. Its IT sector is already relatively strong: IT services exports reached nearly USD 7 billion in 2023, making it one of the country's leading export sectors despite the war.[19]

Ukraine also produces around 130,000 STEM graduates each year – exceeding Germany and France[20] – and it ranks among the top five countries globally for certified IT professionals.[21] Successful IT clusters are active in several cities, and major foreign firms – including Apple, Microsoft, Boeing and Siemens – have established R&D operations in the country.

A dynamic defence tech ecosystem is also taking shape[22], with Ukrainian start-ups attracting almost half a billion US dollars in funding in 2024 – surpassing many of their peers across central and eastern Europe.[23] Experience from countries like Israel suggests that such a foundation can enable the country to emerge as a broader technology hub in the years ahead.

If Ukraine stays the course on institutional reform and continues to adapt its economy to new opportunities, despite the stormy environment, it can emerge as a vital engine of growth and a key contributor to the region's future.

Conclusion

Let me conclude.

Ukraine stands at a pivotal moment – facing the hardships of war, the challenge of reconstruction and the opportunity of deeper regional integration.

In a world marked by shifting geopolitical realities, such integration offers a clear path to recovery and lasting prosperity.

The recent history of regional integration shows not only its immense benefits, but also the importance of managing transitional risks through robust policy frameworks. It also underlines the need to sustain reform over time by ensuring that people feel its benefits.

I am confident that Ukraine will be able to fully realise its economic potential, turning the upheaval of today into the foundation for a dynamic future.

As Ivan Franko, one of Ukraine's greatest poets, once wrote: "even though life is but a moment and made up of moments, we carry eternity in our souls."

This enduring spirit captures the resilience and potential of Ukraine's people and its economy – a spirit that will continue to drive advancement and renewal in the years ahead.

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