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Research Report

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Bruegel Policy Contribution, No. 2019/9

Provided in Cooperation with:

Bruegel, Brussels

Suggested Citation: Leonard, Mark; Pisani-Ferry, Jean; Ribakova, Elina; Shapiro, Jeremy; Wolff, Guntram B. (2019) : Redefining Europe's economic sovereignty, Bruegel Policy Contribution, No. 2019/9, Bruegel, Brussels

This Version is available at:

<http://hdl.handle.net/10419/208038>

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Redefining Europe's economic sovereignty

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Executive summary

EUROPEANS LIKE TO believe the European Union has the collective economic size and capacity to determine its own economic destiny. But the behaviour of others global powers is increasingly calling this ability into question. China and the United States, especially, do not separate economic interests from geopolitical interests in the same way the EU does. They are increasingly using economic connections, from cyberspace to financial links, to gain geopolitical advantage or to serve geopolitical goals. Europe's economic sovereignty is at stake.

THE PROBLEM FOR Europe is real but manageable. This Policy Contribution examines the specific problems that China and the US pose for European economic sovereignty, and considers how the EU and its member states can better protect European economic sovereignty in a range of areas, including state aid to domestic industries, competition policy, investment screening, export controls, the international role of the euro, the role of European development banks, the European payments infrastructure and the global governance system. In each area, we recommend ways to improve the EU's capacity to wield economic power, without advocating increased protectionism or a retreat from globalisation.

WE MAKE RECOMMENDATIONS on how to adapt the EU and national policy systems to better integrate economic and geopolitical considerations. The next European Commission should develop an economic sovereignty strategy to boost Europe's research and scientific base, protect assets critical to national security from foreign interference, enforce a level playing field in domestic and international competition, and strengthen European monetary and financial autonomy.

TO GUIDE THE implementation of this strategy, an economic sovereignty committee should be established that will seek to integrate economic and security considerations within the European Commission. But the answer to this problem does not lie only in Brussels. We recommend a flexible implementation strategy that connects with member-state policy debates and makes use of 'mini-lateral' groups of member states.

1 The problem

The European Union was born during the Cold War. It developed during the *détente*, and enlarged after the demise of the Soviet Union. It is now part of a world that is increasingly shaped by the strategic rivalry between the United States and China. Throughout this six-decade history, the EU never took part in the competition between great powers. Even though several of its member states have deployed some military forces abroad, the EU has considered itself a soldier of peace.

But whereas the EU does not send armies all around the world, its leaders like to believe that the EU has the collective economic size and capacity to determine its own economic destiny, to set its own rules for economic life, to negotiate on an equal footing with partner economies, to tame would-be monopolies and even to set economic standards and regulations for the rest of the world.

Sovereignty, for the EU as a whole, is first and foremost *economic* sovereignty. The collective capacity of EU countries working together to preserve their economic independence underpins the argument that the European integration process provides value to Europe's citizens. That argument is bolstered by the EU's ability to participate in defining the rules of the game for the global economy – what Chancellor Merkel calls *Handlungsfähigkeit* and the French call *Europe puissance*.

But perhaps the EU has been lucky so far. Perhaps the EU's apparent economic independence in the global context was always the result of a lack of geopolitical interference. Perhaps it could only flourish under the benevolent aegis of a real superpower. Perhaps, in other words, it only existed because no serious power was willing to challenge it and because the US was willing to protect it.

Through the first decades of its history and up until very recently, the EU has taken for granted that the global system provides a functional framework for international economic relations, which could be regarded as separate from the spheres of geopolitics and security. For sure, the economic rules were determined by power relations in the wake of the second world war. But in the years that followed, even the US by and large followed them. Sure, the economic and geopolitical spheres often bled into each other, particularly during the Cold War. But the US regarded economic integration among 'Western' countries as conducive to the strength of the free world, and it stood by this principle even after the Soviet Union ceased to exist and was no longer a security challenge.

In this context, the EU was able to conduct an international economic policy that was reasonably insulated from geopolitical concerns. Its construction – with most international economic powers given to EU-level bodies and most security and foreign policy instruments left at the member-state level – reflected this assumption.

This separation between the economic and the geopolitical spheres was always fragile. It now looks outdated. The US and China have fundamentally different relationships with Europe, but have in common that they do not separate economics from geopolitics¹. The competition between them has become simultaneously an economic competition and a security competition.

National security issues are gaining prominence everywhere, as is the almost-forgotten relationship between economics and national security. Economic connections, from cyberspace to financial links, are becoming the primary areas of great-power competition and are

¹ There are of course many other threats or potential threats to European economic sovereignty. Russia is one, but its economic leverage is limited by its economic incapacity. Even its ability to wield the energy weapon is in decline, thanks to increasing energy diversification, EU efforts to liberalise the European gas market and the related programme to build interconnectors to link European gas markets. Non-state actors might also constitute a threat to economic sovereignty by damaging critical infrastructure or influencing election outcomes, with potentially significant economic consequences.

There are more and more cases in which the US and China follow neither the letter nor the spirit of the rules in their relationships with the EU and its member states

increasingly at risk of being weaponised (Farrell and Newman, 2019; Leonard 2016). Powerful countries often no longer abide by the primacy of economics.

In this new world there are more and more cases in which the US and China follow neither the letter nor the spirit of the rules in their relationships with the EU and its member states. As far as the US is concerned, its decision to make full use of the centrality of its currency and its financial system to enforce secondary sanctions against Iran was a major shock to the European partners and the 2015 nuclear agreement with Iran (whose own behaviour had remained fully compliant with principles negotiated between the US, Iran and other parties in the agreement). The US decision to abandon core principles of the global multilateral trading system and to withdraw from the Paris Agreement were further shocks for the EU and the world. Regarding China, it was also a shock to the EU to realise that China is behaving as *“an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of governance”* (European Commission/High Representative, 2019).

For the EU, this new linkage across policy areas is deeply destabilising. Its own rules, and the organisation of its governance, were designed under the assumption that external economic relationships would be preserved from the interference of geopolitics. But now the EU’s main ally openly leverages its economic centrality to enforce its security preferences, while its main trade supplier departs from the internationally-accepted doctrine that investment decisions should be exclusively guided by economic criteria.

In this new context, the EU must redefine its concept of economic sovereignty and the instruments it intends to use to defend and promote it. This is not an easy challenge, but the problem is manageable. There are strategic opportunities for measures the EU can take at national and EU levels to enhance its economic sovereignty without resorting to US-style protectionism and decoupling.

2 The great power threat to European economic sovereignty

There are many threats to European economic sovereignty, ranging from structural demographic and technological trends to lone-wolf hackers in their parents’ basement revealing state secrets. But two great powers – China and the United States – represent specific and particularly difficult problems for the European Union because of their unique capacities and approaches to the international economic order. The two countries present distinct challenges, but overlap in one important respect: both increasingly link their international economic policies to their geopolitical goals and seek to use economic tools to secure geopolitical advantage.

A. CHINA

China is governed by an all-encompassing political institution, the Chinese Communist Party (CCP). It does not treat the economic realm as separate from the political and geopolitical realms. It simultaneously seeks economic growth, technological development and geopolitical influence. For this reason, the acquisition of a European company by a Chinese company might be motivated by long-term national or even CCP priorities rather than private profit-making objectives. Similarly, trade and investment relationships with third countries might be motivated by China’s search for influence and its desire to secure commodity supplies,

rather than by the intrinsic economic value of any particular project².

The EU has three main concerns when it comes to China: China's influence over individual EU countries, the blurring of economic interests and security/military goals, and China's divergence from multilateral standards.

Influence over individual countries

On the first, the influence that China acquires over individual EU countries through its foreign investment risks becoming an obstacle to effective foreign policymaking in the EU. For example, China can seek to use economic tools to mute European opposition to its policies (for example in the South China Sea) and its domestic human rights record.

Chinese economic influence in Europe has already meant that, for example, Hungary, Greece and Slovenia have blocked or diluted resolutions relating to international arbitration over the South China Sea³ and on human rights⁴. Similarly, in March 2018, the EU members of the United Nations Human Rights Council all had to abstain on a Chinese resolution that re-defined the defence of human rights in terms of state-to-state cooperation according to "*mutual interests*" (Piccone, 2018). That vote hardly accorded with EU values or interests, but Chinese pressure on certain vulnerable EU members meant abstention was the only way to avoid an internal EU division.

The 16+1 initiative has also undermined EU unity by creating direct bilateral links between some central and eastern European countries and China⁵. Italy's signing on 23 March 2019 of a Belt and Road Initiative cooperation agreement⁶ is set to further create tensions in the EU on the right approach to China.

These problems mostly stem from the EU's unique internal organisation, particularly the requirement for unanimity on foreign policy decisions. Other powers, including the US and Russia, have long used bilateral relations to undermine EU unity on EU foreign policy.

Blurring of economic interests and strategic objectives

Second, China has an ambitious strategy to gain economic leadership. From a historical standpoint, this is a normal goal for a rising nation, but it nevertheless poses challenges for the EU.

Winning the global competition over emerging technologies such as artificial intelligence, big data and biotech are stated national security and economic imperatives for China⁷. Many emerging technologies have dual uses and the old paradigm that technologies designed for military use will trickle down into civilian applications often works the other way in China. Chinese plans for industrial and technological development are also based on the premise that civilian companies help with military development and applications. Its resolute industrial policies and subsidies to key sectors (solar, batteries, autonomous driving and 5G are prominent examples) represent a clear strategy to gain competitive advantage in key sectors that China sees as critical for future geopolitical and economic advantage.

Of course, technological competition as a part of geopolitical struggle is nothing new. During the Cold War, military-technological competition with the USSR provoked great fear in the West. But the current situation is vastly different. China and the West are deeply in each

2 Wu (2016) described well the challenge for Europe: "When embarking on the process of reintegrating China, China's major partners may not have anticipated the extent to which the Chinese Party-state would reshape its economic structure along its own unique path. Over the past decade, we have witnessed the rise of 'China, Inc.', a form of economic exceptionalism with intertwined linkages between the state, the Party, and public and private enterprises."

3 Robin Emmott, 'EU's statement on South China Sea reflects divisions', Reuters, 15 July 2016.

4 Robin Emmott and Angeliki Koutantou, 'Greece blocks EU statement on China human rights at UN', Reuters, 18 June 2017

5 <http://www.china-ceec.org>.

6 Available (in Italian) at: www.governo.it/sites/governo.it/files/documenti/documenti/Notizie-allegati/Italia-Cina_20190323/Memorandum_Italia-Cina_IT.pdf.

7 See 'Made in China 2025' strategy paper; <http://english.gov.cn/2016special/madeinchina2025/>.

It is legitimate and normal for China to increase its global footprint; the fact China has now the economic and political muscle to do so requires strategic thinking in the EU

other's business to an extent far beyond anything seen during the Cold War. The huge degree of interconnection means there are many more channels through which each sides can hurt the other.

China has some structural advantages in that competition. Important parts of the digital infrastructure are controlled by large multinational corporations, which are subject to pressure and control from their home countries. The Chinese National Intelligence Law enables the government to force private companies to collaborate with Chinese intelligence services.

Restrictions on foreign investment between the EU and China are asymmetric in favour of Chinese companies entering the EU market. In China, there are all kinds of problems for European investors, including the near impossibility of securing arbitration, difficulties in moving capital back from China and challenges to intellectual property rights. China also leverages market access to force companies to transfer technology, a practice incompatible with the spirit of World Trade Organisation rules. Finally, China heavily subsidises its own national champions and favours their access to credit, distorting the level playing field. This asymmetry means China can gain influence over technology from the European economy but this does not work the other way around. Chinese state-owned enterprises, with their enormous financial muscle, are well equipped to use western openness to gain leadership in key sectors of the global economy. There is also a problem with transparency in that it is not always clear which Chinese funds are used to raise ownership stakes⁸.

EU countries have adopted measures on making Chinese investment in the EU subject to screening. The EU-China summit declaration of 9 April 2019⁹ explicitly recognises the importance of *"following international standards in intellectual property protection and enforcement"*. It will be important to monitor progress in these areas.

Challenges to multilateralism

Third, China is increasingly present on third markets and does not necessarily follow the EU's approach or existing multilateral principles. It is legitimate and normal for China to increase its global footprint. It is also understandable that China does not simply accept multilateral standards that were largely shaped by the US and the EU in the post-war period. Nevertheless, the fact that China has now the economic and political muscle to do so requires strategic thinking in the EU.

One topic is China's Belt and Road Initiative (BRI), which creates frictions with the existing multilateral system. Chinese BRI investment can be hugely beneficial for the recipients, offering opportunities for trade and investment for companies around the world: an airport or port, once built, facilitates trade and creates jobs (Dadush and Wolff, 2019). But the BRI deserves some criticism for its lack of transparency and for its sometimes-onerous conditionality.

China's financial claims over overindebted countries could also be turned into control of strategic infrastructure and political influence. This has led the US and the EU to express concern that China does not follow the principles of the Paris Club, which aims to provide multilateral solutions to problems of overindebtedness. The IMF also emphasised that the BRI should *"only go where it is needed and where it is sustainable"* (Lagarde, 2019). Beijing has made some efforts to alleviate these concerns. For the EU, it is important to clearly establish the facts and not fall into the trap of just repeating US official statements.

As part of the BRI, China has raised its profile in the Middle East through humanitarian aid and infrastructure projects, including a July 2018 pledge of \$20 billion for reconstruction in

8 One example seems to have been Geely's February 2018 increase in its ownership stake in Daimler. Another example is the 2015 Chinese acquisition of Swedish company Silex Microsystems, which helped the Chinese transfer a key technology to China. On Silex, see Emily Feng, 'How China acquired mastery of vital microchip technology', *Financial Times*, 29 January 2019.

9 Available at <https://www.consilium.europa.eu/media/39020/euchina-joint-statement-9april2019.pdf>.

war-torn countries in the region, such as Syria¹⁰. This support will be welcome because the support for the region from the west is unlikely to be sufficient. However, China's intervention could also frustrate European efforts to use reconstruction aid to induce greater cooperation from Syrian president Bashar al-Assad on issues such as refugee returns and protection of human rights.

China has also become an important economic partner and investor in African countries. This investment, if well executed, might boost much-needed growth, to the benefit of Africa and also the EU, which could find new trading opportunities. But it also means Europe faces more competition in advancing its policies on Africa. The lack of transparency over Chinese funding could also make it more difficult for western multilateral development banks to lend in the region and carry out any subsequent conditional debt restructuring.

In short, China is a major rising power with increasingly global interests that might collide with European interests. The EU has awakened to the challenge but it has not yet defined its response. It needs to shape a strategy for its foreign policy, its technology and investment policy and its policy on China in third markets and multilateral institutions.

B. THE UNITED STATES

The United States has been Europe's most important ally since the second world war. Naturally, the problems that it poses for European economic sovereignty are of a very different nature than those posed by China. The ongoing alliance with the United States reflects Europe's democratic values and history. However, the presidency of Donald Trump has created serious doubts in the EU about the reliability and implications of that alliance.

A strategic shift

The United States has always had interests and priorities that differ from Europe's. But the primacy of the Atlantic alliance and the strong belief that US national security and long-term prosperity would be best served by the strengthening of a global rules-based economic system meant that infringements of the global rules were the exception rather than the rule. In the words of political scientist John Ikenberry (2000), *"the United States sought to take advantage of the post-war juncture to lock in a set of institutions that would serve its interests well into the future and in return, offered – in most instances quite reluctantly – to restrain and commit itself by operating within an array of post-war economic, political and security institutions."*

Under Trump, however, US policy has placed much less value on the transatlantic alliance and has demonstrated on issues as varied as Iran and trade that it is willing to leverage its economic position to secure policy outcomes, even if that implies undermining the global rules-based system and EU security.

More broadly, the Trump administration has actively reduced the support it gives to the multilateral order and has used its unique position within the global economic order advantageous position to extract immediate economic gains from its economic partners to secure its geopolitical goals, for example in the context of Iran. The dollar, the US's financial system and its current role as a hub for the global digital architecture provide the US with an unrivalled ability to use the global system to serve its own security goals. To what extent future US administrations will continue with that policy is an open question, but it is clear that the damage the Trump administration has inflicted on the multilateral trading system is already real and likely to be difficult to reverse fully.

¹⁰ Laura Zhou, 'China pledges US\$23 billion in loans and aid to Arab states as it boosts ties in Middle East', *South China Morning Post*, 10 July 2018.

Box 1: The enduring monetary asymmetry of the global economic system

Concerns about US abuse of its special role in the international monetary system are not new. In the post-war period, the built-in asymmetry of the Bretton Woods system implied a special role for the US dollar. Countries that pegged their exchange rates to the dollar were dependent for build-up of foreign exchange reserves on US monetary policy and on the availability of US dollar liquidity. Providing the dollars for these foreign exchange reserves required the US to run a current account deficit, but these deficits undermined trust in the US currency (this is the so-called Triffin dilemma). The issuer of the anchor currency enjoyed 'exorbitant privilege' but it also performed an exorbitant duty.

The end of the fixed exchange-rate regime in the early 1970s and the gradual move to generalised floating rates initially seemed set to reduce, and possibly end, this asymmetry. Although the dollar remained the dominant international currency, a floating exchange rate system looked fundamentally symmetric. Each participating economy could conduct its own monetary policy and freely enter into trade and financial transactions with the rest of the world. By the late 1990s, financial opening was assumed to be universally beneficial, international macroeconomic and monetary coordination were widely considered unnecessary and the issuance of an international currency was regarded as yielding only minor benefits.

The experience of the 2008 global financial crisis forcefully challenged this view and provided a stark reminder of the dependence of international trade and finance on the US dollar. Even though the financial troubles originated in the United States, the resulting global liquidity crisis made a massive injection of US dollars into the global financial system an urgent necessity. The US decision to extend dollar swap lines to selected central banks was thus instrumental in containing the effects of the crisis. But this was not done through multilateral institutions, rather on a discretionary basis taking into account the economic, financial and geopolitical interests of the United States.

Ironically, this meant that a financial crisis that originated in America strengthened the value of the US currency and enhanced US influence over the economic policies of other economies. This situation has not fundamentally changed: the current dollar funding requirements of international banks mean that swap lines from the US Federal Reserve remain a critical backstop for the stability of many national financial systems (Bahaj and Reis, 2018).

Subsequent research has shown how the US dollar has maintained and has even expanded its exorbitant privilege in the post-Bretton Woods world. Essentially, increasing international financial integration and global growth have increased the system's reliance on the US dollar, the US financial system and thus US monetary policy. The US remains more than ever at the centre of the global financial system. Policy initiatives from the Federal Reserve and the federal government reverberate throughout the world economy (Rey, 2013).

For example, because so many international trade transactions are invoiced in dollars, as the share of trade in a given country's economy increases, its citizens require more dollar-denominated assets, and thus the local banking sector becomes more dollarised and the central bank requires more dollar reserves (Gopinath and Stein, 2018). This in turn increases the incentive to invoice cross-border trade in dollars and creates a feedback effect.

Similarly, as global growth and investment have boomed, the supply of safe assets (Cabrero *et al*, 2017), or assets that are expected to preserve their value even during adverse events, has not kept pace with demand until the US massively increased its deficits and bond prices corrected downwards. The United States dominates the supply of safe assets, particularly in the form of US treasury bonds and notes because it remains one of the most dynamic economies in the world and one of the oldest democracies with a strong adherence to the rule of law and a long history of political stability.

The monetary and financial centrality of the United States is only one facet of the often underestimated asymmetry of the global web of economic and technical interdependence.

Whereas globalisation was assumed to result in an unequivocal equalisation of economic power, network relationships increase the power of those states that enjoy control of key nodes of the network (Farrell and Newman, 2019; Leonard 2016). In such a setting, sovereignty is unequally distributed.

The effectiveness of US secondary sanctions

The central position of the United States in the international financial system has sovereignty consequences for other countries. These consequences often stem from increasing US willingness to use financial sanctions, including secondary sanctions, to support various US geopolitical goals, for example when it comes to isolating Iran or threatening to sanction German companies over the Nord stream 2 gas pipeline project¹¹.

When the Trump administration decided in spring 2018 to withdraw from the Iranian nuclear deal and to return to a policy of economic isolation towards Iran, the European parties to that deal (the United Kingdom, France, and Germany) objected and decided that it was in their interests to continue with the deal. But the essence of that deal is that, in exchange for ending its nuclear programme, Iran gets to return to global markets as a more or less normal nation. The US government sought not only to cut off Iran from US markets but also to ensure that other countries did not do business with Iran, whether or not they shared US goals. To do this, the US used so-called secondary sanctions that threatened to cut off foreign firms that traded with Iran from the US market, the US financial system and the use of the dollar. The US has supplemented this pressure by threatening to prevent the directors of companies that violate US sanctions from entering the territory of the United States¹².

In principle, a 1996 EU regulation (Regulation (EC) No 2271/96) protects European companies from US enforcement of secondary sanctions. The EU attempted to leverage this to negotiate an EU exception from US secondary sanctions. But in the context of globalisation, the even more central position of the US financial system now means that such regulations no longer have the same deterrent value. European banks and companies do not believe in the EU's ability to protect them and place too much value on their access to the United States to even take the risk. They have pre-emptively complied with US sanctions, even as their governments have urged them not to.

In January 2019, France, Germany and the UK announced the creation of a special purpose vehicle called INSTEX that, by netting out exports and imports, would help substitute gross cross-border payments with gross intra-Iran transactions, in theory reducing the need for EU-Iranian trade to access the global payments system. This vehicle is unlikely to lead to a significant resumption of transactions with Iran, because any company doing business with the United States can be sanctioned directly. For now, at least, INSTEX is limited to humanitarian goods that are not under US sanctions.

More generally, the provision of payments to Iran has not been stopped by technical problems but by often direct political pressure, as shown by the 2018 Bundesbank decision¹³ to suspend its rules on the free convertibility of an Iranian deposit in a bank subsidiary located in Germany into cash. No evidence of possible terrorism or money-laundering concerns was reported to back up this decision.

The challenge the EU faces in preserving its economic sovereignty is compounded by its

11 See for example Hallie Detrick, 'US Threatens to Sanction German Firms Constructing Russian Gas Pipeline', *Fortune*, 14 January 2019, available at <http://fortune.com/2019/01/14/nord-stream-2-sanctions/>, and Daryna Krasnolutska, 'US Reiterates Threat of Nord Stream 2 Gas Pipe Sanctions', *Bloomberg*, 21 May 2019, available at <https://www.bloomberg.com/news/articles/2019-05-21/u-s-reiterates-threat-of-nord-stream-2-gas-pipeline-sanctions>.

12 Jonathan Swan, 'The White House's next Iran fight', *Axios*, 13 August 2018, available at <https://www.axios.com/trump-administration-iran-sanctions-swift-financial-messaging-8fae6cd6-11c9-42a8-9d5b-6d3140a7ae83.html>.

13 See Mark Schieritz, 'Kein Cash für die Mullahs', *Zeit Online*, 8 August 2018, available at <https://www.zeit.de/2018/33/iran-geldauszahlung-deutsche-konten-us-sanktionen-atomdeal/komplettansicht%20>.

security dependence on the US. Despite efforts to at least pursue an independent defence capacity, EU strategic autonomy remains “*limited to the lower end of operational spectrum [and] the prospects for significant change are slim over the coming decade based on current government plans*” (Barrie *et al*, 2019). Barrie *et al* (2019) found that without the US, Europe would need to invest around \$100bn to establish sufficient capacity for a maritime confrontation and \$300bn or more to fill the gaps in defending territory against a state-level attack¹⁴.

These numbers, while high, could without doubt be funded by the rich European countries if there was political will. However, even if military capacity was available, the issue is also of how much solidarity EU countries would be ready to provide. The question is of particular relevance for the central and eastern European EU members. Accordingly, many of the more security-conscious European states reject any sort of distancing from US policy on security issues. Moreover, even with political will, such investments would take ten to twenty years.

C. EUROPE'S RESPONSE

Europe's response to this new situation has been piecemeal. It has shown a readiness to address the new challenges in fields including trade, foreign direct investment, finance and currency internationalisation. But what it needs is a more encompassing strategy for the new context in which partners and competitors are prepared to let economic relationships serve broader geostrategic goals.

Such a strategy should be based on, first, a definition of what the EU considers the key tenets of economic sovereignty; second, on a clarification of the EU's goals and strategy for achieving them; and third, on a review and reform of the EU toolkit so it has the right instruments.

The starting point should be a confirmation that it is in the EU's interest to remain highly open and intertwined with international partners. In the US, there is a growing debate about decoupling from China. It is likely that tariffs already imposed by the US will substantially reduce bilateral trade between China and the US. It is also likely that the various US measures to prevent technology transfers will further contribute to decoupling from China. US actions and announcements also create uncertainties for European companies. This is already raising concerns in a number of sectors, from automobile to information technology.

A decoupling strategy cannot be in the EU's interest. First, the EU is much more open to foreign trade than the US (or even China). Its prosperity critically depends on global economic exchange. Second, China is set to become an increasingly relevant trading partner for the EU and it is therefore in the EU's interest to engage with China. Third, while the US is in direct geopolitical confrontation with China, the EU is not. The US would like the EU to fully be on its side in this confrontation. However, that would mean the EU to subordinating itself to US interests.

The central challenge for the EU is therefore to uphold its economic sovereignty while staying highly intertwined with both the US and China.

Europe has shown a readiness to address the new challenges in fields including trade, foreign direct investment, finance and currency internationalisation; but what it needs is a more encompassing strategy

3 A multifaceted challenge

The multifaceted challenge the EU is confronted with calls for a redefinition of the EU's strategic aims, a systematic review of the instruments at its disposal and the development of a new doctrine for international relations in a more transactional, more confrontational international context.

The EU should not try to emulate the US and China. It will never wield discretionary power

14 <https://www.iiss.org/blogs/research-paper/2019/05/defending-europe>

in the ways that they do. Its economic system is based on explicit, stable principles, and it will remain so. State intervention is and will continue to be bound by the rule of law. These characteristics are not weaknesses. They are strengths. But in a world of mutual dependence, economic sovereignty hinges on the ability to project economic power in response to economic aggression, and on the robustness and diversification of the domestic economic system in order to minimise damage. This is where the EU has to engage in significant retooling.

Three essential aspects of the issue are technology, finance and the EU's participation in global governance.

A. TECHNOLOGY

There is no such thing as technological independence in an open, interconnected economy. But an economy of 450 million inhabitants (excluding the UK) with a GDP of €14,000 billion can aim to master key generic technologies and infrastructures. The EU's aim should be to become a player in all fields that are vital for the resilience of the economic system and/or that contribute to shaping the future in a critical way. This concept of technology sovereignty inspired major past EU initiatives in fields including energy, aviation, aerospace or geopositioning. It applies equally to today's infrastructures – digital networks and cloud computing – and to new fields such as genomics and artificial intelligence.

Technology is central in five debates that pervade strategic discussions:

1. *Innovation and education base*: Does the EU still possess a sufficiently wide world-class education and research base to be able not only to compete but also to understand key technological developments?
2. *Security of supply of key inputs*: Does the European Union have enough self-standing technology companies that can ensure secure supply of critical pieces if needed?
3. *Critical digital infrastructure*: The debate here focuses on the vulnerabilities of digital networks and the security implications of potential control of their key components by foreign powers¹⁵. A related issue is whether cloud computing should be located within the EU as it represents a critical infrastructure¹⁶.
4. *Capacity of European firms to compete in the face of Chinese state subsidies, weaker merger control, lack of market access and forced technology transfers*. The EU's liberal and social market economy is now in direct competition with a very different Chinese political-economic model, which has a less clear separation between the state and business¹⁷.
5. *Appropriation of rents in a data-driven economy*. In a winner-takes-all network industry, US firms have secured dominant positions, but Chinese rivals are catching up fast. US and Chinese firms have advantages in network industries that could result in entrenched monopolies – with long-lasting consequences for Europe's ability to compete in cutting-edge technologies.

Although Europe has designed responses to several of these challenges, so far it has not had a broad discussion on the overall issue of technological sovereignty and it has not defined its strategic aims in this respect. The EU and its member states possess a battery of proactive instruments to strengthen the framework conditions for European companies to prosper. Arguably, these proactive tools are under-utilised.

Proactive instruments that aim to support Europe's technological capacity to lead do not raise issues of principle. Industrial policy is traditionally more controversial but we agree that

Europe so far has not had a broad discussion on the overall issue of technological sovereignty and has not defined its strategic aims in this respect

15 Vodafone, for example, has decided to exclude Huawei from participation in core telecom infrastructure (see Nic Fildes, 'Vodafone suspends installation of Huawei kit in European core networks', Financial Times, 25 January 2019, available at <https://www.ft.com/content/8d55f756-2078-11e9-b2f7-97e4dbd3580d>).

16 The European Commission has a dedicated Cloud Computing Strategy.

17 This concern was expressed in a January 2019 policy paper from the Federation of German industries (BDI, 2019), which prompted a somewhat dirigiste policy reaction, as highlighted in a German government industrial strategy paper (BMW, 2019).

the EU needs to become better in supporting the basis of entrepreneurial success in Europe. In relation to more reactive or even protective instruments, a careful balance needs to be achieved. The EU should remain an economy that is open to foreign investment and competition. Economic research is unambiguous: FDI and competition create jobs and increase growth. However, some essential interests deserve protection because Europe's autonomy and sovereignty would be severely impacted if dominated by foreign powers.

It is not the purpose of this paper to discuss in detail which initiatives the EU should take to catch up in education and research, improve infrastructure, make better use of the scale of the internal market, reform tax systems or even engage in specific industrial policy endeavours. We only want to emphasise that such actions are integral, and often critical, to any economic sovereignty initiative. In what follows we focus on three specific topics that are prominent in the discussion with China: state aid control, merger control and investment and export control.

State aid control

Companies receiving generous state support or tax privileges distort markets. Effective control of state aid to foreign companies, on European markets and extraterritorially, is important to ensure a level playing field. To this end, competition law should be applied in a non-discriminatory way, regardless of the origin of the firm; the criteria for pursuing cases should be where markets are distorted by state aid or leniency towards excessive market power.

In theory, the avenue to pursue is to build on the World Trade Organisation agreement on subsidies and countervailing measures, which provides a platform for an international collaboration and could help the EU to react in the case of subsidies that distort international trade (Mavroidis and Sapir, 2019). However, the current framework suffers from three main problems (Petropoulos and Wolff 2019). First, the notification of subsidies is not fully transparent and its efficacy is limited. One important reason is the difficulty in dealing with state-owned enterprises. Second, remedial action is slow and complex. Third, EU state-aid rules apply to both goods and services, while the WTO rules apply only to goods. In EU economies – which are increasingly driven by services, by networks and data – focusing only on subsidies in the goods sector is insufficient.

As well as working towards more effective WTO instruments, the EU thus needs to ensure a level playing field in the EU economy. The European Commission vigilantly monitors direct or indirect subsidies provided by EU member states to national companies. The same vigilance should apply to state aid provided by foreign governments. The main venue for tackling distortions arising from state subsidies remains the WTO, but this should be no excuse for failing to exercise vigilance. In the event WTO-based measures are not enough to ensure a level playing field, the EU should consider reviewing its competition policy instruments and their possible application to state aid emanating from foreign governments.

Merger control

Increasing returns, network effects and innovation rents contribute to the emergence of winner-takes-all markets. Competition policy in such markets affects technological leadership and has implications for sovereignty. But it is a delicate question whether, as argued by the German industry association (BDI, 2019), merger control should be relaxed to allow for the market-driven creation of European champions, or whether the Council of the EU should be given a final political veto on competition policy decisions, as argued by the German and French economy ministers¹⁸.

We agree with the aim of strengthening the competitiveness of European companies and of assessing potentially dominant positions by looking beyond the confines of the EU market, but we doubt that a strategy of relaxation of competition principles is appropriate. Strong competition on the domestic market is often conducive to success on global markets. We also

18 See <https://www.bmwi.de/Redaktion/DE/Downloads/F/franco-german-manifesto-for-a-european-industrial-policy.pdf>.

consider it unlikely that less competition domestically will make EU companies more able to enter foreign markets, including the Chinese market.

The core of the issue is the balance between producers' and consumers' interests. We agree that competition policy should review how to take into account the contestable character of domestic market shares (that is, the threat of entry and its consequences for the pricing behaviour of incumbent producers) and that a forward-looking definition of the pertinent market is important. But we disagree with the view that competition rules should be amended to give more weight to producers' interests. The very purpose of competition policy is to protect consumers from abuse by the producers of market power, and this principle should be upheld – even more so in a context of increasing concentration and market power at world-wide level.

We also reject the idea of politicising competition policy decisions. Competition policy decisions have a judicial character and they should be taken by independent authorities.

However, we agree that there might be instances when clearly-defined security interests could justify relaxation of a merger decision. For example, in certain key network infrastructures, there might not be much competition among European producers, but disallowing a merger would mean that a foreign company will dominate that infrastructure, with negative implications for security. In our view, there should therefore be security control mechanisms in merger control. The dilemma facing the EU, and as seen in the debate over a European equivalent to the US Committee on Foreign Investment (CFIUS), is that EU countries define what national security is – and the mechanism allows them to block a merger from a third country. But who could define that for intra-EU mergers?

Our proposal would be to empower the EU's High Representative to invoke a security clause, which would then lead to a Commission college decision on whether to overrule the proposal from the Competition Commissioner. The activation of the clause would have to be based on a clearly defined and limited set of criteria directly relating to security concerns. This solution would not require a treaty change and would avoid the politicisation of competition policy decisions. It would, admittedly, require a strengthening of the High Representative and the European External Action Service. But we regard such potential developments as positive.

Investment and export control

The US and the EU are strengthening their investment screening and export control instruments (see Box 2 for the US). However, their approaches and even their aims differ significantly. The US explicitly intends to make use of these instruments to preserve technological leadership, restrict access to critical technologies and serve unspecified foreign policy goals. It grants wide discretion to the executive to determine what their scope will be. By contrast, the EU initiatives are motivated by much more specific aims, of which technological lead is not part. At the EU level, the scope for discretionary decisions is also much more limited.

As far as foreign investment is concerned, the EU and its member states are bound by the provision of the Treaty that prohibits restrictions on the free movement of capital (Art. 63 TFEU). Unlike in the US, limitations on FDI, including from third-country companies, cannot be justified by such broad aims as the preservation of technological leadership. And while a clause of Article 64 TFEU provides an escape from the prohibition of restrictions on capital flows from or to third countries, it requires unanimous agreement of the EU member states. The potential for blocking foreign investments remains therefore much more circumscribed than in the US case.

Several EU countries have introduced, or are considering introducing national security exceptions to standard investment rules. In the UK, the government announced in 2018 that foreign-initiated mergers and investments that might raise national security concerns will be subject to national security assessments. In the event an assessment concludes that there is a risk to national security, the government will impose remedies or block an investment

altogether¹⁹. Similar provisions have been introduced in Germany²⁰.

On 14 February 2019, the European Parliament adopted an EU framework²¹ for screening foreign direct investment. The regulation introduces a mechanism for cooperation and information-sharing among member states but stops short of giving veto powers to the Commission. The objective of the framework is greater coordination of national security-related screening of foreign investment. It will help increase awareness as well as increase peer pressure across the EU. But it does not establish an independent EU authority for investment screening.

Foreign investment can be banned if infrastructure is used in a way that threatens national security. The list of EU-wide interests over which the Commission has the right to issue an opinion is much narrower than US export regulation and CFIUS.

On export control, the EU's regime is limited to dual-use exports (exports of items that can be used for both civilian and military purposes) with a clear focus on peace and security and non-proliferation of weapons of mass destruction. A draft regulation²² proposed in 2016 by the European Commission and under consideration at time of writing, would broaden the definition to include cyber surveillance technology, clarify intangible technology transfer and technical assistance and add a requirement for authorisation of export items not explicitly listed. However, the focus remains on security and human rights aspects rather than on safeguarding technological superiority, as it is in the US.

In our view, the EU is right not to emulate the US in its approach to investment and export control. But the European CFIUS framework is unsatisfactory because it keeps the definition of security concerns at the national level – while an integrated single market requires more than coordination to effectively protect security interests across the EU. The EU should develop a common approach and common procedures for the screening of foreign investments and it should empower the Commission with the right to recommend on security grounds the prohibition of a foreign investment. The final say should belong to the Council deciding by qualified majority.

Furthermore, not all decisions are of a black and white nature. For this reason, the EU should also develop instruments, such as a dedicated investment fund. This would make it possible to offer member states alternatives when foreign investments are deemed undesirable.

Box 2: The revised US approach to export control and foreign direct investment screening

The US in late 2018 updated its legislation²³ on export control and investment screening to address its concerns on China, in particular concerns on technology diffusion. The Export Control Reform Act of 2018 (ECRA) and the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA) were officially signed into law on 13 August 2018. These laws aim at enhancing export and investment control respectively and address the concern that US *critical technology* is released to “*end uses, end users and destinations of concern*”.

Implications of ECRA and FIRRMA

The US Department of Commerce's Bureau of Industry and Services has the authority to impose restrictions on exports that “*provide the United States with at least a significant military or intelligence advantage, or for any foreign policy reason*”. This broad statement gives the executive extensive discretionary powers to limit or ban exports. The legislation expands

19 See https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/728310/20180723_-_National_security_and_investment_-_final_version_for_printing__1_.pdf.

20 See <https://www.bmwi.de/Redaktion/DE/Downloads/V/neunte-aendvo-awv.html>.

21 See [https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2017/0224\(COD\)&l=en](https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2017/0224(COD)&l=en).

22 See [https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2016/0295\(COD\)&l=en](https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?reference=2016/0295(COD)&l=en).

23 https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf

the jurisdictional reach of export controls and tightens restrictions. For example, it establishes an interagency review process in order to identify *emerging and foundational technologies* currently not covered by export controls. Furthermore, the process to obtain export licenses for critical technologies will be more restrictive.

The objective of FIRRMA is to overhaul legislation in relation to an existing inter-agency committee, the Committee on Foreign Investment in the United States (CFIUS). CFIUS is authorised to review certain foreign investments and determine their impact on national security. The new law widens the range of transactions to include non-controlling investments in US firms that are engaged in critical technology or other sensitive sectors. The law also establishes the Critical Technology Pilot Program (CTPP), which focuses on the implementation of the FIRRMA related to businesses that “*produce, design, test, manufacture, fabricate, or develop one or more critical technologies*”. The text highlights that a delay in the CTPP “*would create an unacceptable risk of erosion of US technological superiority*”.

Critical technologies

The rule establishing the CTPP lists²⁴ critical technologies including defence articles, chemical, biological, nuclear and missile technology, and emerging and foundational technologies defined in section 1758 of ECRA. A review process that defines these technologies is at time of writing underway, but according to the legislative text, representative technology categories include: biotechnology, artificial intelligence, position, navigation and timing (PNT) technology, microprocessor technology, advanced computing technology, data analytics technology, quantum information and sensing, logistics technology, additive manufacturing, robotics, brain-computer interfaces, hypersonics, advanced materials, advanced surveillance technologies (*Federal Register*, Vol. 83, No. 223 p. 58202).

B. FINANCE

The EU has long regarded global finance as a domain in which the US-led multilateral order reigned supreme. Reflections on the reform of the international monetary system notwithstanding, the working assumption has been that the US dollar would remain the reference global currency for trade and investment purposes and the global financial architecture would remain centred on the Bretton Woods institutions. As far as payment infrastructure was concerned, the issue was simply not on the radar screen.

These assumptions – which were already somewhat shattered by the global financial crisis and the euro-area crisis – have been challenged by the US decision to leverage its central role in the global monetary and financial system to impose its own international policy preferences. At the same time, China’s assertiveness and its declared intention to promote the international role of its currency and to develop its own financing instruments indicate looming tectonic changes in the global monetary architecture. An already heterogeneous global monetary and financial system is now confronted with a real risk of fragmentation, if not ultimately break-up. In this context the EU is confronted with a series of strategic choices.

Global currencies

With a share of about 22 percent, still close to the 1999 level (but significantly below the level reached in the early 2000s), the euro is the second international currency after the US dollar and significantly ahead of other currencies. As far as central bank reserves are concerned, the euro’s share in 2017 was 20 percent compared to 63 percent for the US dollar, 5 percent for sterling and the Japanese yen, and 1 percent for the Chinese renminbi. Clearly, the euro is an important international currency with a strong regional reach and a strong role in the invoicing of euro-area trade flows, but is very far from challenging the dominance of the US dollar.

24 See https://home.treasury.gov/system/files/206/FR-2018-22182_1786904.pdf, § 801.204.

Ten years ago, Pisani-Ferry and Posen (2009) mentioned five factors that then accounted for the limited international reach of the euro: a limited economic base, financial fragmentation, uncertain governance, non-economic limitations (by which they essentially meant the lack of an European security policy) and a discouraging stance towards its *de-jure* adoption by third countries. In the meantime, the euro crisis has shattered confidence in the solidity of the European currency, though progress has been made on governance. The other observations made by Pisani-Ferry and Posen (2009) remain valid.

The EU's official doctrine has long been that it neither encourages nor discourages an international role for the euro. However, the European Commission (2018) adopted a more positive tone and outlined proposals that would contribute to increasing the use of the euro by non-residents, including the promotion of its use for international agreements and transactions in the energy and food sectors, and for invoicing for sales of aircraft²⁵.

Piecemeal initiatives are unlikely to bring about significant change. Three reforms could however significantly affect the international role of the euro:

1. *The creation of deep and integrated European capital and banking markets:* Numerous obstacles such as differences in regulation or supervision obstruct the cross-border integration of financial activities. There is still much too much ring-fencing in the euro area for pan-national banks to emerge. As a result, financial markets remain relatively fragmented and are insufficiently deep and liquid for foreign investors to invest in.
2. *The creation of a euro-area safe asset:* As emphasised by Coeuré (2019), euro-denominated safe assets amount to a small fraction of dollar-denominated safe assets. There is little doubt that the creation of a non-national benchmark safe asset would greatly increase the attractiveness of the euro for international investors, but there is also little doubt that even if such an asset would not involve debt mutualisation, its creation would require significant political obstacles to be overcome²⁶.
3. *Swap lines to central banks* of countries where the euro is widely used by the private sector. Swap lines are essential to ensure that banks operating in a foreign currency can retain access to liquidity even at times of market stress, which is why during the global financial crisis the Federal Reserve extended liquidity lines to a web of central banks in advanced countries²⁷. However, the provision of such swap lines can involve fiscal risk. For this reason, the European Central Bank in 2008-09 did not directly provide euros to then non-member countries. Overcoming this limitation would therefore require political support and would boost the euro as a truly international currency.

Global financial architecture

The global financial architecture was initially conceived as a single system structured around two sister institutions: the International Monetary Fund and the World Bank. Regional development banks also provided support, but within the framework dominated by the Bretton Woods institutions.

In recent times the system has evolved in at least two significant ways:

1. A web of financial safety nets has supplanted the single net once provided by the IMF. Now, credit lines potentially available from bilateral swap lines, most significantly the Federal Reserve, and regional financing arrangements such as the European Stability

25 European Central Bank board member Benoît Coeuré has also highlighted the potential gains for monetary policy from a greater international role for the euro (Coeuré, 2019).

26 Zettelmeyer and Leandro (2018) argued that the most promising option might be so-called E-bonds issued by a public entity against a diversified portfolio of loans to euro-area sovereigns.

27 These swap lines were in principle reciprocal, but they were *de-facto* asymmetric because the US never drew on them.

Mechanism and the Asian Chiang Mai Initiative each account for amounts broadly equal to the IMF's total resources;

2. A series of new development finance institutions has been created, the most notable of which are the Shanghai-based New Development Bank (2014) and the Beijing-based Asian Infrastructure Investment Bank (2015). Furthermore, China launched in 2013 the Belt and Road Initiative, through which provides investment credit to a wide range of countries.

These changes have been significant enough to raise concerns about the fragmentation of the global financial architecture and to prompt calls for “*bold and defined steps to ensure that today's institutions – global, regional and bilateral – work together as a system*” (G20 Eminent Persons Group, 2018).

An unravelling of the post-second world war financial order is indeed possible. Growing tensions between the US and China could, for example, lead the US to assert dominance over the Bretton Woods system (where it holds a blocking minority) and lead China to secede from it and build a separate system of bilateral, regional and multilateral financing arrangements. Short of outright fragmentation, adversarial behaviour within the multilateral institutions is also a distinct possibility.

To cope with these challenges, the EU is equipped with two significant financial instruments: the European Investment Bank (EIB), with goals of fostering infrastructure development, innovation, investment in smaller companies and the transition to a low-carbon economy in the EU, and the recently-created European Stability Mechanism, which has the core mission of providing financial assistance to euro-area countries that risk losing market access. Both institutions are focused on the EU: 90 percent of EIB lending goes to EU countries, and the ESM's scope is limited to the euro area. The EU also contributes, alongside the IMF, to financial assistance to non-euro area members (balance-of-payment assistance) and to partner countries (macro-financial assistance).

Europe is also home to several financing institutions, the most significant of which is the London-based European Bank for Reconstruction and Development. The EBRD was established in 1991 to support the private sector in central and eastern Europe and the former Soviet Union during the transition to a market economy. It has a diversified shareholder base, with the EU-27 and its member states accounting for 54.3 percent of total capital, and the UK for another 8.5 percent. The United States is also a founding member and holds a 10 percent capital share. China joined EBRD in 2016, holding 0.096 percent capital share. The bank has gradually broadened its scope to intervene in the Maghreb, Egypt, the Middle East and Mongolia.

The EU so far has not taken a strategic approach to the reshaping of the global financial architecture. Moreover, US-EU agreement can no longer be taken for granted. Europe should think strategically and prepare options for responding to a transforming international system. Specifically:

1. *The EU should prepare for the possibility of a politically- or geopolitically-motivated stalemate over the provision of IMF assistance to a neighbouring country.* Currently the EU is not equipped to provide such assistance outside the context of an IMF programme. A way to make this possible could be to amend the treaty establishing the European Stability Mechanism so that the ESM could provide conditional assistance to third countries. A possible, though financially less-potent alternative, could be to reform the balance-of-payments instruments for third countries funded by the EU budget to make this provision independent of the IMF;
2. *The EU should define its strategy towards the role of European development banks in third countries, and the division of tasks between them.* The EIB and the EBRD have different mandates but also different shareholders, with the EIB being 100 percent controlled by the EU whereas the EBRD is a Europe-based international institution with a predominantly EU shareholder base (including after Brexit). There are two clear ways forward: to give the

EIB, which has so far been mostly focused on investment within the EU, a greater international role; or to broaden the geographical scope of EBRD operations to turn it into a sort of a European counterpart to the Asian Infrastructure Investment Bank. The first option would have the advantage that the EU would retain total control, and the downside that the EIB has limited experience of investment in third countries. The second option would build on the EBRD's international experience and on its wider shareholder base. Relying on such a strategy would have the advantage of leveraging the EU's involvement in it.

Payment infrastructure

The willingness of the US to exercise political power over the international payment system makes European firms vulnerable to unilateral pressure. The depth of the EU's and US's economic and financial interdependence would make it extremely difficult to ensure autonomy through the building of parallel systems, as pursued by Russia. The creation of a special vehicle for Iran should therefore be regarded as a political signal rather than an actual channel for significant transactions. In our view, there is a need to strengthen Europe's political power and make it more able to withstand pressure, if necessary through the adoption of appropriate and proportionate economic retaliatory measures.

At the core of the global payment infrastructure is a financial messaging service, SWIFT, which is used for almost all cross-border payments. Such a global public good can only function well if all major players support its activities. By its very nature, it is highly interconnected, and is therefore also subject to political pressures from governments. Disconnecting a country's banks from the SWIFT financial messaging systems isolates that country almost completely from the global financial system, curtailing its ability to conduct business even with countries that have not sanctioned it.

In November 2018, as a result of US pressure, SWIFT, registered and governed under Belgian law, disconnected Iranian banks, saying the step, "*while regrettable, [had] been taken in the interest of the stability and integrity of the wider global financial system.*" The US can monitor SWIFT data thanks to a deal with the EU on the US Terrorist Finance Tracking Programme²⁸ and, in case of non-compliance with the US sanctions, the US Treasury could have sanctioned SWIFT, its executives or its board members.

China and Russia had already noticed the vulnerability that participation in such an interconnected payment system presents. They started collaborating on a payments system in 2014-2015²⁹. They have now fully functional domestic payments (and some domestic cards) and intend to connect them; other countries have expressed an interest in joining.

The option of separating out its financial (and, as a consequence, economic) system from that of the US is not one the European Union can pursue or wishes to pursue. The only way for it to oppose unilateral US secondary sanctions with which it disagrees is to rely on retaliation. The size of the European economy and the European market would be large enough for the threat of retaliatory measures to weigh significantly on US unilateralism.

C. GLOBAL GOVERNANCE

The EU plays a key role in multilateral organisations including the IMF, G20 and WTO. It regards these as fundamental pillars of the rules-based global system. Over last decade, voices of discontent with globalisation and its governance have become more forceful. However, increased interdependence and the emergence of true global public goods call for more cooperation on a global scale. In more and more areas, however, the best options on offer are non-binding coordination procedures and soft pledge-and-review mechanisms

The challenges for the EU are, first, how to make effective use of its voice in existing inter-

28 See https://ec.europa.eu/home-affairs/what-we-do/policies/crisis-and-terrorism/tftp_en.

29 See Karen Yeung, 'China and Russia look to ditch dollar with new payments system in move to avoid sanctions', *South China Morning Post*, 22 November 2018, available at <https://www.scmp.com/economy/china-economy/article/2174453/china-and-russia-look-ditch-dollar-new-payments-system-move>.

The willingness of the US to exercise political power over the international payment system makes European firms vulnerable to unilateral pressure

national organisations, and second and more importantly, how to promote effective collective action on a global scale.

IMF

The EU's voting share at the IMF (EU 29.61 percent; of which UK: 4.03 percent) exceeds by far that of the largest single shareholder – the US 16.5 percent – and is well above the veto threshold. China, by contrast, only has 6.1 percent of the voting rights. For important decisions, 60 percent of the members that hold at least 85 percent of the vote is required, meaning that both the US and the EU hold veto power, whereas China, India, Brazil, Russia and South Africa jointly fail to reach the veto threshold³⁰. This representation has given the EU significant influence, though the EU is generally assessed as less influential than the US.

The EU's mixed-representation model appears to give it significant weight in multilateral forums, with the added complexity that not all EU member countries are members of these clubs. The EU28 has 25 percent of the G20 seats (not counting guest countries), because individual country membership is complemented by the EU as a member (though the EU cannot hold the presidency). The EU has been similarly influential at the Financial Stability Board and the Bank for International Settlements.

Whether a single EU or euro-area seat would strengthen EU's influence at the IMF has long been discussed. In any case, the roots of external weakness are found in internal division: the coexistence of opposite views and philosophies within the EU is not conducive to unified external positions. In other words, the problem is more of substantive positions than of institutional representation. Furthermore, there is currently no appetite among EU countries to delegate external representation to the EU level.

The EU however faces a stark choice. In the context of heightened US-China tension, persistent underrepresentation of China and other emerging countries in the multilateral institutions mirrored by persistent European overrepresentation against the background of its diminishing economic weight, is likely to strengthen the emerging world's defiance against what is often perceived as Western-dominated institutions serving as guardians of a Western-biased global order.

The trade-off for Europe is clear: fight to preserve the power it enjoys within the Bretton Woods system at the risk of precipitating the fragmentation of global governance, or accept a diminished role, as a condition for more involvement in, and ownership of the global institutions by China and other rising powers. The right path is not obvious but the perennial and regularly postponed debate on the consolidation of EU or euro-area chairs in the Bretton Woods system should not be postponed much longer.

WTO

The WTO is at risk of disintegration with its dispute resolution framework already near collapse. The US has criticised the WTO for being unable to uphold rules and for regulatory overreach, but it is also openly defiant of multilateral rules that constrain its freedom of manoeuvre. China has not transformed into a market economy, which everyone hoped would be the result of its membership of the WTO. State capitalism, property rights and developing country classification need to be addressed.

A fundamental goal of international rules on trade is to prevent a large economy from unfairly using its size as an advantage. The US's invoking of a national security clause to impose tariffs is particularly worrying, as it did, for example, in 2018 for steel and aluminium tariffs, and is threatening to do for cars. It leaves it up to the EU to find partners to uphold the basic principles of free and fair competition in trade. The EU has the market size and institu-

³⁰ The Executive Board is composed of 24 directors. Countries with the largest voting shares—United States, Japan, Germany, France, the UK, Russia, China and Saudi Arabia are represented individually. The remaining Executive Directors represent constituencies, or groups of countries, with European countries spread across seven multi-country constituencies.

tional capacity to do so, while the open US-China trade war gives other countries reasons to reach out to the EU.

Unlike the US, China considers itself a champion of trade multilateralism and the WTO. The EU and China have actually declared their intention to collaborate on reforming it. However, China's support to multilateral trade principles lacks depth. While it may abide by the rules of the WTO, it does not abide by their spirit. This is why EU agrees with the US that WTO reform is necessary to better uphold the WTO principles and to address the risk that trade rules fail to take into account the specificities of the Chinese economic model and therefore fail to tackle unfair competition from Chinese producers.

The EU's aim should be to preserve the multilateral trading system as a core infrastructure of globalisation. The EU as an open economy with a large internal market can best leverage its influence over the global rules through a multilateral system. The same applies in a series of other fields, from greenhouse gas emissions mitigation to banking regulation.

But if this approach fails to gain enough traction, as is likely to be the case, alternatives need to be developed. Even post-Trump, the world is unlikely to return to the post-war multilateral architecture. Global governance is bound to be more patchy, more fragmented and more often based on weak mechanisms. As a strong proponent of a rules-based system, the EU should equip itself for this new configuration. Dadush and Wolff (2019) proposed concrete action for an EU trade strategy in the case the WTO ceases to function.

4 Conclusions and recommendations

The EU needs a change of mindset to address threats to its economic sovereignty. It must learn to think as a geopolitical power, define its goals, and act strategically. After decades during which priority was given to internal integration – through the single market, common regulations, common policies and the creation of a common currency – it needs to refocus its attention on its relationship with the rest of the world.

Building economic sovereignty does not imply turning one's back on globalisation or refraining from taking an active part in global collective action. Global competition and linkages are good for growth, innovation and consumer choice. Europe's aim is not, and should not be, to reduce trade or investment links with the global economy. It should be to strengthen the rules-based order, not to undermine it.

Building economic sovereignty also does not mean containing the spread of technology. Such an attempt would most probably be unsuccessful: even at the height of the Cold War, technology diffused broadly within a matter of years. In the current much more interconnected world, technological leadership depends on continuous investment and innovation and benefits from engagement and cooperation. Concretely, the EU is bound to benefit from cutting-edge Chinese technology. The EU's aim should be common and effective rules for intellectual property, investment and subsidies. Simultaneously, it should strengthen Europe's capacity to protect core infrastructure where direct security interests are at stake and to respond effectively to foreign initiatives that undermine its economic sovereignty.

Building economic sovereignty, however, requires the EU to stop thinking and acting as a 'fragmented power'. Currently, European economic governance purposefully ignores geopolitical considerations. Because of a division of tasks in which Brussels deals with international economic concerns such as trade, while related geopolitical issues belong largely to EU member states, the EU has behaved as a fragmented power (Sapir, 2007). It has enormous potential power, but its decision-making structures are too disjointed to use that potential. It is high time to unlock this potential.

Building European economic sovereignty will involve patient negotiation between European partners on a series of specific, often technical measures, and a gradual

implementation period. Not all EU countries have the same perception of their sovereignty and the threats it faces. Some are simply too dependent on the US security umbrella to oppose almost any US initiative. Some have built strong economic ties with China and refrain from criticising it. In the fields of trade policy or single market regulations, where policy initiatives are by nature common, compromises will need to be found. In others such as industrial policy or cyber security, variable-geometry approaches can be implemented.

Details matter. It is easy for economic measures justified on geopolitical grounds to be captured by special interests and to lapse into protectionism with lasting negative consequences for both economic growth and national security. State aid intended to maintain technological competitiveness can easily become inefficient jobs programmes. Efforts to broaden the use of the euro can easily morph into subsidies for favoured banks. These risks imply that such measures need to result from a considered process that is capable both of weighing the trade-offs between economic efficiency and national security and of maintaining a reasonable distance from special interests.

To both achieve a change in mindset and to give it institutional expression, we recommend a four part strategy for the EU:

1. An economic sovereignty agenda
2. A reformed policy toolkit
3. An effective machinery
4. A flexible implementation strategy

An economic sovereignty agenda

We propose an economic sovereignty agenda focused on European and national measures that will create opportunities and incentives to integrate economic and geopolitical considerations at the appropriate levels of governance. The agenda should have four key goals:

- Boost Europe's research, scientific, technology and innovation base;
- Protect assets critical to national security from foreign interference;
- Enforce a level playing field in both domestic and international competition;
- Strengthen European monetary and financial autonomy.

This effort should be top of the policy priorities of the new European Commission when it takes office in late 2019. We would suggest that the new Commission president should outline this economic sovereignty agenda in his or her first speech to the European Parliament, and should publish a more detailed proposal by early 2020.

A reformed policy toolkit

The EU has reasons to be proud of its policy system. It has been able to grow into a respected regulatory, trade, competition and monetary giant whose initiatives measure up to those taken by other major powers. It has done this while ensuring levels of transparency, integrity and effectiveness that meet the best global standards.

But the EU has to adapt its policy toolkit to cope with the new reality of greater geopolitical and geo-economic competition. New initiatives are necessary in eight key fields:

- 1. State-aid control should not be limited to EU companies.** The EU should vigilantly monitor distortions to international trade and investment resulting from support provided to industry by foreign governments. Direct and indirect subsidies should, if possible, be tackled in the context of the WTO. If not possible, the EU should consider reviewing its competition policy instruments and their possible application to state aid granted by foreign governments.

2. **Building on a strong and independent competition policy, the EU should define precise procedures to take into account economic sovereignty concerns in competition decisions.** European Commission merger control and the abuse of dominant position decisions should remain based on economic criteria and on independent, legally-grounded assessments. Importantly, competition policy exists to protect consumers not producers. The EU needs to avoid politicising competition enforcement or it risks capture by powerful producer interests. However, competition policy decisions should also take into account the broader scope of internationalised markets and whether incumbents' market power can be tamed by the threat of potential entry. To address cases in which competition policy decisions might raise security concerns, the EU's High Representative for Foreign Affairs and Security Policy should be given the right to evoke a security clause and object to a decision proposed by the competition commissioner.
3. **Because foreign investment gives access to the entire internal market, the EU cannot regard investment control as a purely national affair.** It should develop a common approach and common procedures for the screening of foreign investments and empower the Commission with the right to recommend on security grounds the prohibition of a foreign investment. The Council should be given the right to decide by qualified majority vote to block a foreign investment based on a Commission recommendation. The current investment-screening mechanism is a step in the right direction but it is insufficient to tackle the common dimension of decisions relating to foreign investment. The EU should also develop instruments, such as a dedicated investment fund, to offer member states alternatives when foreign investments are disallowed.
4. **As the world evolves towards a multi-currency system, economic sovereignty will increasingly require a greater international role for the euro.** But the euro will not become a truly international currency without EU initiatives to support it in this role. Three conditions are crucial: first, a deep and integrated capital and banking market; second (and related), the creation of a euro-area safe asset; third, the ECB should be able to extend swap lines to partner central banks so they can serve as lenders of last resort to local banks conducting business in euros.
5. **The EU should prepare for the possibility of a politically- or geopolitically-motivated stalemate over the provision of IMF assistance to a neighbouring country.** It should consider how an external role could be given to the ESM or how to strengthen EU-budget funded balance-of-payments instruments available to third countries.
6. **The EU needs a strategy for development banks.** It should determine whether it intends to develop the external role for the EIB or rather to leverage its investment in the EBRD to turn it into a truly multilateral development institution based in Europe and controlled by European shareholders.
7. **The EU should also stand ready to respond to unilateral sanctions it disagrees with through appropriate and proportionate economic retaliation measures.** While it can explore ways to overcome secondary sanctions and permit domestic companies to continue to trade with third countries recognised by the EU as legitimate partners, the creation of special vehicles for such transactions will never lead to significant outcomes.
8. **The EU should preserve and leverage its influence over multilateral institutions.** But this requires giving consent to an accelerated rebalancing of quotas and votes, without which European countries could end up enjoying oversized power in diminished institutions. Rebalancing should also be accompanied by a consolidation of European chairs, although that might not in some cases increase European influence.

An effective machinery

European governance was not built to implement an encompassing economic sovereignty strategy, but rather to manage separately sectoral policies. Reforms are thus needed, as follows:

A European Commission Economic Sovereignty Committee: the European Commission has already prioritised making the EU a stronger global player. The priority area brings together several relevant European commissioners (foreign and security policy, neighbourhood and enlargement, trade, international cooperation and development, civil protection and humanitarian aid under the chairmanship of the High Representative). Our proposal would reform this in several ways.

- First, it would introduce an economic security element by including key commissioners whose portfolios are not generally thought of as having sovereignty implications, including competition policy, economic and financial affairs, and research, science and innovation, under the chairmanship of the Commission first vice-president.
- Second, it would introduce a standing staff for the committee with the task of tackling cross-cutting issues and monitoring compliance among directorates-general. This staff should include economic experts alongside diplomats and security specialists.
- Finally, the staff would seek to create an organic link with the staff of similar bodies in key member states, to enable coordination of economic sovereignty efforts across the levels of governance.

In addition we would suggest that a **Committee on Foreign Investment in the European Union**, staffed by some of the economic sovereignty staff and containing representatives of relevant directorates-general, be charged with making recommendations on the national security implications of large foreign (non-EU) investments or mergers in the EU. This committee would present its recommendations to the High Representative and the College of Commissioners. Also, an office of **Financial Sanctions Enforcement** staffed by representatives of the European External Action Service, the Directorate-General of Economic and Financial Affairs, and relevant member state representatives would closely coordinate with banks and other financial institutions to ensure that European sanctions regulations are strictly enforced. It would also impose penalties on entities that violated sanctions.

A flexible implementation strategy

Implementing these changes cannot be just a Brussels-based EU-wide effort. This is not only because many relevant powers remain with the member states, but also because economic sovereignty issues can be divisive within the EU. Perceptions of threats and attitudes towards Russia, China and the United States are far from uniform. It is also because the EU and its member states will need to coordinate closely with other European partners, starting with the post-Brexit UK, which is likely to share many of its neighbour's priorities and concerns.

While an EU-wide approach is desirable, a more flexible approach based on 'minilateral' groups of states is likely to be necessary. As we have noted, EU member states differ significantly in their perceptions of security threats, their vulnerability to external pressures and their attitudes towards both the US and China. Whatever involves the functioning of the single market or the customs union will need to be agreed on by the whole EU but for other aspects, a club-type approach similar to that advocated by Demertzis *et al* (2018) is likely to be the best short-term option. The overarching intent is to create structures that integrate economic and national security considerations at both European and member-state levels.

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