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Dealing with Europe's Economic (in-)security

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Executive Summary[1]

Economic security is a broad and elusive concept. The term is often used to describe the ability of economies to weather risks and shocks, withstand economic pressure and coercion, manage strategic dependencies, protect critical infrastructure, deter cyber-attacks and misinformation, and maintain and strengthen economic leverage and/or technological edge. While the EU should aim to avoid a fragmentation of the global economy and support multilateral institutions, it needs to prepare and deal with protectionism, fragmented value chains, a global subsidy race and weaponization of interdependencies. Economic security risks can be best addressed by deepening European integration, including the single market and EMU, maintaining openness and narrowly defined interventions. We propose three conceptual directions.

First, the EU must take major geopolitical risks seriously and deal with hard economic-military risks. Stress tests on high-risk events can help identify vulnerabilities. A data-driven approach to identify critical vulnerabilities is needed, for example to detect energy and critical raw materials dependency. The EU must address hard security risks, especially as regards R&D for dual use, export controls to limit dual use technology spread, critical infrastructure, cyber-security, resilience to hybrid attacks and inbound investment screening. The "harder" the security dimension, the clearer and stricter government intervention needs to be. Preparing for secondary sanctions and own sanctioning policy is equally important. A **European Economic Security Committee** combining national security competence with EU institutions should be formed to define security risks and translate them in a European economic policy strategy. In the hard security domain, the trade-off with economic efficiency is clearly on the side of security in the new age.

Second, the EU must increase its resilience to better withstand economic coercion and be less affected by shocks to the global trading system including large-scale fragmentation. Resilience cannot be increased by protectionism but by **keeping markets open and concluding trade agreements**, especially in Asia and Latin America. For example, the Mercosur agreement would create opportunities for diversification, including in raw materials. Industrial policy has some role to play in increasing resilience,

[1] An academic version of this paper was published in Global Policy. It is available at https://onlinelibrary.wiley.com/doi/full/10.1111/1758-5899.13303.

build new technological leads and choke points while reducing excessive dependencies. Yet, risks to capture by established interests, to the integrity of the single market, and push-back by countries in the "Global South" as well as high fiscal costs are real worries. The EU should therefore apply the "narrow yard" principle in industrial policy and enhance cooperation with G7 and partners in the Global South to reduce the risks and costs of a global subsidy race. Achieving resilience by aggressive re-shoring and industrial policy would not only be very costly but could even be counterproductive.

Third, securing economic security will require investments in **European public goods** that will be cheaper to procure at EU level. Public investments and subsidies in R&D for security and defense, decarbonization, energy and technology should be financed at the EU level. Joint resources are also needed to deal with fallouts of economic coercion on individual members. Joint EU borrowing for productivity enhancing investments in European public goods would further strengthen EMU and facilitate implementing relatively tight fiscal rules. Strengthening the international role of the euro, banking union, and EU capital markets would add to Europe's economic security and financial power.

Introduction[2]

The European Union (EU) has traditionally paid limited attention to the links between security and economics. It coined the term "open strategic autonomy" in 2020 to refer to its goal of being able to act independently, if necessary, in foreign affairs, but without resorting to protectionism[3]. More recently, it fashioned the term de-risking to emphasize the need to reduce vulnerabilities associated with economic interdependence while maintaining an open global economy.

Recent developments have forced the EU to think deeper about economic security. COVID-19 exposed risks of disruptions to supply chains, and Russia's invasion of Ukraine has put hard security risks at the top of EU policy makers' agenda and shown that energy dependence can be weaponized. Rising trade tensions, the increasing use of subsidies and economic coercion have forced the EU to prepare for disruptions to multilateralism, recalibrate its relations with other great powers, and revise its dependencies on non-EU jurisdictions.

[2] The views expressed in this paper represent those of the authors exclusively. The authors would like to thank, without implicating, Lorenzo Bini Smaghi, Carlos Cuerpo, Maria Demertzis, Gabriel Felbermayr, Alicia Garcia-Herrero, Alexandra Gritz, Jörg Kukies, Muriel Lacoue-Labarthe, Aliénor Margérit, Emmanuel Moulin, Luis Oscar Moreno, Francisco Javier Muñoz, Wolfgang Niedermark, Jean Pisani-Ferry, Enrique Ruiz de Villa, André Sapir, Petra Sigmund, Ole Spillner, Jan Stöckmann, Heiko Thoms, Shahin Vallée, Assen Vassilev, Achim Wambach, Sabine Weyand, Eva Wimmer, Jörg Wuttke, Jeromin Zettelmeyer for open exchanges on the topic.

[3] The European Union has been refining its conceptualization of Strategic Autonomy in the last years. A concept originated in the defense sphere and first mentioned in official documents in 2013 was later extended to the field of foreign policy with the 2016 EU Global Strategy and then entered the economic field in 2020, rebranded "Open Strategic Autonomy". It refers to the capacity of Europeans to live by their own laws without interference, risk of attack, or destabilization from the outside.

Despite recent initiatives to deal with unexpected shocks, increase internal resilience, and learn to "speak the language of power"[4], the EU remains relatively badly prepared for a world of geopolitical rivalry and great power competition. This is the case for several reasons. The EU is institutionally set up for a rules-based world. While trade, single market, competition, investment, and financial policies are largely EU competences, foreign policy and hard security questions reside largely in the hands of Member States. Therefore, defining geopolitical priorities and translating them into economic policies is institutionally difficult for the EU. This stands in contrast to the US, China and other powers where there is no conflict of competences, where being a political union facilitates a strategic vision and where there is more experience in Economic Statecraft.[5] Moreover, EU treaties foresee openness to international trade, investment, and finance (for instance, Art 63 TFEU[6] prohibits restrictions on the movement of capital and payments between EU and third countries) and do not contemplate a breakdown of multilateralism and the rules-based liberal order. Finally, the EU economy and its growth model could be more jeopardized by deglobalization and decoupling from China than other regions.

In this context, this paper argues that European Economic Security needs to focus more on (1) how to deal with hard economic security risks and prepare for high-risk events; (2) how to maintain openness and competition by increasing resilience and building international partnerships; (3) how to address institutional weaknesses and finance European public goods that will increase the EU´s economic security.

1. Preparing for high-risk events and dealing with hard economic security risks

Risk tolerance is lower for hard economic security risks than for simple economic vulnerabilities. Hard economic security risks can generate rapid and high economic and societal risks, for example in the context of a cyber-attack. A risk of a recession is different from a risk that investments lead to the loss of control on sensitive data because (telecommunication) networks are foreign owned. Foreign ownership in such critical infrastructure can entail major security vulnerabilities. For instance, whether the EU has a solar industry is not a particularly hard-security question. Hard economic security is

[4] The EU has adopted a number of initiatives in the last years to increase economic security. First, economic/trade & FDI tools to level playing field and respond to external actions (Investment screening mechanism, Anti-Subsidy Regulation, CBAM, Anti-Coercion Instrument, etc.). Second, initiatives to promote economic resilience and foster industrial capacity, particularly in the green and tech sectors (Chips Act, Green Deal/Fit for 55, etc.) Third, the Economic Security Strategy, published in June 2023 (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52023JC0020), which focuses on promoting competitiveness, protecting citizens, and forging partnerships. Moreover, the Directive on the resilience of critical entities was also recently adopted. Finally, the Spanish EU Council Presidency aims to advance specific proposals on open strategic autonomy in the areas of health, food, digital and energy (https://futuros.gob.es/en/our-work/OSA). The effectiveness of the new tools remains to be tested and some of them might be WTO incompatible, which might turn out to be problematic for the "defence of multilateralism" narrative, that the EU promotes.

[5] See for example, Mark Leonard, Jean Pisani-Ferry, Elina Ribakova, Jeremy Shapiro, and Guntram Wolff, "Securing Europe's Economic Sovereignty," *Survival* (September 2019), 61:5, 75-98: https://doi.org/10.1080/00396338.2019.1662148 (accessed August 15, 2023) and Fabian Zuleeg, "Economic security: A new EU paradigm?," Discussion Paper, *European Policy Centre* (June 8, 2023): https://www.epc.eu/en/publications/Economic-security-A-new-EU-paradigm~516bc0 (accessed August 1, 2023).

[6] European Union, Consolidated version of the Treaty on the Functioning of the European Union, 13 December 2007.

thus about R&D critical for dual military use, critical infrastructure, cyber-security, and resilience to hybrid[7] attacks.

High-end technology of military and commercial use is particularly subject to US-China rivalry. The US is using export controls as well as outbound investment screening in certain national security technologies, particularly semiconductors, quantum information technologies and artificial intelligence[8] to limit their spread. The rules focus only on China (plus Hong Kong and Macao) and investments in a narrow set of technologies are prohibited while in a somewhat larger set, reporting requirements are established.[9] China, in turn, has focused on building its own semiconductor industry in a quest for self-reliance at least since 2014 with its dual circulation strategy and made-in-China 2025 strategy published in 2015. Yet, up to today, self-reliance has not been achieved.[10]

A narrow definition of high-end dual use technology may be the right compromise between preserving security interests while avoiding large economic costs. The US proposal on outbound investment control can fairly be assessed as being in the "small yard, high fence" spirit of de-risking rather than de-coupling. It aims to preserve leadership and choke points in a narrow set of technologies. A wider definition of what constitutes security relevant technology risks would not only undermine trade and commerce massively but may also be very hard to manage due to additional bureaucratic burden. Government intervention should thus focus on narrowly defined hard security risks.

The EU's approach to build a high-tech cluster for semi-conductors with the Chips Act is in principle welcome to strengthen the EU's economic security. Subsidies have been substantial, and one can debate their size and the specific cases. Yet, trying to reduce dependency on the highly concentrated production of high-end chips in Taiwan is a step towards increasing economic security.

A further hard security question is sanctions policy. Sanctions are effective ways of limiting economic activity and technological development. The EU has imposed substantive sanctions on Russia. At the same time, it needs to be prepared for sanctions against the EU or individual Member States.

[7] See, for example, Maria Demertzis and Guntram Wolff, "Hybrid and Cyber Security Threats and the EU's Financial System," *Journal of Financial Regulation*, Volume 6, Issue 2 (September 2020), pp. 306–316: https://doi.org/10.1093/jfr/fjaa006 (accessed August 15, 2023).

[8] The White House, "Executive Order on Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern," (August 9, 2023): https://www.whitehouse.gov/briefing-room/presidential-actions/2023/08/09/executive-order-on-addressing-united-states-investments-in-certain-national-security-technologies-and-products-in-countries-of-concern/ and Office of Investment Security, Department of the Treasury, "Provisions Pertaining to U.S. Investments in Certain National Security Technologies and Products in Countries of Concern," (August 14, 2023): https://www.federalregister.gov/d/2023-17164 (both accessed August 15, 2023).

[9] Martin Chorzempa, "Biden's new outbound investment restrictions with China are a sensible compromise, but further tightening is likely," *Realtime Economics* (blog), *Peterson Institute for International Economics* (August 10, 2023): https://www.piie.com/blogs/realtime-economics/bidens-new-outbound-investment-restrictions-china-are-sensible-compromise (accessed August 15, 2023).

[10] See, for example, Alicia García-Herrero and Pauline Weil, "Lessons for Europe from China's quest for semiconductor self-reliance," Policy Brief, *Bruegel* (November 18, 2022): https://www.bruegel.org/policy-brief/lessons-europe-chinas-quest-semiconductor-self-reliance (accessed August 15, 2023).

The EU's inbound investment screening mechanism needs rigorous implementation to safeguard hard security interests in critical infrastructure. From a macroeconomic point of view, investment stocks of China in the EU are small while EU investments in China are bigger but still small.[11] Yet, information on Chinese investments into the EU single market remains scattered. More coordination is needed to monitor security concerns of these investments. Moreover, a debate on enlarging criteria for the rejection of investments based on the lack of reciprocity appears appropriate to increase the EU's leverage.

International coordination of security-related outbound investment and export controls is important for their effectiveness. G7 countries agreed in Hiroshima in May their basic approach to economic security and are contemplating measures.[12] Nevertheless, the EU and G7 members will need to define their stance on the precise US measures on technology. While there may be scope for some divergences in measures, divergent actions undermine their effectiveness. It is therefore not impossible that the US will push for alignment of measures and even require all companies that are listed on US stock exchanges or even all those active in the US to fully comply with measures, including by resorting to secondary sanctions. If the scope of US export control and outbound investment screening were to substantially increase, the EU would need to define a strategy to defend its interest.[13] Firms need to be prepared for extreme scenarios in which the US forces them to leave China. The more limited US controls currently discussed, however, appear in line with EU interests.

Fully Europeanizing the outbound and inbound investment screening and export control mechanisms would help protect the single market from differentiated national applications based on different security considerations and strengthen European power. Yet, it would require a shared understanding of security risks. We therefore propose to form a **"European economic security committee"** that would ensure better coordination on national security considerations with EU economic policies. It would assess economic security and foreign policy risks and propose feasible strategies to address them, for instance regarding third-country equipment in the telecom infrastructure or investments in European ports. Better coordination and information sharing between national security representatives and economic policy-makers would help to overcome the dearth of security knowledge in EU institutions.[14]

[11] The inward FDI stock of China in the EU amounts to €69,9 bn in 2021, that of the EU in China to €233,6 bn. For comparison: FDI stocks of the EU in the US amount to €2512,9 bn.

[12] Ministry of Foreign Affairs of Japan, "G7 Leaders' Statement on Economic Resilience and Economic Security," (May 20, 2023): https://www.mofa.go.jp/fp/es/page1e_000684.html and Anna Isaac, "UK considers tighter rules on investment in China after US clampdown," *The Guardian* (August 10, 2023): https://www.theguardian.com/business/2023/aug/10/rishi-sunak-weighs-uk-response-to-us-curbs-on-hi-tech-investments-in-china (both accessed August 15, 2023).

[13] In the case of the Dutch limits to TSML lithography machine exports, important negotiations took place to ensure that business interests were safeguarded and Dutch exports would not simply be replaced by exports of other advanced economies.

[13] Our proposal for a security committee would thus go well beyond the proposal made by the Commission in its communication on the economic security strategy as well as Germany's recently published China strategy. For an earlier proposal, see also Spillner and Wolff, China de-risking, DGAP policy brief No 16, https://dgap.org/en/research/publications/china-de-risking , (accessed 18/8/2023).

2. Increasing resilience and building partnerships

The EU needs to continue defending the rules-based international order. The EU's and the world's prosperity depend on global trade in goods, services, and data. Protectionism, ill-guided subsidy races and even worse a fragmentation of the global economy into blocks would entail substantial costs (according to the IMF international trade restrictions could reduce global economic output by as much as 7 percent over the long term, or about $7.4 trillion in today's dollars).[15] Many countries of the so-called "Global South" are also worried by trade deglobalization, look for flexible partnerships and would like to avoid being drawn exclusively either to the US or to China. Moreover, they look at EU to find a way to sustain multilateral trade openness and even reform the WTO.

Yet, the risk of a security-related fragmentation of the global economy is real. The EU should prepare for such worst-case events. For that, a change in mind-set is needed. While the EU needs to continue defending a multilateral order and seek strategic partners to sustain it, it must prepare for a world in which interdependence will be increasingly weaponized, other powers will exercise economic coercion and geopolitical uncertainty will continue.

Stress tests can be useful instruments to prepare for worst case scenarios. How would the EU respond if a major geopolitical confrontation in the Indo-Pacific were to lead to a total fragmentation of global trading system? How would the EU deal with a strategic shift of the US towards decoupling, with extraterritorial measures against firms? What to do if China restricted exports of all critical raw materials beyond the recently reported restriction on Gallium? Such stress tests can obviously not address all vulnerabilities, but they can help establish European routines for communication channels permitting more rapid reactions. Moreover, some key vulnerabilities can become more obvious and could be addressed early on.

Two approaches to increase the EU's resilience are widely discussed and first steps are implemented. (1) Reorganization of global trade patterns and increasing the attractiveness of the domestic market, (2) industrial policy and trade-defense instruments.

Trade and investment policy can play an important role in strengthening the resilience of the EU economy. Global economic fragmentation would be extremely costly[16] and re-shoring would be a very costly way of attempting to increase resilience[17] and would also create new risks. Instead of trying to force re-shoring of production or even trying to fragment global trade based on ideological blocks, the EU should prioritize trade agreements with third countries in combination with investments from a more focused

[15] International Monetary Fund, "The high costs of Global Economic Fragmentation" IMFblog August 28, 2023. https://www.imf.org/en/Blogs/Articles/2023/08/28/the-high-cost-of-global-economic-fragmentation (Accessed September 1, 2023).

[16] IMF (2023), see above.

[17] Clemens Fuest, Lisandra Flach, Florian Dorn, and Lisa Scheckenhofer, "Geopolitische Herausforderungen und ihre Folgen für das deutsche Wirtschaftsmodell [Geopolitical challenges and their consequences for the German economic model]," *ifo Institute* (August 2022): https://www.ifo.de/publikationen/2022/monographie-autorenschaft/geopolitische-herausforderungen (accessed May 31, 2023); Gabriel Felbermayr, Steffen Gans, Hendrik Mahlkow, and Alexander Sandkamp, "Decoupling Europe," Kiel Policy Brief, *Kiel Institute for the World Economy* (October 2022): https://www.ifw-kiel.de/publications/kiel-policy-brief/2021/decoupling-europe-16271/ (accessed May 31, 2023).

Global Gateway. Such agreements and investments create opportunities for diversification and would render the EU economy more resilient. Concluding ambitious trade agreements would also set the EU apart from the US, where concluding trade agreements is now politically rejected.

Ratifying the Mercosur agreement rapidly would be particularly beneficial. In fact, the EU has a ready-negotiated agreement with the Mercosur, which would give access to more than 260 million consumers, including by lowering tariffs substantially and increase the EU's regulatory cloud. It would create the second biggest free trade zone including 770 million people, providing ample opportunities for diversification. Moreover, it would provide access to important critical raw materials.[18] To conclude the agreement, the EU needs to accepts Mercosur as an equal partner, become less demanding and be ready to open its market. The EU should also conclude additional trade agreements in Asia, including with India, ASEAN countries, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) or the Regional Comprehensive Economic Partnership (RCEP). Without a trade agreement, EU firms will be put at a disadvantage relative to firms serving the Asian market from China, given that China is a member of RCEP. This could in turn increase rather than decrease dependency on China.

A stronger and more integrated EU market will also provide incentives to diversification away from geopolitically more risky jurisdictions. The EU should strengthen its own single market by reducing regulatory barriers, enhance convergence and reduce bureaucracy. The Delors program has never been more pressing. EU internal competition as well as global competition will drive innovation.

Some specific supply-chain risks require public policy intervention. In principle, firms need to be responsible for the resilience of their supply chains. However, since externalities exist in the form of systemic vulnerabilities as well as moral hazard of firms hoping for public bail-outs, there is a role for government intervention. Just like systemic risks in the financial system, systemic risks can also exist in supply chains. Empirical, data-driven work should identify which supply chains are at such systemic risk that individual firms cannot properly account for.[19] Public policy intervention should focus on those risks. A priori, there is no reason to single out specific industries since vulnerabilities can arise in many areas. Within this framework, it needs to be understood that black-swan-type event like Covid cannot be foreseen.[20] Overall, the EU should avoid

[18] See for example, Veronika Grimm, Claudia Schmucker, and Guntram Wolff, "China-Strategie: Das Mercosurabkommen abschließen! [China Strategy: Conclude the Mercosur Agreement!]," Frankfurter Allgemeine Zeitung (July 7, 2023): https://www.faz.net/aktuell/wirtschaft/china-strategie-das-mercosurabkommen-abschliessen-19018502.html (accessed August 15, 2023), and Grimm, Schmucker, Wolff, "Ouvrir un autre espace transatlantique: pourquoi l'accord UE-Mercosur est clef", Le Grand Continent, 23/8/2023, https://legrandcontinent.eu/fr/2023/08/23/ouvrir-un-autre-espace-transatlantique-pourquoi-laccord-ue-mercosur-est-clef/ (retrieved 23/8/2023).

[19] Arjona, Roman, William Connell Garcia, and Cristina Herghelegiu, "The EU's Strategic Dependencies Unveiled," VOXEU Columns, *Centre for Economic Policy Research* (May 2023): https://cepr.org/voxeu/columns/eus-strategic-dependencies-unveiled (accessed May 31, 2023).

[20] The production of masks or ventilators is area which prior to a black-swan-type event like Covid, no one would have identified as potentially becoming an issue. The solution to this type of problem cannot be to produce everything domestically, but rather to ensure an open economy with multiple producers in different regions. During Covid, maintaining global supply chains for vaccine production was critical for speedy production of life-saving vaccine (see, for example, European Commission, "United States–European Commission Joint Statement: Launch of the joint COVID-19 Manufacturing and Supply Chain Taskforce," (September 22, 2021): https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_4847 (accessed August 15, 2023)).

mechanical quotas for domestic production. It should use stress tests and data to identify specific vulnerabilities rather than rely on sectors such as health and it should incentivize diversification in the EU and global markets.

Industrial policy, protectionism, neo-mercantilist policy as well as domestic demand suppression have created significant distortions to global markets and costs to the EU economy[21]. Aggressive state subsidies and predatory pricing in the green sector can be characterized as uncooperative and trigger uncooperative responses, with the risk of engaging, a full subsidy race would emerge[22]. In the trade relationship between the EU and China, Chinese policies have created distortions and shifts in trade patterns.[23] High domestic savings and financial repression continue to create large current account surpluses. It is important the EU insists on fair trade and reciprocity in market access and builds pressure points to achieve this objective.

Public subsidies to boost domestic industries have become an important policy tool to respond to the uncooperative game[24]. Yet, subsidies have the potential to create large costs. They can create distortions and lead to a global subsidy race wasting taxpayers' money. The US inflation reduction act (IRA)[25] is a major subsidy scheme. There is a risk that that it could create resentment, especially in poor countries, and may even slow down the green transition and productivity growth[26]. In the EU, an important risk of nationally funded industrial policy is that the relaxation of the EU's state aid rules leads to a fragmentation of the single market as countries with deeper pockets subsidize more substantially. EU-level joint financing of European public goods would address this concern.[27]

To avoid a worsening of the situation, the EU could use anti-dumping measures in WTO spirit. That would send a strong signal to global partners on the value of multilateral institutions and the need for a global playing field. Moreover, industrial policy can be an element of the public policy intervention to increase resilience if properly designed. To be successful, research shows that industrial policy should focus subsidies on R&D, human capital, and new technologies. It should aim to foster change and subsidize newly emerging technologies to minimize the risk of being captured by large incumbents. Fostering change, rather than preserving or even re-gaining industrial structures, for which the EU has little comparative advantage, needs to be the core approach.

[21] Federico Steinberg, "The Neo-mercantilist Moment,", Commentary, Centre for Strategic and International Studies (May 5, 2023): https://www.csis.org/analysis/neo-mercantilist-moment (accessed August 9, 2023).

[22] On the rise of the global subsidy race, see Réka Juhász et al., "Trends in Global Industrial Policy," Policy Brief, *United Nations Industrial Development Organization* (March 2023), https://iap.unido.org/articles/trends-global-industrial-policy (accessed August 15, 2023).

[23] For example, in Q1, 2023, EU exports to China amounted to €56,9 bn while China's exports to the EU reached €116,2 bn. In 2022, China exported €533,8 bn while the EU only €227,6 bn.

[24] Economist Intelligence Unit, "The global green subsidy race. How is it reshaping climate policy and geopolitics?," Report, Economist Intelligence Unit (2023): https://www.eiu.com/n/campaigns/global-green-subsidy-race/ (accessed August 15, 2023).

[25] See, for example, Loyle Campbell and Alexandra Gritz, "Europe's Green Industrial Policy and the United States' IRA," Memo, *German Council on Foreign Relations* (March 21, 2023): https://dgap.org/en/research/publications/europes-green-industrial-policy-and-united-states-ira (accessed August 15, 2023).

[26] Adam Posen, "America's Zero-Sum Economics Doesn't Add Up," Essay, *Foreign Policy* (March 24, 2023): https://foreignpolicy.com/2023/03/24/economy-trade-united-states-china-industry-manufacturing-supply-chains-biden/ (accessed August 15, 2023).

[27] See Mario Draghi, "The Path to Fiscal Union in the Eurozone", The Economist, Sept 6th, 2023).

Precisely defining why a certain subsidy would increase security is essential to avoid arbitrariness. Narrowing industrial policy to the "small yard" would go a long way to minimize harmful global distortions. Policy makers thus need to approach resilience understanding that economic agents react to geopolitical shocks. Instead of using mechanical production goals, stress testing needs to dynamically consider specific security risks.

Energy security and the transition to a green economy matter for economic security. In a context of structurally higher energy prices after phasing out significant amounts of Russian gas imports, energy security has become more dependent on US and Qatari Liquid Natural Gas (LNG) exports. In the short- to medium term, more diversification of LNG production seems necessary. European industry has impressively adjusted to the price shock by substituting the most energy intensive parts of production while maintaining core underlying industrial structures. Yet in the medium-term, some industrial structures may be difficult to sustain if energy prices remain permanently higher. Subsidies cannot permanently work against such comparative disadvantages and should therefore be avoided or limited in time[28]. On the other hand, the deployment of large amounts of renewable capacities may well bring energy prices substantially down, thereby creating new comparative advantages in the medium to long-term.[29] More broadly, the EU's Net-Zero Industry Act and Critical Raw Materials Act should focus more strongly on diversification and following comparative advantages as some raw materials and production of green technologies will simply be too costly and inefficiently produced in Europe.[30]

More cooperation with the US, G7 and countries from the "Global South" on industrial policy, standards and supply chains would reduce frictions and costs. EU policy makers need to collaborate with third countries on their subsidy policy to counter protectionism and reassure that the EU remains committed to free trade. The agreement between the Commission President and the US President[31] to launch a clean energy incentives dialogue and cooperation in the framework of the transatlantic trade and technology council are welcome steps[32]. G7 members do not need seven independently de-risked

[28] For example, trying to produce on a large-scale solar panels in Europe may be economically inefficient, given the higher energy and labour costs. At the same time, forced labour and coal-fired power plants should not be accepted in the supply chain for solar panels, a real concern when it comes to solar panels from China.

[29] The German auction for offshore wind energy with 7GW volume brought a record €12.6bn volume in revenues which will be invested to 90% in reducing the network costs, thereby reducing energy prices. (German Federal Network Agency, "Ergebnisse der Offshore-Ausschreibungen aus dem dynamischen Gebotsverfahren [Results of the offshore tenders from the dynamic bidding process]," Press release (July 12, 2023): https://www.bundesnetzagentur.de/SharedDocs/Pressemitteilungen/DE/2023/20230712_OffshoreErgebnisse.html (accessed August 15, 2023)).

[30] Proposals for improvement have been made by Simone Tagliapietra, Reinhilde Veugelers, and Jeromin Zettelmeyer, "Rebooting the European Union's Net Zero Industry Act," Policy Brief, *Bruegel* (June 22, 2023): https://www.bruegel.org/policy-brief/rebooting-european-unions-net-zero-industry-act and David Kleimann et al., "How Europe should answer the US Inflation Reduction Act," Policy Brief, *Bruegel* (February 23, 2023): https://www.bruegel.org/policy-brief/how-europe-should-answer-us-inflation-reduction-act (both accessed August 15, 2023).

[31] The White House, "Joint Statement by President Biden and President von der Leyen," (March 10, 2023): https://www.whitehouse.gov/briefing-room/statements-releases/2023/03/10/joint-statement-by-president-biden-and-president-von-der-leyen-2/ (accessed August 15, 2023).

[32] The rightly move the EU's position closer to that of the US, rather than China and it is important that they deliver concrete results. See, for example, Claudia Schmucker, Stormy-Annika Mildner, Dominik Tolksdorf, (cont.)

supply chains (for example for gallium), so cooperation would be important. Even more importantly, the EU should make a strong effort to advance cooperation with countries of the "Global South". It should reassure its continued commitment to openness and prevent negative counter-reactions to the limited subsidies undertken. In doing so, it should charter a course independent of that of the US. The EU's global gateway initiative should be strategically used to advance industrial and energy cooperation, among others. Overall, cooperation can help minimize the costs of the global subsidy race.

3. Addressing institutional and systemic European weaknesses

The new geopolitical realities have highlighted the need for European public goods in the fields of R&D, defense, security, innovation, energy, sustainability and technology. Moreover, long-debated institutional and systemic EU reforms would also strengthen economic security. Some of the traditional skepticism towards deeper economic, monetary and financial integration is changing considering the new geopolitical reality. This opens an opportunity for ambitious reforms. We see two areas as crucial.

First, the EU should equip itself with joint public resources to address economic security risks.

- Joint spending on R&D in defense would advance innovation and help build an integrated European defense market. The US experience with DARPA shows that such investments have the potential to be applied to civilian uses and increase economic growth and productivity.

- Joint resources are also warranted to re-build Ukraine. The ongoing support and the re-building of Ukraine will require substantial fiscal resources and can be considered an investment into the EU's future security and economy.

- For both, a joint European debt instrument would be the right way forward. Not only do both constitute truly European public goods, but both constitute investments that will generate EU economic growth.

- To avoid a fragmented single market, industrial policy for decarbonization, green technology, and energy security should be jointly funded from a dedicated part of the EU budget.

- Resisting economic coercion or rejecting foreign investments on grounds of European security may entail substantial costs for individual EU Member States. Joint EU resources can be used to compensate for specific losses, thereby enabling more coherent joint foreign policy positions.

Second**,** the EU also needs to use more strategically its financial power as a geoeconomic tool. It should prioritize integrating its financial system not only from an understanding that financial integration would benefit the functioning of the euro area

"Der Handlungsdruck wächst [The pressure to act is growing]," Memo, *German Council on Foreign Relations* (May 24, 2023): https://dgap.org/de/forschung/publikationen/der-handlungsdruck-waechst (accessed August 15, 2023). Technical standardization is an important area for geopolitical cooperation. Tim Rühlig, "The Geopolitics of Technical Standardization," Memo, *German Council on Foreign Relations* (May 8, 2023): https://dgap.org/en/research/publications/geopolitics-technical-standardization (accessed August 15, 2023).

and enhance growth, but also from a geoeconomic perspective.[33] Financial and monetary power can facilitate economic and political autonomy, increase political leverage, reduce financing costs and even be a key tool for economic coercion if the country that issues the currency is willing to use it.[34] It is thus a key tool of economic security and statecraft.

To use monetary power, the EU must be willing to accept and utilize the political nature of money and promote the euro as an international currency. Important decisions would need to be taken to overcome the limits of the EU's financial and monetary system.[35] Besides completing the banking union and deepening the Capital Markets Union to mobilize private financial resources for investment, the EU should create a permanent safe asset and commit to limited but permanent common debt issuances to finance selected European public goods that enhance productivity and security. Creating deeper, wider, flexible and more permanent markets for joint European debt will probably reduce financing costs in Europe and increase the use of the euro as a reserve currency**.**[36] Over time, larger amounts of EU-issued debt in international markets and foreign central bank reserves will increase the EU political leverage. That would open the discussion as to how to use that power in the realm of economic sanctions, euro swaps with specific countries, financial infrastructure/SWIFT, euro denomination of invoicing of certain commodities such as hydrogen, etc.

Conclusions: Towards a European strategy of economic statecraft

In a context of great power competition, economic security is going to occupy an increasingly important role in the global political economy. The EU is neither comfortable with the weaponization of interdependence nor is it institutionally designed for a less cooperative and more threatening world. Yet, it cannot afford to just continue its old model hoping that a rules-based world will prevail. On the other hand, it would be a severe mistake to turn away from global integration and engage in mechanical reshoring with quotas for domestic production and massive subsidies to achieve that. The economic costs of such a wide-yard approach would be prohibitive. This paper proposes an EU intervention relying on more trade rather than reshoring, data- and stress-test-driven identification of hard security risks to be addressed with suitable instruments,

[33] The importance of monetary power has been highlighted by the international political economy literature (Susan Strange, *States and markets*. Bloomsbury Publishing, 2015, and Benjamin J. Cohen, *Currency power: Understanding monetary rivalry*. Princeton University Press, 2015.), which focuses less on growth and efficiency and more on power structures, dependencies, coercion, and the importance of relative gains. Monetary power generally refers to the ability of a country to influence and shape international outcomes through its control and influence of international monetary arrangements, monetary and exchange rate policies, currency politics, and financial systems (Andrews, David M., ed. *International monetary power*. Cornell University Press, 2006.).

[34] It can do so by increasing isolation and resilience from external monetary shocks, defecting the burden of macroeconomic adjustment on other countries or facilitating (and even circumventing) the application of financial sanctions (McDowell, Daniel. *Bucking the Buck: US Financial Sanctions and the International Backlash Against the Dollar*. Oxford University Press, 2023.).

[35] See also "The EU's open strategic autonomy from a central banking perspective", ECB report No 311, March 2023.

[36] Interest rates on Next Gen EU and ESM bonds are still higher than those of some member states because financial actors find those markets insufficiently illiquid, perceive those bonds as temporary and have problems using them as collateral (Giovanni Bonfanti and Luis Garicano, "Do financial markets consider European common debt a safe asset?" Policy Brief, *Bruegel* (December 8, 2022): https://www.bruegel.org/blog-post/do-financial-markets-consider-european-common-debt-safe-asset (accessed August 9, 2023).

including industrial policy, and deeper economic and financial integration to increase the EU's leverage.

The new geoeconomic context provides an opportunity to deepen economic integration and to address the political and institutional weaknesses that the EU has been dragging along for many years. External threats change the trade-offs and incentives faced by Member States, making it increasingly evident that the response to the new situation must focus on a series of European public goods without which the EU will find it difficult to sustain its economic security. From a macroeconomic perspective, the new geopolitical age may well mean more negative supply shocks, creating difficult trade-offs for European fiscal and monetary decision makers. Forging a **European strategy of economic statecraft** requires better tools to identify risks and the shared willingness to use economic, monetary, and financial power.