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1 The problem

e European Union was born during the Cold War. It developed during the *détente,* and

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

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

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 project[2].

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

Inflluence over individual countries

On the rst, the in uence that China acquires over individual EU countries through its foreign

war-torn countries in the region, such as Syria[10]. is support will be welcome because the support for the region from the west is unlikely to be su cient. However, China's intervention could also frustrate European e orts 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. is investment, if well executed, might boost much-needed growth, to the bene t of Africa and also the EU, which could nd new trading opportunities. But it also means Europe faces

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 de cit, but these de cits undermined trust in the US currency (this is the so-called Tri n dilemma). e issuer of the anchor currency enjoyed 'exorbitant privilege' but it also performed an ex(t)1an ⁄Lang (en-GB)aere

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 e ectiveness of US secondary sanctions

e central position of the United States in the international nancial system has sovereignty consequences for other countries. ese consequences often stem from increasing US willingness to use nancial 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 project[11].

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 Kingom, 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. e US government sought not only to cut o 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 o foreign rms that traded with Iran from the US market, the US nancial system and the use of the dollar. e US has supplemented this pressure by threatening to prevent the directors of companies that violate US sanctions from entering the territory of the United States[12].

In principle, a 1996 EU regulation (Regulation (EC) No 2271/96) protects European companies from US enforcement of secondary sanctions. e 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 nancial 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. ey have pre-emptively complied with US sanctions, even as their govern-

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 attack[14].

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 MsMC /Span <</Lang (en-GB)/MCID 583 >>BDC 9 the M

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. ese characteristics are not weaknesses. ey 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 diversi cation of the domestic economic system in order to minimise damage. is is where the EU has to engage in signi cant retooling.

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

A. TECHNOLOGY

ere 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. e EU's aim should be to become a player in all elds that are vital for the resilience of the economic system and/or that contribute to shaping the future in a critical way. is concept of technology sovereignty inspired major past EU initiatives in elds including energy, aviation, aerospace or geopositioning. It applies equally to today's infrastructures – digital networks and cloud computing – and to new elds such as genomics and arti cial intelligence.

Technology is central in ve debates that pervade strategic discussions:

1. *Innovation and education base:* Does the EU still possess a su ciently 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:* e debate here focuses on the vulnerabilities of digital networks and the security implications of potential control of their key conts?

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. e EU should remain an economy that is open to foreign investment and com-

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.

altogether[19]. Similar provisions have been introduced in Germany[20].

On 14 February 2019, the European Parliament adopted an EU framework[21] 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 regulation[22] 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

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.

e 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. e new law widens the range of transactions to include non-controlling investments in US rms that are engaged in critical technology or other sensitive sectors. e law also

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 aircraft[25].

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 overcome[26].
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 countries[27]. 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 Programme[28] 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 2014-2015[29]. 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

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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. e priority area brings