TO THE HIGH REPRESENTATIVE OF THE UNION FOR FOREIGN AFFAIRS AND SECURITY POLICY

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* Economics used to play a limited role in foreign policy, which was about wars, conflicts and human disasters – and how to avoid them. But neither China nor the United States now separates economics from geopolitics. The competition between them is simultaneously an economic competition and a security competition. This is a threat to the multilateral system the European Union has relied on for nearly seven decades and to the EU's separation of external economic relationships from geopolitics. You and your Commission colleagues must redefine for the EU its concept of economic sovereignty and the instruments it needs to defend and promote it.

* ECONOMIC SOVEREIGNTY
* CHINA-US COMPETITION
* FLEXIBLE STRATEGY

1 STATE OF AFFAIRS

Your predecessors rarely spoke to economists, let alone received memos from them. High Representatives deal with wars, conflicts and human disasters – and how to avoid them. Economists, and your colleagues in charge of economic issues within the Commission, deal with peacetime concerns: growth, inflation, jobs, public finances, trade, competitiveness. Every now and then, economic mismanagement results in a country entering your orbit (like Venezuela currently). Every now and then, an opposite transition takes place and economic development must be supported after peace or civil concord has been restored. But otherwise there has not been much communication between the foreign affairs and security sphere and the economic sphere. It is becoming clear, however, that in the current context increasing interlinkages between economics and power politics mean you must play a greater role in reinforcing and defending Europe's economic sovereignty. This memo summarises and expands on Leonard *et al* (2019) a June 2019 Bruegel and European Council on Foreign Relations paper that discusses in detail the economic sovereignty issue.

*ECONOMIC INTEGRATION

There were good reasons for the division between the foreign policy sphere and the economic sphere. Through the first decades of its history and up until very recently, the European Union took it for granted that the global system provided a functional framework for international economic relations. 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 United States by and large kept to them. It regarded economic integration 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.

* ECONOMIC SOVEREIGNTY

The EU has always believed in the primacy of economics. As a consequence, sovereignty for the EU as a whole was and remains first and foremost *economic* sovereignty. The collective capacity of the EU and its member countries working together to preserve their economic independence underpins the bloc's 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*.

In this context, the EU's international economic policy 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 member-state level – reflected this assumption.

* CHINA-US COMPETITION

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. It is becoming ever clearer that neither the US nor China separate economics from geopolitics. The competition between them is simultaneously an economic competition and a security competition.

Our separation between the economic and the geopolitical spheres was always fragile. It now looks outdated. 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 increasingly at risk of being weaponised. Powerful countries often no longer abide by the primacy of economics.

* ECONOMIC NATIONALISM

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. The US decision in 2018 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 its European partners. The US decisions to abandon core principles of the global multilateral trading system and to withdraw from the Paris Agreement have been further shocks for the EU and the world.

On China, the EU has been slow to realise that, as your predecessor noted together with the European Commission in their joint communication of March 2019, China behaves as *"an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of governance"* (European Commission/High Representative, 2019).

This new linkage across policy areas is deeply destabilising because the EU's own rules and the organisation of its governance were designed under the assumption that external economic relationships would be ringfenced from the interference of geopolitics. In this new context, it will be your responsibility and that of your Commission colleagues to redefine for the EU its concept of economic sovereignty and the instruments it intends to use to defend and promote it.

2 CHALLENGES

European economic sovereignty faces many threats, ranging from structural demographic and technological trends to lone-wolf hackers in their parents' basements revealing state secrets. But China and the United States represent specific and particularly difficult problems.

China

* CHINA'S SEARCH FOR INFLUENCE

China simultaneously pursues 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 Chinese Communist Party 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.

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.

On the first, Chinese influence over individual EU countries is a potential obstacle to effective foreign policymaking in the EU. China has already leveraged investment and other economic tools to influence EU positions, for example to soften opposition to its policies and its domestic human rights record. These problems stem mostly 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

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foreign-policy unity.

Second, China has an ambitious strategy to gain economic leadership. From a historical standpoint, this is a normal goal for a rising nation, but China's stated ambition to win the global competition over emerging technologies such as artificial intelligence and biotech, the breadth of policy instruments at the disposal of the government – including through direct or indirect influence over companies' strategic choices – and the very asymmetric character of the bilateral investment relationship all pose challenges to the EU.

* BELT AND ROAD

Third, China takes liberties with multilateral rules, as demonstrated by the Belt and Road initiative, which aims to leverage Chinese trade flows to build infrastructure and create a broad network of partner countries. The BRI is explicitly not a multilateral framework for trade, investment and financial relationships. Rather it is centred on China. Some worry that China's financial claims over over-indebted countries could be turned into control of strategic infrastructure.

In short, China is a major rising power with increasingly global interests that might collide with European interests. The EU has awoken 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.

* TRUMP ADMINISTRATION

The US

The United States has been Europe's most important ally since the second world war. 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

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about the reliability and implications of that alliance. Moreover, 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 to extract immediate economic gains or secure geopolitical goals. 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.

*IRAN

On Iran – over which the crisis appears to be deepening at the time of writing – a 1996 EU regulation (Regulation (EC) No 2271/96) is intended to protect 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. More generally, the economic relationship with Iran has not been stopped by technical problems but by often direct political pressure. The challenge the EU faces in preserving its economic sovereignty is compounded by its security dependence on the US.

Europe's strategic challenge

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.

* EU OPENNESS

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. But a decoupling strategy cannot be in the EU's interest. First, EU 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 central challenge for the EU is therefore to uphold its economic sovereignty while staying highly intertwined with both the US and China.

3 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 the priority was internal integration – through the single market, common regulations, common policies and the creation of a common currency – the EU needs to refocus its attention on its relationship with the rest of the world.

* GLOBALISATION

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.

* TECHNOLOGY

Nor does building economic sovereignty mean containing the spread of technology. Such an attempt would 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 certain 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 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 capitalise on that potential. It is high time to unlock this potential.

* BUILDING ECONOMIC SOVEREIGNTY

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 to it. 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 could 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.

* FOUR-PART STRATEGY

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. Effective machinery
4. A flexible implementation strategy

An economic sovereignty agenda

As a priority, we suggest that when you take office you start by working out with your Commission colleagues 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 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.

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 several key fields, some of which concern you directly:

* COMPETITION POLICY

1. 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 continue to be 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, you as High Representative should be given the right to invoke a security clause and object to a decision proposed by the competition commissioner.

* INVESTMENT SCREENING

2. 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 certain foreign investments. The Council should be given the right to decide by qualified majority to block foreign investments based on a Commission recommendation, in which you will play a

strong part. 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.

3. The EU should prepare for the possibility of a politically- or geopolitically-motivated stalemate over the provision of International Monetary Fund assistance to a neighbouring country. It should consider how an external role could be given to the European Stability Mechanism or how to strengthen EU-budget funded balance-of-payments instruments available to third countries. Such cases will most likely have a strong foreign policy dimension, which implies that you will play a key role in activating EU assistance.

* DEVELOPMENT BANKS

4. The EU needs a strategy for development banks. It should determine whether it intends to develop the external role for the European Investment Bank or rather to leverage its investment in the European Bank for Reconstruction and Development to turn it into a truly multilateral development institution based in Europe and controlled by European shareholders. You should work with your colleagues to determine which strategy offers more opportunities.

* SANCTIONS

5. 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. Retaliation decisions will involve your trade colleague and other commissioners, but you will need to be part of them throughout the process.

6. The EU should preserve and leverage its influence over multilateral institutions. But this requires consenting to an accelerated rebalancing of quotas and votes, without

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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. You are not a decision-maker in this field, but you should definitely have a voice in the process.

Other initiatives fall outside your remit, but are part of the same economic sovereignty agenda and for this reason you should monitor them:

* STATE-AID CONTROL

1. State-aid control should not be limited to EU companies. The EU should vigilantly monitor distortions to of 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 World Trade Organisation. If not possible, the EU should consider reviewing its competition policy instruments and their possible application to state aid granted by foreign governments.

* EURO'S INTERNATIONAL ROLE

2. 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.

Effective machinery

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

* ECONOMIC SOVEREIGNTY COMMITTEE

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 your chairmanship). 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. It will be important to create strong links with the staff of similar bodies in EU member states, to enable coordination of economic sovereignty efforts across the levels of governance.

* FOREIGN INVESTMENT

In addition, a **Committee on Foreign Investment in the European Union,** staffed by some of the economic sovereignty staff and containing representatives of relevant directorates-general, should 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 you 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 violate sanctions.

* COORDINATION WITH PARTNERS

A flexible implementation strategy

Implementing these changes cannot be just a Brussels-based EU-wide effort. Many relevant powers remain with the member states and 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. Therefore the EU and its member states will need to coordinate closely with other European partners, starting with the post-Brexit United Kingdom, 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 countries differ significantly in their perceptions of security threats, their vulnerability to external pressures and their attitudes towards both the US and China. Decisions involving the functioning of the single market or the customs union will need to be agreed by the whole EU, but for other aspects, a club-type approach, centred on a strong institutional core and 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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Suggested citation:
Pisani-Ferry, J. and G.B. Wolff (2019) 'Memo to the High Representative of the Union for Foreign Affairs and Security Policy', in M. Demertzis and G.B. Wolff (eds) *Braver, greener, fairer: Memos to the EU leadership 2019-2024*, Bruegel, available at https://bruegel.org/2019/07/memos-2019/