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COUNTERING ECONOMIC COERCION

HOW CAN THE EUROPEAN UNION SUCEED?

SUMMARY

This policy brief assesses how the EU can bolster its response and defence mechanisms against foreign economic coercion. At its inception, the EU benefited from a world order where economics, foreign policy, and geopolitics were less intertwined than they are today. However, as global economic power has shifted, these lines have been blurred. Furthermore, many global economies have decided to look after their interests outside multilateral frameworks and increasingly see multilateral institutions as outdated. Today, the long-forgotten concept of economic sovereignty is back on the agenda. The EU has been forced to become more 'geopolitical' instead of just an economic union. While it is a large market, a lack of coordination among EU members makes pursuing a common foreign policy and economic agenda challenging. Nonetheless, in this paper, we present specific and realistic policy measures to defend the autonomy of EU foreign economic policy and ensure that it can pursue progressive goals abroad. The EU should recalibrate its strategic dependencies, strengthen its ability to defend against extraterritorial sanctions, and improve mechanisms for investment and export controls. While we provide links between other areas of economic policy and national security, this paper focuses on the areas where the EU is particularly exposed – sanctions and the global financial architecture.

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STRATEGIC AUTONOMY
pathways to progressive action
SERIES

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European economic sovereignty in the 21st century

We start by discussing what we mean by economic sovereignty, how the perspective towards European economic sovereignty has changed in recent years, and how economic sovereignty can be curtailed or infringed via tools of economic coercion. We define European economic sovereignty as the EU's ability:

- *to determine its own economic destiny,*
- *to set rules for economic life [without infringing the rules of others],*
- *to negotiate on an equal footing with partner economies,*
- *to tame would-be monopolies and*
- *to set economic standards and regulations for the rest of the world.*[1]

Since its inception almost 30 years ago, the EU has largely enjoyed a benign multilateral world order where economics are governed by mutually agreed rules overseen by multilateral organisations (ie, Bretton Woods, the WTO). In this context, EU institutions perceived their role as limited to economic policy coordination – a role decidedly independent of foreign policy or geopolitical considerations. Due to the mutual understanding between the world's largest economies, questions of economic sovereignty did not arise.

However, the external environment has changed markedly in recent years as pressure has emerged from global powers – especially China, Russia, and the United States. These countries, and others, have increasingly incorporated foreign policy and geopolitical considerations into their economic policies. For example, it has been argued[2] that Chinese corporates sometimes act as an extension of the government, be it related to international investments or domestic financial markets. Russia has also frequently been accused of using its critical role in global energy markets to advance its geopolitical ambitions. Meanwhile, the US has gone as far as to challenge the role of multilateral organisations altogether, particularly during the Trump administration.

These developments illustrate that European economic sovereignty is not a present state in danger of being lost but rather one that never really existed at all, an illusion emanating from an economic policy consensus between major powers.

While there are advantages and disadvantages to a dissolution of the strict separation between economics and geopolitics, global developments have prompted a change in the way the EU sees its economic sovereignty and related aspects. At its inception, the EU enjoyed the transparency and relative predictability of multilateral agreements guiding economic interactions and trade. We believe the advantages of such a system clearly outweigh the disadvantages for the EU. The EU's institutions were conceived for an economic union, and small and medium-sized enterprises (SMEs) benefited greatly from a world order with clear multilateral rules and open trade. However, with today's fundamentally altered global economic reality, EU policies will inevitably have to change to preserve the EU's ability to develop and implement its priorities.

1 Leonard, M., Pisani-Ferry, J., Ribakova, E., Shapiro, J. and Wolff, G.B. (2019) 'Redefining Europe's economic sovereignty', Policy Contribution no.9, Bruegel, Brussels, June.
2 García-Herrero, A. (2021) 'Chinese economic statecraft: what to expect in the next five years?', Bruegel, Brussels, November (www.bruegel.org/wp-content/uploads/2021/10/Storms-Ahead_AGH_chp6.pdf).

Economic policies and geopolitics cannot be kept separate if 'rivals' or allies do not do the same. One benefit is that tools of economic coercion can be dramatically less costly than other elements of the foreign policy toolkit, such as military intervention. Economic statecraft is highly effective, particularly when combined with diplomatic efforts.[3]

This paper focuses on critical areas of economic statecraft and economic coercion and how they pertain to European policy. We leave areas such as foreign policy, state propaganda/fake news, cyber security, and defence out of the scope of our paper.

What are the mechanisms of economic coercion?

In its recent proposal on the protection of the EU from economic coercion, the European Commission defines economic coercion as *"a situation where a third country is seeking to pressure the Union or a Member State into making a particular policy choice by applying, or threatening to apply, measures affecting trade or investment against the Union or a Member State."* [4]

In their seminal work on the topic, Robert Blackwill and Jennifer Harris provide a comprehensive menu of what these measures might entail.[5] In our paper, we group them into the following categories:

1. Trade-related measures, including tariffs, embargoes, threats to value chains, the weaponising of strategic supplies such as energy and other commodities, and limits to market access.

2. Global finance-related measures, including economic and financial sanctions, restrictions related to access to critical elements of the international financial system such as the US dollar and payments systems, and limits to monetary and financial policy independence.

3. Technology-related measures, including export controls or licencing restrictions.[6]

In subsequent sections of this paper, we investigate the EU's experience with economic coercion in each of these areas, and the EU's response so far. We also set out our proposals on how to strengthen European economic sovereignty further and protect the EU and its member states – regardless of the country from which coercive measures might originate.

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3 Baldwin, D.A. (2020) Economic Statecraft: New Edition, Princeton NJ: Princeton University Press: 39.
4 European Commission (2021) Proposal for a Regulation of the European Parliament and of the Council on the Protection of the Union and its Member States from Economic Coercion by Third Countries, 2021/0406 (COD), 8 December (https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf).
5 Blackwill, R.D. and Harris, J.M. (2016) War by other means, Cambridge MA: Harvard University Press.
6 Slaughter, A-M. and Ribakova, E. (2019) 'Post-American Networks', Project Syndicate, New York, 22 July (https://www.project-syndicate.org/commentary/post-american-global-networks-by-anne-marie-slaughter-and-elina-ribakova-2019-07).

Key threats to European economic sovereignty

Strategic dependencies in a changing global economic order

Reliance on global trade and financial integration is not in itself a vulnerability but can rather be an important source of strength – and indeed has been for the European Union.[7] The EU's continued commitment to the free exchange of goods and services, as well as global financial integration, is a principled objective and reflects the bloc's genesis as a European single market, but it is also a manifestation of the vital role that trade plays for the European economy and the preservation of prosperity across the continent. Entering the third decade of the 21st century, the EU is highly integrated in global value chains and the international financial architecture. Furthermore, it is a leader in key policy areas such as climate change and digitalisation. However, the EU also faces critical challenges emanating from strategic dependencies against the backdrop of an international order where economic leverage is increasingly used to further geopolitical objectives. The EU therefore needs to evaluate its strategic dependencies – to understand and address risks resulting from other countries' actions, preserve its own policy space, and leverage its influence in EU foreign affairs. While the EU has done extensive work on strategic dependencies in recent years, it needs to take the next steps in terms of institutional design and practical implementation, including strengthening EU-wide investment controls and considering clear limits on single-country dependencies for critical supplies (eg, China has an informal rule of not relying on any single supplier for more than 15% of energy imports). Energy, in fact, will be the key test for both the EU's resolve and its capabilities, given the context of Russia's invasion of Ukraine and potential sanctions on energy imports from Russia. Specifically, the EU will need to prove that it can develop and implement policies on the European level rather than relying on individual countries' uncoordinated efforts to move away from Russian oil and natural gas as soon as possible.

The threat to the global economic order

The global economic order that has contributed to European prosperity is increasingly under threat. Economic nationalism has taken hold in many countries, including the United States, where Donald Trump made it an essential element of his 2016 campaign and of his administration thereafter. While the Trumpian trade wars represented a unique challenge for European leaders given that the US had previously been a steadfast ally in the fight for more – and not less – economic interconnectedness, the 2016 Brexit referendum in the UK brought the issue of economic nationalism irreversibly to Europe's doorstep. And it is more likely than not that focusing on issues of economic self-determination, the outsourcing of blue-collar jobs, and the impact of labour migration will remain effective and thus an irresistible vehicle for mobilising political support.

7 Farrell, H. and Newman, A.L. (2019) 'Weaponized interdependence: How global economic networks shape state coercion', International Security 44, no. 1: 42-79.

The EU continues to be committed to global economic integration, but the set of tools used to maintain its ideals may require rethinking. For example, pursuing adherence to WTO rules and decisions should remain an important objective of EU foreign policy – yet at the same time, the EU must acknowledge that other countries may not follow its lead and that upholding a rules-based international economic order may become increasingly difficult. In fact, the WTO has been losing influence as countries have increasingly turned to bilateral or plurilateral trade agreements, and the WTO's conflict resolution mechanism has been paralysed since the US began blocking new appointments to the WTO appellate body in 2019. In recent years, US–China trade relations have primarily taken place outside the WTO framework.

Moreover, while principled resistance to the current global economic order may be rising, countries also use their economic power to achieve policy objectives without much concern for intrinsically consistent considerations of a foreign policy doctrinal nature. For example, the cost and benefits of building up domestic industrial champions are often not explicitly considered against the costs to consumers due to the loss of benefits from global trade. This represents a different challenge for the EU from that of the overall trend toward gradual de-globalisation due to concerns around the world about globalisation's potentially problematic effects. Because of the EU's dependence on essential export markets such as those of the US or China, and because of its strategic dependencies on specific suppliers of important import goods, the EU's ability to set and execute policies towards the rest of the world – its economic sovereignty – is under threat.

The challenge of strategic dependencies

It is important to underscore that reliance on international trade and commercial relations does not necessarily give rise to the kind of external dependencies that result in vulnerabilities for the EU economy. On the contrary, such links and partnerships help to strengthen the EU's resilience to supply and demand shocks – in addition to creating substantial efficiency gains that help sustain the competitiveness of the EU economy over time. It is instead only those dependencies that significantly affect the EU's core interests and limit its ability to exercise foreign, security and economic policy in line with its values and interests that can be considered strategic. Furthermore, as the world's second-largest economic bloc, the EU is a source of dependency for other countries, notably the US and China.

With time, the European Union has become increasingly aware of the issue of strategic dependencies.[8] The Commission issued a staff working document entitled 'Strategic Dependencies and Capacities' in May 2021, which accompanied the EU's 2020 New Industrial Strategy and in which a wide variety of issues are discussed – from raw materials and hydrogen to semiconductors and cloud computing. The elephant in the room is, not surprisingly, Europe's dependence on hydrocarbon imports from a relatively small number of suppliers – first and foremost Russia (see Box 1). That country's invasion of Ukraine in February has forced European policymakers to reconsider energy-related trade relationships which had prevailed for decades.

8 European Commission (2021) Commission Staff Working Document, Strategic Dependencies and Capacities, SWD(2021)/352 Final, 5 May (https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52021SC0352&from=en).

The coming weeks and months will show how decisively and quickly Europe can address one of its most fundamental strategic dependencies – hydrocarbon-based energy sources – while at the same time preserving economic prosperity and protecting its citizens from hardship. Just a short time ago, a concerted European effort to rid itself of a dependency on Russia that had for long constrained foreign policy options seemed almost unthinkable. However, the invasion of a sovereign, free, and democratic country that borders the EU has changed old truths almost overnight. Regardless of the urgency of the present moment, measures to address strategic dependencies must be carefully examined to maintain the EU's competitiveness by increasing resilience in the most cost-effective way.

BOX 1. EU ENERGY DEPENDENCE: LIMITING POLICY OPTIONS

Strategic dependencies limit foreign and economic policy options. In the case of the European Union, the reliance on energy imports from a small number of suppliers – first and foremost, Russia – is the most critical example. Russia's Gazprom has always been partially a geopolitical project aimed not only at being a reliable and competitive supplier of gas to Europe, but also at making the EU more vulnerable to Russia's weaponisation of energy. For EU countries in the aggregate, Russian imports accounted for around 18% of total available energy in 2020, with dependency on Russia being highest for solid fossil fuels such as coal (45% of total imports), followed by natural gas (35%), and oil and petroleum products (23%).

However, in addition to a specific origin's share, strategic dependencies are also determined by the recipient's ability to replace a supplier in a reasonable period. This second characteristic leads us to distinguish between the EU's reliance on Russian natural gas and other types of Russian energy exports. Europe's natural gas is overwhelmingly imported via pipeline – although the importance of LNG continues to rise – and the necessary infrastructure to receive gas from other sources does not exist and the necessary infrastructure to receive gas entirely from other sources does not exist yet.

By contrast, however, coal and oil are often transported on ships, allowing for supply channels to be altered much more quickly.

While the situation over the winter 2021/22 would have been manageable even in the case of a major disruption of Russian natural gas supplies, a look at the medium-term raises serious questions about Europe's ability to diversify its import sources and reduce its dependence on Russia. For several reasons – among them declining production within the EU itself, the critical role of natural gas in Europe's climate change-related efforts, and growing demand in other regions – Russia's importance is likely to increase in the absence of a concerted effort.

Options for the EU are more limited than they may appear at first glance. In the case of a halt to Russian imports altogether, EU countries would need to replace the equivalent of 1,600-1,700 TWh of pipeline gas or LNG – roughly one-third of their total imports. We identify several alternatives: i) an increase in the EU's own production; ii) larger imports from Norway and Algeria; iii) additional flows from Central Asia; and iv) heavier reliance on LNG imports, especially from the US and Qatar.

What action should be taken for the medium-term to diversify natural gas imports and reduce the EU's dependence on Russia? A complete replacement of Russian natural gas will likely not be possible in the near future. In the event of a complete disruption of flows, Europe would have to rely on demand-side measures to address the situation. Some would be politically difficult, such as a higher reliance on coal-fired power plants or a delay to Germany's exit from nuclear energy; others would be economically painful, such as forcing the closure of non-critical industries. However, given Russia's demonstrated willingness to engage in energy wars – with Bulgaria, Denmark, Finland, the Netherlands, and Poland already disconnected due to their refusal to pay for natural gas in roubles – the EU needs to prepare both an offensive strategy (further sanctions on Russia to curb the country's ability to finance its war on Ukraine) and a defensive strategy (should more EU countries be abruptly disconnected). Russia has engaged in gas wars in the past (2005-2006 and 2008-2009), but always with the aim of discrediting Ukraine. Now, with an actual invasion of Ukraine underway, some of the transit via Ukraine is lost due to the military activity close to critical infrastructure. The EU needs to prepare for the worst-case scenario as far as Russia's use of energy-related strategic dependencies against the EU is concerned.

Economic sanctions

Economic sanctions lie at the core of economic statecraft and the question of European economic sovereignty. While the United States has markedly increased its use of sanctions in the last decade, it is not the only country to see sanctions as a critical part of its statecraft toolkit today.[9] Europe's response to the Russian invasion of Ukraine has primarily played out in the economic sphere, with extremely impactful measures imposed on several sectors of Russia's economy, including its financial system.[10] And just last year, China adopted a framework intended to address foreign economic coercion, which also creates a legal basis for retaliatory measures.[11] While sanctions pose a threat to European economic sovereignty because they can be used by foreign powers to impose costs on European individuals, businesses, or entire countries, they also represent one of the European Union's most powerful foreign policy instruments, especially in the absence of a more integrated European military force and given the opposition of many EU member states to military intervention.

Following Russia's invasion of Ukraine in late February, a dramatic change has taken place in that the EU has responded to the crisis with a level of determination and unity that has surprised many observers. However, as the cost of sanctions is rising for the countries imposing them, this unity is already under threat. What is more, the EU does not have the necessary infrastructure in place to make sanctions more permanent or ensure their consistent application, including during less exceptional times.

The centrality of the US in global finance

The effectiveness of US sanctions – direct or indirect – relies on the size of the country's economy as well as the centrality of its financial system. The US dollar continues to function as the most important reserve currency and as a result US treasuries serve as the risk-free global asset. During periods of stress, the US dollar strengthens, even in cases in which the stress originates in the US, such as during the global financial crisis or debt ceiling negotiations. The US dollar is also central for certain markets (eg, energy markets) for historical reasons: at a time when the US was the largest importer of oil and Saudi Arabia among its top suppliers, the US dollar emerged as the dominant currency in energy trade and many oil-exporting countries linked their currencies to it.[12] However, energy trading in more than one currency is not unprecedented and the euro should be able to gain in importance over time.

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9 Felbermayr, G. et al (2020) 'The Global Sanctions Database', VoxEU, 4 August (https://voxeu.org/article/global-sanctions-data-base); Bartlett, J. and Bae, E. (2022) 'Sanctions by the Numbers: 2021 Year in Review', CNAS, Washington DC, 13 January (https://www.cnas.org/publications/reports/sanctions-by-the-numbers-2021-year-in-review).

10 Hilgenstock, B. et al (2022) 'Russia Sanctions: Climbing the Escalation Ladder', Institute of International Finance, Washington DC, 28 February (www.iif.com/Publications/ID/4797/Russia-Sanctions--Climbing-the-Escalation-Ladder).

11 Tran, H. (2021) 'China's anti-foreign sanctions law: Companies in the crosshairs', Atlantic Council, Washington DC, 28 June (www.atlanticcouncil.org/commentary/blog-post/chinas-anti-foreign-sanctions-law-companies-in-the-crosshairs/).

12 Ribakova, E. (2019) 'How the EU could transform the energy market: The case for a euro crude-oil benchmark', Bruegel, Brussels, 13 February (www.bruegel.org/2019/02/how-the-eu-could-transform-the-energy-market-the-case-for-a-euro-crude-oil-benchmark/).

The euro holds the important second place among global currencies – not a small achievement for a currency that emerged only two decades ago. While a significant international role was not one of the objectives at the euro's inception, it is encouraging to see such dynamics take place.[13] In 2021, the European Commission launched a new strategy to stimulate *"the openness, strength, and resilience of the economic and financial system of the European Union"*, which includes *"a series of targeted actions to promote the international role of the euro."*[14] The ECB also regularly evaluates the international role of the currency. Furthermore, during the recent Covid-19 shock, the ECB started acknowledging that a greater international role comes with greater responsibilities, particularly the creation of swap lines to non-euro countries.[15]

In addition to the dominant role of the US dollar, US-based financial institutions, including banks and asset management companies, also play a critical role in global finance. For example, disconnecting a bank from corresponding accounts with US institutions is akin to disconnecting it from access to the US dollar. With US asset management companies accounting for the bulk of global capital allocation, losing access to US financial institutions also means losing access to a large share of global capital markets. This may change in the future, however. Brexit may have temporarily slowed down the development of deeper European capital markets, but progress towards the capital and banking union has been made. Finally, the size of the US domestic market matters as well. The US remains the world's largest economy, and many foreign corporates are wary of losing access to a large and potentially very profitable customer base.

It is encouraging that the US acknowledged the importance of multilateral and coordinated action in making sanctions on Russia more effective. The sanctions review process that took place in the first months of the Biden administration highlighted that *"sanctions are most effective when coordinated as an Administration and where possible with allies and partners who can magnify the economic and political impact"*.[16] This sanctions review process thus helped the US prepare the ground for closer cooperation with its partners, importantly in the EU. However, should this stance by the US change and should the EU become a target – either directly or indirectly – such policy would pose a significant threat to the EU. Due to the ability of the US to inflict significant pain on foreign entities that are not aligned with its policies, it would be in the interest of European countries to work towards monetary and financial policy independence.

13 Papaconstantinou, G. (2022) 'Strengthening the global role of the Euro', Policy Brief, FEPS, Brussels.
14 European Commission (2022) The international role of the euro, 24 March (https://ec.europa.eu/info/business-economy-euro/euro-area/international-role-euro_en).
15 Nagy-Mohacsi, P. (2020) 'The Quiet Revolution in Emerging-Market Monetary Policy', Project Syndicate, New York, 18 August (www.project-syndicate.org/commentary/emerging-markets-unconventional-monetary-policy-by-piroska-nagy-mohacsi-1-2020-08?barrier=accesspaylog).
16 U.S. Department of the Treasury (2021) Press Release, U.S. Department of the Treasury Releases Sanctions Review, 18 October (https://home.treasury.gov/news/press-releases/jy0413).

Completing the capital markets and banking union, and developing markets (ie, energy) in euro should be the first steps in this. Furthermore, the new era of digital currencies could change the balance of power. While it is still too early to make a definite statement in this regard, it seems that some key advanced economies are behind recent developments in China and Russia. The current position of the US towards central banking digital currencies (CBDCs) is understandable given the US dollar's dominant role. However, a CBDC euro could make a difference for the international use of the euro and could allow Europe to gain independence as far as payments systems are concerned. It could also make both settlements and information exchanges related to international payments faster and more accurate.

The challenge of secondary sanctions

For the purposes of this paper, it is essential to distinguish between two fundamental types of sanctions: primary sanctions and secondary sanctions. Using the example of the United States, primary sanctions prohibit US persons, and non-US persons within US jurisdiction, from engaging in certain sanctioned activities, with violations leading to prosecution and/or monetary penalties. Importantly, primary sanctions also cover transactions that take place via US financial markets. Sanctions that are aimed at activities by non-US persons or entities outside US jurisdiction are called secondary sanctions. They therefore constitute an 'extraterritorial' application of US law.

While a failure to comply with secondary sanctions might not lead to direct fines, it will likely lead to a loss of access to benefits provided by the sanctions-imposing country. This can be impactful in many cases but is particularly so if US sanctions are concerned as access to US markets and the US dollar is critical for foreign businesses. Indeed, the European Commission states that *"as a matter of principle, the EU considers the extraterritorial application of sanctions contrary to international law"*.[17] This does not, however, negate the fact that secondary sanctions are often extremely effective as the risk of running into conflict with US authorities will prove too high for most individuals and companies. Due to their expansive reach, secondary sanctions, in a way, raise even more pressing questions regarding European economic sovereignty.

Secondary sanctions materialised on a large scale following the United States' departure from the Iran nuclear deal, or Joint Comprehensive Plan of Action (JCPOA), in the spring of 2018. While measures imposed on Iran before 2015 constituted multilateral actions, supported by the United States and its European allies, the US reinstated sanctions in 2018 unilaterally. Most importantly, the new US measures threatened European individuals and businesses with severe consequences, including loss of access to the US financial system, if those individuals and businesses continued to conduct transactions with Iran (see Box 2).

17 European Commission (2021) Report from the Commission to the European Parliament and the Council relating to Article 7(a) of Council Regulation (EC) No 2271/96 ('Blocking Statute'), COM/2021/535 final, 3 September (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0535).

In a similar way, US sanctions imposed on the (now cancelled) Nord Stream 2 pipeline between Russia and Germany from 2019 to 2020 also constituted secondary sanctions because they threatened European-based companies involved in the construction of the pipeline with consequences such as the blocking of assets under US jurisdiction and the inadmissibility of corporate personnel to the US. In this, they proved extremely effective because the targeted companies exited the Nord Stream 2 project almost immediately and the pipeline's completion was delayed significantly – before its entry into service was ultimately halted by the German government following Russia's invasion of Ukraine.

At the core of the question of economic sovereignty lies the issue that sanctions imposed by a foreign country determine the business decisions of a European entity that does not fall under that country's jurisdiction. Independent from any judgment as to the economic and geopolitical implications of trade with Iran or the completion of Nord Stream 2, European businesses were thus forced to retreat from existing contractual obligations under the threat of financial ruin. It is encouraging, however, that the EU decided recently to exert its weight to protect one of its smaller members – Lithuania – against measures that are akin to secondary sanctions imposed by China over the use of the name 'Taiwan'.[18] This offers a good example of how the EU will never be able to fully protect individual countries or companies from economic coercion – or be able to properly compensate them for their losses – unless there is a concerted effort by the bloc as a whole to prevent the extraterritorial application of sanctions altogether.

The EU blocking statute's deficiencies

In 1996, the EU adopted Council Regulation No 2271/96 to prevent the extraterritorial application of sanctions, which the EU considers to be a violation of international law. The regulation is commonly known as the 'blocking statute' and was most recently amended in 2018 following the withdrawal of the US from the Iran nuclear deal. Under the blocking statute, companies have reported to the European Commission numerous episodes of extraterritorial sanctions affecting their interests.[19] The statute aims to nullify the effects of such sanctions, prohibits EU companies from complying with measures, and allows for the recovery of damages.

The key issue with the blocking statute is that it de facto delegates the resolution of conflicts between governments to private companies. For example, in the case of the Iran nuclear deal, EU companies were placed in a legal dilemma: if companies failed to comply with US sanctions, they faced severe repercussions, most importantly the loss of access to the US dollar or US markets. However, by complying with US sanctions, they risked being fined in the EU for violating the blocking statute.

While the European Commission has reported numerous instances which theoretically qualify under the statute, we have not so far seen any cases of a successful application to reverse extraterritorial sanctions. For most companies, access to the US dollar and US markets is too important compared to any losses. However, there may be cases where EU companies have such strong interests – for example, related to commercial activities in China – that the decision would be less clear-cut.

18 Liu, N. (2022) 'European Union Rallies Behind Lithuania in Trade Fight with China', 29 January (https://www.voanews.com/a/european-union-rallies-behind-lithuania-in-trade-fight-with-china/6417838.html).
19 European Commission (2021) 3 September (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0535).

For the time being, the deficiencies of the blocking statute render the mechanism tooth less. Furthermore, most companies and banks tend to err on the side of over - compliance, given the high regulatory uncertainty stemming from sanctions. The implementation of sanctions is highly complex, with regulations changing by the day and governments' objectives often poorly explained or not at all. Given the high risk of substantial fees and/or the loss of access to critical markets, many entities tend to be more cautious than strictly required by law. Furthermore, once a country comes under sanctions, as was the case with Iran, companies are much more cautious to return to that country even after the sanctions have been lifted.

BOX 2. WITHDRAWAL OF THE US FROM THE IRAN NUCLEAR DEAL

The unilateral withdrawal of the US from the Iran nuclear deal in 2018 laid bare the EU's inability to assert its national security interests. While the US was only one of the signatories to the Joint Comprehensive Plan of Action (JCPOA), its withdrawal made compliance with the agreement untenable for the others due to the risk of secondary sanctions. Most corporates opted to sever ties with Iran rather than risk losing access to US markets and/or the US dollar in addition to financial penalties. The EU and other countries attempted to set up alternative systems to allow for a continuation of business relations. However, these endeavours were ultimately unsuccessful.

The JCPOA was signed between Iran and several global and regional powers (China, the European Union, France, Germany, Russia, the United Kingdom, and the United States) in 2015. As Iran fulfilled its obligations under the JCPOA, previously imposed multilateral sanctions on that country were largely lifted in 2016. However, the Trump administration announced the withdrawal of the US from the agreement in May 2018, leaving the remaining JCPOA signatories legally required but practically struggling to fulfil their obligations towards Iran because the US reinstated pre-JCPOA sanctions and imposed additional measures.

Among the most-significant sanctions was the curtailing of Iran's ability to use the Society of Worldwide Interbank Financial Telecommunications (SWIFT). SWIFT is an international cooperative of global banks that is akin to a lifeline for all international finance. While the system itself does not settle payments, it transmits transaction-related messages between financial institutions – and currently processes more than 40 million messages per day.

Given the significance of SWIFT for cross-border transactions, disconnecting Iran from the system was considered one of the most severe sanctions possible. In 2012, in a coordinated effort, the EU and US pressured SWIFT to disconnect the Central Bank of Iran (CBI) and around 30 key Iranian banks. At the same time, the US Congress authorised the US president to impose sanctions on institutions that provide messaging services.[20] While some countries were reluctant to follow the EU and US in seizing transactions with Iran, in particular oil purchases, they were nevertheless forced to rely largely on barter deals.

Alignment of sanctions regimes in 2012 was critical to avoid a situation of legal limbo where compliance with restrictions in one jurisdiction may have run into conflict with the respective other's rules.

However, 2018 played out differently, with the US walking away from the JCPOA and unilaterally imposing sanctions on Iran, including its disconnection from SWIFT.

In response, the EU invoked its blocking statute, which aims to make US legislation, administrative actions, and court decisions inapplicable in the EU. Facing pressure from the US, SWIFT, however, chose to disconnect Iranian banks without specifically referring to US sanctions, in a step *"taken in the interest of the stability and integrity of the wider global financial system"*.[21] The actions of the US proved to be highly impactful with trade between the EU and Iran falling by over 70% in 2019 and Iranian exports to the EU essentially coming to a halt.

To facilitate continued cross-border transactions, Germany, France, and the UK announced the creation of a new payments messaging system as an alternative to SWIFT – the Instrument in Support of Trade Exchanges (INSTEX). INSTEX is a government-controlled Special Purpose Vehicle (SPV) set up to allow for engagement with Iran without the risk of facing consequences from US sanctions. However, it ultimately proved to be unsuccessful; the only transaction to date took place in 2020, two years after the withdrawal of the US from the JCPOA, and was conducted for humanitarian purposes which are not covered by US sanctions anyway.[22] As European efforts only had a very limited effect, it will be critical for the EU to revise its toolbox regarding exposure to extraterritorial and secondary sanctions, as well as its exposure to risks stemming from financial sector interlinkages.

20 Syria Human Rights Act of 2012, Pub. L. No. 112-158, 126 Stat. 1214 (2012).
21 Reuters (2018) 'SWIFT system to disconnect some Iranian banks this weekend', 9 November.
22 DW (2019) 'INSTEX: Europe sets up transactions channel with Iran', 31 January.

Export and investment controls

Export controls have become an integral part of economic statecraft. We define export controls as limitations or restrictions on the trade (exports from the home country) of certain goods, sensitive technologies, or software. Goods subject to export controls range from military equipment to the latest microchip technologies. Measures include the outright prohibition of exports of certain goods to certain countries or entities, as well as licencing requirements. Limitations can reach as far as the production of certain goods outside the sanctioning entity's jurisdiction. Requirements are established at national and/or international levels and carry heavy penalties for non-compliance. At the same time, export controls can be difficult to enforce administratively.

Export control in the US and the EU

Historically, export controls were used to pursue a narrow set of foreign policy objectives in the humanitarian and defence spheres. In the US, export controls were originally developed to prevent certain countries – for example, the Soviet Union – from having access to critical military equipment. Since then, export controls have evolved into a sophisticated tool of economic coercion and can be directed at specific users and non-state actors. There are a few key types of export controls that can be imposed by the United States. The first is traditional restrictions pertaining to military and dual-use technology; the second was introduced by the Export Control Reform Act of 2018. Faced with growing competition from China, particularly as a result of the close relationship between the Chinese government and the private sector, the US created a new tool aimed at protecting US competitiveness in certain areas, particularly technological know-how.[23]

This recent reform of the US export controls regime introduces a unique degree of extraterritoriality of application through the Foreign-produced Direct Product Rule (FDPR) contained in the Export Administration Regulations (EAR). The FDPR thus sets out that even if a product is made by a foreign entity outside the US, it can still be reached by US export controls if it contains any components or technologies from the US. This has far-reaching consequences as there are few, if any, chips produced globally without US software or tools. In the case of China, the FDPR has been used since 2020 to prevent Huawei from acquiring third-party technology.

While the US therefore has considerable leverage to implement wide-reaching export controls, authorities understand the importance of multilateral coordination, particularly because in the modern world, unlike a few decades ago, no single country holds undisputed leadership in any given technology. To coordinate policies, the US and EU created the United States-European Union Trade and Technology Council (TTC) whose objective is to *"promote US and EU competitiveness and prosperity and the spread of democratic, market-oriented values by increasing transatlantic trade and investment in products and services of emerging technology, strengthening our technological and industrial leadership, boosting innovation, and protecting and promoting critical and emerging technologies and infrastructure"*.[24]

23 Export Control Reform Act of 2018, Pub. L. No. 115-232, § 4811(6), 132 Stat. 2210 (2018).
24 European Commission (2021) Press Release, EU-US Trade and Technology Council: Commission launches consultation platform for stakeholder's involvement to shape transatlantic cooperation, (IP/21/5308), 18 October.

Compared to the US, the EU's ability to impose export controls is significantly more limited. These are legislated by the EU and individual member states and implemented at the national level. As a result, there is significant variation and flexibility in the implementation of export controls in Europe. Currently, EU-wide restrictions are solely focused on dual-use products, and the EU does not have a model for export controls with broader national security or economic statecraft objectives. The EU Dual-Use Regulation prescribes EU-wide controls that are a requirement for all EU member states. In addition, each EU country has the flexibility to add additional products to their national dual-use export control lists.[25]

Export controls in the case of Russia

Most recently, both the US and its European allies have imposed wide-reaching export controls on Russia to curtail the country's access to microelectronics. The approach appears to be following the playbook of the China/Huawei case. In fact, Russia had already been subject to export controls from 2014 when the US imposed measures targeted at the energy and defence sectors.[26] These have had a significant impact on the exploration of new oil fields and production in the deep-water, Arctic offshore, and shale energy spheres. Export controls were further tightened following Russia's poisoning of a former intelligence officer and his daughter in the UK in 2018, and of Russian opposition leader Alexei Navalny in 2020. On both occasions the export controls were tightened under the US Chemical and Biological Weapons Control and Warfare Elimination Act of 1991 (CBW Act).

Export controls on critical technology may have an element of surprise and could be difficult to circumvent. Many other types of sanctions (access to global payments systems, access to foreign currency and to sovereign debt markets) have been under discussion since 2014, and Russia has had time to prepare – and done so with the development of domestic systems, a geographical shift of reserves, and fiscal consolidation. Developing critical technology independently, however, would likely be almost impossible for the country. Following Russia's invasion of Ukraine, the EU, surprisingly, moved quickly with coordinated export controls alongside the US, even if export controls beyond dual-use goods are often viewed with scepticism in the EU. For the US, having the EU implement similar export controls rather than threaten secondary sanctions was an important win. However, given the degree of EU dependency on Russian energy, export controls proved less controversial to European countries compared to restrictions related to the energy and financial sectors of the Russian economy. Furthermore, export controls will continue to impose costs over the long run by stunting technological advancements and thus productivity growth.

25 European Commission (2021) Dual-use trade controls, 17 November (https://ec.europa.eu/trade/import-and-export-rules/export-from-eu/dual-use-controls/)

26 US Department of Commerce (2022) Bureau of Industry and Security, Resources on Export Controls Implemented in Response to Russia's invasion of Ukraine, Washington DC (https://libguides.wvu.edu/c.php?g=418946&p=2855160).

Investment controls

The US and the EU have both strengthened their investment screening in recent years, but their objectives differ significantly. The US explicitly intends to make use of these measures to preserve technological leadership and pursue foreign policy goals.

However, the EU and its member states are bound by the provision of the Treaty on the Functioning of the European Union (TFEU) that prohibits restrictions on the free movement of capital (Art. 63 TFEU). A clause of Article 64 TFEU provides an escape from the prohibition of restrictions on capital flows, but it requires a unanimous decision by the EU's member states.

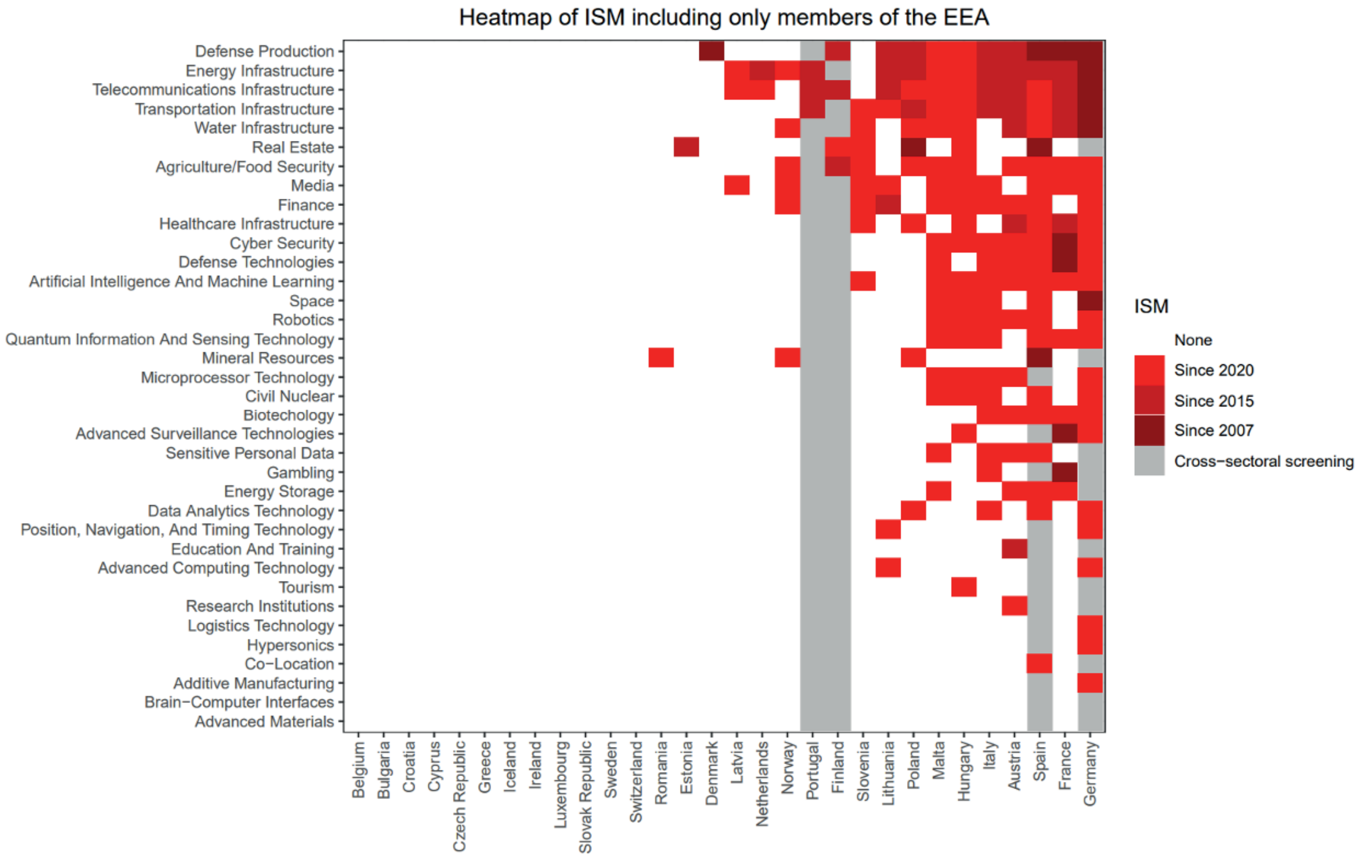
At the EU level, the European Commission can currently make non-binding suggestions on investments in member states. The new EU-wide framework became fully operational in 2020 following the adoption by the European Parliament in 2019 of a regulation for the screening of foreign investment (Regulation 2019/452).[27] The regulation sets minimum standards, but ultimately leaves the decision-making to national authorities. The framework is not aimed at harmonisation of EU investment controls, nor does it replace measures at the national level. Instead, it aims to promote transparency, information sharing, and cooperation. In this respect, the regulation appears to be effective with some 200 cases screened per year.[28]

The regulation nevertheless stops short of giving veto powers to the European Commission. If infrastructure is used in a way that threatens national security, foreign investment can be banned only through national legislation. The list of EU-wide interests over which the Commission has the right to issue an opinion is much narrower than the interests covered by US export regulations, discussed above, and by the authority of the Committee on Foreign Investment in the United States (CFIUS).

At the national level in Europe, there are substantial discrepancies in the approach to investment screening (Figure 1).[29] While many member states have introduced some sort of screening mechanisms in recent years, others still lack a comprehensive framework. The European Commission expects all member states to implement investment screening schemes by 2022.

27 European Commission (2020) Press Release, EU Foreign Investment Screening Mechanism Becomes Fully Operational, (IP/20/1867), 9 October.
28 Duchâtel, M. (2021) 'The New Landscape of Investment Screening in Europe', Institut Montaigne, Paris, 21 June (www.institutmontaigne.org/en/blog/new-landscape-investment-screening-europe).
29 Eichenauer, V.Z., Dorsc, M. and Wang, F. (2021) 'Investment Screening Mechanisms: The Trend to Control Inward Foreign Investment', EconPol Europe 5, no.34 (www.econpol.eu/publications/policy_report_34).

Figure 1: Investment screening mechanisms (ISM) in the European Economic Area (EEA) [30]



Even where investment screening procedures are in place, they do not always achieve the desired outcome. A recent case involving Germany is particularly pertinent: while the country does have a national investment screening mechanism,[31] the responsible agency (*Bundeskartellamt*) cleared Russian oil company Rosneft's increase in investment into one of its key oil refineries just days before Russia's war on Ukraine began. Rosneft, thus, could have acquired a majority stake in key strategic energy infrastructure in Germany exactly at the time when the country is planning to diversify from Russian energy supplies. At the time of the approval, the Bundeskartellamt commented that *"political considerations play no role in our agency"*.[32]

The US has proposed greater coordination and synchronisation between EU procedures and those of CFIUS. In addition, the Trade and Technology Council refers to investment screening as an area of cooperation.

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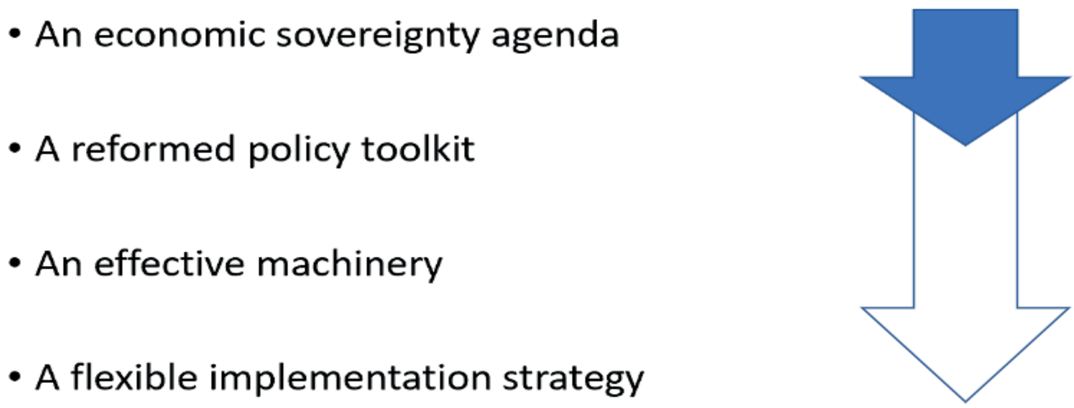
30 Eichenauer, V.Z., Dorsc, M. and Wang, F. (2021), cit., available at: www.econpol.eu/publications/policy_report_34.
31 Erickson, S. (2021) 'Recent Developments in EU Foreign Investments Screening', CSIS, Washington DC, 19 April (www.csis.org/blogs/strategic-technologies-blog/recent-developments-eu-foreign-investment-screening)
32 Rundfunk Berlin-Brandenburg (RBB) (2022) 'Russischer Mineralöl-Konzern darf Anteile an PCK Schwedt aufstocken', 23 February (https://www.rbb24.de/studiofrankfurt/wirtschaft/2022/02/bundeskartellamt-rosneft-pck-schwedt-russland-gas.html).

Conclusion and policy recommendations

In earlier research, we recommended changes to achieve greater economic sovereignty for the European Union. Where do we stand now?

We believe that to achieve a change in policy objectives and institutional set-up, the four-part strategy described in our earlier research is still relevant (Figure 2).

Figure 2: Action plan for economic sovereignty of the EU



The resolve of the EU to pursue economic sovereignty has changed irrevocably in recent years – due to both a fundamental shift in the external environment and an acknowledgment on the side of the EU that a new strategy is urgently needed. Since we wrote about what seemed to have been a long-forgotten issue just a few years ago, economic sovereignty now appears to be at the top of every EU policymaker's agenda. The European Commission is now geopolitical, and the ECB regularly provides updates on the global role of the euro.

The EU's concerted and multilateral response to Russia's invasion of Ukraine in the form of economic sanctions has been unprecedented in terms of speed and degree of coordination. Clearly, the resolve and political will to act swiftly to protect European interests are there. And the profound and rapid effect of sanctions on the Russian economy demonstrates that the foreign and economic policy toolkit is far from empty.

However, the Ukraine crisis has also brought back a transatlantic alignment of objectives – one of the supporting factors of what we previously identified as 'illusionary' economic sovereignty. Furthermore, as large and globally integrated as Russia's economy is (or has been), it does not even come close to the role played by China, which is generally considered the most critical test case for a European economic sovereignty agenda. In addition, there is a risk that the EU's institutional capacity may be lagging and, apart from emergencies such as a land war in Europe, may not be performing as efficiently and expeditiously as it should.

While the European Commission's recent proposal for a 'Regulation of the European Parliament and of the Council on the protection of the Union and its Member States from economic coercion by third countries'[33] represents an important and well-thought-out step forward, we want to conclude this paper by putting forward a series of recommendations that we believe are critical to protect and preserve European economic sovereignty in the 21st century.

A reformed policy toolkit and an implementation framework to counter threats

Strategic dependencies

Strategic dependencies are among the challenges that most urgently need to be addressed. Not only can they lead to significant costs for governments, businesses, and households in the EU, but they can also fundamentally undermine the independence of the bloc's foreign and economic policy. Recent events following Russia's invasion of Ukraine are a case in point: EU governments know very well that the continuation of energy imports from Russia provides Russian authorities, and the Russian economy as a whole, with foreign currency inflows that undermine multilateral sanctions against the country. However, at present, EU governments also fear the effect of a potential energy embargo on the European economy and Europeans' energy bills.

Diversification of energy import suppliers, particularly for natural gas, appears to be key – together with improvements to Europe's natural gas transport and storage infrastructure (including LNG terminals), and the socialisation of risks to protect individual countries from economic coercion. Ultimately, while natural gas is being considered a critical transitional energy source by many governments in Europe, the reduction of energy-related strategic dependencies aligns very well with the continent's climate change agenda. In the short term, however, reducing dependencies may require politically difficult decisions such as the extension of nuclear power plant life cycles, higher usage of coal, or shale gas exploration.

33 European Commission (2021) 8 December (https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf)

Sanctions and the blocking statute

The EU's blocking statute is in urgent need of an overhaul. While it is well intentioned and may work on paper, it has not had a meaningful effect on the conundrum of European businesses when they are faced with the extraterritorial application of sanctions, as in the Iran case. The key weakness of the statute is that it essentially leaves the resolution of a conflict between governments to private businesses that are in no position to withstand substantial pressure. When threatened by a foreign power (eg, the United States) with what essentially represents assured financial ruin, entities will in almost all cases choose to violate the blocking statute rather than face financial penalties or loss of access to important markets or the US dollar.

The deficiencies of the blocking statute illustrate the almost impossible task of upholding a clear distinction between economics and geopolitical objectives. In our view, the EU will never be able to fully protect individual companies from economic coercion – or be able to properly compensate them for their losses. What is needed is a concerted effort by the EU to prevent the extraterritorial application of sanctions altogether. It is therefore particularly important that, should an EU embargo on Russian energy be implemented, the EU imposes alongside it direct sanctions limiting the country's ability to divert energy to non-sanctioning countries (via maritime insurance, for example) rather than resort to the extraterritorial application of sanctions by the US. To deter such behaviour, the EU should consider asymmetric responses that take advantage of its own strategic role as the world's second-largest economy. What worked quite successfully during the Trump-era trade wars should be applied more broadly to protect European economic sovereignty.

Strategic role of the euro

Much of the ability of United States to engage in economic coercion is founded on the US financial system's importance and the US dollar's role as the world's reserve currency. The euro has achieved much success in establishing itself as the clear number two currency, despite it only being around for two decades, and it can obviously go much further. However, the euro will not become a truly international currency without a concerted effort to support its role. Three requirements are crucial: first, a deep and integrated capital and banking market; second (and related), the creation of a euro area safe asset; third, the establishment of swap lines with partner central banks so that the ECB can serve as a lender of last resort to local banks that conduct business in euro.

While access to the US dollar and the US financial system will likely remain a critical factor for many companies, it may no longer be a life-or-death business decision for some should the euro provide them with a comparable ability to conduct cross-border transactions.

Global payments systems

SWIFT remains the most important global financial messaging system and being disconnected from it has dramatic consequences for financial institutions – as recent developments related to sanctions on the Russian banking system demonstrate. In the past, the US has exerted pressure on SWIFT to cut off access for financial institutions, but the US has not involved its European allies in the process.

For European economic sovereignty, it is critical to protect the independence of SWIFT and/or to create systems than can take over its functions should the situation require it.

In the Iran case and following the unilateral withdrawal of the US from the JCPOA, the remaining signatories struggled to allow companies to continue to interact with Iranian entities. Ultimately, INSTEX, which was set up for this exact purpose, failed to accomplish its goal. The EU should continue to develop infrastructure that can facilitate cross-border transactions in the case of unilateral actions by a global power (eg, the US) hindering the operation of existing systems. In this regard developing a digital euro is of critical importance as it would greatly facilitate global payments using the euro.

Export and investment controls

The United States has for some time now understood the geopolitical importance of export and investment controls – to exert pressure on 'rivals' and to protect critical sectors from foreign coercion. The EU, on the other hand, continues to rely on a fragmented system that distributes competences between the Union and its member states. The result is that policies are neither properly coordinated nor sufficiently aligned to 'compete' with other countries' more concerted efforts. In particular, the European CFIUS-like framework is unsatisfactory because it keeps the definition of national security concerns on the national level. This does not allow for effective protection of such concerns across the EU.

What sets the issue of export and investment controls apart is that the EU can improve its instruments through institutional changes alone. This is markedly different from addressing strategic dependencies or strengthening the role of the euro, which will take a considerable amount of time, or creating an effective blocking statute, which will necessitate a fundamental change in the way the EU thinks about the application of asymmetric measures.

In our view, the EU should develop a common approach and common procedures for the screening of foreign investments, and it should empower the European Commission to recommend, on security grounds, the prohibition of foreign investments, with the final say belonging to the Council. Furthermore, not all decisions are of a 'black and white' nature. For this reason, the EU should also develop instruments such as a dedicated investment fund. This would make it possible to offer member states alternatives in cases where foreign investments are deemed undesirable.

Multilateral institutions

While countries such as the US and China are increasingly challenging the global economic order of the 20th century and the critical role of multilateral institutions such as the IMF and WTO, the EU should continue to support conflict resolution within the existing multilateral framework. This may require rethinking the specific role of these multilateral institutions and reforming their governance structures. Furthermore, as the world appears to be moving towards more plurilateralism, the EU needs to actively prepare. Although the EU can be thought of and is at times very effective as a union of clubs, it can and should think strategically, and when faced with an external threat it should avoid fragmentation. It has demonstrated an ability to be a standard-setter in areas of green and digital architecture, and it should continue to be so, including in helping shape the global agenda on sanctions. The EU should use its power to contribute to rethinking multilateral institutions to reflect the new reality of the economic sovereignty debate, particularly now that we cannot think of economics in isolation from national security objectives.

To summarise, the EU has made great progress in winning and safeguarding its economic sovereignty – but critical challenges remain. Europe has responded with unprecedented unity and determination to Russia's invasion of Ukraine – a direct military threat at the borders of the EU. Key questions remain regarding how we can best harness this determination and transform it into a new institutional set-up that fits the purpose of protecting the EU from economic coercion.

At its inception, the EU benefited from a world order where economics, foreign policy, and geopolitics were less intertwined than they are today. However, as global economic power has shifted, multilateral institutions have come under pressure and are today accused of being outdated. The EU should recalibrate its strategic dependencies, strengthen its ability to defend against the application of extraterritorial sanctions, and improve mechanisms for investment and export controls.

34 Demertzis, M., Pisani-Ferry, J., Sapir, A., Wieser, T. and Wolff, G. (2018) 'One size does not fit all: European integration by differentiation', Policy Brief 3/2018, Bruegel, Brussels.

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STRATEGIC AUTONOMY
pathways to progressive action

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