



STRENGTHENING THE GLOBAL ROLE OF THE EURO

HOW CAN THE EU REINFORCE THE INTERNATIONAL DIMENSION OF THE SINGLE CURRENCY AND HOW CAN THIS BE USED TO ENHANCE THE EU'S STRATEGIC AUTONOMY?

ABSTRACT

The sanctions on Russia following the invasion of Ukraine show the importance of currency dominance in international financial markets. This policy brief addresses the issues relevant to reinforcing the international dimension of the euro and using it to enhance EU's strategic autonomy.

The euro remains a strong second to the dollar amongst international currencies. The recent renewed motivation for policies to foster a stronger international role for the euro can be linked both to historically high public support for the common currency and to concerns about an increased weaponisation of the dollar by the US.

Strengthening the international role of the euro involves policy action on three fronts:

- 1) filling in the missing elements of the economic and monetary union: completing banking union with a common deposit insurance scheme, creating a capital markets union, a fiscal capacity for macroeconomic stabilisation, and a euro area safe asset by making the instruments of the Next Generation EU initiative permanent;
- 2) improving financial market infrastructure and efficiency in euro transactions, including by extending the use of swap lines to facilitate liquidity in euro;
- 3) policies that expand the use of the euro in key strategic sectors such as energy, commodities, and transport – sectors that are now heavily reliant on the use of the dollar.

These policy actions will significantly strengthen the international position of the euro and thus contribute to EU's strategic autonomy.



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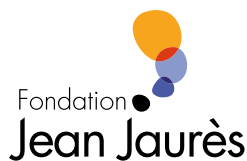
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1. Introduction

Following the announcement by the EU, together with the US, of a number of sanction packages against Russia in response to the latter's invasion of Ukraine, the discussion of 'EU strategic autonomy' has taken on a new urgency. It is a multifaceted debate, with considerations ranging from common European security and defence capabilities to energy security and trade relations. Central to these considerations is the capacity to pursue a policy that defends European economic and geopolitical interests while operating in international financial markets. The role and importance of the common European currency is therefore critical.

How can the EU reinforce the international dimension of the single currency and how can this in turn be used to enhance the EU's strategic autonomy? The aim of this brief is to explore the policy issues around strengthening the global role of the euro. The brief will assess the progressive pathways through which the international role of the euro, as a key element of the EU's integration and autonomy, could be further supported by means of monetary and fiscal policy, adaptations to its governance structure, and specific policy initiatives.

The discussion around strengthening the international role of the euro is taking place against a background in which the common currency successfully overcame what was described as an 'existential threat' during the eurozone crisis – a threat that served as a wake-up call to address some of the euro's original design faults. Today the euro is firmly established as the second most widely used currency worldwide across a number of metrics: global payments, foreign exchange turnover and reserves, international debt and loans. However, it lags significantly behind the dollar

in all these areas – and the relevant numbers may in fact understate the true dominance of the dollar as a global currency. Over the last few years, discussion on the global role of the euro has found new space but, with the EU now emerging from the Covid-19 pandemic, this discussion is today taking place in a different global environment – one that is characterised by geopolitical shifts – which grants the discussion renewed urgency.

In this context, the structure of this policy brief is as follows. Section 2 discusses the motivation and political context today for strengthening the international role of the euro. Section 3 goes back to economic fundamentals as they relate to currencies: the international functions of currencies, the factors that determine the share of a currency in international markets, and the case of the dollar, with its particularities as the world's reserve currency and its unique role in the global economic and financial architecture.

Section 4 examines evidence of the international role of the euro today in different markets and addresses the factors that account for its still limited international reach. Section 5 then outlines and critically assesses the different policy goals behind seeking a stronger international role for the euro; it examines the broad policy framework being put into place in this vein and the key policy actions proposed or undertaken. Concluding remarks and recommendations are then set out in Section 6.

2. Motivation and political context

The discussion on reinforcing the international dimension of the single currency has traditionally been fairly muted. It would be fair to say that for a long time after the euro's creation the prevailing attitude in European institutions was one of 'benign neglect'. While

the international position of the euro had always been monitored, there was no explicit policy of increasing its role in international product and financial markets, nor were there any initiatives to this effect. The reason for this can be traced to both economic and political factors. For example, the European Central Bank (ECB) typically took the position that as far as the euro was concerned, the economic policy of EU institutions such as itself should stick to the fundamentals of maintaining price stability – and the extent of the international use of the common currency would then be the outcome of market forces.¹

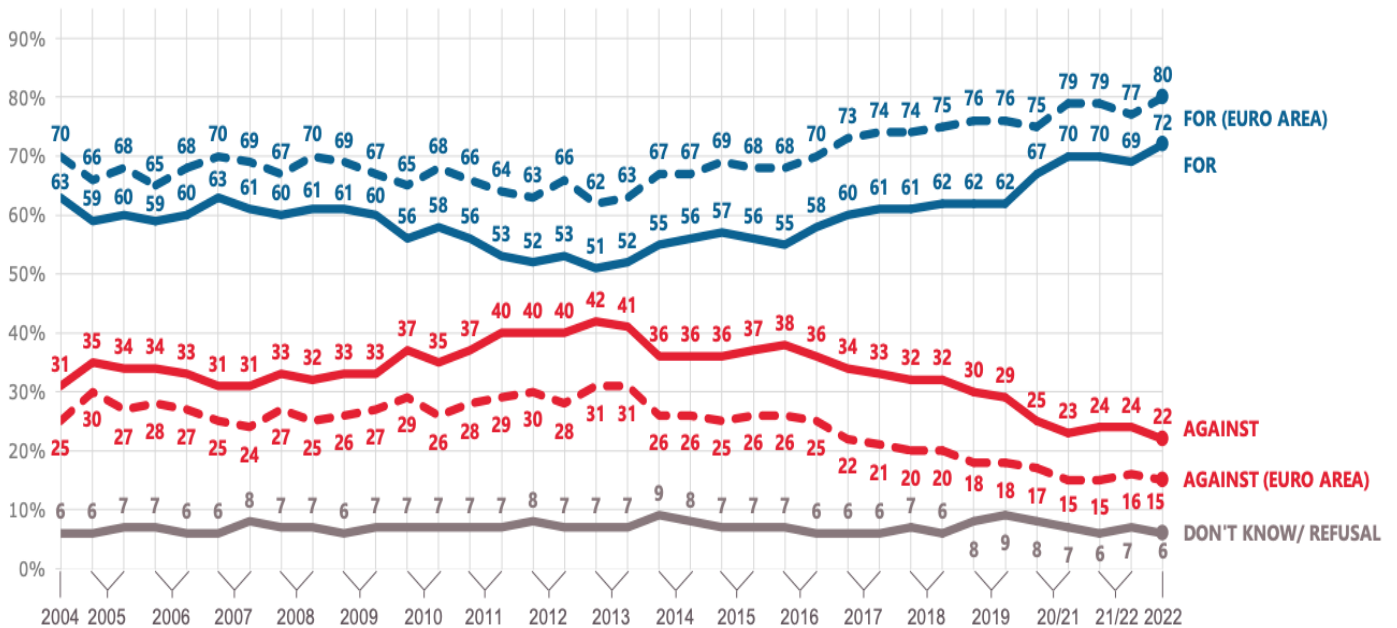
Following its successful launch in 1999 and a first decade of establishing itself as a reality for Europeans but also as a steadily increasing force internationally, the eurozone crisis provoked a sort of existential crisis for the common currency after 2009. The euro's known construction faults, present since its launch, came back to haunt it. It was blamed as a straitjacket for economic policy in the weaker members, and commentators – especially in the UK and the US – were quick to predict its imminent demise.² At that time, there was not much appetite to push for a wider international role of the euro when its very existence within the euro area was being questioned. When you have problems of acceptability at home, how can you think about expanding abroad?

All this has changed recently. Perhaps the clearest signal of a new attitude towards the euro's internationalisation can be found in the 2018 State of the Union address by then Commission President Jean-Claude Juncker: “[By] next year, we should also address the international role of the euro. ...It is now the second most used currency in the world with 60 countries linking their currencies to the euro in one way or another. But we must do more to allow our single currency to play its full role on

the international scene.”³ Following this speech, the Commission produced a host of documents to operationalise this vision.⁴

What has driven this change of tone and policy focus? Both internal and external factors are at play. **Internally**, there has been a resurgence of confidence in the euro following the end of the eurozone crisis. This is clearly seen in the latest Eurobarometer data, which show that 8 in 10 Europeans view the euro positively (Graph 1 below) – a historic high after the Covid economic response, and an increase of 15 percentage points compared with the years of the eurozone crisis. In another Eurobarometer survey focusing on the euro area, there is an edge in positive opinions when people are asked about the importance of the common currency for the EU as a whole, as opposed to its importance for one's own country.⁵ This could simply reflect the view that 'others' are benefiting more from the euro. However, it may also reflect an understanding of the euro's role in projecting the EU globally, and an associated desire for a larger international role of the euro.

Graph 1. Attitudes towards the euro



Source: Eurobarometer Summer 2022 (Standard Eurobarometer 97).

This surge in internal confidence has given European policymakers the policy space to work towards strengthening the international role of the euro. Arguably however, it has been **external developments** that have acted most as a spur – notably concerns that during the Trump administration, EU strategic interests were diverging from those of the US. Using the dollar in financial warfare is not new; a number of US administrations have used the dominance of the US currency in international transactions and clearing to enforce sanctions on companies or states. But one event in particular crystallised in European eyes the danger of dollar dominance: sanctions placed on Iran after the unilateral withdrawal of the US from the 2015 nuclear deal, with the US administration weaponising the US currency to impose its decision to abandon the Iran agreement, impose sanctions on Iran, and punish any company, even in Europe, ignoring these sanctions. While official EU

policy continued to support the Iran agreement, European companies found themselves unable to continue financial and economic dealings with Iran and Iranian companies because of the risk of being shut out of the international financial system.⁶

The Covid-19 pandemic added another reason to push for a stronger international role for the euro. The disruption of global supply chains and associated shortages in critical goods put a focus on the concept of ‘EU strategic autonomy’. Accordingly, and in the context of launching the Next Generation EU initiative (NextGenEU), the Commission embedded the aim of strengthening the international role of the euro in the broader pursuit of a model of open strategic autonomy, aimed at diversifying global supply chains and shaping a new system of global economic governance, while protecting the EU from unfair and abusive practices.⁷ While

the reasoning was not fully articulated, the need for the EU to regain some post-pandemic control over its international trade and financial relationships was linked to a stronger global role for the common currency. The large stock of European bonds issued to finance NextGenEU projects clearly underpinned this need.

The **ongoing war** in Ukraine has been a further factor impacting this discussion. The punitive sanctions on Russia taken by the G7 countries and the EU have highlighted the crucial importance of currency dominance and of controlling the levers of the international financial system in a rapidly fragmenting global financial architecture. At the same time, the calls for an additional EU borrowing facility to fund European defence as well as to accelerate the green transition and reduce dependence on Russian oil and gas are inevitably linked to the discussion about a European safe asset

– which has long been part of the debate on strengthening European economic governance and through that the international role of the euro.

3. The underlying economics and currency dominance

Understanding the debate around a stronger international role for the euro and assessing the policy proposals currently on the table requires a prior look at the underlying economics of international currencies and of currency dominance. A good place to start would be the well-known functions of money: just as domestically money serves as a unit of account, a medium of exchange and a store of value, in the same way in international transactions it is used to fix prices, settle payments, and as a liquid asset.

Table 1. International functions of currencies

Functions of money	Private use	Official use
Unit of account	Invoice/quotation currency	Pegging currency
Medium of exchange	Payment/vehicle currency	Intervention currency
Store of value	Investment/financing currency	Reserve currency

Source: Papadia and Efstathiou (2018) based on Krugman (1984).

Table 1 maps these functions into six international private and official uses of currencies. As far as the unit of account function is concerned, international trade contracts are denominated in a given currency (“invoice/quotation”), while for the official sector the exchange rate of a currency such as the dollar or the euro is often used as a peg (“pegging currency”). A currency is used as a medium of exchange (“vehicle”) in international private transactions, and at the same time it is bought and sold by central banks and becomes an “intervention currency”. Finally, when it comes to money as a store of value, private agents hold assets in a given currency for investment and financing, while particular currencies act as a reserve for central banks.

The economics literature has grounded the case for the internationalisation of a currency on **network externalities and increasing returns**, i.e. the idea that economic agents (whether individuals, firms, or governments) are more likely to use a particular currency if others are also using it. Currencies in the global economy are in this sense similar to other ‘network’ goods such as operating systems in information and communication networks: the greater the use, the greater the utility, and hence the use. The limits to this argument relate to risk diversification: the risks associated with holding assets in just one currency rather than diversifying to more.⁸

Empirically, a number of factors have been identified as important for the share of a currency in international markets. First among these is the **size of a country, measured in terms of GDP or trade**, both of which act as proxies for network externalities. Size impacts the number and cost of transactions, but also facilitates vehicle and investment/financing transactions on the private side, while on the official side, the size of an economy impacts

the ability to use the currency as an intervention tool but also the ability for a currency to act as a safe asset and thereby become a reserve currency. Furthermore, a currency’s role as a unit of account for invoicing tends to be complementary to its role as a safe store of value; this leads to the emergence of a single dominant currency in trade and global banking, with firms in emerging markets tending to borrow in the dominant currency even when multiple large countries share similar fundamentals.⁹

Next to size, other important factors include the **liquidity and depth of financial markets**, as well as relative financial stability. The former is important for the investment/financing function, as liquid and deep financial markets reduce transaction costs, while also facilitating the use of a particular currency as a safe asset. The latter enhances the currency function as a store of value, and should be seen in relative terms, especially in crises (as for example when comparing the relatively quick rebound of the dollar compared to the euro after the global financial and eurozone crises). To these factors should be added another, **freedom of capital movements**, which allows unfettered trade in currencies and underpins all functions of money in international markets.

A different set of factors relate to the **policy stance** or to explicit economic and financial policy choices that promote the international use of a currency. A policy stance that favours low inflation and exchange rate stability facilitates the international use of a currency. In terms of **explicit promotion policies**, the ability and willingness of a central bank to act internationally, especially with respect to liquidity provision, is typically singled out as one of the most important determinants of the international use of a currency.

Based on these factors it is not difficult to understand how dominant currencies persist over time and become ingrained in monetary and financial history. The current dominance of the dollar can be traced to the size of the US economy, the liquidity and depth of its financial markets, its relative financial stability, as well as an explicit policy to facilitate its international use, as for example through global liquidity provision by the Federal Reserve during the last financial crisis. To this should be added the undisputed political and military power of the US that acts as both a carrot and a stick and buttresses the dominance of its currency. The carrot relates to the projection of US strength on a global 'flight to the dollar'; the stick relates to the ability of the US to weaponise its power, when necessary, against other currencies and those holding them.

Dollar dominance has been widely analysed in terms of an '**exorbitant privilege**', manifesting itself in different ways.¹⁰ These range from the ability to run large US current account deficits backed by financial holdings in US dollars across the globe, to 'seigniorage' revenue (profits from currency issuance, going beyond cash, and allowing a lower return on dominant-currency safe assets than on similarly safe assets in other currencies); reduced transaction costs for domestic users from the use of the dollar in international transactions; US banks having easy access to dollar liquidity channelled globally; as well as the wider international dollar use imparting both hard (leverage) and soft power (reputation).

Against these benefits, one can count a number of costs: the '**exorbitant duty**' of a dominant currency to provide insurance to the world (as with the Federal Reserve swap lines in the global financial crisis); the possible unsustainability of US external debt from meeting global liquidity demand; and undesired currency appreciation

linked to global demand for the dollar. Such costs relate to the country issuing the currency. In addition, there are external costs to the global economic and financial system. These relate to the vulnerability of emerging markets relying on dollar funding to swings in US financial conditions and changes in monetary policy; or more broadly the severe shocks that US monetary policy can induce in global financial markets in a dollar-dominant world.¹¹

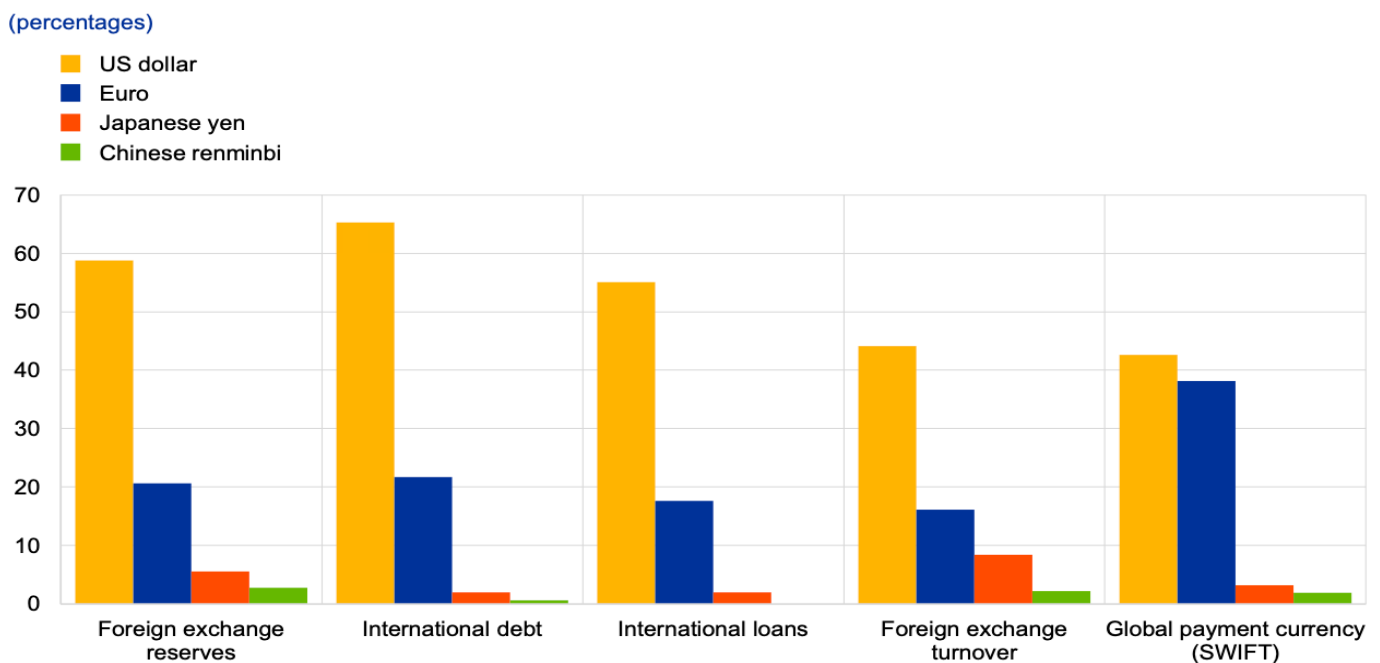
Will this dollar dominance continue? Or has it peaked, as a result of fragmentation in global financial markets, a more assertive China, and the resentment of US dominance? The end of dollar dominance has been proclaimed many times in the past; it has been linked to growing euro strength¹² and more recently to China's overtaking the US as the leading exporter and closing in in terms of economy size.¹³ Yet while the challenges are there, most commentators do not see a rapid erosion of dollar dominance; 'dethroning' it is unlikely in the near future. This discussion has nevertheless taken a new turn following the sanctions against Russia and concerns about their implications on the international role of currencies such as the dollar (primarily) and the euro.¹⁴

4. The euro today: role and limits

In the dollar-dominant world, how does the euro fare? Surprisingly well for a currency that is only two decades old. Since its creation, the euro has consistently been second to the dollar as the most used international currency, with its role strengthening over time, particularly in cross-border payments, but less in terms of foreign exchange reserves holdings. Around 60 countries in the world are today either using, will use or link their currency to the euro (European Commission, 2018b). As a safe store of value, the euro represents around 20% of

international reserves of foreign central banks. In terms of debt issuance, more than 20% of debt issued on international markets (business and governments) is denominated in euros. In terms of international payments, about 36% of international transactions are invoiced or settled in euros, compared to a little over 40% for the US dollar (Graph 1).

Graph 1. The euro in the international monetary system, 2021



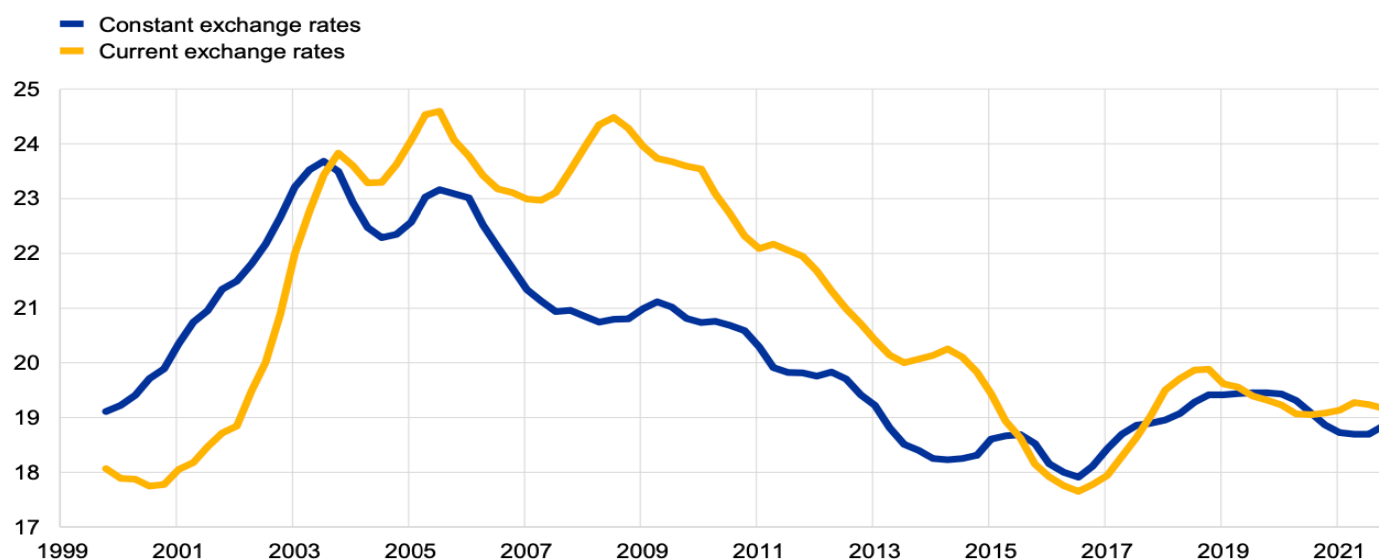
Source: European Central Bank, 2022.

In its annual review of the international role of the euro, the European Central Bank provides a summary measure of the currency’s evolution since its creation (Graph 2). This composite index is based on the shares of the euro at constant and current exchange rates in stocks of international bonds, loans by banks outside the euro area to borrowers outside the euro area, deposits with banks outside the euro area from creditors outside the euro area, global foreign exchange settlements, foreign

exchange reserves, and global exchange rate regimes. The picture that emerges is a sharp rise in the combined share in the early years of the euro’s creation, followed by a significant decline in the years of the global financial crisis and the eurozone crisis, and a partial recovery after 2016. By 2020, when the Covid crisis acts again as a break on the share held by the euro, it had not regained the ground lost during the previous crisis.

Graph 2. Evolution in the role of the euro: composite index

(percentages; at current and Q4 2021 exchange rates; four-quarter moving averages)



Source: European Central Bank, 2022.

Looking beyond this summary picture into the evolution of the euro in separate markets relative to other currencies and especially the dollar, a number of conclusions can be drawn (ECB, 2022):

- **Holdings of foreign exchange reserves:** in an environment of foreign exchange reserves increasing faster than GDP, the euro has remained a steady (but distant) second to the dollar, while in recent years it has lost ground to other currencies (the share of the dollar has also been dropping).
- **International debt:** in terms of debt securities outstanding, the euro was catching up with the share of the dollar over the euro's first five years of existence, but it has steadily lost share since, while the dollar has cemented its role in the investment/financing function. Greater stability emerges with respect to each currency's share in outstanding international loans and deposits.
- **Foreign exchange turnover:** against a background of a steadily increasing total value of euro-denominated settlements, the euro's share in global foreign exchange settlements has been volatile over time (rising in 2020), although it has always remained the second most actively settled currency.
- **Global payments:** over the last decade, the euro's share in invoicing or as a settlement currency for extra-euro area trade has generally remained stable, with the dollar remaining the dominant invoicing and settlement currency, but with the euro claiming a share that goes beyond its narrow regional presence in countries close to the EU.

The international presence and role of the euro in these areas paint a general picture in which, despite overall dollar dominance, the euro has established its presence, even though the share of the EU in global GDP as well as in exports and imports of goods and services has declined. The euro maintains a consistent and strong second place, with its distance from the dollar varying according to the currencies' function: very close to the US dollar as a means of payment, not far behind it in the investment financing and reserve roles, but far from it in terms of the invoicing of (commodity) trade and as a vehicle currency in foreign exchange.¹⁵

The euro's success in a short period (since its creation) is undeniable. But what is holding back its international reach? Beyond the built-in dollar bias of the Bretton Woods system and the relative newness of the European currency, certain impeding factors can be traced to the limited economic base of the euro area as well as its financial fragmentation. The EU as a whole remains a close second to the US in terms of GDP (although not in trade), while shrinking in relative terms on the global stage. At the same time, the EU's financial markets remain fragmented, lacking the liquidity and depth of financial markets in the US.

Other factors are more directly related to the **uncertain governance of the eurozone**. It is no accident that the eurozone crisis had a significant impact on confidence in the solidity of the euro. Nor is it an accident that the dollar – despite the US being at the origin of the 2007-9 global financial crisis – remained a preferred currency for international investments and increased its 'safe haven' function after the crisis (the exposure of European banks to US toxic assets added to the euro's vulnerability). In the global quest for assets with the right risk/reward ratio, financial stability is a relative concept.¹⁶

To this should be added the discouraging stance of EU authorities towards the *de jure* adoption of the euro by third countries, as well as the still limited ability or willingness of the ECB to act internationally. Unlike the US Federal Reserve, which effectively acted as 'backstop' to the world financial system through currency swaps in the global financial crisis, the European Central Bank has only engaged in this practice to a limited extent. This partly reflects the relatively more modest use of the euro (hence, ability); beyond that, however, it betrays a different conception of the two central banks on their role vis-à-vis the use of their respective currencies (willingness). Finally, at a time of currency weaponisation, non-economic limitations such as the lack of a common European security policy clearly play a part and cap the international role of the euro. Being able to project power internationally has spillovers on the use of the currency.

5. Policy goals and instruments

What are the policy goals relating to a stronger international role for the euro? These can first and foremost be traced to the direct and tangible benefits of a wider global euro use, in terms of **facilitating transactions, reducing risk, and increasing resilience**. The European Commission has identified a number of these benefits: lower cost and risk of trading internationally for EU businesses; additional choice for market operators across the globe; lower interest rates for households, businesses and EU member states; more reliable access to finance for businesses and governments through deeper, more liquid, and integrated European financial markets; and an improved resilience of the financial system and the economy, making them less vulnerable to exchange rate shocks.¹⁷

A stronger global role for the euro may also have tangible **consequences for the conduct of EU monetary policy**. In this context, three broad implications have been identified.¹⁸ The first relates to the effect on exchange rate pass-through because of trade invoicing in euro; how responsive international prices are to changes in exchange rates has a strong influence on the international transmission of shocks. The second is the effect on interest rates: a strong international role for the euro would reduce the exposure to foreign spillovers in setting interest rates. The third is that with a stronger international role for the euro, spillovers through international trade and finance would probably be larger. Not all effects go in the same direction; but with the right economic policies, a stronger global role for the euro could help facilitate the transmission of monetary policy across euro area financial markets.

The advantages of a stronger international role for the euro need to be understood in the context of today's fragmented multi-currency world. Dollar dominance is a fact, but countries such as China have sought to raise the international profile of their currencies. The renminbi, for example, was included in 2016 in the International Monetary Fund's special drawing rights (SDR) basket alongside the US dollar, euro, yen, and pound sterling; China has also developed a SWIFT-like system for international settlements and has understood that financial policies by a central bank such as extending swap lines can jump-start the use of its currency outside a country's borders.¹⁹

The establishment of a **robust multipolar currency system** could in normal conditions improve the functioning of the global financial and monetary system as it would allow for diversification of both assets and liabilities, and would make economies less vulnerable to shocks originating from one dominant currency,

thus improving system-wide stability. In this context, the policy goal for Europe cannot be to replace the dollar as international reserve currency – an impossible feat in the foreseeable future. Rather, it would be to examine what aspects of the euro are hindering its broader use in different markets because overcoming these hindrances would reduce dependence on the dollar.

Much of the impetus for a stronger international role for the euro nevertheless goes beyond the strictly economic benefits outlined above. Indeed, this impetus can be traced to more **indirect and intangible potential benefits** relating to the role of the currency as a symbol of European unity on the world stage and as a tool to **project and support the global influence of the EU**. Beyond underpinning European growth and prosperity, policy goals related to a stronger international presence of the euro that are explicitly or tacitly mentioned include helping the EU in its economic competition with China, increasing European autonomy and supporting European sovereignty, as well as leveraging broader political goals such as political union through demonstrating the success of the European project in the global economy.

The war in Ukraine has added clear **geopolitical policy goals** to this list. We seem to be moving further into a global environment characterised by fragmentation, pitting the US and the EU, on the one hand, against Russia, China, and possibly other emerging economies such as India on the other. In this environment the ability to influence the direction of the global financial and economic system will partly depend on the global role of currencies. The euro needs to be on a near-equal footing with the dollar for the EU to be able to co-decide with the US on broader geopolitical or geo-economic issues. This has been evident in the sanctions already imposed

and even more so where trade in energy – currently mostly invoiced and settled in dollars – is concerned.

The strong connection between economic and broader non-economic policy goals is not lost on policymakers or analysts.²⁰ Turning the EU into a global political force involves a combination of 'soft power' (with economic policy levers such as a currency that plays a reserve role in global markets) coupled with 'hard power' tools (such as a common foreign policy and diplomacy, and a common European defence policy). Different political considerations guide the development of each policy although they are all highly interconnected and might imply policy choices in the economic and security space that are not accepted by all EU member states.²¹

The clearest official articulation of policy goals with regard to strengthening the international role of the euro can be found in the March 2021 Euro Summit statement, which committed the EU to “strengthening the international role of the euro with a view to enhancing our strategic autonomy in economic and financial matters while preserving an open economy, contributing to the stability of the global financial system, and supporting European business and households”.²²

The statement highlighted a number of important **policy directions** in this respect: (i) the role of the Recovery and Resilience Facility for a robust recovery and structural transformation of the European economy, considered a precondition for a strong international role of the euro; (ii) the completion of the banking union and progress towards a true capital markets union as tools for deep and liquid euro-denominated financial markets and for a financial infrastructure that advances financial stability and resilience; (iii) a stronger and more innovative digital finance sector and

more efficient and resilient payment systems, including through the possible introduction of a digital euro; and (iv) the development of the EU's green financial market.

Against this background, proposed economic policies that are aimed at strengthening the international role of the euro fall under three headings. **The first relates to completing and deepening the economic and monetary union.** The aim is to strengthen the institutional architecture of the euro area and through that the place of the common currency in international markets. The main action points are the completion of the banking union with a common deposit insurance scheme, a capital markets union, a fiscal capacity for macroeconomic stabilisation, and a euro area safe asset. To these should be added the policies to increase the growth potential and resilience of the European economy, such as those represented by the combination of investments and reforms for a twin digital and green transition funded through NextGenEU.

Most of these policies are clearly understood to be key to increasing confidence in the euro in international financial markets. And while there is progress on all fronts, this necessary deepening of the economic and monetary union is proving elusive. The final pillar required for the banking union and more cross-border banking activity – the common deposit insurance scheme – is still victim to the attempt to find an acceptable political compromise between risk-sharing and risk-reduction. Obstacles to unifying financial markets continue to hinder the creation of a capital markets union.²³ And despite the EU fast becoming in its pandemic response one of the largest debt issuers in the euro area, significantly expanding the supply of euro-denominated assets, and in the process also promoting the use of green bonds (it is proposed to issue 30% of the bonds under

NextGenEU in the form of green bonds), a true euro-area safe asset is still not on the horizon.²⁴ Indeed, while the central debt facility inaugurated as a response to Covid represents a significant step forward, the unwillingness so far to develop it into a permanent facility could be seen as the single biggest roadblock to a greater international role for the euro.²⁵

The recently published Commission orientations on economic governance reform unfortunately do not make any progress in this regard.²⁶ The Communication focuses on policy changes aimed at simplification and greater transparency in the economic governance framework of the Stability and Growth Pact (for example through adopting a single operational indicator – net primary expenditure) but does not broach the question of a central fiscal capacity or more broadly the issues around strengthening the international role of the euro. Ensuring debt sustainability and enhancing sustainable growth are viewed narrowly through the lens of changes to the design and implementation of the Stability and Growth Pact.

The second heading relates to policies aimed at improving financial market infrastructure – the plumbing of the financial system that facilitates investor access to euro-denominated markets, promotes euro-denominated investments, and facilitates the use of euro as an invoicing and denomination currency. Proposals made on this include increasing the clearing obligations in euro, facilitating the cross-border use of payment solutions in EU member states, and ensuring the interoperability of existing instant payment solutions. They also include the development of a common regulatory environment to promote security, stability, and transparency to nurture euro-denominated debt issuance. Other proposals that are aimed at removing more technical obstacles involve

examining financial-market infrastructure vulnerabilities as regards extra-territorial application of unilateral sanctions by third countries, and assessing technical issues relating to the transfer of financial contracts denominated in euro cleared outside the EU to counterparties located in the EU.²⁷

Two particular issues merit mention in this respect. One relates to **extending the use of swap lines to facilitate liquidity in euro**, in the same way that the US Federal Reserve has widely used swaps to facilitate global dollar liquidity, especially during crises.²⁸ While the European Central Bank has recently extended liquidity lines with non-euro area central banks,²⁹ its engagement remains significantly smaller than that of the Federal Reserve. More extensive currency swaps and repo lines with central banks of countries that use the euro would offer a liquidity backstop to countries using the euro, as well as smooth financial and commercial transactions, thus increasing the currency's international role and providing the euro area with more financial autonomy. For an institution, however, such as the ECB that has a purely domestic mandate, extending the swap lines already implemented incurs risk that needs to be covered through some backing of a 'Treasury', as well as possibly new legal arrangements.

The other issue that merits mention relates to **digital currencies**. Work is currently underway to review legal and technical questions emerging from the possible introduction of a digital euro, in the context of a broader move by a number of central banks worldwide to examine the introduction of central bank digital currencies (CBDCs). Such moves have been prompted partly in order to improve inclusion as well as efficiency in payments through eliminating the cost of holding cash, and partly as a result of the emergence of privately

issued digital currencies (cryptocurrencies such as Bitcoin or so-called 'stablecoins' such as Facebook's Diem) and the risks these might entail for monetary sovereignty.³⁰ Despite the recent collapse of cryptocurrency markets, the dangers they pose for financial stability and therefore the imperative of regulation remain strong.

A digital euro that would be directly accessible to households and businesses could indeed support the digitalisation of the EU's economy and its strategic autonomy. Furthermore, in the current geopolitical environment, the discussion on digital currencies has taken on a new urgency. Economic sanctions against Russia's central bank and the exclusion from SWIFT of a number of Russian commercial banks may lead to the wider use of private digital currencies in an effort to bypass the western-controlled global financial system for settlements. While this is not currently reflected in the price of cryptocurrencies such as Bitcoin, the potential stability risks and weakening of reserve currencies as a result of more widespread use should not be dismissed.

The third heading relates to policies aimed at expanding the use of the euro in key strategic sectors such as energy, commodities, and transport. These sectors are currently almost entirely dominated by dollar transactions; shifting them to a greater use of the euro requires undertaking specific and targeted policy initiatives. In energy trading for example, it is proposed that the euro could be used for contracts concluded within the framework of intergovernmental agreements between EU member states and third countries. Additional proposals involve developing euro-denominated commodity derivatives for energy and raw materials, benchmark indices and trading venues covering core sectors (including nascent energy markets, such as

that of hydrogen) as well as expanding the role of policy instruments like the EU emissions trading system (ETS) in areas such as maritime transport, and supporting further ETS trading activity in the EU.³¹ On top of that, connecting such initiatives to the stated aim of increasing the share of debt issued relating to green bonds (in public and private markets) has the additional benefit of connecting the goal of a greater international role for the euro with that of accelerating the EU green transition.

6. Concluding remarks

From a situation where the international standing of the euro was simply seen as the outcome of market forces, the discussion has evolved to accepting that there must be an alignment between policies that make the euro area more robust and policies that strengthen the euro's global role. As a purely *laissez-faire* economic approach in EU policy on this matter has gradually given way to a more complex and nuanced understanding of the broader considerations that need to guide policy in this area, European institutions and EU member states have moved in the last few years to outline a series of policy proposals and initiatives to improve the financial infrastructure and overall conditions for wider use of the euro as an international currency.

The pandemic added to this discussion by embedding the ambition of strengthening the global role of the euro into a broader policy goal of furthering EU strategic autonomy, in its various areas, putting economic considerations alongside geopolitical realities and risks. Following the Russian invasion of Ukraine, however, the issue has now taken on a new urgency, as we are observing the politicisation of international economic relations as never before. We have now firmly moved from rules-

based to power-based international economic relations.

In this new age of fragmentation between major power blocs, with the weaponisation of currencies and of the tools of the global financial system, it has become imperative to adjust EU strategy also with respect to strengthening the international role of the euro. Policy proposals regarding its role must of course continue to be based on solid economic fundamentals. But until now, their respective costs and benefits could only be assessed in the context of a competitive but relatively benign global economic environment; the new reality calls for a reassessment. The avoidance of catastrophic risks needs to be the order of the day. This in turn implies a more robust effort to entrench a stronger international role for the euro in a polarised multi-currency world by all available means so that the euro can support the broader European economic and security goals.

Practically speaking, this policy brief suggests that strengthening the international role of the euro involves policy action on three fronts. The first relates to filling in the missing elements of the economic and monetary union: completing the banking union with a common deposit insurance scheme, creating a capital markets union, a fiscal capacity for macroeconomic stabilisation, and a euro area safe asset by making the instruments of the Next Generation EU initiative permanent. The second relates to improving financial market infrastructure and efficiency in euro transactions, including by extending the use of swap lines to facilitate liquidity in euro. The third relates to policies that expand the use of the euro in key strategic sectors such as energy, commodities and transport – sectors that are now heavily reliant on the use of the dollar. If these policy actions are pursued together in a determined and consistent manner, the international position

of the common currency will be significantly strengthened, contributing to European growth and competitiveness, and to EU strategic autonomy.

Endnotes

- 1 In Draghi's words (European Central Bank, 2018): "the international role of the euro is primarily determined by market forces. The Eurosystem neither hinders nor promotes the international use of the euro." This phrase had disappeared in the 2021 edition of the same ECB annual report.
- 2 An analysis of critical US commentary on the euro during its earlier period can be found in Jonung and Drea (2009). An example of similar commentary during the eurozone crisis can be found in Krugman (2013).
- 3 See https://ec.europa.eu/info/sites/default/files/soteu2018-speech_en_0.pdf.
- 4 See European Commission (2018a) *Strengthening the International Role of the euro – Results of the consultations, Working Document, 12 June*; and European Commission (2018b) *Towards a stronger international role of the euro, 15 December*.
- 5 Positive opinions about the importance of the common currency for the EU as a whole are almost 10 percentage points higher than in responses about the importance of the common currency for one's own country. See *Flash Eurobarometer 512: The Euro area*, December 2022.
- 6 For a discussion of the use of economic and other networks in geopolitics see Farrell and Newman (2019), 'Weaponized Interdependence: How Global Economic Networks Shape State Coercion', *International Security*, Vol. 44, No. 1 (Summer), pp. 42–79 (https://doi.org/10.1162/ISEC_a_00351).
- 7 See European Commission (2020a) *Europe's moment: Repair and Prepare for the Next Generation*, COM(2020) 456, 27 May.
- 8 For a summary of the main economic arguments in the context of an analysis on the role of the euro, see Papaioannou and Portes (2008).
- 9 Papadia and Efstathiou (2018) discuss the empirical evidence for the share of a currency in international markets while Gopinath and Stein (2018) make the argument on the complementarity between a currency's role as a unit of account for invoicing and its role as a safe store of value. Corsetti et al (2022) use data on the invoicing currency patterns of UK exporters to show a more complicated pattern for invoicing in multiple currencies.
- 10 Eichengreen (2011) discusses the 'exorbitant privilege' of the dollar in international markets, a term coined by French President Valéry Giscard d'Estaing in the 1960s. More recently, Marin (2021) discusses policy dilemmas associated with the dominance of the dollar ('the Hegemon's dilemma').
- 11 The arguments are expanded in Regling (2021).
- 12 Back in 2008, Frankel boldly entitled a VoxEU piece 'The euro could surpass the dollar within ten years'.
- 13 A recent example of the discussion on whether China is trying to dethrone the dollar is found in Liu (2022).
- 14 For a recent summary discussion on whether sanctions threaten dollar dominance see Eichengreen et al (2022)
- 15 For an early assessment of the ability of the euro to rival the dollar see Lim (2006). A recent picture is provided in Papadia and Efstathiou (2018).
- 16 Coeuré (2019) provides a lucid assessment of the factors holding back the international role of the euro as well as the implication of this for the conduct of monetary policy.
- 17 See European Commission (2018b).
- 18 For a discussion of the implications of a stronger international role of the euro for the conduct and transmission of EU monetary policy see Coeuré (2019).
- 19 In a recent paper, Bahaj and Reis (2020) explore the complementarity in the currency used for financing and the currency used for invoicing sales in the case of China. They examine the creation of swap lines by the People's Bank of China and show that signing a swap line with a country is associated with increases in the use of the renminbi in payments to and from that country in the following months.
- 20 See for example Pisani et. al. (2019) and Cameron (2021).
- 21 Tooze and Odendahl (2018) make the point that the attempt to internationalise the euro is seen in Germany as a stealthy way to push the country to accept economic policies it rejects, such as a European safe asset.
- 22 "To that end, we: a) stress the need for a robust, inclusive and sustainable recovery and enhanced economic resilience, as preconditions for a strong international role of the euro. The Recovery and Resilience Facility is essential to support ambitious reforms and investments to finance the green and digital transition and increase our

economies' growth potential; b) highlight the importance of a sound financial architecture as well as deep, liquid and wellfunctioning euro-denominated financial markets, and of preserving the EU's ability to ensure its financial stability and resilience. Strengthening the Economic and Monetary Union, completing the Banking Union and making progress towards a true Capital Markets Union remain essential; c) call for a stronger and more innovative digital finance sector and more efficient and resilient payment systems. In this context, exploratory work on the possible introduction of a digital euro should be taken forward; d) ask for continued swift work on an effective framework to further stimulate the growth of the EU's green financial market. This will help foster Europe's leadership in green finance." (Euro Summit, 2021).

23 Some of these obstacles are identified in European Commission (2020b). Proposals that would help integrate national capital markets into a single market would be aimed at consolidating cross-border arrangements with respect to shareholder rights, settlement services, trading data provision, protection of investments, and common capital market rulebooks to cultivate supervisory convergence.

24 Hudecz et al (2021) estimate that by 2026, €850 billion of new EU bonds could be issued, most to finance the Recovery and Resiliency Facility, thus expanding the pool of highly rated bonds to about 40% of GDP, which would offer a new alternative for low-risk euro-denominated investments.

25 For an argument along these lines, see the paper by Arroyo (2022) in the European Commission Discussion Paper series.

26 See European Commission (2022).

27 These are some of the "key actions" for strengthening the international role of the euro and for increasing the resilience of EU financial market infrastructures that are proposed in European Commission (2021).

28 An explanation of the ECB operations of swap lines and repo agreements can be found in the ECB blogpost: www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200819~0d1d04504a.en.html.

29 See www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr221215~6bc5ecf0ff.en.html.

30 Boar et al (2020) discuss the landscape around the emergence of CBDCs as well as the risks involved.

31 See European Commission (2018b). Specific proposals for promoting the international role of the euro in the energy field, which is largely dominated by dollar-denominated transactions, are in European Commission (2018c).

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STRATEGIC
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pathways to progressive action

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A FIVE-POINT AGENDA FOR HOW DEVELOPMENT COOPERATION CAN SUPPORT THE EU'S STRATEGIC AUTONOMY



ABSTRACT

The European Union and its member states have consistently been the single largest contributor of official development assistance (ODA). One effect of this is that the main way the EU interacts with a large section of the developing world is through development cooperation. However, there appears to be a reluctance among European policymakers to acknowledge the fact that the EU and its member states could implement a development cooperation policy that connects with foreign policy objectives. This policy brief argues that development cooperation has never really been divorced from national – or in the case of the European Union, regional – interests. Acknowledging this fact, and communicating the linkage both to itself and its development partners, is a critical first step in the EU identifying how development cooperation can support its strategic autonomy ambitions. This might also start a process that leads to some policy coherence within the EU and among the EU institutions. The policy brief provides some insight into how such policy coherence might enable development cooperation to support the EU's strategic autonomy across five priority policy areas: people and skills, climate policy, critical raw materials and supply chains, energy policy, and digital policy.

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PROGRESSIVE PATHWAYS TO EUROPEAN STRATEGIC AUTONOMY

HOW CAN THE EU BECOME MORE INDEPENDENT IN AN INCREASINGLY CHALLENGING WORLD?



ABSTRACT

The debate on European strategic autonomy (ESA) has gained new momentum with Russia's invasion of Ukraine, even though the idea of European autonomy has been present throughout the history of EU integration. The main idea behind the concept of ESA is the EU's ability and means to enhance its freedom from a set of external dependencies – and also to enhance its freedom to conduct its policy autonomously and in line with its fundamental values and interests. Yet does the EU have the capacity and agency to set priorities and make decisions autonomously in its external action? What political, institutional, and material steps are needed to achieve strategic autonomy? Guided by these questions and in search of a progressive answer to them, FEPS, the Fondation Jean-Jaurès and the Friedrich-Ebert-Stiftung conducted a research project looking into three policy domains in which it is vital for Europe to attain the necessary freedom and wherewithal to pursue this objective of ESA: security and defence, economy and trade, and digital and technology. This policy brief summarises the main findings of our ESA research project. Overall, Europe must adapt to the new and challenging global realities. To do this, the EU needs to act with more unity and coordination in different domains, as well as to build resilience and reduce its external dependence on certain fundamental resources.

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TOWARDS A SUSTAINABLE AND RESILIENT FUTURE INTERNET

THE CASE FOR PUBLIC DIGITAL INFRASTRUCTURE



ABSTRACT

In 2020, the European Commission published its 'Shaping Europe's Digital Future' Communication. It announced a set of digital policies that would enhance Europe's technological sovereignty, whilst ensuring a sustainable and resilient internet. This policy brief analyses the EU's digital policy initiatives and argues that they risk remaining too fragmented to effectively reduce Europe's dependency on a few foreign firms and miss a powerful opportunity to spur the development of an ecosystem of value-added alternatives. Whilst recently proposed and enacted laws for online platforms and data governance are promising, they do not take a holistic view of the way the different levels of the technology stack interact, and most importantly fail to pay sufficient attention to developing open standards, protocols and digital public goods.

If the EU wants to break through the harmful dynamic of centralization of power that dominates the current digital economy, it should adopt a public digital infrastructure (PDI) model. This policy brief provides a blueprint of the institutions necessary to implement such a PDI framework. First, an independent public digital infrastructure agency would develop the open standards and protocols around data governance, collaborative interoperability, and more. Second, on top of that, a public technology fund would develop and maintain open tools, such as mobility apps, online education tools and an open European web index to enable growth. Finally, these institutions should support the development of a secure personal data wallet and self-governed online identity, which would allow individuals to share and pool their data, in full respect of their privacy and interests.

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LEVERAGING TRADE POLICY FOR THE EU'S STRATEGIC AUTONOMY



ABSTRACT

In a context of increasing weaponisation of interdependence – highlighted by the pandemic and Russia's invasion of Ukraine – Europeans must actively reduce their critical dependencies. The objective of strategic autonomy for the EU is becoming pressing to prevent supply disruptions and ensure the resilience of value chains. While strengthening European production capacities for certain essential goods, this objective of strategic autonomy calls for a shift of European trade policy, which should now be leveraged to secure access to essential inputs when foreign markets are closed. A major turning point has already been reached with the new European level-playing field agenda, which is progressively equipping the EU with autonomous defence tools to protect the interests of its businesses. But EU member states are also to agree on the challenge posed by China, the level of dependence on the Chinese market they are prepared to accept, and the role the EU should play in the context of the US-China decoupling. They also need to bridge the gap between the political rhetoric of reducing European strategic dependencies and the decisions of private companies that have no mandate to secure European supply. Supporting companies' efforts to diversify their supply calls for the EU notably to coordinate more closely with companies to increase collective intelligence on strategic dependencies. It also calls for the EU to promote European standards more actively to initiate new bilateral negotiations for access to strategic raw materials, and to support an international effort to limit export restrictions.

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PARTNERSHIPS AND EUROPEAN STRATEGIC AUTONOMY

HOW TO TURN THEM INTO A WIN-WIN APPROACH



SUMMARY

To become more strategic and autonomous, the European Union has to better use its global partnerships. Managing external security threats for the EU requires active and viable partnerships, first and foremost with more capable and like-minded partners. Moreover, partnerships can increase the Union's capacity to act in Europe and beyond. Today, the EU has several partnerships. While the number has grown over the last decades, their palpable use in the security and defence domain has rarely been demonstrated.

But the pressure on the EU to deliver more in the field of international security is growing. The Russian war against Ukraine is a watershed for European security, by pressuring both EU institutions and member states to unprecedented collective decisions, such as sanction packages on Russia and the delivery of weapons financed by the European Peace Facility. Russian military aggression adds to ongoing security challenges around Europe, from instability in the south to transatlantic challenges. While the US administration is strongly committed to supporting Ukraine and European defence, America's focus on the systemic rivalry with China remains a structural trend that risks turning US attention away from Europe again.

Internally, the narrative of strategic autonomy has been pushed mainly by France and the European Commission led by Ursula von der Leyen. The 2022 Strategic Compass operationalises that ambition through four lines of action: Act, Secure, Invest and Partner. The importance of partnerships as an enabling tool is hence growing. In order to deliver, EU partnerships with NATO, the UK and the UK have to be prioritised and pushed forward. The EU should focus on identifying its interests, engage partners and invest in implementation.

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EUROPEAN INDUSTRIAL POLICY

A CRUCIAL ELEMENT OF STRATEGIC AUTONOMY



ABSTRACT

A sea change in the geopolitical environment and the 'green and the digital revolution' are forcing Europe to rethink its approach to industrial policy. Russia's war in Ukraine has ushered in a new era for Europe's economic diplomacy, supply security and military spending. The war poses a fundamental challenge, and the EU has also set ambitious goals on decarbonisation and digitalisation.

The EU's past approach to industrial policy mostly assumes an absence of great power rivalry, a limited relevance of economies of scale, and benign approaches by other countries to international trade. But other countries are now weaponising economic dependencies and markets for many advanced and emerging technologies when these technologies are found in high concentration and have significant spillover effects within the home country of dominating firms.

The EU needs to recalibrate its approach and focus on the emergence of key industries and key supplies, and provide key infrastructure in Europe. The right balance between selective protectionism and openness to trade and investment needs to be struck. The goal of industrial policy should not be to produce everything at home, but to preserve the capability of production. To this end, Europe should target new products or technologies rather than existing ones, enhance market competition rather than protect actors from it, and help more productive companies rather than unproductive ones. The EU could do this with strategic regulation, FDI screening, public procurement and other tools, all while shielding policies from special interest and inefficiency.

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Strengthening the global role of the euro