The EU search for economic security and the role of industrial policy

Cinzia Alcidi

Outline

- A more uncertain and hostile landscape
  - Risky ties: EU-China and EU-US
- Quest for economic security (and strategic autonomy)
  - Only “weak” tools in the EU toolbox?
- The return of industrial policy
  - What can EU industrial policy achieve?

A more hostile landscape

Uncertain geopolitical environment

- Conflicts in Ukraine and Palestine with risk of escalation
- Escalating trade tensions between the US and China, are extending to other countries
    - The Trump's 'shock and negotiate' attitude source of uncertainty and disruption

Unfavourable geoeconomic environment

- The rule-based system is under threat
    - The pandemic, the Russian invasion of Ukraine, and the US-China race for technological supremacy have fundamentally altered the dynamics of openness and economic integration
- Global powers have been seeking to reduce external reliance for a decade:
    - US: 'America First', Inflation Reduction Act, increasing resort to tariffs
    - China: Dual circulation strategy and 'Made in China 2025'

EU quest for EU economic security (& strategic autonomy):

- Where are the key risks?
- What tools?
    - Role of industrial policy

Big picture: EU-China

Lessons from COVID and the war in UA & energy crisis

- Trade integration means trade (inter)dependency
- High risks associated with EU imports (e.g., medical equipment and gas supplies)

Facts:

- China is increasingly more assertive and potentially an unreliable trade partner:
  - Increasing resort to economic coercion and trade retaliation (growing list of instances)
  - Recent cases against the EU:
    - 2021: Trade coercion measures against Lithuania in response to action considered politically not aligned with Beijing's view
    - 2023: Restriction of exports of gallium and germanium, EU alignment with the US (which imposed export controls on chips & semiconductors)
    - 2024: In response to CVD on EV, China has launched anti-subsidy and anti-dumping investigations into some EU exports and has indicated it may reduce its FDI in EV manufacturing in the EU
- **Rising political concerns:**
  - Need to avoid another "Russia" - trade weaponization

Big picture: EU-China cont.

The alternative to the West-centred financial and monetary system:

- De-dollarisation:
  - Reduction in holdings of USD-denominated assets (reserves) and promotion of the yuan as a reserve currency for EMEs
  - Active promotion of the yuan as invoicing currency (at least for Chinese transactions)
    - in March 2024 the volume of China's outbound and inbound cross-border payments made in yuan outstripped those made in US dollars
  - While keeping the current account not fully open and the yuan not fully convertible
- Objective shared by other BRICS+ countries: the seek alternatives to USD and the euro
- Find an alternative to SWIFT (after sanctions against Russia)
  - CIPS (Cross-border Interbank Payment System) was proposed in 2009 and launched in 2015 to provide an alternative international payment system
  - In 2024 support for Russia's new system to overcome SWIFT
  - Backing Russia's new cross-border payment system called BRICS Pay

Big picture: EU-China cont.

What the EU has been doing?

- Identify (strategic?) EU import dependencies and GVC exposure
- Objective: De-risk from China
  - Key EU imports are concentrated in China (e.g., raw materials, computer electronics)
  - China has high VC capacity in strategic sectors and multiple productions used in different sectors and industries ⇒ large global manufacturing influence

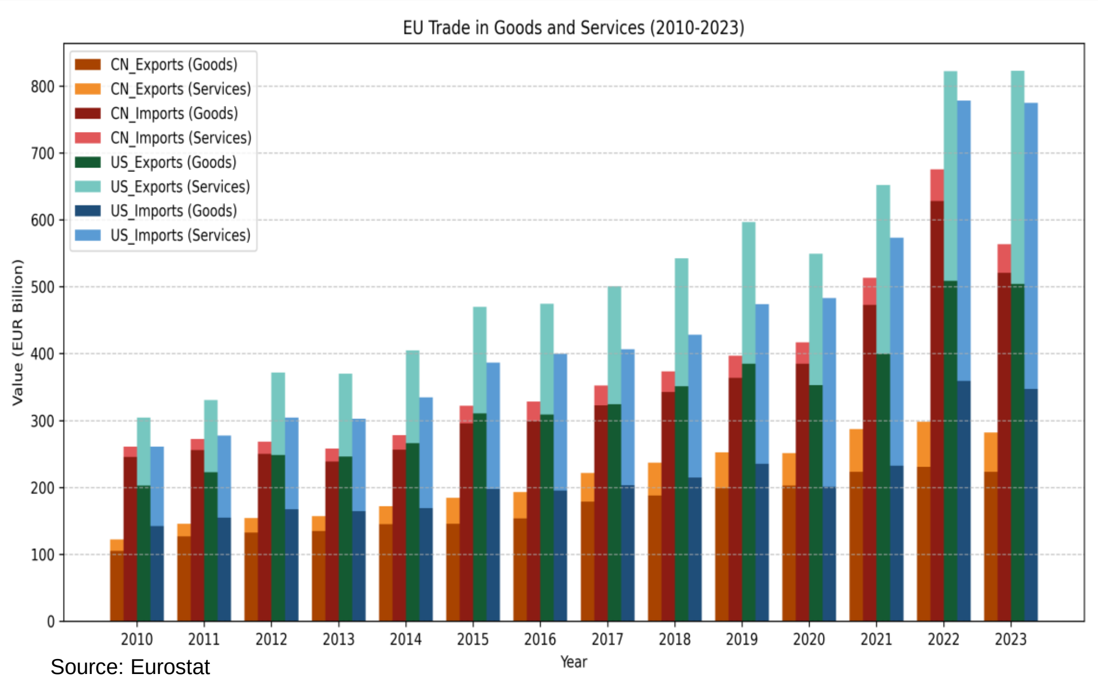
De-risking is difficult (and costly)

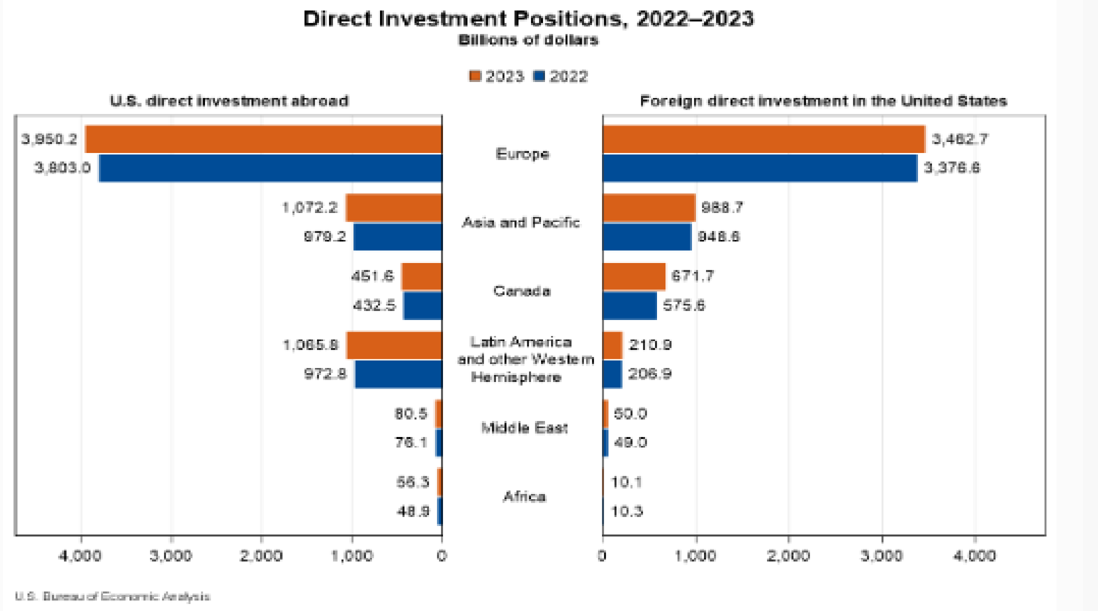
- Decoupling in certain sectors is impossible in the short-term
- Observed decoupling in direct trade may overshadow indirect linkages through the industrial supply chains of trade partners
- Market efficiency is replaced by other (security?) considerations
  - who pays? Consumers or governments?
- US aggressive in its derisking from China, while EU is mostly reactive
  - US resorted to tariffs, export controls, subsidies for domestic industries
  - EU used new anti-coercion instrument and countervailing measures
- Should the EU follow the US approach?

Big picture: EU-US

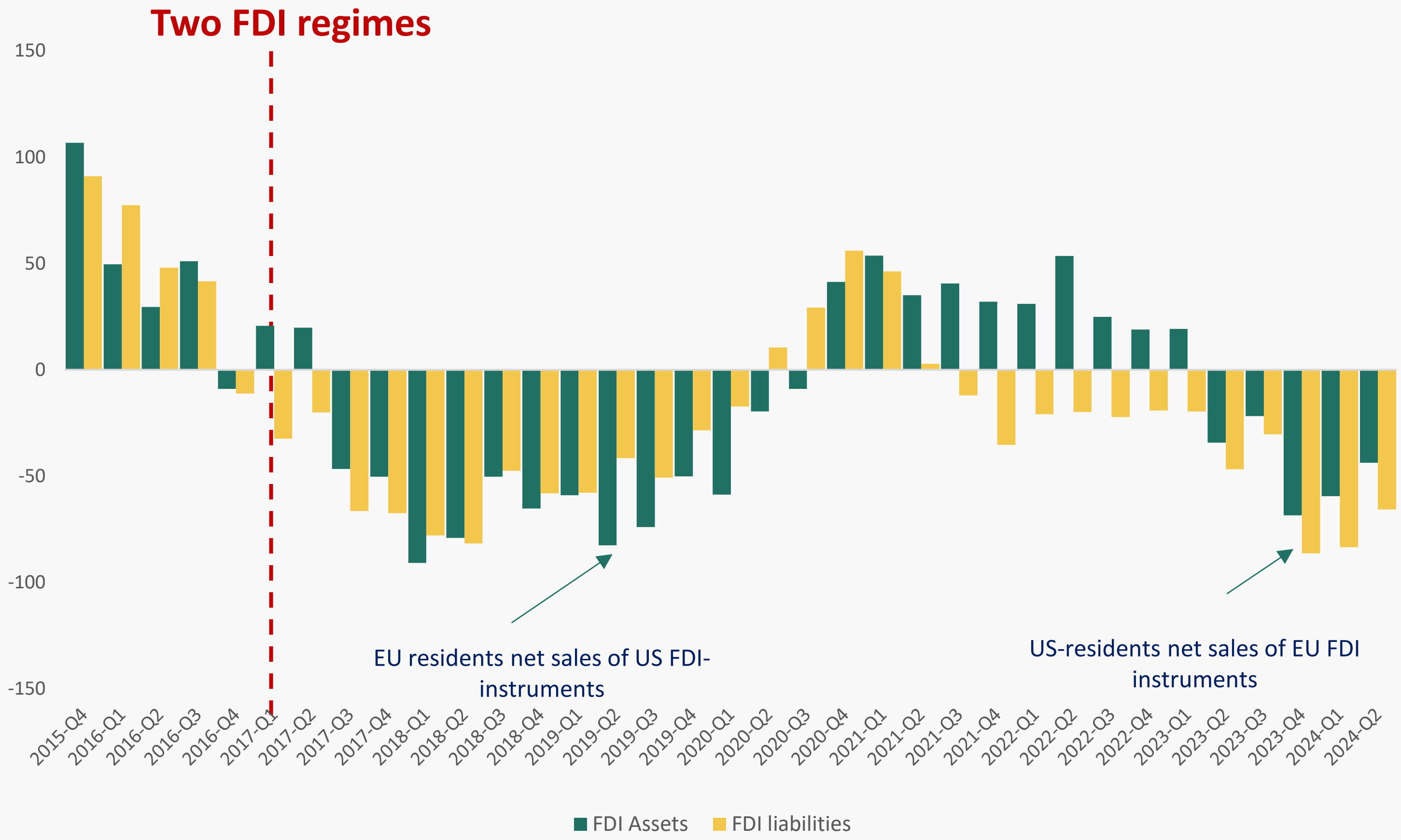
The US is the main EU partner

- Defence, trade and finance
- **Trade**:
  - US goods and services trade with the EU totalled an estimated EUR 1.6 trillion in 2023.
  - The US is the largest destination of EU exports and source of EU imports (if we count services)
- **Finance**:
  - US is the most important destination for EU FDI
  - US is by far and large the main direct investor in the EU
  - Recent developments in EU capital flows point to some important changes that appear correlated with changes in US policies





EU-US FDI linkages are "fading"



Source:Source: Eurostat, Balance of Payments data.
Note: Moving average over 4-quarters. The FDI liabilities refer to US residents' investment in the EU or their purchases of liabilities issued by EU residents. Negative values imply US residents' divestment from the EU. FDI assets refers to FDI investment abroad (purchases of foreign assets) by EU-27 residents. Negative values correspond to EU residents' net sales of foreign assets in the quarter

Trends:

- There seem to be two 'regimes' for FDI, with a switch around 2017
  - High and stable (even during the financial crisis) vs. low and volatile
  - 2017 US Tax Cuts and Jobs Act – is a watershed

Recent developments

- 2022-2024: disinvestment wave
  - Intra-group operations could drive it? War in UA? US IRA?
- Difficult to say whether this is just a temporary or more persistent development

Big picture: EU-US cont.

Facts:

- In recent years US policies have become increasingly centered on domestic objectives and led (more or less unintentionally) to impacts on the EU
  - Increasing long list of policies: TCJA, IRA, financial sanctions against RU, targeted tariffs against CN (to exclude China from certain markets) and now across-the-board tariffs
  - The approach is largely bipartisan in US politics, even if Trump's approach is more extreme

Is the US still a reliable partner?

- Should the EU de-risking from the US?
- Or attempt to establish a special relationship?

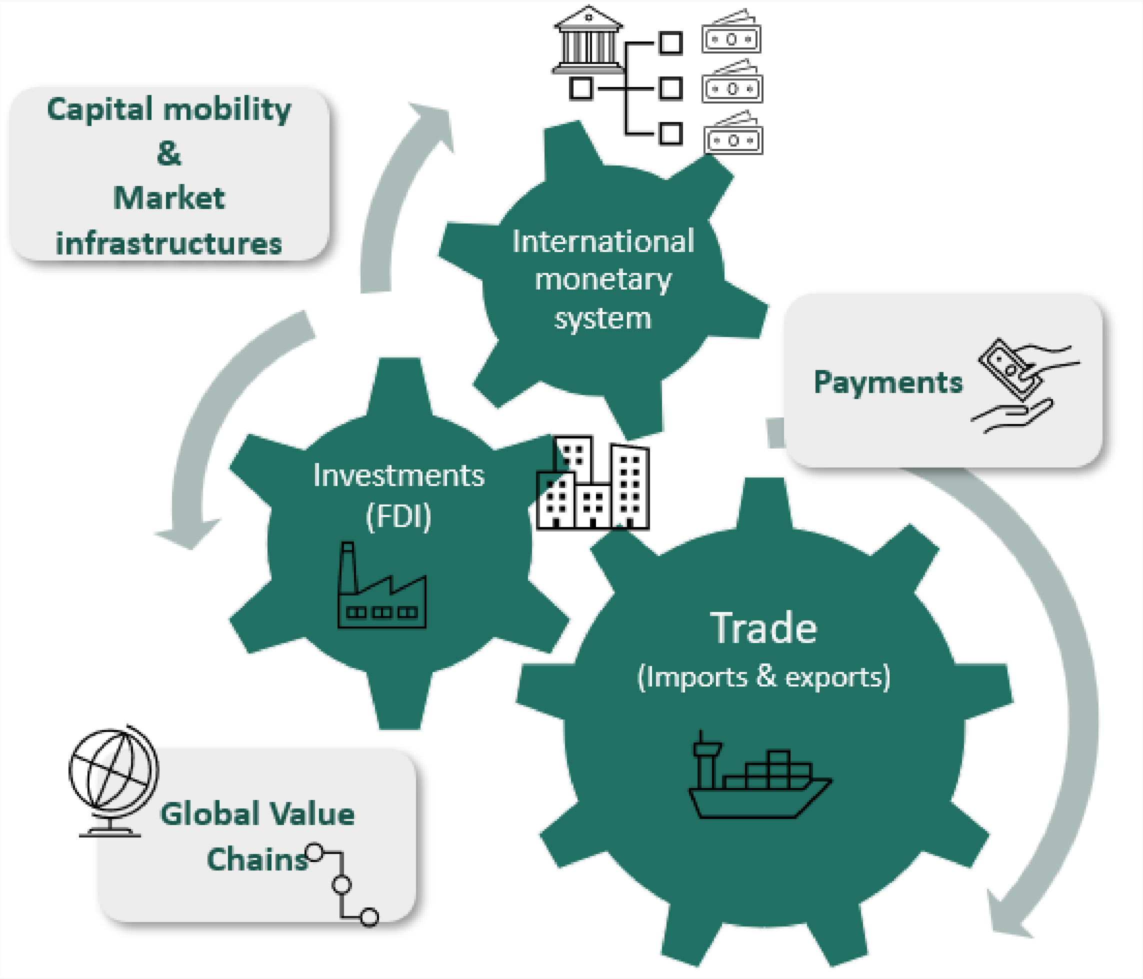
Should economic security be rethought beyond China?

The EU current toolbox

- **EU existing tools are based on free market principles**
  - Deviations from free trade are reactive – i.e. responses to unfair treatment (countervailing duties and the anti-coercion instrument)
  - De-risking has relied on diagnosis (assessment of risks to economic security, e.g. GVC resilience, trade dependencies) and broad policy guidance, not intervention
  - Economic Security Package: main novelty FDI screening (revision of the 2019 Directive)
- **They look weak compared to the US and Chinese arsenal**
  - Aggressive trade measures
  - Industrial policy to support domestic production (subsidies/tax credit/public investments)
- **Should the EU resort to trade retaliation?**
  - Risks: It will exacerbate further trade tensions, with unclear benefits for the EU economy (see economics of tariffs)
  - Risks: The EU is a much more open economy than the US and China and has no “central power” (and resources), in a trade war, it would:
    - Be exposed to much larger potential losses
    - Have low chances of being able to win a subsidy race

What else can the EU do?

- Do not lose sight of the big picture – many changes at the same time:
  - trade is closely linked to investments (FDI) and depends on the functioning of the international monetary and financial system (system approach)
- Diversification remains key: several countries in the world may have little interest in taking sides or closing their economy
  - The EU has already intensified its effort to sign new bilateral trade agreements (EU-Mercosur)
  - Old linkages with Africa – feel the gap left by the US? (see USAid case)
- Investments to restore competitiveness (in an unlevel playing field) and manage the twin transition
  - How to secure and mobilise private investments?
    - EU attractiveness for foreign investors
    - More domestic investment?
      - Single Market & CMU key
- What role of policy – EU industrial strategy?



The EU industrial strategy

- While economists debated for decades on the need for it – the US change of direction moved the question from if to how
- In the EU Industrial policy instruments are framed by the single market regulatory framework: key principle ‘no state aid’
  - Direct subsidies to industries must comply with EU rules to ensure fair competition
  - Key assumption: rule-based system – within the EU and outside. *This does not hold anymore*
- EU announced its industrial strategy in 2020: Objectives without instruments?
  - EU level funding programmes (E.g. CAP, RRF, Green Deal, Chip Act), while overall large in size (comparable to US and CN) the use is very decentralised and not necessarily pursuing a common EU objective
    - This approach may be changing: see the InvestAI initiative
  - Occasional deviation from “no state aid” to allow national subsidies (e.g. EUR 10 bn subsidies for a chip manufacturing facility in Magdeburg)
  - National industrial policies, which are driven by domestic needs and priorities
    - Ad hoc approach risks exacerbating disparities among MS, both in terms of their industrial capabilities and development

Conclusions and policy considerations

1. **To achieve economic security, China and US deserve special attention**
    - China: a key export market for some EU MS and the main supplier of products in sensitive industrial ecosystems and of CRM
        - High VC capacity in strategic sectors and multiple productions
    - US is the EU's largest export market and tariffs can have very large implications for the EU, but retaliation may not be the smartest response
    - Decoupling is not only costly but also impossible in the short term, de-risking takes time and requires a strategy
2. **External strategic dependencies should be reduced while maintaining a commitment to openness**. This requires a combination of actions:
    - Re-thinking production systems towards risk reduction in supply chains, including favouring relocation and domestic production of some strategic products/services
    - Energy access and cost as a priority: efficiency in consumption and potential relocation
    - Foster technological innovation, including to reduce dependency on critical raw materials
    - Developing new trade partnerships to reduce import dependencies and expand export markets
    - Engaging/leading the reform of the global trade system

Conclusions and policy considerations cont.

3. Comprehensive reassessment of the EU's industrial strategy is imperative

- EU countries face the fundamental challenge of a restructuring of their industry, especially the most energy-intensive sectors
- Serious evaluation of the needs in terms of industrial re-structuring required to accommodate the priorities of the green and digital transitions – in MS, in VC and in companies
- Different MSs follow different approaches and have different amounts of resources available but economic security is a concept that should be applied at EU level
- Exploring ways to expand the EU's industrial policy instruments beyond those designed for the single market
    - See current reflections about a different approach to the next MFF

Thank you!

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Cinzia.Alcidi@ceps.eu

@CEPS_thinktank

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