POLICY PAPER
NOTE DE RECHERCHE
N°135

Arnaud Leconte - 6 September 2022

The European Union's Economic Governance of the (Post-)Pandemic and the War

The twin effects of the pandemic and the war in Ukraine are far-reaching, exacerbating significant political and economic policy challenges in an increasingly fragmented world. The pandemic and the war in Europe have occurred at a time when the influence of the EU in the world is shrinking. Thirty years ago, the EU represented a quarter of the world's wealth, in 2021 the EU- wide GDP stood at just over $17 trillion in 2021 or made up 12,78% of the world economy, regaining its pre-Covid-19 size, according to the European Statistical Office (Eurostat), but surpassed by China.

This paper discusses how Europe is facing up to the new geopolitical landscape in terms of European economic governance.

Background

In line with Robert Schuman's Declaration on 9 May 1950, *"World peace cannot be safeguarded without the making of creative efforts proportionate to the dangers which threaten it. The contribution which an organized and living Europe can bring to civilization is indispensable to the maintenance of peaceful relations"*, European countries have increasingly adopted common objectives, such as a single economic area, and embedded them in European common laws.

In 1999 the Economic and Monetary Union (EMU) was a logical step towards reinforcing the Single Market: the euro eliminates exchange rate risk, facilitates trade and supports confidence in price stability. Trade as a share of GDP rose from 31% to 54% in the euro area between 1999 and 2019, whereas in the United States it rose from just 23% to 26%[1]. Europe's integration with global value chains (GVC) was also intensified, with GVC participation roughly 20 percentage points higher than in the United States[2]. Over 70% of the euro area's participation in global value chains was already regional in 2019[3]. In fact, the regional integration of supply linkages in Europe is higher than in any other continent and has continued to increase in recent years.

The EMU also has a strong geopolitical dimension. Article 42(7) of the Treaty on European Union stipulates that *"If a Member State is the victim of armed aggression on its territory, the other Member States shall have towards it an obligation of aid and assistance by all the means in their power, in accordance with Article 51 of the United Nations Charter."* An attack against one of its members – including those that are not NATO members – would be an attack against the European Union.

Seen from this perspective, the EMU is not an end in itself but a means to an end, offering peace, freedom and prosperity. However, the progress made on the EMU has not always been smooth[1], illustrating Jean Monnet's dictum: *"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises"*[4].

The war macroeconomics: shaking the (post)-covid recovery

The post-2008 financial crisis decade of performance was marked by a GDP growth lower than long term predictions; low inflation (often below the target of 2%), low unemployment and high employment rates (although not everywhere). In terms of monetary policy, nominal interest rates were close to zero, with a lower bound trend, with very low real interest rates; In terms of fiscal policy, public sector debt/GDP ratios were pushed up by the financial crisis, then stabilised.

In that context, the COVID-19 crisis was not a financial crisis-induced recession, but one created by exogenous health factors.. It triggered a containment policy that became necessary to flatten the epidemic curve and caused a deep recession where the world economy shrank by 4.3% in 2020, a setback matched only by the Depression of the 1930s and the two world wars. This recession was not a normal recession: it was both a productivity shock (an inflation shock due to shortages in supply chains) and an aggregate demand shock: households spent less, uncertainty lowered expected future profits, and world trade contracted. The resulting credit constraints reduced con-

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sumption smoothing and triggered a higher multiplier than in normal times: research suggests a multiplier of government investment on economic output as high as 2 for COVID-19. Unlike a typical recession, there was no 'silver lining' of weeding out failing enterprises, and cash flow and insolvency problems were not systematically related to underlying performance.

The policy design was then aiming at conducting "continuity whilst on hold" policies in order to prevent long-term supply side damage. The most significant of these measures was the Pandemic Emergency Purchasing Programme (PEPP), launched in March 2020, whereby the European Central Bank – over two years – purchased private and public sector securities amounting to about €1,700 billion and resulting in an ECB's balance sheet which doubled that of the U.S. Fed as a percentage of GDP (more than 60%). In contrast to previous ECB asset purchase programmes, the PEPP was given the flexibility needed for purchases to be calibrated over time, across asset classes and among jurisdictions. This enabled action to be directed more effectively to where the risks to monetary policy transmission were greater.

On the budgetary front, the European Commission and the Member States launched, in July 2020, their Next Generation EU (NGEU) recovery plan of 750 billion euros, financed by a common debt instrument. Fiscal "Maastricht "and state aid rules were suspended until 2023.

The War macroeconomics: weaponising money, food and energy

The shock from Russia's invasion of Ukraine in February 2022 has cast doubt on a strong global economic recovery from the COVID-19 pandemic.

With Russia supplying around 19% of the world's natural gas and 11% of oil, energy prices have jumped alarmingly. Europe in particular is highly dependent on Russian gas and oil. Gas spot prices in Europe are now more than 10 times higher than a year ago, while the cost of oil has nearly doubled over the same period. The price shock risks are increasing poverty and disrupting the production of goods and services worldwide.

Russia and Ukraine are important producers of wheat, fertilizers and metals used in industry, such as nickel and palladium. Disruptions to wheat, maize and fertilisers risk raising hunger and food insecurity across the world, in particular in emerging markets and low-income countries. Soaring metals prices could affect a wide range of industries such as aircraft, car and chip manufacturing.

Weaponising energy, the end of the Russian Pact on Energy and food

The EU imports about 30 per cent of its oil and 40 per cent of its gas from Russia, paying Moscow roughly USD 850 million a day, at current prices, to keep the hydrocarbons flowing.

The link between gas and geopolitics was already in place prior to the war in Ukraine. In February 2022, the storage sites owned by Gazprom in Europe were only 16% full compared to 44% for the other storage sites. Furthermore, among these acquisitions on European soil, Gazprom has been able to win, over the past decades, 10% of European storage capacity.

While technical or commercial explanations have been put forward to explain the slowdown in Russian supplies during the second half of 2021, the link between gas and geopolitics was finally confirmed in January 2022 by the International Energy Agency (IEA).

In June 2022, the European Council adopted a sixth package of sanctions that, among others, prohibits the purchase, import or transfer of crude oil and certain petroleum products from Russia to the EU. The restrictions will apply gradually: within six months for crude oil and within eight months for other refined petroleum products[2].

As the majority of the Russian oil delivered to the EU is seaborne, these restrictions will cover nearly 90% of Russian oil imports to Europe by the end of the year[3]. Weaning Europe off Russian oil is challenging. One of the main problems with Russia's oil and gas exports is that it is very hard to redirect them to new markets. Unlike in the oil industry, where big producers such as Saudi Arabia have historically held back additional capacity to help balance the market in the event of a disruption to global supplies, the gas industry has tended to operate at or close to capacity. Gas is also less fungible than oil, since moving it from the point of production to the point of consumption requires a pipeline or liquefaction facility and therefore a bigger upfront investment. The EU would have to turn to producers such the U.S., Tanzania and

Qatar, which would ship liquefied natural gas (LNG) in tankers.

With grain the task is much simpler as grain is a much more mobile product and much more easily stored. Notably, friendly or neutral countries account for 73% of Russia's grain exports, making agricultural restrictions a powerful Russian sanction the Kremlin can use to strike back at its detractors and as leverage over those countries that are still sitting on the fence. "In these current conditions, a shortage of fertilizers on the global market is inevitable," Putin said on 5. April 2022. "We will have to be more careful about food supplies abroad, especially carefully monitor the exports to countries which are hostile to us." Fertilizer prices are at their highest since the global commodity bubble in 2008, with the cost of nitrogen fertilizers rising by 253% in Europe in 2021. The Russian government already announced in December 2021 that it would restrict nitrogen fertilizer exports for a period of six months to ensure supplies at home.

In that context, the grain export deal[4] signed on 22. July 2022 by Russia and Ukraine comes as a big relief to the Horn of Africa. On the one hand, the agreement would allow 22 million tons of Ukrainian grain, currently trapped in Ukrainian ports by the war, to be exported. On the other hand, Russian exports of grain and fertilizer via the Black Sea would be facilitated and could make it easier for Russia to import agricultural machinery and spare parts. In 2021, imports made up more than 75 percent of the Russian agricultural equipment market, coming largely from Germany and the Netherlands. However, despite the benefits for the Russian economy, President Vladimir Putin's behavior has shown that economic logic is of little use in trying to predict his actions in the longer run.

Weaponising money, the Russian fortress strategy since the annexation of Crimea in 2014

Cutting off Russia from SWIFT (Society for Worldwide Interbank Financial Telecommunication[5]), a global payments system, is not the weapon of financial mass-destruction expected by its supporters.

There are at least three reasons for this. First, the Kremlin has been bracing itself for the possibility of being cut off from SWIFT since 2014 when America floated the idea as punishment for the invasion of Crimea. Exclusion triggered capital flight and a run-on firms and banks reliant on foreign funding, but coping mechanisms soon kicked in. Russian banks and their foreign partners used other means of communication. And transactions would migrate 'en masse' to SPFS (System for Transfer of Financial Messages), a Russian alternative to SWIFT that is not nearly as ubiquitous and sophisticated, but still usable. That caused some disruption—but not disaster - in the Russian financial system. Over time, investment in SPFS would make the system speedier.

Second, the politicisation of SWIFT gives China an incentive to bolster CIPS (Cross-Border Interbank Payment System), its rival to SWIFT, for cross-border payments in yuan. It also helps China court any country with uneasy relations with Western countries looking for alternatives[6].

Third, Russia had built up more than USD 600 billions worth of foreign currency reserves held in dollars, gold and other currencies, with about half believed to be frozen by the restrictions imposed on its central bank. Despite losing access to half of its reserves, the central bank has stopped a fall in the ruble that prompted it to more than double its key interest rate to 20% on 28 February. It did so by imposing capital controls that prevented Russians and others from moving foreign exchange out of the country and by requiring Russian energy exporters to sell 80% of their foreign-currency revenues and buy rubles. However, as long as Russia can channel the flow of foreign exchange from exports to needed imports, the central bank will not feel the loss of access to these assets.

Furthermore, starting April 1., Russia demanded to be paid in rubles for shipments. But the EU told member states that the mechanism the Kremlin proposed, which required opening euro and ruble accounts with the state-controlled Gazprombank, would violate the sanctions. However, on 6. August, Turkey – a NATO member and EU candidate – agreed to switch part of its Russian gas payment to rubles. By having the gas payments cleared only when they are converted into rubles, Russia is seeking to have European companies circumvent the sanctions on the Russian central bank. On its side, Gazprom has already cut supplies to Poland, Bulgaria, Finland, Netherlands, Denmark and Latvia and partially to Germany.

War Macroeconomics: a "term of trade tax" for the euro area

The economic consequences of these shocks are significant and are accumulating over time.

With regard to Russia, the sanctions were meant to sever Russia from the global financial system and choke off funds available to Moscow to finance the war. But the IMF's World Economic Outlook in July 2022 upgraded Russia's GDP estimate for this year by 2.5 percentage points, with crude oil and non-energy exports holding up better than expected, although its economy is still expected to contract by 6 percent.

For the euro area, the steep rise in oil and gas prices over the past year represents a massive "terms of trade tax". As the euro area is a net importer of energy, rising energy prices mean that the euro area is losing purchasing power and import partners are gaining it. This transfer in purchasing power to the rest of the world has already amounted to 3.5% of euro area GDP in the last quarter of 2021, compared with the same period in 2020. In absolute terms, this would imply an estimated loss of about €440 billion in one year[3].

Leading economic indicators suggest that such demand destruction is already underway. In July 2022, the Economic Sentiment Indicator (ESI) plummeted in both the EU (-4.2 points to 97.6) and the euro area (-4.5 points to 99.0), falling below its long-term average. The Employment Expectations Indicator (EEI) also decreased markedly (-3.6 points to 106.6 in the EU and -3.2 points to 107.0 in the euro area) while remaining above its long-term average. Households are expecting higher inflation and lower economic growth. As a result, they are revising down their spending plans. Business expectations for activity in a year's time have also slumped, foreshadowing lower investment.

source: European Commission services

Overall, annual growth in 2022 will mainly reflect the mechanical effect of the rebound in GDP. But quarter-on-quarter growth rates will be very low this year. The adverse impact of the war could well bring them into negative territory and produce longer-lasting effects.

Individual households are feeling the pain. Imported inflation is pinching people's real incomes and eating into demand. Since households cannot easily reduce their consumption of food and energy in response to rising prices, they will have to cut back their spending on other items, reverberating across the economy. Low-income households will be particularly hit as consumption of food and energy absorbs a larger share of their income.

A reduced fiscal policy space

On the fiscal side, policy space was already eroded in many countries by the pandemic. Withdrawal of extraordinary fiscal support was projected to continue. The surge in commodity prices and the increase in global interest rates will further reduce fiscal space, especially for oil- and food-importing emerging markets and developing economies.

Uncertainty around these projections is considerable, well-beyond the usual range. Growth could slow down further while inflation could exceed the projections if, for instance, sanctions extend to Russian energy exports. Continued spread of the virus could give rise to more lethal variants that escape vaccines, prompting new lockdowns and production disruptions.

Several economies will need to consolidate their fiscal balances. This should not prevent governments from providing well-targeted support for vulnerable populations, especially in light of high energy and food prices. Embedding such efforts in a medium-term framework with a clear, credible path for stabilizing public debt can help create room to deliver the required support. Debt sustainability (in the sense of the stabilization of the debt to GDP ratio) depends crucially on the difference between interest payments that increase government debt and the nominal growth rate that reduces the debt to GDP ratio. An important implication is that the debt to GDP ratio can be stabilized or even decline without the government having to run a primary surplus. In 2020-2021 all EU countries with high (above 50%) debt-to-GDP ratio run a primary deficit (see tables below). However, growth and/or interest rate projections may be over-optimistic, thereby creating the il-

lusion of a sustainable debt position when the differential can quickly turn around, thus shutting countries out of financial markets.

Table 1: EU Countries above 50% of General government gross debt, % of GDP

Country Code	2018	2019	2020	2021
AUT	74,045	70,563	83,213	83,061
BEL	99,858	97,708	112,77	108,254
HRV	73,208	71,082	87,281	80,862
CYP	98,351	91,082	114,961	103,932
FIN	59,779	59,594	68,986	66,691
FRA	97,783	97,414	115,152	112,331
DEU	61,271	58,925	68,724	70,206
GRC	190,147	185,082	211,897	198,933
HUN	69,05	65,479	80,036	78,109
IRL	63,136	57,215	58,434	55,265
ITA	134,442	134,139	155,313	150,859
MLT	43,524	40,605	53,282	57,361
NLD	52,426	47,561	52,755	56,744
POL	48,819	45,607	57,445	55,545
PRT	121,481	116,608	135,186	127,54
ROU	36,468	36,796	49,643	51,359
SVK	49,629	48,142	59,742	60,433
SVN	70,305	65,606	79,762	74,698
ESP	97,514	95,537	119,951	118,719

Table 2: Primary balance, % of GDP , the selected EU countries have high (above 50%) Debt % of GDP

Country Code	2018	2019	2020	2021
AUT	1,398	1,645	-7,384	-4,975
BEL	0,995	-0,2	-7,386	-4,671
HRV	2,285	2,18	-5,628	-2,38
CYP	-1,259	3,407	-3,698	-0,01
FIN	-0,689	-0,786	-5,296	-2,745
FRA	-0,68	-1,713	-7,879	-5,817
DEU	2,63	2,043	-3,893	-3,281
GRC	4,191	3,211	-7,879	-5,905
HUN	0,173	0,094	-5,809	-4,882
IRL	1,728	1,777	-3,924	-1,241
ITA	1,299	1,66	-6,311	-3,795
MLT	3,351	1,66	-8,618	-8,011
NLD	2,279	3,033	-4,012	-5,36
POL	1,197	0,633	-5,829	-1,393
PRT	2,874	2,933	-3,075	-0,534
ROU	-1,603	-3,788	-8,483	-5,397
SVK	0,148	-0,266	-4,474	-5,539
SVN	2,538	1,918	-6,424	-4,146

Source: Kose, M. Ayhan, Sergio Kurlat, Franziska Ohnsorge, and Naotaka Sugawara (2017). "A Cross-Country Database of Fiscal Space." World Bank Policy Research Working Paper 8157, World Bank, Washington, DC, last update on April 29, 2022

Last but not least, by 2. August 2022 more than 6,1 million people had already fled Ukraine and 3,766,193 are now registered for Temporary Protection or similar national protection schemes in Europe[7]. So far, refugees have primarily gone to a small number of neighboring countries (Poland, Romania, Hungary, Moldova, Slovakia). However, Poland, Hungary and Slovakia have open borders with other EU countries under the Schengen agreement. Many refugees who first arrived in these countries have since moved on to others. Burden sharing and EU support to the major host countries will be needed for support to be delivered more effectively and sustainably.

Monetary and reserves management policies: Is rising inflation set to continue ?

Inflation has become a clear and present danger for many countries even prior to the war: it surged on the back of soaring commodity prices and supply-demand imbalances in 2021.

Many central banks, such as the Federal Reserve, had already moved towards tightening monetary policy. War-related disruptions amplify those pressures: projected inflation may remain elevated for much longer. In the United States and some European countries it has reached its highest level in more than 40 years, in the context of tight labor markets. There is an increased risk of inflation expectations drifting away from central bank inflation targets, prompting a more aggressive tightening response from policymakers. Furthermore, increases in food and fuel prices may also significantly increase the prospect of social unrest in poorer countries.

Immediately after the invasion, financial conditions tightened for emerging markets and developing countries. So far, this repricing has been mostly orderly. Nevertheless, , several financial fragility risks remain, raising the prospect of a sharp tightening of global financial conditions, as well as capital outflows.

So how should monetary and fiscal policy react to this situation?

First, the high inflation is mostly due to global factors – including the increase in the prices of oil, gas and

other commodities – over which monetary policy has little leverage. For this reason, relying on monetary policy alone to bring down short-term inflation while inflation expectations remain well anchored would be extremely costly. A tightening of monetary policy would not directly affect imported energy and food prices, which are driven by global factors and now by the war.

Domestic demand would have to be massively suppressed to bring down inflation. That would mean considerably lowering real activity and employment, knocking down wages and income. In practice, this would mean adding to the ongoing sacrifice in real income suffered by the European economy. And with the current levels of imported inflation, in order to hold headline inflation to 2%, domestic inflation would have to be deeply negative. In other words, domestic deflation would be the result.

In this situation, a coherent fiscal and monetary policy strategy would alleviate the cost of reducing inflation. Against the backdrop of a considerable hit to real income, fiscal policy can help mitigate the challenge of higher inflation by containing the effects of higher energy prices, for example by reducing indirect taxes or increasing transfers to the most affected households. Supply-side public intervention can also address the challenge of more persistent supply-demand mismatches through direct investment, incentives or regulatory intervention.

Monetary policy will play its role, adjusting policy in line with the medium-term inflation outlook. And it must ensure that its policy stance is transmitted evenly throughout the euro area, which would also prevent financial fragmentation from hindering the necessary monetary and fiscal interventions

However, the European Central Bank (ECB) 's price stability mandate implies that the Central Bank would not hesitate to tighten policy to safeguard price stability if supply shocks were to feed into domestic inflation through volatile inflation /subject to a sharp deviation from expected inflation rates and accelerating wage growth inconsistent with inflation targets and with productivity gains. There is no clear evidence of such second-round effects today. And they may not materialise, given the credibility of the ECB's commitment to preserve price stability, which helps anchor inflation expectations, and the exceptional degree of uncertainty which may induce workers to prioritise job security over wages rises.

In July 2022 the ECB council surprised the market and consensus expectations by starting its first rate hiking cycle in over a decade by raising its main policy rates by 50bps, but also abandoning forward guidance and introducing an anti-fragmentation tool ,which is called the Transmission Protection Instrument (TPI). When Italian 10-year borrowing costs spiked above 4% in mid-June, the ECB was forced to hold an emergency meeting to soothe markets. Its pledge to *"accelerate the completion of the design of a new anti-fragmentation instrument"* has worked as a stop-gap. The TPI may ease concerns within the ECB Governing Council (GC) about tightening monetary policy. This is because it addresses the risk that higher rates could cause yields for some sovereigns to rise very sharply, and at different maturities, causing a destabilising variance in monetary policy transmission, known as fragmentation, across the eurozone.

The TPI is not the ECB's only tool with which to address fragmentation risks. The ECB's first line of defense is the flexible reinvestment of Pandemic Emergency Purchase Programme (PEPP) redemptions. A third instrument is the Outright Monetary Transactions (OMT) programme. However, eurozone countries have a strong incentive to avoid OMT activation as it is attached to a European Stability Mechanism (ESM) programme involving strict conditionality.

The TPI can be activated to counter what the ECB considers unwarranted, disorderly market dynamics that seriously threaten the transmission of monetary policy. The scale of purchases would depend on the severity of the risks to transmission and is not restricted ex ante. To be eligible for the TPI, countries should be compliant with the EU fiscal framework, have a sustainable public debt trajectory, and sound and sustainable macroeconomic policies with no severe macroeconomic imbalances. Eligibility will be decided by the ECB's GC alone. However, TPI could still face legal challenges on the basis that it violates ECB rules prohibiting the monetary financing of fiscal deficits. Furthermore, the EU fiscal framework is currently suspended, and it is unclear how this factor would be assessed until the suspension ends.

In this difficult environment, national-level policies and multilateral efforts will play an important role.

The war macroeconomics: a tectonic shift for European Economic Governance?

In the "2016 EU Global Strategy" the EU made a clear reference to *"an appropriate level of strategic autonomy"*[8], not limited to security and defense. It applied to a wide range of issues including trade, finance, digital and investments. In 2020 the European Commission went further and mentioned the concept of "open strategic autonomy" : "*This will mean shaping the new system of global economic governance and developing mutually beneficial bilateral relations, while protecting ourselves from unfair and abusive practices.*[5]"

The Pandemic Already Marked Major Shifts in European Economic Governance

The pandemic marked major shifts in European economic governance: first, the new European common fiscal instruments were designed with the explicit recognition that the EU is more than the sum of its parts. Funded collectively, the NGEU package has created a critical fiscal policy space akin to the federal budget support existing in other economies. This reflected the growing awareness of how interdependent European economies are. For example, the European Commission estimates that countries like Belgium, Austria and Germany will obtain most of the GDP stimulus from NGEU through the boost in external demand stemming from other corners of the EU.

The second shift is the recognition that reforms are more likely to emerge in a growing economy where resources can be redistributed more easily. Europe's sovereign debt crisis had demonstrated that, while fiscal discipline is paramount, pro-cyclical austerity does not pay. And the economy had to adapt to the new economic environment created by the pandemic, with resources being reallocated across sectors and firms. In other words, support to both demand and supply were necessary to escape the low growth trap.

The experience of the pandemic crisis drew three main lessons: first, situations requiring a joint monetary policy and fiscal policy response may arise frequently. Second, for EMU to be viable, European policies must be conducted for the benefit of all EU member states. Third, under non-cooperative policies, each fiscal authority has an incentive to create too much debt, leading to speculation that the ECB may eventually respond to high average debt by accepting EU-wide higher inflation. This behavior is supported by an external effect, as the costs associated with fiscal consolidation are incurred predominantly at national level, while the costs associated with higher inflation tend to be shared by all EMU countries.

However, the EU is facing new challenges: from economic shocks to security and war risks, climate change and the need to speed up the energy transition.

The War, another tectonic shift for European Economic Governance?

In the EU Heads of State and Government's Versailles Declaration of 10 and 11 March 2022[9], EU leaders defined Russia's aggression against Ukraine as a "*tectonic shift in European history*". The Declaration identifies security as a common public good and three key dimensions to achieve it:

- bolstering defense capabilities
- reducing energy dependencies,
- building a more robust economic base.

The defense budgets of Member States are likely to increase significantly. Between 1999 and 2021, EU combined defense spending increased by 20%, according to reports by the European Defence Agency. That compares with a 66% increase by the US, and 292% by Russia and 592% by China, over the same period [8]. If all EU countries, including those which are not in NATO, were to live up to NATO commitments and increase their defense spending to 2% of GDP, government spending in the EU would increase by 0.7% of GDP. For the euro area, this would mean an increase of around €80 billion per year.

Even before the invasion of Ukraine, the attainment of the EU's 2030 climate targets required energy-related investments of €402 billion (2.9% of 2019 GDP) per year on average in the decade. Compared with the previous decade, it implies additional annual investment needs of around €220 billion on average [4] [7]. On top of this, the EU aims to progressively eliminate its dependence on Russian fossil fuels by 2030 while fulfilling the agreed climate targets. Under the Versailles Declaration the Commission has been given a mandate to launch REPowerEU, an ambitious plan aimed at achieving that objective. According to the EU, the REPowerEU objectives require an additional investment of €210 billion between now and

2027. Cutting Russian fossil fuel imports can also save almost €100 billion per year. These investments must be met by the private and public sector, and at the national, cross-border and EU level. Central to it is diversifying gas supplies and reducing dependence on fossil fuels by increasing the share of renewable energy[10]. [9].

Such steps are costly in the short term but, if well implemented, will support the efficiency and resilience of the EU economy. Accelerating the climate transition would reduce reliance on external energy sources and exposure to large imported energy price swings. Likewise, joint European investment in green technology and defense R&D would be cost-efficient and deliver innovations that benefit all countries.

In the coming years, Europe will also have to increase its investment in order to speed up digital transformation, strengthen the health sector, expand research and development activities, enhance the formation of human capital and reduce dependence on key imported agricultural products and services. It should represent an opportunity to complete the single market for services, and the European Capital Market. The latter remains segmented, limiting risk-sharing via cross-border debt and equity holdings.

If the responsibility for higher investment and the associated costs were to fall exclusively on the shoulders of the individual Member States, it could lead – depending on the country – to under-investment or a narrowing of fiscal space. And cross-country heterogeneity and financial fragmentation could also increase.

Implications for Europe's economic governance: fiscal federalism?

Today fiscal matters among Member States are guided by the principles of intergovernmental co-operation (joint decision-making by the Council under strict voting requirements) and of subsidiarity. The latter implies that national responsibility for fiscal affairs is the norm and Community responsibility the exception.

The ensuing call for more fiscal resources on a permanent basis at the European level may lead to further important steps towards the creation of a European fiscal union.

Fiscal responsibilities should be centralised only when the benefits outweigh the costs. The benefits of centralisation include economies of scale, efficiency gains and better accounting for the external factors produced by the policy measures taken by each Member State, which may have significant spill-over effects on other countries. The costs in turn relate to the possibility that European policies fail to reflect the heterogeneity of preferences across Member States. Theory therefore suggests that the EU should provide for public goods that cannot be offered more effectively or efficiently at national level, and for which the preferences of citizens are sufficiently homogenous across Europe. Such EU public goods do include the investment needs in security, defense and climate.

The crisis thus offers a possibility to create stronger fiscal capacity at European level that could also be used to pursue the delivery of common public goods while not neglecting optimal risk-sharing, counter-cyclical stabilisation, and promotion of growth and convergence.

Trade policy, the Green Deal does not mean energy independence

Strong demand, high shipping prices and increased tariffs or punitive sanctions amid the Ukraine conflict are encouraging companies and countries to prioritise resilience over efficiency. The just-in-time manufacturing model has sometimes struggled to pass the test posed by financial crises, natural disasters, the pandemic and now a major war. Importers encounter more trading restrictions, often from populist governments seeking to further their domestic ambitions.

However, the geography of the production of metals necessary for the ecological transition is more concentrated than that of hydrocarbons. Vulnerability is therefore no less of an issue for renewable energies than it is for fossil energies[11]. For oil and gas, the three main supplier countries extract less than 50% of world production. For copper, nickel, cobalt, rare earths and lithium, three countries control between 50 and 90% of the global extraction of each of these raw materials.

- Chile, Peru, China in the case of copper,
- Indonesia, the Philippines, Russia in the case of nickel,
- the Democratic Republic of Congo, Russia, Australia in the case of cobalt,

- China, the United States, Myanmar in the case of rare earths,
- Australia, Chile, China in the case of lithium.

For example, Russia accounts for over 20% of global exports of vanadium, cobalt and palladium which are used in the production of 3D printers, drones, robotics, semiconductors and catalytic converters. Russia and Ukraine are also among the largest exporters of iron ore and nickel which are used in the iron and steel industries.

Today, the data shows a looming mismatch between the world's strengthened climate ambitions and the availability of critical minerals that are essential for realising those ambitions. If trade is not necessarily a factor of peace, self-sufficiency in energy and other matters is illusory. It will therefore be appropriate, when the time comes, to rethink inter-dependencies with various suppliers, including the Russian neighbor.

Reinforcing multilateral governance

On climate, the EU should close the gap between stated ambitions and policy actions. The current EC proposal of imposing a tariff on carbon emissions of imported products (a so-called Carbon Border Adjustment Mechanism or CBAM) will be extremely challenging politically, and the EU's future climate policy should not rely only on its successful implementation. CBAM does not provide enough incentives for reducing emissions to achieve global temperature goals as it only taxes exported goods from countries that do not have a domestic carbon tax.

In addition, an international carbon price floor, differentiated by country income levels, would provide a way to coordinate national efforts aimed at reducing the risks of catastrophic climate events. Furthermore, the adverse social consequences of climate policies should be taken into account and minimised in each European climate policy proposal. Unavoidable impacts should be addressed by targeted compensation measures. The scope of the European Globalisation Adjustment Fund for Displaced Workers (EGF) can be broadened and the mechanism adjusted to aid the transition in hydrocarbon regions. Finally, EU policymakers should promote the European Green Deal on the back of a reform of EU neighborhood and development policy.

Equally important is the need to secure equitable worldwide access to the COVID-19 tools to contain the virus, and to address other global health priorities such as zoonotic diseases and antimicrobial resistance. Multilateral cooperation remains essential for advancing these goals and the "One Health" approach, including the interface of animal, human, and ecosystem health.

EU Policymakers should also ensure that the Global Financial Safety Net (GFSN[12]) operates effectively. For some countries, this means securing adequate liquidity support to tide over short-term refinancing difficulties. But for others, comprehensive sovereign debt restructuring will be required. The Group of Twenty (G20)'s Common Framework for Debt Treatments[13] offers guidance for such restructuring but has yet to deliver. The absence of an effective and expeditious framework is a fault line in the global financial system. It should be borne in mind that defining debt sustainability is more art than science, even within the IMF/World Bank Debt Sustainability Framework.

Conclusion

The war increases the risk of a more permanent fragmentation of the world economy into geopolitical blocks with distinct technology standards, cross-border payment systems, and reserve currencies.

The concept of open strategic autonomy guiding Europe's economic governance has still to deal with weak European fiscal integration and capital markets and face the economic reality of strong trade inter-dependencies. The combination of a rules-based international order with a drive to reduce Europe's strategic vulnerabilities will not go without critical political choices in terms of trade, fiscal and monetary policies at a time when the inflation and growth outlook have become worrisome.

Particular attention should also be paid to the overall stability of the global economic order to make sure that the multilateral framework that has lifted hundreds of millions out of poverty is not dismantled. Such a tectonic shift would cause longterm efficiency losses, increase volatility and represent a major challenge to the rules-based framework that has governed international and economic relations for the last 75 years.

Footnotes

1 *Take the example of the 2012 euro crisis, "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." See Draghi, M. (2012), Speech at the Global Investment Conference in London, 26 July.*
2 *Source: https://www.consilium.europa.eu/en/policies/sanctions/restrictive-measures-against-russia-over-ukraine/sanctions-against-russia-explained/*
3. *The list of sanctioned products includes among others, crude oil and refined petroleum products, with limited exceptions (with phase out of 6 to 8 months), coal and other solid fossil fuels (as there is a wind-down period for existing contracts, this sanction will apply as from August 2022), gold, including jewelry, steel and iron, wood, cement and certain fertilizsers, seafood and liquor (e.g. caviar, vodka)*
4. *The deal is set to last for 120 days, with a co-ordination and monitoring centre established in Istanbul, staffed by UN, Turkish, Russian and Ukrainian officials. It can be renewed if both parties agree.*
5. *SWIFT is used by more than 11,000 financial institutions and companies around the world, across over 200 countries*
6. *CIPS already counts some big foreign banks as members. By late 2021 it had a daily average volume of transactions of 310bn yuan ($50bn)—well behind swift's estimated $400bn but nearly double the volume of a year before.*
7. *Source: UN Refugee Agency (UNHCR) https://data.unhcr.org/en/situations/ukraine*
8. *Source : European External Action Services https://www.eeas.europa.eu/sites/default/files/eugs_implementation_plan_st14392.en16_0.pdf*
9. *Source: Versailles Declaration*
10. *The Commission expects to be able to replace 50 billion cubic meters (bcm) of Russian pipeline gas with LNG by the end of the year and another 13.5bcm with non-Russian pipeline gas and biomethane. Renewable energy and energy could replace an additional 38bcm of Russian gas.*
11. *The Role of Critical Minerals in Clean Energy Transitions, Source: International Energy Agency https://www.iea.org/reports/the-role-of-critical-minerals-in-clean-energy-transitions, May 2021*
12. *The GFSN has a triple objective vis-à-vis sovereign governments: to provide precautionary insurance against a crisis; to supply liquidity when crises hit; and to incentivize sound macroeconomic policies. It consists of four layers: countries can self-insure against external shocks using foreign reserves or fiscal space at national level. At the bilateral level, there are swap lines concluded bilaterally among countries. At regional level, the protection comes from Regional Financing Arrangements. And finally, the IMF provides a global financial backstop. Source: European Stability Mechanism https://www.esm.europa.eu/content/what-exactly-global-financial-safety-net-gfsn*
13. *The Common Framework for debt treatment" is an initiative endorsed by the G20, together with the Paris Club, in November 2020 to support, in a structural manner, Low Income Countries with unsustainable debt.*

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Policy Paper / Note de recherche est publiée par le Centre international de formation européenne, association dont le siège est 81, rue de France, F-06000-Nice.
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Ce projet a été financé avec le soutien de la Commission européenne.
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