# THINK GLOBAL – ACT EUROPEAN IV

## THINKING STRATEGICALLY ABOUT THE EU'S EXTERNAL ACTION

Directed by Elvire Fabry
in collaboration with Chiara Rosselli

*Foreword by Pascal Lamy and António Vitorino*

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# FOREWORD

*by Pascal Lamy, Honorary President,* Notre Europe – Jacques Delors Institute
*and António Vitorino, President,* Notre Europe – Jacques Delors Institute

Twenty years after the Treaty of Maastricht created the Common Foreign and Security Policy, Europeans face the risk of being marginalised on the international scene. The euphoric period following the fall of the Soviet Union – when it seemed obvious that the world would westernise and that politics would become more democratic and economies more liberal – has ended.

Long-term economic shifts underway since the 2000s – the rise of ever more economically potent and politically assertive powers – have translated into a gradual yet relentless reversal of global relationships of power. 2012 will be remembered as the turning point when the production of the rising economies exceeded that of old industrialised countries. With this shift of economic power – mainly towards Asia and soon towards Africa – European influence and regulatory capacity on the global level are increasingly questioned.

In this time of complex evolutions and shifting tectonic plates, the 'Think Global – Act European' project brings together 16 think tanks and over 40 experts to examine the EU's external action.

The economic crisis has commended EU efforts to concentrate on the internal challenges of recovery and fiscal consolidation. Yet the EU is entering a new phase of its existence in which it is called upon to anticipate the negative spillover of the crisis on the attractiveness of the EU model both at home and abroad. To do so the EU must equip itself with an integrated global strategy introducing more coherence with its internal policies.

Developing a common foreign policy reflecting both European values and interests is an instrument for the much needed legitimisation of the European

project in the eyes of our fellow citizens. The way we view foreign policy is not just the way of having a say in international affairs, but it's also a key element in the internal consolidation of an innovative and inspiring European common project.

At a moment when the forces of discordance amongst Member States intensify, as increased economic competition fosters the renationalisation of European policies, the fourth edition of this report assumes, with more resolve than ever before, the 'united in diversity' motto that has been the guiding principle of the project since its inception.

The 'Think Global – Act European' report is indeed the product of a process of collective thinking, outlining key recommendations for strengthening and increasing the coherence of the EU's instruments of external action as well as providing the building blocks for new strategic thinking in the ambit of the EU's external action.

We are proud to present the product of such a stimulating process of cooperation, which has allowed for the constructive and enlightening confrontation of different viewpoints.

The hope is that this report will provide the impetus for new strategic reflection on the EU's role as a global power, allowing the EU to achieve a new and open outlook on the evolution of the new trends that are reshaping our current world order. Our wish is that European institutions as well as national diplomacies will grant serious consideration to the relevant and innovative proposals for concrete action put forward by the authors of this valuable report.

# 10 KEY RECOMMENDATIONS

In the context of increasing global interdependence, the European Union needs to emphasise long term strategic thinking to react to the tectonic changes occurring on the global scene. In order to anticipate the negative spill-over of the economic and financial crisis on the EU's international influence and avoid the progressive marginalisation of Europeans, the EU must equip itself with a more integrated external action strategy, by:

## 1. Improving the coherence of internal and external EU policies

The benefits of the Single market – as a springboard for the promotion of European common interests abroad – are limited by the slow development of the external dimension of internal policies. In addition, the fragmentation of external policies and the delimitation of tasks between the European Commission (EC) and the European External Action Service (EEAS) stand in the way of a more political mindset, which is a prerequisite for developing a comprehensive forward looking strategy.

To emphasise the external dimension of internal policies in fields where Member States can concur on the long-term strategic interests of the EU, and to improve the consistency between new foreign policies and traditional diplomacy, a more active cooperation between the two institutions is required and could be usefully supported by initiatives amongst which:

- the appointment in the next 2014 Commission of a Commissioner for Enlargement and Neighbourhood that is also deputy to the High Representative for Foreign Affairs and Security Policy;

- the creation of permanent joint task forces allowing for the pooling of expertise, instruments and resources of the EC and the EEAS on specific issues, for instance on mobility.

## 2. Addressing the fragmentation of economic governance within the EU and its external representation

Member States hope to make up for the lack of EU domestic demand with proactive national trade diplomacy emulating the "geo-economic" strategies of rising economies. This will likely not be sufficient to boost the EU's economic competitiveness. Beyond the Commission's mandate for the negotiation of market access, there is little emphasis on trade as a coordinated EU external strategy and competition between Member States undermines their long term interests. The priority for the EU's long-term economic competitiveness is therefore:

- to knit Europe's markets closer together by consolidating the Single market, especially in relation to services.

Leveraging EU economic performance abroad also requires strengthening the EU's voice in global macroeconomic and financial affairs. In particular two initiatives seem promising:

- the creation of a single voice for the euro area at the IMF;
- the extension of the recently established European Supervisory Authorities (ESAs) as institutional platforms to coordinate and represent European views in global financial regulatory negotiations.

## 3. Engaging with traditional and new global players – especially with China

Within the current multipolar framework, strategic cooperation between the EU and the US is required to create a global level-playing field promoting

western values in global economic governance and addresses the ever more recurrent abuses of state capitalism.

*Vis-à-vis* new economic powers, and in particular China, the EU will lack assertiveness if relations remain channelled through individual Member States. New initiatives aiming at developing mutually beneficial relationships include:

- transparency on the sovereign debt bonds purchased by China;
- the creation of a system of incentives supporting existing demands for liberalisation and pointing at a 'second opening' of the Chinese economy (encouraging Chinese private initiatives in order to strengthen Chinese private capital; supporting the development of private company ownership, IPOs, intellectual property rights…).

## 4. Developing a comprehensive strategic approach for sustainable growth and access to strategic resources

Green growth and sustainable development, a pillar of both the EU's internal and external actions, will remain at the forefront of the EU agenda despite the burden of the financial and economic crisis on its Member States' green transition. Highly strategic interests, like quality of life and economic competitiveness, would be threatened if climate change and natural resources depletion were to be unsuccessfully managed. These challenges are not only internal but global in nature, requiring better coordination and coherence between these two dimensions.

For the EU this implies:

- gaining credibility at the global level by strengthening internal instruments, particularly saving emissions trading from irrelevance;
- empowering Europeans via collective rather than unilateral actions, especially in relation to accessing key natural resources such as natural gas;

- developing the external dimension of key internal policies (energy and other raw materials);
- avoiding the trap of a narrow Eurocentric vision when developing renewable energy projects abroad, by conceiving these as mutually beneficial endeavours, for instance in the promotion of low-carbon energy in Mediterranean Partner Countries;
- meeting food security and environmental challenges in European agriculture;
- and systematically looking for more efficient and ecological ways of managing natural resources on both internal and external markets.

## 5. Supporting legal migration

Beyond the short term challenges induced by rising unemployment, the labour force shortage fuelled by the ageing of the European population calls for a serious debate and further action regarding a more comprehensive EU migration policy. The following tree initiatives would be of particular interest:

- Within the framework of Mobility Partnerships, groups of states, sharing a similar need for (highly) skilled workers and offering similar working, salary and living conditions, could cooperate more closely to put in place attractive and mutually-reinforcing policies for the recruitment of workers with the right profile.
- Internally, the EU should improve existing rules on the admission of migrants and reinforce the possibility for residing migrant workers to move within the EU for employment purposes.
- Enhanced coordination of integration policies is needed to support this process.

## 6. Moving beyond a "security-driven perspective" on migration and developing a comprehensive approach with other EU policies

A foreign ministers' approach would allow broadening the debate on migration to social, economic and environmental issues and should be developed by:

- strengthening the role of the European External Action Service.

EU policies which have an impact on migration, such as development and cooperation policies, need to be taken into account to achieve consistency. This implies:

- abandoning the principle of conditionality which makes support for development conditional upon results obtained in migration control (readmission and border control). Cuts in development aid will not help address migration issues.

## 7. Moving from a defensive attitude towards the neighbourhood to the development of mutual interests

The EU has yet to find an adequate response to competing influences in the neighbourhood (illiberal values, alternative attractive markets…) and to react more promptly to the mismatch between on one hand the EU's long-term policies and institutional slowness and on the other hand the fast-paced changes and urgent demands of its neighbours. Whilst article 8 TEU mandates Europeans to actively engage their vicinity, a more positive outlook on the opportunities that could be seized in a stabilised and integrated neighbourhood implies:

- addressing the decrease in effectiveness of the principle of conditionality used in EU policies, by setting political and policy benchmarks with measurable criteria (e.g. very narrowly defined objectives, such as freedom of speech) for a more rigorous allocation, or reduction, of funding;

- support regional stability through innovative incentives more strictly correlated to the pragmatic short-term objectives and interests of the neighbouring countries' civil societies (particularly in trade and mobility) and acknowledging the potential of partners' traditions in promoting pluralism and democracy.

## 8. Shifting towards a proactive and cooperative engagement with other regional actors like Turkey and Russia

Specific forms of cooperation with Turkey could help achieve shared objectives in the neighbourhood, particularly in the Mediterranean region.

- Whilst assertively engaging Brussels and Ankara in finding a solution to the Cyprus issue, the EU and Turkey should jointly and strategically engage with neighbours - notably the Arab states, appreciative of the Turkish model - in as many regional projects as possible (infrastructure, higher education and research, business development, etc.).

- The feasibility of a progressive opening of the EU-Turkey customs union to other neighbours could be investigated in order to boost intra-regional trade and the economic transformation of the region.

The engagement of Russia is a more daunting task yet there is no alternative.

- The Common Spaces dialogue should be revamped to serve as a forum for constructive exchange between working groups of ministry officials on small-scale projects in their shared neighbourhood.

- But the official track has to be accompanied by a strengthened outreach to civil society (partnerships between municipalities and schools, student exchanges and trilateral projects with East European partners) in order to gain an acute understanding of partner expectations and to support actors that are key for the successful implementation of the EU's goals in the East.

## 9. Conducting an EU defence policy review

The Common Security and Defence Policy (CSDP) will not become a vehicle for great military power competition; but nor should the EU expect to only have to deal with relatively-small peacekeeping operations. There are a number of potentially important tasks in-between that may require the use of military force, ranging from responding to major humanitarian crises to protecting maritime trade routes.

EU governments should therefore re-state the purpose of CSDP by:

- conducting a "European defence review" outlining the EU's geo-strategic priorities, the threats to European security, and the types of operational scenarios EU governments must prepare for.

## 10. Grasping the nettle of military capabilities

EU governments need to consider how they intend to maintain and develop military capabilities that give them the agility and autonomy they need to respond to future crises and challenges. If cuts in national budgets and capabilities continue their current trends, most European armies might eventually become irrelevant. EU governments should therefore:

- look beyond their current "pooling and sharing" efforts towards integrating military capabilities;

- and make more efforts to integrate their procurement needs, which would help further consolidate the European defence industry.

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This selection remains under the responsibility of the rapporteurs.

# GENERAL SYNTHESIS

*by Elvire Fabry, Senior Research Fellow,*
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## 1. Time for a strategic rebound

**The sovereign debt and banking crisis has drained the energy of European leaders.** It is distracting them from the major geo-economic and geo-political trends which are transforming the world. **The European Union's external stakes are largely neglected.**

With the ECB's Outright Monetary Transactions (OMT) programme markets have calmed down. Partial progress has also been made with the decision to create a first pillar of a Banking Union in the euro area. But the crisis is far from resolved with persisting risks of liquidity and banking crises. **Squaring the circle, in order to perform a strategic rebound in a time of austerity and avoid a 2030 scenario of a G8 counting no European State, is particularly difficult.** The crises in the euro area have highlighted major flaws in European economic and political governance. Strong divisions and distrust between Member States reflect profound questioning about the EU's tools to return to growth. While further steps towards integration in the field of EMU remain necessary, policy makers are wary of how these will impact national sovereignty, making them unlikely to embrace these unless there is strong pressure from either civil society or another round of crisis. Yet growing social unrest is accompanied by ever more citizens calling for a re-nationalisation of European policies. Further integration will likely take time. In addition, the intervention fatigue resulting from the internal crisis fuels a rather defensive attitude towards an increasingly turbulent neighbourhood. **There is no evidence that political leaders will find the strength and drive to see beyond internal worries and engage in global strategic thinking.**

**Yet existential doubts about the EU's added value in facing external challenges will not help** citizens to buy into difficult reforms and further integration; and the relative decrease of EU influence on the global scene is becoming more apparent.

With the rise of new economic powers and the diversification of international players, particularly non-state actors, **centres of decision making are increasingly diverse and competing world-views are materialising.** The emerging powers challenge the liberal order based on Western values and institutions (open markets, social bargains, democraticy, multilateral institutions and cooperative security) and what until the crisis was expected to be a progressive Westernisation of the world trough globalisation. **Europeans have to prepare to engage in an ever more intense competition over values.**

**In addition, this diffusion of power provokes a dilution of international responsibility for global public goods,** such as security, environmental sustainability, trade openness, or macroeconomic and financial stability. Economic empowerment is not directly translated into global political or hard power – in spite of dramatic increases in military expenditure in countries like China and India. The priority of rising economies remains that of fostering their growth model – also affected by the crisis – and to conduct internal reform. China, in particular, is using global governance fora for its own self-interested agenda rather than for ensuring the provision of global public goods. This tendency of the new economic powers to perform as free riders at the global level with yet no clear agenda with regards to global order, coupled with the Obama administration's focus on internal concerns, as well as the relative decline of EU influence on the international scene and the weakening of the multilateral system could lead to **a vacuum in global leadership.**

To regain international influence and have a say in the shaping of the new world order, Europeans have **no other alternative than to focus on their shared interests in the changing world and to translate these into a long term strategy.** Defining this strategy implies looking beyond the conventionally defined and widely debated new centres of powers. For instance there is a tendency to underestimate Europe's interests in Africa. By 2030 Africa will count a population of 1.5 billion and represent, together with China

and India, two thirds of the world's young professionals between 19 and 25 years of age. Europeans could better anticipate the benefits that their geographical position and historical links with Africa could offer – notably by realising the potential of this young labour force for tackling the EU's medium term demographic challenge.

Nevertheless any attempt to define a European global ambition would arguably be too rhetorical to provide a useful basis for the elaboration of a comprehensive European external strategy. **A cautious step is instead that of beginning by an accurate assessment of the main challenges derived from new demographic, economic and geopolitical realities.**

**The 16 European think tanks involved in this project have therefore opted to conduct this assessment *via* the definition of topical strategic approaches:**

- the promotion of EU economic interests abroad,
- a sustainable management of strategic resources,
- a comprehensive migration strategy addressing the EU demographic challenge,
- an innovative neighbourhood policy allowing to regain influence in the region,
- and a more coordinated management of hard security capacities allowing to preserve EU's credibility and influence long term objectives.

These areas of interest underline fields where the external dimension of internal policies should be actively developed in order to reap the benefits of the Single market – an obvious asset for the EU's attractiveness and influence abroad – and where more consistency could be attained between new foreign policies and traditional diplomacy, were the EEAS to succeed in thoroughly exerting its role, recognised by the Court of justice, of ensuring coherence between all aspects of EU external policies.

# 2. EU economic governance: leveraging European interests on the global scene

Whilst crisis management has triggered some important governance reforms in the euro area, **there is no alternative to further economic integration** to face both internal and external European challenges.

## 2.1. Beyond the export contest

The EU has yet to come up with a convincing growth strategy. This firstly requires the accomplishment of internal economic and financial integration and of a coordinated interaction with Europe's major trading partners. Yet the export-oriented policy of some Member States undermines a common EU approach and fails to reap the full benefits of the EU's economic weight, doing little to boost European long run prosperity, productivity and innovation.

- **The implementation of the Single market** – starting with removing remaining barriers to trade in the area of services – remains the main driver to boost internal demand and increase EU competitiveness abroad. Other than being a driver for growth, it could pave the way for a reinforced common external economic strategy and contribute to project European norms globally. *(J. Springford, EPC & R. Youngs, Fride – p. 39)*

## 2.2. Increasing the efficacy of the EU's external economic representation

Achieving a single European voice in monetary, financial and regulatory affairs has become critical. Yet, the fragmentation of the EU's external representation and its failure to influence the global regulatory agenda are striking.

Strengthened regulatory authority and compliance within the EU, coupled with improved information sharing and coordination among all relevant European actors (public and private), would contribute to institutional compatibility and effective communication of agreed EU positions and increase its bargaining power at the global level.

- **Extending the recently established European Supervisory Authorities as institutional platforms to coordinate and represent European**

**views in global financial regulatory negotiations, would constitute a significant improvement.** *(F. Chatzistavrou & D. Katsikas, Eliamep & Y. Tirkides, CCEIA - p. 76)*

In addition, **increasing coordination among Member States for the representation of the euro area within international organisations** requires first and foremost understanding that European Member States are currently overrepresented and that this *status quo* is unlikely to resist indefinitely. The EU should anticipate these evolutions and organise so as to best preserve its power.

- A stepping-stone towards unified external representation would be the **creation of a euro area committee to coordinate voting rights within the IMF**, providing for fewer coalitions and subsequently strengthening the negotiating power of the European bloc. *(D. Schwarzer, SWP & F. Steinberg, Elcano & D. Valiante, CEPS - p. 66)*

## 2.3. Engaging with the US and China

**Fragmentation not only undermines EU action but also affects relations with traditional and new strategic partners**, which are mostly developed through national capitals. Other than the Commission's mandate for the negotiation of market access *vis-à-vis* economics partners, there is little emphasis on trade as a coordinated EU external strategy.

Within the present multipolar setting, more strategic cooperation between the EU and the US is required to create a global level-playing field which promotes Western values in global economic governance and addresses the ever more recurrent abuses of state capitalism (illegal subsidies, forced technology transfers or disrespect of intellectual property rights).

- **A renewed Transatlantic Free Trade Agreement** – removing remaining trade barriers – could increase the EU's GDP by 0.7 per cent per annum and contribute to setting the standard for future trade negotiations with emerging countries.

- More targeted initiatives like the **creation of a Transatlantic Innovation and Research Space and a joint EU-US Research Energy Council**

could help bring new technologies to the market and be a driver of much needed innovation and growth.

- Finally, the EU and the US should engage in **permanent economic dialogue on macroeconomic issues** in order to explore mutual challenges and interdependencies, and strengthen the normative framework for the international economic and monetary system. *(P. Świeboda, demosEUROPA - p. 50)*

**Yet, Europeans also need to find a European way of engaging with the new economic powers in the construction of a new global economic order.** China exerts ever-stronger economic and political power and Europeans must realise that they have interests that cannot be satisfied by the enduring pursuit of 27 diverging policies *vis-à-vis* China. No single Member State can successfully compete with China on a bilateral basis. A more proactive strategy is needed, using both multilateral channels and pragmatic EU-China bilateral alliances. The recent more assertive attitude of the EU (on public procurement, reciprocity and anti-dumping issues) must be reinforced to protect European investments in China, whilst simultaneously pursuing constructive cooperation in areas of shared interests (e.g. potential Chinese investments in the EU's neighbourhood). Europeans would benefit from:

- **more coordination on European sovereign debt bonds purchased by China** (introducing transparency between the Member States would ensure that purchases do not affect policy);

- **as well as the creation of a system of incentives supporting existing Chinese internal demands for liberalisation and pointing at a 'second opening' of the Chinese economy** (efforts to welcome Chinese private enterprises, strengthening Chinese private capital, supporting the development of company ownership, IPOs, intellectual property rights, etc.). *(A. Kratz & J. Parello-Plesner, ECFR - p. 58)*

# 3. EU natural resources: towards sustainable and strategic management

Highly strategic interests, like quality of life and economic competitiveness, would be threatened if climate change and natural resources depletion were to be unsuccessfully managed. Faced with rising powers' increasing consumption of natural resources and ever more assertive resource policies, the EU needs to equip itself with the necessary tools to guarantee its supply of natural resources whilst preserving its sustainability objectives. Yet recent international negotiations have highlighted that in spite of the EU's concrete and commendable efforts, in a time of global economic crisis, the EU's ability to positively influence the international debate on regulation has been drastically reduced. **Sustainable development may well be the field in which external ambition will be most driven by internal achievements.**

## 3.1. Acting at home

Despite the financial and economic crisis slowing down the green transition of European economies, **the EU has little choice but that of leading by example.**

- In the short-term, it is first of all by **focusing on domestic implementation and showcasing the resulting environmental and economic gains of energy efficiency and waste management**, that the EU will advance the sustainable development cause internationally. *(A. Ahtonen & A. Frontini, EPC – p. 93)*

Yet implementation is frustrated by the fact that a key strategic resource, energy, remains of shared competence between the EU and Member States. In the face of threats to EU security and prosperity, driven by increasing EU dependency on energy imports, at the very least **the EU must become more assertive internally by consolidating its common energy market.**

- **The setting of mandatory targets for the Energy Efficiency Directive** would be a step in the right direction. *(A. Ahtonen & A. Frontini, EPC – p. 93)*

- The EU must **define an unambiguous regulatory framework and clarify official EU positions on contested issues such as shale gas and**

**genetically modified organisms**, so as to be able to identify a targeted number of efficiently funded research projects on the one hand, and on the other, provide clear future prospects for investors. *(S. Andoura, Notre Europe – Jacques Delors Institute & C. d'Oultremont, Egmont – p. 102)*

- Where there are striking internal divisions, such as on **Carbon Capture Storage**, the EU would benefit from **being more transparent which would avoid mismanaging expectations both internally and internationally.** *(S. Tindale, CER – p. 130)*

## 3.2. Aligning external action with domestic choices

The EU needs to equip itself with a systematic strategic approach to resource management, consistently identifying existing resources and assessing ways to preserve and develop these according to European needs. Coherence between internal choices and EU external action is to be established in those policy areas where Member States can agree on shared European long-term strategic interests.

- One such case would be **incorporating environmental externalities in the prices of agri-food products whilst standing firm in applying the same internal regulation to external operators active in the Single market**, as well as continuing its efforts to promote internal norms on a global scale. *(N. Chambon, Notre Europe – Jacques Delors Institute – p. 121)*

- In the international context of cut-throat competition, the EU's legal tools are not always the best and sole instruments with which to pursue the EU's interests. The Union must develop a more comprehensive strategy encompassing political, diplomatic, security and economic tools. The creation of a European common market for energy must be complemented externally by a commitment to the **conclusion of unified EU energy partnerships tailored to the diversification of supply and the strengthening of Member States' negotiation power.** *(S. Andoura, Notre Europe – Jacques Delors Institute & C. d'Oultremont, Egmont – p. 102)*

## 3.3. Getting out of the Eurocentric vision

For the sake of coherence between its neighbourhood and energy policies, the EU needs to abandon its euro-centric approach which supports European industries and engineering firms whilst too often neglecting the development of its partners. This does not imply a less zealous pursuit of the EU's interests, much to the contrary. It entails the realisation of genuinely mutually-beneficial projects for the EU and its partners – hence ensuring their long-term sustainability.

- **The Mediterranean Solar Plan provides a good example of the need for the EU to foster the creation of a shared area of prosperity and reinforce its projects' development potential**, providing thus for the region's growing energy demands but also creating new economic opportunities for all partners. *(G. Escribano, Elcano – p. 112)*

**Furthermore, the EU needs to distance itself from overly normative and improbable rhetoric**, if it is to succeed in having international echo, particularly amongst emerging economic powerhouses which exert ever more influence over the resource debate by expressing the concerns of developing countries. The EU must learn to act as a mediator between opposing factions by **developing more pragmatic short-term measures.**

- With regards to the greening of global markets, **the EU could target transparency and fragmentation in global supply chains, resource nationalisation and the creation of credible incentives for resource efficiency.**

- **To engage with other influential powers, it should support both unilaterally and within international trade fora, the Asia Pacific Economic Cooperation's (APEC) efforts towards increasing trade in environmentally friendly goods, as well as all similar initiatives.** *(A. Ahtonen & A. Frontini, EPC – p. 93)*

# 4. EU migration strategy: from zero to positive sum

**Movements of people have been deeply transformed over the past years.** In addition to the constant onset of new conflicts forcing people to flee from their country, booming young labour force in economies with low employment capacity, instability of Mediterranean countries experiencing a political transition, economic turmoil in the euro area periphery and attractiveness of rising economies, are all provoking new movements of people and call for better anticipation of European long run needs. Beyond the development of very negative discourses around immigration and integration induced by rising unemployment, **the need to address the labour force shortage of ageing societies threatening the sustainability of the EU social model, calls for a serious debate and further action regarding the establishment of a more comprehensive EU migration policy.** *(H. Martens, EPC – p. 146)*

## 4.1. Shifting away from a security-driven perspective

A reset of migration rhetoric in positive terms, reconciling domestic labour force needs, security and development, is imperative. **The EU has to depart from its antagonistic security paradigm, driven by Home affairs diplomacy, and develop a constructive comprehensive approach with other EU policies (development, cooperation policies…).**

- **A foreign ministers' approach relying on an increased role of the European External Action Service (EEAS) in migration issues, would be commendable in order to broaden the debate to social, economic and environmental concerns.** *(S. Carrera & L. Den Hertog & J. Parkin, CEPS – p. 152)*

- It would also imply **giving up the principle of conditionality in the ambit of development support, whereby support for development is made conditional upon results obtained in migration control** (readmission and border control). *(R. Gropas, Eliamep – p. 182)*

### 4.2. Engaging in the global war for talent

If the EU chooses to remain a "fortress Europe", reluctant to welcome third country nationals, it will experience a backfiring effect when needing to attract low, middle and highly skilled migrants to fill in labour shortages. Support to legal migration by a comprehensive EU policy allowing Member States to compete in the "global war for talent" is urgently required.

- **It could be developed within the framework of Mobility Partnerships,** where groups of Member States, sharing similar needs for (highly) skilled workers and offering similar working, salary and living conditions, could cooperate more closely to put in place attractive and mutually-reinforcing policies for the recruitment of workers with the right profile. *(T. Maroukis & A. Triandafyllidou, Eliamep – p. 173)*

- To be the most attractive labour market for highly qualified migrants the **EU also needs a more unified labour market** facilitating flexibility in the allocation of workers. It should **improve and develop existing rules on admission of migrants and reinforce the possibility for residing migrant workers to move within the EU for employment purposes.** *(A. Ette & R. Parkes, SWP & A. Sorroza & C. Gonzales Enriquez, Elcano – p. 162)*

- But this process has to be accompanied by enhanced integration policies fostering social inclusion of migrants. **Further information and discussion on best practices of integration need to be developed between Member States.** *(H. Martens, EPC – p. 146)*

## 5. The EU's neighbourhood as an opportunity

**The litmus test for the EU's credibility at the global level is its capacity to manage successfully a neighbourhood that has become ever more challenging** with the perspective of lasting instability following the Arab political transition, the growing regional influence of a more assertive Russian neighbour and the emergence of new actors in the Mediterranean area. Too embedded in a Euro-centric vision and a defensive attitude, the EU has not yet found an adequate response to competing influences in the neighbourhood

(illiberal values, alternative attractive markets on the East, etc.). Unrest in Egypt and Tunisia as well as the Syrian conflict indeed highlight the limits of the fast yet rather formalistic European response to the Arab upraise.

The decreasing appeal of a crisis-ridden EU enjoying lower financial leverage needs to be counterbalanced by profound rethinking of EU strategic relations and priorities beyond the 2011 European Neighbourhood Policy review, allowing to reduce risks of conflict and attracting neighbours to the EU's values and Single market. Instead of fearing to be reduced to a provincial power in the global setup, by focusing on their neighbourhood, Europeans should **view the opportunities that can be seized in a more stabilised and integrated neighbourhood more positively, and prepare a positive agenda to engage the area more decisively.** *(M. Comelli, IAI – p. 197)*

- **A communication produced by the Commission (possibly jointly with the EEAS) would usefully highlight the mandatory formulation of Article 8 TEU on the engagement of the Union in the neighbourhood, and encourage discussion among institutional actors as to what the EU is to achieve through its neighbourhood competence.**

- A strengthened and more coherent ENP could be supported by **the appointment in the next 2014 Commission of a neighbourhood commissioner that is also a deputy to the High representative for foreign affairs and security policy.** *(C. Hillion, SIEPS – p. 204)*

## 5.1. Developing mutual interests beyond conditionality

Pursuing a policy of continuity, the EU has reinforced the principles upon which the ENP has always been based, first amongst which, conditionality. But **the efficacy of the principle of conditionality is ever more problematic**, especially in an era marked by the rise of new donor countries – the so-called new economic powers – with an entirely different approach to conditionality.

- Implementation efforts require **setting political and policy benchmarks with measurable criteria (e.g. very narrowly defined objectives, such as freedom of speech) for a more rigorous allocation or reduction of funding.** *(M. Comelli, IAI – p. 197; L. Najšlová & V. Řiháčková, Europeum &*

*O. Shumylo-Tapiola, Carnegie Europe – p. 225; H. Amirah Fernández, Elcano & T. Behr, Notre Europe – Jacques Delors Institute – p. 215)*

- Beyond that, concrete short-term objectives are urgently needed to react more promptly to the mismatch between on one hand the EU's long-term policies and institutional slowness and on the other hand the fast-paced changes and urgent demands of its neighbours. The EU needs to **support regional stability through innovative incentives more strictly correlated to the pragmatic objectives and interests of neighbours** (e.g. visa liberalisation, trade agreements, etc.). *(M. Comelli, IAI; L. Najšlová & V. Řiháčková, Europeum & O. Shumylo-Tapiola, Carnegie Europe – p. 225; H. Amirah Fernández, Elcano & T. Behr, Notre Europe – Jacques Delors Institute – p. 215)*

- **Deep engagement with civil society via the development of concrete and visible joint policies involving businesses and non-governmental organisations (NGOs)** is mandatory for the EU to understand its partners' expectations and support the voice of actors fostering public interest. In a time of austerity, capitalising on this relatively low-cost yet high value added approach is key for the successful implementation of the EU's goals in the region. *(L. Najšlová & V. Řiháčková, Europeum & O. Shumylo-Tapiola, Carnegie Europe – p. 225; H. Amirah Fernández, Elcano & T. Behr, Notre Europe – Jacques Delors Institute – p. 215)*

- In addition, in the Southern neighbourhood, the EU must **prevent the dangerous segmentation of southern civil society by making a bigger effort in engaging with traditional and faith-based parts of civil society.** The EU could apply its civil society concept more flexibly, developing a greater dialogue with Islamic donors and NGOs along with acknowledging the potential of its counterparts' traditions in promoting pluralism and democracy. *(H. Amirah Fernández, Elcano & T. Behr, Notre Europe – Jacques Delors Institute – p. 215)*

## 5.2. Developing co-management with other regional actors

To manage threats and establish the neighbourhood as a hub for sustainable economic growth, Europeans must manage their trust capital with their

partners. They should develop a more proactive and cooperative engagement with other regional actors, like Russia, Turkey or Qatar, pragmatically combining trade, hard security, migration and development objectives, as well as carrying out joint initiatives with more geographically remote powers such as China. *(A. Balcer, demosEUROPA – p. 236; L. Najšlová & V. Řiháčková, Europeum & O. Shumylo-Tapiola, Carnegie Europe – p. 225)*

- In Turkey, the EU's expertise in civil society engagement can play a substantial role in the consolidation of the country's democratic transition and a stronger Turkish civil society could help reinforce the perception of Turkey as a successful model for the Mediterranean.

- **Europeans should also explore areas where the EU and Turkey have mutual interests** and could develop common projects together with the Arab states (infrastructures, higher education and research, business development, etc.).

- **A progressive opening of the EU-Turkey customs union to other neighbours** could significantly boost intra-regional trade and provide a great example of how the EU could positively impact the region's economic development whilst simultaneously pursuing its own interests. *(A. Balcer, demosEUROPA – p. 236; H. Amirah Fernández, Elcano & T. Behr, Notre Europe – Jacques Delors Institute – p. 215; M. Comelli, IAI – p. 197)*

- In the light of the newly forged customs union between Russia, Belarus and Kazakhstan and its noteworthy potential power of attraction for EU Eastern neighbours, a re-evaluation of EU policies towards the region is also commendable to tackle growing indifference towards EU proposals – and notably towards the Eastern partnership. Yet building trust with Russia is necessary in order to progressively merge EU and Russia's interests in their neighbourhood. **The revamping of the Common Spaces dialogue** (to serve as a forum for constructive exchange between officials and working groups of ministry officials on small-scale projects) **should be accompanied by a strengthened outreach to civil society** (partnerships between municipalities and schools, student exchanges and trilateral projects with East European partners). *(L. Najšlová & V. Řiháčková, Europeum & O. Shumylo-Tapiola, Carnegie Europe – p. 225)*

# 6. EU defence: the capabilities and credibility conundrum

Talks on the Common Security and Defence Policy (CSDP) foreseen in the agenda of the December 2013 European Summit, **re-considering the role military instruments should play in the overall toolbox of EU power resources**, could not be more timely.

The economic crisis has impacted national defence budgets, and cuts in budgets without coordination across Member States are leading to the expansion of capacity gaps at a time when elsewhere, particularly in the rising economies, the main trend outlines a tremendous increase of defence expenditure. The issue at stake is not simply a loss of credibility but of basic security, as neighbours' instability and the instability of our neighbours' neighbours threaten to produce potential spill-over effects on the EU itself. The recent Libyan, Syrian and Malian cases have illustrated the increased willingness of the US to leave Europeans to deal with their own security, whilst underlining the lack of European consensus on the use of robust force. *(D. Keohane, FRIDE – p. 250; J. Techau, Carnegie Europe – p. 267)*

## 6.1. Conducting an EU defence policy review

The possession of a wide diversity of instruments, ranging from civilian tools – diplomatic corps, development and humanitarian projects – to traditional defence activities, has become the hallmark of EU foreign policy and has proven to be effective, for example in the Horn of Africa. Yet the use of defence as a form of statecraft needs to be clarified as there remain a number of potentially important tasks that may require the use of military force, ranging from responding to major humanitarian crises to protecting maritime trade routes.

- **A clear explanation of why Europe needs a military option is imperative and should be conducted *via* a "European defence review"** outlining the Europeans **geo-strategic priorities** (e.g. focusing on the neighbourhood *vs* remaining a security provider in Asia?), **functional shared interests** (e.g. protecting energy supplies, maritime trade routes, etc.), **and existential interests** (e.g. promotion of international law, traditional defence, etc.) as well as the types of operational scenarios EU governments should prepare for. *(N. Witney, ECFR – p. 258; J. Techau, Carnegie Europe – p. 267)*

- **EU governments should also develop defence dialogue and military cooperation with strategic partners like India, Russia, Japan and South Korea**, similar to the ones initiated with Brazil and China – respectively in 2012 and 2013 – **to develop more transparency and mutual trust.** *(D. Keohane, FRIDE – p. 250)*

## 6.2. Grasping the nettle of military capabilities

Going beyond the limited "pooling and sharing" initiatives – mainly in training and equipment – creates sovereignty issues.

- To address the dilemma between watered-down national sovereignty on the one hand and weak European power on the other, governments should **use the full potential of Permanent structure cooperation offered by the Lisbon Treaty, which means not only cooperation but military integration.** *(R. Kempin, SWP – p. 276)*

- The latter could have a real impact, despite reductions in defence expenditure, if **beyond the focus on equipment, duplication of production and procurement were also addressed. The leverage produced would be even more important if further developments in common logistics support systems (transports capacities…) and interoperability were pursued.** *(J.-P. Darnis, IAI – p. 284)*

**Negotiations in this field need to be conducted at the level of chiefs of state and governments** for they do not only determine the EU's agility and autonomy to respond to future crises and challenges by combining diplomatic, development and humanitarian resources, but also ultimately deeply impact Member States' industrial policies, competitiveness and employment.

None of the above can be translated into action **if a more entrepreneurial mindset is not developed** via increased mutual trust and complementarity between Member States, the European Commission and the EEAS. The proposals addressed here by the 16 think tanks therefore pave the way for **a positive agenda of EU external action** allowing for the fostering of trust of both institutional actors as well as citizens, in the EU's capacity to effectively engage with a new global order defined by fast-paced changes and ever more diffuse centres of power and decision making.

# PART 1:
# EU ECONOMIC GOVERNANCE: LEVERAGING EUROPEAN INTERESTS ON THE GLOBAL SCENE

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## SYNTHESIS

### 1. External and internal challenges

For several years now, the European Union has been facing two simultaneous challenges: the first internal, dealing with the crises in the euro area, and the second, interrelated, external challenge, dealing instead with the declining role of the EU in the world economy. Within Europe, the ongoing sovereign debt crisis has put the euro area under strain. In a low-growth-high-unemployment environment, most Member States are implementing substantial structural reforms and budgetary consolidations. At the same time, the euro zone area is creating a banking union, and has made progress with reforms for fiscal and economic governance, but has yet to move towards a meaningful fiscal and political union, which are necessary conditions for the economic and political sustainability of the euro. **Given the urgency for crisis management and the ongoing need to improve banking, economic and fiscal governance structures, political attention has been mostly concentrated on EU internal developments.** This inward orientation urgently needs to be rebalanced in order to tackle the second, interconnected, challenge the EU

faces: **that of maximising its external influence in a rapidly changing world in which Europe is rapidly losing relative power and influence.**

## 2. The decline of the EU's economic influence

**The rise of new players on the world scene, notably China and other emerging countries, is reflected in the evolution of the institutions of global economic governance.** In 2008-2009, the G20 summit took over from the G7/8 as the most important forum for the discussion of global economic and financial developments and potential international coordination efforts. One out of five G20 members is European. In the G8, half of the members were European. Also the EU's presence in the International Monetary Fund (IMF) has been relatively reduced: the European governments had to give up two of their eight seats in the Executive Board. Europe's voice has further been weakened by the fact that several European states have become recipients of IMF aid. **Together, the relative loss of economic weight and the visibly poor performance in terms of growth, debt and banking stability have accelerated the decline of Europe's normative power.** Neither EU countries nor the US are today necessarily considered as 'models' and Western liberal preferences have less weight in shaping the debate on the future organisation of global economic and financial affairs.

One could expect that its weakened role on the global level would have pushed EU Member States closer together in their appearance on the global scene in order to defend joint interests more effectively. For instance, given that the EU is the largest trading block in the world and that trade policy is an area where Europe speaks with a single and powerful voice, one could thus expect an influential role for the EU. **Quite the contrary, the EU is not doing particularly well in handling the external dimension of trade. And the same could be said about economic, financial and monetary issues.**

Moreover, the **fragmentation of its external representation, in particular in macro-economic policy fields, and its troubles influencing the global regulatory agenda and the reform of the international monetary system are striking.** Most problems can be traced back to the unwillingness of some Member States to transfer more power to unified representations in

multilateral institutions or the fragmented ways in which European Member States exercise power when dealing with external partners.

This applies to the EU's attempts to leverage its economic performance abroad and, in particular, to its strategy in dealing with traditional and new partners. New initiatives need to be taken in order to once again move closer to the EU's traditional American partner and promote western values in global economic governance. Europeans also need to find their own way of engaging with the new economic powers in the construction of a new global economic order. The problem is less in itself the rise of new powers like China or India, than it is Europeans' lack of an accurate assessment of new demographic and economic realities at the political level and the absence of a clear understanding of EU interests.

# 3. Ways ahead

## 3.1. The EU's trade strategy: crisis-driven competition versus long term EU competitiveness

Member States pursue commercial diplomacy in a way that is increasingly undermining to a common EU approach. Competition between Member States for market access is rising as they desperately seek sources of growth in exports to make up for slow domestic growth, as consumers are weighed down by debt and governments cut spending. This strategy is unlikely to make Europe richer. Besides moving forward with the banking, the fiscal, the economic and the political union, **the EU has to fuel domestic demand by promoting policies that boost consumption and investment in those Member States** that are not as harshly hit by the debt crisis. **In the long term, Europe has to improve its slow rate of productivity growth. The EU needs new efforts to boost trade among the EU Member States by knitting Europe's markets closer together** and by increasing competition between European firms, especially in services. This is more likely to be successful than current attempts by Member States to try to emulate emerging economies' 'geo-economic' strategies. *(J. Springford, CER & R. Youngs, FRIDE – p. 39)*

## 3.2. Engaging with China

With regard to the BRICs, and especially with regard to China, Europe needs to redefine its strategy in order to ensure that both parties benefit from an increasingly close and diversified relationship. So far, **Europe's approach to the BRICs has been fragmented and essentially based on trade and competition policy.** With China, the EU recently became more assertive, notably on public procurement, reciprocity, and anti-dumping issues. China chose to retaliate, slowing down investment in developed countries where China was not welcome. **The EU needs to clearly define European priorities in the strategic partnership, to match Chinese 'core interests'** and consistent demands on the arms embargo, Market Economy status and the One-China policy. Regarding Chinese bond holdings, foreign country purchases of sovereign debt in Europe should be made public so that opacity cannot be employed to enhance political influence. Joint European messages should be delivered at bilateral visits to ensure that sovereign debt purchases do not affect policy. Europeans should moreover create a system of incentives for co-operating with reformers in China. Thus, the EU could leverage already existing insider demands for liberalisation in order to achieve its economic goals. With regard to rising Chinese FDI in Europe, the EU should make a special effort to welcome Chinese private enterprises, which will also strengthen the position of Chinese private capital at home. But it is essential to ensure reciprocity and the protection of European investments in China. Finally, Europe should encourage a 'second opening' of the Chinese economy, one that increases domestic consumption and acts as a new source for global growth. Company ownership and IPOs, intellectual property rights, the financial and service sectors, and public procurement are all areas of pressing interest for Europe in this context. *(J. Parello-Plesner, ECFR & A. Kratz, ECFR – p. 58)*

Besides China, the EU needs to develop comprehensive strategies to deal with other key emerging powers like India and, particularly with middle powers like Mexico, Brazil, Indonesia, South Africa or – closer to the EU – Turkey: economies that may have an increasing influence in the world over the next decades.

## 3.3. Reinventing the transatlantic economic partnership

The EU should work towards a major initiative to advance the recently launched transatlantic trade and investment agenda. Eliminating tariffs would make companies from the US and the EU more competitive. Removing existing trade barriers could increase the EU's GDP by 0.7% and the US's GDP by 0.3% per annum and promote common standards, especially in trade in services, that could later be adopted by third parties or included in WTO negotiations. On macroeconomic issues, the EU and the US should engage in a regular strategic economic dialogue in order to explore mutual challenges and interdependencies, and coordinate policies more effectively. Other important areas of dialogue include energy and climate change, within the ambit of which the US shale gas and oil revolution has improved the country's position fundamentally. In the field of climate change, research collaboration on major technologies across the energy mix would be a promising perspective. Creating a Transatlantic Innovation and Research Space and a joint EU-US Research Energy Council would greatly help to bring new technologies to the market. Finally, Europe should seek cooperation with the US in its efforts to strengthen the normative framework for the international economic and monetary system. *(P. Świeboda, DemosEUROPA – p. 50)*

## 3.4. A single voice for the euro in monetary, financial, and regulatory affairs

**Europe could increase its influence in global macroeconomic issues if it is capable of creating a single voice for the euro area in global financial and economic affairs in general and in the IMF in particular.** Increasing coordination among Member States for the representation of the euro area within international organisations can be pursued in two ways. The first option would be to simply improve coordination in the use of voting rights currently allocated to euro area members, which are today split in two individual memberships and six different coalitions. This could be done through the creation of a euro area committee. The second option would be the creation of a single chair for euro area countries. Membership would need to be officially handled by an institution that has control on budget and fiscal policies, since the voting rights are immediately linked to the effective quota held within the Fund. This institution could be potentially represented by the European Stability

Mechanism, which may increase its importance in the future economic governance set up of the euro area if it becomes central in the coordination of fiscal policies. An alternative would be a euro area economic government, if the EU was willing to embark on a major treaty change. This option requires a reform, or at the very least a reinterpretation, of IMF Articles of Agreement, since officially only 'countries' can be part of the IMF. The second impediment to such a proposal concerns the re-calculation of the formula. By removing intra-EU flows from the calculation of the quota, the Euro area total quota may fall well below 21%, making the first option more attractive if no major reform of the formula is going to be undertaken in the coming years. However, this option would make more sense (for the benefit of having an integrated framework of external representation) if the IMF was to modify this formula and reduce the weight of euro area countries that are currently overrepresented. *(D. Valiante, CEPS & D. Schwarzer, SWP & F. Steinberg, Elcano – p. 66)*

In the field of financial governance, the EU's current process of internal financial and banking reform should be used to strengthen the EU's voice. The task is to promote a more unified and cohesive external representation of its positions. However, this potential may not be realised unless its design takes into account the institutional characteristics of global financial governance, which is composed of a variety of organisations often transcending the traditional public-private dichotomy. The EU should build on its own experience from international accounting harmonisation by turning its ad hoc governance initiative with the International Accounting Standards Board into a full-blown strategy in all areas of financial regulation. The generalisation of this strategy consists in extending the recently established European Supervisory Authorities (ESAs) as institutional platforms to coordinate and represent European views in global financial regulatory negotiations. More specifically, in order to strengthen the EU's regulatory capacity and ensure its institutional compatibility and complementarity with global financial regulatory fora, the newly established ESAs should act as institutional platforms to coordinate and represent European views in global financial regulatory negotiations. Moreover, it should be ensured that the design of the new European banking supervisory authority takes into account both the dimension of the EU's external representation in global banking regulation as well as the new agency's relation to the European Banking Authority (EBA), thus avoiding further fragmentation in the European financial regulatory landscape. To complement

the ESAs, appropriate governance structures compatible with the global financial regime are needed. *(F. Chatzistavrou, Eliamep & D. Katsikas, Eliamep & Y. Tirkides, CCEIA – p. 76)*

**A well formulated deepening of integration is the only solution to both internal and external European challenges.** The EU needs to solve its internal economic problems (low growth and productivity and incomplete governance of the euro) in order to be able to exercise more influence globally. The internal crisis is an opportunity. The internal changes, required to make the monetary union sustainable and the European economies more competitive, require a higher level of political integration, and further integration in turn could facilitate the construction of a single European voice in foreign economic policy.

# EUROPE'S TRADE STRATEGY: PROMISE OR PERIL?

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## Summary

Europe's growth strategy is based on a larger trade surplus with the rest of the world, to make up for slow domestic growth, as consumers are weighed down by debt. Therefore, Member States have pursued commercial diplomacy, with foreign ministries organising trade fairs, brokering sales of energy, transport, and arms equipment, and in some cases making bilateral trade deals, undercutting EU efforts. Governments are doing everything they can to drum up export growth, especially in emerging economies. This strategy is unlikely to make Europe richer in either the short or the long term. The continent's short-term problem is a lack of domestic demand: overall exports to the rest of the world would have to grow at an unlikely pace to offset it. The continent's long term problem is a slow rate of productivity growth. More competition between Europe's firms is more likely to raise productivity, and with it living standards, than a government-sponsored export drive.

## Introduction

Some Europeans are tempted to shift trade policy away from laissez-faire. As China and other emerging powers seek to lock up foreign trade, investment and resources for their firms, EU Member States are tempted to respond. In straitened circumstances, and desperate for sources of growth, European governments are drumming up exports through commercial diplomacy and by brokering deals, particularly in energy. Member States differ on how far governments should directly try to steer trade strategy; but all have embarked on a more systematic engagement with trade. This is not new policy, but more

countries have been pursuing it, with more vigour, since the onset of the economic crisis.

A more politicised foreign economic policy is not entirely without merit. If EU Member States worked together, they might be able to induce rising powers to rely more on markets, and less on state control.

However, the current tangle of competing 'geo-economic' policies is risky, and ineffective. Fiercer competition between EU Member States does not augur well for the longer term challenge of managing relative decline. Rising powers are proving adept at playing European countries off one another to strengthen their own positions. And most grievously, the EU is ignoring what most matters: the underlying productivity of its economy. Rather than obsessing about exports to the rest of the world, the EU should focus on measures to boost demand and internal trade through the Single market. This, rather than politically motivated trade deals, is the route to improving European living standards.

## 1. The export contest

Germany has taken so-called 'geo-economics' furthest. Chancellor Merkel's trade and investment efforts are increasingly and conspicuously oriented towards China, through a flurry of high-level visits, investment delegations and trade fairs. The German government is agreeing to more foreign arms sales: between 2000 and 2010 the number of export deals approved by the state doubled.[1] Germany has hesitated little in striking out on its own in pursuit of its interests. It negotiated bilaterally with China to agree on standards for electric cars and associated renewables-related trade, undercutting the EU. It also struck bilateral deals with Kazakhstan and Mongolia on access to rare earths in response to China's restrictions on exports, undermining parallel EU efforts.[2]

1. Deutsche Welle, "Arms exports show apparent hypocrisy of German foreign policy", 21 April 2011.
2. Hans Kundnani and Jonas Parello-Plesner, "China and Germany: why the emerging special relationship matters for Europe", *Policy Brief 55*, European Council on Foreign Relations, May 2012.

While Germany attracts most attention, nearly all Member States are moving in a similar direction. Denmark has created a new post, minister for Trade and Investment, in its ministry for Foreign Affairs, charged with helping Danish companies win contracts. The new ministry has developed individual commercial partnerships with each of the Brics countries.[3] The Netherlands is deploying a new commercial diplomacy strategy, of which one part is improved embassy support for businesses.[4] Poland is exploring the 'globalisation of Polish foreign policy', with more emphasis on trade beyond Europe.[5]

The French government has called for a new 'economic patriotism'. Spain has given its embassies a 'specifically economic mandate' and 'Marca España' (the 'Spanish brand') is now the guiding principle of Partido Popular's foreign policy. Spain won train contracts in Saudi Arabia and Kazakhstan, which the Spanish king lobbied for; the latter contract is worth €1 billion over 15 years. Even the free trading UK has launched an overtly commercial foreign policy. Foreign secretary William Hague has restructured the Foreign ministry around trade. David Cameron has instructed ambassadors around the world to report back on what they have done to back British business. The prime minister led the UK's biggest ever trade delegation to India; follow-up trips by Indian ministers secured the two countries' biggest ever joint investment packages, worth more than €5 billion. The UK now strives to be 'the Gulf's commercial partner of choice': a network of new bilateral accords has been constructed across the region to back British businesses in beating the competition to contracts.[6]

Member States have pursued economic diplomacy in different forms. German state bodies plan a broad-based mercantilist strategy to boost the exports of its Mittelstand. The French government favours a narrower diplomatic backing of national champions to secure contracts in global markets. The UK, Netherlands and Nordic countries have become keen to actively promote exports, but are more reluctant for the state to cut overtly across multilateral rules.[7]

3. Claus Grube, "The international situation and Danish foreign policy in 2011", in: Danish Institute for International Studies, *Danish foreign policy yearbook*, 2012, p. 24.
4. Huub Ruël and Lennart Zuidema, "The effectiveness of commercial diplomacy: a survey among Dutch embassies and consulates", *Clingendael Discussion Paper No. 123*, March 2012.
5. DemosEUROPA conference, "Poland and the world in 2030", 2012.
6. Lord Howell, Foreign Office Minister, "UK relations with the GCC region: a broadening partnership", Speech, GCC and the City conference, 20 June 2012.
7. Maaike Okano-Heijmans, "Power shift: economic realism and economic diplomacy on the rise", in: E. Fels et al (eds), *Power in the 21st century*, 2012.

The Commission has become increasingly concerned about Member States bending rules to support national champions in their global export drives.[8] While the Lisbon Treaty enshrines a commitment to wrap bilateral investment treaties into single EU deals, in practice the scramble for exports has tipped the scales even more towards bilateralism and away from common EU approaches. Competition is increasing between Member States for commercial access to emerging markets. This has not been accompanied by co-ordination measures at the EU level. Support for common EU mechanisms on seeking debt purchases or investment contracts has not been forthcoming. There has also been debate in Brussels and Frankfurt about market intervention to lower the value of the euro as a means of boosting exports, in a mercantile strategy for recovery.

This uncoordinated export contest will do little to boost European prosperity in the short run. Europe's growth strategy is unduly reliant upon export growth, rather than building domestic demand. The euro area is being reformed in Germany's image: an economy dependent on exports, with very low growth in domestic consumption and investment. But emerging economies will not be willing to buy more from Europe than they sell back, as their growth strategies are also founded on exports. Moreover, not all European countries can specialise, as Germany does, in machine tools, chemicals and infrastructure equipment that emerging economies need to build industrial capacity. The US is increasingly annoyed with the Europeans for piggybacking on American demand, rather than raising levels of consumption and investment at home.

For European countries to grow in the short term, they must restore domestic demand. But there has been no attempt at symmetrical adjustment to the debt crisis. The periphery of the euro area must grow to pay down its debts. The core could help if it stopped saving so much (the inevitable consequence of a very large trade surplus) and boosted consumption and investment. Higher demand in the euro area would help the continent to grow.

To succeed in the long term, Europe must raise the rate of productivity growth. While the Commission and several Member States have introduced initiatives

8. Alex Nourry and Nelson Jung, "Protectionism in the age of austerity – a further leveling of the playing field?", *Competition Policy International*, Volume 8, Number 1, Spring 2012.

aimed at meeting this challenge, foreign economic policy pulls in the opposite direction. The unseemly scrabble for contracts to build Indian nuclear power stations or to sew up energy deals with Russia will do very little for domestic firms' rate of productivity growth, or for their innovative capacity. Europe's current trade strategy is mostly an exercise in states competing to select which European firms will export, rather than trying to make them become more productive companies. Long-term growth is founded upon productivity growth, not how many exports a country sells. Why else would the United States be the richest large economy in the world, but export far less than Europe? To boost living standards, Europe would do well to concentrate more on raising the level of trade between its members than increasing the volume of exports with the rest of the world. Such a strategy would deal with two unalterable facts about international trade: emerging economies are slowly producing higher quality goods and services; and to increase productivity and innovation in manufacturing and services – and thus maintain its position at the top of the value chain – Europe needs a good deal more competition between its firms.

Europe's foray into geo-economics involves a risk: it appears to neglect an understanding of the conditions that really drive growth.

## 2. External trade and the Single market

For decades before the 2008 crash, international trade grew much faster than the global economy as a whole. Trade slumped in 2009, but since 2010, this trend has reappeared. How can trade be growing faster than GDP? The answer lies in the growth of cross-border production: multinational corporations increasingly use international supply chains, so exports and imports grow faster than the economy. Container ship technology made international freight transport cheaper and faster. Governments reduced tariffs and subsidies that held back trade. The iPhone is designed in the US, while its chips are made in South Korea, and it is assembled in China.

Two forms of specialisation underlie globalisation. The EU should take them into account when considering forays into geo-economic strategy. First, different countries specialise in production at different levels of quality and

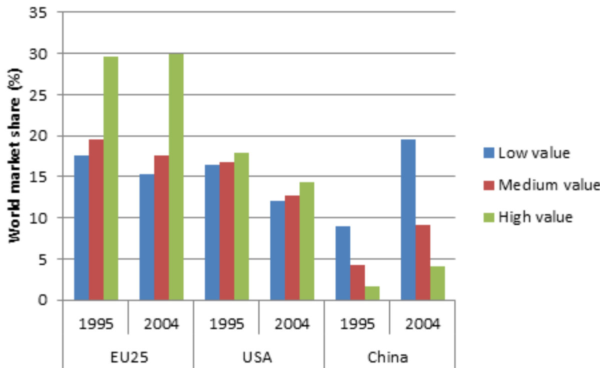
technological complexity, depending on the cost of land, labour and capital. In short, countries specialise in luxury or low-cost goods and services.

The trend towards specialisation by production value is long-standing. In the 1950s and 1960s, South Korea made lower 'value added' goods – textiles, steel and shipping – at scale, in vast quantities, for international markets. It had abundant cheap labour, and the government steered capital investment towards exports. South Korea specialised in goods where small margins on each unit turned into large profits when sold to millions of industrial and household consumers across the globe. China, Russia and then Brazil have since pursued the same strategy in their own way, specialising in manufacturing, energy; and agricultural and mineral commodities respectively.

To leaders in the developed world, this is double edged. Cheap goods from developing countries improve consumers' purchasing power, allowing them to buy more goods and services overall. Yet the world's markets in tradable goods are bifurcating: the developed world is losing unskilled and semi-skilled manufacturing work to the poorer, but fast growing countries. Global production is increasingly based upon factor costs: keeping high cost work with high margins in rich countries, and moving lower value added production to China and other developing countries.

This process is happening very quickly. Between 1995 and 2004, China's world market share in low and medium value goods doubled, while the American and European share shrank (see Figure 1). In the low value goods trade, Chinese companies took market share at a rate of 0.9 per cent a year. And it has plans to move into higher value goods, just as Japan has, followed by South Korea, Singapore and the other Asian 'tigers'.

### Figure 1. Market shares in goods, by value




Source: European Commission, DG Trade, Global Europe: EU performance in the global economy, October 2008, p. 16.

However, European leaders should not fear this global division of labour. This is how the gains from trade are realised. The theory of comparative advantage holds that even if Germany is better at making low value added goods than China, it should still specialise in higher value added goods because it will make more money by doing so. There are losers in the process – namely, the poorly skilled – but this is better tackled by investment in education and by redistributive policies than by protecting domestic firms, which pushes up prices for all domestic consumers, including the poor.

The second form of specialisation is more local. Firms and workers making similar products clump together in clusters, such as biotechnology in Boston and finance in the City of London. Within countries, local communities of expertise are formed. Workers with specialist skills will move to an area where job opportunities are plentiful, encouraging firms that can use their skills to group together. Financiers specialising in particular sectors will do the same, hence the number of venture capital firms in Silicon Valley. Companies in sectors based upon scientific research, such as biotechnology, tend to cluster around universities. Nearby firms can also more easily learn from each other, borrowing innovations and headhunting innovators. And different companies in the same supply chain – accounting firms, business consultants and multinational

company headquarters, for example – reduce their transport costs if they are near each other.

As transport costs have fallen and international supply chains and markets have grown, local clusters are needed to keep a competitive edge in high value international markets. The US leads the world in information and mobile technology and applied science because of its clusters in Silicon Valley and around its world-beating universities. Germany's Rhineland manufacturing cluster is the main reason for the EU's very large trade surplus in manufactured goods: its medium and high technology cars, household durables and machine tools are of the best quality.

The EU has some significant strengths – and some big challenges to overcome – when these trends in international trade are taken into account. As China specialises in lower – and increasingly medium – value-added production, Europe has to focus on higher-value added work. The question is: how should the EU respond?

The EU's Member States are still the biggest traders with the rest of the world – larger than the US. It has a strong position in high value added production, especially in pharmaceuticals, manufacturing, fashion, financial services, arms and aerospace. However, it could do better.

The EU should cultivate competition at home. Competition, among other things, drives productivity growth: when a company's profits are under threat from a more efficient competitor, it has a greater incentive to try to improve productivity. Competition also encourages more innovation. In competitive markets, consumers will quickly switch to companies that provide better quality products, or new products that satisfy an urge or an appetite, and even create new consumer tastes (mobile devices have satisfied an unrealised consumer desire for incessant communication in different formats, for example). If the EU could raise the level of competition its companies face, they would become more productive and innovative.

The obvious tool to raise the level of competition is the Single market. On average, trade between the American states is four times higher than it is between

EU Member States.[9] This puts American companies under far greater competitive pressure: if a firm in New Hampshire has to compete with Californian firms – or those based in all 50 states – rather than those based in its own state, it must spend more resources on improving the efficiency of the production process and the quality of its products to survive. A more integrated market, with more common regulation and more mutual recognition, would raise competition between firms across the EU.

More integrated markets across the EU would also encourage firms specialising in particular industries to group together. There are still large barriers that firms – and indeed, workers – must hurdle to move from one Member State to another.[10] The US also has far larger clusters of companies taking advantage of pools of skilled labour, learning from each other, and taking advantage of university-led innovation. This shows up in the proportion of workers employed in clusters: approximately 60% of US employees work in industries with firms that are more clustered together in America than in Europe, compared to around a quarter of European workers employed in more clustered industries than in the US.[11] Lacking such geographic concentration, European firms do not take as much advantage of lower transport costs and specialist pools of labour, and all firms in the market do not take up new innovations as quickly.

European leaders would boost firms' performance by knitting Europe's markets more closely together. Policies they could deploy to do so include:

- Meaningful recognition of other Member States' qualifications, and reductions in the number of regulated professions;

- Recognition by Member States of each other's regulations, especially in the service economy;

- A tougher competition authority;

9. Consuelo Pacchioli, "Is the EU internal market suffering from an integration deficit? Estimating the 'home-bias effect'", *Working Document*, Centre for European Policy Studies, May 2011.
10. John Springford, "How to build European services markets?", Centre for European Reform, September 2012 for barriers in the services sector, many of which are also prevalent in the goods sector.
11. Christian Ketels *et al.*, "EU vs US: A comparative analysis of geographical concentration patterns of employment across cluster categories", Swedish Network for European Studies in Economics and Business, May 2008.

- A fully integrated energy system, regulated at the EU level, which would drive down energy costs;

- Policies to promote non-bank forms of finance: especially bond and equity markets for smaller European companies;

- A common corporate tax policy.

As a trade strategy, this is far more likely to be successful than trying to copy emerging economy 'geo-economic' strategy. If countries lock up commodities and agricultural products for themselves, rather than relying on market mechanisms, productivity in raw materials and farming will fall, and prices will rise. Developing economies may benefit from a fair amount of state control of investment to develop their heavy industry and manufacturing sectors. But developing economies have many more unused resources than rich countries, and so the state is more likely to pick winners than it would in an economy where resources are already largely employed and where productivity improvements are found by taking existing labour or capital equipment and deploying it more effectively in another way. In mature economies, productivity and innovation across the entire economy determine economic growth. Better productivity and innovation may mean that Europe exports more high value added goods and services. Or maybe not: more productive Europeans would have higher wages, and might decide to buy more expensive products themselves, rather than selling them overseas.

Many prominent writers have argued that Europe needs to devise a more ruthless strategy in pursuit of geo-economic interest as the core determinant of the continent's future prosperity.[12] It has become commonplace for analysts to argue that the EU needs to start meeting rising powers on their own terms. While it is convincing to urge the EU and its Member States to get more serious about developing foreign economic policy, the geo-economic route is not the panacea it has become widely assumed to be. To succeed, Europe needs most of all to tend its own garden.

12. Stephen King, *Losing control: the emerging threats to Western prosperity*, Yale University Press, 2011; Dambisa Moyo, *How the west was lost*, Penguin, 2012; Parag Khanna, "Europe needs a truly global action plan for 2020", in: Jan Techau (ed), *Strategic Europe*, Carnegie Endowment for International Peace, 2012.

## 3. Main recommendation

By conducting bilateral trade deals and commercial diplomacy, and brokering export sales, European governments hope that state action can drive up export sales. This strategy is wrong-headed: these deals undercut EU trade efforts, and are unlikely to significantly raise European exports as a whole.

Instead, **the EU should focus on boosting trade between its Member States, which will help to raise the continent's low rate of productivity growth – the key to long term prosperity.**

# TOWARDS A TRANSATLANTIC MARKET

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## Summary

A new transatlantic momentum has been set in motion by the economic crisis. Both the US and the EU need every impulse for growth they can find. Their effort can also help to create a single global market based on regulatory convergence, equality of rights and responsibilities, and a level-playing field. The success of TAFTA, the new trade and investment agreement which is being launched, is necessary if the US and the EU want to take advantage of their predominant role in the international economic system. In parallel, the EU and the US need to better understand each other's macroeconomic policies with a view to improved coordination which is required by their structural interdependence. Finally, the jury is still out on whether the EU and the US can come to a joint understanding on issues of energy and climate change. Research collaboration on new technologies can help to bridge the existing policy gap.

## Introduction

The transatlantic economic agenda has been shaped in recent years by the economic crisis and the interaction of different strategies pursued by the US and the EU in an effort to overcome it. Much of the debate has addressed the main sources of instability, particularly in the context of the euro area crisis. There is now an opportunity to break through the growing wall of distrust with a major initiative to advance the transatlantic trade and investment agenda.

That project has been on the back burner in recent years for a number of reasons. Efforts to revive the Doha round of multilateral trade talks played a role in the early period. A potential global agreement was prioritised to bilateral arrangements. The EU was closely attached to the objective of effective

multilateralism. In the meantime, however, the balance of power in the WTO tilted towards smaller and less developed countries, making any breakthrough agreement difficult. Conclusions had to be drawn. As a result, in recent years the EU has focused on bilateral trade agreements with other partners such as South Korea, India, Singapore and Canada, while the Obama administration has been on the defensive in its trade policy, continuing earlier initiatives without floating new ones.

## 1. Getting the most out of the crisis

Economic slowdown has helped refocus attention on the benefits of a new transatlantic trade and investment agreement. Michael Froman, a senior official in the White House, has spoken of the need to have it completed 'on one tank of gas'. At least part of the reason is that exports have been a powerful driver of growth in the US economy. They account for almost half of US growth in during the recovery period, much more than the average 12% in previous economic cycles. The Brookings' 'Export Nation 2012' report found that manufacturing was responsible for three-quarters of additional sales abroad between 2009 and 2010. Last year, the EU imported a massive US$ 243.5 billion in US goods.[1]

In spite of the crisis, Europe provides a more attractive type of demand than emerging economies, whose growing middle classes will continue to want basic consumer goods throughout the next decade. The EU and the US remain each other's most important trade and investment partners. Over US$600 billion is traded between the EU and the US each year – about one-third of global trade – while US$1.9 trillion is invested by the US in the EU and US$1.5 trillion by the EU in the US (2010 figures).

The American government has moved to assertively promote American exporters' prospects. US ambassadors around the world have been instructed to shift their focus to economic statecraft. Trade policy, however, has remained fairly static. No new initiative was launched during President Obama's first term in office. He has had to renegotiate deals with South Korea, Panama and

1. US Census Bureau figure.

Columbia, agreed under George W. Bush, in order to appease the auto industry and labour unions. The Transpacific Partnership, Washington's flagship project, has absorbed US policymakers but is not near completion. The domestic political consensus has become anti-trade.

## 2. The promise of a Transatlantic Free Trade Area (TAFTA)

This means that an agreement with the EU could be an opportunity for President Obama to kick-start his trade policy as debate in the US cools down, not only with the end of the electoral season but also with China's shrinking current account surplus and independent analysis of the undervaluation of the renminbi. The latter showed that the beast is not as ugly as it has often been portrayed. Political frictions will continue and Obama is not likely to be granted the fast-track Trade Promotion Authority from the Congress which Mr Romney would have won. However, the Republican-dominated House will be easier for Mr Obama to deal with given the suspicions on trade issues among the Democrats.

In Europe, just as 2012 was a year of stabilisation, 2013 will be about an intensive search for new sources of growth. The potential deal with the US features highly on that list. There is no reason to doubt EU leaders' commitment. Chancellor Merkel made it the cornerstone of her 2007 EU presidency. That attempt faltered as the crisis unfolded but the determination remains strong. In the meantime, the EU has had a very good run on trade policy. Even though it is a complex and slow-moving organisation, it has concluded a free trade agreement with South Korea and got it ratified faster than the US has been able to proceed with a similar package. It has also sealed a deal with Singapore and is close to the final accords in talks with Canada. It is the latter which clearly has a lot of impact on the thinking of US policymakers. The North American Free Trade Agreement (NAFTA) has shaped the American economy more than any other external factor. Canada is now one of the top destinations for US exports. If the EU concludes a free trade agreement with Canada, it will have landed in Washington's backyard.

The EU has traditionally been in a better position when it comes to its trade balance: it stood at a surplus of nearly US$100 billion in 2011. The surplus fell

with the onset of the economic crisis in 2007-2008 but has grown again since 2010. Foreign Direct Investment (FDI) flows from the EU to China are consistently growing but, at €75 billion, are nowhere near the level of European investment in the United States. The scale of that transatlantic relationship dwarfs any other in the world. The EU imports three times more goods from the US (US$286.1 billion in 2011) than China but exports twice as much as it does to China (US$368 billion in 2011). It is also a balanced relationship in which the US runs a deficit in goods, a surplus in services and FDI flows are similar in size. About 15 million jobs have been created as a result, on both sides of the Atlantic.

Mutual benefits from a new comprehensive trade agreement are clear. The US Chamber of Commerce estimates that lowering remaining tariffs on goods from the current level of 5-7% to zero would increase transatlantic trade by more than US$120 billion within five years with a related increase in GDP of about US$180 billion. Eliminating tariffs would make US and EU companies more competitive, especially as more than one third of them are affiliates of the same companies. Removing regulatory barriers would also offer substantial gains, increasing EU GDP by 0.7% and US GDP by 0.3%, according to a study by ECORYS commissioned by the European Commission. Where Europe is concerned, the transatlantic deal could lead to the introduction of more flexibility into economic, investment and labour policies on the continent, helping the process of structural change.

Mutual sensitivities over issues such as EU restrictions on genetically modified organisms or US laws on airline ownership remain. They have sunk past attempts at free trade deals while new disagreements have emerged in areas such as internet privacy. Not everyone will be happy. The National Pork Producers' Council, for one, has already written to the US trade representative to express concern. The negotiations will be arduous and the list of issues to be covered is enormous, from service liberalisation and regulatory differences, to intellectual property and public procurement. Some early decisions will be of systemic importance. They include the choice of whether harmonisation or mutual recognition should be pursued in the regulatory context.

The prospects for the EU-US trade deal will benefit from the fact that both economies are relatively aligned on social, labour and environmental

standards, especially compared to other bilateral relationships. In the US, in an unprecedented move, trade unions and the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) have come out in favour of the talks being launched. American people support closer trade ties with Europe – 58% have backed the idea (28% were against) in a 2010 Pew opinion poll. The deal may help demystify trade in the US domestic debate. It could also be an opportunity for President Obama to improve his relationship with businesses.

It remains to be confirmed within the political context whether negotiations should be comprehensive in character, spanning all policy areas or selective, hoping to generate momentum on a case-by-case basis. The former would be far more ambitious. It would, however, make the whole exercise vulnerable to single issues or interest groups, thus slowing the momentum of the process. Apart from being mutually beneficial, the EU-US trade agreement would have the added advantage of setting the standard for future trade negotiations with emerging countries on regulation, tariffs and investment rules.

## 3. Strategising economic dialogue

Apart from pursuing an aggressive trade and investment agenda, the transatlantic relationship will need to extricate itself from the fallout of the financial and economic crisis. The latter increased EU-US tensions after an initial period of smooth cooperation. In late 2012 and early 2013, governance in the EU and US converged with crisis legitimacy playing a big role on both sides of the Atlantic and brinkmanship being practiced with growing ease. As Thomas Kleine-Brockhoff has rightly observed, the US has europeanised its crisis response through the recourse to cliffs and deadlines and not seeking a comprehensive solution.

This may make it more likely for the EU and the US to agree to a regular strategic economic dialogue in order to better understand each other's perspectives on mutual challenges and more effectively coordinate macroeconomic policies. Such a dialogue is necessitated by the structural interdependence of the transatlantic economy, where sovereign debt issues or current account imbalances create problems which rapidly spread to the other side of the Atlantic. Annual

strategic economic dialogue could involve officials from the Federal Reserve, the ECB, the US Treasury, finance ministers from European Union Member States and relevant officials from the European Union. A regular peer review could be conducted of economic assumptions on both sides of the Atlantic, structural impediments to growth, policy goals and actions. It would also facilitate eventual transatlantic market integration.

## 4. Bridging the gap on energy and climate change

Some sectoral challenges have grown to become agenda items in their own right. Other important areas of dialogue include energy and climate change, as the US shale gas and oil revolution has changed the country's position entirely. The US is not far from becoming self-sufficient when it comes to its energy needs. It is likely to become an exporter of liquefied natural gas (LNG) which recent NERA studies have shown makes economic sense. Furthermore, the US is expected to become the world's largest producer of oil and LNG. The EU is nowhere near improving its energy position in similar terms, having pinned its hopes on the growth of the renewables' sector where no revolution comparable to that of shale gas has been forthcoming. However, the EU has benefited from developments in the US which have had a powerful impact on the world gas prices. That process is expected to continue if the US begins exporting LNG.

The second term of President Obama holds the promise of a renewed effort at EU-US consensus on climate change. The EU has remained faithful to its emissions trading scheme, even though the jury is still out as to whether appropriate carbon pricing in fact influences investor decisions. The US is unlikely to adopt cap-and-trade legislation and will rely on tax incentives and regulatory changes implemented by the Environmental Protection Agency. However, largely as a result of its switch to gas, the US achieved a 9% reduction in emissions between 2007 and 2011 – more than the EU recorded in the same period. One potentially rewarding approach focuses on research collaboration in major technologies across the energy mix. Creating a Transatlantic Innovation and Research Space and a joint EU-US Research Council with programmes in the field of energy would greatly help to bring new technologies to the market.

## 5. Towards a world of norms

The final issue of enormous significance for the future world order, including the role played by the transatlantic relationship, has to do with efforts to strengthen the normative framework for the international economic system. The closer the transatlantic community stays together on these issues, the more likely emerging powers will feel inclined to become responsible stakeholders in the system.

The flip side of the coin must be a level playing field. Assurances are necessary that in a more competitive environment countries will play by the rules and not attempt to bend them to their advantage. The multilateral process has been focused on the removal of tariff barriers to trade and it has not found sufficiently workable means to address non-tariff barriers, including protectionist regulations, mandatory technology transfers, sub-market subsidies or unfair joint venture requirements. International institutions and processes are currently not in a position to address these new types of barriers. In parallel, state capitalism is bearing heavily on the global playing field, given the advantages that state-owned and state-controlled enterprises tend to enjoy, including preferential funding arrangements and protection from competition.

Both the US and the EU are becoming increasingly active in fighting such abuses, whether in the form of illegal subsidies, forced technology transfers or violations of intellectual property rights. The level of their commitment to that process will become a crucial litmus test of their ability to work together in the multipolar world. Both the EU and the United States will need to actively elaborate policies to address these issues, examining the way in which the OECD-inspired principle of 'competitive neutrality' can be made operational in the international environment. From a wider international perspective, the single transatlantic rule book will be a manifesto of faith in the liberal economic order.

## 6. Recommendations – The best opportunity in a decade for the transatlantic economic project

Parallels to an 'economic NATO' have been drawn to reflect both the depth of a potential new transatlantic agreement which is expected to cover comprehensively trade in goods, services, investment and agriculture, and the powerful impact it would have on the outside world. The dynamic is indeed growing but it will require a lot of perseverance. The EU and the US have been down this path before. This time must be different.

Momentum should be built by seeking early agreement on the least sensitive part of the agenda while identifying, right from the start, elements which will require bigger bargaining within the most important dossiers. **The current agreement needs to be comprehensive in nature if it is to have a ground-breaking character**. Parties will have to move away from their pre-determined positions in order for a compromise to be found. This can be helped by engaging the opinion of independent experts and opening up extensive public debate on the substance of the agreement throughout the process of negotiation.

# HOW CAN THE EU PROMOTE ITS ECONOMIC INTERESTS WITH CHINA?

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## Summary

There are many areas in which the EU tries and wishes to promote its interests with a rising and increasingly powerful China. In the diplomatic field, for example, the EU has tried to include China on a number of fronts, with various degrees of success. Among these efforts are the EU's attempt to involve China further in the resolution of the Syrian conflict, or the EU's push for a firmer attitude from China on nuclear anti-proliferation, especially with regards to Iran and North Korea.

Nevertheless, as China and the EU grow increasingly dependent economically, economic interests have taken the lead, and are now central to EU action. At a time of economic hardship, especially in Europe, economic and financial issues matter more than ever, and Europe needs to redefine its strategy in order to promote its interests with China and ensure that both parties benefit from an increasingly close and diversified relationship.

## 1. The EU and China: Two mutually dependent economic partners

The EU and China's economies are closely associated, and economic ties between the two partners have grown tighter over the past few years. In 2011, Europe was China's main trade partner, and China was the EU's second trade

partner after the US. That same year, Europe was the second largest foreign investor in China after the US (excluding Hong Kong). Although the share of EU investments in total FDI towards China declined in 2012, due notably to the EU's debt crisis, the volumes of these investments remained significant. Moreover, China has rapidly increased its investments in the EU, and the EU has become, along with North America, one of the two main destinations for Chinese investments, globally speaking. Lastly, the two economies are linked in many other ways: for example, up to 25% of China's reserves are believed to be invested in EU bonds,[1] China's exchange rates are a decisive factor in EU competitiveness, and China's economic rise has sped up climate change – the country's carbon emissions were the highest in the world in 2012 – and brought China to the environmental discussion table.

The EU-Chinese economic relationship is also slowly evolving. From a somehow complementary relationship – where China manufactured low value-added products, and the EU high value-added and technological goods – the two powers have moved towards a more economically competitive position. In fact, although relative trade links between the two partners have evolved in favour of the EU[2] over the past five years, "the future looks less positive",[3] as Europe is quickly losing its competitiveness. "Between 2000 and 2010, the complementary index for European exports and Chinese exports has dropped by 20 percent", which means that today, the EU is in direct competition with China concerning 35% of 5,775 types of goods traded, compared to 15% in 2000.[4] China is gaining competitiveness. Chinese companies have developed expertise in the production of higher value products such as household durables, high-tech components, and other technological products. This is an important issue for the EU, which so far retained a certain technological edge over China in many of those sectors (automobiles, aeronautics, chemicals, etc.). The EU and China may also increasingly compete in other economic areas – for resources, for

1. There is no way to know exactly how much of China's foreign reserves are invested in EU bonds, as neither China nor the EU keep an accurate and precise geographical account of those investments. Therefore, this number can only be taken as a rough estimation.
2. The EU's trade deficit with China decreased for the first time in 2011, and did again in 2012, while EU exports to China have increased steadily since 2007. As Jonathan Holslag (2011) explains, this has played in Europe's favour because the ratio of EU-to-China trade deficit over EU-China overall trade has decreased from 43% to 29%. This means that while EU exports to China have grown by 80% over the period, China's exports to the EU have 'only' grown by 29%. A UBS note relays this statement: "China-to-EU export growth has dramatically slowed since early 2012, indicating a rebalancing in the two partners' trade relations". T. Wang, H. Hu and D. Weng, "China Economic Comment: The Good Old Exports and Credit", *UBS Investment Research*, 15 October 2012.
3. Jonathan Holslag, "Assessing Sino-European Trade Relations", Discussion note prepared for ISS Seminar, Paris, October 2012.
4. *Ibid.*

example. China's economic development will quickly increase its demand for energy and commodities, and the country will become a crucial participant in climate change talks.

Finally, since the start of the EU crisis, in the context of those increasing trade and investment ties, EU countries have been looking to China for financing and support. But China's contribution to solving the euro area crisis through bond purchases from indebted countries is believed to have been limited and not exactly game changing. At best, China has maintained its holdings in euros as a proportion of its total reserves, which induces a small increase in volume, but much less than was probably hoped for by some European countries. China did, nevertheless, participate indirectly to EU bailouts through its contribution to the IMF. Nonetheless, this emerging economic interdependence, whereby indebted developed countries turn to cash-rich China for financing, might induce a new dynamic for Sino-European relations, as the creation by China of a Central and Eastern European secretariat offering a package of soft loans for infrastructure and other deals can attest.

This context explains why economic interests and issues have come to the fore between China and the EU, and why the EU needs to deploy a coherent strategy to promote its economic interests with the world's second largest economy.

## 2. The EU needs to promote its economic interests with China as the relationship develops

Until recently, the EU's common economic interests with China derived mainly from trade relations. Godement explains that so far, "the European debate was polarised by the issues of anti-dumping and China's demand for a Market Economy Status".[5] Thus, the EU's strategy to promote its economic interests with China was limited, mostly based on competition policy, and relied mainly on the EU's Directorate-General (DG) for trade and the WTO.

Nevertheless, now that EU-Chinese economic relations have taken a more diversified and intertwined turn, the interests at stake for the EU are themselves

5. François Godement, Jonas Parello-Plesner, Alice Richard, "The Scramble for Europe", *Brief 37*, ECFR, July 2011.

diversifying, and increasing. China's development means that Chinese companies now compete with EU companies on many more levels, including technology, investment, bids and public procurement. On those markets, China's unique economic system creates challenges for EU countries. Today, about 30% of the Chinese economy is public, but in fact, public influence runs much further than pure ownership. The Chinese government can influence and promote domestic companies through indirect ownership, policies, and financing schemes. This creates unfair competition for EU companies, which, although subsidised in a number of ways, do not receive significant and organised financial and policy support for their activities abroad, as do Chinese companies.

Besides, China's growing economy has altered the balance of power between the two partners. Firstly, China's development has diminished EU leverage on Chinese policymakers. Secondly, China's significant trade surplus, with the EU and the US notably, has led the country to accumulate huge foreign reserves – $3.2 trillion as of 2012 – granting the country significant financial power, especially in relation to the distressed economies of certain EU Member States and developing countries. Lastly, the EU crisis has diminished the continent's economic influence, as well as its political coherence. The crisis has limited cooperation between EU members on certain important international matters, and made it harder for the EU as a whole to promote its interests.

In sum, China's growing economic power and the multiplying areas of interaction and competition between the two partners have meant that EU economic interests are increasingly linked to China. Thus, the EU needs to set up a clear strategy to make sure those interests are preserved and promoted.

As a first response to this pressing necessity, the EU has recently toughened its economic stance towards China. The EU's DG for Trade, led by Commissioner Karel de Gucht, has launched a series of realistic challenges to certain aspects of China's economic policy which affect matters of essential importance to the EU, such as the negotiation of a bilateral (EU-China) treaty on investments, demands for public procurement reciprocity measures with EU trade partners (not only China), and stepping up anti-dumping and anti-subsidy filings where the largest pending case is on solar panels.

These recent actions taken by the EU, though highly necessary, have greatly complicated Sino-EU relations, and caused China to retaliate. Notably, China has promised to set up a new public department to handle the country's international economic relations, and to develop its economic diplomacy. The country "intends to continue flexing its economic muscles to pursue its international goals".[6] The China Investment Corporation (CIC) also announced that it would slow its investments in developed countries where China was not welcome. While this is a direct reaction to the governments of developed countries and institutions questioning the nature and content of Chinese investments, as well as their real contribution to these economies, a decline in Chinese investments in Europe – at a time when global FDI is slowing – may not be good news for the EU.

## 3. National vs. EU-wide strategy

As it stands, EU Member State strategies towards China are quite diverse, due to differing national circumstances and interests vis-à-vis China. EU Member States present very different economic models that make them more or less dependent on China than other EU countries. Some are highly export oriented, like Germany, and need international market access for their products. Some are much more EU oriented: while they do export goods, they are highly specialised in supplying the EU market. Thus, different incentives exist among EU countries that cause their individual relationships with China to differ from those of other countries.

Lastly, EU Member States have very diverse economies: some are less affected by the EU crisis – so far at least – and display better growth figures and trade strength. But others, notably Southern European economies, are highly distressed and lack financial resources, which China could provide. This puts them in a difficult position and can create a biased relationship with China, potentially making them renounce on EU priorities due to their need for Chinese capital.

6. Li Jing, "China sets up new department to flex economic muscles for global goals", *South China Morning Post*, 10 October 2012.

These discrepancies in interests and circumstances can lead to contradictory attitudes in Member States, who can alternatively speak in their name or that of the EU, and alternatively act in either their onw interest or that of the EU. For example, the EU's DG for Trade filing on solar panels were somewhat undermined by statements made by Angela Merkel during her trip to China, showing little support for the case, probably to avoid retaliation from China against German exports. Another example is Poland, which, along with other Central and Eastern European countries, organised a separate regional summit with China to promote their economic interests.

This is rather typical of EU Member State attitudes towards China. Indeed, all European countries have a direct bilateral relationship with China, and most of them have signed bilateral 'strategic partnerships' with the People's Republic. This situation has created a very diverse set of 'Europe'-China relations. At the moment, strictly 'EU-China relations' do not exist; instead there are 28 relationships, based on very different interests, objectives and power balances. This situation can be used by China to its advantage, making it harder for the EU to promote its common economic interests.

## 4. What is a better EU approach?

The main objective for the EU today is to continue grounding the Sino-EU relationship on more realistic principles. China is a very powerful economic partner of the EU, and the EU should be careful not to let those ties deteriorate as the EU seeks to obtain more reciprocity from one of its main economic partners. In any case, the EU will not be able to promote its interests if it does not adopt a common position with China. EU countries may have diverging interests, but none of them have enough weight to successfully negotiate with China on a one-to-one basis. If anything, a single, concerted EU strategy is needed to promote the Union's economic interests, and EU members must be behind such an approach.

## 5. Recommendations

Below are a series of areas that we believe the EU could target to preserve and promote its economic interests:

- **What does Europe want from China?** The EU needs to clearly define European priorities in the strategic partnership, to match China's 'core interests' and consistent demands on the arms embargo, Market Economy status and the One-China policy. This debate has to be led by Catherine Ashton. The rotating presidency, however, can play a role in nudging on the debate among Member States as well as linking it specifically to the trade policy still run by the rotating presidencies. It requires a good team player and coordinator behind the scenes.

- **Connect the dots in the China strategy.** Internal EU policy changes have an impact on the overall China strategy. For example, agreeing on public procurement instruments which target third countries that close Europe out of their markets will have broader positive ramifications for negotiating with China. The same applies to climate change and energy.

- **Greet Chinese bond diplomacy with transparency and common messages.** Europe must learn to talk toughly with its banker as well. Stringent standards and reporting tools, like those in place at the US Treasury, should be implemented. Foreign country purchases of sovereign debt in Europe should be made public and regularly published so that opacity cannot be employed to enhance political influence. Joint European messages should be delivered at bilateral visits to ensure that purchases do not affect policy.

- **Incentivise reformers.** Europeans should follow debates inside China more closely and create a system of incentives for co-operating with reformers, just as China incentivises EU Member States. In other words, Europe needs to build links with reformers. For example, just as European companies do, private Chinese companies often complain about the dominance of the public sector and the lack of a level playing field. Even within the government, some officials are more inclined towards reform: for example, Premier Li Keqiang has expressed his desire to lead reform on

sustainable urbanisation, an area in which Europeans have expertise. Thus, the EU could leverage already existing insider calls for liberalisation to achieve its economic goals.

- **Welcome and leverage Chinese investment.** Foreign investment is a natural development for the world's second-largest economy and one that could contribute positively to growth and employment in Europe. The increase in Chinese investment in Europe comes at a time when many European countries and companies need capital inflows. Thus there is a new financial umbilical cord between China and Europe. But Europeans have concerns about national security and the lack of transparency in China's state-owned enterprises, which are hybrid animals that are politically guided but commercially driven. If these concerns are not properly addressed, they will fuel protectionism on the part of Europe.

Europe should therefore:

- **Be open to Chinese investment:** The EU should make a special effort to welcome private Chinese enterprises, which will also strengthen the position of Chinese private capital at home. Meanwhile, Europeans should be consistent in their demands for more transparency from state-owned enterprises (SOEs). Many ordinary Chinese citizens are demanding more information about how state funds are channelled into SOEs. Thus Europe must set high standards for transparent corporate governance based on OECD and other guidelines to ensure that opacity is not imported into the EU. Competition policy could also play a role in this.

- **Push for equal treatment and a 'second opening' of the Chinese economy:** Europe should encourage a 'second opening' of the Chinese economy, which would coincide with China's own objective of relying more on its domestic purchasing power and growth and on a global agenda to reduce economic imbalances. Company ownership and IPOs, intellectual property rights, the financial and service sectors, and public procurement are all areas of pressing interest for Europe in this context. The EU should work for better market access for European companies in China as a *quid pro quo* for better protection of Chinese investments in Europe, both of which could be enshrined in an investment treaty.

# TOWARDS A COMMON EXTERNAL REPRESENTATION FOR THE EURO AREA?

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## Summary

Since the introduction of the euro in 1999, the external representation of the euro area has been incrementally developed, but no formal amendments have been made. This Policy Paper discusses the case for a consolidated representation of the euro area in international economic fora, analyses the obstacles to achieving it, and puts forward proposals to solve some of the existing obstacles. It argues that there is a strong case for creating a single voice for the euro in the world in general and in the IMF in particular, especially after the global financial crisis and the emergence of the G20 as the main forum for global economic governance. However, some euro area countries are unwilling to give up sovereignty and transfer more power to Brussels. In addition, the functioning of the IMF, which is based on high majority voting, may induce major euro area countries not to give up their individual influence over IMF decisions. Nevertheless, the recently created European Stability Mechanism could act as a catalyst for solving some of these problems.

## Introduction

Since the introduction of the euro in 1999, the external representation of the euro area has been incrementally developed, but no formal amendments have been made. The Maastricht Treaty sketched the general framework, but key questions on the representation of the euro area in international economic

organisations and its relationships with major strategic partners were left open. While the European Central Bank (ECB) represents the euro area in monetary affairs, external representation with regard to macroeconomic and financial matters remains fragmented between the Member States and the European Commission. The Treaty of Nice (2001) and the Treaty of Lisbon (2009) left the provisions for the external representation of the euro area unchanged. Article 138 of the TFEU[1] maintains the legal base for a consolidation of the euro area's external representation that has existed since its launch. This suggests that, although the currency union was primarily created for internal reasons, the EU's architects also had in mind that the single currency could become an important instrument in the Union's foreign economic policy.

This Policy Paper discusses the case for a consolidated representation of the euro area in international economic fora and analyses the obstacles on the way there. After a brief description of the changing global economic environment, it examines the potential benefits of establishing a single voice for the euro in the international arena and its main obstacles. The conclusion presents some specific proposals.

## 1. A changing global environment

Two recent changes in global economic and financial governance have emphasised the decline of European power in global economic and financial governance. In 2009, the G20 summit was launched to discuss the sources and consequences of the global crisis and potential international coordination efforts. In comparison to the previous top economic and financial summits, the G7 and later the G8, the EU's (just like the US) relative weight is far inferior. In the G8, four out of eight members, or 50%, were European. In the G20, they number four out of 20 and hence only 20% of the membership. Moreover, the EU's presence in the IMF has been relatively reduced. According to the decision of October 2010, European governments had to give up two of their eight seats on the Executive Board. In both reform events, the growing economic weight

1. Article 138.1 states that "In order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission, shall adopt a decision establishing common positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences".

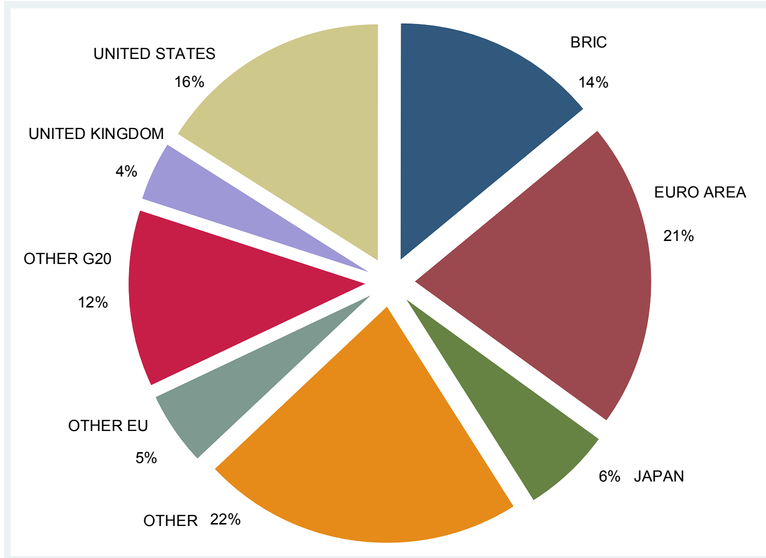
of new players on the global scene was a root cause for the change. The recent crisis has accelerated the loss of relative economic weight and weakened the EU politically, as several Member States have become recipient countries of IMF aid, accelerating the decline of Europe's normative power.

As the debt crisis has unfolded in the euro area, the discussion about a common representation in key international organisations with direct powers on global financial flows and the economy, such as the IMF, has intensified. The goal is to improve coordination and influence over decisions affecting the euro area as a whole, or, single Member States. For instance, IMF programmes currently run in three euro area Member States: Greece, Portugal and Ireland, with the application of conditions that affect national policies. The unification of euro area Member States' representation within international organisations can have strong economic, legal and political implications, in particular in terms of internal redistribution of powers among euro area Member States. However, as we will see below, some key players to date remain sceptical.

## 2. The euro area in the IMF

Only three euro area members are top 10 IMF countries and none of them are the top 3 (according to their voting share). The US has the biggest quota and voting share, resulting in a single concentrated power, able to influence the entire activity of the Fund. A different balance of powers would emerge if the voting shares of euro area countries were combined. The sum of their voting shares is roughly 21% of the IMF total quotas (see Figure 1 below), well above the US (around 16%). Some coordination among euro area members does already take place, but it rarely results in effective representation of the euro area.

**Figure 1: Overall euro area voting share in the IMF compared to other members**




Source: Giovannini, Valiante (2012) from IMF.
Note: after full implementation of 2010 quota reform.

## 3. Obstacles to unifying euro area external representation

There are essentially two reasons why governments are hesitant to opt for unified representation. Internal distrust among Member States emerges due to the absence of common rules on the political governance of the euro area, emphasised by the absence of common democratic institutions able to take this role and coordinate the common seat. Member States do not want to lose political control over their foreign and economic policies. The second factor that contributes to political distrust in a common representation is an exogenous one: the governance of the IMF. In effect, the organisation's voting system mainly relies on high majority voting (mostly 70% and 85%). As a result, every decision would require a consensus among all major countries. Due to its fragmentation in eight single memberships and 16 coalitions (188 members), a relatively medium-size country may also influence the outcome of a decision;

in effect, decisions are rarely taken without consensus. By holding the power to stop important initiatives, a country may not be interested in merging quotas simply because doing so may only reduce its control over the organisation's decision-making process. Therefore, this voting structure may persuade major euro area countries not to give up their individual influence over IMF decisions. Moreover, some countries argue that the euro area is actually more powerful with the *status quo* because euro area countries are over-represented on the Executive Board. In order to maximise influence, they must simply coordinate their positions.

Besides IMF decisions, on which euro area countries mostly vote together in the end, there are more conflicting issues. For instance, EU Member States do not have a common position in debates about the international monetary system, the euro's role as a reserve currency or global macroeconomic imbalances. Coordination is hence more difficult. Important tensions exist, for instance, between France and Germany. While the former prefers a lower exchange rate for the single currency, to promote exports, and ultimately wants the euro to challenge the dollar's hegemony, the latter sees exchange rate developments not as a matter of political choice but a result of competitiveness. It generally favours a strong currency to help control inflation and sees less benefits in the euro's internationalisation (international currencies tend to have more volatile exchange rates and their central banks can be forced act as international lenders of last resort in situations of panic).

In sum, there are domestic political aspects and external factors that complicate the assessment of benefits and costs of a unified representation. However, digging more into the details, this initial analysis may prove wrong for two reasons. We will explore these in the following section.

## 4. Arguments for consolidated representation

Firstly, the concentration of quotas among euro area Member States would increase the direct quotas of control and officially harmonise the actions of these countries at the IMF, thus reducing coordination problems that may

clash with the need to support euro area-wide decisions.[2] Second, the merging of quotas would reduce the total number of coalitions. Fewer coalitions means the possibility of exercising more influence over other coalitions or attracting a high number of satellite countries into a coalition led by the euro area – countries which are already in different coalitions with individual euro area countries. A merged quota would then provide fertile ground for new initiatives and formal power to block any decision without euro area approval.

There are also more general reasons that would justify a common seat at the IMF level. Firstly, common representation in international organisations would promote greater internal coordination on political governance of the whole region (EU). Secondly, it may stimulate international cooperation (e.g. trade agreements) which would benefit the whole region, because it reduces coordination issues and provides one access point for non-euro area countries. Thirdly, it makes representation at the global level more effective in terms of cumulative votes that can be exercised in the decision-making process. Fourthly, common representation in international financial organisations can provide a springboard for developing coordination in other important areas such as foreign policy.

A decline in economic weight, diminishing financial resources and the loss of normative power will weaken the EU's capacity to influence global governance and regulatory efforts. Europe will only be able to secure its place among the major players if it combines a sound economic base with an effective representation of its interests on a global scale. It will also have to retain stable alliances, in particular with the US, which itself wants the EU to improve the coherence of its external representation.

If all this is not followed through and if internal divergences grow further and increase political tensions, the euro area is likely to sell itself short. From a macroeconomic perspective, it is technically one economy as long as the single currency and the Single market exist. But it will only be perceived and treated as such if it manages to overcome internal economic and political tensions and translate internal economic unity into unified external political representation.

2. Differences of interest will remain among Member States, for instance dealing with global imbalances or certain aspects of the financial regulation debate in the G20 context, but the euro area will be forced to achieve a common position.

Recent economic trends increase the pressure on European governments to pool their strength and both informally and formally improve the external representation of the EU in international economic and financial fora.

## 5. The internal dimension of external representation

As a result of the current crisis, the EU has started reforming its internal economic governance mechanisms. A so far unexplored question is the extent to which internal governance reform holds consequences or opens up opportunities for a better external representation of interests.

Sketched in very broad terms, the EU's reaction to the financial and economic crisis has created a new impetus in five policy areas. First, EU financial market regulation is undergoing changes, with more supervisory power for the euro area and an attempt to create a single rule book. Second, budgetary policy coordination is being further strengthened with tougher rules and quicker sanctions at the European level, while national fiscal policy should underpin the jointly agreed objectives. Third, a new mechanism for macro-economic policy coordination has been introduced, including the 'Euro Plus Pact', a top-level attempt to get binding commitments from euro area heads of state and government to an annually-defined reform catalogue intended to help improve European competitiveness and prevent persistent current account imbalances within the euro area. Lastly, the euro area has equipped itself with a new permanent crisis resolution mechanism (the European Stability Mechanism (ESM)) to facilitate a joint intervention with the IMF in the event of a sovereign debt crises in the euro area.

An increased degree of internal policy coordination may, in the long run, harmonise economic developments and policy preferences to a certain extent. This could mean that Member State positions on global economic and finance issues are at least partially aligned. Recently, however, internal divergences have actually translated into contradictory positions on global governance issues.

Macroeconomic imbalances between euro area Member States are, for example, a pressing issue to tackle within the currency union, just as they are at the

global level.[3] Over the past few years, for instance, China, Germany and oil and gas exporting countries in the Middle East have accumulated large trade surpluses while the US has experienced growing deficits. Such systemic macroeconomic imbalances can cause a misallocation of capital and financial bubbles, as they did in the euro area. This danger was revealed by the recent crisis, when large capital flows into the US drove down the cost of loans and thus contributed to the bubble in the housing sector.[4] There is hence a need, both at the European and global level, to promote policy changes which address domestic and international distortions that are a key cause of imbalances.

While the current account of the European Union is more or less balanced, several EU member countries run large surpluses or deficits. Aside from creating differences between EU representatives in the G20 debates, it also hinders European governments from effectively leading negotiations to set up macroeconomic surveillance and coordination procedures in the EU.

In the G20, there seems to be agreement that the deficit countries cannot resolve their imbalances alone. The partners differ, however, on how to reduce global macroeconomic imbalances. In Pittsburgh, leaders agreed on a new 'Framework for Strong, Sustainable and Balanced Growth' under which they would review each other's national economic policies, supervised by the IMF. Numerical targets as well as enforcement mechanisms, such as penalties or sanctions, were left out of the agreement.[5] The two largest Member States of the EU, France and Germany, disagreed over the proposal to include targets and sanctions. Paris first warmly greeted the idea of defining a limit for trade imbalances to GDP,[6] which appeared in the debate before the Seoul summit. Meanwhile, Germany, shoulder-to-shoulder with China, wiped this idea off the table. The EU has managed to formulate a joint position. At the G20 summit in Seoul in late 2010, leaders agreed to work on indicators to measure the sustainability of imbalances. In February 2011, G20 ministers developed a set of indicators in order to focus on persistently large imbalances require policy actions. A goal has been set to establish indicative guidelines by the

3. Olivier J. Blanchard and Gian Maria Milesi-Ferretti, "Global Imbalances: In Midstream?", *CEPR Discussion Paper No. DP7693*, 2010.
4. Eric Helleiner, "Understanding the 2007-2009 Global Financial Crisis: Lessons for Scholars of International Political Economy," in: *Annual Review of Political Science*, 14, 2011, p. 67-87 (here: 77).
5. "G20 Leaders Statement: The Pittsburgh Summit", 24-25 September 2009.
6. "G20: EU Split over US Offensive against Global Imbalances", European Information Service, 25 October 2010.

next meeting in April, against which each of these indicators will be assessed.[7] Such progress on the question of how to fight imbalances, however, does not eliminate the divergent views that exist concerning why imbalances should be fought at all.

## 6. How to move forward

As we have seen, there is a strong case for creating a single voice for the euro in the world, but some euro area countries are unwilling to give up sovereignty and transfer more power to Brussels.

Increasing coordination among Member States for the representation of the euro area within international organisations such as the IMF may be potentially pursued through two sets of actions.

**The first option** may not require any major institutional reform at the EU or IMF level; basically, it **would improve coordination in the use of voting rights currently allocated to euro area members** and split into two individual memberships and six different coalitions (with very limited coordination at EU level). It can be implemented in the form of a euro area committee, established within the current EU institutional framework (preferably the Eurogroup)[8], which would coordinate the set of voting rights within the IMF and perhaps change the current set of coalitions into one or few. Memorandums of Understanding among Member States may need to be drafted to make sure that a clear set of rules is defined ex ante on how votes should be exercised. This option, in practice, would not require any IMF reform, but it would require strong political support within the euro area and perhaps the reshuffle of the current six coalitions within the IMF Executive Board.

**The second option would involve the creation of a single membership for euro area countries.** Membership would need to be officially handled by an institution that has control over budget and fiscal policies, since the voting

7. "Communiqué", Meeting of Finance Ministers and Central Bank Governors, Paris 18-19 February 2011.
8. See Alessandro Giovannini and Diego Valiante, "Unifying eurozone representation at the IMF: a two-step proposal", *Working Paper*, 2013, forthcoming ECPR.

rights are immediately linked to the effective quota held within the Fund. This institution could be represented by the European Stability Mechanism, which may increase its role in future economic governance in the euro area if it becomes central in the coordination of fiscal policies. An alternative would be a euro area economic government, if the EU embarks on a major treaty change. Regardless of which institution becomes central, this option may face two significant impediments. First, it requires a reform or at least a reinterpretation of IMF Articles of Agreement, since officially only 'countries' can be part of the IMF. A clear, international-level agreement would be needed to determine whether these countries can be federated into one institution representing them. The second impediment to such a proposal concerns the re-calculation of the formula. By removing intra-EU flows from the calculation of the quota, the euro area total quota may fall well below 21%, making the first option more attractive if no major reform of the formula is planned in the coming years.[9] However, this option would make more sense (for the benefit of having an integrated framework of external representation) if the IMF modifies this formula and reduce the weight of euro area countries that are currently overrepresented.

9. *Ibid.*

# STRENGTHENING EU PRESENCE IN GLOBAL FINANCIAL REGULATION REFORM

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## Summary

The institutionalisation and legalisation of the European financial governance will undoubtedly enhance the implementation of agreed regulations and improve supervision; moreover, it has the potential to strengthen the EU's voice by promoting a more unified and coherent external representation of its positions. However, this potential may not be realised unless such changes take into account the institutional characteristics of global financial governance, composed of a variety of organisations that often transcend the traditional public-private dichotomy. The EU should build on its experience in international accounting harmonisation by turning its ad hoc governance initiative with the International Accounting Standards Board (IASB) into a full-blown strategy in all areas of financial regulation. The generalisation of this strategy involves extending the recently established European Supervisory Authorities (ESAs) as institutional platforms to coordinate and represent European views in global financial regulatory negotiations, adapting them to newly added governance structures – namely the European banking supervisory authority – as well as complementing them with appropriate governance structures where this is needed.

## 1. Regulatory reform before and after the financial crisis

The financial crisis exposed a number of problems in the areas of public policy and international finance. In response, extensive legislative initiatives were undertaken in many jurisdictions, most notably in the US and the EU, as well as at the international level. This was often accompanied by a revamping of existing institutions such as the Basel Committee of Banking Supervisors (BCBS) or the introduction of new organisations such as the Financial Stability Board (FSB). These initiatives notwithstanding, in contrast to previous major crises, current financial regulatory reform has not resulted in a major paradigm shift in the area of international finance; changes have tended to be incremental and primarily aimed at closing regulatory loopholes, without questioning more fundamental aspects of the global financial system. This limited agenda is not likely to change given the gradual recovery of the global financial system and the sovereign debt crisis in the euro area, which have shifted attention away from financial regulatory reform.

The Basel framework for banking supervision, perhaps the most important international financial regulatory framework, is a case in point. Between Basel I and Basel II the BCBS spent more than fifteen years trying to improve a prudential regime that eventually proved inadequate to protect both individual banking institutions and the financial system at large. The Basel framework was organised around the concept of value at risk, that is, the level of capital sufficient to limit the probability of collapse of an individual bank. However, the large number of banks that have experienced serious difficulties during the crisis demonstrates that banking risk was seriously underestimated by the Basel prudential framework.

Financial markets do not function efficiently during times of crisis. Consequently, it is important to define a regime specific to banking crises for which the rules of intervention of supervisors and public authorities are distinct from those prevailing in normal times. The only way of breaking the vicious circle of recurrent banking crises is to give regulatory agencies more powers to take charge of troubled banks before they really endanger the funds of their small depositors or the stability of the financial system. Prudential policy, on the other hand, should establish simple and verifiable criteria that would trigger the intervention of a supervisor. Solvency ratios, and, more

generally, regulatory indicators, need to be simplified. What is needed is a series of simple and easily verifiable indicators that will point to those institutions that may experience problems.

Basel III, while retaining the framework of Basel II, tries to incorporate elements of this approach, including new liquidity and leverage ratios. Internationally, however, delays in implementation and deviations in the form of national exceptions are increasing, raising concerns about its effectiveness. In Europe too, the European Commission, the European Parliament and the Council are engaged in tough negotiations for the incorporation of Basel III in European law; the final compromise is likely to be well below the standard agreed at the BCBS, undermining further the credibility of this flagship international reform initiative.

On the institutional side, Europe is finally addressing its financial fragmentation. The crisis prompted Europe to take steps towards a comprehensive Pan-European regulatory framework from early on, including the establishment of a European Systemic Risk Board (ESRB) and three new independent pan-European agencies: a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority and a European Securities Authority. This framework is now being complemented by the decision of euro area leaders at last October's summit to establish a Single Supervisory Mechanism (SSM) for banks. The process of setting up a fully-fledged banking union will take years to complete but the first steps have been agreed with the adoption of the Roadmap for the completion of EMU at the European Council meeting of 14 December 2012. The SSM will ultimately encompass all 6,000 euro area banks; there will be a common bank recapitalisation policy, a single resolution mechanism and increased harmonisation of deposit guarantee schemes. It is scheduled to be operational by 2014.

The institutionalisation and legalisation of European financial governance will undoubtedly enhance the implementation of agreed regulations and improve supervision; moreover, it also has the potential to strengthen the EU's voice by promoting a more unified and coherent external representation of its positions. However, this potential may not be realised unless their design take into account the institutional characteristics of global financial governance.

## 2. Global financial reform: a case of soft law governance

Recent international regulatory initiatives launched since 2008 constitute a process of institutional reform and legalisation that remains largely based on network forms of public and private governance, and international soft law standards and rules. Most of the new agreements on bank regulation and supervision, derivatives, hedge funds and so on remain non-binding, reinforce private regulation and provide flexibility in enforcement and implementation at national level without delegating authority to a third party.

In general terms, the choice of merely soft law arrangements expresses the preference of states and regulators to implement standards and practices generated at the international level through informal consultations and negotiations. The interest in favouring soft law arrangements as an optimal instrument of governance can be explained by the fact that softer commitments reduce transaction and sovereignty costs. Non-binding norms, as a prime tool of compromise and learning, facilitate political bargaining and improve information sharing. In fact, soft law agreements reduce systemic risk in the international financial system while promoting competitive equality amongst financial institutions. Moreover, soft law arrangements leave decision-making authority to national bodies and can be incorporated into national law in a manner that respects national sovereignty.

However, the severity of the global financial crisis has increased, to some degree, the legalisation process in the area of international financial supervision with new forms of institutionalised governance. For example, hedge funds and derivatives transactions, previously self-regulated, were brought under the public international regulatory umbrella. In the case of the FSB, there have been signs of adopting a more restrictive regulatory framework. The FSB centralises policymaking authority in a single regulatory and standard-setting body with wider membership, including the G20 countries and the European Commission. Despite all this, the FSB is in an ambiguous position, due, among other factors, to conflicting interests among participating countries. Otherwise, the renewed global regime is still based on the exchange of information, the cooperation of national regulators and the coordination of regulatory activities in order to supervise the transactional activities of banks

and other financial institutions. Therefore, international bodies have limited regulatory authority in general.

While the pace of interactions and changes in global financial governance is accelerating, the EU is called upon to act in these shifting circumstances. The challenge here is to develop reliable financial structures and instruments based on soft law and transnational governance within the highly formal institutional framework of European governance.

## 3. Regulatory coordination, bargaining and EU regulatory capacity

In terms of market power – business volume and sophistication – European financial markets are a major force in the global financial system. More specifically, the European Union is one of the two most important jurisdictions in global finance (along with the United States). This market power would normally put the EU into a privileged position to influence the regulatory shakeup of the global financial sector. However, while market power is a necessary condition for success in international regulatory negotiations, it is not always a sufficient one, particularly when there is a divergence of regulatory preferences among the great economic powers. In such cases, institutional power – the ability to indirectly influence the agenda and work of international institutions – becomes a crucial negotiating tool. Recent scholarship has shown that domestic institutional regulatory arrangements can be a significant source of institutional power. More specifically, a jurisdiction's regulatory capacity, as well as the institutional complementarity and compatibility of its domestic regulatory framework with the institutional framework of the global regulatory regime represent significant institutional resources that can prove valuable negotiating tools. Regulatory capacity involves regulatory expertise, (the ability to identify regulatory challenges, develop policy solutions, implement them, and provide comprehensive monitoring), coherence of regulatory authority in a policy domain and the statutory sanctioning authority of regulators. Institutional compatibility refers to the institutional correspondence of the structures of regulatory coordination at one level of aggregation (domestic or regional) with those at a higher level of aggregation (international). Thus, there is institutional compatibility in a jurisdiction when, for example, its regulatory

infrastructure includes a private standard-setting body which can participate in international standard-setting negotiations in an issue-area where regulatory coordination is dominated by a private organisation. Institutional complementarity on the other hand, denotes the institutional fit between domestic and international regulatory structures, that is, the degree to which specific institutional characteristics of domestic arrangements (e.g. hierarchical organisation with a single authoritative agency representing the national position) allow the efficient and effective participation of domestic regulatory agents in global negotiations. The latter two features are particularly important for private and other transnational, soft-law regulatory arrangements such as those that dominate the international financial regulatory landscape.

To a large degree, the EU's difficulties in influencing international regulatory negotiations stem from a lack of these institutional resources at the regional level. In most areas of finance, EU regulatory capacity is limited. This is because regulatory coherence is restricted as EU agencies must share regulatory authority with national regulators, which typically also retain implementation responsibility and sanctioning authority. The recently established European Supervisory Authorities (ESAs) are a case in point. The ESAs are part of a complex structural development in which a highly invasive regulatory approach is combined with a decentralised supervisory structure. The ESAs' legal status is less ambiguous than that of the Lamfalussy process, but still quite hazy. The three ESAs are independent advisory bodies acting as umbrella organisations in the financial supervision of banks, stock markets and insurance companies. They are endowed with legal personality[1] and dispose of administrative and financial autonomy. Their tasks include legally-binding mediation between national supervisors, the provision of high regulatory and supervisory standards as well as the oversight and coordination of colleges and networks of supervisors. Exceptionally, they may take binding decisions in relation to individual financial institutions and be given further tasks in EU financial market legislation. It is clear that while ESAs contribute to the improvement of EU legal and regulatory design, a good part of the regulatory tasks remain in the hands of the national regulators acting in networks.

1. On the basis of Article 114 TFEU.

This fragmentation has led to the emergence of a European financial regulatory landscape comprising numerous organisations and agencies, at both the national and supranational levels, characterised by institutional divergence and overlap. How does this situation affect the EU's regulatory capacity to act within its borders and vis-à-vis international fora? There are two main implications. First, in the majority of global standard-setting bodies, public or private, the leading role is played by the national supervisory authorities, but the status quo of the EU's external representation varies. The European Commission (or one of the new European agencies) is invited to either participate officially without voting rights, meaning that the final decision does not depend on the EU's consent, or it has only observer status, as is the case with the transnational regulatory network of the BCBS, or the International Organisation of Securities Commissions (IOSCO). Even when a supranational European agency enjoys full member status, this typically coincides with the separate representation of the national regulatory authorities of EU Member States; for example this is the case with the International Association of Insurance Supervisors (IAIS), and the FSB. This fragmentation of EU representation in the international arena leads EU Member States to approach international negotiations mainly with a national set of priorities.

Secondly, while EU administration has been developed with the aim of fostering financial cooperation between national authorities, the role of law enforcement agencies is still left to Member States' administrations. In this context, predominately national and regional preferences often generate weak political commitment on the part of EU Member States to financial convergence. Furthermore, decentralised European supervisory structures still based on national regulator networks complicate control over the implementation at the national level of regulatory standards designed at the global or European level.

Things become increasingly complicated with regard to the transnational organisations dominating various aspects of the global financial reform agenda: they are characterised by institutional differentiation and innovation and render most of the traditional national institutional channels obsolete. This situation in turn means that in most cases the EU lacks institutional compatibility and/or complementarity with international and/or transnational regulatory governance.

## 4. Strengthening EU bargaining power

To overcome these problems, this Policy Paper suggests that the EU builds on its experience in international accounting harmonisation. Divergent regulatory preferences and institutional legacies between the United States and Europe obstructed harmonisation in this issue-area despite more than three decades of efforts in a variety of international and transnational fora. The stalemate was resolved by the EU's decision to adopt the International Financial Reporting Standards (IFRSs), produced by the International Accounting Standards Board (IASB) – a private transnational organisation. The decision to adopt these standards was not a *chèque en blanc*; it was accompanied by the establishment of a new differentiated and innovative European accounting institutional framework, which allows the EU to participate in the workings of the IASB. Previously, the high regulatory capacity of the SEC, combined with the institutional compatibility between the private standard-setting process of the US Financial Accounting Standards Board (FASB) and the IASB, had allowed the US to play a dominant role in the shaping of the IASB's agenda and work. On the other hand, the EU's fragmented regulatory authority and lack of institutional compatibility with the IASB had effectively denied it any substantial role in negotiations over IFRSs. While the United States continues to disproportionately influence the work of the IASB, the EU's ability to participate in IASB workings and influence the standard-setting process has been upgraded substantially, as the new European governance structure includes the European Financial Reporting Advisory Group (EFRAG), a private sector organisation, which includes all interested parties (including standard setters) and provides the technical assessment of the proposed standards. Moreover, the new regulatory framework has given the EU the opportunity to employ new bargaining tools, such as the adoption of equivalency requirements for foreign jurisdictions (such as the United States).

The proposition put forward here is that the EU should turn this specific, ad hoc initiative into a full-blown strategy in all areas of financial regulation. The objectives of such a strategy would be: a) to strengthen regulatory authority and compliance within the EU, b) to improve information sharing and coordination among all relevant European actors, both public and private, and thus c) to ensure the EU's institutional compatibility and complementarity with transnational regulatory organisations in order to communicate effectively on agreed

positions and strengthen its bargaining power at the global level. Obviously, this is not an easy task. A replication of the IASB strategy would necessitate the concentration of significant regulatory authority within European agencies, a prospect fiercely resisted by national authorities in the past. However, as a first step, the second and third objectives could be given priority; they could probably be achieved without substantial transfer of regulatory authority from the national to the European level.

More specifically, in order to strengthen the EU's regulatory capacity and ensure institutional compatibility and complementarity with global financial regulatory fora we propose:

- To improve the EU's regulatory coherence and external representation, by using the newly established ESAs as institutional platforms to coordinate and represent European views in global financial regulatory negotiations once a coherent position has been formed.

- To ensure that the design of the new European banking supervisory authority based at the European Central Bank (ECB) takes into account both the dimension of EU external representation in global banking regulation as well as the new agency's relation to the EBA, thus avoiding further fragmentation in the European financial regulatory landscape.

- To complement the ESAs, where needed, by establishing appropriate governance structures compatible with the global financial regime, which is composed of a variety of organisations often transcending the traditional public-private dichotomy.