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Achilles Heels and EU policy Troy-al and Error

Eurozone special

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Summary

- Europe's structural weaknesses as it aims for 'strategic autonomy' are a lack of key resources, industrial competitiveness, and military power. All three are now interconnected.
- All three require huge spending. However, governments have limited fiscal and policy room.
- How Europe deals with this conflated challenge will determine its long-term prosperity.
- We argue a traditional policy response is inadequate: rather, a holistic approach is needed.
- We ponder a solution that has elements of 'rate hikes and acronyms', 'credit bifurcation', 'selected protectionism', and 'strategic spending'.
- These are actually not new solutions to new problems, but old solutions to old problems.

EU strategic autonomy: its trifecta of challenges

Europe's structural weaknesses have been exposed by the deterioration in the global security order highlighted first by the Ukraine War, now by the risk of escalation in the Middle East.

Strategic autonomy – the ability of a state to pursue its national interests and adopt its preferred foreign policy without depending heavily on other foreign states – is the European Union's policy goal. The EU recognises that a realpolitik 'geopolitical' world requiring greater self-reliance and supply-chain resilience, as opposed to our previous 'neoliberal' world of peaceful free markets and free trade, means it must address three complex issues:

1. Raw materials & energy transition;
2. Industrial competitiveness; and
3. Military weakness.

Each is a huge challenge requiring large-scale, long-term capital investment; and they are *intertwined*, so must be addressed *simultaneously*. This also needs to happen within a Eurozone institutional fiscal framework that leaves little room for such massive spending. Yet failure to do so implies markedly negative socio-economic consequences for Europe. In short, EU governments will probably be forced to dip into their pockets, as during Covid and the 2022 energy crisis.

Policies will also need to change. In recent years, EU regulation and directives have already shifted in pursuit of strategic autonomy. However, we believe that achieving this goal will prove extremely difficult unless we see new thinking in the overall conceptual policy framework.

This report details the EU's Achilles' heels, how they conflate, the potential risks from not acting, the price of acting, and a high-level overview of how the EU may ultimately have to tackle them from a 'grand strategy' perspective that transcends traditional policy frameworks. We will conclude by showing this is not new thinking about new problems as much as old thinking about old problems – which we had forgotten.

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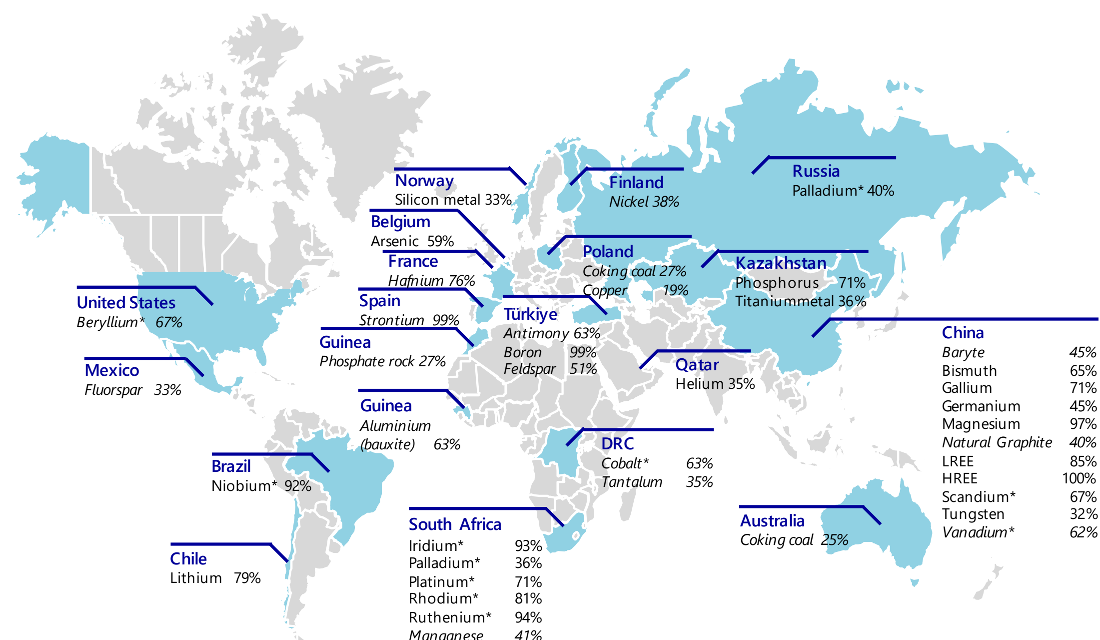
Achilles' heel: Raw materials & energy transition

As we saw in 2022, Europe has a shortage of raw materials: both fossil fuels and 'green' minerals for the energy transition,[1] which exposes it to supply-chain risks. Europe also wants the transition on its terms on technology, value-added, and high-paying jobs. Yet the Global South, US, China, etc., have the same ambitions, forcing a zero-sum geopolitical framework.

The EU relies on LNG imports from Norway, the US, and Qatar, and green imports from the BRICS (Brazil, Russia, India, China, South Africa), as seen in the European Commission's critical materials dependency report (figure 1). Supply from Russia is obviously sub-optimal, while China recently unveiled restrictions on graphite exports, a mineral crucial to manufacturing EV batteries, and earlier imposed restrictions on gallium and germanium, also key inputs for cleantech. In addition, these raw materials are also critical for the military complex.

Figure 1: The EU's green transition remains reliant on China for now



Note: *: share of global production; *italics: extraction stage*; regular: processing stage. Source: European Commission

In November 2023, the European Parliament approved the Critical Raw Materials Act to reduce such dependencies. The Act sets – unfunded – benchmarks for diversification that, by 2030, aim to reach at least 10% of the EU's annual consumption for extraction, 40% for processing and 15% for recycling, and to reduce dependency on one single country to no more than 65% of annual consumption.

A shift from procuring cheap raw and processed materials from abroad towards more domestically produced materials will involve higher prices, through more expensive labour and/or the need to invest in capacity and innovation. The cost of a wind turbine already increased 40% over the last couple of years: now it may rise further again.

The cost of procuring essential inputs will also rise further if we see further supply chain disruptions due to military activity or geopolitical trade fragmentation.

[1] The potential breakthrough in sodium ion tech in Sweden could change things dramatically on the energy front; but the current crisis is pressing, and the time frame to successfully develop alternatives is unclear.

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Green spending

The green transition conjures up images of wind turbines and solar panels, and investments in the power grid and storage and capture solutions. But in order to reduce the reliance on fossil fuels, houses will have to be made more energy efficient, industrial processes have to be transformed, and the transportation fleet has to be replaced as well.

Estimates of current annual investments and the costs involved to reach climate targets differ. The International Energy Agency estimates annual world clean energy investment will need to increase from $1.2 trillion in 2016-2020 (1.5% of world GDP) to $4.4 trillion by 2030 (4%). Bloomberg New Energy Finance estimates the goal of net-zero emissions by 2050 requires $194.2 trillion by 2050; on an annual basis this requires a scale-up from $2 trillion in 2021 to $7 trillion. The Climate Policy Initiative sees average biannual climate finance flows would need to increase from $1.1 trillion in 2021/2022 (1% of GDP) to $8-9 trillion until 2030 and over $10 trillion thereafter. Clearly estimates vary, but the conclusion is clear: massive investments are required, implying that a significant scale-up of efforts is imperative.

Between 2011 and 2020 annual investments in the EU to reach climate targets averaged €683 billion per year (about 5% of GDP). According to European Commission calculations, investments would need to increase to €1,040 billion per year between 2021 and 2030, to reach the 2030 targets. That's an increase of some 2% of GDP annually.

For comparison, total annual private fixed investment in infrastructure and the like amounts to some 5% of GDP and total public investment some 3% of GDP, but much of that investment is not even climate-related and the (post-GFC) trend in both government and infrastructure spending has remained sluggish.

The EU supports green investment efforts with both regulation and funds, but most money has to come from national budgets and the private sector: and it is not only about the money, but also about time, people, materials, and space, none of which have an infinite supply – and more so given other pressing needs that we shall explore shortly.

Although estimates are surrounded by considerable uncertainty and participation by the business sector could reduce the financial burden for governments, we would argue that the minimum additional cost for European governments in this policy area amounts to some 0.5-1%, but a multiple of that is possible as well.

Estimated cost: 0.5% to 2% of GDP annually going forwards

Sizeable EU financing, but not enough by any yardstick

The European Commission has earmarked via the Recovery and Resilience Fund, multi-annual budgets, and the receipts of the EU Emissions Trading System for spending on the climate. Combined, this amounts to about €800 billion between 2021 and 2027 (5% of 2022 GDP).

If you add to that the amounts of national co-financing required to obtain these structural funds from the EU budget, and the expected private investment triggered with InvestEU guarantees – backed by the EU budget – through the European Investment Bank and others, it adds up to some €1.2 trillion or €171 billion per year.

While immense, a six-fold in investments is actually required to reach climate targets. Moreover, national governments need to reach investment and reform objectives to receive money from both the budget and RRF, and most member states do not wish to make use of the loan part of the RRF for a variety of reasons.

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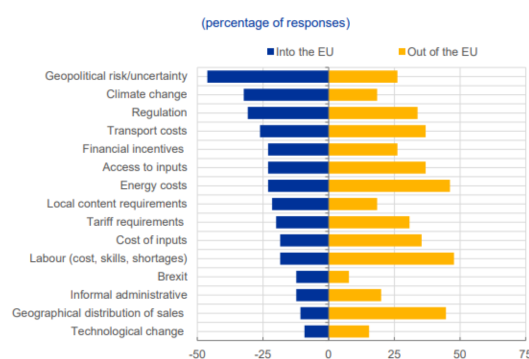
Achilles' heel: Industrial competitiveness

Strategic autonomy requires a strong industry that can produce key civilian and military goods. Yet Europe has been deindustrialising. Steps must be taken to improve competitiveness of this sector, and manufacturers must be provided more certainty that affordable energy and resources will be available.

Europe's raw material shortages are inflationary in a crisis, as we saw in 2022, and also permanently force the EU's cost of production up vis-à-vis its competitors and rivals: the US and China will both have far cheaper energy for decades ahead. As a result, we now see fears of EU – a and most so, German – deindustrialisation.

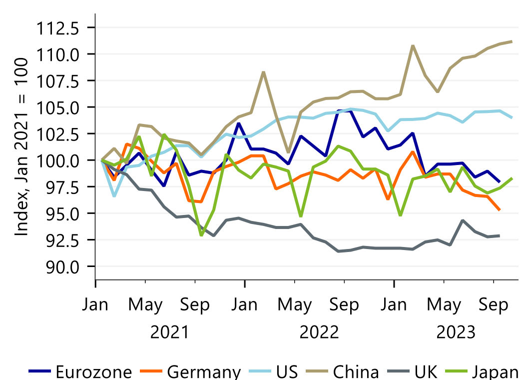
Even as European gas prices have fallen back sharply from their 2022 highs, companies are still more likely to move production out of the EU (to the US and China) than into the bloc from elsewhere: they cite energy costs, the tight labour market, and access to and costs of inputs as key reasons to move elsewhere (figure 2). This is particularly true for energy-intensive sectors crucial to the EU's defence apparatus, and vital for strategic autonomy. For example, since the outbreak of the Ukraine War, Germany's industrial output has declined 5% while China's has risen 11%, US industrial production grew 5%, and Japan's dropped 3%. Only the UK has fared worse than the EU, due to the fall-out from Brexit (figure 3), its own failed attempt at strategic autonomy. Indeed, in the EU, China dominates downstream cleantech such as EV batteries, solar panels, and inverters, raising the question how Europe can retain – let alone expand – key green industries.

Figure 2: Reasons for moving in/out of the EU



Source: ECB

Figure 3: Europe already an industrial laggard



Source: Macrobond, RaboResearch

Industrial spending

Europe has taken several stopgap measures to lessen the impact of the energy crisis. Germany recently agreed a support package that includes a reduction in electricity taxes for manufacturers (from €15.37 to €0.50 per MWh) as well as support for energy-intensive firms for the next five years, providing some certainty.[2] The cost is estimated at c. €12 billion, or 0.3% of GDP in 2024.

Yet it does not eliminate the risk of rationing should Europe again find itself in as dire a situation as summer 2022; neither does it remove the challenge of an expected increase in production costs due to higher emission prices in light of the EU's climate targets. Some manufacturers may therefore still avoid Germany or Europe, or will be hesitant to expand there. The limited rebound in energy-intensive production despite the major drop in energy prices underscores these worries. So too does the anecdotal evidence of fertilizer producers moving out of the EU and into the US, or that production of chemicals being offshored.

[2] The recent ruling by the German constitutional court has injected fresh uncertainty.

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Indeed, subsidies of this kind risk lulling Europe into a false sense of security. Investments in LNG storage capacity are permanent, but security of supply remains the real problem. So a combination of both may be required.

It is extremely difficult to reliably estimate the costs involved with reversing this trend of European deindustrialisation. What we do know is that the EU allocated some EUR540bn (4% of annual GDP) during the 2021-2022 energy crisis to shield households and firms from the energy crisis, as estimated by Bruegel.[3] But there is wide variation between countries, with some 0.5% of GDP for Denmark to nearly 7% for Malta. As said, Germany plans to be spending at least 0.3% of GDP over the next five years to shield its industry. But even assuming 'no crisis' and spreading such amounts over a longer timeframe, a 0.5 to 1% of GDP annual price tag does not sound unreasonable to us. Some of that spending, however, may also benefit the sector we discuss below: defence.

Estimated cost: 0.5% to 1% of GDP annually going forwards

Figure 4: Europe trying to keep its industrial lights on

Source: Getty Images

[3] Sgaravatti, Tagliapietra, Trasi and Zachmann (2021) 'National policies to shield consumers from rising energy prices', Bruegel Datasets.

Achilles' heel: Military weakness

Europe lacks military strength. Ukraine showed the EU's lack of realpolitik muscle. Now war in the Middle East again emphasises its weakness close to its border, i.e., Cyprus. In an increasingly hard power world, European soft power is not enough for true strategic autonomy. However, getting 'harder' is very hard – and very expensive.

Clearly, the EU's global influence is limited without the ability to show a credible 'fist'. Yet where China and Russia are adding overseas bases to expand their global reach, Europe is retreating: the French military, Europe's most powerful, just withdrew from Francophone Mali, Burkina Faso, and soon Niger.

Europe relies on NATO for common defence. But since the end of the Cold War this has meant US, not European, military spending. This has left Europe unable to defend itself or project power abroad without the US, as we see in, e.g., Ukraine. Yet there is now a growing fear that the US may be overextended, or that the US could walk away from NATO if Trump were to win the 2024 election. At the very least, it should be clear that relying on the US for defence is entirely incompatible with any true EU strategic autonomy.

Figure 5: The Bab-el-Mandeb chokepoint and the Suez Canal problem

Source: RaboResearch

Defence capabilities are also inextricably associated with EU industry. Force can be required to resist geoeconomic coercion, and Europe is dependent on foreign commodities just as a global scramble for 'green' resources gets underway. The EU also cannot guarantee the safe passage of its ships through the Suez Canal[4] for goods exports or imports, or the Strait of Hormuz for imports of LNG, or to safeguard its critical maritime distribution generally, and this at a time when low water levels in the Panama Canal are already leading to disruption and higher inflation.

A related problem is Europe's lack of internal unity. Military strategists see national power as *scale* times *cohesion*. Europe has the required economic scale, but its institutional political cohesion has been based on an ever-closer embrace of neoliberal free markets internally and global free trade externally, not the policies needed for a 'geopolitical' world of war.

Where Europe does attempt to become geopolitical, it faces internal splits, as seen over Ukraine; and with the Middle East, relative unity at the government level still exposes huge internal divisions within the diverse EU population.

[4] NB Recent attacks on Israeli and international shipping in the Bab-el-Mandeb by Iran-backed Houthis, to which the US response has been extremely restrained due to 2024 election concerns, seeing the warning that: "*If the drone and missile attacks on shipping in the Red Sea continue, expect to see more shipping lines avoid the Suez route, opting to instead sail around the Cape of Good Hope. The implications could be ugly for global freight buyers*."

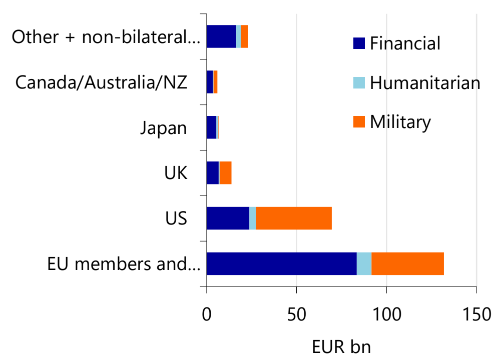
Military spending

Europe is waking up to the importance of a strong military – perhaps[5].

The Kiel *Institut für Weltwirtschaft* says Europe provided more financial, military and humanitarian support to Ukraine than the US, at €132 billion between January 2022 and July 2023 (figure 6). However, the US still provides far more *military* aid: EU money for war without the weapons to buy with it is of little use in any battle.

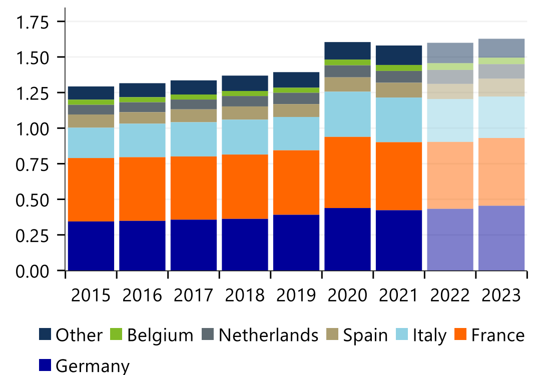
EU military spending has now also hit multi-year highs. Yet individual EU member countries still aren't committed to the NATO target of 2% of GDP, [6] which itself does not account for a new Cold War or two hot ones (figure 7). By contrast, Russia is about to spend 6.0% of GDP on its military, if not more, the US 3.5%, and China 1.7%, though some estimate it is three times that. This backdrop is only widening the relative power gap between Europe and the rest of the world, even if Europe feels it is catching up.

Figure 6: EU committed >€130 billion to Ukraine



Note: As of July 2023. Source: *Institute für Weltwirtschaft*

Figure 7: Still not at 2% GDP for NATO



Source: Macrobond, RaboResearch

Notably, any escalation of the conflict in the Middle East or geopolitical flashpoints in Asia could shift US attention away from Ukraine. Likewise, US support for Kyiv may also dry up should Trump win the 2024 elections – and we already noted risks that the US could then perhaps walk away from NATO entirely. Any of these outcomes would require a further massive step-up in EU support for Ukraine and for its own defence capabilities.

Relatedly, unless European firms make a wider range of defensive weaponry at scale, even if Europe rearms or arms Ukraine faster, it will still have to import military materiel from the US. That undermines EU strategic autonomy. Even worse, the US itself is seeing a huge backlog of military orders that it already cannot meet.

In short, Europe urgently needs a vast increase in its stock of indigenous military assets, not just in their low rate of flow. And this is before one considers the EU's need to boost spending on external border patrols to try to control migrant flows, etc.

Estimated cost: 0.5% of GDP per year does not seem unreasonable given geopolitical pressures. In the worst case, multiples of this figure.

[5] As EU President Charles Michel remarked in his speech at the EDA annual conference on 30 November 2023: "we must make our European defence stronger. Now, tomorrow, and in the future."

[6] Notably, Germany still has not begun to spend in earnest the €100bn in emergency military expenditure it promised after Russia invaded Ukraine, five anti-Western coups took place in West Africa, Azerbaijan won a war with Armenia, another war began in the Middle East, tensions continue to rise over Taiwan, and Venezuela voted to annex an oil-rich region of neighbouring Guyana.

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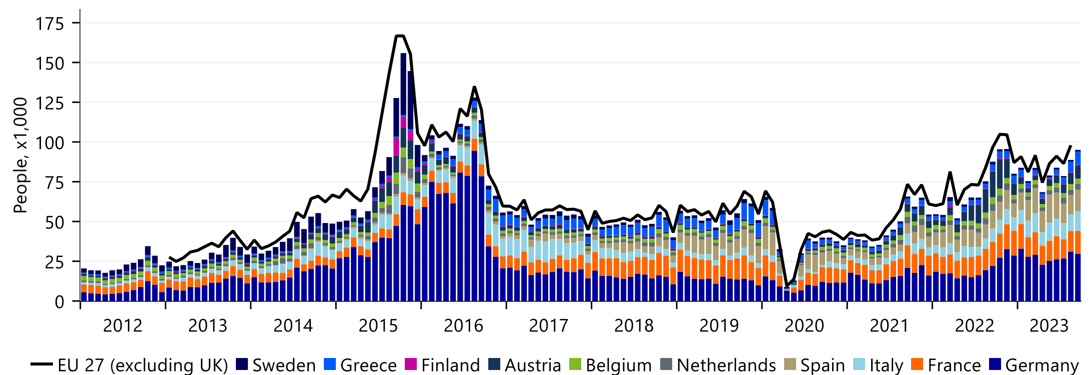
Another Achilles' heel: EU cohesion

Europe's internal cohesion, and even its socio-political stability, could also be threatened by the consequences of external events.

In the aftermath of the Arab Spring, Europe saw a flood of asylum seekers. Covid stifled migration flows, but since then the number of applicants has steadily recovered, with a fresh peak recorded in 2022 (figure 8). Amidst housing shortages and a cost-of-living crisis, many EU members have warned that their societies' willingness and ability to absorb these quantities of asylum seekers is faltering. However, should the war in the Middle East spread we could see new surge in refugees.

Figure 8: Asylum applicants in the EU

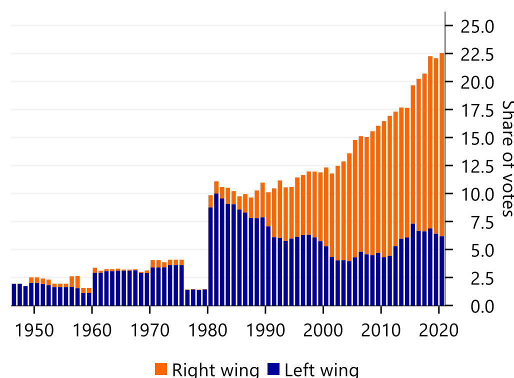


Source: Macrobond

Notably, the EU is already seeing a swing to far right political parties (figure 9), which we predicted in 2019 as a future trend, moving the policy window towards harder stances on immigration. The stricter measures agreed by the German government are one example; another is the landslide victory for the Freedom Party in the Netherlands; the recent riots in Ireland are a potential third; and the 2024 EU elections could easily continue this trend. The longer-run consequences of this for the EU project remain to be seen. For example, it could stall efforts to address the other key structural problems Europe faces. Of course, a new supply shock of higher commodity prices would undermine EU social cohesion given the high share of people already at risk of food or fuel poverty (figure 10), and likely accelerate the political move to the right.

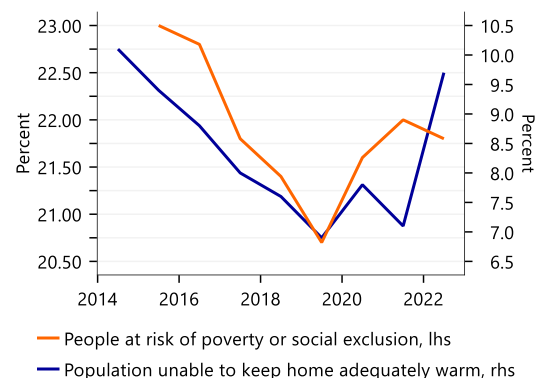
Estimated cost: 0.5% to 1% of GDP, including social spending and populism if fewer immigrants, etc.

Figure 9: Rise in right-wing in last two decades



Source: Macrobond, Timbro
Note: in the Dutch elections, PVV took 25% of the vote; in Germany, Belgium and France, AfD, VB and RN are currently polling at 21% respectively 23% and 24%.

Figure 10: Energy crisis felt most by poor



Source: Macrobond

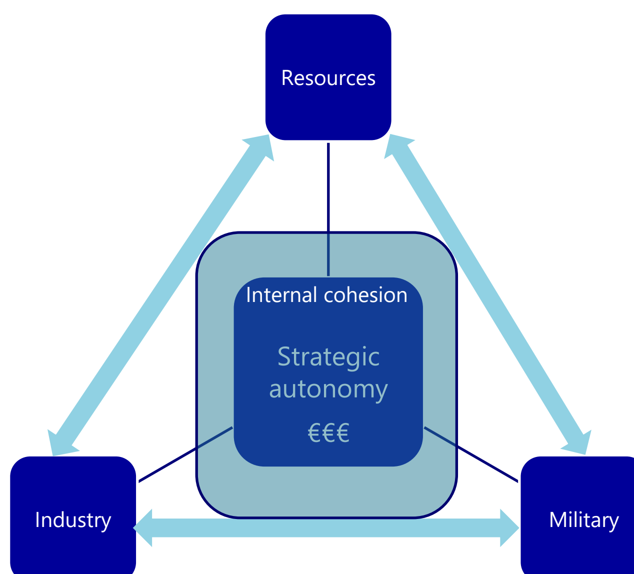
The cost of inaction

The EU was set up as a pacifist free-trading bloc, but it now faces a very different world. While the costs of responding to the challenges this presents are enormous, the price to be paid for not responding to them is far higher.

Europe is committed to the energy transition at vast cost. Its ability to do so on its own terms regarding technology, value added, and jobs created, will require further vast sums. The military needed to ensure that this can happen will also take massive expenditure. So will maintaining social cohesion. However, the price of not acting is far higher.

In a zero-sum realpolitik world if one does not control resources, one eventually loses industry; and if one loses ones industry, one does not have a significant military; and if one loses one's military, one cannot then control resources. This can begin a downwards spiral of a lower exchange rate, larger external deficits, higher debts, higher inflation, higher interest rates, and higher unemployment; that is to say, a structural decline in macroeconomic, then socioeconomic, stability. This is the historical pattern seen in past declining great powers.

Figure 11: The three corners of strategic autonomy



Source: RaboResearch

We have already previously attempted to quantify how deleterious this backdrop could be for Europe. Standard economic modelling fails to capture how a geopolitical world means a structural balance of power crisis, leading to structural commodity-driven balance of payments crises, which then results in structurally bad economic and market outcomes. Our alternative model assumes the risk of higher input costs, fewer export opportunities, and of balance of payments crises with less space for fiscal and monetary policy easing. This results not in any traditional economic rebalancing, but rather in snowballing deindustrialisation and a structural deterioration of international competitiveness in developed markets. And, as a consequence, macroeconomic and market instability.

Specifically, our modelling approach finds significantly lower forecasts for the Eurozone trade balance, GDP growth, and exchange rate, with higher inflation, out to 2027 – and beyond. We are already seeing some worrying indicators that this outcome may be playing out. Therefore, the impetus must be for a change in approach on the part of the EU and its member states.

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The old policies won't work

The EU can't afford not to address its Achilles' heels. Yet it can't afford to address them in a financial sense, nor in the sense Keynes referred to in 1942 when he argued, "Anything we can do, we can afford." That is, if spare capacity exists, financing is not the problem. Regrettably, Europe does not have the spare capacity. As such, trade-offs will need to be made within the realms of *political* economy. In that regard, neoliberal pro-market paradigms are not adequate.

To underline this fact, we previously discussed the potential *first order* economic implications of an escalation of war in the Middle East and observed Europe now has a weaker starting point, so another supply shock (higher energy prices/disruption of trade) could have a more profound impact than the 2021-2022 energy shock. But aside from the usual 'automatic stabilisers', this analysis did not explicitly take into account the need for more state spending. Arguably, such a shock would lead to increased pressure on governments to speed-up the energy transition, diversify suppliers and reduce dependence on import of strategic raw materials, shield industry from the (energy) supply shock, raise military spending, and raise social spending to alleviate the impact on households' real disposable incomes. We have already estimated these huge costs.

Yet such expenditures would *also* be happening against a backdrop of high government debt and large structural fiscal deficits, and in an environment of higher interest rates, tight labour markets and sticky underlying inflation. These new spending priorities would be seen as competing against each other, creating policy dilemmas: This is not just 'guns or butter?', but also 'food or climate?', as well as 'free markets or national security?'

Importantly, a joint fiscal response is necessary and beneficial to the EU as a whole. Yet, the near-term price of fiscal largesse may be far from uniform. Large-scale stimulus will put upward pressure on interest rates across the Eurozone, but the increase will be quicker for countries that have a weaker fiscal position to start with. This could also raise fresh concerns about Eurozone fragmentation, especially now the ECB has embarked on a gradual wind down of its asset portfolio, which, arguably has had limited repercussions for spreads so far (figure 12).

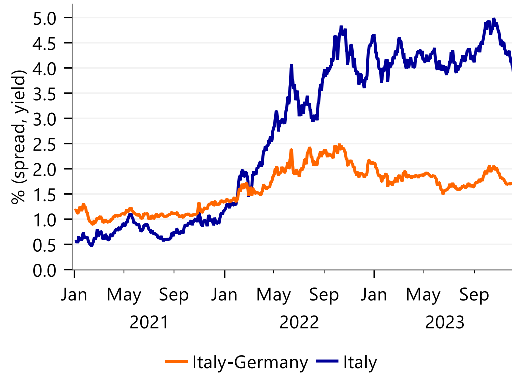
Earlier this year, we looked at the impact of rising rates on government finances. We showed that high inflation reduces public debt ratios in the short-run, even though rising rates worsens them. Ultimately, higher interest costs will push budget deficits and debt ratios higher as more debt is refinanced. In that analysis, we took the IMF's (relatively optimistic) projections for primary balances as a base scenario. We argue *here* that a lot of extra spending may be required on a structural basis, ranging from a minimum of 2% to potentially more than 5%. Whilst governments may be able to find some ways to save on other expenditures or to increase their tax take, the sheer size and interconnectedness of the sums required suggests this will not be very successful.

Therefore we look at two scenarios of a permanent 1.5% respectively 3% shock to the primary deficit. We then calculate the resulting debt trajectories and compare them to the path in the base scenario. To be clear, this is only a *partial* analysis. We basically assume that the lifting effect on growth and/or inflation and its subsequent downward effect on debt ratios is offset by a commensurate increase in interest rates. Admittedly, it takes time for interest rates to suppress growth. Moreover, in the short-term the impact of both real GDP growth and higher inflation is larger than the impact of higher interest rates. Indeed, debt ratios could well decline initially. Arguably, though, a more-than-proportional increase in interest rates is more likely in an environment where core inflation is already above the central bank's target.

Both scenarios would put European government debt on a rising trajectory again (figure 13). Obviously, the position would be far worse factoring in all the extra expenditure that could be required. There would also be some 'snowball' effects: e.g., in a scenario of a 3% structural shock, Italy would see its interest expenditures-to-revenues ratio hit 10% in 2027 instead of 2028.

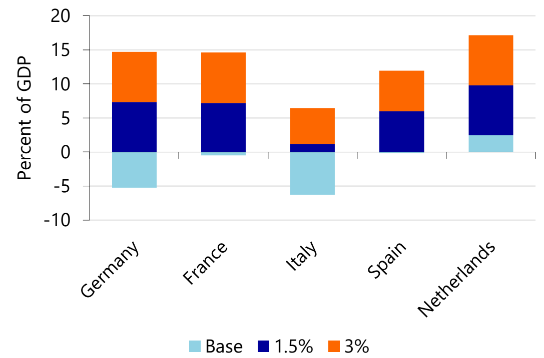
And this is --again-- *ceteris paribus*. Equally obviously, then, something will *have* to change.

Figure 12: Would 'lo spread' hold with a 1.5% or a 3% deficit shock?



Source: Macrobond

Figure 13: Rising debt ratios with structural deficit shocks (2028 compared to 2023)



Source: RaboResearch

The old policies really won't work

Europe has reached a point where a big strategic rethink is required to fix its structural weaknesses, and to change what it can afford in both a fiscal and a conceptual sense. A holistic approach is going to prove essential to achieve many goals at the same time.

Neoliberalism: tight money, fiscal belt-tightening, free markets, free love

Some believe a return to neoliberal policy will solve Europe's current problems. This would mean: (i) tight monetary policy to achieve a speedy return of inflation to 2%; (ii) austerity, with the removal of subsidies, to preserve debt sustainability; (iii) a laissez-faire approach to investing in the energy transition and the industrial base; (iv) openness to imports, regardless of where they flow; (v) openness to immigration; and (vi) no increases in defence spending.

It should be immediately obvious that this approach will not work. Tight monetary and fiscal policy would have a deleterious impact on growth, and so on both public and private investment in the energy transition and industry. Europe could import cheap green goods from China, but that would mean an energy transition on their terms rather than benefitting Europe's economy. Europe would remain defenceless against geopolitical event risk or related economic coercion. Internally, the EU would also see a decline in social cohesion as deindustrialisation would sit alongside higher population growth depressing wages, so exacerbating socio-political tensions.

In short, Europe might get lower inflation faster in the short term, and be able to go 'green'; but it would be hollowed out industrially, marking higher long-term inflation and lower growth, and would remain entirely without strategic autonomy.

Keynesianism: easy fiscal and monetary policy, and protectionism

EU and national governments could achieve a stronger defence and industrial revitalization, speeded-up energy transition, and ensure social cohesion by running very loose fiscal policy. However, this would be extremely inflationary, and very expensive if the ECB reacted with tighter monetary policy.

At the same time, if the social safety net were expanded while immigration were not moderated, we would see growing social tensions; yet curtailing immigration would be more inflationary. Likewise, higher state spending could see firms opt for imports over local production, undermining macro stability, unless we see protectionism (i.e., 'made in Europe'), in which case inflation would rise even further.

It should be immediately obvious that such policy offers a seemingly quicker path to strategic autonomy, but the economic price to be paid is too high.

Something else?

Logically, the EU needs to try something else. And logically, it needs to be a fusion of fiscal, monetary, FX, trade, industrial, energy, transport, education, housing, labour, immigration, foreign, and defence policy. They all need to work together towards a *'grand strategy' global of strategic autonomy*. With that in mind, we argue that the EU could be heading into a whole different direction with previously untested policy combinations.

Holistically healing 'heels'

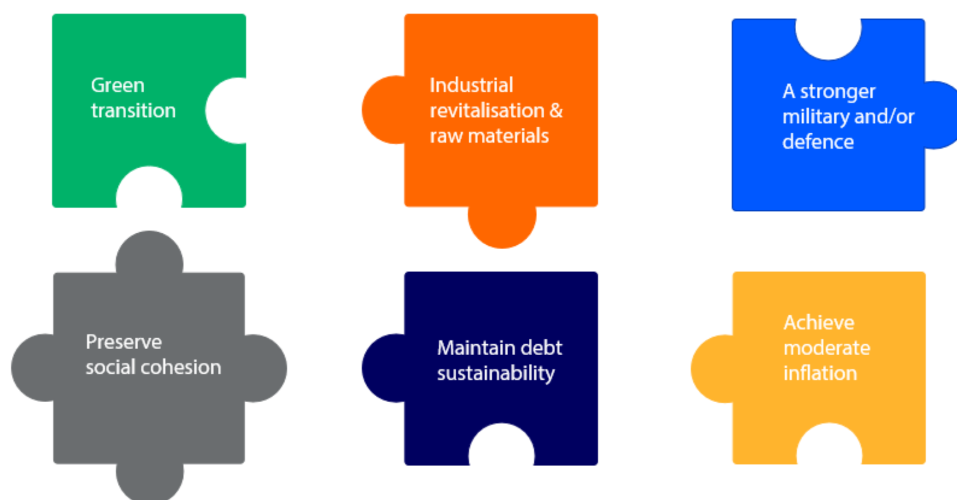
The structural reforms that could reduce Europe's strategic weaknesses may require unprecedented policy coordination and an untested policy mix of targeted fiscal easing, combined with higher rates, and targeted credit easing - among other key policy shifts.

At a high level of abstraction, our analysis boils down to three key investment aims that policy makers are looking to achieve – energy transition, industrial revitalisation, and a stronger military – subject to three conditions – moderate inflation, maintaining debt sustainability, and preserving social cohesion. Finding the framework that best solves this puzzle is somewhat akin to finding the 'holy grail'. Which implies that choices will have to be made.

Fiscal "whatever it takes"

The energy transition, reviving critical industries, and rebuilding defence capabilities all require huge resources. On their own, markets will not allocate sufficient capital to these strategic sectors: they haven't done so when rates were low, and they won't do so now they are high. As such, the government will have to step in either directly, or by incentivising markets to expand in these sectors. For example, the state could place so many orders that their demand will attract new suppliers; or they could use ESG-style regulation to steer the private sector in the 'right' direction.

Figure 14: The holy policy grail: key objectives subject to key conditions



Source: RaboResearch

Such policies will have to come at the expense of a decline in consumer goods production unless Europe is prepared to run a larger trade deficit and/or see higher inflation: the amount of available natural resources is finite, and the labour market is set to remain structurally tight from a demographic point of view. In other words, this would require rationing, either by price or quantity, i.e., temporary restrictions on some purchases as seen during the Covid pandemic.

Reshaping the EU economy would create (temporary) unemployment in some sectors as non-strategic manufacturers shed their workforce. Those employees may find jobs in the sectors that are being boosted, but that will entail re-training costs. Expect the government to fund this schooling and to improve social security measures in the meantime.

Between the direct spending and/or subsidies for key sectors and related social security outlays, governments will need deep pockets, especially given high interest rates. Higher state spending – unless compensated by higher taxation– will bring questions of fiscal sustainability to the fore and drive up risk premia and sovereign spreads. Yet higher taxation would put social stability at risk.

So how can Europe achieve higher spending in strategic areas without endangering debt sustainability and/or causing an uncontrolled increase in inflation? We would argue that any solution would likely involve two elements: *a bifurcated monetary policy response*, and *selective protectionism*.

Rate hikes & monetary acronyms

Clearly, monetary policy plays a key role in this new paradigm, but the ECB will be put in a bind. They have to raise rates to combat inflation, but raising rates would contravene Europe's strategic ambitions on the fiscal front.

To reconcile both objectives, the ECB could seek *targeted rate increases*, or rather, it could try to exempt some sectors from higher rates: alongside rate hikes, it could conduct quantitative easing aimed at sovereign bonds, for specific spending, and bonds issued by companies operating in sectors that are deemed vital to the EU's strategic autonomy. Likewise, they could introduce a new series of TLTROs, where the lending targets are specifically designed to encourage banks to provide cheap credit to these parts of the economy. This 'rate hikes plus acronyms' approach essentially creates a *bifurcation of credit* that should allow the future-proofing of Europe to continue while also limiting the inflationary impact.

Moral hazard

Naturally, regulatory policing would be necessary to ensure there is no fungibility between strategic and non-strategic sectors. This raises serious questions. For example, how does the ECB determine which sectors are strategic? Surely this is beyond its remit. To circumvent this issue, the ECB could limit its acronyms to sovereign debt. But that exposes it to the risk of financing 'unwanted' policies too – and the legality of any such monetary support will be challenged.

The ECB's focus on the climate has already led to accusations of mission creep. Policymakers justified their actions, responding: *"Destroy nature and you destroy the economy."* Obviously, this argument could be made for other threats: If Putin aims to destroy the European economy, does that give the ECB a mandate to bankroll military spending? The list easily becomes endless.

At some point, the need for a more structural solution would be required. One avenue in that respect could be an ECB-backed European investment fund, sharing some resemblance to the current, but 'temporary', Rescue and Resilience Fund. In fact, such a solution may well kill several birds with one stone, as it would:

- Sever the direct link between policy and ECB stimulus;
- Create a new future source of safe European assets for investors, i.e., Eurobonds; and
- Remove key 'strategic' investment funds from national budgets, allowing governments to run golden-rule oriented frameworks.

Clearly this would be an enormous step and it would likely require another revamp/adjustment of the budget rules and perhaps even changes in the European Treaty. But since the German government has become bogged down in its off-balance-sheet approach to self-imposed tight budget rules, it may have a little more love for the European way.

That is, a European fund might allow certain strategic money flows be kept out of the budget. We also acknowledge this framework would require a lot of work by relevant policy makers before it can be implemented. Even so, we argue that if the EU's issues are dealt with in a holistic way, the chances of success would be a lot bigger: and, as already shown, none of the old policy alternatives are better.

Selected protectionism

Any feasible policy response will feature financial incentives to stimulate the supply of strategic goods – an industrial policy that is a new state-led spin on 'supply side economics'. But financial incentives on their own may not lead to the desired outcome. First of all, Europe must be careful that the additional supply is produced *inside the EU*, or allies, rather than simply encouraging more imports from rivals. Protectionist measures, designed to support strategically important sectors, could mitigate these risks and ensure that the domestic supply of critical materials, and EU 'infant industries', are able to grow.

Notably, the military industrial complex would demand long-term, large-scale purchasing commitments from governments (or others) before they would be prepared to scale up production that is already extremely profitable for them, as oligopolists, even at a smaller scale with higher margins. (Although politicians are unlikely to let that status quo stand for long!)

This could also entail sanctions, capital and trading controls to ensure the private sector gets behind the EU's national security goals. Indeed, as underlined by 'Wars without Gun Smoke: Global Supply Chains, Power Transitions, and Economic Statecraft', the differing profit imperatives of firms within rising/challenging powers and declining hegemonic ones has historically seen businesses opt to do business with geopolitical rivals despite government suasion to stop: The same is true vis-à-vis trading with Russia during the Ukraine war. In both cases, this is necessitating increasingly severe US and EU policy responses.

Of course, trade partners may well respond in kind, and neutral countries be repulsed, increasing the risks to EU exporters, and accelerating global fragmentation. *Then again, the policy alternative of free trade in a geopolitical world is arguably worse.*

A matter of philosophy as much as politics or economics

The question of how deeply one should intervene is, at heart, a matter of political philosophy as much as it is economics: how does one best allocate capital using the effectiveness of markets, which are apolitical, within an urgent geopolitical envelope? How does one get money only where it is needed, *and not anywhere else?* This kind of thinking is already evident in ESG-directed investment: will defence or national security be added to the 'G' shortly? Of course, once one starts down this path, the neoliberal market model starts to unravel quickly – as we first argued in 'Thin Ice' in 2016.

Coordination issues

Any discussion on what is strategic and what is not could quickly lead to internal tensions. Surely, member states are likely to have different opinions on these matters as they have different economies and types of specialization. One only need to mention the car or food-production sector to emphasize this point. Coordination starts with a common goal and sense of urgency, but the long and winding paths of major trade agreement negotiations in the past show that although things can be achieved, it may not be at the speed that is required.

Decision-making has always been challenging in Europe and, as such, it would at the very least require a shift from unanimous decisions to qualified-majority voting in a much broader range of policy areas. Otherwise 'veto' power could derail plans at their infancy or towards the very last stretch.

Old policy doesn’t work; very old policy might

What we are describing may look like *radical new policy* to address *radical new threats* to the EU. However, broader reading shows the problems facing Europe are *very old* ones, and the best response is ancient too: ‘grand strategy’ – the study of military and non-military resources can best be leveraged in tandem to achieve the national interest.

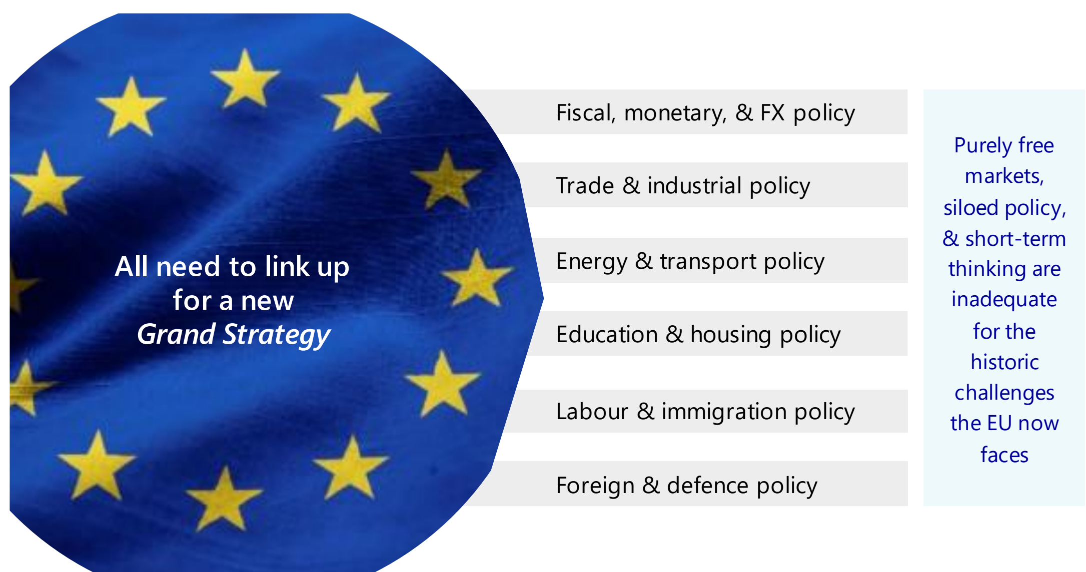
See Homer on the Greeks vs. Troy; Thucydides on Athens vs. Sparta; Polybius on the rise of Rome; Gibbon on its fall; China’s response to the Xiongnu, the Wu and Wei, and Sun Tzu; Machiavelli on politics; Von Clausewitz on war; Kennedy on the rise and fall of the great powers; Kotkin on the fall of the USSR; and Luttwak on geostrategy’s “logic of war in the grammar of commerce”.

Neoliberal economists should note both Adam Smith and David Ricardo argued one of the key conditions for free trade was globally immobile capital, which they assumed as natural. Indeed, the classical economists were focused on how capital should be allocated, not just for economic welfare, but in terms of moral or national goals.

The American School proposed by Alexander Hamilton in the 1790s argued for a high tariff to protect infant US industries, high land prices, and the public development of infrastructure, financed by tariffs and land sales; a “harmony of interests” of social cohesion between workers and businesses for a common national cause was then added; and this became known as “the American System”, then the “national economics” promoted by List. Such grand strategy was used not only by the US, but by Germany in the 19th century, Japan and Korea post-WW2, and China after 1979. Now it’s re-emerging under a new “national conservative” movement within the US.

Central banks also played key national financing roles long before QE was used. The first modern central bank, the Bank of England, was specifically created to finance the Napoleonic Wars; yet seignorage was a standard method of financing war long before then, and since. From 1945 until the 1980s, Western central banks used to play a significant, if camouflaged, fiscal role: for example, see the actual history of ‘The Fiscal Fed’ if arguing there can be no ‘fiscal ECB’. Moreover, during the Cold War domestic credit was often rationed by sector, with variable costs of borrowing reflecting different strategic preferences for that national economy.

Figure 15: Towards a grand strategy – “The European System”?



Source: RaboResearch

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Troy-al and Error

In this thought piece we highlight the massive challenges that Europe is facing in the next decades. We show that Europe's structural weaknesses, a lack of resources, industrial power, and military power are interconnected. All three require huge spending. Putting real numbers on that bill requires some difficult calculation, but we argue that these costs could easily run into several percentage points of GDP annually.

However, governments have limited fiscal and policy room. We therefore argue a traditional policy response is inadequate: rather, a holistic approach is needed. We ponder a solution that has elements of 'rate hikes and acronyms', 'credit bifurcation', 'selected protectionism', and 'strategic spending'.

We acknowledge that our 'proposals' are bold and very unlikely to be realized in full, especially given EU division(s). Strategic autonomy probably cannot be achieved in full, but perhaps the best outcome, would be a trial-and-error approach in realising these aims. This would, perhaps, lead to only a limited, gradual loss of power. The worst outcome, of course, is that Europe will be paralyzed.

But, as a reminder, things didn't end up too well for Troy when they didn't ask questions. Don't let neoliberal orthodoxy be a Trojan Horse!

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