Nationaløkonomisk forening

The European economic security situation

3 oktober 2024

NØF SIDEN 1873 Nationaløkonomisk Forening – The Danish Economic Society

European economic security in an interdependent world

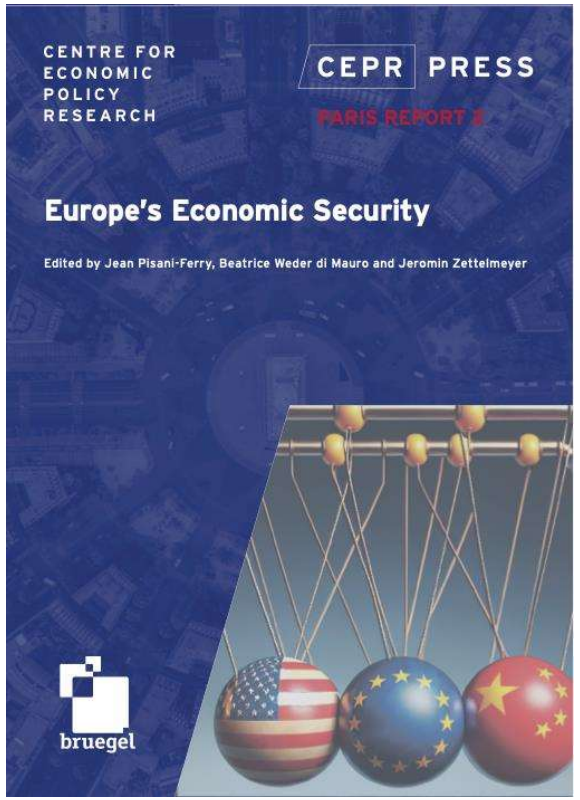
2024 CEPR-Bruegel **PARIS REPORT 2**

with chapters by Jean Pisani-Ferry, Beatrice Weder di Mauro and Jeromin Zettelmeyer; Morgan Kelly and Kevin O'Rourke; Isabelle Mejean and Pierre Rousseaux; David Baqaee, Julian Hinz, Benjamin Moll, Moritz Schularick, Feodora Teti, Joschka Wanner and Sihwan Yangi; Chad Bown; and Conor McCaffrey and Niclas Poitiers

The main takeaways (Chapter 1 of the report)

Jean Pisani-Ferry, Beatrice Weder di Mauro and Jeromin Zettelmeyer

Danish Economic Association Seminar, October 3, 2024

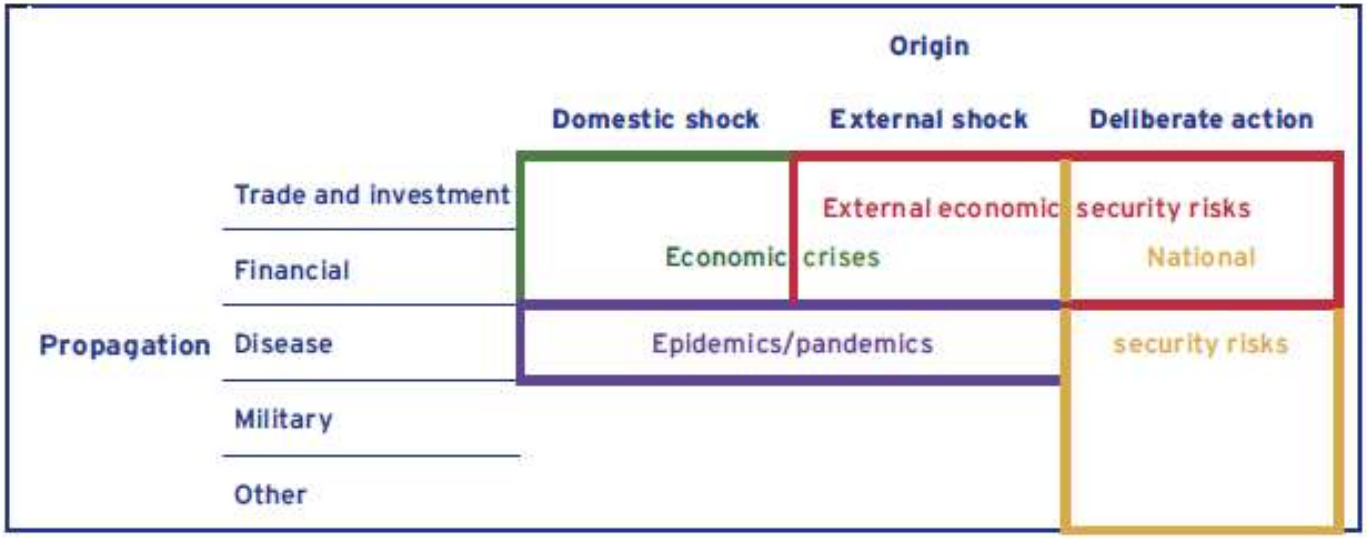


"Economic security" is one component of an EU security/sovereignty agenda

1. *Defence autonomy/national security*
   - Capacity of the EU to defend itself (+ support Ukraine) that is robust to swings in U.S. engagement in Europe.
2. *Economic security*
   - Capacity to withstand trade/supply chain disruptions, economic coercion, and potentially sanctions.
   - *NOTE:* this is a narrower definition than in the Commission's economic security strategy, which includes includes prevention of tech leakages (export controls, FDI screening) for national security reasons.
3. *Competitiveness*
   - Mainly for growth/cohesion. But may feed into 1 and 2 (by attracting investment, creating fiscal space and avoiding technology dependence).

Paris Report 2 focuses on the second element.

How economic security differs from: (1) crisis prevention; (2) national security



Source: Authors' illustration.

Note. The columns in Table 1 define the origin of a bad event – an exogenous shock originating at home or abroad (production disruption, natural catastrophe, transportation or infrastructure disruption, confidence shock); or a deliberate action by a foreign government or a non-governmental entity. The rows define the propagation channel: economic activity related to trade or finance, disease, military action, or other (for example, through IT infrastructure).

The case for policy intervention to raise economic security

Firms' efforts to protect themselves may not go far enough, because:

- They don't have full information about their risk exposures (an issue particularly with long/complex supply chains).
- "Network externalities": a firm sitting in the middle of a supply chain can bring down the whole system. May not be priced correctly.
- They hope to get rescued if things get really bad.

- *This creates a generic case for policies focused on "de-risking"*

Problem: what and how to derisk?

De-risking may be costly!

1. "Trade dependencies" reflect specialisation, which is the main source of gains from trade.
2. Reducing trade integration may makes us safer with respect to foreign shocks/threats, but less safe with respect to domestic shocks
3. Aggressive reduction in integration could damage international cooperation.
   - As a lack-of-trust signal (the opposite of confidence building)
   - By reducing the cost of conflict on both sides ("Security dilemma" in IR).
4. Aggressive de-risking could damage cohesion within EU
   - In turn makes threats harder to deter.

The conventional prescription: selective, product-specific reduction in dependencies

- Identify critical import dependencies, ideally at the product level; reduce them, mainly by diversification; maintain maximum integration (albeit more diversified) to harness gains from trade.

The conventional prescription may be wrong (or at least heavily incomplete).

The first main takeaway from the Paris Report

(based on Chapter 3, by Isabelle Mejean and Pierre Rousseaux: product-level empirical analysis of EU supplier structure of EU imports).

Identifying product-level "trade dependencies" is really hard.

Reason to miss/underestimate dependencies: indirect dependency (via supply chains)

Reasons to exaggerate dependencies: substitutability on either the supply or the consumption side

- product-specific derisking may be a fool's errand.

Top "strategic dependencies" identified by Mejean and Rousseaux (extract/49)

- *Identify goods based on*:
  (1) high extra-EU import share of consumption
  (2) low EU production relative to consumption
  (3) Concentrated extra-EU importer structure
  (4) High "stickiness" of supplier relationships in normal times
    - 75% percentile (⇔ 25-month relationship in normal times) ⇒ 49 goods)
- *Why the list could be too short*:
  - Misses indirect dependencies
  - Unclear what the right stickiness cut-off is. 25 months seems long. Normal times versus crisis times.
- *Why the list could be too long*:
  - Includes goods where even an extended disruption would not result in large welfare/output costs, due to high substitutability (temporally, or with other goods) on the consumption side. Some obvious, others not.

Product	Exporter (market share)	HHI
Castor oil	India (98%)	0.96
Diphosphorus pentoxide	China (98%)	0.96
Heterocyclic compounds containing pyrimidine or piperazine ring, other derivatives of malonylurea	India (97%)	0.94
Alkaloids	United Kingdom (96%)	0.92
Quebracho extract	Argentina (96%)	0.92
Artificial flowers, foliage and fruit (of plastics)	China (95%)	0.90
Electro-thermic appliances (domestic purpose)	China (95%)	0.90
Bran, sharps and other residues	Argentina (93%)	0.87
Magnesium (raspings, turnings and granules)	China (91%)	0.83
Heterocyclic compounds containing pyrimidine or piperazine ring, malonylurea and its salts	China (90%)	0.82
Trichloroethylene	USA (90%)	0.82
Electric blankets	China (90%)	0.81
Vacuum flasks and other vacuum vessels	China (90%)	0.81
Nickel mattes	Russian Federation (87%)	0.76
Camping goods (of textile materials)	China (84%)	0.71
Phosphinates and phosphonates	China (83%)	0.70
Yarn of coir	India (82%)	0.70
Hair-dressing apparatus	China (81%)	0.67
Azelaic acid, sebacic acid and esters	China (81%)	0.67
Padlocks	China (81%)	0.66
Tents of synthetic fibres	China (80%)	0.65
Cases and containers (trunks, suit-cases, vanity-cases, etc.)	China (80%)	0.65
Borates: disodium tetraborate	Turkey (77%)	0.64
Magnets of metal	China (79%)	0.63
Fabrics, woven of jute	India (75%)	0.61
Silver nitrates	United Kingdom (73%)	0.60
Complex cyanides	China (75%)	0.58
Aromatic monocarboxylic acids and phenylacetic acid	China (73%)	0.56
Lighting or visual signalling equipment (bicycles use)	China (74%)	0.56
Cooking appliances and plate warmers	China (73%)	0.56
Iodine	Chile (73%)	0.56
Oxalic acid and esters	China (72%)	0.54
Yarn (not sewing thread) of synthetic staple fibres	Turkey (71%)	0.54
Saturated acyclic hydrocarbons	Russian Federation (70%)	0.53

The second main takeaway from the Paris Report

(based on Chapter 4, by David Baqaee, Julian Hinz, Benjamin Moll, Moritz Schularick, Feodora Teti, Joschka Wanner and Sihwan Yangi, based on the Baqaee-Farhi sector-level model of international trade).

The costs of a hard stop to trade with a highly integrated partner are an order of magnitude higher than the costs of a gradual decoupling

Intuition: as long as we keep trading with the rest of the world, gains from trade are largely preserved.

- may justify a pre-emptive reduction in trade integration with a potentially hostile partner (across the board, and particularly on the export side).

Output costs of decoupling in the Baqaee-Farhi model: impact vs. long run

- Trade model with 43 countries and 56 sectors.
- Three trading blocks: friends (G7+EU), rivals (China+Russia), rest of world
- "Decoupling" = full stop in trade between friends and rivals, but both friends and rivals continue trading with rest.
- Output costs for Germany (most exposed, together with Japan):
  - 5 percent of GNI on impact (low elasticity of substitution). China: 8 percent.
  - Only 1.26 percent of GNI with slow adjustment (high elasticity of substitution).
- Long-run effects smaller in US and other EU countries (0.5-0.7 percent of GNI), much higher for China and Russia (2 and 5 percent, respectively).

Intuition: the world is big and diverse even without China.

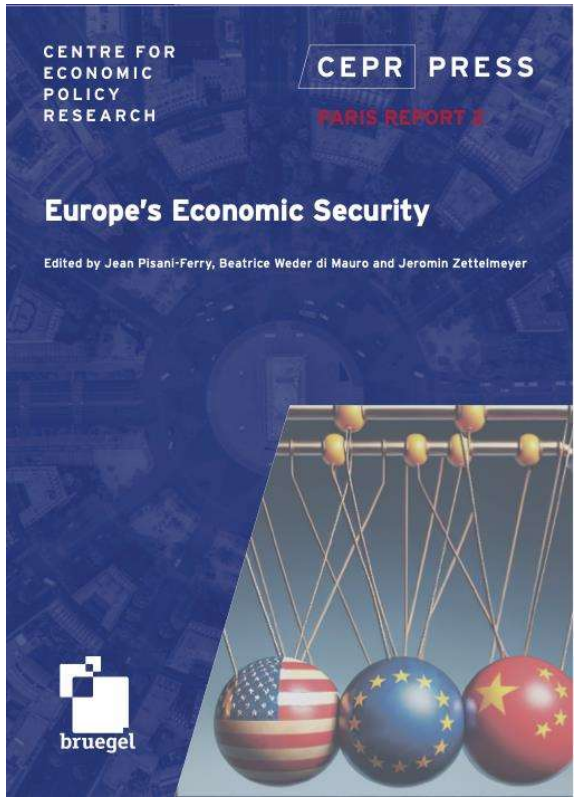
Implications

1. Focus product-level import de-risking on products where costs of interruption are unquestionably large (natural gas; computer chips; critical medical supplies. *Not* solar panels).
2. Need to worry about export dependency and financial dependency, not just import dependency
3. Raising resilience is at least as important as de-risking. We don't know and will likely never know enough to protect ourselves against most relevant threats.
   - Another reason to strengthen single market.
4. For the same reason, need to worry about deterrence, not just de-risking
5. Should EU reduce its overall integration with China (like the US has done)?
   - Does a 5% output shock happening with probability *p* justify an e.g. 0.5% "insurance premium" for sure? depends on *p*.
   - But note 0.5% "insurance premium" does not reflect the (political) damage to international cooperation. There may be an additional, potentially large, fixed cost.

How has the EU done?

1. Import de-risking: *ok, with some caveats.*
   - Ok: focus on critical raw materials, chips. Less convincing: clean tech (mixes security with jobs/competitiveness).
   - Policy instruments relatively weak.
2. Export dependency, financial dependency: *largely ignored*.
3. Raising resilience via deeper single market: *not much emphasis so far*.
4. Deterrence, not just de-risking: *solid response.* (Anti-coercion instrument)
5. Reduce integration with China? *Should have a discussion*.
   - Comparatively easy with respect to policy instruments (export tariffs, diversification charges).
   - Would likely have unintended consequences.
   - EU political economy very difficult
   - A likely better option: prudential approach to company/sector exposures.
6. The elephant in the room: economic coercion by a potential new Trump administration

Thank you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Europe's Economic Security
Edited by Jean Pisani-Ferry, Beatrice Weder di Mauro and Jeromin Zettelmeyer
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What the EU has/has not tried so far

Objective	Available instruments	Problems
Reduce import dependency for critical products	Important Projects of European Interest (IPCEIs)	Imperfect match between critical products and targeted products.
	European Chips Act	Lack of cost-benefit analysis
	Critical Raw Materials Act	Weak EU level instruments
	Net Zero Industry Act and related sections of the Temporary Crisis and Transition Framework for State Aid	Weak governance – actions and funding rely mostly on member states and lobbying by large firms.
	Health Emergency Preparedness and Response Authority (HERA)	
Diversify concentrated export exposures at the firm level	None, except for intention to negotiate additional free trade agreements with "friends".	Lack of instruments leaves the European Union vulnerable to coercion
Deepen the single market and make it more flexible	Internal Market Emergency and Resilience Act (IMERA)	No economic security-motivated deepening agenda
Deter economic coercion	Anti-Coercion Instrument	Council majority required to allow the Commission to deploy ACI powers
Limit overall trade dependency on China's market	None, except for intention to negotiate additional free trade agreements with 'friends'.	Economic cost of sudden decoupling may deter appropriate action by the European Union

Næste medlemsarrangement 25. november kl. 17

Debat om industripolitik

Lykke Friis (Tænketanken EUROPA), Lars Gert Lose (Copenhagen Infrastructure Partners) og Jan Rose Skaksen (ROCKWOOL Fondens Forskningsenhed) vil debattere industripolitik under stor forandring.

Under debatten vil Jan Rose Skaksen give et økonomisk perspektiv på industripolitikkens udvikling.

Lykke Friis vil tale ud fra et europæisk politisk perspektiv, mens Lars Gert Lose vil sætte fokus, hvordan Copenhagen Infrastructure Partners oplever industripolitikkens forandring i Kina og USA set fra et kommercielt perspektiv.

Til sidst vil der blive åbnet op for spørgsmål fra publikum.

Tak for i dag

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