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The EU's Open Strategic Autonomy from a central banking perspective

International relations committee of
the European System of Central Banks

ABSTRACT

This is the non-technical summary from the ECB occasional paper published in March 2023 by the international Relations Committee workstream on Open Strategic Autonomy. This report was extensively presented by Isabel Van Steenkiste, Director General for International Affairs ECB, during an event at the National Bank of Belgium, June 12th, 2023.

Geopolitical factors affect the EU's economy and the policies of central banks. Geopolitical considerations are playing an increasingly important role in determining international economic relations. This report is a first, broad attempt to provide a quantitative and qualitative analysis of how a changing geopolitical environment and the EU's Open Strategic Autonomy (OSA)[1] agenda may affect the EU in general and Economic and Monetary Union (EMU) in particular, and the potential implications for the policies of the ECB and the European System of Central Banks (ESCB).

Since the inception of the euro, the world has moved gradually from a dominant narrative favouring an open, multilateral international order to a narrative in which geopolitical considerations are having an increasing impact on the economy. This might be affecting the process of globalisation and the structure of the international economy. Geopolitical factors are increasingly influencing decision-makers, including those at the ECB. Central bankers in the EU and around the world are being called upon to deal with the repercussions of strategic economic relations for macroeconomic variables, inflation dynamics, monetary policy, financial stability and market infrastructures.

The change in narrative is gaining traction, despite the fact that the current open, multilateral rules-based system continues to be the engine of economic growth for much of the world's population. Multilateral institutions and rules are being tested by geopolitical competition against a background of changes in the economic weight of different countries and regions. At the same time, political

[1] More recently, the EU Council, in its conclusions of 29 March 2022 on the EU's economic and financial strategic autonomy, emphasised that "the EU needs to continue pursuing an appropriate balance between both objectives, striving to achieve its economic and financial autonomy, while maintaining its openness, global cooperation with like-minded partners and competitiveness, and reap the potential benefits thereof."

polarisation, social unrest and within-country wealth inequality[2] are rising in many parts of the world, leading in some cases to a questioning of the open-based multilateral system. There is also a significant policy and academic debate underway as to whether the international economy is following a trend towards “deglobalisation”. Existing evidence appears to indicate that, at least for the time being, there is no such consistent trend, but rather a change in the nature of globalisation, which is leading to a rise in the regionalisation of trade and a certain slowdown in global value chain (GVC) integration and the international trade in goods. At the same time, the growth of international trade in services seems to be signalling a continuation of globalisation trends in those sectors spurred on by technological developments. Some of these phenomena might, to some extent, be a result of geopolitical factors. This changing nature of globalisation is being determined not only by public policies, but also by private business initiatives and interests seeking to respond to these changing economic conditions in a context of heightened economic uncertainty and a perception that geopolitical shocks are occurring more frequently.

The EU contributes to and benefits from global economic, trade and financial openness but, almost by definition, openness guided primarily by economic comparative advantage has a flipside, namely (inter)dependence. This report also provides a thorough empirical analysis of the EU’s trade, financial and labour supply interlinkages with the rest of the world. The section documents the extent to which the EU and the euro area’s economy and financial system are deeply intertwined with those of major geopolitical powers. Interdependence is high with the United States and the United Kingdom in terms of both finance and trade,[3] with China in terms of trade and with Russia in terms of energy and critical raw materials (CRMs), despite the recent action taken by the EU to reduce its dependency on Russia following the latter’s invasion of Ukraine. While this interdependence is an advantage in a first-best, rules-based, comparative-advantage world — for example through GVC participation, seeking the most efficient suppliers or allowing foreign financial players to operate freely in the domestic market — it can also turn into a vulnerability in a second-best, increasingly “geopolitical” world.

The EU’s OSA agenda is an emerging set of regulatory, structural and fiscal policies seeking to address the EU’s economic vulnerabilities arising from geopolitical factors. These include different types of policies such as those affecting the configuration of GVCs, foreign direct investment (FDI) screening, as well as policies aimed at increasing the resilience of financial market infrastructures, promoting the international role of the euro and designing efficient sanctioning regimes. There may be trade-offs between these and other policy priorities which may also induce (new) dependencies. Some examples from the analysis set out in this report are as follows:

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[2] As argued in Box 5 of the ECB strategy review (Work stream on globalisation, 2021), even though over the past three decades there has been a steady fall in inequality worldwide across countries, inequality within countries (notably in some advanced economies) has increased markedly. Globalisation is often seen as one of the key forces driving the rise in inequality in advanced economies, although this effect cannot easily be disentangled from the effects of technological progress. Moreover, countries exposed to similar degrees of trade and financial openness and technological change have exhibited different trends in inequality.

[3] Beyond purely economic and financial considerations, external security represents a very important interdependence between the United State and Europe, both within a NATO context and beyond. An analysis of this interdependence and its implications are outside the scope of this report.

(i) A reshoring or friend-shoring of GVCs decreases the impact of foreign supply shocks and reduces external dependence, although it may increase exposure to domestic disruptions and amplify the impact of domestic shocks.

(ii) (ii) FDI screening may be necessary to protect strategic sectors from foreign buyers, but it may also reduce the availability and efficiency of capital allocation, especially if it is uncoordinated within the Single Market.

(iii) (iii) Reorienting trade towards reliable partners that respect an open, multilateral trade order may imply higher costs and prices, with implications for domestic inflation and monetary policy. This is especially relevant for the energy sector and CRMs.

(iv) Greater reliance on domestic payment and other financial infrastructures may imply less vulnerability to foreign providers but needs to be met with appropriate measures to ensure continued competition and innovation.

A number of these policy choices and trade-offs are beyond the remit of the ECB but are likely to affect the landscape in which it operates. In the EU, developments in the area of strategic autonomy are also relevant to the debate on strengthening the EU and EMU, while the increasing significance of geopolitics requires further coordinated EU policy action. The appropriate deepening of EMU and further economic integration in the EU are integral to any attempt to increase resilience and competitiveness and enable the EU to speak with one voice in a more complex world economy. Ambitious EU and national reforms could help increase resilience and reduce vulnerabilities to geopolitical shocks. In line with the position adopted by the ECB Governing Council,[4] material advances in the capital markets union and the banking union agendas could contribute to reducing constraints in EU/EMU financial markets and the banking sector. The Single Market and the EU trade policy have shown that there are advantages in speaking with one voice vis-à-vis external partners. Closer and more effective coordination of other policies, for example in the energy sector through better interconnectedness of EU energy infrastructures or in energy negotiations with partners outside the EU, illustrate the benefits of such an approach.[5] In addition, strengthening the international role of the euro could enhance the euro area's strategic autonomy in economic and financial matters while preserving an open economy. Safe assets denominated in euro in the form of national government debt or common EU/euro area-issued debt could further support this process. The more significant role played by geopolitics and OSA-type policies is likely to influence inflation dynamics, price-setting mechanisms, productivity, competition and the natural interest rate, thereby affecting the landscape in which the ECB operates. More frequent geopolitical shocks and OSA-type policies may imply costs and second-best solutions that the ECB needs to take into account.

Of course the report focuses also on the impact of these developments on the ECB's policies. A retrenchment of globalisation could lead to a regionalisation of trade flows and value chains, an increase in reshoring initiatives, a reduction in international labour mobility and/or an intensification

[4] See Eurosystem (2021). The Eurosystem's position is that "Completing Economic and Monetary Union remains essential to strengthen the euro area's shock absorption capacity. This includes the completion of the banking union and capital markets union. In addition, a permanent central fiscal capacity, if appropriately designed, could play a role in enhancing macroeconomic stabilisation and convergence in the euro area in the longer run."

[5] See, for example, McWilliams et al. (2022).

of industrial policies that seek to encourage the local production of goods considered strategic. These dynamics could affect inflation directly in both the short and the medium term by substituting cheaper inputs with more expensive but “safer” ones, and indirectly through their impact on competition and market structure, price-setting mechanisms and workers' bargaining power. The dynamics impact productivity, which is a critical variable in the determination of the natural rate of interest. At the same time, efforts to diversify imports may result in lower dependencies on some countries, which may have a positive effect on global interest rates, given that the savings of these countries have played an important role in depressing global interest rates.

The report shows also that GVCs can amplify shocks in the economy as they move up and down the production network and change the slope of the Phillips curve. Moreover, shocks to central nodes, as well as shocks to suppliers of CRMs, tend to generate higher economic and price fluctuations through strong spillover effects. In addition, OSA-like policies that target near-shoring or reshoring could foster either economic convergence or economic divergence across EU/euro area countries, with potential implications for the transmission of monetary policy. In the particular case of energy, the greening of the economy makes it possible to reduce dependencies, but this requires time and introduces elements that impact inflation, inflation volatility and relative prices within the energy mix.

Geopolitically induced shocks of a transitory nature may blur the picture for monetary policy by increasing uncertainty. More frequent geopolitical shocks have the potential to increase output and inflation volatility, which may generate persistent dynamics that, even if transitory, could pose a challenge to the conduct of monetary policy, its communication and its transmission.

Geopolitical factors could also impact capital and financial flows[6] and the smooth functioning of payment and financial market infrastructures, thus posing risks to financial stability. The euro area is more financially open than other major strategic players and is also home to a number of major investment hubs. Nevertheless, a number of elements (such as the prominent role of offshore centres or complex multinational entities in intermediating FDI and portfolio flows) blur the picture of the ultimate investor-destination linkages and make it difficult to map financial exposures. With regard to financial market infrastructures, the current overreliance of EU market participants on third-country payment and clearing services, with the EU authorities having only limited reach in a crisis situation, is a potential source of financial stability risks.

Economic and financial openness has been a boon for the EU/euro area economy. Thus, it is important to guide the OSA strategy in a way that will allow Europe to continue to reap the economic and social benefits of globalisation, while at the same time protecting it from the challenges of a tenser geopolitical world. From this perspective, the case for OSA-type policies should be sufficiently scrutinised, especially for those initiatives of a structural nature which could introduce distortions and increase economic policy uncertainty if not well defined. Against this background and given that

[6] For the sake of simplicity, for the remainder of the text we will use the term “capital flows” to refer to both capital and financial flows, the latter including direct, portfolio and other investments, as defined in the IMF’s Balance of Payments and International Investment Position Manual, 6th edition.

in at least some cases the search for strategic autonomy might imply a second-best solution to an openness based on pure comparative advantage, the EU's defence of an open, multilateral rules-based system is still the first-best option.