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POLICY BRIEF

DEFENDING EUROPE'S ECONOMIC SOVEREIGNTY: NEW WAYS TO RESIST ECONOMIC COERCION

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SUMMARY

- European countries are increasingly coming under threat of economic coercion from great powers.
- The European Union and member states have few tools with which to combat the economic coercion waged against them. The EU's vulnerability threatens its sovereignty and its openness.
- The EU should move quickly to consider and adopt a suite of tools to protect and enhance European sovereignty in the geo-economic sphere.
- The mere acquisition of such powers will have a deterrent effect. Such tools are thus necessary to preserve the EU's economic openness as well as to defend and preserve the rules-based international order.
- This collection outlines ten such tools that the EU could adopt.

Preface

Mark Leonard

Europeans have been among the biggest advocates and beneficiaries of a rules-based, open economic order. By promoting the idea of free and fair trade, EU governments and institutions hoped that globalisation would benefit everybody.

But, even before covid-19, this order was coming under enormous pressure. The most important structural feature of our world today is not multilateralism, but rather a bipolar competition between China and America – Europe's two most important economic partners. As a result, the nature of globalisation is changing. Because neither China or America wants a conventional war, their most powerful weapon is to manipulate the architecture of globalisation.

Both China and the United States are merging geo-economics with geopolitics. The Chinese are using investments strategically, manipulating markets through state aid and undermining the European Union's voice on the world stage by deliberately weakening multilateral institutions and undercutting the EU in third countries. But America, too, is increasingly politicising things we once thought of as global public goods: the US financial system, SWIFT, the World Trade Organization, the internet, and the International Monetary Fund. Rather than being a barrier to conflict, interdependence will increasingly be weaponised.

There is a real danger that Europeans will be squeezed in the middle of the Sino-American competition. Europeans are likely to increasingly face extraterritorial sanctions, forced sensitive data transfers, and extraterritorial export controls that distort the European market and global competition. The Chinese government has tried to pressure European states into making political concessions by threatening to withhold medical supplies during the pandemic. Donald Trump has undermined Europe's diplomacy on Iran – and international law – with secondary sanctions on European companies. An already heterogeneous global monetary and financial system is now confronted with a real risk of fragmentation, if not an eventual break-up.

If we want to prevent the rules-based order from fragmenting, we need to build European strategic sovereignty and better integrate economic and geopolitical policy. However, to do this, Europeans will need to overcome some barriers in our thinking, our capabilities, and our institutions.

Firstly, the intellectual barrier. The EU must learn to think as a geopolitical power, define its goals, and act strategically. In a very small number of areas, the EU may want to limit its dependence on others or make it less one-sided but, on most issues, European autonomy is not possible or even desirable. European sovereignty should mean being able to decide for ourselves about our interests and bargain effectively within an interdependent system through credible counter-threats against threats and hostile actions. It is not about giving up our liberal values or further undermining the rules-based order. But, sometimes, the best way to stop people from undermining these things is to raise the costs for rule-breakers by implementing effective countermeasures. This is something that Europeans have learned well in trade, where the European Commission is empowered to take countermeasures against sanctions from others, even our closest allies. However, the ultimate goal in this is to preserve the rule of law and deter others from undermining an open system.

Secondly, the institutional barrier. Building economic sovereignty requires the EU to stop thinking and acting as a 'fragmented power'. Currently, European economic governance effectively ignores geopolitical considerations. Because of a division of tasks in which Brussels deals with international economic concerns such as trade, while related geopolitical issues belong largely to EU member states, the EU has behaved as a fragmented power. This prevents Europeans from being able to respond effectively when other powers instrumentalise economic tools to achieve political ends.

And, finally, the EU needs to develop some capacities to deal with specific vulnerabilities. The European Council on Foreign Relations outlined an ambitious agenda for how Europe can strengthen its economic sovereignty in its earlier report, Redefining Europe's Economic Sovereignty. The ten papers in this series focus on how to deal with some of the disparate risks of economic coercion. The European Commission has the tools to respond to punitive tariffs. And the EU's investment screening framework helps it address worries about foreign investments in strategic sectors of European economies. But there are also other forms of economic coercion Europeans do not know how to respond to or how to disincentivise. Therefore, this series puts forward concrete proposals, including building a digital euro, establishing an EU Resilience Office, issuing personal sanctions as a reciprocal reaction, and creating a level playing field instrument, a collective defence instrument, and a positive trade agenda.

The guiding star for Europeans is to have an open, rules-based order; and our goal should always be to defend and advance that. But – as with trade – sometimes the best way to defend that order is to deter others from undermining it. That is why we need to develop a toolkit: so that we know (and everyone else knows) what our options are. The enclosed papers are creative ways of thinking about achieving this. Hopefully, we will never have to use them.

Protecting Europe from economic coercion

A European toolbox for countering economic coercion

Jonathan Hackenbroich

Politicians need options. In most areas, they will have the means to design and implement policies; in some, they lack the capabilities they need. But, even where they are unable to act immediately, they can still imagine what they would do if they had the right tools to hand.

The European Union today has no options – no effective instruments – and only emerging policy ideas when confronted with other global players' use of economic coercion to gravely violate either European or national sovereignty. Powerful countries – ranging from China to Europe's ally, the United States – are increasingly reverting to economic punishment and blackmail to change the behaviour of European entities, be they the EU, member states' governments, or businesses. They also have sights set on European foreign, economic, and energy policy, and often act to try to secure advantages for domestic companies relative to their European competitors.

The problem

This coercion comes in a range of forms:

- **Tariffs and trade curbs:** China has used the threat of punitive tariffs on cars to pressure Germany into accepting a bid by Huawei to build the country's 5G infrastructure. It also threatened to curb medical supplies to the Netherlands in April 2020, to force it to reconsider changing the name of its Taiwan office. And, when Canada arrested Huawei executive Meng Wanzhou in line with an international arrest warrant, Beijing banned Canadian agricultural products immediately; its goal was to coerce Canada into releasing Meng. The US has used tariffs in relation to issues ranging from the Iran nuclear agreement to French plans to levy taxes on digital services, thereby interfering with a core dimension of national sovereignty.
- **Sanctions:** The US uses coercive extraterritorial sanctions directly against Europeans, and causes even more collateral damage through those sanctions' secondary effects. In October 2019, Washington put in place an executive order to cut off Europe's trade relations with Turkey – another NATO ally – in yet-to-be-defined sectors in order to pressure Recep Tayyip Erdogan to change course in Syria. Following the US withdrawal from the Iran nuclear deal, Europe has been unable to uphold its trading relations with a third country when one of the great powers threatens to cut off access to its market or currency. In September, the Trump administration listed the chief prosecutor of the International Criminal Court because she investigated alleged US war crimes. It has also threatened action against German state officials over Nord Stream 2. Many such measures are being imposed or threatened by a bipartisan coalition in Congress. And the Trump administration increased the pressure through its update of the Countering America's Adversaries Through Sanctions Act guidance in June.

Republicans are proposing further such measures, including those against Europe. And many in the US are thinking about the "Iranisation" of their China policies; in other words, they contemplate targeting China with financial sanctions, whose secondary effect would be to pressure Europeans into compliance with the United States' China policies (rather than cooperating with Europe to establish a much more effective China stance). China does not yet have as critical a position in global economic networks as the US does. But China could soon use similarly sophisticated measures to shape Europeans' trade with third countries, through the centrality of its digital currency, technological advances, or efforts to take up a crucial position in Europe's infrastructure.

- **Extraterritorial export controls:** Export controls from both China and the US use re-export rules to squeeze Europeans ever more tightly and increasingly cut off or control European trade with unrelated third countries. More and more, European companies have to request authorisation from Beijing or Washington to export their products to unrelated third countries – simply because a small number of upstream products in their supply chain originally came from China or the US.
- **Sensitive data transfers:** Both China and the US are increasing pressure on companies to transfer sensitive data. In the US, there is less and less clarity on procedures for proceedings in areas such as anti-bribery, anti-dumping, antitrust, foreign investment control, and commercial litigation. In China, there are next to no transparent procedures whatsoever.
- **Russia:** Moscow has used similar blackmail. In 2014 it banned the import of a vast array of EU agricultural products, especially those produced by Poland, in response to Western sanctions on Russia over the war Ukraine. While these actions were geopolitically motivated, Russia justified them by pointing to public health concerns. But decision-makers in Moscow are starting to debate how to use such economic tools much more overtly in the future.

In all these forms of coercion, powerful countries are increasingly using their centrality in an economic network, or sector, to determine with whom Europeans trade.

The search for solutions

Europeans find it difficult to develop options for an effective response to these various forms of economic coercion. On US sanctions with extraterritorial effect, for instance, Europe does not lack analyses or relatively vague policy proposals, but there are no concrete options for decision-makers that promise to be effective. Part of the problem is that Europeans often examine US sanctions in isolation – thereby somewhat neglecting the fact that they are part of a much broader phenomenon of economic coercion that emanates from several countries, and that violates both national and European sovereignty. This coercion is most dangerous when it comes not from Europe's closest ally, the US, but from other, less friendly, powers. Recognising the broad nature of the phenomenon would help Europeans formulate concrete options for more effective responses.

This report presents a toolbox of measures Europeans could build and use to respond to various forms of economic coercion. Some, such as the proposal to build a European Export Bank, are geared specifically toward US economic coercion because they address the weaponisation of the world's dominant currency, the dollar. But most – from a new Collective Defence Instrument for the European Commission to a competition instrument to balance out the disadvantages imposed on European companies, to an attractive digital currency – could address the lack of European responses to economic coercion whatever their source. Europeans can expect most economic coercion to come from China and possibly Russia in the future.

The tools show what options European decision-makers could realistically choose if required. Each policy comes with its own disadvantages and challenges. And some tools present particular difficulties, thereby underlining how hard it is for Europe to come up with concrete and viable options. Therefore, the toolbox seeks to offer a creative yet realistic overview of options. Its recommendations are not set in stone. Europe's political leaders will have to choose their preferred options and carefully weigh the potential benefits and costs of each.

It is not that Europeans, including the authors of this report, necessarily want to take any of the more difficult measures contained in this toolbox, but that economic coercion against them might leave them with no other choice. Indeed, some of America's grave violations of sovereignty, including threats against state officials, are pushing many committed Atlanticists in Europe to contemplate some of the options presented in this report – a position they never wanted to be in. Europe's first and preferred option is – and should always be – a strong transatlantic relationship and, more broadly, multilateralism. So, Europe should, for instance, try even harder to agree on a reform of the World Trade Organisation along the lines of the proposal made by the "trilateral initiative" of the trade ministers of Japan, the US, and the EU.

But, when multilateralism fails to prevent grave forms of coercion, Europeans should embark on clear signalling and diplomatic initiatives to convince, and increase pressure on, third countries to engage in dialogue. This is also the point at which Europeans could test the legality of coercive measures in international courts.

Europe then needs to develop other tools to protect its companies, trade, and foreign relations more effectively. If applied prudently, these instruments could help keep open markets that might otherwise be closed by third country economic coercion.

With several of the tools discussed in this report, decision-makers will have to weigh carefully two types of cost: will the political and economic cost of inaction, or of using a measure not in this toolbox, outweigh the political and economic cost of deploying them? Some will argue that inaction, or more diplomacy, will lead to greater cost in the end. They believe that taking action helps demonstrate to third countries that violations of sovereignty come at a price; they believe these efforts will help de-escalate a situation, as occurred when the European Commission imposed counter-tariffs in response to US tariffs on European aluminium and steel. However, others think that, if Europe takes certain measures, this might be more costly than inaction because it could lead to escalation or further erode free and fair trade. The answer to this question depends on the exact situation political leaders find themselves in, on the calibration of possible measures they take, and not least on their resolve to stop economic coercion one way or another.

This report is a product of the European Council Foreign Relations' work and the opinions expressed in it those of the individual authors. The toolbox presents ideas for the European debate. It is based on a systematic consultation exercise that engaged with high-level public and private actors, mainly those from Germany and France. ECFR's Task Force for Protecting Europe from Economic Coercion worked on these proposals during 2020. Members of the task force discussed a range of possible responses to extraterritorial coercion and grave violations of sovereignty through economic measures. The papers do not reflect a consensus of the task force. The authors of the papers took into account how participants from diverse backgrounds in the public, economic, and financial sectors, and academia, collectively viewed opportunities and challenges on each instrument.

ECFR will publish a strategy paper at the end of the year that will suggest ways in which Europe could move towards its goal of achieving greater resilience in 2021, and another paper on the international role of the euro in achieving this end.

Europe's vulnerability to economic coercion might soon be coming to an end. This paper seeks to make a contribution to that goal.

Overview – Responding to extraterritorial and other violations of sovereignty: 11 policy options for European resilience

Financial policy	Trade policy	Other policy areas
European export bank Create a public EU bank to keep payment channels open with third countries sanctioned by great powers	**Positive incentives** Set positive incentives in relations with the US and China and build Europe's own strength	**Market distortion** Calculate the cost and market distortion of coercion, provide the EU with a redressive instrument to level the playing field
Digital currency Build a digital euro for greater resilience from economic coercion and to reduce third-country insights into European financial transactions	**Collective defence instrument** Create a European collective defence instrument to give the European Commission the power to react to economic coercion against one or more member states to respond to a violation of sovereignty under international law	**Personal sanctions** Impose personal sanctions on third-country persons, such as travel bans and asset freezes
EU resilience office Create one unified interlocutor for OFAC and Chinese MOFCOM and other offices. Conduct cost assessments of third-country coercion, document blackmail, accompany and support EU companies, and issue project and investment certificates through the office	**Blocking statute** Strengthen the EU blocking statute to make it more efficient and supportive of companies. Restore its original deterrent effect	**EU resilience fund** Provide European export credit guarantees to guard against coercion. Support companies in defending against coercion. Build solidarity through compensating particularly hard-hit sectors and member states
International role of the euro Adopt concrete measures for more trade in euros and create an ever more attractive alternative to the dollar and the renminbi (forthcoming)	**Stop sensitive data transfers** Negotiate a new framework agreement with the US. Require EU notification and approval for core sensitive data transfers. Protect companies from illicit sensitive data grab under Chinese Cybersecurity Law, Chinese informal blackmail, the US Cloud Act, anti-bribery/-corruption/-dumping procedures, OFAC requests	

How to defend European sovereignty in the face of economic coercion

To protect Europe from extraterritorial and economic coercion, the EU and European governments could:	EU-27 unanimity required?
Immediately	
Calculate the cost & market distortions caused by extraterritorial coercion (See Levelling the Playing Field)	
Marshal senior business leaders and agree a public-private compact to counter sanctions (See A European Resilience Fund)	
Draw up a list, whether in private or public, of who to impose personal sanctions on in response to economic coercion (See Personal Sanctions)	
Ramp up diplomatic pressure on those who use economic coercion against Europe (See Protecting Europe from Economic Coercion)	
In the short term (the next 3-12 months)	
Join together in a group of member states to impose personal sanctions such as travel bans and asset freezes (See Personal Sanctions)	
Adopt a framework regulation for personal sanctions without concrete listing under the Common Foreign and Security Policy (See Personal Sanctions)	
Create a collective defence instrument so the European Commission can impose countermeasures (See Collective Defence Instrument)	
Impose EU countermeasures under a collective defence instrument such as fees on cross-border services or restrictions on EU public procurement markets (See Collective Defence Instrument)	Not once the instrument is established
Central banks to include sanctions resilience in their digital euro plans (See Digital Currency for Resilience from Economic Coercion)	
Agree data free-flow with the US, prohibiting forced sensitive data transfers and a dispute settlement mechanism (See Guarding Against Forced Sensitive Data Transfers)	
Reform the EU blocking statute to allow businesses to go to third-country courts and clarify compensation procedures (See Reviewing the EU Blocking Statute)	
In the medium term (the next 1-3 years)	
Build a European Export Bank governed by public law with no exposure to the US dollar (See Payment Channel Resilience)	
Impose personal sanctions such as travel bans and asset freezes under the Common Foreign and Security Policy (See Personal Sanctions)	
Levy fees on third-country companies that benefit from economic coercion under EU competition policy (See Levelling the Playing Field)	Only once, after changing the EU's subsidy definition
Give an EU entity the competence to authorise or reject highly sensitive data transfers from EU companies to third countries (See Guarding Against Forced Sensitive Data Transfers)	but possibly not in all policy areas
Upgrade the EU strategy on connecting Europe & Asia to a truly global "EU Global Connect" (See Building European Strength at Home and Abroad)	
Allow companies to use different payment infrastructures with varying transparency for third countries based on the EU crypto asset regulation (See Digital Currency for Resilience from Economic Coercion)	
Offer EU export credit guarantees for certain undertakings (See A European Resilience Fund)	
Set up a European Resilience Fund to give greater support to businesses & European solidarity (See A European Resilience Fund)	
Establish an EU Resilience Office to help businesses deal with SECAD in China & OFAC in the US (See An EU Office for Resilience from Economic Coercion)	for giving it certain competencies
In the long term (more than 3 years)	
Build a digital euro on purely European/ECB infrastructure, & under the sole jurisdiction of EU (See Digital Currency for Resilience from Economic Coercion)	

Promoting a positive trade agenda and building European strength at home and abroad should be on European minds immediately, in the short term, and in the medium to long term.

An EU Office for Resilience from economic coercion

Providing a central interlocutor, analyst, and support for business

Jonathan Hackenbroich

The problem

The European Union has no equivalent of third country agencies that decide on and implement economic coercion against the European Union. This means that there is no central body that represents European interests in dialogue and negotiation with entities like the Chinese State Export Control Administrative Departments (SECAD), the US Office for Foreign Asset Control (OFAC), and others. A third country can easily exploit or promote EU divisions. And European companies often find themselves left alone when confronted with problems in third countries, such as when a third country's agency begins applying pressure on them, or, through its coercive actions, causes compliance complexities, creates costs that no one has taken into account, or requests sensitive data transfers. The lack of a European equivalent to third country agencies comes with a cost to European foreign policy and companies.

Member state governments may not regard this as problematic when there is no damage to their narrow interests or companies in a given situation. There is also little appetite among them to supranationalise EU enforcement of economic instruments, which is currently a member state competency. But each member state can face economic coercion from entities in Russia, China, the United States, and other powers.

The opportunity

Establishing an EU Resilience Office would create more symmetry with other actors, move Europeans a step closer to having a body of equivalent status to oversee policy areas in which they are currently lacking, and provide better support to European businesses. The office's experts would serve as a permanent interlocutor with relevant third country entities, gather expertise, coordinate European resilience efforts, warn governments and businesses of economic coercion risk early on, and serve as a resource for European businesses. It would systematically assess instances of coercion, identify patterns, and provide a strategic overview of how economic coercion is impacting on European policy and business. Its work should focus on helping member states by assisting them to avoid significant political and economic cost. Setting up an EU Resilience Office would be in each member state's interest and necessitate no treaty change or further transfer of competencies to the EU level. It would not be a new institution, but rather a new entity within EU institutions, like the new Chief Trade Enforcement Officer.

The office would also help overcome some of the EU's problems with the horizontal nature of economic coercion. It would bring together a standing staff of experts from the EU institutions, for instance from the directorates-general covering trade, finance, and economy, and the European External Action Service. It could work closely with economists and legal experts as well as geo-strategists, given that geo-economic matters require collective analysis from all these perspectives. The office could be headed by a Special Representative for Economic Coercion to lead the dialogue with third-country authorities and to anchor it at a high level within the European Commission.

The following is a long list of services the Resilience Office could provide to member states and European businesses. The EU will have to prioritise between these, as such an office is unlikely to be able to take on the potential full array of functions immediately. It could start with a cost assessment and add further services as and when they become viable:

- **Cost assessment of third country coercion:** The office could fulfil three critical sub-functions. These are:
    - *Collateral effects:* Flagging to third country agencies the damage they could do to Europeans even if particular policies do not target Europe directly – for example, US sanctions on Venezuela.
    - *Cost to European policy:* Publicly outlining which policies third-country coercion has prevented the EU from pursuing.
    - *Cost to European businesses and market distortion:* Periodic public reports on the direct, indirect, opportunity, and transatlantic cost. (See separate paper on market distortion)
- **Documenting third-country coercive behaviour:** Business actors could inform the office about any threats or disadvantages a third country uses to try to affect their behaviour. There could be a requirement to report to the office certain types of third-country action.
- **Guidance review:** The office could review third-country agencies' guidance and regulations to privately flag to member states where they curtail EU interests and, where it serves EU interests, it could flag these to third countries too.
- **Accompanying and supporting European companies:** The office could offer European businesses expertise on how to best deal with the pressure from a third country, especially in their bid for waivers and exemptions.
- **Conducting impact assessments of EU measures:** The more the EU strengthens its own capacity the more resilient it will be. The office could provide economic and political impact assessments of European sanctions and other foreign economic tools and feed these into the EU's review procedures.
- **Early-warning function:** The office could issue alerts to member state governments, business associations, and individual businesses to publicly or privately inform them about heightened coercion risk and EU responses, and get in touch with them early on to understand what they need to protect their interests.

- **Issuing EU certificates:** There is a range of areas where EU certificates could lead to greater certainty and greater resilience (when other conditions are met – see below). The EU could signal its special support for investments this way, declare certain due diligence procedures to be sufficient, and push back against third-country agencies that disagree. The EU could seek to align with other countries on these standards and interpretations.
- **Asset localisation support:** EU persons could receive assistance in understanding how to localise assets when it is their right to do so under EU law.
- **Investigation**: The EU could determine the degree to which the office should be tasked with preparations for investigations into third-country businesses operating in the internal market or European businesses illegally complying with third country coercive measures.

Challenges and limitations

This idea represents a real opportunity, but also comes with challenges that Europeans would need to address:

- **Equivalence:** An EU Resilience Office as outlined in this paper will not truly be an equivalent to third-country agencies. EU member states would have to give up core national competencies, passing them up to the EU level, such as in sanctions enforcement. If they do not do this, they will fail to build a real equivalent body. But the necessary treaty change for this is not on the cards. This is why the EU Resilience Office can only represent one tool of a broader strategy for protecting Europe from economic coercion. The office would need to receive high-level political backing for it to be an effective tool.
- **EU interest test:** There is a risk the office could end up supporting third-party coercion if it helps EU companies comply with that coercion. The office must review its actions and the support it provides in the light of the EU's strategic and policy goals to make sure this does not happen.
- **Clashes with legal norms:** Some functions of the office could clash with EU or member state laws. The EU blocking regulation makes it difficult for companies to provide precise information on economic coercion because this might expose them as violators of the regulation. The statute only applies to a limited set of cases of economic coercion, but where it applies companies are hard pressed to demonstrate that they do not comply with third-country coercion. They will not be open to discussing with an EU agency how third-country coercion is curbing their trade relations because there is an EU law in place that requires them to not restrict such dealings due to coercion. Some member state laws, such as the German *Rechtsdienstleistungsgesetz* law, which regulates the provision of legal services to entities such as companies, also limit the extent to which the office could give legal advice to companies. This illustrates how some of the office's political functions, such as on certification, might clash with Europe's legal approach to economic coercion.

- **Usefulness:** It is unclear whether an EU due diligence certificate as proposed above would truly alleviate EU companies' compliance burden, for instance.
- **Speed:** Some of the functions enumerated above might be difficult to provide within hours, which is the timeframe in which others might act.

Reviewing the EU blocking statute

Restoring deterrence and efficiency

Jonathan Hackenbroich

The problem

The EU blocking statute is dysfunctional. The statute – which was enacted in 1996 in response to US attempts to interfere with lawful European trade with Cuba, Iran, and Libya – is designed to shield EU individuals and entities and their lawful international trade from the extraterritorial effects of economic coercion. It is meant to serve two strategic goals: protection and deterrence. However, it has generally failed to provide such protection. Paradoxically, it has prompted many companies to attempt to further reduce their risks, rather than providing them with a sense of security.

Europeans could potentially accept these adverse effects if the blocking statute achieved its broader strategic goal: deterring the United States (or others) from implementing sanctions in the first place. For more than 20 years, when successive American presidents refrained from activating Title III of the Helms-Burton Act, the statute appeared to be having the desired effect. It was finally implemented in 2019 under the Trump administration and allows US individuals and companies to sue Europeans when they engage in certain transactions with Cuba. But even if Donald Trump were not in the White House, today's great-power competition means any US president would find it much less compelling to show such restraint. Moreover, Trump's strategy is one of maximum pressure. The statute has no deterrent effect in the face of such an approach.

The fundamental question thus remains how to provide protection and deterrence in a new geoeconomic age, not just with regard to the US. The manner in which Europeans deal with US extraterritorial is also sets a precedent for other powers, which might impose similar measures in the future. But the problem with the blocking statute is not just that the policy itself does not work; the European debate surrounding it is also somewhat unproductive.

There are two camps in Europe: those who believe the blocking statute could change the calculations of private businesses and actually help them in negotiations with great powers when they face extraterritorial coercion; and those who view the blocking statute as merely symbolic. According to the first view, toughening the blocking statute and its enforcement would allow European businesses to use the defence of "foreign sovereign compulsion" (that the laws of their home country require them to behave in a certain way) before the American authorities and courts. Tougher European penalties, public enforcement action in Europe against those suspected of having complied with US sanctions, and investigations into business decisions after sanctions are announced or imposed would help with this. At the very least, it is argued, it would buy companies more time in the US or help them negotiate for waivers. And with political support and compensation, this could lead them to refuse to comply with third countries' attempts at economic coercion.

On the other hand, those who view it as merely symbolic believe that, ultimately, Europe cannot possibly alter business calculations with a blocking statute. The European 'carrot' can never be sweet enough and the European 'stick' can never be hard enough when compared to US threats to deny access to financial markets or the dollar. According to this view, European entities are caught between a rock (US sanctions) and a hard place (the blocking statute) – and this dilemma defeats the blocking statute's purpose of protecting Europeans. Toughening the blocking statute would also mean more compliance work (and thus disadvantages for small companies), but no change of outcomes. This is because Article 5 of the statute's guidance allows EU operators to start, continue, or cease business operations in the countries concerned as they please. In essence, they simply have to invoke their freedom of business, rather than third-country measures, as the reasoning behind their decision to withdraw from a certain market. But without these liberties under Article 5, this argument suggests, European businesses could face the threat of going out of business altogether.

Both of these positions are right – and wrong – in different ways and scenarios. It is true, for instance, that the "foreign sovereign compulsion" argument has been persuasive to US institutions on occasion. The difficult position European companies find themselves in due to the regulation is undeniable, too. But maintaining each of these positions in their entirety could end up endangering Europe's capacity to act.

Ways out of the dilemma

Common public resistance

In a way, Europeans suffer from a collective action problem with regard to secondary sanctions. If everyone complied with the blocking statute without exception, it would work. The US would cause a massive economic and financial crisis with huge costs to its own economy if it then followed through with its threats and sanctioned a large number of European companies. America's incredibly effective sanctions policy, a key tool in its foreign policy armoury, would be exposed as ineffective – a scenario that many in the US are already alarmed about. This is an option to think about and, if a critical number of European companies were contemplating it, the blocking statute could help with compliance from less committed actors. But until that becomes the case, this theoretical way out remains only a thought experiment.

Reforming the blocking statute

Europeans could reform the blocking statute to make it as effective as possible. The existence of the blocking statute is better than having no means to tackle the threat of extraterritorial forms of economic coercion. As suggested, it has successfully deterred coercion in the past, sends an important signal, and is helpful with regard to the Helms-Burton Act. It could also be a useful tool in combination with other instruments that this report proposes. To make it more effective and to help businesses, Europeans could continue to prohibit companies from complying with extraterritorial coercion. However, rather than allowing conflict between third-country laws (the rock) and EU law (the hard place) to make the situation ever more difficult for companies to navigate, European authorities could use the blocking statute to trigger a political dialogue with third-country authorities (see the "European Resilience Office" proposal discussed in a separate paper). Thus instead of imposing penalties on businesses, the blocking statute could help to establish a clear and supportive procedure for businesses – allowing them to defend their interests in third-country courts, spelling out procedures to work with the European Commission, and providing greater support for businesses. This should also clarify compensation procedures in cases where compensation as a result of successful lawsuits against third-country companies in the EU is difficult, or impossible, to obtain because they have no assets in the EU that could be expropriated.

Protection through deterrence

Common public resistance could be a solution to Europe's problems in the face of extraterritorial coercion, but it is unlikely to work in practice. Reforming the blocking statute is viable in practice, but would only provide marginal relief. A third way – one which tries to address the concerns of both sides in the European debate over the blocking statute and which goes back to the original spirit of the 1996 statute – could be both viable and effective. The notion of "protection through deterrence" would be guided by two principles. Firstly, the blocking statute should be effective in deterring, or minimising, extraterritorial effects on Europeans. Secondly, it should protect European companies, not impose an impossible dilemma on them.

There are scenarios where the current version of the blocking statute can already protect and deter successfully: for instance, if a US entity (whether an individual or company) sues a European company under the Helms-Burton Act in the US (because it believes US law should prohibit the European company from engaging in trade with a Cuban company), the European company can sue the US entity in return in Europe. Under the blocking statute's "clawback clause", it can aim to recover damages incurred through the lawsuit in the US in Europe. EU member states would need to allow for the asset-based jurisdiction necessary for reclaiming damages in this way (Austria, Germany, and Sweden already do so). But US government sanctions still remain a problem for companies, as European reciprocal lawsuits are only possible in response to US entities' lawsuits in the US.

The problem is that there is no perfectly equivalent form of compensation when a government like the US is itself the author of the measure damaging a European company (as is the case with Iran secondary sanctions, for instance). But there is a type of equivalent response nonetheless. European institutions could launch an investigation and identify which US entities are benefitting from the opportunity cost US sanctions are placing on European entities. This could be companies that directly fill the vacuum left by a European retreat from a certain market or sector, or it could be European companies' US competitors which gain relatively from sanctions even if they do not directly fill any vacuum. The basis for this is that European entities suffer from unjustified disadvantages in international trade.

The private enforcement principle in the current clawback clause would then work in the following manner: European institutions (either the EU or national governments as part of a coalition of likeminded countries) could take into account the status of a company as a "sanctions beneficiary" in the application of their already-existing regulatory measures. This need not be done through an "EU Office for Foreign Asset Control" (like America's OFAC) or counter-sanctions, which may never be enacted. To give an example, the European Commission could treat unjustified advantages gained by US companies as (external) state aid or subsidy in the context of its trade defence or competition policy. Just like US sanctions decisions, EU institutions could allow for exceptions on the basis of negotiation with those companies.

This report's separate papers detail some of the possibilities (see "Levelling the playing field and tackling market distortion" and "A collective defence instrument"). Sticking to the dysfunctional 1996 version of the blocking statute could be a fourth option for Europe. But it would not block much, and risks being merely a declaration of disapproval. Europeans will then have to rely even more on other geoeconomic countermeasures to defend their values and interests.

Levelling the playing field

Tackling market distortion caused by economic coercion

Jonathan Hackenbroich

The problem

Europeans lack a realistic means of assessing the cost and market-distorting impact of extraterritorial economic coercion. They can calculate the damage that punitive tariffs inflict on their economies, but less easily that of forced sensitive data transfers, extraterritorial export controls, or extraterritorial and coercive sanctions. These measures distort both the European market and global competition.

The European Union already monitors potential barriers to entering other countries' markets; provides companies with the chance to flag the disadvantages they face; and has proposed a level playing field measure to redress distortions caused by foreign subsidies. But there are no equivalent policies to tackle new distortions to markets caused by extraterritorial coercive measures. Thus, there is no systematic impact assessment of the direct and indirect disadvantages suffered by European businesses even within the EU market. And there is no means to redress these disadvantages.

The opportunity

Europe could address these twin gaps while at the same time defending free and fair trade, and increasing the EU's resilience. Firstly, it needs a regular, systematic assessment of the cost and market distortions caused by economic coercion. Secondly, after careful evaluation, EU institutions could use a new measure to offset the impact of these distortions on the European market.

The major benefit of such an approach is that it might both provide Europeans with an effective tool and reduce the likelihood of costly tit-for-tat escalation. There should be little danger of escalation in simply assessing market distortions. Moreover, even if Europeans provide the European Commission with a tool for redress, this would not involve ad hoc countermeasures taken in the heat of a geo-economic conflict. Instead, this measure would slow the dynamic of potential disagreement and establish a transparent process based on clear criteria of fair competition. Europeans would bolster liberalism and disincentivise such coercion as third countries factor in the possible cost and opt instead for dialogue.

A cost and market distortion assessment

Although coercive measures may have clear costs for a particular enterprise in a specific situation, only a strategic assessment of the overall impact can provide a realistic overview of the increasing costs to European businesses – both in their own market and globally. Such an assessment could analyse different forms and cases of coercion; compile evidence of the economic patterns that are involved; and estimate the significant economic chilling effect that the mere threat of coercion causes.

Ideally, the cost assessment could look at the following factors:

- **Direct cost:** The volume of European trade that is lost because businesses disengage from, or cannot facilitate, transactions that European governments would not curtail.
- **Relative cost:** The reductions in overall company size and in economies of scale resulting from the loss of an export market that European companies incur – relative to their competitors from the country implementing the coercive measures – and the resulting advantages companies from that country are enjoying in the European or global markets.
- **Opportunity cost:** The estimated loss of trade and investment caused by uncertainty and steps to reduce risk.
- **A transatlantic dimension:** The market shares Europe and the United States have collectively lost to China in strategically important regions (for instance, along the Silk Road) as a result of coercion.

If and when it is established, a European Resilience Office (see separate proposal) could be charged with conducting this regular assessment and could coordinate the existing expertise within the Commission (especially within the competition, financial services, and trade directorates). In the short term, however, Europeans could task an economic research institute (or several of them) with calculating the cost and distortion stemming from major cases of economic coercion over the past year. A first report could be published within months.

A redressive instrument

A redressive instrument would apply to undertakings – for instance, business transactions – occurring in the EU that benefit from a third country's economic coercion. When coercive measures are threatened or used against Europe, the EU could assess the potential economic motives of such actions, and determine whether they significantly distort, or have the potential to significantly distort, the internal market and cause damage to European companies. It could develop transparent indicators for its assessment and also conduct an "EU interest test" (to determine whether there are benefits from inaction in a particular case that outweigh the market distortion) before moving to correct the distortion.

Following such an assessment, the EU could offset the damage and distortion through:

- Redressive fees levied on a third-country company that has gained an advantage due to measures taken by its government. The resulting payment would go to the EU and member states, and could potentially fund other resilience measures.
- Divestment of certain assets.
- Prohibition of certain investments.

Some examples:

- Due to economic coercion from country X, European company Y can no longer sell products to country Z even though European governments regard transactions between Y and Z as legitimate. Sales to Z were 20 per cent of Y's revenue. The company suffers losses, a reduction in overall size, and economies of scale in the EU market, and incurs further opportunity costs resulting from investment uncertainty and divestment – all as a result of country X's economically coercive actions. Its main competitor – company N – in the EU market comes from country X and, therefore, has to pay a redressive fee to level the playing field in Europe.

- Country X's extraterritorial measures lead to a sharp fall in European trade in certain goods from country Y. Europeans have to substitute products they receive from Y with products from X. X's companies thereby benefit in the EU market relative to European importers of Y's products. X's companies have to pay a redressive fee or divest from assets to level the playing field. Companies from X are able to obtain more leeway in the Y market than European ones – thanks to their closeness to X's authorities – and are active in the European market. Accordingly, these firms benefit from their overall size and economies of scale in the European market. And they pay a fee, too.

Challenges and limitations

This idea represents an opportunity but also comes with challenges Europeans would need to address:

- **Fundamentals of EU competition policy:** Seeking to tackle the costs of extraterritorial measures comes with a risk of politicising EU competition policy This would involve a significant departure from the principles of EU competition policy (which are currently focused on concrete costs caused by third-party financial contributions). It could also invite many actors to call for a further widening of the scope of competition policy.

- **Retaliation?** In principle, this proposal seeks to avoid escalation. But the authors of economic coercion policies might escalate, or threaten to, when Europe decides to implement a redressive instrument. There is also a risk that third countries could start to offset the cost to their businesses of EU measures. Europeans would have to manage this politically and underline the fact that they are seeking to correct not all collateral market distortions but only those caused by economic coercion (that is, where there is an intent to change Europe's policies).

- **EU and WTO law:** The EU would have to widen its subsidy definition (regulation 2016/1037) to treat economically coercive measures as major market-distorting benefits to third-country companies. According to the EU white paper on foreign subsidies in the single market, market-distorting "financial contributions" can take various indirect forms – for instance, tax credits or uncollected public revenue. For other forms of economic coercion to be included, European governments would need to significantly widen the scope of the EU subsidy definition. To comply with World Trade Organization (WTO) rules, the EU would have to make the case that sanctions are equivalent to financial help and that they provide concrete and calculable advantages to foreign companies. For that, the assessment underlying redressive action would have to be conservative. Legal experts have confirmed it is possible to envisage the measure as being compliant with WTO rules (although this is subject to thorough legal verification). Alternatively, it could be regarded as a countermeasure under international law (see the separate proposal on a collective defence measure).

- **Causality and proof:** It may be tricky to make a clear case for benefits where extraterritorial measures give foreign companies only an indirect advantage.
- **Speed:** Third countries engage in economic coercion very quickly, while the EU would take time to react through this measure. This is an advantage: the EU can avoid escalation by seeking to calm the situation. At the same time, however, it is also a disadvantage: in some instances, a retroactive remedy of costs incurred will not be a deterrent.

Personal sanctions

Travel bans and asset freezes as a reciprocal reaction

Jonathan Hackenbroich, Pawel Zerka

The problem

Europeans struggle to find a way to respond when third countries, ranging from China to the United States, increasingly use sanctions as a tool to punish both individuals and entities – whether they be companies, banks, governments, or even local politicians – in trade transactions that they want to curtail for geopolitical or economic reasons. Europe uses personal sanctions as a foreign policy tool to counter violence and repression, aiming to penalise foreign individuals for specific violations of international law and to deter further such behaviour. But there is no European tool to respond to personal sanctions or violations of European or national sovereignty through economic coercion. If Europe had a tool – as it did when the European Commission deployed the threat of counter-tariffs to deter car tariffs – the EU would have a stronger hand in negotiations.

The opportunity

Personal sanctions (such as travel bans, asset freezes, and prohibitions on providing economic resources) could equip the EU with a tool to respond to acts of economic coercion. They would have a number of potential benefits:

- **Low cost**: They would be less cumbersome and costly than other measures, as they only involve individuals.
- **Deterrence**: They would be targeted at specific bad behaviour, inflicting serious penalties on individuals and sending a strong deterrent message.
- **Country-neutrality:** Personal sanctions target individuals, not countries. Europe would simply put in place a mechanism to target those who, in very specific cases, facilitate major violations of the sovereignty of member states or the EU through economic coercion.
- **Potential to limit confrontation and minimise economic damage**: It is arguable that personal sanctions cause less damage to political and economic relations with third countries than other measures do. US relations with Saudi Arabia, for instance, have not been badly damaged by the use of provisions in the Magnitsky Act to list 17 people who are alleged to have been involved in the death of Jamal Khashoggi. If there was a transparent, carefully calibrated mechanism for when and how personal sanctions were triggered (rather than ad hoc designations), the EU could channel tensions into a process without suffering much economic harm itself. And other actors might factor in the cost and think twice about using economic coercion. But, as noted below, there could be escalation as a result of such an approach.

Europeans would only sanction people based on a clear causal link to, and personal responsibility for, illicit activity – as well as on other general, objective criteria. This would make this tool transparent and predictable to others, enhancing its deterrent function and lessening the likelihood of escalation. By contrast, sanctioning persons who are not involved in illicit activity (in an attempt to cause maximum retaliatory damage) would not reflect the EU's commitment to a rules-based international order or align with its sanctions policy practice. As such, this could face constraints in EU law.

Europe would thus target those responsible for, and who have had a personal role in, imposing or implementing economic coercion. These targets could be, for example, the authors of specific guidance – officials who use informal blackmail on European companies or who are responsible for proposing or implementing a designation, or politicians who threaten businesses informally. These individuals would thereby feel that there could be consequences for their actions. Other targets could include third-country bank staff who implement an asset freeze, or those who help a third-country government in any significant way in coercing Europeans.

The legal basis

At the EU level, there is currently no simple mechanism for triggering counter-sanctions in response to economic coercion. If they achieve unanimity, member states can impose such sanctions jointly as part of standard Common Foreign and Security Policy (CFSP) decision-making. But economic coercion is often designed to hit some member states more than others, and to thereby split the EU – making unanimity difficult to achieve.

This is why Europeans could take a different first step at the EU level. Detaching the decision from any concrete case of economic coercion could make it easier to build a European consensus. Europeans could enact a regulation as part of the CFSP. This would impose travel bans and asset freezes on, and prohibitions against providing economic resources to, "the individuals in the annex" in cases involving economic coercion. This annex would be left blank for now. Putting anyone on the list in the annex would still require unanimity as things stand today (or a certain qualified majority, if that were agreed). However, the process of building a consensus on such a regulation would bring Europeans a step closer to being able to respond to third-country acts of economic coercion. The mere fact of publicly entertaining such an idea might also serve as a deterrent and signal how seriously the EU takes economic coercion. A framework regulation would state unequivocally which kinds of economic coercion Europeans jointly define as *corpus delicti*.

Laws in some member states either already provide room for the imposition of personal sanctions in response to economic coercion and extraterritorial measures. Where they do not, parliaments could create such a legal basis. For example, in Germany, the government may be reluctant to consider national sanctions as an option because its long-term practice has been to rely on an international (EU or UN) basis for sanctions. But, according to legal analysis, it should be able to introduce asset freezes and prohibitions to provide economic resources to a designated party based on section 4 and section 6 of the Foreign Trade and Payments Act. It could probably impose such measures for six months immediately. To make measures more permanent, it could change the statute implementing the act under section 4 (using the justification that the sanctioned persons significantly impair the country's foreign relations). Some may question whether there is a sufficient legal basis in section 6 (which is intended to address at the national level temporary, unintended, and dangerous gaps in multilateral sanctions regimes) and section 4 (which seeks to protect against a significant impairment of foreign relations). If it wanted to make things very clear, the Bundestag could amend section 4 and add a provision for personal sanctions in response to grave economic coercion or blackmail. Germany could impose travel bans independently of these considerations. It could deny visas, or entry, based on a threat to the public order or the security of German citizens.

In France, authorities are unwilling to consider national sanctions in response to exteritoriality as an option because, according to the existing legal basis, these would only be justified in the case of either the financing of terrorism or an infringement of an UN Security Council resolution. However, according to legal advice, the French government could also consider a different policy. Using sanctions in response to economic coercion would likely require adopting a new law to create an explicit legal basis for asset freezes, or extending existing legislation that permits such personal sanctions (Articles L562-1 to L562-15 of the *Code monétaire et financier* allows these in the case of bribery, money laundering, or terrorist financing). Such a move would likely be reviewed by the Constitutional Court to determine whether the problem is sufficiently grave to justify property restrictions. But, on counter-terrorism sanctions, the court has already allowed such restrictions. France also has roughly the same rules as Germany on the imposition of travel restrictions.

Challenges and limitations

There are a number of potential challenges and limitations to consider:

- **Retaliation**: Despite the assessment above that there is limited potential for confrontation, Europe could still face a disproportionate response to personal sanctions. Personal sanctions make things personal. The Huawei case suggests that countries such as the US and China could respond through further retaliatory actions, posing a significant risk for Europe. The US broke the taboo on threatening European officials with sanctions. Europeans would rather not respond in kind by threatening US officials or bank staff, hoping instead that America will soon come around to its view of things once again.

- **Decision-making process**: Deterrence requires a streamlined, transparent, and reasonably certain decision-making process. Both coalition-building for joint national-level responses and EU-level decisions on listings would take some time. Unanimity might be difficult to achieve on the EU level. An empty annex that never leads to any listings could undermine European credibility.

- **Asset localisation**: For asset freezes to be credible and borne by all member states, the EU would need to be able to locate personal assets across the bloc. The EU would need to harmonise, or at least catalogue, the numerous different asset registries across the union, which vary in quality by asset class, member state, and access procedures.

A European collective defence instrument

Setting incentives for cooperation against economic coercion

Jonathan Hackenbroich, Pawel Zerka

The problem

The European Union has significant gaps in its defences against economic coercion. In terms of what tools it does have, the EU currently possesses a variety of trade defence instruments to guard against specific unfair trade practices. In addition, the EU is currently putting in place investment screening to counter strategic takeovers, and it has launched a process to correct market distortions caused by foreign subsidies. However, the EU has no legal instrument to respond to third parties' infringements of national sovereignty and its essential security interests through the use of instruments such as trade tools, sanctions, vastly expanded export controls, or other extraterritorial measures. These infringements can be intended to coerce member states into specific policy choices in core areas of their sovereignty – such as tax policy – or to change their policy on a given issue, as seen in the Chinese ban on Canadian agricultural products in response to the arrest in Canada of Huawei executive Meng Wanzhou.

Moreover, the World Trade Organization's dispute settlement mechanism does not prevent such violations or account for third parties' rapid deployment of economic coercion measures that interfere with Europeans' sovereignty and essential interests. At the same time, Europeans want to, should, and do remain fully committed to the WTO system.

The opportunity

Europeans could envisage an instrument of collective protection from economic coercion. Such a collective defence instrument would give the European Commission and member states the capacity to directly protect Europe from economic coercion. The European Commission and its vice-president, Valdis Dombrovskis, have already indicated that they are working on "an instrument to deter and counteract coercive actions by third countries" as part of the EU's trade policy review.

How it could work

The EU could pass a framework regulation that provides the European Commission with an additional legal instrument to respond to the imposition of economic coercion against EU member states or the EU as a whole. Use of this instrument would be strictly limited to responding to grave, illicit acts that violate member state sovereignty or Europe's capacity to act. The EU should unequivocally state that such measures damage essential European interests and explicitly set out a definition of what constitutes grave acts of economic coercion against the EU, namely: the use of economic instruments that leads to economic damage to European businesses and that aims to coerce Europeans to adopt a certain policy in a core area of sovereignty or in economic or foreign policy.

Countermeasures under international law…

Economic coercion may involve a grave violation of national sovereignty or "EU sovereignty" in areas where the EU has exclusive competencies. Such a violation of public international law may, for example, occur where another power coerces a state into adopting a certain domestic tax policy, interferes with its core energy security policies, or tries to force it to adopt a certain foreign policy – as China sought to do when it curbed Australian meat imports in response to Canberra's call for an independent investigation into the origins of covid-19. In all cases, using a violation of sovereignty to achieve these goals is illegal. Third countries regularly evoke WTO security exceptions to justify their actions but, even if they allowed these actions, security exceptions do not grant them permission to violate other norms of international law. In instances of grave economic coercion against Europeans, the EU could move to protect the national sovereignty of a member state or of European sovereignty through decisive countermeasures aimed at stopping the violation and protecting its essential (security) interests.

Europeans might find a legal basis for this in public international law and WTO rules.

Firstly, international law, as *lex generalis*, is complementary to WTO law as *lex specialis*. Behaviour not sufficiently covered by WTO rules, such as the violation of sovereignty, is covered by international law. According to several resolutions of the UN General Assembly (for example, UNGA Resolution 2625), "no State may resort to or encourage unilateral recourse to economic, political or other measures to compel another State to subordinate to it the exercise of its sovereign rights." According to Article 49 of the *Articles on the Responsibility of States for Internationally Wrongful Acts* (the articles), states may implement countermeasures in the case of a violation of international law to induce the author of the violation to comply with its obligations. Article 48 might also help the EU, since it allows states other than the targeted state (probably the EU27 collectively) to take action to correct the internationally wrongful act if the obligation breached is owed to a group of states that includes the target. The UN General Assembly passed these articles almost 20 years ago. And jurisprudence and international law experts have frequently applied and referred to many of them ever since.

The use of an anti-coercion instrument under these articles could be limited to grave cases of economic coercion as described in this paper. In fact, Europeans should not, and would be unlikely to, take countermeasures if there is a realistic chance to stop the violation of international law through mutual agreement or in a multilateral organisation, and if they can be relatively sure that coercion would not be used against them again. Article 50 of the articles obliges them to use a functioning and adequate dispute settlement mechanism if the matter at hand can be effectively dealt with via that mechanism. But, at present, the WTO mechanism might not provide for sufficient dispute settlement. With its appellate body crippled by the US decision to block new appointees from becoming judges, the mechanism no longer guarantees an outcome on litigation. Together with 22 other multilateralism-minded WTO members, the EU founded the Multi-Party Interim Appeal Arrangement (MPIA) to uphold arbitration among themselves; but the MPIA does not help in disputes with the greatest economic coercers, as these are not members of the MPIA. So, Europeans could justify responding to a violation of international law with economic measures: Articles 22 and 25 of the articles on state responsibility stipulate clearly that a breach of international law is justified if that breach is a countermeasure to an internationally wrongful act.

…and under WTO exceptions

Secondly, WTO rules, however, remain and ought to be critically important for Europeans. If they decided to adopt an instrument as described here – in addition to justifying their behaviour under international law – they would need to base their actions on WTO law to protect their long-term interests in a rules-based international trading order. In principle, WTO law prohibits an economic response to economic measures without first attempting the litigation route, unless this response is covered by an exception in WTO treaties. So, the EU could base its actions on the "essential security interests" and "public morals" exceptions. It could argue that it needs a deterrent in areas where the WTO system does not effectively protect it from economic coercion (such as a violation of its rights outside the WTO context). It could argue not just that the dispute settlement is dysfunctional, but also that the system does not provide for emergency litigation at the speed third that countries deploy very effective economic coercion. In addition, the EU could point to its essential security interests to protect itself from violations of core principles such as national sovereignty in times of economic warfare that Europeans neither started nor contributed to.

The EU would have to demonstrate good faith for it to legitimately use such exceptions to WTO law. One way it could do so is what it might term *retaliatory enforcement*. Under this concept, the EU could move quickly to impose countermeasures to protect itself under the new instrument proposed in this paper, in response to what it deems a violation of public international or WTO law (or both). Such rapid action would be needed in grave cases because a decision by international courts or the WTO would likely come too late, after the act of economic coercion had already achieved its goal. When the act of economic coercion began, the European Commission would impose countermeasures to defend its sovereignty and essential interests. It could simultaneously take the measure to the International Court of Justice, if possible, or the WTO dispute settlement mechanism (or both). If, later on, such bodies held that the EU had no right to implement countermeasures (either under international law or under WTO law), the EU would retract them. It could additionally repair the damage incurred by the third country in certain cases by granting more favourable market access conditions for a certain period – which would show extraordinary good faith.

Concrete measures

To make the new instrument as effective as possible, Europe should mostly look at areas where the European Commission enjoys extensive competencies under current EU treaties. The following is a menu of possible measures Europeans could potentially consider under the instrument:

- Levying fees on the cross-border provision of services or blocking trade in services.
- Toughening data transfer restrictions.

- Toughening or threatening investment provisions; some might suggest going as far as limiting profit reallocation to the home country.
- Imposing restrictions on European public procurement markets. Some restrictions may be possible while sticking to European obligations.
- Levying redressive fees on entities that benefit from economic coercion, to level the playing field (see separate proposal "Levelling the playing field").

Europe could also look at suspending enforcement of certain protections under TRIPS (intellectual property). For example, the EU could stop the enforcement of piracy laws on certain products, threaten or impose (temporary) tariffs, or threaten or impose (temporary) quantitative restrictions on imports from certain countries. The EU would have to choose carefully from this menu, if it decided to establish an instrument as proposed in this paper.

Benefits of countermeasures under international law

- **A direct and calibrated response**: The use of the collective defence instrument enables a direct, proportionate, and timely response to specific actions that interfere in the sovereign affairs of EU member states or that pose a national security threat.
- **Enhancing solidarity**: By adopting the instrument, the EU would effectively be agreeing in advance to solidarity. If the instrument was used, the European Commission would impose the penalties, and member states could still have some say in implementation (via implementing act procedures, for instance) or, possibly, have a right to stop the European Commission by through a qualified majority, which would be a more creative approach.
- **Deterrence:** The existence of a clear response mechanism could deter extraterritorial and other forms of coercion in the first place, thereby avoiding future disputes.
- **Credibility**: An instrument as described here would radically boost the EU's credibility. As with a previous EU response to punitive tariffs, Europe could react swiftly. Europe has avoided automobile tariffs so far this way. And the European Commission has been able to act in certain areas even when some member states were not concerned by particular third country policies. It managed to bypass divisions without aggravating them.

Challenges and limitations

- **Weighing the cost**: With this tool in particular, decision-makers will have to weigh carefully two types of cost: will the political and economic cost of inaction, or using a measure not in this toolbox, outweigh the political and economic cost of deploying it? Broadly speaking there are two camps in Europe on this critical question. Those Europeans who believe the cost of inaction to be greater than that of action favour the implementation of this instrument because other instruments are ineffective and Europe's inaction actually invites further economic coercion against it. Those Europeans who believe that the cost of acting under this instrument is greater than that of inaction or of using a different instrument believe the existence of the instrument will invite further economic coercion against Europe (See Protecting Europe from Economic Coercion)

- **Instrumentalisation**: Third countries could try to establish a narrative that the EU is violating the law, even though Europe remains fully committed to the WTO system, international law, and the rules-based order. Europe's response in such an instance should be that third countries are attacking and destroying the rules-based order – to a point where Europeans are forced to invoke their essential interests to protect their national and European sovereignty in extreme situations of grave economic coercion. Third countries could still try to turn this around and claim that Europeans are eroding the rules-based order. The EU would have to very carefully craft a strategy to clarify its stance and trigger dialogue for strengthening the WTO – including by issuing invitations to restore (and reform) the WTO if third countries truly cooperated.

- **Retaliation**: Europeans' prosperity depends on trade that is free, fair, and rules-based – qualities that form a crucial basis of Europe's (and others') strength. If this new instrument fails as a deterrent, it might engender tit-for-tat responses from China, the United States, or other targets – which could create an escalatory spiral. This underscores the importance of establishing a transparent mechanism based on international law, which would set the right incentives for third parties to refrain from using economic coercion if Europe's leaders decided to adopt ideas in this paper. The instrument would demonstrate the EU's strategic approach (including signalling, diplomacy, and incentives), and it would be fully geared towards improving cooperation rather than endangering it.

- **Target identification**: The selection of sectors to counter-sanction and instruments to use may be technically, legally, and politically difficult. There can be various economic and political consequences from certain measures (such as data transfer restrictions) that Europeans would have to carefully consider. Many European countries also have other bilateral or plurilateral obligations. For example, investor-state dispute settlement provisions grant foreign investors the right to access an international tribunal to resolve investment disputes. The EU would also have to minimise collateral damage and prevent such damage from becoming concentrated in particular European regions or member states.

- **Legal questions and scope**: Europeans would have to thoroughly analyse the legal basis for this instrument, taking into account a variety of legal perspectives on the questions it poses. They would have to take into account how other binding agreements constrained the possibility of using this instrument. The idea of *retaliatory enforcement* (litigation and provisional retaliation at the same time) needs to be evaluated further. The framework regulation would have to be very specific in its definition of economic coercion and grave forms of interference with national or European sovereignty. This would be to avoid overly protectionist tendencies and, at the same time, allow for flexibility so that the European Commission could respond swiftly.

- **Misuse risks:** Once it existed, a tool could be misused. If not limited to certain grave cases, it might facilitate protectionism.
- **Solidarity risks**: The tool would run the risk that a member state that strongly opposed a specific act of retaliation – perhaps because it would incur serious damage to its economy or to a strong bilateral relationship it had with a third country – might be overridden and ignored by other member states or the European Commission.

Building European strength at home and abroad

Dr Janka Oertel

Economic coercion results from a deterioration in political relations between states. To address the destructive potential of coercive economic policies, it is not enough to respond defensively. Instead, it is important for Europe to be a strong and enduring economic partner and to achieve an overall international environment for economic interaction that favours cooperation and disincentivises coercive measures against European individuals, businesses, and governments.

Building strength at home

The competitiveness and innovativeness of European businesses and the power of the single market have made Europe a key economic partner for many countries around the world and a crucial player in global business and supply chains. The stronger Europe is at home, the stronger its position will be to actively deter economic coercion.

To ensure Europe's relevance as an economic powerhouse, the recovery fund designed to address the impact of covid-19 will have to be invested smartly and targeted specifically to address the challenges ahead. To compete in the future Europe should:

- implement the new industrial strategy, which is led by the European Commission in cooperation with the member states. This includes targeted investments in enhanced strategic sovereignty in the realm of critical (digital) infrastructure (including on 5G networks), to reduce dependence on non-EU players and the potential for disruptions of supply and services. Enhancing European industrial capacity could also help prevent the emergence of new vulnerabilities especially along the technology supply chain. Additionally, across Europe and in cooperation with business federations, companies of heightened strategic relevance should be identified and a mapping of remaining supply-chain vulnerabilities in strategic sectors conducted;
- make a concerted effort to promote digitalisation and green growth, including through dedicated funding opportunities for start-ups and foundational science to avoid dependence on US (and Chinese) capital, especially on the late-stage rounds, in order to help retain Europe's most promising start-ups, and create an attractive business environment for innovation at home;
- invest in a concrete analysis of the risks and opportunities of reshoring and nearshoring – the deliberate return of manufacturing and other commercial activities to Europe and its immediate neighbourhood – not only to enhance the resilience of supply chains, but also to potentially improve EU cohesion through seeking and advancing the economic and industrial capacities of member states in eastern and south-eastern Europe, including increased investment in infrastructure initiatives to promote intra-EU connectivity.

Shaping the international economic environment

Europe needs to enhance its efforts to actively shape the international economic environment based on rules, norms, and multilateral cooperation, which are increasingly threatened by great-power rivalry. The European Union and its member states need to define their priorities and make progress in areas of greatest concern. These include:

- Seeking provisional agreements on data free-flow with key, trusted partners, including the United States and India, as a prelude to more comprehensive free trade negotiations.
- Defining key areas of regulatory harmonisation to be pursued with a potential new US administration. Such areas might include financial services and privacy regulation and could include protections against extraterritorial sanctions as a basis for the harmonisation of standards.
- Continuing to strive for the conclusion of a substantive Comprehensive Agreement on Investment with China to enhance the basis for rules-based trade and a level playing field by the end of this year, while at the same time not hesitating to walk away from the negotiating table if Beijing continues to renege on real reciprocity by this clearly defined deadline.
- Revamping the EU strategy on connecting Europe and Asia into a truly global "EU Global Connect" strategy with a strong emphasis on digital connectivity and a specific focus on the Western Balkans and Africa. To improve the EU's communication about its existing efforts especially in its neighbourhood the connectivity strategy could also be used to frame current projects within the strategic connectivity narrative. This could include, for example, the European Neighbourhood Policy, where dedicated funding lines already provide financial support in Europe's vicinity, but connectivity as such has not been explicitly defined as a priority yet. At the same time, there should also be greater attention paid to the potential of strategic connectivity outside of Europe's immediate neighbourhood beyond Asia with Latin America.
- The basis for the EU's global connectivity efforts across all of its dimensions – from transport infrastructure, digital networks, energy links, to connectivity that serves and facilitates *people-to-people* interaction – should be that in principle it is open to cooperation with other major connectivity initiatives, including the United States' Blue Dot Network, designed as a tool for building and financing quality infrastructure, and even China's Belt and Road Initiative, if this cooperation is based on mutually agreed standards regarding sustainability, labour rights, and competitiveness.
- Using the political momentum generated by the German Indo-Pacific guidelines, which were published in September 2020 and seek to reshape German and European engagement with the region, to actively embrace strategic connectivity partnerships with Japan, India, and Australia. These nations are having to deal with similar challenges under the new geopolitical realities and are eager for greater cooperation with the EU.

- Creating effective new cross-cutting coalitions within the EU bureaucracy between the various directorates-general that share responsibility for the various aspects of connectivity including development, trade, digitalisation, and foreign policy. This effort should be led by the president of the European Commission. To be effective, a comprehensive connectivity strategy needs the necessary financial resources to implement projects at scale. This could be achieved through active and strategic inclusion of EU development funding in the connectivity agenda.
- Incentivising private business through guarantees and securities to boost Europe's financial firepower and leverage investment in countries of strategic relevance with high potential, but where greater risk taking is necessary to compete – especially with China.
- Identifying short- and medium-term measures including flagship connectivity projects to be explored in the areas of trade diversification and value chains; technology and digitalisation; and climate change.

Payment channel resilience

Building a European Export Bank

Jonathan Hackenbroich

The problem

Europeans lack payment channels that allow them to continue making transactions when a third party imposes a specific form of economic coercion – financial sanctions – against them. The centrality to trade finance and project finance of the US dollar and the US financial system means that EU entities are vulnerable even when they are not involved in trade with the United States. The absence of payment services for entities that would like to trade with countries targeted by third country sanctions lists has not been filled by the market. However, the state could step in to provide such critical infrastructure. The European Union and its member states have multiple governmental and quasi-governmental export credit agencies (ECA). But all of these, with the minor exception of the special purpose vehicle INSTEX, have significant exposure to the dollar market and the US financial system.

The opportunity

A new European Export Bank (EEB) that has no exposure to the US financial system or the US dollar could provide payment services, from the transfer of money to letters of credit. It could potentially also offer similar services to current ECAs, including direct lending, credit insurance, and export guarantees. The bank would be able to do so within a financial ecosystem that is less vulnerable to US sanctions. It would probably need branches in relevant countries to enable direct transfers. The particular opportunities and challenges would depend on the exact design of the EEB but the key benefits could be:

- **Being a public institution:** The EEB would be governed by public law. To avoid having to go through the process of changing EU treaties, the EEB could be an intergovernmental agency similar in status to the European Stability Mechanism and staffed with high-level EU and national officials. Third countries will be much more hesitant to sanction high-level officials and an interstate institution, especially if many of the EU27 jointly establish the EEB.
- **Non-confrontational signalling:** Even taking steps to create an EEB will demonstrate to the US that the misuse of sanctions could in the medium to long term be risky for the dollar's pre-eminence. Once the EEB comes into being, and if it functions well, its very presence will decrease the likelihood of any retaliation or political confrontation arising from specific sanctions. The US would struggle to find a way to punish entities that have no US operations.
- **European refinancing:** The EEB's refinancing would only be in euros or other EU currencies, and investors would have to be based in the EU.

- **EU-compliance:** The EEB could aim to be EU-compliant only, meaning it is not compliant with US unilateral sanctions but as noted above would be resilient in the face of them.

- **SWIFT, Target II, SEPA:** As a European institution, the EEB could gain access to SWIFT, Target II, and SEPA.

- **Gateway to commercial banks I:** The US Office of Foreign Assets Control (OFAC) and others could link commercial banks to "sanctionable behaviour" if they accept payments from, or wire payments to, the EEB (even if the EEB has access to SWIFT, Target II, or SEPA). However, Europeans could address this problem in one of two ways:

    - They could agree on a public-private compact between governments and commercial banks: governments assure banks of political protection and banks accept EEB payments in exchange. This would have to be an agreement at the highest levels, in several European countries. If governments or the EU expanded export credit guarantees for more cases of economic coercion, this could further help assure banks.

    - Europeans could establish an automated offsetting mechanism with commercial banks, including technical measures to make it difficult for third countries to trace transactions. They could require commercial banks by law to accept these payments, at least indirectly. This could still put banks between a rock (sanctions) and a hard place (EU law). In contrast to the statute, however, the legal obligation would be very specific and would not concern sanctions compliance directly. OFAC typically pressures banks to challenge such requirements in court. But courts might either hold this lawsuit inadmissible or uphold the legal requirement. (This is the prevailing legal view).

    - Europeans could require all companies and state institutions to establish an account with the EEB. This way the EEB would provide parallel payment channels and could process transactions outside the reach of third country sanctions.

There are two additional benefits to building an EEB. Firstly, it might, to some degree, promote the use of the euro in trade and in national reserves. Secondly, many countries around the world, and particularly China and the US, are increasing their use of export and project finance as a tool of foreign policy. The EEB would increase EU competitiveness in this effort, in a manner that is more insulated from US influence.

Challenges and limitations

This idea represents an opportunity, but also comes with challenges that Europeans would need to address:

- **Time:** Setting up an international EEB branch network, or even just the core EEB, will be no quick fix.

- **Gateway to commercial banks II:** Commercial banks could face a difficult situation where they have to accept a payment from the EEB without being in a position to conduct the due diligence they would normally do (or having to ignore due diligence requirements). Europeans would probably have to facilitate commercial banks' acceptance of transactions with the EEB through (legally binding) guidelines over due diligence on EEB-related transactions.

- **Gateway to commercial banks III:** OFAC could ignore European banks' legal constraints and still target them. This could lead to major transatlantic tensions and great economic cost on both sides. Commercial banks could try to circumvent the legal obligation. Europeans would then have to be more creative, at least until the EEB reaches critical scale. Companies could pay their employees in other countries from the money in their EEB account or their taxes to an EEB account of the relevant member state. There could be a system of points that actors could redeem in exchange for state or other services.

- **Contractual freedom:** If Europeans oblige commercial banks to indirectly accept payments from the EEB, they infringe upon basic principles of contractual freedom. While still a challenge, requiring everyone to have an account with the EEB (see above) might be easier than introducing such an obligation. An automated offsetting mechanism could make payments from the EEB easier to accept for commercial banks.

- **Retaliation:** The existence of the bank might threaten the future efficacy of US sanctions even if it does not immediately violate any existing sanctions. It could spark immediate retaliation, either through designation of the bank itself or through efforts to force European entities and individuals to avoid the bank. Europeans are particularly vulnerable in the financial sector – from SWIFT and credit cards to Europe's dependence on US rating agencies and benchmarks, US institutions settling euro trade, and critical euro clearing located outside the EU in London.

- **SWIFT:** To the extent to which the EEB relies on SWIFT for financial messaging, it will run into some well-known problems. The US gains vast insights into transactions through SWIFT and already pressures the Belgian company and its board members. Europeans would need to seriously tackle this difficult problem.

- **Critical mass:** The EEB will need to quickly find sufficient scale to make it too difficult for US authorities to try to strangle it in its crib. To achieve a critical mass of businesses using the EEB from its inception may require additional legislative support, particularly at the very outset. These could include tax incentives to use the EEB and obligations on European companies to use it. Critically, there may be a need to coordinate business actors at the beginning and get them to start using the EEB at the same time: the US could try to do this by targeting the first businesses and their CEOs that use the bank.

- **A limited market:** Many larger banks, big multinationals, and even many medium-sized companies have too much exposure to the US on a number of unrelated fronts to want to use the EEB. Sometimes even companies that have no US exposure risk damaging their relations with commercial banks because their credit agreements on unrelated undertakings oblige them to be sanctions-compliant.

- **Compliance:** Particularly if it used a new digital currency, the EEB would need a strong policy framework to avoid falling foul of anti-money laundering regulations and other frameworks now mostly enforced by US authorities.

- **Cost and euro liquidity:** Euro refinancing and proprietary trade are likely to come with additional cost. In addition, the bank would have to rely on public subsidy, at least for its first few years. The EEB could charge risk premiums, but these cannot be too high as it would need to ensure its services are attractive. Europeans need to assess whether euro capital markets are sufficiently deep for EEB refinancing under various scenarios.

- **Competition law:** The EEB would not face legal problems in competition law as long as it just offers services that commercial banks decline to offer. But where there is an offer from commercial banks, the EEB might violate laws on fair trade finance competition given public sector support that, from this perspective, would be deemed unfair.

- **Foreign policy:** Russia and China are undertaking similar initiatives and the EEB could benefit from cooperation with their efforts. However, this might signal to the US that the EEB is part of an effort to counter the US rather than build European resilience. Europe would need to underscore that it is not becoming a strange bedfellow of Moscow and Beijing more broadly.

Whatever it takes?

Ultimately, the EEB's success or failure in increasing sanctions resilience will come down to the question of risk. Private sector actors will have to accept a certain degree of risk in using the EEB. But Europeans would probably have to be willing and capable of protecting the EEB and companies that use it. Protection would mean: the state would have to stand ready to compensate a sufficient degree of damage, quickly and without complicated procedures. EEB staff would have to be European, have no assets outside the EU, and have the opportunity to get loans through the EEB, such as central banks already provide to their employees. Currently, Europeans are unable to help sanctions-targeted individuals if they lose their credit cards due to US measures. Participating companies would have to ringfence US citizens. If there is no critical mass of companies determined to use the EEB, whether or not any of them have been designated, Europeans might have to put a protection programme in place for companies that use the EEB. This all could amount to a fundamental question: will Europe do whatever it takes to protect the EEB?

In sum, an EEB could be a helpful tool in the European toolbox. There is a risk that it would only be helpful for those who do not have US exposure, and especially if they engage only in non-sanctioned transactions (where commercial banks 'over-comply'). But if it receives strong political backing, its power to strengthen European sovereignty could be significant.

Digital currency for resilience from economic coercion

Short-, medium-, and long-term solutions for future payment transaction infrastructure

Prof. Dr. Philipp Sandner

Head, Frankfurt School Blockchain Center

The problem

Existing forms of payment transaction infrastructure such as the SWIFT network currently offer a wide range of possibilities for authorised third parties to inspect transaction data or – in case of sanctions – to hamper transactions. Therefore, this system makes financial sanctions effective and targeted.

To build future payment infrastructure, several countries and central banks are trying to establish digital currency solutions. The Chinese central bank started to build its digital currency platform – called Digital Currency/Electronic Payment (DC/EP) – in 2014. In 2020 it is conducting test runs with 40 million individuals. The bank's aim is to replace physical cash with a digital version of the Chinese currency. It appears that this system is centrally governed but technically distributed based on the so-called distributed ledger technology (DLT).

In the United States and Europe, similar efforts on behalf of institutions are also currently being made to establish a central bank digital currency (CBDC). However, China is more than six years ahead of US and European central banks. Yet, in the US and Europe, the private sector has made significant advances – with, for example, multiple projects by commercial banks and Facebook's Libra, which is expected to go live in the next 12 months.

The US and China will try to bring transaction partners into their payment network to build and exploit the resulting network effects. For example, each country could set procurement rules such that a European company could only be awarded a contract if that firm was willing to receive payment from China via the DC/EP system. Companies may actually be willing to adopt the DC/EP system given the benefits of the system: real-time cross-border payment, technical integration, and automation. In any case, this could trigger the adoption of the Chinese DC/EP system among non-Chinese companies too. The same could be true for the adoption of a US-based system among non-US companies.

Payments processed in these systems could be analysed by authorised US authorities or their Chinese counterparts respectively. This could give the institutions that operate their digital payment systems broad insights and discretionary power over transaction processes and their respective data. This would not only have implications for data protection; it would also make a new generation of financial sanctions against European companies or countries very effective and targeted.

Systems such as a digital euro issued by the European Central Bank (ECB) – a euro CBDC – will not be operational until 2026, at the earliest, or even 2028.

The opportunity

The establishment of a European payment infrastructure for a digital euro could reduce the risk of comprehensive disclosure of transaction data – depending on the specific infrastructure design. A digital euro could, therefore, increase Europe's sovereignty in payment infrastructure and thereby reduce its dependence on foreign payment networks, with the aim of enhancing the resilience of European trade relations to sanctions.

Unlike the existing architecture, a DLT-based digital currency can prevent data manipulation or unnoticed 'read access' by unauthorised third parties, if it is set up correctly. Currently, whole databases can be copied to a USB stick and there is no way to determine whether a copy has been made or – even worse – whether and how often this copy has been duplicated.

With modern DLT-based digital payment infrastructure, an unnoticed 'database scan' would no longer be possible. To be precise: data analyses and a read access of data are still possible but in a form that – by definition – is tamper-proof and that will be noticed and logged or, depending on the design of the system, must be approved by certain actors (such as the European authorities). On request, the system could provide authorised government agencies with detailed insights to prevent financial crime.

Short-term measures: Building infrastructure for the digital euro

One way of tapping into the benefits of this technology would be to set up a separate system for the digital euro. However, the ECB would need several years to set up its own infrastructure in Europe, which takes years of careful planning and engineering. The technological progress that China has now achieved will be difficult or impossible to catch up with.

A digital euro created by private organisations

If Europeans would like to find a solution in the short term, they could think through what it would mean to liberalise the launch of payment infrastructure platforms by private actors while at the same time ensuring appropriate regulation. Payment traffic could thereby switch to non-US or non-Chinese payment systems, which could be set up by different actors thanks to this liberalisation. The European Commission presented in September 2020 its regulation on crypto assets – the "Markets in Crypto-Assets" (MiCA) regulation. This regulation also defines regulatory requirements and covers so-called stablecoins (as one type of crypto asset) on the basis of a DLT system, such as Libra. Organisations that meet these requirements could launch a digital euro.

The core aspect of this consideration is that the monetary unit (the euro) should be conceptually separated from the underlying technical infrastructure: monetary unit and payment infrastructure are different levels and can be combined in different ways; there does not need to be a 1:1 relationship. It can be assumed that China is trying to route as many of the payments denoting the Chinese currency as possible through the DC/EP system, such that there is a 1:1 relationship between the currency and the underlying technology. The same can be assumed for the US, which is likely to do everything possible (analogous to China) to avoid or prevent payments in US dollars that do not run on its own infrastructure. The result would be that close to all US dollar payments would run on its own system – a 1:1 relationship. This would make all transactions fully visible to authorised US authorities.

However, the above proposal for the euro is based on a different consideration: if the euro is denoted on different sets of infrastructure (1:n relationship), which are in competition with each other, the transaction partners – end users such as companies, public authorities, and private individuals – have a choice. For example, the economic activities of an organisation that processes euro payments via different networks with different technical characteristics would probably not be as easily analysed by US authorities as are today's 'monolithic' SWIFT network, which handles most of the transactions. Of course, banks and financial organisations would need to connect to multiple payment infrastructures. In Germany, one bank has already started to investigate the connection to multiple such systems. This revealed that the required IT effort would not be prohibitive. Therefore, it is reasonable to argue that it is the very 'opening' of the technical infrastructure that could fulfil both objectives of 'digitising' the euro and shielding or isolating the currency from US or Chinese systems. At the same time, monetary policy would still be fully in the hands of the ECB.

Medium term: A dedicated payment system for the digital euro created by the ECB

In the medium term, the ECB could set up a separate payment system for the digital euro – a euro CBDC. This is the only way to ensure that the payment system is not compromised by sanctions imposed by these third parties.

In China, a DLT system is probably in use in which only the Chinese central bank can change the architecture and program code but other actors, such as banks, are able to confirm and execute transactions. The system is distributed accordingly, but governance is centralised. Governing centrally and distributing technically could also be a viable set-up for the digital euro issued by the ECB.

Long term: Data sovereignty in the digital euro system

If a DLT system denoted not only the euro but also the identities of transaction participants, this would create a useful architecture that protected the data of all participants in the system. In such systems, technically, only the person (be it an individual, company, or organisation) to be identified has sovereignty over their identity. Therefore, an unnoticed reading of data points is, by definition, no longer possible.

Challenges

- It is essential to have measures that protect the payment system itself against external attacks, in addition to the security measures of the agencies and companies that have access to certain transaction data. While the risk can be minimised, such as through zk-Snarks, it is not impossible that third parties, including state agencies, could gain insight into transaction data – but doing so would require significantly greater effort.

- It is important to note that, once trading between multiple assets takes place, or services or products have been paid for, a person's identity might need to be revealed – if, for example, such trades take place within a regulated financial organisation. Again, through appropriate security measures, the disclosure risks can be mitigated but not removed.
- Appropriate governance systems would have to be defined before implementation, to safeguard the freedom of European citizens, their privacy rights, and appropriate data access for certain parties. This would ensure that certain parties can only access specific data points and that participants cannot gain unauthorised access to the data of other parties as well as to comply with the rules regarding KYC, AML, and CFT.
- Europeans will have to ensure they do not sacrifice personal data protection standards in any way.

A European Resilience Fund

Fighting uncertainty, supporting business, building solidarity

Jonathan Hackenbroich

The problem

Economic coercion imposes costs on European companies. And protecting Europe from coercion could sometimes have the same effect. Losing access to the Chinese or US markets would impose massive damage on many businesses; this is precisely the leverage Beijing and Washington use in their coercive policies. But, beyond this obvious and existential cost, there are three areas in which Europeans could provide critical support to their businesses and build European resilience in so doing: uncertainty, compensation in specific cases, and European countermeasures.

The opportunity

Europeans could build their resilience by supporting businesses in these three areas:

- **Countering uncertainty through broader and European export credit guarantees:** Economic coercion imposes a tremendous chilling effect on trade relations and risks closing ever-more markets to European companies. In the realm of financial sanctions, for instance, banks generally take action to reduce their potential future risk (to the extent that some even term their behaviour “overcompliance”). To counter uncertainty, the EU or European governments could offer new export credit and investment guarantees, and expand the scope of existing ones. Some European governments, such as Germany’s, have started to offer export credit guarantees under which businesses can recover costs resulting from a sudden US listing of a business partner in specific cases, even when the European company is the one that withdraws. The European Union could take such an approach across Europe. A guarantee could also cover specific projects that might be targeted by US measures, thereby keeping open markets that might otherwise close due to uncertainty surrounding coercion.

- **Specific cases – A last resort for critical fates, personal illiquidity, self-defence:** Europeans could set up a facility to act as a lender and guarantor of last resort for certain highly critical undertakings. The state could jump in where there is a special EU interest or where a critical function provided by certain businesses or organisations faces an existential threat. The state could also reassure business leaders facing specific financial risks when they suddenly find themselves designated under financial sanctions. It could temporarily support such individuals in the case of sudden illiquidity between the moment of designation and their possible removal from a list or other solution. It could also provide compensation for legal support in these cases. Finally, Europeans could support their businesses when they challenge policies the EU regards as economic coercion in third-country courts, undertake lobbying activities against them, or use a European Export Bank or INSTEX (a euro-denominated clearing house Europe has established for trade with Iran hampered by US sanctions). The EU could set clear criteria to determine which endeavours are worth supporting in these ways.

- **A solidarity mechanism for European countermeasures:** European responses to punitive tariffs, or to defend national or European sovereignty, may impose direct or indirect costs on European companies. Moreover, an effective European countermeasure could impose collateral costs on specific European actors or sectors – for instance, in the case of tightened data transfer restrictions on those European businesses that rely on the unhindered cross-border flow of data – or spark temporary retaliation by a third country against a specific sector until the situation is resolved by negotiations. Europe needs to show solidarity with these specific sectors and member states. And it could foster this through special financial support for them.

A European Sovereignty Fund partly funded by third parties

A European Sovereignty Fund could partly fulfil the three functions listed above. It could include public sector funding to bolster Europe's capacity to act on foreign and economic policy; contributions from companies that would like, or are required, to purchase insurance-like coverage; and indirect third-party funding. There is a clear limit to the volume of financial support the EU and European governments can provide. But their countermeasures in response to economic coercion could lead to penalties on third-country actors, such as redressive payments (the "clawback clause" of the EU blocking statute already operates in this manner). Redressive payments on Chinese and US sectors, increased tariffs, and other penalties could thereby finance the European Sovereignty Fund. This would also ensure that the fund's financial firepower increased as economic coercion by a third country intensified.

Challenges and limitations

This idea also comes with a number of challenges that Europeans would need to address:

- **Chinese and US market access:** Unless it is part of a broader and bolder strategy for setting up a European Export Bank, it is neither realistic nor desirable for Europe to compensate for the loss of access to the US or Chinese markets (see separate paper).

- **Taxpayers:** Europe will not be able to comprehensively offset costs even in the areas discussed above. The measure might never be self-sufficient, thereby placing a burden on taxpayers. But partial compensation for damages and support could make a big difference, as many private sector actors confirm. It would send a powerful signal to both business and third countries that Europe was willing to throw its political and financial weight behind them.

- **Efficacy:** Europe needs to assess whether it can provide sufficient funds to have an actual impact. What is more, export credit guarantees only cover loss of a business deal – and provide no protection against going out of business. Therefore, their effect could be limited.

- **No market?** Companies may prefer to retreat rather than launch a defence against economic coercion.
- **Incentive for high risk:** European guarantees and compensation could end up rewarding high-risk behaviour. One way of dealing with this would be for a political actor (for instance, the European Resilience Office discussed in a separate paper) to make a decision about which undertakings to actually support.
- **Insurance principle:** Calculating the balance of risk and the cost of premiums is very difficult with regards to economic coercion.

Guarding against forced sensitive data transfers

Pawel Zerka

The problem

EU companies are facing intense pressure from non-EU authorities to respond to data transmission requests. In this process, sensitive data can easily be exposed, having a direct and deep impact on the European Union's economic interests, sovereignty, and strategic autonomy.

This increasingly common practice lacks clarity even in its procedures, which often counteract the normal judicial cooperation channels for transmitting information. The problem can occur in various types of proceedings in other countries (for instance, anti-bribery, anti-dumping, antitrust, foreign investment control, and commercial litigation cases). In China, where businesses are increasingly under pressure, the 2016 cyber security law, and various other norms, provide the basis for data transmission requests. However, and more importantly, they only partly codify what is happening in very informal ways. In the United States, this issue is increasingly becoming a problem for European businesses, too. The US Cloud Act requires digital service providers and subsidiaries to respond to data transmission requests from American prosecuting authorities by transmitting EU companies' information stored on their servers.

These transfer requests are often based on an extraterritorial application of laws, or mere pressure and coercion, and they pose a danger of being misused for geopolitical and other purposes. Consider a scenario in which a company violates US sanctions; as a result, a criminal investigation is initiated against it in the US, during which sensitive data could be requested – whether directly related to the case or not – significantly exposing the company and opening up vulnerabilities. Such a scenario would be even more alarming if it happened in China. If these requests concern a strategically important company, essential national or European interests could be endangered. But small businesses, too, can represent national or European interests and they are even more vulnerable because they may not have the capacity or means to protect their data which are available to big companies.

The opportunity

Europe's best response to the problem may depend on the political atmosphere over the coming months and years. Europeans could consider two options:

A framework agreement with third countries

The EU could negotiate a framework agreement on the transparent handling of data transfers with third countries, primarily the US. There should be great interest on both sides of the Atlantic in coming to an agreement on data flows more broadly – after the European Court of Justice struck down the "EU-US Privacy Shield", and given that Europe is a key market for US companies like Amazon and Google that provide services based on data. A new agreement would clearly stipulate the procedures that need to be respected in various types of proceedings (such as anti-dumping cases). It could also include a control mechanism to ensure compliance by both parties, and a system to settle disputes. It could be based on the ideas discussed during the Transatlantic Trade and Investment Partnership negotiations, but concluded independently from any larger trade deal. Such an agreement would clearly be in the interests of both the US and EU. However, it would be less of an option for reducing the EU's vulnerability to forced transfers of sensitive data in China and elsewhere.

EU authority to protect sensitive information

An EU authority (for instance, the European Resilience Office discussed in a separate paper) could be given the task of protecting European companies by requiring the EU's approval of sensitive data transfers to third countries. If necessary, such an EU body could be supported by national authorities. Companies could be obliged to notify the EU authority whenever they were subject to any investigation by non-EU institutions that could expose their most sensitive data. To establish the authority's role in this field, the EU would need to adopt a regulation on the protection of sensitive business information. In administrative matters – even in areas in which it has competence, such as antitrust cases – the EU currently lacks the legal basis to interfere in the relationship between a non-EU authority and an EU company during a foreign investigation. This is also the case in criminal matters concerned with extraterritoriality or economic coercion, for which the EU has not yet developed legal rules.

The EU authority would not intervene on the basis of the merits of the case, but on procedural grounds, to filter information; and it would do so in all matters, even criminal ones. Such an approach would tackle the problem of the absence of an EU response and EU representation without heightening tensions around sovereign national competencies. The authority would also serve as an equivalent to non-EU authorities (such as those in China or the US). The EU could thereby support companies that currently have to deal with such third-country agencies on their own, under very asymmetrical and difficult circumstances. It would reassure European businesses that they are not alone when facing pressure from non-EU authorities. Giving an EU body such a role would provide a degree of deterrence in relation to third countries, too. At the same time, this would make it easier for European companies to support the EU's efforts to improve its geo-economic defences, as it would signal to them that the EU backs them in protecting their most sensitive data.

Challenges and limitations

Between a rock and a hard place? Enforcement

There is a risk that companies bypass the EU agency where it does not serve their immediate interest to notify the body or wait for its decision on the transfer (for instance, when there is strong third-country pressure and the company fears a disproportionate immediate cost). For similar reasons, Europeans must also be careful not to lose credibility by creating an EU agency whose decisions might not be respected by various economic actors. While this would probably be considered a nuisance by businesses, EU member states, acting on the basis of an EU directive, could explore threatening to fine companies for non-compliance with the notification requirement and decision given by an EU agency. Such fines could also serve as a useful alibi for EU companies in turning down a non-EU data transmission request. However, there needs to be a careful analysis of whether the benefits of providing companies with such an alibi outweigh the disadvantages of putting them between a rock and a hard place.

Proportionality

Protective measures have often come to be seen as too intrusive, penalising, and burdensome to the private sector in countries where they have been implemented (for instance, in France, where the blocking statute is currently under review). Moreover, many European companies have based their business model on the free flow of data. The key will therefore be to design a measure that would protect, but not unduly burden, companies. This means striking a delicate balance between protection and restriction.

This is why Europe could base its protection on a narrow definition of most sensitive data (with a test such as "sensitive to economically coercive policies") to limit the number of cases in which the authorities would have to be informed about data transfer requests. It should also encourage companies to anticipate – by coming to joint understandings with the authorities – the information that would need to be notified, even before any request is made by foreign authorities. Europeans may need to develop guidelines for, and support companies in, categorising their data into different levels of sensitivity; otherwise, it could be difficult for authorities to determine whether specific requests concern sensitive data or not.

It may be unavoidable that some companies end up seeing even a minimal degree of protection as too restrictive because their business models are based on a free flow of data. However, the goal of the proposed intervention is not to reconcile the interests of all the different EU businesses but to seek an overall adequate, proportional degree of protection with regard to national and European security.

Administrative burden

As Europe remains a continent of many languages, notifications from across the EU will require some national processing. While this is seemingly a minor issue, it points to the larger administrative challenges that the initiative would pose to institutions. The EU would have to design a highly streamlined and supportive process for businesses, and clearly define and limit its scope – not just to ensure private sector buy-in, but also to avoid establishing a toothless, overmighty bureaucracy.

Retaliation

Blocking data transfers requested by third-country authorities could allow the EU to be taken more seriously and deter such requests in the future. However, it could also provoke retaliation. This is a particular challenge with respect to the US, given the EU's current levels of digital interdependence with its transatlantic partner. Thus, the EU could pursue a framework agreement with the US to complement the protection of sensitive information by an EU authority.

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