

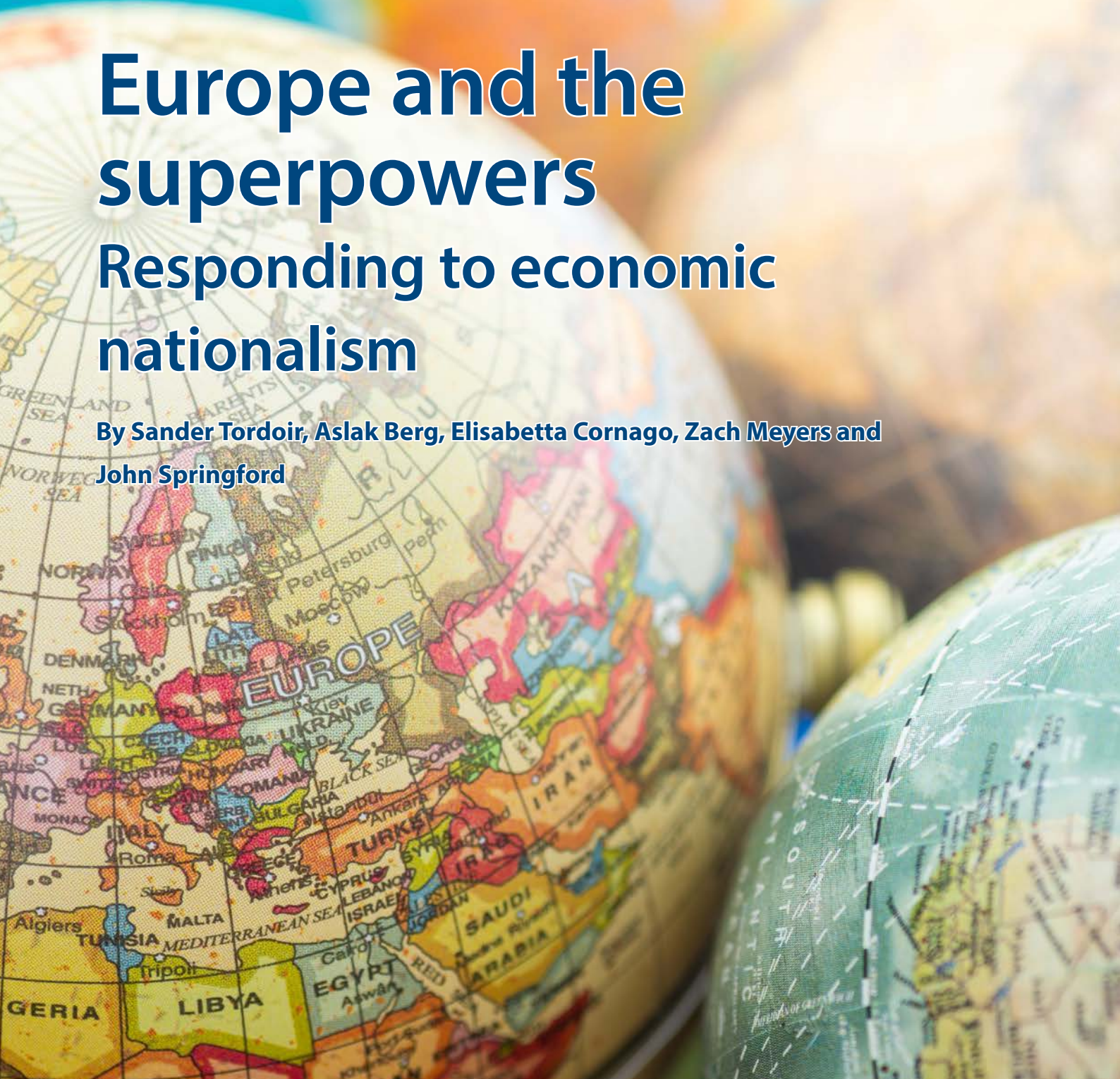
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Europe and the superpowers

Responding to economic nationalism

By Sander Tordo, Aslak Berg, Elisabetta Cornago, Zach Meyers and John Springford



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Between 1989 and 2008 the world economy was governed by a set of rules and institutions that limited trade tariffs and subsidies, bailed out countries in financial distress in exchange for raising taxes and cutting expenditure, and provided development aid conditioned upon reform and anti-corruption measures. Now, the US is following the Chinese model of spending big on subsidising industries of the future and protecting local production. The small- and medium-sized economies of Europe, on the other hand, have few common pots of money for subsidies and rely on international law to keep markets open. For them, the rivalry between China and the US is a huge challenge.

In November 2023, at its annual Ditchley economics conference, the CER gathered leading politicians, officials, academics, journalists and thinkers to discuss how Europe should respond to this growing economic nationalism in China and the US. These are the main conclusions:

- ★ Europe's economic model faces significant challenges. Several EU countries have kept pace with the US in terms of GDP per capita growth, if properly adjusted for exchange rates and hours worked. But the gap may now be widening as the US uses public funds to boost investment and growth. Europe might also be drifting further behind the technological frontier.
- ★ The continent's best chance of improving productivity – contrary to some Europeans' desire for technological sovereignty – is to disseminate and diffuse foreign technology throughout the economy rapidly, piggybacking on risky breakthrough innovation in the US and China. Deepening Europe's single market still holds great promise, but initiatives in the past twenty years have not significantly reduced market segmentation between EU countries, for examples in services, banking or capital.
- ★ Joe Biden's signature green subsidies programme – the Inflation Reduction Act (IRA) – might prove less detrimental to the EU than first thought. Although viable green projects in Europe may be delayed as firms frontload investment in the US, it is doubtful they would be cancelled outright. The EU might also benefit from the spillovers of the US lavishing money on expanding demand, innovation and scale in clean technology manufacturing.
- ★ China's economy faces serious headwinds. Its investment and export-led development model worked well in the 1990s and 2000s but now seems exhausted. Yet Chinese leaders continue to suppress workers' consumption and recycle their savings into increasingly inefficient investment, as evidenced by the real estate bubble. Chinese policy-making is also increasingly erratic and focused on technological self-reliance not economic dynamism.

- ★ Experts disagree on what Chinese economic weakness means for Europe and the US. Beijing may respond to its weak growth by ploughing even more subsidies into manufacturing which, given weak consumption at home, will drive Chinese exports up even further, intensifying global imbalances and trade disputes with the West. Others believe that China will have more to lose than the EU and US from a widespread trade war.
- ★ A significant challenge for Europe is that the EU lacks instruments to step up its green industrial policy in response to growing US and Chinese economic nationalism. Tax credits seem to be working well in the US, but the EU requires unanimity on tax measures. At the same time, there are various risks from the EU's current approach. Economists praise the EU's carbon pricing; but penalising emissions-intensive activities without subsidising alternatives might not give enough impetus to the green transition. Letting EU member-states continue to lavish state aid on their own firms could also threaten the level playing field of the internal market. But there is little political willingness to pool resources.
- ★ The rise of economic nationalism also has implications for the role of the EU in the financial realm. The dollar and, to a lesser extent, the euro remain the dominant currencies globally. But Russia, China and other countries are starting to invoice trade in other currencies, while demand for gold as a reserve asset has increased significantly.
- ★ With many developing countries in debt distress, the West should finance an expansion of the World Bank's balance sheet and use the International Monetary Fund (IMF) more effectively, especially now that China is cutting back on development lending after many of its loans went sour. However, caution is necessary since many previous attempts to reform these institutions have not worked. The West's existing development support continues to be a sizeable and attractive offer for emerging markets and developing economies.

From 1989 to 2008, the global economy adhered to a framework of regulations and organisations that minimised tariffs and subsidies to foster international trade. That policy consensus was already under pressure in the period after the global financial crisis. A new era altogether may now be opening. The US is emulating China's approach by subsidising industries poised for future growth and protecting its market. The US now views China's 2001 entry into the World Trade Organisation (WTO) as a mistake and aims to curtail the WTO's authority. Western capitals also fret that China and Russia may try to supplant the central role of the dollar and the euro in the global financial system, and that Beijing seeks to replace the World Bank and the IMF in providing support to developing countries.

This rise in economic nationalism and superpower competition poses a significant challenge for Europe, whose economy is much more dependent on trade than the US, and which relies heavily on fraying international law to keep markets open. In November, the CER held its annual economics conference at Ditchley Park on how Europe should respond. The conference, organised with the support of the EU Delegation to the UK and Gavekal Dragonomics, has a unique role in European economic policy discussions. The CER brings together 40-45 politicians, officials, academics, journalists and think-tankers working on economic policy issues – all of whom are listed at the end of this report.

The debate was organised around five central questions. These included inquiries into whether the global system of trade governance is in terminal decline, if the EU's green industrial strategy will work, how the West should navigate its relationship with China, the outlook for Europe's economic model, and the extent to which the global financial system is rupturing under geopolitical pressures. This paper reflects the main takeaways from each of these debates and draws key lessons for Europe's policy response.

Is the global trade system ‘brain-dead’?

The World Trade Organisation (WTO) faces an uncertain future. Its tools have not helped the EU and US limit China’s beggar-thy-neighbour exports strategy or its policy of requiring technology transfers from Western companies. The US increasingly sees international trade law as a barrier to addressing climate change and domestic political priorities. Among the superpowers, only the EU remains dedicated to WTO principles – although even Brussels is resorting increasingly to unilateral instruments like its carbon border adjustment mechanism (CBAM). Can the WTO accommodate fractures between China and the West? Or will the EU eventually join the US and China in abandoning the WTO’s principles?

EU-US relations

The EU and the US agree on many overarching principles – including the need to deal with climate change and that China poses a commercial and security threat. But there are also many reasons why co-operation is very limited, as evidenced in the October 2023 EU-US summit, which failed to reach a permanent solution on transatlantic steel and aluminium tariffs. The EU must stick with the WTO while the US increasingly chooses not to.¹ The Union’s economy is heavily dependent on global trade, so the WTO’s rules, which promote free trade, are indispensable. The EU has designed WTO-compliant measures like the CBAM to address climate change. However, these efforts are provoking transatlantic tension. The US is opposed to CBAM and wants to be exempt from it while corraling the EU into imposing WTO-breaching tariffs and export controls on China.

Some American policy-makers believe that the WTO was never designed to tackle the types of problems posed by China or the climate crisis, and believe the US should be willing to let the WTO slide into irrelevance. They point to America’s strong economic growth before the WTO existed, arguing that the US would do fine economically without it.

Others note that the erratic US approach to trade policy poses a problem for any transatlantic co-operation on WTO reform. President Biden ignores WTO rules because they get in the way of the US’s preferred approach to tackling China and the climate. President Donald Trump, on the other hand, is opposed to the WTO on principle. This makes the US an unpredictable negotiating partner on trade policy.

Nevertheless, many Europeans remain optimistic that there can be more transatlantic co-operation without the EU being forced to abandon international trade norms. The US might have an ideological aversion to the EU’s CBAM and President Biden must show he is fighting for voters in industrial ‘swing states’ like Ohio and Pennsylvania. But the US economy is not going to be hit badly by CBAM, especially if subsidies succeed in ‘greening’ the US steel and aluminium industries.

¹: WTO rules constrain countries from imposing tariffs which target imports from certain countries and which allow retaliation through trade measures (in cases where foreign subsidies harm a country’s exports).

The most optimistic view is that US willingness to participate in protectionism and a ‘subsidy race’ will be temporary, given its financial costs and inefficiency, and the EU and US might ultimately co-operate to reform the WTO. Subsidy races might be viewed like tax competition. Despite their differences, most countries have co-operated on global rules to improve tax transparency and minimise strategic tax planning – recognising that tax havens make nearly everyone poorer. The same dynamic may help limit subsidies in the future. Multilateral rules for subsidy transparency could make it easier for the media to scrutinise where subsidies go, and show that they often fail to deliver value for money. Under the US Inflation Reduction Act (IRA), for example, many subsidies are not going to ‘US firms’ but to multinationals owned by international investors. The EU’s new unilateral instruments – like its anti-coercion tool – may also help dissuade US presidents from imposing trade measures which harm the EU’s interests.

China’s role in the WTO – and the WTO’s potential for reform

Pessimists argue the WTO can never work effectively with China in it. China has successfully exploited weaknesses in the WTO rules on subsidies and ‘bent’ many of the WTO’s other rules. For example, it is difficult for other countries to pinpoint where the Chinese government is distorting markets: much of China’s total investment is from state-owned enterprises which benefit in indirect ways from public support.

In assessing whether WTO tools can help address these problems, we can compare the US’s policy of restricting imports of Japanese cars in the 1980s (which breached WTO rules but succeeded in improving car production in the US) and the EU’s policy of using consumption subsidies to improve uptake of solar panels in the 2000s (which floundered). The EU’s WTO-compliant approach allowed Chinese firms to benefit from subsidies and did little in the long run to increase solar panel manufacturing in the EU. Perhaps, that means the EU’s trade policy will therefore inevitably drift towards less WTO-compliant restrictions on trade over time.

The more optimistic view is that China's breaches of WTO rules have never been properly confronted, and that WTO reforms would enable a tougher approach to China – if the EU and US can convince China that agreeing to the reforms is better than abandoning international trade law altogether.

If WTO subsidy rules can be reformed, different rules on subsidies could apply to different industries. Subsidies can play a useful role and help provide public goods, address market failures, provide positive 'spillovers' to other countries, and help promote economies of scale and therefore lower prices. The EU and US, for example, can 'free ride' off Chinese subsidies for solar panels – which have

enabled the cheapest source of electricity on the planet. Stricter subsidy rules should instead apply to industries like steel which have less scope for rapid innovation.

Finally, the need for WTO reform is not just about China. The current world trade situation looks dire. At least by some metrics, globalisation peaked in 2019, and the decline since then has come from growing protectionism across emerging markets and declining liberalisation in services trade. The slowdown in trade integration is likely to be a big contributor to a corresponding slowdown in productivity growth, less discipline on inflation and lower living standards. It is difficult to see the situation improve without re-invigorating multilateral institutions.

Will the EU's green industrial strategy work?

Caught between US support for local investment and China's generous subsidies for domestic manufacturing, the EU is nervous about losing the green tech race. It is now trying to revamp its industrial policy, but it can neither match US tax credits nor the unscrupulousness of China's support for domestic manufacturers. Loosening state aid rules will only help bigger, richer member-states, and production targets are unlikely to move industry without further incentives. Should Europe accept that some of its industry will inevitably move offshore? Is there an economic rationale behind the rush to 're-shore' and 'friend-shore' key economic activities? Should Europe create a Recovery Fund 2.0 to power its way through the energy transition with more public investment?

Europe's industrial policy attempts

Biden's signature green subsidies program – the Inflation Reduction Act – might prove less detrimental to the EU than many economists first thought. Although viable projects in Europe may be delayed as firms frontload US investments, they remain feasible and therefore should not be cancelled because of US subsidies – especially where they involve goods like energy which are difficult or expensive to trade across the Atlantic. The EU might also benefit from the spillovers of the US lavishing a lot of money on expanding demand, innovation and scale in green manufacturing. Still, there are reasons to pursue stronger EU green industrial policy, and the question is how the EU should balance its policy toolkit of carrots and sticks. While economists widely endorse using carbon pricing, doing so without subsidising alternatives might not give enough impetus to the green transition.

Industrial policy and protectionism are not identical. Carbon emissions are an unpriced externality and a market failure. Carbon pricing is supposed to address the fact that firms and consumers cannot account for the release of greenhouse gases into the atmosphere during production and consumption processes, but there are other arguments for green industrial policy. These include accelerating innovation, and helping green technologies to scale and reach widespread deployment. Achieving these goals requires tackling oft-neglected market failures

such as the co-ordination failures and financial frictions that hinder technological scaling and commercialising. For example, firms may be hesitant to invest in hydrogen or electrification, and banks may not be willing to lend to such firms, if there is uncertainty about the future pathway of demand.

The EU state aid regime, and existing pots of EU funds, already allow significant industrial support for green technologies like renewable energy. But the EU lacks key instruments to step up its green industrial policy. For example, its Net Zero Industry Act accelerates permitting and loosens procurement rules, but it contains no direct financial support. Tax credits seem to be working well in the US, but the EU requires unanimity amongst member-states on tax measures. There is also little willingness amongst member-states to harmonise national tax rates or Research & Development tax credits.

The EU's current approach has risks. For example, the EU single market's level playing field is threatened by letting member-states distribute state aid with little oversight. National subsidies of energy prices, for example, might come at the expense of common investments in strategic goods like interconnectors, electricity distribution grids and hydrogen. Commission President Ursula von der Leyen proposed a European sovereignty fund to support industrial policy and innovation at the European level. But the initiative has not taken off, while state aid for

cross-border European projects is underused except for battery production.

Does the EU need a new Recovery Fund to fund its green industrial policy?

For the EU to have an ambitious and credible industrial strategy, it must put its money where its mouth is. A way to do that would be creating an EU Green Facility to provide member-states with grants and loans – akin to what the current Recovery and Resilience Facility does now – to boost their green manufacturing capacity.

This EU Green Facility could be funded with common debt or with dedicated revenues (new Own Resources in EU parlance). For example, revenues from CBAM are seen as a possible contributor to the EU budget, but might give the EU perverse incentives to use the CBAM for revenue-

raising and protectionism rather than to ensure a level playing field. Nonetheless, a permanent commitment to jointly funded green investment could avoid issues that have plagued debt issued under the EU's Covid recovery funds, such as their higher-than-expected interest rates. Investors may be demanding a higher interest rate as compensation for the uncertainty that EU debt is not a permanent asset class (at scale) or that there is no dedicated European revenue stream to repay them.

Some who are sceptical about EU joint industrial policy argue that Europe will struggle to go beyond its national-level, state aid-based approach to industrial policy, due to a lack of trust among EU member-states. A European pot of industrial policy money could end up just allocating funds to countries like Germany, which are already at the industrial frontier – de facto ending up with the same result as the current national subsidy-race.

Does Europe's economic model have a future?

EU member-states' economies are more open than their size and wealth would predict, in part because of the strictures of EU membership. Some have argued that is one reason why their welfare states are more generous than those of other countries, as the heightened risk workers face from intense import competition has been socialised. In part thanks to the euro, Germany's export competitiveness has grown, but its recent weakness suggests its growth model is in trouble. France's growth has disappointed for decades, and Italy's has been disastrous. The UK has had no real wage growth for 13 years. Poland and other central and east European states continue to converge on western European living standards, but eventually the fruits of European integration will be exhausted. So what is the future of Europe's economic model?

Europe's economic doom seems overblown

Europe awaits reports from former Italian prime ministers Mario Draghi and Enrico Letta on Europe's economic woes. However, the sentiment of doom and gloom about Europe's economic model is premature. The EU has kept pace with the US in terms of GDP per capita, if properly adjusted for exchange rates and hours worked. Europe has also successfully increased its labour supply, particularly among workers over 65, although the demographic drag on the economy will eventually kick in.

But threats to the EU's economic and social model loom on the horizon

A few areas of concern remain. Europe continues to rely on the rest of the world for demand. As a result, Europe is increasingly dependent on other countries for growth while its share of the global economy is shrinking. Europe may also be drifting away from the technological frontier, particularly in areas like quantum computing and artificial intelligence. But the continent can maintain productivity growth simply by making sure technology is disseminated and diffused throughout the economy rapidly, thereby piggybacking on risky and expensive breakthrough innovation in the US and China.

A more pessimistic view is that the real divergence with the US is only now starting to open up. The US has regained its pre-pandemic growth path whereas the EU lags several percentage points behind. The fact that Europe was hit harder by the Russian war-induced energy shock played a role. But the US also ran a much looser fiscal policy in part to reindustrialise and green the economy. The Biden administration is engineering a 'high-pressure economy', in which high demand through a loose fiscal policy is fueling some inflation but also raising demand for labour and improving workers' bargaining position vis-à-vis employers. This helps low-income workers and has already helped to close one quarter of the increase in wage inequality that had opened in the last 40 years. Europe is unable, or unwilling, to spend on that scale even though it may be good for productivity and growth. Perhaps, though, its prudence will pay off in the future, for example in the form of lower debt servicing costs.

Deepening the single market, the key to Europe's prosperity, remains an area of unfulfilled promise. European markets have not consolidated much in the last 20 years. This includes banking, which remains fragmented across national borders, despite Europe's efforts to create banking and capital markets unions. Meanwhile, the single market for services has remained

elusive for decades, even though it has the potential to bring benefits equivalent to the economic gains derived from the integration of the goods market. Integration has intensified the density of goods trade by a factor of five, while services trade lags. The potential gains are so large because services make up a larger share of European economies, even though they remain less tradeable than goods even without regulatory barriers.

Looser fiscal policy and increased public investment might be essential to rebalance the European economy

and reduce its dependence on demand from abroad. Many economists want the EU to provide more support for public goods like defence, innovation and climate change mitigation. But a *'juste retour'* logic tends to dominate European fiscal debates, in which each country focuses on getting at least as much money out of EU programmes as it puts in, instead of on the wider benefits. As a result, common industrial projects like the European Space Agency flounder compared with other countries.

How should the West deal with China?

Politicians in the EU and the US had hoped that China's growing integration with the global economy would make it more liberal. But the EU and the US are now increasingly fearful of Chinese assertiveness and of their dependencies on China for strategic goods such as rare earths. The US and the EU positions on China are still not fully defined, however. And economists disagree on what China's slowing economic growth means – and whether it poses more opportunities or risks for the EU and US.

China's economic troubles

China's economic model faces headwinds. Its political leaders have adopted an export-led development model based on suppressing employee income and subsidising local investment at the cost of consumption. Consumption's share of GDP in China is exceptionally low, similar to levels only seen in tax havens and small oil-producing states.

This model worked in the 1990s and 2000s, largely because domestic investment in China had been depressed in previous decades. But China's economic growth has been slowing dramatically for several years as it is increasingly difficult to find productive investments – the deflating real estate bubble being a case in point. Manufacturing capacity vastly exceeds demand: there are already far too many car-makers and battery manufacturers in China, for example. Beijing's hardline response to the pandemic means domestic consumption has still not recovered to the already low pre-pandemic levels. China faces other problems too. Its policy-making has been erratic in its response to Covid and its clampdown on technology firms. Investors are now far less willing to trust the government. Youth unemployment is also a growing issue. Young people would prefer to work in the public service, which offers jobs for life, rather than for Chinese tech giants – creating a 'brain drain' away from economically productive sectors. China's economic leadership does not seem well-equipped to handle these problems nor does it seem to be their priority, especially now that technologists and security-minded politicians, not economists, have a growing influence on Chinese policy.

China might respond to weak growth by increasing domestic subsidies, creating more over-capacity and

further boosting exports. The country's current account and trade surpluses are higher than ever. 'Exporting' China's domestic problems means tensions with the West will likely intensify. This may force the US to accumulate more debt (and increasingly public rather than private debt) to accommodate higher consumption – something European countries may be unable or unwilling to do. One answer to this threat would be for the EU and the US to intensify their co-operation and use subsidies with build local or friend-shoring requirements to diversify away from China as a trading partner.

US-EU co-operation on China

Can the transatlantic relationship support a unified line on China? The US has a stronger rivalry with China than the EU. Some in the US administration are mainly concerned about China's behaviour (such as its export subsidisation) and say they do not oppose China's global rise per se. But most decision-makers in Washington see China's rise as an inherent threat to US pre-eminence.

As a result, the US continues to push the EU to take a tougher approach towards China. Some Americans point to the US's support for Ukraine, its assistance in mitigating Europe's energy crunch, and its newfound willingness to act on climate change, and ask: why is Europe unwilling to reciprocate by falling behind the US on China? And how long can the EU continue to rely on WTO rules, which are inadequate to deal with both climate change and China's non-market practices? China hawks point out that countries aligned with the US make up a majority of world GDP – and that China's model based on exports means it arguably has more to lose than the EU and US from economic confrontation.

There might be good reasons for European caution:

- ★ China will not want to play on an economic chessboard set by the US – especially while the US is prepared to abandon international trade norms. An approach that hinders Chinese growth generally, and sees Chinese competitiveness in all markets as threatening, would risk pushing China towards confrontation. Many Chinese people think that ‘the West’ wants it to fail – and perhaps the EU needs to do more to convince China that this is not the case.

- ★ The EU also has an interest in ensuring that China remains stable – which could justify a softer approach. Intense nationalism in China may provide a political buffer against the dangers of slowing growth. But China’s history has been punctuated by domestic disturbances caused by economic and demographic changes.

- ★ The EU’s economic detachment from China will entail a higher cost of living because it involves less emphasis on efficiency and more on diversity and resilience. There is not much willingness among politicians to be honest about this trade-off.

The EU and the US can still agree on some objectives, including preserving prosperity on both sides of the Atlantic; avoiding a military dispute; protecting the planet; and preserving democracy and capitalism. Achieving these objectives will require a difficult balancing act of co-operation, competition and managed confrontation with China.

De-risking and its discontents

If they want to work together and distinguish their approach from a broader de-coupling from China, the EU and the US should first define their security interests narrowly and precisely – an approach sometimes referred to as a ‘small yard with a high fence’. EU and US leaders might, for example, try to clearly distinguish between:

- ★ Goods the EU does not want China to be able to build at all – in order to ensure the EU and US maintain some leverage over China, such as in high-end microprocessors used for artificial intelligence. Some European countries have joined the US in applying export controls on chip manufacturing equipment to this end.

- ★ Goods like electric vehicles, for which the EU has a thriving industry it believes it can maintain with fair

global competition. For these goods, the EU has an interest in ensuring a ‘level playing field’.

- ★ Goods which the EU needs as cheaply as possible. For example, China’s role in driving down production costs for solar panels and other green technologies can be seen as a global public good.

But there are also several reasons to be sceptical of any de-risking strategy. First, de-risking could simply lengthen supply-chains to give the appearance of de-risking, leaving China in an important role as an indirect supplier to the West through intermediary countries. Critics argue that this would still leave China with significant leverage over the EU and US.

Second, Europe’s attempts to diversify or self-supply may fail, or the EU may not be able to tolerate Chinese retaliation, such as current Chinese export controls on certain rare earths. Although Europe was able to survive the loss of cheap Russian gas as an energy source better than many feared, that does not necessarily mean the EU could tolerate retaliation from China as easily – China produces many more resources, and more sophisticated types of goods than Russia does.

Third, Western de-risking may incentivise China to speed up its self-sufficiency efforts. However, whether ‘speeding up’ is possible is doubtful: China has been focused on its own de-risking for years, and is already stockpiling strategic goods such as oil. It has been obsessed for decades with indigenous innovation, and is providing huge incentives to attract talent. However, it is difficult to maintain the pace of innovation while being disconnected from other countries’ innovation efforts.

Finally, de-risking might underplay Europe’s strengths. Trade linkages between China and democracies create vulnerabilities – but they also create points of leverage for both sides. The EU as a whole is not especially dependent on China. There are specific items that China supplies which are important inputs into European supply chains. But the same is true in reverse, such as in high-end microprocessors and aerospace equipment. Europe could consider doubling down on its strengths to increase its leverage, rather than solely limiting China’s capacity to achieve self-sufficiency. The risk of this strategy is that China may extract intellectual property and technological know-how from European companies.

Is the global financial system becoming 'geopoliticised'?

Global economic politics are becoming increasingly confrontational in the aftermath of the Russian invasion of Ukraine and trade tensions with China. Western countries, and the US in particular, are increasing their use of sanctions as a political tool, leading some countries to look for alternatives to the dollar-dominated financial system. At the same time, the IMF, the World Bank and other multilateral development banks (MDBs) face competition from China as sources of financing for developing countries. Is the global financial system now increasingly politicised and can the Western-dominated institutions adapt to the new reality?

The dollar will remain the pre-eminent reserve currency, but alternatives will develop

Despite geopolitical tensions, the dollar – followed at a significant distance by the euro – will remain both the dominant currency for official reserves and for trade. These two functions are interlinked and circular: much of trade, particularly commodities, is denominated in dollars, which means countries need dollar reserves to pay for imports and to cover local liabilities in dollars in crises. The US has, however, increasingly leveraged the dominant position of the USD to implement sanctions, which has led affected countries to look for alternatives. But so far there has only been a small decline in the percentage of foreign reserves held in dollars, with most of that shifted to currencies of countries that are allies of the US.

There are a few incipient warning signs of de-dollarisation. Demand for gold as an official reserve has picked up strongly. Several countries have also taken out renminbi-denominated loans and more of their firms conclude oil and other commodity contracts in renminbi. While the Chinese currency only constitutes about 3 per cent of foreign reserves held by central banks abroad, China's central bank has opened swap lines with many other countries, including Argentina, Brazil, Mongolia, and Pakistan, which they could rely on instead of reserves if needed. These developments suggest the use of other currencies than the dollar could continue to grow. At the same time, there are good reasons to believe the renminbi is unlikely to replace the dollar's status as the pre-eminent reserve currency. The Chinese government does not seem willing to fully float its currency or open its capital account, crucial impediments for central banks and global investors before they can rely more on its currency.

Western sanctions and their impact

Many of the sanctions on Russia, including industrial export restrictions, have been less tough than intended in practice because they are vulnerable to circumvention and the US, UK and EU wound down the state capacity to prevent this after the Cold War.

For example, the price of virtually all of seaborne Russian oil surpasses the price cap. Likewise, the dollar value of Russian imports of goods affected by sanctions has been

stable. And after being shut out of Western systems, Russia has also been able to set up alternative payment systems for domestic use and in part for international transfers. This shows that countries can partially protect themselves from sanctions, especially if they run current account surpluses (which brings in foreign exchange) and do not rely on external financing, like Russia.

Boosting the effectiveness of Western sanctions requires its governments to set up much stronger controls and audits on their non-financial companies involved in trading with geopolitical competitors. This is akin to the 'know your customer' rules in the financial sector, which were bolstered in the last two decades. In the absence of such reforms, the traction for Western sanctions is likely to remain the strongest in the financial sector.

The challenge for developing countries

Increased geopolitical rivalry has also made itself felt in the financing landscape for developing countries. Generally, developing countries rely on official development aid (ODA), MDBs like the World Bank, bilateral government creditors and bond markets for outside funding. And if countries are unable to repay their creditors and face a debt crisis, they can go to the IMF for a bailout. Since 2013, many poorer countries have turned to China for funding. Its Belt and Road Initiative has competed with the World Bank's development finance, and its bailouts with the IMF's programmes. How extensively developing countries have relied on Chinese financing varies by country, but in many cases the dependence is significant.

Developing countries are now in financial trouble. The World Bank estimates that 60 per cent of low-income countries are heavily indebted and at high risk of debt distress, while many middle-income countries also face significant budgetary challenges. After lots of its loans went sour, China is cutting back on development lending. And as global interest rates have risen, it is harder for poorer countries to obtain funding from private bond markets, including from Western private creditors.

MDBs have proven to be an extremely successful effective model to leverage relatively small amounts of public sector capital into large amounts of funding. But the MDBs may require capital injections from donor countries to

expand lending further. Likewise, the IMF is providing very little new net funding with its bailouts and is currently mostly extending previous commitments to countries.

But geopolitical tension has made the work of institutions like the IMF more difficult. China is now a significant financial actor and the five Chinese state banks have lent out around one trillion dollars over the last decade, about as much as the multilateral institutions. Many highly indebted countries need a debt restructuring to cut their debt load and give the IMF's traditional bailout programmes a fighting chance of restoring economic stability. But disagreements between intransigent Chinese and Western creditors are making these debt restructurings harder.

The G20 Common Framework, the main attempt to solve the issue, has so far produced limited results. The Zambian restructuring was delayed because China failed to convey financial assurances in a timely way. In the case of Sri Lanka, which is outside the Common Framework, China has refused to share its final terms with the IMF and to participate in the official creditor's

committee, which has led to a fracturing of restructuring terms. Moreover, China has defined four out of five state-backed banks as private actors for the purposes of debt resolutions (which, given that participation in resolutions is essentially voluntary, is their prerogative). As a result, Chinese lending also poses challenges to the resolution framework for private claims, and this will probably remain an issue until China better defines the terms it is willing to accept.

All of this has opened a debate on how and whether to give China an increased voice in the Bretton Woods institutions, for example through increased voting rights at the IMF. On the one hand, giving China a bigger seat at the table – one more commensurate with its economic heft in the world – may make Beijing more co-operative. On the other hand, it risks the Bretton Woods institutions becoming unworkable. The G7 countries that still dominate decision-making at the World Bank and IMF can often find consensus. China's past unco-operative behaviour implies it may be unwilling to make the institutions work.

Conclusion

The global economic landscape is undergoing significant shifts with the rise of economic nationalism in China and the US. The established rules and institutions that governed the world economy after the Cold War ended, characterised by limited tariffs, conditional financial assistance, and development aid tied to reform measures, are now facing challenges. The uncertain future of the World Trade Organisation poses dilemmas for the EU, while Biden's green subsidies programme may present both opportunities and challenges for Europe's economic trajectory. Europe's economic model will be tested by widening gaps vis-à-vis the US in technological innovation and productivity. This will require disseminating foreign technology better and deepening the single market. However, the EU's capacity to respond to growing economic nationalism, particularly in the realm of green industrial policy, is constrained by political and institutional factors.

China's economic outlook is fraught with challenges, including dwindling returns from its investment-led development model and policy shifts towards technological self-reliance. China's economic weakness implies the country will rely even more on demand from the US and the EU, further fuelling global trade imbalances and potential trade disputes with the West. Meanwhile, while there is little evidence of widespread de-dollarisation, Beijing and Moscow are trying to drive a shift away from Western currencies. Amidst all these changes, Western support remains crucial for emerging markets and developing economies to navigate debt distress.

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