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A union that stands strong together

Ursula von der Leyen, in her annual State of the Union speech, outlines the European Union's main political priorities for the next working year

Never before has this Parliament debated the State of our Union with war raging on European soil. We all remember that fateful morning in late February. Europeans from across our Union woke up dismayed by what they saw. Shaken by the resurgent and ruthless face of evil. Haunted by the sounds of sirens and the sheer brutality of war.

But from that very moment, a whole continent has risen in solidarity. At the border crossings where refugees found shelter. In our streets, filled with Ukrainian flags. In the classrooms, where Ukrainian children made new friends. From that very moment, Europeans neither hid nor hesitated. They found the courage to do the right thing.

And from that very moment, our Union as a whole has risen to the occasion. Fifteen years ago, during the financial crisis, it took us years to find lasting solutions. A decade later, when the global pandemic hit, it took us only weeks.

But this year, as soon as Russian troops crossed the border into Ukraine, our response was united, determined and immediate. And we should be proud of that. We have brought Europe's inner strength back to the surface. And we will need all of this strength. The months ahead of us will not be easy. Be it for families who are struggling to make ends meet, or businesses, who are facing tough choices about their future.

Let us be very clear: much is at stake here. Not just for Ukraine – but for all of Europe and the world at large. And we will be tested. Tested by those who want to exploit any kind of divisions between us. This is not only a war unleashed by Russia against Ukraine. This is a war on our energy, a war on our economy, a war on our values and a war on our future.

This is about autocracy against democracy. And I stand here with the conviction that with courage and solidarity, Putin will fail and Europe will prevail.

The courage to stand with our heroes

Today courage has a name, and that name is Ukraine. Courage has a face, the face of Ukrainian men and women who are standing up to Russian aggression. I remember a moment in the early weeks of the invasion. When the First Lady of Ukraine, Olena Zelenska, gathered the parents of Ukrainian children killed by the invader. Hundreds of families for whom the war will never end, and for whom life will never go back to what it was before.

Let us chart once again a joint way forward. With more freedom to invest. And more scrutiny on progress. More ownership by member states. And better results for citizens. Let us rediscover the Maastricht spirit – stability and growth can only go hand in hand

We saw the first Lady leading a silent crowd of heartbroken mothers and fathers, and hang small bells in the trees, one for every fallen child. And now the bells will ring forever in the wind, and forever, the innocent victims of this war will live in our memory. And a nation of heroes has risen. Today, Ukraine stands strong because an entire country has fought street by street, home by home.

Ukraine stands strong because people have stayed in Kyiv to lead the resistance. And we have seen in the last days the bravery of Ukrainians paying off. Europe's solidarity with Ukraine will remain unshakeable. From day one, Europe has stood at Ukraine's side. With weapons. With funds. With hospitality for refugees. And with the toughest sanctions the world has ever seen.

Russia's financial sector is on life-support. We have cut off three quarters of Russia's banking sector from international markets. Nearly one thousand international companies have left the country. The production of cars fell by three-quarters compared to last year. Aeroflot is grounding planes because there are no more spare parts.

The Russian military is taking chips from dishwashers and refrigerators to fix their military hardware, because they ran out of semiconductors. Russia's industry is in tatters. It is the Kremlin that has put Russia's economy on the path to oblivion.

This is the price for Putin's trail of death and destruction. And I want to make it very clear, the sanctions are here to stay. This is the time for us to show resolve, not appeasement. The same is true for our financial support to Ukraine. So far Team Europe have provided more than €19 billion in financial assistance.

And this is without counting our military support. And we are in it for the long haul. Ukraine's reconstruction will require massive resources. For instance, Russian strikes have damaged or destroyed more than 70 schools. Half a million Ukrainian children have started their school year in the European Union. But many others inside Ukraine simply don't have a classroom to go to.

So I am announcing that we will support the rehabilitation of damaged Ukrainian schools. And that is why we will provide €100 million. Because the future of Ukraine begins in its schools. We will not only support with finance – but also empower Ukraine to make the most of its potential. Ukraine is already a rising tech hub and home to many innovative young companies.

So I want us to mobilise the full power of our Single Market to help accelerate growth and create opportunities. In March, we connected successfully Ukraine to our electricity grid. It was initially planned for 2024. But we did it within two weeks. And today, Ukraine is exporting electricity to us. I want to significantly expand this mutually beneficial trade.

We have already suspended import duties on Ukrainian exports to the EU. We will bring Ukraine into our European free roaming area. Our solidarity lanes are a big success. And building on all that, the Commission will work with Ukraine to ensure seamless access to the Single Market. And vice-versa.

Our Single Market is one of Europe's greatest success stories. Now it's time to make it a success story for our Ukrainian friends, too.

One lesson from this war is we should have listened to those who know Putin. To Anna Politkovskaya and all the Russian journalists who exposed the crimes, and paid the ultimate price. To our friends in Ukraine, Moldova, Georgia, and to the opposition in Belarus.

We should have listened to the voices inside our Union – in Poland, in the Baltics, and all across Central and Eastern Europe. They have been telling us for years that Putin would not stop. And they acted accordingly.

Our friends in the Baltics have worked hard to end their dependency on Russia. They have invested in renewable energy, in LNG terminals, and in interconnectors. This costs a lot. But dependency on Russian fossil fuels comes at a much higher price. We have to get rid of this dependency all over Europe.

Therefore we agreed on joint storage. We are at 84% now: we are overshooting our target. But unfortunately that will not be enough. We have diversified away from Russia to reliable suppliers. US, Norway, Algeria and others. Last year, Russian gas accounted for 40% of our gas imports. Today it's down to 9% pipeline gas.

But Russia keeps on actively manipulating our energy market. They prefer to flare the gas than to deliver it. This market is not functioning anymore. In addition the climate crisis is heavily weighing on our bills. Heat waves have boosted electricity demand. Droughts shut down hydro and nuclear plants.

As a result, gas prices have risen by more than 10 times compared to before the pandemic. Making ends meet is becoming a source of anxiety for millions of businesses and households. But Europeans are also coping courageously with this.

Workers in ceramics factories in central Italy, have decided to move their shifts to early morning, to benefit from lower energy prices. Just imagine the parents among them, having to leave home early, when the kids are still sleeping, because of a war they haven't chosen. This is one example in a million of Europeans adapting to this new reality.

I want our Union to take example from its people. Reducing demand during peak hours will make supply last longer, and it will bring prices down. This is why we are putting forward measures for member states to reduce their overall electricity consumption.

But more targeted supported is needed. For industries, like glass makers who have to turn off their ovens. Or for single parents facing one daunting bill after another. Millions of Europeans need support. EU member states have already invested billions of euros to assist vulnerable households.

But we know this will not be enough. This is why we are proposing a cap on the revenues of companies that produce electricity at a low cost. These companies are making revenues they never accounted for, they never even dreamt of.

In our social market economy, profits are good. But in these times it is wrong to receive extraordinary record profits benefitting from war and on the back of consumers. In these times, profits must be shared and channelled to those who need it the most.

Our proposal will raise more than €140 billion for member states to cushion the blow directly. And because we are in a fossil fuel crisis, the fossil fuel industry has a special duty, too. Major oil, gas and coal companies are also making huge profits. So they have to pay a fair share – they have to give a crisis contribution.

These are all emergency and temporary measures we are working on, including our discussions on price caps. We need to keep working to lower gas prices. We have to ensure our security of supply and, at the same time, ensure our global competitiveness.

So we will develop with the member states a set of measures that take into account the specific nature of our relationship with suppliers – ranging from unreliable suppliers such as Russia to reliable friends such as Norway.

Another important topic is on the agenda. Today our gas market has changed dramatically: from pipeline gas mainly to increasing amounts of LNG. But the benchmark used in the gas market – the TTF – has not adapted. This is why the Commission will work on establishing a more representative benchmark.

At the same time we also know that energy companies are facing severe problems with liquidity in electricity futures markets, risking the functioning of our energy system. We will work with market regulators to ease these problems by amending the rules on collateral - and by taking measures to limit intra-day price volatility.

And we will amend the temporary state aid framework in October to allow for the provision of state guarantees, while preserving a level playing field. These are all first steps. But as we deal with this immediate crisis, we must also look forward.

The current electricity market design – based on merit order – is not doing justice to consumers anymore. They should reap the benefits of low-cost renewables. So, we have to decouple the dominant influence of gas on the price of electricity. This is why we will do a deep and comprehensive reform of the electricity market.

Now - here is an important point. Half a century ago, in the 1970s, the world faced another fossil fuel crisis. Some of us remember the car-free weekends to save energy. Yet we kept driving on the same road. We did not get rid of our dependency on oil. And worse, fossil fuels were even massively subsidised.

This was wrong, not just for the climate, but also for our public finances, and our independence. And we are still paying for this today. Only a few visionaries understood that the real problem was fossil fuels themselves, not just their price.

Among them were our Danish friends. When the oil crisis hit, Denmark started to invest heavily into harnessing the power of the wind. They laid the foundations for its global leadership in the sector and created tens of thousands of new jobs. This is the way to go! Not just a quick fix, but a change of paradigm, a leap into the future.

Staying the course and preparing for the future

The good news is that this necessary transformation has begun. It takes place in the North Sea and the Baltic Sea, where our member states have invested heavily in offshore wind. It takes place in Sicily, where Europe's largest solar plant will soon produce the latest generation of solar panels. And it takes place in northern Germany, where regional trains now run on green hydrogen.

Hydrogen can be a game changer for Europe. We need to move from the niche market to the mass market for hydrogen. With REPowerEU, we have doubled our goal: we want to produce ten million tons of renewable hydrogen in the European Union, every year by 2030.

To achieve this, we need to create a market leader for hydrogen, and in order to fill the investment gap and link future supply and demand I can announce that we will create the European Hydrogen Bank. It will help to ensure the purchase of hydrogen, in particular by using the resources of the innovation.

It will be able to invest €3 billion to help build the hydrogen future. This is how the economy of the future will be built. That is our European Green Deal. And we've all seen in recent months how important the European Green Deal is.

The summer of 2022 will be remembered. We have all seen the dry rivers, the burning forests, the extreme heat. And the situation is much more serious. Until now, the glaciers of the Alps have served as an emergency reserve for rivers such as the Rhine or the Rhône. But as Europe's glaciers melt faster than ever, future droughts will be much more serious.

We must work tirelessly for climate adaptation and make nature our first ally. That is why our Union will push for an ambitious global agreement for nature when of the United Nations Conference on Biodiversity to be held in Montreal this year. And we will do the same at COP27 in Sharm el-Sheikh.

But in the short term, we also need to be better equipped to deal with climate change. No country can fight extreme weather events and their destructive forces alone. This summer, we sent planes from Greece, Sweden or Italy to fight fires in France and Germany.

But as these events become more frequent and intense, Europe will need more capacity. That is why today I am announcing that we will double our capacity to fight against fires over the next year. The European Union will buy ten light amphibious aircraft and three additional helicopters to complete our fleet. This is European solidarity in action.

The last years have shown how much Europe can achieve when it is united. After an unprecedented pandemic, our economic output overtook pre-crisis levels in record time. We went from having no vaccine to securing over 4 billion doses for Europeans and for the world. And in record time, we came up with SURE – so that people could stay in their jobs even if their companies had run out of work. We were in the deepest recession since World War 2. We achieved the fastest recovery since the post-war boom.

And that was possible because we all rallied behind a common recovery plan. NextGenerationEU has been a boost of confidence for our economy. And its journey has only just begun. So far, €100 billion have been disbursed to member states. This means: €700 billion still haven't flown into our economy.

NextGenerationEU will guarantee a constant stream of investment to sustain jobs and growth. It means relief for our economy. But most importantly, it means renewal. It is financing new wind turbines and solar parks, high-speed trains and energy-saving renovations. We conceived NextGenerationEU almost two years ago, and yet it is exactly what Europe needs today.

So let's stick to the plan. Let's get the money on the ground. The future of our children needs both that we invest in sustainability and that we invest sustainably. We must finance the transition to a digital and net zero economy. And yet we also have to acknowledge a new reality of higher public debt.

We need fiscal rules that allow for strategic investment, while safeguarding fiscal sustainability. Rules that are fit for the challenges of this decade. In October, we will come forward with new ideas for our economic governance.

But let me share a few basic principles with you. Member states should have more flexibility on their debt reduction paths. But there should be more accountability on the delivery of what we have agreed on. There should be simpler rules that all can follow. To open the space for strategic investment and to give financial markets the confidence they need.

Let us chart once again a joint way forward. With more freedom to invest. And more scrutiny on progress. More ownership by member states. And better results for citizens. Let us rediscover the Maastricht spirit – stability and growth can only go hand in hand.

As we embark on this transition in our economy, we must rely on the enduring values of our social market economy. It's the simple idea that Europe's greatest strength lies in each and every one of us.

Our social market economy encourages everyone to excel, but it also takes care of our fragility as human beings. It rewards performance and guarantees protection. It opens opportunities but also set limits. We need this even more today. Because the strength of our social market economy will drive the green and digital transition. We need an enabling business environment, a workforce with the right skills and access to raw materials our industry needs. Our future competitiveness depends on it.

We must remove the obstacles that still hold our small companies back. They must be at the centre of this transformation – because they are the backbone of Europe's long history of industrial prowess. And they have always put their employees first – even and especially in times of crisis. But inflation and uncertainty are weighing especially hard on them.

This is why we will put forward an SME Relief Package. It will include a proposal for a single set of tax rules for doing business in Europe – we call it BEFIT. This will make it easier to do business in our Union. Less red tape means better access to the dynamism of a continental market.

And we will revise the Late Payment Directive – because it is simply not fair that 1 in 4 bankruptcies are due to invoices not being paid on time. For millions of family businesses, this will be a lifeline in troubled waters.

The lack of staff is another challenge for Europe's businesses. The number of unemployed is lower than ever before. This is good! But at the same time, the number of vacancies is at a record level.

Whether truck drivers, waiters or airport staff. Whether also nurses, engineers or IT technicians. From unskilled to university degrees, Europe needs them all! We therefore need to invest much more in education and training.

To this end, we want to work closely with the private sector, because they know best which specialists they need today and tomorrow. And we need to better reconcile this need with the objectives and wishes of the job seekers themselves for their career path. In addition, we want to recruit more targeted specialists from abroad who work here for companies and strengthen Europe's growth.

An important first step is to improve their skills in Europe and to recognise that Europe must become more attractive for those who can do something and want to get involved. That is why I propose that 2023 be the European Year of Enlargement.

Whether we're talking about custom-made chips for virtual reality or storage cells for solar systems – access to raw materials is crucial in the transformation towards a sustainable and digital economy and for the success of our small- and medium-sized enterprises.

Lithium and rare earths will soon be more important than oil and gas. Our demand for rare earths alone will increase fivefold by 2030. And that's a good sign! Because it shows the speed at which our European Green Deal is progressing.

The only problem is that a single country currently dominates almost the entire market. We must avoid becoming dependent again, as with oil and gas. This is where our trade policy comes into play. New partnerships help us not only to strengthen our economy, but also in advancing interests and our values globally. With like-minded partners, we can also work standards and ensure environmental standards.

Above all, we need to strengthen our relations with these partners and with important growth regions. I will therefore ratify the agreements with Chile, Mexico and New Zealand. And we are conducting negotiations with important partners such as Australia and India ahead.

But securing supplies is only a first step. The processing of these metals is just as critical. Today, China controls the global processing industry. Almost 90 % of rare earths and 60 % of lithium are processed in China.

We will identify strategic projects all along the supply chain, from extraction to refining, from processing to recycling. And we will build up strategic reserves where supply is at risk. This is why I am announcing a European Critical Raw Materials Act.

We know this approach can work. Five years ago, Europe launched the Battery Alliance. And soon, two third of the batteries we need will be produced in Europe. Last year I announced the European Chips Act. And the first chips gigafactory will break ground in the coming months.

We now need to replicate this success. This is also why we will increase our financial participation to Important Projects of Common European Interest. And for the future, I will push to create a new European Sovereignty Fund. Let's make sure that the future of industry is made in Europe.

Standing up for our democracy

As we look around at the state of the world today, it can often feel like there is a fading away of what once seemed so permanent. And in some way, the recent passing of Queen Elizabeth II reminded us of this.

She is a legend! She was a constant throughout the turbulent and transforming events in the last 70 years. Stoic and steadfast in her service. But more than anything, she always found the right words for every moment in time.

From the calls she made to war evacuees in 1940 to her historic address during the pandemic. She spoke not only to the heart of her nation but to the soul of the world. And when I think of the situation we are in today, her words at the height of the pandemic still resonate with me. She said: *"We will succeed – and that success will belong to every one of us."*

She always reminded us that our future is built on new ideas and founded in our oldest values. Since the end of World War 2, we have pursued the promise of democracy and the rule of law. And the nations of the world have built together an international system promoting peace and security, justice and economic progress.

Today this is the very target of Russian missiles. What we saw in the streets of Bucha, in the scorched fields of grain, and now at the gates of Ukraine's largest nuclear plant – is not only a violation of international rules. It's a deliberate attempt to discard them.

This watershed moment in global politics calls for a rethink of our foreign policy agenda. This is the time to invest in the power of democracies. This work begins with the core group of our like-minded partners: our friends in every single democratic nation on this globe.

We see the world with the same eyes. And we should mobilise our collective power to shape global goods. We should strive to expand this core of democracies. The most immediate way to do so is to deepen our ties and strengthen democracies on our continent.

This starts with those countries that are already on the path to our Union. We must be at their side every step of the way. Because the path towards strong democracies and the path towards our Union are one and the same.

So I want the people of the Western Balkans, of Ukraine, Moldova and Georgia to know: you are part of our family, your future is in our Union, and our Union is not complete without you!

We have also seen that there is a need to reach out to the countries of Europe – beyond the accession process. This is why I support the call for a European Political Community – and we will set out our ideas to the European Council.

But our future also depends on our ability to engage beyond the core of our democratic partners. Countries near and far, share an interest in working with us on the great challenges of this century, such as climate change and digitalisation.

This is the main idea behind Global Gateway, the investment plan I announced right here one year ago. It is already delivering on the ground. Together with our African partners we are building two factories in Rwanda and Senegal to manufacture mRNA vaccines. They will be made in Africa, for Africa, with world-class technology.

And we are now replicating this approach across Latin America as part of a larger engagement strategy. This requires investment on a global scale. So we will team up with our friends in the US and with other G7 partners to make this happen.

This is part of our work of strengthening our democracies. But we should not lose sight of the way foreign autocrats are targeting our own countries. Foreign entities are funding institutes that undermine our values. Their disinformation is spreading from the internet to the halls of our universities.

Earlier this year, a university in Amsterdam shut down an allegedly independent research centre, which was actually funded by Chinese entities. This centre was publishing so-called research on human rights, dismissing the evidence of forced labour camps for Uyghurs as 'rumours'.

These lies are toxic for our democracies. Think about this: we introduced legislation to screen foreign direct investment in our companies for security concerns. If we do that for our economy, shouldn't we do the same for our values? We need to better shield ourselves from malign interference.

This is why we will present a Defence of Democracy package. It will bring covert foreign influence and shady funding to light. We will not allow any autocracy's Trojan horses to attack our democracies from within.

For more than 70 years, our continent has marched towards democracy. But the gains of our long journey are not assured. Many of us have taken democracy for granted for too long. Especially those, like me, who have never experienced what it means to live under the fist of an authoritarian regime.

Today we all see that we must fight for our democracies. Every single day. We must protect them both from the external threats they face, and from the vices that corrode them from within. It is my Commission's duty and most noble role to protect the rule of law.

So let me assure you: we will keep insisting on judicial independence. And we will also protect our budget through the conditionality mechanism. And today I would like to focus on corruption, with all its faces. The face of foreign agents trying to influence our political system. The face of shady companies or foundations abusing public money.

If we want to be credible when we ask candidate countries to strengthen their democracies, we must also eradicate corruption at home. That is why in the coming year the Commission will present measures to update our legislative framework for fighting corruption.

We will raise standards on offences such as illicit enrichment, trafficking in influence and abuse of power, beyond the more classic offences such as bribery. And we will also propose to include corruption in our human rights sanction regime, our new tool to protect our values abroad.

Corruption erodes trust in our institutions. So we must fight back with the full force of the law.

Our founders only meant to lay the first stone of this democracy. They always thought that future generations would complete their work. *"Democracy has not gone out of fashion, but it must update itself in order to keep improving people's lives."*

These are the words of David Sassoli – a great European, who thought that Europe should always look for new horizons. And through the adversities of these times, we have started to see what our new horizon might be.

A braver Union. Closer to its people in times of need. Bolder in responding to historic challenges and daily concerns of Europeans. And to walk at their side when they deal with the big trials of life.

This is why the Conference on the Future of Europe was so important. It was a sneak peek of a different kind of citizens' engagement, well beyond election day. And after Europe listened to its citizens' voice, we now need to deliver.

The Citizens' Panels that were central to the Conference will now become a regular feature of our democratic life. And in the Letter of Intent I have outlined a number of proposals for the year ahead that stem from the Conference conclusions.

They include for example a new initiative on mental health. We should take better care of each other. And for many who feel anxious and lost, appropriate, accessible and affordable support can make all the difference.

Democratic institutions must constantly gain and regain the citizens' trust. We must live up to the new challenges that history always puts before us. Just like Europeans did when millions of Ukrainians came knocking on their door. This is Europe at its best. A Union of determination and solidarity.

But this determination and drive for solidarity is still missing in our migration debate. Our actions towards Ukrainian refugees must not be an exception. They can be our blueprint for going forward. We need fair and quick procedures, a system that is crisis proof and quick to deploy, and a permanent and legally binding mechanism that ensures solidarity.

And at the same time, we need effective control of our external borders, in line with the respect of fundamental rights. I want a Europe that manages migration with dignity and respect. I want a Europe where all member states take responsibility for challenges we all share. And I want a Europe that shows solidarity to all member states.

We have progress on the Pact, we now have the Roadmap. And we now need the political will to match.

Three weeks ago, I had the incredible opportunity of joining 1,500 young people from all over Europe and the world, who gathered in Taizé. They have different views, they come from different countries, they have different backgrounds, they speak different languages. And yet, there is something that connects them. They share a set of values and ideals. They believe in these values.

They are all passionate about something larger than themselves. This generation is a generation of dreamers but also of makers. In my last State of the Union address, I told you that I would like Europe to look more like these young people. We should put their aspirations at the heart of everything we do. And the place for this is in our founding Treaties.

Every action that our Union takes should be inspired by a simple principle. That we should do no harm to our children's future. That we should leave the world a better place for the next generation.

And therefore, I believe that it is time to enshrine solidarity between generations in our Treaties. It is time to renew the European promise. And we also need to improve the way we do things and the way we decide things.

Some might say this is not the right time. But if we are serious about preparing for the world of tomorrow we must be able to act on the things that matter the most to people. And as we are serious about a larger union, we also have to be serious about reform.

So as this Parliament has called for, I believe the moment has arrived for a European Convention.

They say that light shines brightest in the dark. And that was certainly true for the women and the children fleeing Russia's bombs. They fled a country at war, filled with sadness for what they had left behind, and fear for what may lie ahead.

But they were received with open arms. By many citizens like Magdalena and Agnieszka. Two selfless young women from Poland. As soon as they heard about trains full of refugees, they rushed to the Warsaw Central Station. They started to organise. They set up a tent to assist as many people as possible.

They reached out to supermarket chains for food, and to local authorities to organise buses to hospitality centres. In a matter of days, they gathered 3,000 volunteers, to welcome refugees 24/7.

Magdalena and Agnieszka's story is about everything our Union stands and strives for. It is a story of heart, character and solidarity. They showed everyone what Europeans can achieve when we rally around a common mission. This is Europe's spirit. A Union that stands strong together. A Union that prevails together. Long live Europe. ■

Ursula von der Leyen is President of the European Commission

This article is based on the 2022 State of the Union Address, Strasbourg, 14 September 2022

Pulling the curtain on Russian myth making

Nikolai Levin writes behind the Kremlin's threats and bluster lies a broken country that has never really made it to the 20th century, let alone the 21st

In Europe the fascination with Russia, its art, history, and literature runs deep. Russia sparks our imagination, calling to the mind images of the infinite Siberian steppes, golden domes, omnipotent tsars, and dystopian dreams. Ever since the Russo-European relationship has started to go off-track (notably since the invasion of Crimea in 2014), Russia has been impressively capable of capitalizing on this fascination via the use of a well-functioning propaganda machine, maybe the most capable industry of the whole state, as well as less elegant methods, of course.

The lengths to which the authors of Russian influence campaigns were willing to go could be witnessed in the wake of the collapse of Austrian Chancellor Sebastian Kurz's government in 2019 or the odd Moscow encounters between Russian officials and Italian politicians from Lega.

This combination of factors allowed the Russian president to carve himself into the pantheon of European nationalists as an archetypical incarnation of a sovereign, traditionalist leader free of the pesky counterweights of liberal democracies. Furthermore, he became a point of reference for those who dislike the United States enough to be forgiving towards Russia.

This cloak of idealization and myth that Russia is wearing abroad can be seen almost entirely in the video from the Spanish Russian embassy: *Time to move to Russia*; a country with an unshakable economy, traditional values, vodka, and without the hypocrisy of the politically correct. A vision in contrast with my experience and the stories of relatives and friends that have lived, in one way or another, in contact with Russian reality.

As for the unshakable economy, Russia has indeed been able to withstand sanctions better than forecast. Before calculating the impact of the sanctions, however, it is worth understanding Russia's economy in the first place.

Unsurprisingly, economic realities in many ways run counter to the picture Russia wishes to project abroad. Russia's GDP is close to the Italian one (c. 1.8 trillion USD, less than half of the German one) while having more than twice the population.

This author only understood what this meant when living in the countryside near Moscow: if there was a need for water, you had to go to the well, if there was a need for a toilet, you had to go outside, in a closet with a hole dug in the ground. When you realize that thirty million people – according to *Novaya Gazeta* – more than one-fifth of the population live in these conditions, it is possible to start understanding Russia.

It is a land spanning nine time zones where not just various cultures, but different epochs live together. Only with this in mind do the otherwise ridiculous stories of Russian soldiers discovering flush toilets in Ukraine start to make sense.

In essence, Russia is a state that embodies Europe's dreams, yet realized none of them

Looking beyond the opulent cities of Moscow and Saint Petersburg we see villages whose economy can only be described as medieval and whose power structure is essentially feudal. The only thing sewing the country together is the obligatory portrait of the president hanging behind the provincial official's desk and his never-ceasing omnipresence on state television.

Russia has long tried to hide this side of itself internationally. It has been helped in this mission by Western reporters focused on Moscow's powerful means of international force projection. But more so, the story machine on Russian greatness is homemade.

Russia Today, which had established itself as a source for alternative facts and carefully crafted fake reality on both the extreme left and the nativist right before it was banned in the wake of Russia's attack on Ukraine, had raked up more than ten billion views: the most followed news channel in the world. And this was just the most overt element of the Russian influence machine.

A moment of closer attention would quickly dispel the idea that Russia could be some kind of role model for the disengaged and sceptical portions of the European electorate. Nevertheless, its president still serves as a source of inspiration for too many European politicians, and to a certain degree, there is a logic to this fact.

Despite the ongoing war his approval rating, according to official polling, is solidly above 70%, numbers a liberal democrat would not dare dream of and elicits in some the desire for harmony and consensus-based decision making, where the political process of the people is freed from the constant conflict and bickering so present on Western news cycles. Even if the consensus is enforced and the bickering has given way to a silence that is less an expression of consent but rather of fear.

At the same time, we would do well to not elevate the president too much. When Westerners react with horror at the ban on 'LGBT propaganda' in Russia, they are reacting to an illiberal degeneration of the whole country more than an autocratic overreach. Russians are deeply homophobic, and the new laws are read better as a dictatorship of the majority, that that of a single man.

While this form of dictatorship is alive and well in Russia today, the other kind has started to show cracks. We can see this clearly in the aftermath of 'partial mobilization'. Since its announcement, the number of mobilized Russians was dwarfed by more than twice as many emigrated ones, 'how to break an arm' became the top Google search, and many hid away the best they could.

Among them was an acquaintance of mine, who sought cover in an abandoned house in the woods out of Moscow, and went through the lengths of living for a month without electricity or running water to avoid the draft.

Even if this example were not to discourage the most extreme populist, it should still warn against blindly following the will of the people, or in Russia's case, the majority's silent approval.

It comes at the expense of those young men who did not escape the mobilization and are now fighting and dying to keep alive the brutal whims of a tyrannical majority and the very narrow economic interests of a corrupt elite.

Where Russia departs, at least in theory, from the illiberal democracies aspiring to its international clout, is the verticality of its power structure. Citizens are coerced to think by force, quite directly, and the force of television. The vertical means, people don't need a voice - they are reduced to mere echos of predetermined politics, and every wheel in the machine works to ensure that it stays this way.

For a university student, the price of dissent is expulsion from university, for a friend of mine who is still in high school, the price was to never enter it, prevented by a threat made to her mother by policemen and the school director.

It is a thin layer indeed of performative democracy and rhetoric that covers a political system with naked power and contempt at its heart.

In essence, Russia is a state that embodies Europe's dreams, yet realized none of them. It is an invincible economy without hot water in hospitals, an illiberal democracy where the people listen to the elites, a state where no one gets 'cancelled' because no one can speak.

When in the XVIIIth century Denis Diderot defined Russia as a giant with feet of clay, he was referring to the biblical story in which Nebuchadnezzar dreamed of a giant made of precious metals. It had a golden head, large silvery shoulders, a bronze stomach, and iron legs, only its feet were made of clay. According to Diderot, the Russia of empress Catherina II rested on fragile foundations. Since then, many things have changed, but most did not.

Defending democracy these days also means stripping Russia of its masks and glittery self-presentation. Only by looking beyond the propaganda and the fearful aggression of its army alike, into the mud and clay of Russian reality, one can know how utterly undeserving the country remains of both fear and admiration. ■

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Enlarging and deepening

Franz Mayer, Jean Pisani-Ferry, Daniela Schwarzer and Shahin Vallée consider the European Political Community and argue that it could act both as a bridge to a larger EU and as a framework for continental-scale partnership

Executive summary

France's President Emmanuel Macron and Germany's Chancellor Olaf Scholz have stressed the geopolitical emergency of re-designing the European Union's relationship with its neighbourhood. Both acknowledge that EU enlargement is necessary, but also emphasise that profound EU institutional reform is required beforehand, though deepening and widening the EU are complex processes that veto players could block.

The geopolitical challenges mean it is in the critical interest of the EU to bring stability to its neighbourhood by ensuring geopolitical alignment with the EU, limiting the blackmailing power of external, authoritarian states, supporting more resilient democracies and strengthening the rule of law.

Meanwhile, the EU's neighbours are seeking a political space in which challenges to collective security and stability can be addressed and concrete policies decided. Given the urgency, it is not enough to rely on lengthy EU accession processes.

A 'European Political Community' (EPC), which had its first summit on 6 October 2022, could act both as a bridge to an eventual larger EU and as a framework for continental-scale partnership. Leaders should use the summit to start the building of a platform that can combine political dialogue with policy delivery in a quick and flexible way and will thus structure more impactfully the relationship between the EU and its neighbourhood.

The EPC could start as a soft law agreement between states and the EU. It would work with existing institutions as far as possible, while aiming at more effective decision-making than currently in the EU. For instance, it could function without vetoes and could work in geopolitically relevant areas that are not yet EU competences.

An ambitious EPC would provide financial resources for deeper cooperation on energy and climate, security and defence, and economic and social convergence.

The EPC would not be, and should not be, regarded as a substitute for EU accession, but should be designed to work as an accelerator. For countries not seeking to join the EU, it would provide an ongoing framework that sustains structured cooperation with the EU.

1 The need for a new approach

The war in Ukraine has shown that the European Union needs a new approach to structuring relationships with its neighbours. Russian aggression led the bloc in June 2022 to grant candidate status to Ukraine and Moldova, showing that the EU is conscious of the extent to which the new geopolitical situation requires rapid and determined action.

But it is unclear if the EU can respond to these risks simply by adding new members. There is no consensus on speeding up the accession process and in any case, the process should not be rushed because a precipitous accession of Ukraine and Moldova with unchanged EU institutions and treaties would weaken the EU in the long run and put off candidate states that have been waiting for years at the door.

An unreformed EU of 36 members (adding only current candidate countries to the current 27) would be entirely dysfunctional. It would be hobbled by veto rights, a bloated European Parliament, and a hopelessly fragmented executive[1].

Indispensable prerequisites to enlargement include governance reforms regarding the scope of qualified majority voting, the distribution of seats in the European Parliament and the assignment of executive responsibilities within the European Commission. These issues must be at the heart of treaty reform.

However, just letting EU enlargement proceed slowly through the existing uncertain process will turn the politically significant commitment to Ukraine, Moldova and other candidates into a discouraging obstacle course. It will fail to take advantage of the geopolitical momentum, which calls for regular, credible and concrete high-level political engagement of the EU with its neighbours[2].

Indeed, until the accession process is completed, a candidate country is confined to a bilateral dialogue with the Commission[3]. In general, no candidate country or neighbour has a voice in the system, including on issues of first-order importance for its future (Ukraine's energy linkages for example).

In normal times, when the EU changes only slowly, this can be regarded as annoying, but inconsequential. In the current circumstances, it undermines the attractiveness and the effectiveness of the whole process and comes at a very high political cost for EU and accession countries.

The European Political Community may provide an opportunity to advance with defence cooperation in areas that have been stuck in the EU for years

The risk therefore is that putting Ukraine and other candidate countries through a long, slow and painful accession process, without ambitious policies and forums for strategic exchange, could fail to anchor them as long-term political, economic, energy, security and defence partners of the EU.

Moreover, the current lack of flexibility in designing relationships with third countries also hampers the establishment of structured partnerships with former EU members (the United Kingdom) and long-term accession candidates (Turkey).

In this context, French President Emmanuel Macron and German Chancellor Olaf Scholz have argued strongly for profound institutional reforms[4], though neither has suggested a roadmap. Building on an idea floated by former Italian Prime Minister Enrico Letta (see Letta, 2022), Macron on 9 May proposed to create a 'European Political Community' (EPC). European Commission President Ursula von der Leyen said subsequently the Commission would set out proposals on this[5], and also supported the idea of a convention to reform the European treaties, though she did not link it to the idea of an EPC.

We argue that a smartly defined European Political Community would be a suitable response to the new geopolitical situation. It can also help address the EU's internal deficiencies and the challenges in its neighbourhood.

A first meeting of the political community – meaning an informal summit of EU country and candidate country leaders – will be held in Prague on 6 October 2022. It should be used to set out key principles for the community and an ambitious timeline.

2 The European Political Community: a proposal

Since Macron's announcement of the idea, little progress has been made in spelling out the concept of the EPC. It runs the risk of becoming a leaders' forum that would meet once or twice a year, like the bilateral EU-Africa summits or Asia-Europe Meetings, but would not meaningfully define policy.

Creating a more formal structure relying on EU institutions to turn the EPC's leaders' dialogue into policy action, would however risk encroaching on the mandates of those institutions while infringing the principles underpinning the EU. Building the EPC more formally could thus expose it to lengthy legal challenges.

We suggest a middle ground between an intergovernmental agreement resting on EU institutions, and a loose leaders' forum. As illustrated by the G7/G20, one solution is to rely on existing institutions to implement decisions.

Another is to use a soft law agreement as a cooperation and experimentation framework. It could be formalised at a later stage by the combination of EU treaty reforms and a mixed agreement between the EU, its members and non-EU member states.

There is a precedent for such a cooperation framework: the Conference on Security and Co-operation in Europe in the mid-1970s was a meeting of leaders that eventually led to the creation of the Organisation for Security and Co-operation in Europe.

In another field – education – the Bologna Process started as a round of ministerial meetings to organise comparability of higher education standards and eventually led to the creation of a European higher education area.

It should be noted that a European political community was proposed already in the 1950s. The attempt to create it was contingent on the agreement to establish a European Defence Community, based on a treaty signed in 1952.

The failure by France to ratify this treaty in 1954 undermined both the creation of a collective European approach to defence and an ambitious framework for political and policy dialogue. Our approach today is the reverse: establish the foundation of a political and policy dialogue first, in preparation for future EU and international law processes.

2.1 Membership

The perimeter of the EPC will be central to its success. Clearly, geography cannot be the only criterion for deciding on its members. Given that the geopolitical conflict with Russia is the trigger for its creation, it is natural for the EPC to be based on shared values and geopolitical alignment.

To ensure this coherence, broad ex-ante entry criteria should be defined collectively, unlike for the EU accession process, in which the so-called Copenhagen criteria[6] serve as 'last hurdles' before eventual membership.

Assessing alignment of values and geopolitical stance is however hard to pin down with rules. Even when it can be done, applying the criteria raises difficult issues, as EU members, candidate countries and third countries cannot be dealt with in exactly the same way. Moreover, there are inevitably political choices that cannot be avoided.

We recommend that the EPC be as inclusive as possible, which implies extending invitations to all EU countries and all candidates, plus Georgia, Kosovo and also Norway, Switzerland and the UK. No country should be excluded at this stage, provided all participants are made aware that decision will be made on the nature of eligibility criteria and that invitation initially doesn't necessarily equate to guaranteed longer-term participation.

The preparation of a joint declaration setting out membership criteria and exclusion mechanisms should begin before the 6 October summit and should involve a diverse group of EU and neighbouring countries. The October meeting should have the goal of securing approval by a first group of countries by the end of 2022, before formally launching the EPC.

At minimum membership criteria should include:

1. Observance of democratic values and the rule of law as laid down in the political aspects of the Copenhagen criteria,

2. Respect for human rights (full participation in the Council of Europe)[7],

3. Geopolitical alignment with the EU stance on the Russian aggression (full-faith participation in sanctions).

When developing these criteria, it is important to consider that all EU countries are bound by EU treaty provisions. Respect for fundamental rights belongs to the values that are common to the member states according to Article 2 of the Treaty on European Union (TEU). According to Article 7 TEU, breaches may lead to the suspension of voting rights. In theory, this would suggest that membership in the EU is, by itself, a sufficient criterion for assessing compliance with the Union's values and principles.

In practice, however, effectiveness of this provision is blocked because it requires unanimity of the other member states. Hence the EPC should be able to suspend or withdraw the membership of certain countries, even if they haven't been sanctioned by the EU.

Non-EU members and non-candidate countries are not subject to any legally binding EU conditions, but as members of the Council of Europe, they are bound by the principles of the European Convention on Human Rights and subject to the jurisdiction of the European Court of Human Rights. This would in theory argue for the inclusion of the UK and Turkey.

The situation for geopolitical alignment could be even more complex because the EU treaties essentially deal with procedures rather than substance on foreign policy and geopolitics.

Moreover, while Finland and Sweden are becoming members of NATO, Austria and Ireland remain outside. Membership of the EU or NATO are therefore not substantively significant criteria for deciding on these matters: belonging to the EU or NATO is not a sufficient guarantee of geopolitical alignment.

These examples show that EPC membership cannot be rooted in pre-existing hard-wired rules, but should rather be based on the endorsement of a common set of principles covering fundamental values, democracy, the rule of law and compliance with key principles of international relations.

For geopolitical reasons, it would be highly preferable if all countries subscribed to the principles of the EPC, so that new divisions are not created in Europe as it makes progress towards stronger regional integration.

Ukraine, although at war, should be allowed to join the EPC, as it is there that the geopolitical conflict plays out most brutally. This would be coherent with the decision to grant it EU candidate status despite the view prevailing since the accession of Cyprus to the EU that no country involved in a territorial conflict, let alone a full-fledged war, should become an EU member. Sticking to this view would give Russia an indirect veto power over EU enlargement. The same reasoning should apply to the EPC.

Given the complexity involved in thinking about the perimeter of the EPC, and given the benefit of being inclusive towards countries in the 'grey zone' in the hope of leverage and change, there are, in principle, two ways for deciding on membership:

- There could be a formal process of inclusion/exclusion, but this would most likely make the EU, as the convener of the first meeting, into the prime decision-maker, which could result in the Council of the EU taking responsibility for deciding who to allow in and who to exclude.

- A more diplomatically elegant approach would be for the EPC declaration to be prepared jointly by, say, half a dozen countries from within and outside the EU. This agreement should at least be as ambitious as the EU and Council of Europe principles (see above). It would set the bar for commitment substantive enough that countries that do not sub- scribe to the principles and goals self-select out.

In any case, there should not be an arbitrary decision on participation. Countries that do not want to comply with the entry requirements should be welcome to join at a later date. Solving these fundamental issues in months may seem unrealistic.

But the first G20 summit, where essential principles were agreed on, took place only two months after the collapse of Lehman Brothers in 2008. Wars, like financial crises, are accelerators, and what seemed impossible to reach in years can be achieved in weeks.

2.2 Governance

Unlike the EU accession process or neighbourhood policy, which give no say to non-EU countries, all EPC participants would be on an equal footing. The EPC's decision-making rules would treat all members (irrespective of EU membership) as having equal rights.

Unless specified otherwise, political decisions should be taken by 'rough consensus'[8], and in any case without veto powers. The agreement on such decision-making is critical. Without it, the EPC would be limited by to an exchange of views and would fall short of being a real political and policy forum.

However, the EPC must not weaken EU process or institutions. The EU Court of Justice closely guards the autonomy of the EU legal order. A decision would have to be made between creating an independent intergovernmental secretariat (like, for example, the European Stability Mechanism), which would need to be anchored in hard international law, or giving this role to the European Commission on a softer legal basis.

Provided they agree on and are bound by the principles and mechanisms laid out in the EPC founding document, members should not be forced to participate in all of its policy programmes. A degree of flexibility should be retained and operationalised through opt-in and opt-out clauses.

For each of the three main cooperation areas (outlined below), the European Commission would play the central institutional role of secretariat and be given certain operational powers. By providing a modicum of flexibility, the EPC could act as a catalyst for a new and adequate modus vivendi between European countries.

Given the intertwined geopolitical and geoeconomic challenges Europe is facing, a 'whole-of-government' approach may be needed to foster cooperation and overcome the fragmentation of domestic and European policymaking[9].

2.3 Resources

To achieve tangible results, the EPC will require considerable budgetary and financial resources beyond what is already available to support EU accession. A limited commitment of resources from members can be envisaged – as for most international organisations – and/or could be channelled through the EU budget for EU member states.

Non-EU countries should contribute in proportion to their resources and their involvement in cooperation areas. Each area of cooperation should be endowed with its own funds, as the extent of participation will depend on the area of cooperation.

In-kind contributions to overcome the traditional donor-recipient logic between accession countries and the EU would be welcome. In some instances, this would be highly strategic: for instance, Ukraine would be able to provide excellent cyber and defence capacity.

Flexibility should be retained: EPC members could be called on to contribute in each area of cooperation, but retain the flexibility to be a net recipient in one area and a net contributor in another, while opting out from yet another.

However, given the currently limited size of the EU budget, this would undoubtedly trigger an acceleration of the debate on its reform, on the EU's own resources and on a common borrowing capacity.

2.4 Areas for cooperation

The first set of political priorities with clear deliverables could cover three main areas. Further areas of cooperation could be considered, such as research, but we advocate starting with just three areas which are geopolitically the most pressing ones and then building on experience gained and adding others.

2.4.1 Networks, energy and climate action

The current energy crisis is an opportunity to set up a new inclusive cooperation framework, to redefine the relative roles of the EU and its member states and to involve neighbouring countries in a unifying project (energy independence and climate transition) (McWilliams *et al* 2022).

Germany and France have a special responsibility, not least because of their opposite energy models. Finding a cooperative compromise that will lead to greater European solidarity beyond the EU's borders, while pro-actively supporting accession and neighbouring countries, is of utmost geopolitical importance.

The connection of Ukraine to the European electricity grid, the need for gas agreements with Norway and the need for green hydrogen infrastructure call for a broader cooperative framework.

The Energy Community[10], which provides the infrastructure and the technical cooperation to integrate European energy markets, provides an interesting precedent. It includes the EU and non-EU neighbours (including Ukraine, Moldova and Georgia; Armenia, Norway and Turkey are observers). It is based on a 2005 Treaty, has its own secretariat and is equipped with a budget. The EU is represented by the Commission, which serves ex officio as a vice-president.

The EPC should be assigned more ambitious tasks and it should be given more effective legal and financial instruments. Most importantly, the Energy Community shows that there is potential in variable-geometry arrangements.

The EPC should be a framework for deepening and extending energy cooperation in at least five directions:

- A new transnational cooperative framework with new governance that would take coordinated decisions on rationing and solidarity. As demonstrated by the current context, an integrated European market is much better equipped than national markets to mitigate risks. But it should be clear that the cooperative framework also involves risk-sharing, for which principles and mechanisms should be designed.

- Common framework agreements for the purchase of fossil fuels and hydrogen. The experience with COVID-19 vaccines demonstrated the benefits of a joint approach. It makes no sense for EPC members to attempt to outbid each other in bilateral negotiations with suppliers. Common principles should be defined and negotiated, to which individual contracts should make reference.

- The building of coordinated and sometimes common infrastructures that enhance electricity, gas and future hydrogen interconnections, production and storage capacity. It is essential to signal a move towards greater integration of energy markets and more cooperation in the development of critical infrastructure through the EU Trans-European Networks for Energy[11], the EU liquified natural gas strategy[12], the EU hydrogen strategy (European Commission, 2020) and the partnerships for green hydrogen[13].

- A common climate-action strategy based on the European Green Deal but with broader scope and differentiated targets. Both the EU and the EPC partners can gain by joining forces.

- Budgetary and financial instruments following the model of the EU's Just Transition Mechanism; these would provide equity finance, risk-reduction instruments and outright budgetary mechanisms to help the EPC members accelerate the energy transition and boost their energy security.

  This approach will require considerable financial solidarity, but can blend private and public financing, as well as financing from the EU budget and from individual member states.

2.4.2 Foreign and security policy, defence and democratic resilience

The war in Ukraine is exposing the weakness and incompleteness of Europe's security and defence architecture. Although some progress has been made with the EU Permanent Structured Cooperation on Defence (PESCO[14]) and with the recent national and European responses to the war, Europe still has a very long way to go.

To support the emergence of a new European security architecture in the medium term, the EPC could make several contributions in the short term. Cooperation in the area of foreign and security policy, defence and resilience of democracies should start as a coalition of the willing and expand over time.

As a starting point, members should discuss security and further geopolitical issues at their meetings. They could use as a basis for discussion the joint EU threat assessment laid out in the March 2022 Strategic Compass (EEAS, 2022).

The EPC's contribution would be to bring in the important perspectives of Ukraine, Moldova and the Western Balkans, which were not included in the EU emerging strategic debate. Most obviously, Ukraine's experience from its war against what was thought to be the second or third most capable military in the world should be incorporated into European defence and strategic thinking.

- Security should be understood in broad terms including energy, infrastructure, cyber and human security. Measures to address the resilience of democracies should also be addressed. The EPC has the potential to work across policy areas more horizontally than is usually the case on national and European levels. Through very targeted analysis, debate and action, it can potentially be a catalyst for a more holistic approach to complex problems.

- The EPC cannot replace NATO, which despite its weaknesses remains the most credible agent for military coordination, defence and nuclear deterrence. The NATO Secretary General should thus be invited to EPC meetings. The EPC can serve as an important forum for EU and NATO members and non-members, for which security is a matter of common concern.

In particular, the EPC can discuss how growing defence budgets, which in some countries may double, can be spent most usefully. Building capabilities and making best use of cooperation, division of tasks and synergies will be vital in the new security environment, and should be approached with flexibility among European countries.

- Cooperation in the areas of counter-terrorism, cybersecurity and digital connectivity (satellite, data centres, undersea cables) could yield important mutual benefits and enable countries like Ukraine to share with the EU their valuable advanced know-how and experience, proving that the partnership is not a one-way street. The EPC should also be open to learning from non-EU experiences on countering Russian propaganda – for example, from the NATO STRATCOM centre in Riga.

- The EPC may provide an opportunity to advance with defence cooperation in areas that have been stuck in the EU for years. Smaller groups, for instance involving Ukraine, could develop armaments projects of mutual interest. The EU's European defence fund should be made available to countries respecting the third-party participation rules[15].

- A common procurement policy would enhance European sovereignty best if it is paired with a strategy for the development of a European defence industry. Hard security threats on the EU's doorstep call for the Europeanisation of industrial capacities. Little progress has been made so far on this in the EU context, but the EPC could help create new avenues for cooperation.

- If Europe makes progress in building joint armament capacity, arms-export rules will have to be defined. Common policy and industry require common rules but strategic and diplomatic cultures vary greatly in Europe. Arms-export policy should eventually become a European competence.

By agreeing at minimum to cooperate, and at best to harmonise, the arms-control frameworks of members, and by subjecting them to qualified majority voting, the EPC could greatly expand the reach of its arms-export policy and bypass internal obstacles.

- Sanctions policy would benefit from deeper cooperation across Europe. Switzerland and Norway joining sanctions against Russia is an important precedent. Coordination of sanctions policy in the larger EPC group, and decisions taken by qualified majority in these areas, would be a real leap forward in foreign policy.

2.4.3 Framework for economic and social convergence

The EU has long viewed its market as its single largest source of appeal. Economic, social and political convergence are however interrelated. Beyond current levels of economic integration, a more structured framework is needed, going further than a customs union (Turkey is part of one with the EU) or a Deep and Comprehensive Free Trade Agreement (Ukraine is part of one), to ensure gradual and sustainable economic, social and political convergence.

The EPC should therefore build on existing initiatives, such as the Berlin Process and the accession process, to substantially upgrade economic, social and political cooperation. Trade and investment cooperation and treaties are the basis of the EU's partnership with its neighbourhood.

This approach gives a considerable place to market integration but sometimes neglects necessary investments in infrastructure and capacity building. Indeed, free trade should be pursued but must also be accompanied by a broader range of supporting and enabling policies. This could involve at least the following instruments:

- Convergence and cohesion policy have historically been accessible only to EU members, but it provides resources to encourage and finance economic convergence that could be critical in the accession process.

Critical infrastructure financing should be made available to EPC countries to accelerate their convergence and the cohesion of the EPC, over and above the modest pre-accession assistance that is available. This could be of particular importance to Ukraine for rebuilding after the war.

The EPC could provide an additional forum to help ensure that reconstruction happens with a focus on regional networking and resilient infrastructure, not only for Ukraine, but also for countries such as Moldova or Georgia that are likely to be suffer from fall-out from the war in Ukraine.

- To accelerate socio-economic convergence, additional conditional funding could be made available under the principles established and methods used for the EU's Recovery and Resilience Facility, which has been set up in the context of the still-underdeveloped area of coordination of the economic policies of EU countries.

  Additional conditional funding could, once legally stabilised in the EU, be exported to non-EU EPC countries. By setting out areas of policy coordination (climate, economic, social) and providing financing against agreed milestones, the EPC could be a powerful engine of convergence.

- Digital convergence between the EU and its neighbours should be happening a lot faster than the formal EU accession process allows. For instance, Ukrainians have been developing extensive collaboration with American tech firms, to the extent that Ukraine could end up closer to the US than to Europe in terms of digital and privacy standards after the war.

  At the same time, the fact that Ukraine is not covered by EU legal frameworks on platform regulation puts it at the mercy of large platforms on content moderation policies in relation to Russian disinformation. The EPC should find ways to address this.

3 Roadmap

Given the geopolitical context, the EPC's 6 October 2022 summit declaration should commit participating countries to meet twice a year at leaders' level and to prepare a founding document to be signed by spring 2023.

This should lay out areas of cooperation, budgetary resources, governance, voting rights, participation criteria and an exclusion process. Setting up the EPC is urgent, but it should be designed and launched with long-term objectives in mind, as presented in this roadmap.

The building of the EPC and the EU's own institutional reform agenda are in principle independent. But as deep EU internal reforms must be agreed and implemented before future enlargements, the EPC could be used as an arena to experiment with alternative policymaking and governance, for example decision-making without veto rights and by 'rough consensus' (see section 2.2).

The strength of the EPC would be in being flexible enough to be established rapidly and implemented effectively. By virtue of being rooted in soft law and taking the form of a joint declaration of heads of state and government, it would not require a lengthy formal ratification process, and the absence of a tight legal corset would allow for a more flexible framework.

However, this can only be a transitional arrangement. The EPC will subsequently need to move from a soft law agreement into a more formal concept at some point. This should be done alongside ambitious EU treaty reform.

Core elements of such a reform should be enhanced transparency and accountability of institutions for a more democratic EU, a greater role for the European Parliament and national parliaments, a strengthening of the EU's executive powers in a larger set of areas, the expansion of qualified majority voting to all critical areas (energy, security, fiscal and budgetary affairs) and an overall consolidation of the European integration project as a community of law, based on the rule of law.

These changes would then either have to be ratified by all willing member states, which would require changes to existing ratification procedures, or only the willing parties would enter into a new treaty. These changes are needed because the EU will otherwise fall prey to vetoes, which can block institutional reform and hence enlargement (Bribosia, 2009).

The EPC would then be based most likely on a mixed agreement between the EU, its members and non-EU states. This formalisation would allow even more durable relationships and cooperation to be established with states that would not want to join the reformed EU[16]. Ratification of the EU-EPC agreement – in fact a treaty – will take time. The transition from soft law to hard law can be smoothed out by means of a provisional application of the core elements of the new treaty, though.

It is crucial to anchor and align the EPC's emergence in a process of deeper EU institutional reform that could follow a roadmap combining the creation of a European Political Community, EU institutional reforms and enlargement:

- Statement of EPC leaders following the 6-7 October 2022 summit.

- Founding document for the EPC setting out participation criteria, governance, decision making, areas of cooperation, budgetary resources by end-spring 2023.

- Formal launch of the EPC by summer 2023.

- New convention to prepare an intergovernmental conference on EU Treaty reform by summer 2024, after the European elections.

- Launch of intergovernmental conference for EU Treaty reform in summer 2025.

- Agreement on new EU Treaty proposal by end of 2026, followed by ratification before the 2029 European elections.

- Agreement on new EU-EPC Treaty linking the reformed EU to non-EU EPC members.

- Enlargement of the EU to new member states after 2030. ■

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Endnotes

1. As noted by German Chancellor Olaf Scholz in a speech in Prague on 29 August 2022. See https://www.bundesregierung.de/breg-en/news/scholz-speech-prague-charles-university-2080752

2. See Sapir (2022) and Alexander Stubb, 'The case for a confederal Europe', European Council on Foreign Relations, 21 June 2022, https://ecfr.eu/article/the-case-for-a-confederal-europe/?amp

3. Except for the intergovernmental Berlin Process for the Western Balkans, led by Germany.

4. Macron in a 9 May 2022 speech in Strasbourg (see https://presidence-francaise.consilium.europa.eu/en/news/speech-by-emmanuel-macron-at-the-closing-ceremony-of-the-conference-on-the-future-of-europe/) and Scholz on 29 August 2022 in Prague (see https://www.bundesregierung.de/breg-en/news/scholz-speech-prague-charles-university-2080752).

5. See von der Leyen's State of the Union speech, 14 September 2022: https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_22_5493

6. See https://eur-lex.europa.eu/EN/legal-content/glossary/accession-criteria-copenhagen-criteria.html

7. Kosovo has expressed interest in membership in the Council of Europe and already has partial agreements eg. membership of the Venice Commission. It should not be excluded from EPC membership if is affirms its adherence to the norms and principles laid out for the EPC and continues to pursue Council of Europe membership.

8. 'Rough consensus', a concept created for deciding on technical issues related to the internet and intended to ensure that all stakeholders remain on board, is achieved when the group as a whole agrees, but the agreement falls short of unanimity, and opposing views are taken into account.

9. The whole-of-government approach is a concept first introduced in the UK in the late 1990s to emphasise the significance of collaboration and coordination between different public entities within a government.

10. The Energy Community is an international organisation that brings together the European Union and its neighbours to create an integrated pan-European energy market. The Treaty establishing the Energy Community was signed in October 2005 (see https://www.energy-community.org/legal/treaty.html). The main objective of the Energy Community is to extend the EU internal energy market rules and principles to countries in south-east Europe, the Black Sea region and beyond, on the basis of a legally binding framework.

11. The Trans-European Networks for Energy (TEN-E) policy seeks to link the energy infrastructure of EU countries. As part of the policy, nine priority corridors and three priority thematic areas have been identified. The EU helps countries in priority corridors and priority thematic areas to work together to develop better-connected energy networks, and provides funding for new energy infrastructure. See https://energy.ec.europa.eu/topics/infrastructure/trans-european-networks-energy_en

12. See https://ec.europa.eu/commission/presscorner/detail/en/MEMO_16_310

13. The Clean Hydrogen Partnership's main objective is to contribute to the European Green Deal and the EU hydrogen strategy through optimised funding of research and innovation activities. The Clean Hydrogen Partnership is the successor of the Fuel Cells and Hydrogen 2 Joint Undertaking (FCH 2 JU) and took over its legacy portfolio as of 30 November 2021. See https://www.clean-hydrogen.europa.eu/index_en

14. See https://www.pesco.europa.eu/

15. The EU's current defence policy allows third countries to take part in EU initiatives including the Permanent Structured Cooperation, the European Defence Agency, the European Defence Fund and European industrial policy. For background, see https://www.europarl.europa.eu/RegData/etudes/ATAG/2022/729348/EPRS_ATA(2022)729348_EN.pdf

16. See in this regard the proposal made in August 2016 by Pisani-Ferry et al (2016).

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Does the EU need an energy crisis fund?

Simone Tagliapietra, Georg Zachmann and Jeromin Zettelmeyer argue that an EU energy fund is justified, but for different reasons than commonly assumed, with implications for the fund’s design

A German plan for a €200 billion national energy emergency fund, proposed at the end of September, set alarm bells ringing across the European Union. The fear is that EU countries with more fiscal space, such as Germany, will be able to outspend others when dealing with the crisis. This could fragment the EU single market, *"setting up a race for subsidies, and calling into question the principles of solidarity and unity that underpin our European project,"* according to a widely-syndicated article by two top EU officials, internal market commissioner Thierry Breton and economy commissioner Paolo Gentiloni. Preferable, the commissioners argued, would be a *"mutualised tool at the European level"* that *"protects all European companies and citizens,"* similarly to the support instruments created during the COVID-19 pandemic.

Some of the commissioners' concerns are valid (though they also reflect a misunderstanding of the German fund, which attempts to pre-fund energy-crisis related expenditures – most of which are not gas price subsidies – over a two year period). However, their arguments are unlikely to convince either Germany or other sceptics of EU fiscal mutualisation.

The obvious objection to mutualisation is that the purpose of building fiscal buffers – that is, reducing debt in good times – is to have more room for manoeuvre in bad times. Some (ourselves included) would prefer to create such buffers at the EU level, in the form of a much larger EU budget with a borrowing capacity. But so long as this does not exist, EU countries must have incentives to build such buffers at the national level. Redistributing fiscal resources to ensure equal treatment of households and firms in the EU after a bad shock would undermine such incentives.

This is the logic underlying the European Treaty's no-bailout clause. It does not mean that there cannot be pan-EU solidarity with the hardest hit, but it does mean that member countries will worry mostly about their own citizens.

A different crisis

The less-obvious objection to a common energy emergency fund has to do with the nature of this crisis and, particularly, of the crisis response. In the pandemic, the responses of EU countries, such as higher spending in support of businesses and households (including to enable people to stay at home), also helped other EU countries by reducing deaths and stimulating demand for imports.

The integrity of the single market is a core economic interest of all EU countries, not least Germany, which relies on the pan-European integration of its industrial supply chains. As such, the fund could play an important role

But since higher spending is financed locally, governments, especially those with little fiscal space, would not normally take these 'externalities' into account when formulating their spending plans. As a result, a highly-integrated economy such as the EU could have seen too little crisis spending in the pandemic.

It thus made sense for the EU level to subsidise such spending, which was done in the form of grants or cheaper lending from the common Next Generation EU and SURE funds.

This crisis is different. A demand externality still exists, but at a time of high inflation, this is not necessarily a good thing (higher demand in country A could lead to even higher inflation in country B). More importantly, the instinctive national reaction to the crisis – subsidising gas and other energy consumption, as is happening in many EU countries – imparts a negative externality on other EU countries: higher energy demand in one country pushes up the gas and electricity prices in the entire bloc. In extremis, this could require more rationing.

For this reason, the cooperative, unified EU response (which we, the European Commission, the Council of the EU and Council President Charles Michel have all called for) should not focus mainly on EU-level fiscal support. For this crisis, 'solidarity' does not necessarily mean more spending. Rather, it means less energy consumption.

The principal measure of solidarity should not be whether an EU country is willing to support other countries financially, but whether it designs its own support plan with incentives to reduce energy consumption, whether it acts to unlock all energy supply options, and whether it will share scarce energy with neighbouring countries in case of an emergency.

Therefore the German 'gas price brake' and 'electricity price brake' – which are to be financed by the €200 billion plan – could become instruments of solidarity if they reduce German energy demand. This could be the case if they subsidise energy prices only up to a threshold (such as 70%-80% of past consumption), while allowing the prices for additional consumption units to be determined by the market, as proposed by the expert commission tasked with designing the gas price brake (see here for a useful Twitter thread in English).

Arguments for an EU energy fund

An EU-level support fund could nevertheless be a good idea, even critically important, for three reasons.

First, there is a valid concern that if some countries are more generous than others in the support they give energy-intensive firms that compete internationally, it might not only distort the level playing field during the crisis but could improve the competitive position of these firms even post-crisis, to the detriment of EU competitors.

While a stronger fiscal position gives a country every right to be more generous to its citizens than a fiscally weaker country, it does not give it the right to inflict damage on other countries through its ability to provide state aid. State-aid rules can limit such damage, but this is not enough to maintain a (roughly) level playing field unless a minimum level of support is provided everywhere.

Second, an EU-level fiscal instrument would greatly improve the chances that support for firms is provided in a way that encourages energy savings and is consistent with the green transition. Even in countries with the best governance, distributing subsidies to firms is subject to lobbying, connections and state capture. Providing these funds at EU level will not stop these problems, but can reduce them significantly.

Third, beyond promoting incentives-friendly firm support, the fund could also be used to create incentives for EU countries to implement those policies that are essential to a cooperative and effective response to the energy crisis.

Countries would lose access to the fund if, for example, they implement policies inconsistent with meeting their energy-demand reduction commitments, or close their borders to energy trade. Additional support from the fund could go to countries that make special efforts to increase supply, for example, by increasing local gas production, authorising additional pipelines or extending the life of nuclear plants.

How to design it

A fund that meets these objectives should not simply be a replica of past fiscal stabilisation funds such as SURE. Instead, it should provide support based on criteria that are carefully designed both to level the playing field among internationally active, energy-intensive firms and to encourage energy savings. This could happen in one of two ways.

One approach would be to (at least temporarily) take subsidisation of such firms out of the hands of national governments altogether. Industrial consumers that meet certain criteria – size, energy use, export orientation, perhaps value added inside the EU – would receive support from the EU-level fund.

Parallel national-level support would be forbidden at least for the duration of the crisis. Support would either avoid price subsidies altogether (for example, if it is based on past energy consumption only) or it could be based on the ideas proposed by the German expert commission on the gas price brake, which would maintain incentives to save in line with market prices.

An alternative approach would be for national governments to continue administering funds, while imposing restrictions on how they can do this (state aid rules), and providing each government with earmarked resources. Disbursement would have to be done in a way that encourages gas savings in the industrial sector rather than gas consumption.

One way to do this would be to require government to adopt criteria for state support that mirror those that would make sense at the EU level. Only governments that comply would benefit from the fund. Another way would be to link transfers from the EU fund to the actual savings achieved by each country.

The distributional implications of the fund will depend on how it is financed. If it is based on member-state borrowing in proportion to GDP or EU budget shares, it would benefit countries with a structurally high ratio of gas consumption by energy-intensive exporters to GDP, including Belgium, Germany, Italy, the Netherlands and Poland.

This redistributive effect could be neutralised by basing contributions on this ratio rather than on GDP. An additional redistributive effect, benefitting members with higher borrowing costs, would arise if the fund were to be based on common borrowing or joint guarantees.

An EU-level support fund cannot be the main pillar of the EU's response to the energy crisis. That should be a coordinated set of demand-reducing and supply-expanding policies at the national level, and an EU-wide effort to obtain better deals from external suppliers.

However, an EU fund can complement such efforts by maintaining a level playing field among energy-intensive exporters, by ensuring subsidies to these exporters are provided in a way that encourages energy savings, and by incentivising implementation of critical elements of the joint EU energy plan. The integrity of the single market is a core economic interest of all EU countries, not least Germany, which relies on the pan-European integration of its industrial supply chains. As such, the fund could play an important role. ■

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Will the EU price cap on Russian oil work?

The G7 Russian oil price cap is an ambitious but untested instrument. Ben McWilliams, Simone Tagliapietra and Georg Zachmann argue that the cap has the potential to be the most potent of sanctions

The Western response to the unprovoked Russian invasion of Ukraine has entered a new and more ambitious phase. On 5 December, G7 and EU nations agreed on their price cap on Russian oil, which comes alongside the EU's embargo on Russian crude oil imports. The cap is significant because, since 2006, over 60% of Russia's federal budget revenues have been from oil and gas, with the contribution from oil around five times higher than that from natural gas.

The G7's aspirations are bold: to restrict Russian oil revenue while not increasing global oil prices. The myriad of factors that interfere with oil markets make it difficult to draw any quick conclusions on the cap's effectiveness. Here, we try to provide a structure to evaluate the likely consequences of the cap and decide whether the G7 will ultimately be able to declare success.

Economics behind the cap

When considering the cap's effectiveness, it is helpful to think through three variants of a Western oil embargo on Russia.

The embargo is a starting point that does not seek to prevent Russia exporting oil to third countries. The EU's own oil embargo bans the import of seaborne crude oil from Russia. In 2021, 45% of Russian crude oil exports flowed to the EU, or around 3 million barrels per day (mb/d).

By 2023, a little over 0.25mb/d of this oil will continue as Germany and Poland have committed to end pipeline imports via the northern Druzhba branch, while Bulgaria has an exemption to continue importing Russian seaborne oil.

The immediate effect of this embargo is to lower demand for, and therefore the relative price of Russian oil. However, oil markets are interconnected. As the EU enters global markets to replace its Russian purchases, some alternative buyers will be found for Russian barrels. In a perfect market, global oil trade would simply rebalance.

Success will also depend on wider global economic forces, such as decisions taken in China regarding COVID-19 lockdowns, where falling oil prices strengthen the hand of the G7

In reality, logistical and political frictions prevent this. As the EU increasingly shunned Russian oil in past months, Russia found new buyers for around 1mb/d of displaced crude oil, but did so only by accepting substantial discounts to global prices. Russia will now need to find buyers for a further 0.8mb/d exports via western ports.

The second variant is where the EU and G7 allies do not only refuse to buy Russian oil, but also attempt to prevent Russia from exporting oil elsewhere. The EU's initial plan was to include this feature in its embargo starting 5 December by banning EU firms from providing *"technical assistance, brokering services of financing or financial assistance, related to the transport"* of Russian oil to third countries.

This aimed to amplify the logistical frictions that prevent Russia from finding new buyers, reducing the volume of Russian exports, and making the discount that Russia must accept to sell any oil even larger.

The EU was able to take this step because member countries play an enormous role in the global shipping insurance market. Prior to the invasion in Ukraine, the EU, G7 and Norway insured over 85% of ships carrying Russian crude oil, 65% of which they still insure today.

A risk with this plan was that it may have led to higher global oil prices. While the EU was bidding up the price of non-Russian oil, it would have prevented Russian exports from meeting displaced demand elsewhere.

Something similar happened in the natural gas market, where Russian supply cuts to the EU dramatically increased global prices. The EU was able to redirect demand to the global LNG market while Russia cannot redirect its gas exports.

Fearful of such global economic consequences, the US lobbied for a third variant of an EU oil embargo: one in which the EU continued providing insurance (and now shipping) services for tankers transporting Russian oil, but only if transactions verifiably occurred below a price cap.

Theoretically, if the price cap is set at a binding level and Russia complies, the proposal achieves the best of both worlds. Rents to the Russian state are reduced while exports are maintained, and oil markets are calmed. This is the optimal outcome that the G7 architects are hoping for in the coming months.

After long negotiations, on 2 December, the EU agreed to set the price cap at $60/barrel, with an adjustment clause to ensure the cap remains below 5% of Russian market prices. For context, Russian (Urals) oil was recently reported to sell at $52/barrel while in recent months a more typical price has been closer to $65/barrel.

Russia's move: the price cap in reality

In response, Russia must choose whether to comply with or reject the cap.

Russian compliance

If Russia complies with the cap, exports will continue to flow, and the question becomes only whether the Kremlin's revenue is impacted. The obvious risk here is that the price level is set too high.

In a worst-case scenario, the G7 actions may even increase Russian revenue. For months, markets have been discounting a barrel of Russian oil by $25, due to associated logistical and political frictions.

Setting the price level at $60/barrel signals the strong desire from the G7 to keep Russian oil flowing to market. G7 endorsement offers encouragement to trade Russian oil at the capped price, and this will increase Russian revenue if the price cap is set at a level less than $25 below market prices. This risk is non-negligible given that Brent trades today at $80.

The International Sanctions Group considered this risk as concretely occurring with a price cap set at $75/b. A more subjective risk lies over exactly how hard revenue should be hit. Even at a price of $60 per barrel, the Kremlin is still able to extract substantial rents, with government taxes scaling substantially above $25.

If the price level turns out to be binding, a second risk is monitoring compliance. The high price level may also represent an admission from the G7 that it does not believe it's able to inflict a price far below market prices, because it would be extraordinarily difficult to monitor compliance with the cap.

Even assuming that an international administration system can be effectively run to ensure that no ship carries Russian crude priced above $60, side-payments will be almost impossible to monitor. Assuming the cap is binding, excess demand will exist for Russian oil at the price level.

With prices unable to balance demand, it would be up to the Russian state, Russian companies, or international trading houses to extract whatever concessions help them choose who to sell to at a discounted price via 'creative negotiating'.

However, there might be a trade-off between how much of this extra revenue from 'cheating the cap' accrues to Russian owned companies and how much to international trading houses, which the G7 may be willing to remain blind to later.

Russian rejection

Russia has signalled that it will not comply with these sanctions. Vladimir Putin has repeatedly stated that Russia will not sell to any country who implements the cap, most recently drafting a Presidential decree prohibiting domestic companies buying and selling Russian oil to anyone that participates in the cap.

Assuming rejection, the G7's price cap will default to an outright ban on G7-companies providing insurance or shipping services (like the 'second variant' of the EU embargo described above). Overnight, Russia will become the largest source of (G7-defined) illicit oil. For Russia to continue exporting, new ships, new insurances and new buyers willing to cooperate in a new system must be found.

It is not unreasonable to see this system being created. A US Treasury official confirmed estimates that up to 80-90% of Russian oil could continue to flow outside of the cap mechanism, and with six months to prepare, Russia has procured a shadow fleet. Success along this route for Russia would require open defiance from major non-G7 oil buyers, and lead to a bifurcated global oil market.

In addition, the Kremlin may cut exports to spite the cap to try to raise global oil prices. The logic of the cap is that Russia will not do so, as it would be unable to enjoy increased prices per barrel.

However, this holds only if circumventing the cap is not possible. Even if cutting exports hurts Russia, the Kremlin may decide to do so as a signal of its willingness to suffer economic pain. This would show that the Kremlin will do what it takes to cause more pain to its adversaries.

However, it would be a risky strategy for Russia, potentially threatening Russia's stature in OPEC+ and losing its status as the major global oil exporter alongside Saudi Arabia. Russia would have to hope for a quick victory as its actions could increase oil prices temporarily, but markets would rebalance, ultimately leaving a smaller share of the pie for Russia.

The coming oil stand-off

The EU's embargo and G7 price cap will kickstart a period of escalating tension in oil markets.

Russia will use all its possibilities to circumvent the cap from day one, appearing likely initially to reject trade that is done based on the cap. It will want to demonstrate independence, put pressures on global oil markets, and avoid the cap becoming an entrenched instrument.

Russia may cut exports with the goal of increasing global oil prices and exerting pressure on the G7 and EU alliance to back down. In line with this, Russia announced its intention to set a 'price floor' for its oil exports shortly after the cap was announced.

The G7 and EU alliance has promised to review the price of the cap every two months, adjusting it when deemed appropriate. The alliance will also bring forward a cap on Russian product exports (notably including diesel) in February, when the EU also prohibits its own imports.

These effects will likely be even more substantial than for crude oil. The use of secondary sanctions for countries who do not respect the cap would mark a dramatic but possible escalation.

Meanwhile, OPEC will watch closely – alarmed by the concept of buyers setting (albeit one country's) oil prices, and continually re-evaluating Russia's strength as a partner in OPEC+.

Success will also depend on wider global economic forces, such as decisions taken in China regarding COVID-19 lockdowns, where falling oil prices strengthen the hand of the G7.

Ultimately, the results of this power struggle will be determined by whether Russia can find solutions to circumvent the cap, how urgently it needs the money from current oil sales, and how sensitive the EU and G7 are economically and politically to the spectre of rising oil prices.

Establishing the cap was a sensible first move. The allies of Ukraine must now look to strengthen and reinforce the cap: by ensuring that it is binding; by increasing their own economies resilience to oil price fluctuations, and by developing tools for monitoring and reducing non-compliance.

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The European Climate Law and the ECB

The EU has adopted the European Climate Law. Frank Elderson considers how the ECB will be affected

A topic close to my heart – apart from the law – is the ongoing climate and environmental crises. I am glad that we have long since moved on from the time when only scientists and activists were concerned with this topic. It is now high on policymakers' agendas, as we saw at the recent United Nations Conference of Parties (COP27) at Sharm el-Sheikh, at which – along with world leaders and a wide range of policymakers and interest groups – the ECB was also represented.

I was struck by one story in particular[1]. The tiny Pacific nation of Vanuatu is badly exposed to cyclones and rising sea levels. To the inhabitants of Vanuatu, climate change is a human rights issue. And, as Vanuatu's president, Nikenike Vurobaravu, stated, *"we are measuring climate change not in degrees of Celsius or tonnes of carbon, but in human lives."*

Vanuatu now plans to ask the UN General Assembly to seek an opinion from the International Court of Justice on the human rights implications of the climate crisis. That opinion could determine the rights of countries most exposed to climate change. It could also touch on the obligations of those most responsible for driving the climate crisis.

Let's now focus on Europe and the possible implications of these developments in international law for my own institution, the ECB. Under the Paris Agreement adopted at COP21 in 2015, many countries committed to the long-term goal of holding the increase in the global average temperature to well below 2°C above pre-industrial levels[2].

To fulfil its commitment as one of parties to the Paris Agreement, the EU last year adopted the European Climate Law[3]. The implications of the Climate Law are significant. Before going into why, let me first explain what the Climate Law does.

The Climate Law has three key elements. The first is its objective that the EU reduce its greenhouse gas emissions by at least 55% by 2030, with a new reduction target to be set for 2040. The EU should achieve climate neutrality by 2050 and aim to achieve negative emissions thereafter.

The second important element is to ensure that we move towards that objective. The European Commission has established a framework for assessing concrete progress and checking whether national and Union measures are consistent with the objective. It will issue regular reports on the conclusions of these assessments.

If we waiver, the costs will only increase both in a moral and financial sense. I will be even more forceful: our mandate requires us to be ready

The third and last element is to ensure that we use the most effective instruments to achieve the objective. The introduction of a European Scientific Advisory Board on Climate Change promotes the idea that all policies should be based on up-to-date scientific insights.

It is hard to overstate the importance of the Climate Law. The EU is setting the bar high. Allow me to quote what the law says about the transition to climate neutrality. It *"requires changes across the entire policy spectrum and a collective effort of all sectors of the economy and society […] all relevant Union legislation and policies need to be consistent with, and contribute to, the fulfilment of the climate-neutrality objective while respecting a level playing field"*[4].

We are starting to see this happen. From housing to energy and from transport to finance, the EU is introducing reforms to put Europe on track to become the first climate-neutral continent by 2050.

So how will the Climate Law affect the ECB? For me, as a member of the ECB's Executive Board and the Vice-Chair of its Supervisory Board, this question is relevant to both our monetary policy and banking supervision tasks.

This question matters because, in the field of the environment, the ECB is a policy taker, not a policymaker. So what does the ECB need to take from the policy and objectives reflected in the Climate Law? To answer this, we first need to consider whether the ECB is bound by the Climate Law. If so, the ECB would have to take measures towards achieving the climate-neutrality objective.

There is more, though. If the ECB is bound by the law, it would also have to ensure continuous progress in enhancing adaptive capacity, strengthening resilience and reducing vulnerability to climate change. Moreover, it would have to ensure that its policies on adaptation are coherent with and supportive of other such policies in the Union[5].

That is quite a full plate. So, is the ECB bound by the Climate Law? There are definitely indications that it is. The Climate Law is addressed to *"relevant Union institutions and the member states."* In the European Anti-Fraud Office (OLAF) judgment[6], the European Court of Justice made it clear that, in principle, the ECB is bound by all regulations which bind the Union. There is no distinction to be made between the different institutions, bodies, offices and agencies. All are equal under the law, so to say.

However, the word 'relevant' is ambiguous. Does it refer to any institution, where relevant? That would mean that every EU institution should comply with the Climate Law, whenever it develops policy or takes action relevant to the objective of the law.

Or does it refer only to those institutions with competence to create policy relevant to achieving the objective of the Climate Law? The ECB would be directly bound by the law under the first interpretation but not under the second.

The Climate Law is not crystal clear on this point. It does not define 'relevant institution'. But there are a number of strong indications that the ECB is not a relevant institution under the Climate Law. Let me explain why.

The Climate Law does not contain many specific obligations. The law sets out a destination: climate neutrality. It does not tell us how to get there. How we do so will depend on environmental and economic policymaking. This is a Union competence the ECB does not have.

There are further arguments that support this interpretation. If the ECB is deemed to be a relevant institution, then it would have to submit its policies to the Commission for assessment and the Commission would monitor progress.

That would be a fundamental change to the ECB's accountability framework. Under current law, the ECB is only directly accountable to the European Parliament and the European Court of Auditors[7].

A final reason for this view is institutional. If the ECB were deemed to be a relevant institution within the meaning of the Climate Law, this would be an implicit acceptance that the Council of the EU and the Parliament could set additional objectives for the ECB through the ordinary legislative procedure.

However, the ECB's objectives are laid down in the Treaty on the Functioning of the European Union (TFEU)[8], and their scope cannot be changed by secondary legislation. That would be a violation of the Treaty. Changing the ECB's objectives requires a special procedure.

The ECB is – it seems – not directly bound by the Climate Law. So, can we ignore it? Not at all. To do so would be a violation of the Treaties. Article 11 of the TFEU provides that environmental protection requirements must be *"integrated into the definition and implementation of the Union's policies and activities."*

This imposes an obligation on the ECB to take into account and consider the objectives of the Climate Law when performing its tasks. In addition, Article 11 could be understood as supporting measures which incorporate environmental considerations as secondary aims. This means the ECB could rely on Article 11 to support the climate neutrality dimension of measures falling within its monetary policy or supervisory competences.

But it does not go so far as to establish an autonomous competence to adopt environmental measures. In addition, under Article 7 of the TFEU, the activities and policies of the ECB need to be consistent with Union law and therefore also with the Climate Law.

We have diligently assessed how these provisions of the Treaty, together with the Climate Law, affect our tasks, always being guided by and staying within our mandate. The ECB is not an environmental policy institution. The ECB is a central bank and banking supervisor. As such, let me share with you what we have done to reflect these legal requirements in the common fight against the climate crisis within our mandate.

First of all, when defining and implementing monetary policy, we need to take into account environmental protection requirements, such as the climate-neutrality objectives contained in the Climate Law. And that is what we have done. Last year the Governing Council adopted a comprehensive action plan[9] to further incorporate climate change considerations into its monetary policy framework.

There are a number of actions to which the ECB is committed under this plan. Let me now give a very concrete example of how the ECB has taken into account climate change considerations in the context of its corporate sector purchase programme (CSPP).

Under the CSPP, the Eurosystem purchases corporate bonds for monetary policy purposes. Right now we are in the reinvestment phase which means that we are no longer increasing our portfolio but only reinvesting bonds that mature. Up until October 2022, the Eurosystem purchased these bonds in accordance with the 'market benchmark'.

However, owing to the way the corporate bond market functions, this 'market benchmark' has been criticised as leading to the purchase of a larger proportion of bonds from carbon-intensive firms.

Therefore, from October 2022, the ECB started to implement its decision to 'tilt' CSPP reinvestments to increase the share of assets from issuers with better climate performance, rather than those with poorer climate performance. There are two main reasons for this decision.

First, the ECB considered this essential in order to effectively pursue its primary objective of maintaining price stability. Given that carbon-intensive issuers are more vulnerable to physical and transition risks arising from climate change, large holdings of bonds from such companies pose higher financial risks to the Eurosystem's balance sheet, which has an impact on the implementation of its monetary policy.

Second, 'tilting' the CSPP also serves the ECB's secondary objective of supporting the general economic policies in the Union. 'Tilting' its corporate bond reinvestments towards 'greener' companies enables the ECB to align these reinvestments with the objectives set out in the Climate Law, which form part of those economic policies. This action was assessed as also being conducive, and not prejudicial, to price stability.

More generally, this measure ensures that the CSPP complies fully with the ECB's obligations under Article 11 TFEU by integrating the objectives of the Climate Law into the definition and implementation of the ECB's policies and activities.

This is one of the first steps in the ECB's climate action plan, but the ECB is also looking into other ways to take climate-neutrality objectives into account in its monetary policy – for example, through the collateral that we ask when providing liquidity to banks.

For banking supervision, there are several dimensions that I will briefly discuss. Again, we do not directly apply the Climate Law. The Climate Law does not directly relate to our tasks as a banking supervisor nor does it relate to prudential supervision. Therefore the ECB does not impose an obligation on banks to take the necessary measures to contribute to the achievement of the objectives of the Climate Law.

However, we cannot ignore it. Not only because we need to integrate environmental obligations into our policies due to Article 11 TFEU, but also since the law will have prudential implications. Therefore, the Climate Law and its consequences feature in our supervisory assessments, interactions with the banks and measures we take.

Why is that? Banks will be at the forefront of the energy and climate transition, whether they want to be or not. Their clients will face increasing hazards from climate change and environmental degradation as well as increasing regulation. Some clients will have to wind down their operations, others will be stuck with stranded assets.

A mandatory energy label has been introduced for real estate[10], affecting the value of banks' mortgage portfolios. Therefore, the ECB has identified exposure to climate-related and environmental risks as a key risk driver in the Single Supervisory Mechanism (SSM) Risk Map for the euro area banking system[11].

In order to guide banks regarding their risk management, the ECB has published supervisory expectations in its *Guide on climate-related and environmental risks*[12]. In addition, we have conducted a comprehensive review of banks' practices related to strategy, governance and risk management on climate risks – the 2022 thematic review.

We will continue to set expectations for banks to progressively manage risks on this front. These expectations are certainly not open ended. By the end of 2024, banks need to be in full compliance with all the supervisory expectations we set out in 2020.

Banks need to build their capabilities to withstand climate and environmental risks. We are happy that the Commission and the Council have acknowledged that this needs to have a foundation in prudential regulation as well. In the new banking package, the concept of 'transition plans' is important.

Under Article 76 of the proposed amendments to the Capital Requirements Directive (CRD VI)[13], a bank's management board is required to monitor and address environmental risks arising in the short, medium and long term[14].

Banks have to make sure that their business model and strategy are not misaligned with the relevant Union policy objectives towards a sustainable economy and they need to manage potential risks from such misalignments.

Article 11 TFEU, the requirement to integrate environmental requirements into the policies and activities of the Union, plays a role in supervision. The ECB has a duty to integrate the Climate Law's neutrality objectives into its supervisory policies and activities. However, we have some discretion as to how we do this.

After all, the climate neutrality objective affects the ECB's mandate in many respects and Article 11 TFEU does not prescribe how the ECB should integrate the environmental requirements. Do not expect us to act to regulate or enforce environmental policies.

We will stick to our mandate. Our mandate is to keep under control the risks that banks and the financial system are facing, and in that capacity we have to look closely at the risks that are building up in the banking sector as a consequence of the climate crisis.

Lastly, I would like to draw your attention to the work of the Central Banks and Supervisors Network for Greening the Financial System (NGFS). In November 2021 the NGFS published an important report on climate-related litigation[15] which seeks to raise awareness about the growing source of litigation risk for public and private actors not convincingly supporting the climate change transition.

Understanding the risks arising from climate-related litigation is clearly crucial for central banks and supervisory authorities, and the NGFS is continuing to monitor this field carefully. It plans to publish a further report next year with an update on the many developments since 2021.

I hope I am leaving you with the right impression. The ECB is not an environmental activist, but rather a prudent realist. It is our job to point out risks, whether they are macroeconomic, macroprudential, microprudential or related to litigation, and to ensure that the financial sector takes them duly into account.

Before I finish, let's turn back to the brave fight of Vanuatu. You cannot blame Vanuatu's president for seeking to defend the rights of countries most exposed to the ongoing climate and environmental crisis. Nor can we blame him for wanting to impose obligations on those most responsible for driving the crisis.

Vanuatu's mission is a stark example what the fight against the climate crisis is about. It underpins the task we have on our side. Europe has realistically no other choice than to deliver on the objectives of the Paris Agreement.

If we waiver, the costs will only increase both in a moral and financial sense. Speaking as a European citizen, I would like us to be ready for the challenge ahead. As European central banker, supervisor and scholar of the law I will be even more forceful: our mandate requires us to be ready.

Frank Elderson is a member of the Executive Board of the European Central Bank

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To cap or not to cap

Simone Tagliapietra, Georg Zachmann and Jeromin Zettelmeyer argue that a EU gas price cap would be counterproductive, but the reasons why it is supported widely must be addressed

Since Russia's invasion of Ukraine, Europe has taken major steps to ensure security of energy supply and help families and businesses tackle rising energy prices. Gas storage facilities have been refilled, gas and electricity demand has declined, and prices have receded from their August peaks.

However, energy prices remain extremely high compared to 2021, and the EU is divided on how best to reduce prices while guarding against new disruptions. To resolve the division, it is important to understand the reasoning on either side and to adopt a mutually-satisfactory solution. This is what we set out to do here.

For several months, EU countries have been divided into two main camps. The first camp, which includes France, Italy, Spain, Poland, Portugal, Greece and nine other EU countries, would like to cap the wholesale gas price, arguing that this addresses the problem at source, can be implemented quickly and will help reduce inflation.

The second camp, led by Germany and the Netherlands, argues that such a cap would raise demand and make it harder for the EU to attract gas supplies.

This situation is unfortunate for many reasons. It is blocking agreement on a coordinated solution and undermining EU unity in the face of Russian aggression. And it is perpetuating divisions the EU has worked hard to overcome.

The split more or less aligns with the divide between the fiscally 'frugal' north and the less-frugal rest (the main difference being that eastern EU countries are now mostly aligned with the rest).

How is this possible, given that the geography of this crisis – with Germany, Italy and some eastern EU countries among the hardest hit, and Spain and France much less affected (Figure 1) – is so different?

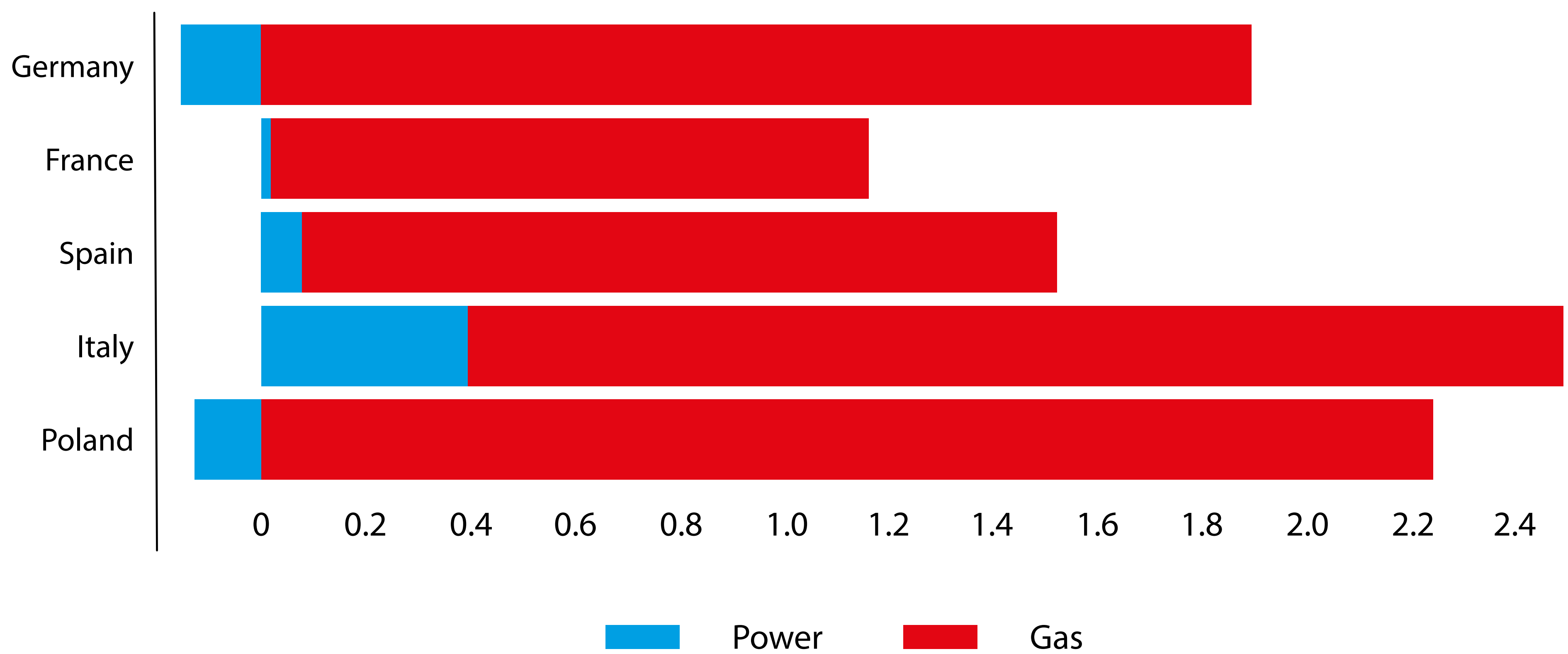
The answer has to do with differences in fiscal headroom, and the tensions and concerns created by these differences.

A wholesale price cap could in principle stabilise energy prices at low or even zero fiscal cost. For example, the so-called Iberian exception, implemented by Spain and Portugal since June 2022, caps the price of gas as an input to electricity generation. Because gas is the most expensive ('marginal') input, the effect of the cap is to reduce

Energy prices remain extremely high compared to 2021, and the EU is divided on how best to reduce prices while guarding against new disruptions wholesale electricity prices, the profits of electricity generators that use cheaper ('inframarginal') inputs such as renewables, and ultimately prices paid by consumers.

Gas suppliers then receive a subsidy that covers the difference between the market price and the cap, and the cost of the subsidy is passed on to consumers, who nevertheless remain better off because they subsidise only the gas input, but benefit from lower prices on all electricity consumption.

Figure 1. Change in net energy import costs (H1 2022 vs. H1 2021, as % of H1 2022 GDP



Note: based on average wholesale prices.
Source: Bruegel based on Bloomberg, Ember, Eurostat, IEA.

The state pays nothing. Such an approach would level the playing field between countries like Germany with a lot of fiscal space, and those like France, Italy and Spain with less fiscal space, by preventing a subsidy race that would be won by Germany.

Price cap problematic

This line of argument helps in understanding the geography of the price cap debate in Europe and offers support for such a cap. However, an EU-level gas price cap is a still a bad idea, for two main reasons.

First, it makes no sense from an energy policy point of view. While it would not necessarily raise gas demand relative to previous years (if the gas price is capped above the level in previous years), it would do far less to reduce demand than well-designed alternatives such as Germany's gas price brake, which would cap retail prices for 70%-80% of last year's consumption while exposing consumers to market prices for any additional consumption.

And as its opponents have argued, the cap might indeed harm Europe's ability to attract gas on global markets, putting at risk much-needed supply during 2023.

Second, a price cap could create more division than it prevents, by having large distributional effects, which would need to be compensated in some form. Consider, for example, the idea of applying the Iberian exception EU-wide.

Since France uses very little gas in the power sector, it's consumers would pay very little for the scheme. At the same time, France would benefit through low-cost electricity imports from Germany and the Netherlands. In effect, German and Dutch consumers would be paying to reduce the electricity bills of French consumers.

That said, advocates of a price cap are right to worry about the implications for the EU level playing field of subsidies given to firms. A subsidy race could harm fiscally weaker EU countries in two ways.

First, it could suck all the gas into the countries with the most generous subsidies. This is not what Germany has in mind; its subsidies are designed to reduce German demand, not to increase it, benefiting other EU countries.

Second, even if Germany manages not to suck in gas from other countries, it has plenty of fiscal space to support its firms – unlike Italy, for example. If German energy-intensive firms emerge from the crisis largely unscathed while their Italian competitors go under, a deep wound would be inflicted on the EU, on top of the scars that remain from the euro debt crisis.

Under pressure from member states to deliver a price cap that does not have massive adverse consequences, the European Commission has proposed a very restrained version of a price cap – essentially limiting the volatility of the main gas price index.

The effectiveness and side-effects of this relatively light intervention will depend on its detailed implementation. The costs may outweigh the upside, but the proposal contains sufficient safeguards to ensure that costs do not spiral out of control. But the proposal does not stack up either economically or politically.

It might win over a few countries, but does not address the concerns that are driving the call from more than half of EU countries for a price cap. EU leaders at a 15-16 December summit will seek a deal, in follow up to an energy ministers' meeting of 24 November. What would it take to resolve differences? In our view, the EU should drop the price cap ideas and instead tackle the level playing field concern, more efficiently and transparently.

This could take the form of an EU fund to protect consumers from high gas prices, while also incentivising energy savings and accelerating the roll-out of clean solutions. Or the EU should pool its gas demand in a joint purchasing scheme to give it more bargaining power relative to external supplies.

Energy crisis fund

An EU energy crisis fund should support three essential policy goals.

First, it should promote energy savings. The energy crisis is fundamentally a supply crisis and therefore reducing demand is imperative. Compensation schemes should be available to gas and electricity users to give them incentives to reduce their usage.

Second, it should provide a minimum level of support to all European industry, to ensure a level playing field.

Third, the fund should be used to help accelerate the rollout of clean tech, to fully decouple Europe from Russian fossil fuels. Fast tracking of renewable electricity generation, heat pumps and energy efficiency measures will reduce demand for Russian gas, simultaneously stabilising security of supply, pushing down energy costs and decarbonising the power and heat sectors.

Deploying a common EU fund would narrow the growing gap in capital costs for clean technology investments that arises because of lending rate differentials across the EU. Prioritising renewable capacity installation – that in the short term might face equipment shortfalls – could increase the positive impact.

This would be especially the case for countries where such investment can most efficiently displace large volumes of gas, such as Italy, which still burns gas even when solar electricity could be generated for free.

Europe's energy crisis fund could be financed primarily from the €40 billion already made available by Commission President Ursula von der Leyen for energy-price support, using the leftovers of EU cohesion funds. Member state contributions or common borrowing could add to the amount.

A complementary measure to reduce gas prices would be joint purchasing of gas through the EU energy platform tool. The European Commission proposed in October that joint purchasing should cover at least 15% of EU countries' storage requirements for 2023, but this is still subject to discussion by energy ministers on 24 November.

This initiative needs to be ready for the 2023 storage refilling operations, to put Europe in a better position at a time when global LNG market might be even tighter than in 2022. This initiative could prevent European countries outbidding each other to secure LNG cargos, and would facilitate the allocation of scarce gas volumes across borders in case of severe supply problems. This would reduce the risk of EU energy-market fragmentation, and of subsequent energy security, economic and political fallout.

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Monetary policy in the euro area

Christine Lagarde says the ECB will not let this phase of high inflation feed into economic behaviour and create a lasting inflation problem

After a long period when inflation in the euro area was too low, it is now far too high. We are in the tenth consecutive month of record-high inflation rates and we may see this streak continue in the near term. Inflation is being caused by a series of unprecedented shocks, which have led to turning points in the global economy. As a result, price pressures have proven much stronger and more persistent than originally projected.

In this setting, monetary policymakers must ensure that inflation does not become entrenched and that it returns to target in the medium term. And our policy response will need to account for the special combination of shocks that we are facing in the euro area. In my remarks, I would like to address two issues. First, the nature of the inflation shock we are facing in the euro area today, and second, the implications this has for monetary policy now and in the future.

The shocks hitting the euro area economy

In our monetary policy strategy, the appropriate response to a deviation of inflation from our target depends on three factors: the source, size and persistence of that deviation.

Typically, when the source of an inflationary shock is stemming mainly from demand, monetary policy will respond proactively to prevent the economy from overheating. And when faced with supply shocks, to the extent that such shocks are seen to have no lasting impact on inflation, central banks will 'look through' and extend the medium-term policy horizon if necessary.

But such a neat categorisation does not adequately capture the situation we are facing in the euro area today. We are not seeing the type of demand-led overheating that is visible in the United States and, despite a tight labour market, the risk of a wage-price spiral so far seems to remain contained.

Instead, the euro area is seeing an increase in inflation driven by two unprecedented shocks. These shocks have constrained global supply, but they have also shifted demand and led to a large and persistent inflation response.

The first shock was the pandemic. Pandemic-related supply bottlenecks and rising prices have reinforced each other, with firms reacting to the threat of shortages by ordering more and earlier. This 'bullwhip effect'[1] has driven up prices along the pricing chain.

Monetary policy cannot prevent the first-round effects of many of these shocks. But it can ensure that they do not become embedded. This is what the ECB is doing

At the same time, the fiscal and monetary policy response to the pandemic has succeeded in protecting nominal incomes, thereby supporting a fast recovery of demand when our economies reopened. The resilience of incomes has, in turn, triggered large swings in demand across sectors.

During the lockdown period, and thanks notably to e-commerce, consumption was concentrated on durable goods. Then, when the economy reopened, we saw strong pent-up demand for services. Since the start of the pandemic, the volatility of durable goods consumption has been almost ten times higher than during the preceding two decades, and almost 30 times higher for services.

This has led to inflation broadening into both industrial goods and services. Today, around three-quarters of the items in the core inflation basket have inflation rates above 2%.

The second shock has been Russia's unjustifiable invasion of Ukraine. Even before the invasion, OPEC+ production cuts and capital constraints on US shale producers were restricting energy supply. This resulted in a spike in energy prices which was a major factor in our underestimation of inflation[2].

But the invasion has hugely aggravated the supply squeeze and sent energy prices to extraordinary levels, making it all the more challenging to forecast inflation. European gas and electricity prices are up 105% and 75%, respectively, since the months before the invasion[3], and around 650% and 450%, respectively, since the first half of 2021.

This surge in energy prices has directly contributed around 30% to the headline inflation rate since the start of this year and, indirectly, has added to the broadening of price pressures across the economy. In fact, the models used by the national central banks indicate that the indirect effects of higher energy costs are currently contributing around one-third to core inflation.

The persistence of inflation

Collectively, these shocks have pushed inflation a long way from our target. Headline inflation – which was negative as recently as December 2020 – has risen by 9.4 percentage points from its trough during the pandemic to its peak last month. Core inflation has risen by 4.1 percentage points.

In the recent past, elastic global supply has meant that shocks to production or energy have dissipated eventually. Following the Iraqi invasion of Kuwait in the 1990s, for example, oil prices fell below their pre-war level after around five months. And following the Japanese earthquake and nuclear disaster in 2011, production is estimated to have returned to normal after only seven months for Japanese firms[4].

But the shocks triggered by the pandemic and the war have also created what I have previously called a 'new global map' of economic relationships[5]. The economic turning points on this new global map imply that supply constraints are likely to last longer than in the past. And this means, in turn, that it is taking longer for the inflationary effects of those shocks to fade out.

Two issues are worth considering here. First, geopolitics have shaken up European energy markets. The cut in gas supplies owing to the Russian invasion has become a major structural change which will have ramifications for several years.

For example, following the two oil shocks of the 1970s – the OPEC embargo and the Iranian revolution – the effect on oil prices was still persistent after three years. This was because, in both cases, the shocks were related to a lasting shift in the geopolitical landscape, and reductions in oil supply could not be fully offset by oil from other sources[6].

Today, although the EU response will cushion the rise in energy costs, fossil fuel prices are likely to be higher for some time. Fully replacing European imports of Russian fossil fuels is a challenge in the short term, even though there are an increasing number of examples of substitution effects taking place[7].

Over the longer term, the war is likely to accelerate the green transition in Europe, including the switch to renewables. This will require considerable green investment but will also weigh on investment in oil and gas production during the transition phase. That could put upward pressure on fossil fuel prices while demand for those fuels remains high.

If energy prices are durably higher during the transition, it may have an impact on industrial production in Europe, affecting both supply and prices. This is certainly how firms in the euro area see the situation. In a recent ECB survey, at least 80% of respondents expected the ongoing transition to make the raw materials and energy they use more expensive, leading to higher prices for their products8.

Second, globalisation is and will be changing. The disruptions created by the pandemic, the exposure of vulnerabilities, the new geopolitical landscape and the prospect of higher energy and transport costs look set to trigger a reassessment of global value chains.

While I doubt that we will see de-globalisation, firms are likely to hold higher inventories on a permanent basis and shorten their supply chains to relocate high-value services and R&D centres. This is especially true where strategic considerations come into play.

We might also see energy-intensive production being relocated owing to the uneven impact of the current energy price shock. Added to this, the speed of the transition and the new energy mix will contribute to material transformations.

A recent survey finds that around 60% of firms had increased their inventories of critical products by the end of 2021, and almost 90% were expecting to regionalise their production over the next three years[9].

This is likely to reduce efficiency and increase costs, which could create inflation pressures while supply chains are adjusting. It could also make the economic cycle more volatile[10].

Over time, however, the turning points I have identified could also dampen the impact on prices. The green transition, for example, should ultimately lead to falling electricity prices. And insofar as the inventory cycle returns, it will be a multiplier for lower prices when inventories are liquidated in a downturn.

The ECB's monetary policy response

So, to sum up, we are currently facing a situation where lingering supply constraints are an important factor causing above-target inflation to persist for longer – and their effect is being exacerbated by the release of pent-up demand. In this setting, monetary policy needs to avoid deviations from our target becoming entrenched and return inflation to 2% in the medium term.

Two considerations are important here. The first is the destination of monetary policy: we need to normalise policy, and be ready to adjust rates by as much as necessary to reach our inflation target in the medium term.

The second consideration is the pace of rate increases: since interest rates are rising from very low levels, the pace of rate increases can mobilise the signalling channel of monetary policy directly.

Let me address each of these points in turn.

The destination of monetary policy

First, when inflation is high and growth is constrained by inelastic supply, monetary policy cannot remain expansionary and add to inflationary pressures by pushing up demand. It is therefore appropriate to pursue a strategy of monetary policy normalisation.

As I explained in a blog post earlier this year[11], normalisation implies ending net asset purchases and then raising rates to neutral levels – so levels that are neither expansionary nor restrictive.

That is why the ECB has not only started raising interest rates, but also communicated that we expect to raise interest rates further over the next several meetings. And to ensure that these changes in our policy stance are effective, we have taken several decisions over the last few months to preserve the orderly transmission of our stance throughout the euro area[12].

As we move forward, we will reassess whether a normalisation strategy is sufficient to bring us back to 2% inflation over the medium term. Ultimately, the terminal rate at which our hiking cycle ends must be compatible with inflation returning durably to our target – and that rate will depend on how the economic environment evolves around us.

One key factor will be how the persistence of the shocks we are facing affects inflation expectations and potential output. If there were evidence that high inflation risked de-anchoring inflation expectations, then the policy rate that is compatible with our target would lie in restrictive territory.

Similarly, were we to conclude that ongoing supply shocks had durably lowered economic potential, we would have to ensure that demand remains aligned with supply.

Another key factor will be how the growth outlook affects inflation. Negative supply shocks will result in a growth slowdown, which will likely have an impact on the prevailing inflation rate. In past euro area recessions going back to the 1970s, headline inflation has fallen by about 1.1 percentage points a year later, while core inflation has fallen by about half that amount[13].

But this is not a hard-and-fast rule: in some recessionary episodes, such as those triggered by a worsening of supply conditions, inflation has stayed the same or even risen. In our downside scenario, which captures – among other shocks – the impact of a complete cut-off of Russian gas, we project that the economy will contract next year before picking up in 2024. But inflation is expected to be higher at the end of the projection horizon than in the baseline scenario[14].

A third factor will be the actions of governments. Monetary policy will do whatever is needed to return inflation to our target. But a truly European approach where monetary and fiscal policy complement each other can improve the inflation outlook.

In particular, how fiscal policies support firms and households through the difficult winter ahead will play an important role in inflation dynamics. Targeted, temporary and tailored measures are needed to protect the incomes of the most vulnerable, while also preventing a significant loss of capacity owing to production cuts and bankruptcies.

But beyond that, it will make a difference whether fiscal policy focuses mainly on public consumption and transfers – which may add to inflationary pressures – or on public investment and debt sustainability. As many of the sources of inflation today are on the supply side, government policies that lift supply and redirect investment to where it is needed are necessary to support sustainable growth.

The pace of rate increases

The second consideration in responding to current inflation is the pace of rate increases.

When inflation is high for a long period of time, an important role for monetary policy is to ensure that inflation expectations remain anchored as the shocks work their way through the economy. If expectations become de-anchored and trigger a wage-price spiral, it can lead to inflation becoming persistent even after the shocks disappear.

Raising interest rates has a mechanical effect on demand and inflation, and thereby on inflation expectations. But when interest rates are starting from unusually low levels, rate hikes are more powerful if they also create signalling effects that influence expectations directly.

In this context, especially compared with the traditional focus on 25 basis-point increments, adjusting the pace of rate hikes is a key tool to signal our determination to fulfil our mandate and keep inflation expectations contained. And moving faster at the start of the hiking cycle clearly conveys our commitment to bring down inflation to our medium-term target.

At present, inflation expectations remain relatively well anchored across a range of measures. But there are two reasons why it would be unwise to take this for granted.

First, the shock is severely affecting the prices of those consumption items, such as groceries and petrol, that have the greatest influence on households' inflation expectations[15]. The ECB's Consumer Expectations Survey shows that, since February this year, both mean and median expectations for inflation three years ahead have risen by around 1 percentage point.

Second, we are seeing a rapid change in the economic environment, with inflation switching from being very low to being extremely high. History suggests this can leave a scar on expectations.

For example, research finds that differences in inflation expectations between people from the former East and West Germany can largely be explained by the lasting effect of the inflation shock after reunification. This contrasted strongly with the perceived norm of zero inflation in the German Democratic Republic and seems to have led former East Germans to over-adjust to an environment of rising prices[16].

This imperative to anchor inflation expectations helps explain why, over the last two policy meetings of the ECB's Governing Council, we raised our key interest rates by 125 basis points in total.

This is the fastest change in rates in our history and it has sent a strong signal of our determination to return inflation to our medium-term target in a timely manner. This major step also took into account the unusually low level of interest rates and the limited risk of overreacting at the start of the hiking cycle.

Going forward, the appropriate pace of future rate increases will be decided on a meeting-by-meeting basis. Indeed, as we have repeatedly emphasised, we will remain data dependent in all scenarios. Where rates ultimately settle, and the size of the steps that we move in, will depend on how the inflation outlook evolves as we proceed.

Conclusion

Inflation in the euro area has proven to be much higher and more persistent than originally projected. This reflects the unprecedented series of shocks we have faced, and the fact that those shocks have led to turning points in our economic environment.

Monetary policy cannot prevent the first-round effects of many of these shocks. But it can ensure that they do not become embedded. This is what the ECB is doing.

We have taken major steps along the path of normalising our monetary policy, frontloading our rate increases. This signals that we are determined to bring inflation back to our medium-term target of 2% in a timely manner and ensure that inflation expectations remain well anchored.

We will not let this phase of high inflation feed into economic behaviour and create a lasting inflation problem. Our monetary policy will be set with one goal in mind: to deliver on our price stability mandate. ■

Christine Lagarde is President of the European Central Bank

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How to fix the EU's proposed Data Act

The proposed EU Data Act on industrial and non-personal data should be simpler and clearer, or the benefits could be limited, Bertin Martens argues

The draft European Union Data Act, proposed by the European Commission in February 2022, aims to fill a big gap in data regulation. It is intended to tackle a situation in which manufacturers design machines to give themselves exclusive access to the data those machines generate. Manufacturers can then leverage this data monopoly to sell exclusive data-driven services to machine users.

Businesses that want to access the industrial and commercial data their activities generate, or persons who want to access non-personal data that is relevant to their activities, cannot access the data and use it for other purposes or obtain competing data-based services. This distorts competition in markets for data-driven services related to machine usage.

For example, a farmer might want to access farm data collected by his tractor and share it with other machines used alongside the tractor, or with agronomical service providers. This could enable him to get better farming advice or fine-tune the use of seeding and spraying machines. But currently, farm machine manufacturers can prevent access to and transfer of the data, and force farmers to use their own related agronomic services.

Monopolistic data control by product manufacturers thus boils down to de-facto ownership of data. But allowing such exclusive ownership rights to one party denies the claims of other data co-generators and is economically inefficient because data is non-rival: it could be used for productive purposes by several parties simultaneously.

The Data Act's focus on access rights is a welcome and decisive step away from exclusive data-ownership. The Act, if approved by the European Parliament and Council of the EU, would complement other data laws, including the EU general data protection regulation (GDPR), which grants individuals access to their personal data but says nothing on businesses' access to their industrial machine data.

Fuzzy definitions of 'products' and data

Unfortunately, the Data Act proposal limits access rights to 'product' data, or data generated by tangible physical devices. The distinction between 'product' and 'non-product' data is not clear. Smartphones and laptops, for example, are clearly tangible products.

Overall, the interpretation and implementation of the Data Act would be greatly simplified if fuzzy definitions and the anti-competitive third-party pricing rule were replaced by a single and simplified data-access rule

But the Data Act would not apply to them. This creates confusion, especially because smartphone apps and laptops are often used to operate industrial and consumer devices. The Data Act in effect creates two categories of tangible product – within the scope of the act or not – without any meaningful justification.

The focus on tangible products results from earlier Commission proposals to introduce an ownership right to 'machine' data. The authors of the draft Data Act may have wanted to maintain a distinction between 'machines' and other computing devices, resulting in a dividing line that is rather arbitrary and unnecessary.

Other EU data laws, including the Digital Markets Act (2020) and the proposed European Health Data Space (2022), grant data access rights irrespective of any link with tangible products. The Data Act takes a step backwards in this respect.

The Data Act is ambiguous about the data that should be portable. In some instances, it refers to *"raw data introduced by the user"*; in other instances, it mentions *"data generated by the use of a product", or even "all data available to the manufacturer."*

The Data Act has inherited the artificial distinction between user input data that supposedly belongs to the user present under the GDPR, and processed output data that is assumed to belong to the manufacturer. In fact, data is co-generated by the two parties. Output data would not exist without an input, and input would not be delivered without the expectation of an output.

Moreover, all digital data is processed, from the moment it is picked up by a sensor and converted into a digital signal. This ambiguity in terms of what data is in scope would create uncertainty in the implementation of the Data Act.

It could also lead to incoherence with other EU data regulations that do not make these distinctions. For example, the recently proposed European Health Data Space (2022) does not make a distinction between raw input and processed output data.

Anti-competitive provisions in the Data Act

More importantly, the Data Act contains three main anti-competitive restrictions on data access that defeat the purpose of the pro-competitive measure.

Charging a price for data transfers

First, the Data Act would grant manufacturers the right to charge a price for data transfers to third parties – similar to paying a license fee. Data pricing should be fair, reasonable and non-discriminatory (FRAND). FRAND conditions were first applied in essential patent pricing, where the legal interpretation of FRAND has already generated considerable controversy.

Pricing will enable manufacturers to squeeze the profit margins of third-party service providers, who will be forced to pass on at least part of this cost to their customers. Such pricing would mean the data-based services provided by device manufacturers would have an advantage over those of third parties.

The Commission argues that charging a price for data transfers to third parties (other than the device user) will be an incentive for device manufacturers to invest in data collection and processing. But revenue from data sales to third parties will in most cases be marginal compared to revenue from sales of devices and related services to device users.

Moreover, device users already pay for the data when they buy a device or a related service. Making data transfers to third parties free would avoid double payment for the same data and would not discourage investment in data collection.

A general prohibition on the use of data for competition purposes

Second, the Data Act contains a general prohibition on the use of data to compete with the product and related services offered by the device manufacturer. Data holders should not use data to affect the commercial positions of users or third parties. These provisions reduce competition and innovation in data-driven services and product markets.

They seem to suggest that maintaining the private welfare of product manufacturers, data holders, users and third parties is preferable to innovation. Non-use of information seems to be preferable to efficiency and welfare-enhancing use.

Data transfers to very large 'gatekeeper' platforms

Third, the Data Act would prohibit transfers of device data to very large platforms that hold a monopolistic market position and are likely to be designated as 'gatekeepers' – or almost unavoidable platforms – under the EU Digital Markets Act (DMA).

This will likely include core services such as operating systems and app stores operated by Google, Apple, Amazon or Microsoft. The prohibition would stop users from transferring data to apps in the most popular smartphones, computers and app ecosystems.

It would create data portability bottlenecks that would reduce user choice. There is no need for this restriction because the DMA already contains data-sharing obligation that force gatekeepers to make this data available to users.

The rapidly growing market for smart home appliances illustrates this problem. Google and Amazon have developed strong market positions with their standardised operating systems that connect seamlessly with many smart home devices from a wide range of smaller producers. That gives these small producers access to a wide market.

It also benefits users who can integrate a wide variety of brands and models of smart fridges, heating systems or security devices into their Google or Amazon-operated devices. The Data Act's prohibition on porting data to gatekeeper platforms would prevent that.

Consequently, consumers will face a very fragmented market with many hurdles to integrate devices from different manufacturers into a single home network. Producers of smart home devices will have to develop their own home systems, without the leverage of network effects that larger platforms can generate.

Producer rights

In addition to its anti-competitive provisions, there are gaps in the Data Act architecture that should be filled to make it more effective. It is silent on the rights of product manufacturers to access and use data. It assumes that producers already have access to product and (related) services data.

This is not necessarily true. Producers may sell parts and components to other producers who assemble them into a new product or service. Parts producers do not necessarily have access to the data generated by their use inside other products.

The big advantage producers have over users is access to the combined dataset across all the products and services they sell to users. Aggregating all this data may generate valuable insights that can be leveraged for innovation purposes. Without access to the data, producers may not be in a position to realise these benefits.

This data-driven innovation bottleneck can be overcome by giving data access rights to producers as well as users. Producers and users should both have the right to use product and service data as they wish, subject only to restrictions imposed by pre-existing rights for the other party – such as GDPR rights for people's personal data, or intellectual property rights and trade secrets for businesses (as users or as producers of devices). In a business-to-business setting, this would level the playing field between both parties.

Furthermore, the interpretation of trade secrets in a data-economy context is subject to considerable uncertainty and would therefore need further clarification of the protection offered to business data. Defining the appropriate scope of trade secrets in business-to-business data sharing can have a substantial impact on the pace of data-driven innovation. This requires further research.

Overall, the interpretation and implementation of the Data Act would be greatly simplified if fuzzy definitions and the anti-competitive third-party pricing rule were replaced by a single and simplified data-access rule: all users of data-generating devices and services should be granted free-of-charge real-time data access and portability rights to any destination they want, for all data generated by usage of a device or a service, irrespective of the type of device.

Other anti-competitive prohibitions and restrictions on data transfers to very large DMA gatekeeper platforms should be dropped. To stimulate innovation, data access and portability rights for users could also be complemented with similar rights for product manufacturers. ■

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