

Peterson Institute for International Economics

Europe's future in 3D: Fiscal, trade, and defense challenges

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[00:05:23.03] - Adam S. Posen

Hello everyone and welcome back to the Peterson Institute for International Economics. I'm Adam Posen, the Institute's president, and it's my pleasure to to have you in for the last, uh, show of what has been a fantastic spring meeting set of events at the Peterson Institute. And we're deeply grateful to our meetings team, our operations and communications teams as well, for making this run so smoothly. We're, we're going out with a forward-looking bang this week, uh, with an event on what I've called Europe's Future in 3D. Fiscal, trade, and defense challenges. As many of you know, and many of you are European, the Peterson Institute has long done as much work almost on Europe as we do on any place else, including the US. We've long had a staff bolstered and complemented and benefiting from European colleagues. And we have been around long enough to have been through the creation of the single market and the euro. And now we come to the point where, as we said titling a previous event discussing this a couple weeks ago, this is the true Zeitenwende. This is the moment of true change in Europe, not just Germany where that term was coined, And so we want to look forward in an objective but open-minded and, dare I say, hopeful way about how Europe is responding to the environment we're in, what changes are happening, what changes are needed, and how we get to close the gap between what's happening and what's needed.

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And with that, we have three superb speakers today. Um, the first speaker is our colleague Olivier Blanchard, who is Senior Fellow at the Peterson Institute and now resident and teaching at Sciences Po in France, in Paris. Previously was the inaugural Siegfried Bergson Senior Fellow here, and of course is the Robert M. Solow Institute Professor Emeritus at Massachusetts Institute of Technology. I will not go through everything about Olivier, but just to say that he remains, and if anything more than ever, is a vital voice in Europe's ability to think about its future in economic terms, in political terms, and responsible terms. He will be followed by another dear colleague, Cecilia Malmström, who is also a non-resident senior fellow at Peterson and has been with us for the last 4 years. Previously, she was a member of the

European Commission and the European Parliament, currently a visiting professor of the School of Business, Economics, and Law at the University of Gothenburg. Most of you know Cecilia as during her time as Commissioner for Trade in a previous European Commission from 2014 to 2019, but also served prior to that as Commissioner for Home Affairs in 2010 to 2014.

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Dealing with important migration issues. And Cecilia straddles between trade, security, politics, and brings an incredible note of practicality but insight for our internal discussions. And I'm grateful that both she and Olivier continue to spend time with us in Washington, however Washington comes. We're delighted to have with us today as our discussant after the two formal presentations, or not so formal initial presentations, Dr. Constanze Stelzenmüller. Constanze is many things. She is the director of the Center on the United States and Europe and the inaugural holder of the Fritz Stern Chair on Germany and Transatlantic Relations at Brookings. I've been privileged to know Constanze for many years. She is a brilliant voice. We see her columns in the Financial Times and the German press and elsewhere. But she's not just a brilliant voice, she's a brilliant thinker and remains committed to the transatlantic relationship. And she has been spending her professional life between here, Berlin, time in the UK, and continues to work on issues of transatlantic relations, German foreign policy, and she will today allow us to go, as we said, 3D, to go beyond the economic into a new dimension when we get into the discussion.

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So thank you all for joining us today, and I'd like to turn this to Olivier, please.

[00:10:31.07] - Olivier Blanchard

Thanks, Adam. I think my job is to cover the macroeconomic landscape, so I'll try to do that. I have bad and good news. I shall make 5 points. One topic I would love to talk about is tariffs, but there's somebody even more competent than me to discuss it, Cecilia, so I shall leave this to her. First point is Europe a year ago, before Trump, before Putin, Europe was going through an existential crisis. The numbers were bad. Productivity growth had been lower than the US for about two decades. Productivity growth since 2019 was actually zero. There was a sense that it was losing at the frontier. It was not— there was a Draghi report which indicated that we were not doing what we should be doing at the frontier. There was the failure of the apparent failure of a German model which was based on cheap energy from Russia and a goods market from China, a German recession. There was a sense that things were not going well. And on the

demand side, there was gloom and doom, and the consumers were very pessimistic. The saving rate, the household saving rate, was unusually high. People just didn't want to spend.

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So I think at the time we worried very much. And the question is, should we worry less or should we worry more? As a result of what has happened in the last year. So that's the second point. So the last year is Putin and Trump, and both individually and together in their decision, in the Trump decision on Ukraine. So if you look at the demand side, the good news is that Putin has forced Europe to think about defense. This is— we all know, but— and that Europe has been willing, at least in principle, to do what's needed, which implies a fairly substantial fiscal effort. So this clearly is going to help in the sense that demand was weak, and that's going to strengthen demand. But unfortunately, On the other side, there is a number of factors which go the other way, which we all know about but are all relevant. The first one is the tariff on EU exports, which are going to slow down exports. We don't know exactly how much, but clearly it's going to have an effect. We were hoping for a depreciation of the euro, which is what should have happened had there been less uncertainty.

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At least that's what the textbook predicts, but it went the other way. The euro has appreciated by nearly 10%, which in terms of tariffs is nearly a 20% equivalent tariff on EU goods that the markets basically have effectuated. So that's also not very good news. There is the indirect effect of the tariffs on China, which is really first order for Europe, which is that if China really cannot come to the US, It has a growth model which is still very much based on exports. And if it cannot export to the US, there's going to be enormous pressure to export to Europe. And that's going to complicate our life quite a bit. And then there is kind of the world fact— dominant factor at this point, which is uncertainty, which nobody has any clue as to how it's going to come out. And that's affecting the US very much. It's affecting any firm which is an importer or an exporter, but indirectly it's affecting any firm which works with one of these firms. And there is general uncertainty about are interest rates going to go up, are they going to come down. So the uncertainty effect is surely affecting all countries in the world.

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I mean, if you look at the revision of the IMF forecast, I think uncertainty is what explains why all the numbers are down. That's really the main factor. So how is this adding to the first point? Is it going to make things better from just a purely macro short-run forecast view, or is it going to make things worse? I have a sense it's going to make things worse because the fiscal push is

going to come not right away. It takes time. To actually increase defense spending, it takes time to finance it. So my impression is for the next year, things look quite bad. And if I had to take a guess, I'm not into that business, but I would think that the ECB will have to cut rates at least as much as they think and probably more than that would be my point. But so this is the bad news. And for some of you, it's probably the most relevant news. But there are also good news, which is that Europe basically has had to wake up in a number of ways and has done it. So on this, I want to make the last 3 points.

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The first one is the Draghi report, which has had an enormous psychological impact on Europe. Basically, it argues that Europe is not at the frontier in many, if not most, of the high-tech fields. And it is— nearly catastrophic in tone, which is, if we don't do something drastic, Europe will disappear from the map. I'm barely exaggerating. I have a less pessimistic view. I think that countries do not need to be at the frontier, surely not everywhere at the frontier, but even they could be nowhere. Most countries in the world are not at the frontier, and most of them, many of them are doing okay. You basically have to be able to use the innovations from the firms at the frontier. And Europe is very good at what's known as mid-tech, which is basically using this for more standard products, from automobiles to other things, planes and so on. So I don't think it's the end of the world. I worry a bit that it is sexy for policymakers to push the idea that we're going to spend a whole lot on high-tech and we're going to solve our problems. I suspect our low productivity growth comes largely from other things.

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From labor markets which may not be right, from the lack of risk-taking capital. And I worry that it's so much harder to do a labor reform than to give money for R&D on something, that the pressure is going to be there. But it is going to be useful, and I think that the European Commission is thinking about a number of things inspired by the Draghi report. Fourth point is the the fiscal situation. So if you remember, the fiscal rules, all fiscal rules just collapsed basically with the COVID crisis and they already were not doing very well before. So there was this revision effort, just rewriting the rules. This was a long and tough process. I think it was a very good process for the most part. And the realization was that there are no magic numbers. It's not 60 and free. You can be at 100 and it's fine, and you can be below and it's not. So there was a sense that we should basically be more ambitious, and so we developed the so-called DSA, Debt Sustainability Analysis approach, which is let's take into account everything we can take into account and see where debt is going.

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That actually was the initial proposal. But the Germans came back and said, "No, no, we want numbers." So the final product is the usual mix of good and bad stuff. But it has been put in place and then right away, basically, we've realized because of the events that that was not good enough. So there is now, as you know, there is the fiscal turnaround in Germany, basically allowing all defense spending above 1% to be financed by debt. There is a large outside the budget funds for infrastructure. So Germany has really made a 180-degree turn, and the Commission is going in the same direction. I don't think that any decision has been taken, but there is a number of proposals on the table. Is it worrisome? I don't think it's terribly worrisome. Actually, the numbers are not so bad. So debt has increased, debt-to-GDP has increased in the European Union by about 10% since 2019. That reflects the whatever-it-takes approach which was taken with respect to COVID and Ukraine. But it is expected to increase by another about 5% of GDP between now and 2030. So not perfect, but And the level of debt at this stage, I think, for European Union is 76%.

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So we're not doing perfectly. It would be good to have smaller deficits and less of an increase in debt, but I don't think it's the end of the world. The—

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yeah, one last point on this. There is one country which worries me, mine, in which we have a primary deficit of about 4% with defense spending and the rest, it's 5% probably that we need to adjust. We have a political situation where it's very difficult to do a 0.1% adjustment. So I'm afraid that there are going to be bumps. But that's really one of the only countries. The countries which were at the center of the euro crisis actually have primary surpluses for some of them and stable debt even if it's high. So I worry about France but not about the European Union in general. And then the last point is financial implications of what's happening. So it's clear that there is— and this was very much discussed last week because of the bump in financial markets— there is a desire by investors to basically diversify away from the dollar. Whether the dollar is a safe asset or the dollar is equity. And I think Europe there has an opportunity to do something, which is to create a deep and large euro bond market. So there were proposals along these lines during the euro crisis. They didn't go anywhere because the issue of risk sharing basically made the Germans not want it.

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But it seems to me that there is there something to do. The other thing which was in play before and may happen faster is the capital markets union, which is very much discussed. I'm less

optimistic that it will dramatically change things, but it's a useful thing. And then the last thing I would say is I think the issue in Europe is really not primarily the issue that the capital markets union is dealing with. It is the lack of risk capital. And basically it's very difficult when you start to actually get a billion to continue. And as long as we don't solve that, as long as we have a bank-based financial intermediation system and we don't deal with that, I think we will not do as well as we can. I'll stop here. Cecilia.

[00:22:34.24] - Cecilia Malmström

Thank you very much. Good morning, everybody. Indeed, Europe is facing a situation where the current world order as we knew it is no longer relevant. It began with the brutal invasion of Russia into Ukraine, a sovereign, totally independent country, and the realization that the President of the United States aligns with the President of Russia when it comes to how this is seen, reinforced, of course, by the famous Munich speech by Vice President Vance. Also now in the middle of a tariff war, trying to navigate, as Olivier said, in a sort of existential crisis. The EU and the US are each other's most important trading partners. We trade for 1.6 €1.2 trillion, almost the same, a little bit less than in dollars, every year. And this economy sustains 16 million jobs at least. There have been numerous attempts to facilitate trade, to actually take away obstacles through different transatlantic economic councils, enhanced cooperation agreement, the free trade agreement TTIP, and the trans— the Trade and Tech Council. None of this has really led to anything, but there is a great potential to facilitate trade, not to make it more difficult. Under the Trump administration, the world also faced tariffs on steel and aluminum of 25% and 10% each, and the, the world came together, took this case to the WTO, and the EU retaliated.

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A little bit later, there were new threats of tariffs on French wine, champagne, German cars, etc. And at that moment, there was a possibility for the EU to do a kind of mini deal in the White House, promising to buy more soya, more LNG gas, cooperate on China in the WTO, and some smaller tariff lifts on seafood. So there were no additional tariffs imposed after that. Whether that was lack of time or lack of— because it was this deal is hard to know. And there was a global reaction at that time. Trade wars are not good and they're not easy to win. And if you want to elaborate on this, you can read Adam's essay in Foreign Affairs with that title as well. And many countries lined up and saying, we do not want these trade wars. So there was actually a possibility to conclude more trade agreements during this time between the EU and Japan, Singapore, Canada, Vietnam, several countries in Central America, in Africa. With Ukraine, Moldova, etc., and launching with New Zealand, Chile, Australia, almost finishing with Mercosur

and Mexico. So there was this network of countries saying that multilateralism is still good and trade is beneficial.

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Now we're facing a second administration, and we see the same patterns again: 25% on aluminum, steel, cars, and car parts, uh, 20% was the the figure given to, or imposed by the EU, now it's down to 10%, as you know, with a 90-day pause. So the situation arises again. So what can we do looking forward? Well, first of all, the EU has indicated that they are ready to find a deal, zero for zero tariffs on industrial goods. Not much has happened in here. There are no ongoing negotiations, and it's also a little bit difficult to know what's really on the agenda because it's not really about It's about so much else that is hard to negotiate: VIT, tech rules, phytosanitary rules, weapons standards, the view on China, etc. So this— right now there's not much to do. I think the EU is waiting a little bit to see what's coming out from the other ongoing negotiations and how the market will keep on reacting. A second path is, of course, to retaliate. The European Commission announced retaliatory tariffs worth \$22 billion. They were announced for like 20 hours before they were withdrawn with the pause installed.

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Personally, I think it was a mistake to withdraw those tariffs because they were only targeting the steel and aluminum tariffs and they are still there. And according to the EU, they are illegitimate and they're not according to WTO rules. But they were withdrawn with the announcement that we are ready to negotiate. There is, however, a very long list of potential retaliation tariffs that could be activated. And there are also other tools under the anti-coercion instrument where you could use access to public procurement, licenses, market access, and different ways of export limitation on services and other, and other trade. So if it escalates, this might be used, but in the current time, I don't see this happening. The third way is, of course, to do more trade agreements and to use the momentum that was created already 7 years ago, but also the feeling that most countries have that multilateral rules, rule-based trade is actually a very good thing. So the EU should try to finalize and ratify negotiations done with Mercosur and Mexico, finalize with Indonesia, keep moving with India, There were just launch of negotiations with the United Arab Emirates and other countries in the Gulf.

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They are negotiating with Malaysia, with Philippines, Thailand. The EU should join or align with CPTPP and make that a forum for further discussions. And there are also small sectoral deals being made right now, lately with South Africa. Multilateralism is still something very, very

important, and most countries, as I said, do believe in that. So the EU should keep on pushing in the the WHO, with the Coalition of the Willing there as well, to see what can be done with those who want to make agreements within the CPTPP, but also maybe in a broader group when it comes to digital trade, green trade, etc. Smaller sectoral deals could be made there as well, plurilaterals, even if a broader reform is of course needed, but not really on the agenda right now. And ideally, after some time, there could be a coordination of joint actions towards the tariffs when the dust has settled a little bit. The fifth thing the EU should do, and that is also referring to what Olivier said, is to do its own homework. The EU has a lot of things to do independently of what's happening in the White House and the rest of the world.

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We have the Letta report, we have the Draghi report. There are lots of things there that are absolutely worth trying. It's being rolled out, some of these reforms right now from the Commission. Together with the simplification agenda, the needs to work on capital markets and other things that Olivier mentioned. Also to make sure that the Green Deal survives and that you find a way to make the green transition competitive and a source of innovation. So the war in Ukraine and the tariffs are, of course, the central attention right now. But the EU also has the coming years a lot to do on its own. The competitiveness agenda, the innovation agenda, the reform agenda, the preparation for a long-term budget, which will very much determine where the EU is going. Preparation for future enlargement, including Ukraine and other countries, and the reforms needed to do that. And of course, the climate agenda. So lots to do. And independently of what happened in the world, the EU has A very busy to-do list. And I think I'll leave over to Constanze to go into more of the security dimension. Thank you very much.

[00:30:48.13] - Constanze Stelzenmüller

Do you want to introduce me or do you want to— I already introduced everybody. I'll do it here. It's fine. It's fine. I'm sorry. I have been the cause of confusion and disruption. Because I thought we could do this as a discussion, and I apologize to everybody. This is because I'm a lawyer by training, and I've studied law at the University of Bonn, where we shared the building with the economists. For those of you who know economics in Bonn, you know that they were heavily mathematically and game theory oriented, and they treated us with deep contempt. You were told every day if you met an economist in the building how stupid you were. And that you really didn't deserve to share a building with them. And the result of that was that when I had the great good fortune to spend 3 years at Harvard, that I tried to do some remedial economics by taking game theory with Tom Schelling and international monetary economics with Jeffrey Sachs when he was not yet mad. But I mean, I will say it changed the way I think about security and strategy, which was very helpful. I'm not sure that it may have made me an economist.

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But as you can see, I'm still insecure. But I can, I think, widen the picture presented here by Olivier Bronfleur and Cecilia Malmström on economics and trade to defense issues, because that is what I now do. And yes, the picture is pretty dire. Let me talk a little bit about what I think the Trump administration is doing then about European responses and what we should be doing and how the issues of economics, trade, and defense are now baked together, as Cecilia already made clear. I think it's become clear by now that the Trump— while Trump himself may be a creature of attitude and impulse, He is surrounded by people who have been thinking very hard for the past 4 years about strategy and have been thinking very hard about what needs to be done and how it needs to be done. That said, there are still some quite notable and important internal contradictions. I would say there are, by way of simplification, 2 groups of strategic thinkers, and I would call them the reactionary or the ultra-libertarians, sorry, the ultra-libertarians and the reactionary national conservatives. And they disagree on most things except, sadly, Europe. The ultra-libertarians want no state, no government, no regulations, lots of qualified immigration and friendly relationships with China.

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Some of the major tech bros, I need not name names, have a lot of business in China. And don't really want to lose it. The reactionary national conservatives, on the other hand, want a strong common good legislating state, sharp public authorities, watertight borders, and are very hawkish on China. I think we have seen that that battle is not yet won here in this town. Where they agree is in their contempt for Europe, sadly. Where they agree is in the feeling that the European hard right are their friends, and that Russia has been badly treated and ought to be America's friend. There is, I think, an increasing clarity that a lot of people in the Trump administration, including the president himself, could quite live with the idea of a global tripartite condominium of the United States, Russia, and China, in which case which would, I think, go a long way to explain the sudden predatory interest in Greenland and Canada. And then again begs the question where Europe falls and where the distinction between the American and the Russian sphere of influence falls. And I would put the following to you, because that raises interesting defense issues for Europe as well, that the interest in Canada and Greenland is not so much for the territory of Greenland and Canada, but for their maritime exclusive economic zones, for maritime access rights, for exploitation rights, both of the sea and of the seabed, and because of interest in things that— other things that are on the seabed.

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Which means that the North Atlantic and the Arctic, but the North Atlantic as well, become zones of contestation, and which I think for Europe raises a Western flank problem. And I have recently been traveling to the UK, to Ireland, I'm going to Iceland and to Norway next week. I can assure you that it is perceived as such in those countries, and that even the Irish who have an official neutrality policy like the Swiss are reconsidering their security and defense options, not to the extent I think of joining NATO, We're not quite there yet, but they are thinking very hard about what they need to do. That said, because this administration has been trying to do so many things at the same time, I think the plans for territorial expansion in the Northern Hemisphere are currently in something of a state of suspension, which is not to say that they are stopped. I'm just noting the suspension. I have no idea where it goes. I don't think the Canadians at this point are of a mind to let any of this happen. If anything, this, as we all know now, has unified the Canadians. And I think the Greenlanders are also, at this point, strike me as unlikely to collaborate.

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The other striking thing about this moment, though, is, of course, Liberation Day. Which frankly I have to confess was the week when I first read Stephen Merrin's famous essay, A User's Guide, and then realized that the strategic ambition of this administration was even more hideously all-encompassing than I had realized. Because if you read Merrin, not just the essay that he wrote for Hudson Bay Capital last year, and if you read the Bessant piece The Economist, which I then also belatedly read, but then Mirren's remarks at Hudson recently. I think these strategists around the president, and I think with the president's blessing, are doing nothing less than trying to revise the American domestic constitutional order, the global security order, the global trade order, the currency order, and acquire energy and technology dominance all at the same time. That is astounding. And all in the name of a purported deep unfairness, which has been exploited not so much by America's adversaries, but by its allies, and with a goal of reestablishing the American primacy. Which is not something I think we have, you know, seen in American foreign and security policy ever. Certainly I have not in my lifetime.

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Goes well beyond any of the plans that I think we've seen in the last 100 years. And at this point, I think the execution, the implementation, we can see the We can all see the weaknesses, we can all see the willingness to retreat, but I think what is so startling about this moment is that it is such a wild overestimation of what American power can do, right? It is a complete misreading of America's power to coerce, or to coerce by threats of economic force in an interdependent world. And while we've already seen the damage done to the markets, in the markets, to the dollar, the enormous sums lost, I think the damage to not just to America's

reputation, but to American power and to the— an international order that has always been sustained by American power. That is something that at this point is as yet completely incalculable, but I have a general feeling that what we are seeing right now is sort of the— we're in a tsunami sort of situation, right? We're seeing small waves curling around our feet, but we cannot calculate the size of the tsunami coming for us, right? That is the context.

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That's the context in which Europe needs to reconsider its defense. That is, I think, the single most existential, the single greatest, all-encompassing security crisis Europe has ever faced since World War II. And that is the context in which we need to discuss defense expenditure, competitiveness, our technological capabilities, the desirability of enlargement and integration, and how to deal with the rising extremist forces, and of course, with a continually brutally aggressive Russia that is waging a brutal war on our borders. I don't want to speak for too long, so I will just say the following here. On European reactions. I thought before Liberation Week that the sort of fiscal bazooka unleashed by the European Union and by the Germans with the loosening of the debt brake might, as you suggested, have the, not just the effect of allowing us to spend much more on defense, but also have an impact on competitiveness and thereby create a political solidarity signal within Europe, have a unifying function within Europe and also be signaling to our other allies as well as our adversaries. It seems to me that we now have time until the end of the suspension of tariffs, which I think is July 9th, to understand that if this market and currency chaos continues, that bazooka, the effects of that bazooka will be swept away by the tsunami.

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It may not be enough despite the fact that it is by our standards, right, by any standards, absolutely huge. And so I do think we have to think about things like economic resilience in Europe, economic deterrence, the ability to undertake economic coercion or threaten it credibly, right? And we have to close vulnerabilities at the national level, right? We all know, right, that corruption is a national vulnerability across Europe and not just in EU member states. Switzerland is another entryway. I would— I think that that is now squarely a security issue and it needs to be dealt with. And finally, I think in the context that I have just described, the question of whether capital markets union is desirable or not has to be answered with a resounding yes, right? It is the only way in which we can mobilize private capital at scale. Private investors are waiting to do this. Many of them aren't banked, the ones who— the defense startups, and they're telling us we have to do this. So I suggest that we get going. And my final point is that if we don't mobilize this capital, if we don't make credible— a credible case that we are willing and

able to defend ourselves in extraordinary circumstances, All of this turns into a political guns-versus-butter debate at home, and we all know who will win that: the extremists.

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In my country, that's the Alternative for Germany, which is gearing up to hunt the new government every day after the new chancellor is installed on May 7th. If we don't want Europe's populists to win this battle, We have to be able to defend ourselves and to defend the European project, which was once created to prevent us from going to war against each other, then became an instrument for prosperity and social stability, then became a framework for democratic transformation after the fall of the wall and the enlargement of Europe and NATO. And I think it's now in a battle for its survival. And at a time when the American project is in doubt, I think we have an even greater responsibility to make sure that we preserve what we inherited. Thank you.

[00:45:02.13] - Adam S. Posen

Thank you, Constanza. Thank you, Cecilia. Thank you, Olivier. Um, a lot of highs and lows, uh, in all three remarks. Um, and as I tried to say from the start, I'm grateful to have our experts try to navigate us between the, uh, needs, uh, the aspirations, and the realities. I'll just ask one question back to Olivier. One thing you didn't mention, I didn't ask you to, it's fine, but you didn't mention during your remarks was the, you mentioned the fall of the dollar versus the euro combined with the tariffs and the trade effects. But what happens if this is also a lasting systemic move that people are really moving out of the dollar and genuinely seeing the euro as worth reallocating to more than in the past rather than just the near term? Does that change your picture at all, or is that just something that can be coped with and doesn't need to be thought about? Please hit the button.

[00:46:35.12] - Olivier Blanchard

My sense is clearly that there is going to be over the next 10 years some desire to at least decrease the share of wealth that you have in US assets being by the central banks or the investors. I think what prevents this from happening very quickly is that there is no obvious alternative. The question is whether this is a slow adjustment or whether it's a bumpy one. On the part of Europe, I think that Europe should actually try to develop the alternative. It will be good. It will make it easier to make this transition. We actually had a discussion last night on this issue and the question is, Can there be bumps? And I actually slept badly because I could think of a multiple equilibrium which could happen right away, which is that— this was in the discussion last night— the reason why foreign investors hold Treasuries is not just the safety.

It's what we call the negative beta, which is when things go bad, it's good to go there. If for some reason the beta changes, as it did last week, then right away, it is no longer the kind of asset you want to hold.

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So there can be a shift nearly overnight in which the flows change direction, the beta changes justifying the change in direction. And we may have had just a taste of this 10 days ago or 8 days ago. Yes, in the long run, surely the dollar will not be the only safe asset. That's very clear.

[00:48:21.18] - Adam S. Posen

Thank you, Olivier. I will just note, yesterday we had an event on the dollar with Maury Obstfeld, Warwick McKibbin, Markus Brunermeier, and myself, which talks independently of Olivier of some of the reasons this beta might flip and what it might mean. Cecilia, one thing which you mentioned and dealt with, and I know you thought a lot about, but I'd like to ask you to expand on a bit, is EU-China trade and economic relations. I mean, you, you have a situation now where potentially some in Europe might say, well, if the U.S. is going to pick a fight with China, maybe we should go the other direction. Of course, there are arguments on Europe's own interest why it needs to take a harder line on China. How do you see this going forward?

[00:49:19.12] - Cecilia Malmström

That's a very important question, and, uh, I think this is pushing Europe a little bit towards China. How much remains still to be seen. Uh, the EU has never shared the notion that you should decouple from China because it needs China, it trades a lot with China, we need Chinese technology, especially in the green area, but has rather encompassed the notion of de-risking, especially when it comes to rare earth metal minerals and a few other items where companies are trying to diversify as much as possible. A lot of other complaints on China is shared between the EU and the US when it comes to unfair subsidies, not following the rules, overcapacity, dumping, the lack of transparency, and of course the lack of human rights. But there are definitely forces in the European Union now who are pushing towards a little bit more with China. We have a sleeping investment agreement that was finalized in early 2020, which is on paper a very good agreement. China commits to a lot of discipline, a lot of transparency, a lot of cooperation, and it was about to enter into force when there was this sanctions against 20 European citizens, members of parliament, journalists, researchers, etc.

[00:50:44.12]

So it was paused. Now we hear that China is reviewing that sanctions list, which is a first step to maybe do something about it. If that happens, I think there will be forces pushing in Europe to ratify this agreement, which is not a trade agreement, it's an investment agreement, but still it's a quite ambitious one to see what this will happen. But there will still be tensions in the EU-China relationship. And there's still a lot of worries that China will dump products in the European Union that they cannot sell in the US, and therefore, you know, threatening European industries in key areas. And there are preparations for that as well. So, mixed picture. I think this is one of the very interesting things to watch the coming weeks, where it's going. The Prime Minister of Spain was there just a couple of days ago, and there are forces in the European Union who are, not only Orbán, who has his own relations, but who are pushing towards a more more open relation with China.

[00:51:43.12] - Adam S. Posen

Thank you. Constanze thank you very much for bringing your perspectives to our discussions. We are economists, so instead of nightmares, we think about multiple equilibria, but we tend to be friendlier. In that spirit, can I ask you to expand a bit on two things which you touched on? First is Given the kinds of shifts in threat perception, need for self-defense in the Western governments, how do you see Western European governments and Eastern European governments, how do you see the UK-EU relationship going forward in this context versus or not versus what it might have been given the security relationship? And second, How do you see navigating US demands for more purchase of US weapons systems, which seems to be part of the pre-existing Trump agenda?

[00:52:45.06] - Constanze Stelzenmüller

Sure. Can I also say something about the China point?

[00:52:47.29] - Adam S. Posen

Sure.

[00:52:50.08] - Constanze Stelzenmüller

So it's notable the Chinese offered to lift sanctions on 5 individuals, some of the more outspoken European parliamentarians, and former parliamentarians like the famous Reinhard Bütikofer or Raphael Glucksmann. But the European External Action Service immediately reacted by saying, you know, we're not lifting our sanctions, so fine. You know, so I, and I think, you know, what has really changed since the suspension of the investment agreement is of course our understanding of Chinese support for Russia in the war in Ukraine. That is a

completely new framing, which reinforces what was already a very visible convergence and direction of travel, which is an understanding increasingly that what the Chinese are doing in Europe is not just there for economic reasons. You know, the Germans always like to use to say about Nord Stream, it's only an economic deal. And we also need to talk about Nord Stream in this context. But that is, you know, there is very clear that the Chinese have political, have a political strategy, right? And it is one of, at the very least, being able to split the Europeans when necessary, and at maximum, to be able to exercise dominance when they need it, right?

[00:54:19.10]

And you look at the strategic purchases of physical and digital infrastructure, that I think most of us are by now very alert to that. So that's my point on China. On UK-EU, I mean, I think it's, we have to say there is a raging conflict right now between France and I don't know, possibly one or two other member countries and another camp in the EU that's, so the French want to have, you know, buy European defense policy, whereas other Europeans are saying we need to open markets to the UK, to Turkey, Norway, and of course to the US, which will be your second question. In general, I was at a Ditschni conference in late March about the UK-EU negotiations where some of the senior negotiators attended And I came away from that thinking that everybody seemed to be extremely determined to get this done and to be pragmatic about it. And I think the model for this is the set of agreements that Switzerland has just renegotiated with the EU, right? Those are seen as a model for a much more flexible EU approach, which is no longer our way or the highway, but we can adapt to your needs.

[00:55:48.04]

We need you close to us. You don't have to be a member, right? So I think, and that is also, you know, tells you something larger about the relationship with that the EU is willing to have with countries with which it shares interests, values, and possibly increasingly security threats. There is a, I think, a deepening tissue of relationships where it is no longer, you know, an article of faith that either you join or you don't. Right?

[00:56:19.26]

And we've learned from some negative experiences and mistakes that we have made in the past, of course. So I think the— this EU-UK relationship is going to go well. I mean, anybody who understands anything about Brexit knows that this was a, you know, egregious failure, failure. And I think that with what the Trump administration is doing on the ground in negotiations with the Russians and things like cutting off, you know, for a while Starlink to the

Ukrainians is especially shocking for the Brits who are deeply invested in supporting Ukraine. And I think that has also, I think, unpicked some of the special relationship, right? So again, it's still a moving target, but I think the direction of travel is in the direction of the EU. Now, on the US weapons purchases, the In the medium to long term, all constraints become vague, and we Europeans can muscle up as much as we want if we spend all the money that we want, right? In the short term, we are exquisitely vulnerable, and we do not have the strategic enablers that the US now provides to us and to Ukraine. And I think the only way to get around this is to say to the Americans, Listen, you have some of the weapons that Ukraine desperately needs.

[00:57:44.22]

We don't produce them. Ukraine can't produce them yet. Can we buy them from you and give them to Ukraine? I think that would allow the Trump administration to say, we've made a deal. They are paying us lots of money. The Ukrainians would get the weapons they need. And we could continue our sort of medium-term strategy of Europeanizing defense and deterrence and helping the Ukrainians bolster their own defense industrial base.

[00:58:13.27] - Adam S. Posen

Thank you. Let me now open it up to questions. There should be a traveling mic up front, and then there's a standing mic in back. Please identify yourself when asking a question and please make it a question.

[00:58:27.10] - Audience

Yeah, thank you. Christoph von Marschall. Officially, I'm a Global Europe Fellow at the Woodrow Wilson Center, as far as the Woodrow Wilson Center still exists. We had to clear our desks 2 weeks ago, although we are told that the fellowship continues.

[00:58:41.23] - Constanze Stelzenmüller

So from—

[00:58:41.29] - Adam S. Posen

So could we get to the question, please?

[00:58:43.25] - Audience

Yes, I have a question for Cecilia and a question to Constanze.

[00:58:47.07] - Adam S. Posen

You get one question. Well, pick one.

[00:58:52.10] - Audience

Okay, then I ask Constanze. It also picks to your point about the weapon things. You said €800 billion sounds much in European terms. Well, it is not much. It is less than the US spends in one year, what we want to do. And second thing is money doesn't buy weapons. This is not a supermarket where the supply is bigger than the demand. When what we need in Germany, for example, to defend Lithuania is more Patriot.

[00:59:21.15] - Adam S. Posen

Could you make it a question, please?

[00:59:23.07] - Audience

Yes, it will be a question, Adam. Very soon. Very short.

[00:59:26.27] - Adam S. Posen

No, make it a question now, please.

[00:59:29.06] - Audience

So how do we get, for example, Patriot batteries sold out for the next 10 years? Yeah. So we have to produce. And how do we get there that the US produces more and we produce much more?

[00:59:41.11] - Adam S. Posen

Thank you.

[00:59:42.08] - Constanze Stelzenmüller

Christoph, I'm not a defense industrial. Expert, right? I can't—I think the only interesting answer to give to that question is one that draws on knowledge that I don't have. I'm sorry.

[01:00:02.10] - Adam S. Posen

Okay, then you get your other question.

[01:00:07.11] - Audience

A minor detail. When you said we have to make sure that the Green Deal survives, but it is competitive, isn't that a small contradiction in itself? China uses the European Green Deal in order to push us out of the market, not adhere to the treaties. In addition, they are considered to be developing countries. So how can the Green Deal survive if China, from my point of view, uses it as it is using it to get us out of the competition?

[01:00:39.08] - Cecilia Malmström

That's not a detail. That's a very long question. I don't think there is a contradiction between moving towards decarbonization and fulfilling the goals and also making sure that this is done in a competitive way. We see a lot that has happened. If you look at European companies, how they have moved towards green transition, towards adopting their production lines and so on. It's not enough, but impressive things have happened. So that needs to combine. And I think it's a really— it's a danger if you portrayed it as that a green transition cannot be competitive. Because that's not true. And you can see a lot of things happening in many countries right now. There's a need of simplification, there's a need of maybe adjusting some of the deadlines and so on, but that has to be done within the general framework. The EU has been leading on this and there is very strong support among member states, citizens, European Parliament and others that this leading role should continue.

[01:01:36.11] - Adam S. Posen

Thank you. At the back mic, please.

[01:01:38.06] - Olivier Blanchard

Can I—

[01:01:38.25] - Adam S. Posen

Oh, if you'd like to, sure.

[01:01:41.12] - Olivier Blanchard

On the China-Russia alliance, the question is whether it's an alliance of convenience or whether they are really committed to helping Russia. And my sense is that part of it was to make the West very unhappy. Things may have changed in some ways, so I would not think that this is

going to be an obstacle or an absolute obstacle to actually doing business with them. But that's to be seen.

[01:02:07.29] - Adam S. Posen

Thank you, Olivier. At the back mic, please.

[01:02:12.08] - Audience

Tam Bayoumi, King's College London visiting school. I guess I was interested in the future of the European projects in general. You know, one of the reasons that you have strong centralized states is because they're good at providing defense, right? That was history of how States began, uh, starting. Now the EU is this funny sort of mixture of sort of a bunch of states who come together in some areas and not in others. Will there be a strong move towards centralization as a result of the need for a common defense?

[01:02:52.04] - Adam S. Posen

Very big question. All of you can take a piece. Constanza?

[01:02:56.07] - Constanze Stelzenmüller

Yeah. I tend to think that we will see centralization in specific areas, right? Like defense spending and, and capital markets union, banking union, that kind of thing, because it's necessary. And without that, you know, the vulnerability remains. I could imagine a couple of Nordic countries thinking quite hard about joining either the eurozone or the EU, not so much for economic reasons, but as political insurance, right? In much the way, the same way that the Finns and the Swedes joined NATO. And also because they would be in a position to enter at the top, right? They would have a, very strong position from the get-go. And I think that's something that appeals at least to elites in those countries. I'm sure there are, you know, tensions in politics and in the electorate, but you can see polls going up for that in Norway, for example. There is, however, a key problem that remains, and that's the hostile member problem. And the problem is that we now have hostile members in both arrangements, both the EU and NATO. We have Hungary, and to a lesser degree, because it's less powerful and less invested in its relationship with Russia and China, Slovakia.

[01:04:29.14]

But the Hungarians are for all practical purposes proxies of Moscow and Beijing, and are topi doing sanctions votes and things like that. So the question there becomes, I think, What point

do the other Europeans get fed up? It is, as you all know, not possible to throw a member state out. That's provided neither by the European Lisbon Treaty nor by the Vienna Treaty on Conventions. It's possible that we will use punitive instruments, right? But it is equally likely that we will just be using workarounds. Which in the European case always means the Council. That has limitations, but it's feasible. In NATO, the problem is, of course, that you've, you know, we've always managed to work around, you know, the Turks, you know, going one way or the other, the French going one way or the other, the Hungarians sabotaging when necessary, or passing, you know, others passing on intelligence. But for the guarantor, the guarantor of the European Security Order to become a hostile ally, right, that's a new one in NATO. But it is not as though we've never formed coalitions of the willing in the NATO context before. We did that, in fact, after 9/11.

[01:05:47.17]

And so I think you will see countervailing tendencies. You will see both integrational movements on specific issue areas, and where it matters on politics, defense, and security, I think you'll see more pragmatic, flexible political arrangements that may circumvent the European institutions, but probably done with the— it won't done with the complete assent, right, of the Commission, because things need to get done.

[01:06:14.08] - Adam S. Posen

Olivier, you've written on coalitions of the willing.

[01:06:17.15] - Olivier Blanchard

Yeah, so my sense is Europe has a very strong future, but of as concentric circles. So I think that unanimity will be less the rule, especially if we increase the number of members, but we'll be able to act with a subset of the members on many issues. I think the sense that Europe is important is actually stronger due to what's happening. So I'm reasonably optimistic, but I'm sufficiently far that maybe I'm too optimistic. Maybe Cecilia should have the last word.

[01:06:51.29] - Adam S. Posen

Yes, Cecilia gets the last word.

[01:06:54.02] - Cecilia Malmström

On defense, I don't think we are looking at a European independent defense if that was your question. But certainly, a lot of things are happening right now. Constanze outlined some of

them, and we also see a lot being done that is not so much costly in money, but it's more about the interoperability of the already existing systems. A lot can be done there as well. But a pure EU defense is not on the short-term radar, in my view. But lots of things are happening. You refer to the public opinion. I mean, it's— It's increasing in Norway. It's increasing in Iceland. They will have a referendum whether to restart negotiations. And there's a majority in favor both of the euro and the EU in Iceland. Not a majority yet in Norway, but it's increasing. And they have elections in September, I think. So that's— and there's also an increase of support for the euro in Sweden. I haven't seen any polls from Denmark.

[01:07:50.05] - Adam S. Posen

Great. Thank you all very much for joining us, and let us give thanks to our colleagues Olivier Blanchard, Cecilia Malmström from PIIE, and Constanze Stelzenmüller from Brookings.