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Walking out of the Woods: EU Industrial Policy between the Energy Crisis and Decarbonisation

by Pier Paolo Raimondi

Europe is in the midst of a profound and complex energy crisis. This is not limited to the gas sector as a result of Russia's invasion of Ukraine but involves all energy sources. French nuclear generation, for example, has fallen to a thirty-year low over the past year due to maintenance works and corrosion.[1] Due to extreme heat over summer, unprecedented drought has reduced hydropower generation as well as the possibility to import coal by river.[2] Oil has not been immune to turbulences either. The EU embargo on Russian crude oil finally began on 5 December 2022, coupled with a price cap at 60 US dollars/barrel generating uncertainty over future supply and prices. In February 2023, the second step of the embargo, on refined products, will kick in, with diesel potentially becoming the next chapter of the European energy crisis.[3]

So far, Europeans have coped quite successfully with these challenging developments. As far as the gas sector is concerned, they have managed to refill their gas storage, reduce Russian energy imports and attract liquified natural gas (LNG) cargoes as well as encourage demand reduction/destruction. However, all of this was possible at an extremely high cost (not only for Europeans)[4] and also thanks to fortunate (yet precarious)

[1] "Explainer: Why Nuclear-Powered France Faces Power Outrage Risks", in *Reuters*, 9 December 2022, https://www.reuters.com/business/energy/why-nuclear-powered-france-faces-power-outage-risks-2022-12-09.

[2] William Wilkes, Jack Wittels and Irina Vilcu, "Historic Drought Threatens to Cripple European Trade", in *Bloomberg*, 10 August 2022, https://www.bloomberg.com/news/features/2022-08-10/europe-s-low-water-levels-threaten-rhine-river-hit-80b-trade-lifeline.

[3] Tom Wilson, "IEA Warns Surging Diesel Prices Risk Worsening European Energy Crisis", in *Financial Times*, 15 November 2022, https://www.ft.com/content/e6984b1f-8ee0-4fc7-a1ed-ff7bc162a01f.

[4] Shotaro Tani and Benjamin Parkin, "Europe's Appetite for LNG Leaves Developing Nations Starved of Gas", in *Financial Times*, 23 September 2022, https://www.ft.com/content/752b1285-3174-4cf1-83c0-b1151888bf4e.

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circumstances such as lower Asian (mainly Chinese) gas demand and milder temperatures.

The energy crisis brings to the fore not only energy security but also the role of industrial policy at the international and European level. Since Covid-19, the role of the state (and the EU as well) in the economy has expanded dramatically through recovery plans and relief packages in response to the health, economic and energy crises. This is likely to remain so in the mid- to long-term, as the world's economy and industry are facing an epochal transformation driven by the global energy transition.

Fragmentation, disunity and deindustrialisation?

Although being only the latest stress test for the EU, the energy crisis represents a watershed moment for the Union and its future.[5] How this future will be shaped is still unknown. Much will depend on how governments and citizens will react to the crisis and its consequences, gauging their resilience.[6] What is sure is that uncoordinated and nationalistic responses would reduce European resilience and unity, causing fragmentation of the EU's single market as well as fuelling intra-European competition, hence worsening the energy crisis.[7]

The crisis poses significant pressure on European industry. The development of a number of sectors and companies had indeed been premised on access to cheap Russian energy. Thus, European industry needs to find new solutions to navigate the uncharted waters of a (potentially) complete stop of Russian energy supply and high energy prices for the next two or three years. So far, EU companies have managed to reduce gas consumption while preserving production. Should energy prices remain high and without a clear EU industrial vision consistent with its climate goals, however, the risk is that Europeans may find themselves in an industrial wasteland at the end of the energy crisis. Given that Europe's major gas-consuming industries generate an economic value of more than 600 billion US dollars a year and employ almost 8 million workers,[8] a European deindustrialisation in these sectors could trigger an economic downturn and social instability, ultimately threatening to derail the energy transition.

European industry on the path to net-zero

Europe has not scaled down its climate ambitions; quite the opposite,

[5] Pier Paolo Raimondi and Margherita Bianchi, "Energy Unity or Breakup?", in *IAI Commentaries*, No. 22|39 (September 2022), https://www.iai.it/en/node/15846.

[6] Nathalie Tocci, "Putin vs Monnet: European Resilience, Energy and the Ukraine War", in *IAI Papers*, No. 22|25 (September 2022), https://www.iai.it/en/node/15989.

[7] Pier Paolo Raimondi and Margherita Bianchi, "Letter: Europe Must Use Lull in Gas Prices to Build Energy Resilience", in *Financial Times*, 14 November 2022, https://www.ft.com/content/27319363-4f91-4905-871a-8bda8ed5d12e.

[8] Fatih Birol, "Europe Urgently Needs a New Industrial Master Plan", in *Financial Times*, 5 December 2022, https://www.ft.com/content/2a68ef41-76ee-4406-a1f1-b64b2efc58a0.

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as shown by the REPowerEU plan aimed at weaning Europe off Russian energy imports along with fostering decarbonisation or the decision to end the sale of new CO_2-emitting cars in Europe by 2035. The automotive sector, still mainly based on internal combustion engines, employs around 13.8 million people in the EU while representing over 7 per cent of its GDP.[9] The industrial transformation of this strategic sector requires a compelling roadmap and political vision toward a net-zero future.

Along this way, Europe will face greater industrial competition. China has established itself in a dominant position in key clean energy technologies and global supply chains, while the US launched its massive Inflation Reduction Act (IRA) aimed at reviving the domestic industry while fostering decarbonisation, which earmarks about 370 billion US dollars in subsidies and tax breaks. Other Asian countries, such as South Korea and Japan, have worked on similar strategies and plans in several sectors.

An EU industrial plan?

Against this backdrop, Europeans are called to consider how to protect and develop their industrial sectors in light of not only high energy prices and decarbonisation efforts but also of other economies' attempts to gain competitive advantages. Voices are growing louder that urge the EU to have an industrial plan.[10] This is certainly key.

The EU may feel between a rock (the US) and a hard place (China). Notwithstanding, the Union must avoid the temptation to follow the path of other economies. Entering a subsidy race with the US seems economically unrealistic and politically counterproductive. At first glance, instead, a top-down approach like the one pursued in China may seem attractive. Beijing's 'state capitalism' has yielded remarkable industrial and economic growth. China has gained strategic leverage over the global supply chains of several key sectors and technologies, such as batteries and solar panels. While some benefits are apparent, however, this development was driven by state-owned companies, direct subsidies and technology transfers, which come with major risks, notably massive debt, corruption and potential inefficiency, as well as low innovation.

What alternative options does the EU have to become a crucial driver of technological and industrial development? France and Germany called for a renewed impetus in European industrial policy,[11] while the President of the European Commission Ursula von der Leyen stated that the EU must "simplify and adapt" its rules on state aid in light of the US

[9] European Commission website: *Automotive Industry*, accessed 13 December 2022, https://europa.eu/!GF7W3P.

[10] Fatih Birol, "Europe Urgently Needs a New Industrial Master Plan", cit.

[11] Bruno Le Maire and Robert Habeck, Joint statement: "We Call for a Renewed Impetus in European Industrial Policy", 22 November 2022, https://presse.economie.gouv.fr/?p=103071.

IRA.[12] In October 2022, the EU already prolonged and amended its State aid Temporary Crisis Framework to enable member states to continue to benefit from some flexibility with regard to state aid rules.[13] However, since state aid control preserves the internal market, further loosening it may undo the level playing field in the European market, causing fractures between rich and poor member states. Additionally, state aid may prove to be useless as industry thrives nonetheless in those countries where energy resources are relatively cheap (as occurred with solar PV production).

Others called for the introduction of industrial support plans financed by new rounds of joint EU debt in order to overcome divergent debt capacity among member states.[14] While having some merit, the discussion over new EU-wide funds may lead to lengthy (and probably inconclusive) discussions along traditional cleavages (frugal vs non-frugal member states). For the EU, it is crucial to undertake decisions without losing time as it occurred in the US with the IRA despite the polarised political debate. Furthermore, it is clear that there is no shortage of funds, especially after the Covid-19 pandemic; constraints are rather on the ability to use these funds swiftly and streamline them with a coherent vision.

The EU already has powerful tools to shape industrial decisions and investment. Horizon Europe, building on the experience of Horizon 2020, is the largest-ever transnational programme supporting research and innovation with a budget of around 95.5 billion euro for 2021–2027.[15] Other notable tools are the Important Projects of Common European Interests (IPCEI), already applied to clean energy technologies such as hydrogen and batteries, or the European Investment Bank (EIB). Moreover, the EU could also expand its public procurement rules for industrial purposes.[16]

Rather than replicating a top-down approach or entering a subsidy race, the EU should establish a clear framework through existing tools and funds in order to encourage investment. It should not consider industrial policy as a replacement for competition policy,[17] but rather reconcile the

[12] Henry Foy and Sam Fleming, "Ursula von der Leyen Promises EU Help for Companies Lured by US Green Subsidies", in *Financial Times*, 4 December 2022, https://www.ft.com/content/19a28687-0172-445a-829d-a8fd08592197.

[13] European Commission, *State Aid: Commission Prolongs and Amends Temporary Crisis Framework*, 28 October 2022, https://ec.europa.eu/commission/presscorner/detail/en/IP_22_6468.

[14] Nikolaus J. Kurmayer, "Commission Chief: Cooperation not Confrontation in US Subsidies Row", in *Euractiv*, 5 December 2022, https://www.euractiv.com/?p=1849465.

[15] European Commission, *Commission Welcomes Political Agreement on Horizon Europe, the Next EU Research and Innovation Programme*, 10 December 2020, https://ec.europa.eu/commission/presscorner/detail/en/IP_20_2345.

[16] André Sapir, Tom Schraepen and Simone Tagliapietra, "Green Public Procurement: A Neglected Tool in the European Green Deal Toolbox?", in *Intereconomics*, Vol. 57, No. 3 (2022), p. 175-178, https://doi.org/10.1007/s10272-022-1044-7.

[17] Georgios Petropoulos, "How Should the Relationship between Competition Policy and Industrial Policy Evolve in the European Union?", in *Bruegel Blog*, 15 July 2019, https://www.bruegel.org/node/6211.

latter with a clearer and common industrial policy. Competition policy yields innovation, which is crucial for industrial development and evolution. In this sense, Brussels should work on completing the Single Market and its competition policy.[18] While protecting existing competitive advantages and industries, the EU should also prompt the creation of new industries and technologies. To be sure, this may result in a loss for certain sectors and regions. This is why it is also crucial to enhance compensation tools aimed at reducing regressive consequences, such as the Just Transition Mechanism.

Cooperation with key partners

Lastly, the quest for a European industrial policy should not fuel trade hostilities and undermine cooperation with key partners, such as the US and some Asian countries. While it is clear that IRA poses a threat to European industry, the EU should not oppose the attempt of other economies to foster decarbonisation domestically. Major challenges to Europe's industry do not come from US industrial policies but rather from the collapse of energy trade between Russia and the EU, which had provided cheap energy imports.

Some decarbonisation strategies, also in the EU, will inevitably affect other economies. The point is to find possible solutions that do not scale down decarbonisation efforts but encompass ways to reduce possible regressive or undesirable outcomes for others. This is also true for the US, which should take into account some of the European concerns and consider possible adjustments and exceptions for the EU. Washington and Brussels should foster dialogue and try to find common solutions through mutual adjustments. The US-EU Trade and Technology Council can be an adequate diplomatic platform to this end. Faced with these new challenges, the EU should come together with like-minded countries in climate clubs to cooperate in the innovation of technologies and industries, investment, rules and standards as well as economies of scale.

The evolving geopolitical landscape, characterised by greater industrial competition, requires industrial and strategic thinking from the EU. At the same time, the Union should develop its approach based on its own characteristics, that is, centred on competition policy, in order to prevent distortive effects within its market and borders. This would enable the EU to protect innovation, which yields industrial evolution, and become a driver of the transformation underpinned by the energy transition.

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[18] Alessio Terzi, Aneil Singh and Monika Sherwood, "Industrial Policy for the 21st Century: Lessons from the Past", in *European Economy Discussion Papers*, No. 157 (January 2022), https://europa.eu/!vYmNqf.

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