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Hybrid Threats in the Western Balkans: A Case Study of Bosnia and Herzegovina

Martin Solik, Jan Graf, Vladimir Baar[1]

Abstract: *The aim of this paper was to identify the nature of hybrid threats posed by Russia in Bosnia and Herzegovina and, subsequently, to identify to what extent the Kremlin is successful in destabilising the political situation in this country. For this purpose, disciplined interpretative case study was employed. This study is primarily based on four expert interviews which were conducted in August 2021, in Sarajevo. The theoretical part of this study introduces the concept of hybrid threats. This concept is then applied to the case of Bosnia and Herzegovina. Based on a comprehensive analysis, the authors were able to identify three areas where the Kremlin's hybrid threats are the most significant. These are political and economic influence, information space and proxy organizations. This paper may contribute to the understanding of how Russia constructs its hybrid threats and may also lead to further research on hybrid threats in the Western Balkans.*

Keywords: *Bosnia and Herzegovina, Republika Srpska, Russian Federation, hybrid threats, hybrid war.*

Introduction

In recent years, security analysts and scholars have increasingly discussed the concept of hybridity in international relations. Hybrid threats gained particular attention after Russia had illegally annexed Crimea in 2014, see, for example, Rácz (2015), Hajduk and Stępniewski (2016) or Rusnáková (2017). In the context of Russian hybrid activities, Russian interference in the US elections or the Kremlin's efforts to influence the outcome of the referendum on Brexit could be mentioned as examples of Russian hybrid activities. Finally, Moscow's ties to ultra-nationalist politics in Europe could also be considered a Russian hybrid strategy (Chivvis 2017: 5). Using these hybrid strategies, the Kremlin's political leadership has sought to undermine the unity of the West and citizens' trust in democratic institutions.

Western Balkan states have also recently faced Russian hybrid attacks. They are motivated by the general desire of these countries to be part of the Euro-Atlantic integration structures (EU and NATO). Considering the integration of the Western

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Balkan states into the North Atlantic Alliance, the Kremlin's attempts have not succeeded, as only Bosnia and Herzegovina (BiH) and Serbia remained outside NATO. It should be noted that the governments of these two countries have not yet applied to join this organisation.

Russia perceives the pro-Western orientation of the Western Balkan governments as a potential threat, as these countries are located at a critical geopolitical crossroads and play the role of a buffer zone between the West and the alleged Russian sphere of influence. Therefore, Russia seeks to dissuade these countries from their pro-Western orientation through subversions. For that reason, the authors chose the topic of Russian hybrid threats in BiH for their study.

Russia had been involved in the Western Balkans already in the 1990s. Nevertheless, Moscow shared the West's view of the ongoing conflict in the former Yugoslavia. As a result, Russian troops participated in peacekeeping missions until 2003, when Russia's top leadership decided to withdraw its forces from the region, as the purpose of the mission had been, according to them, achieved. After 2014, relations between Moscow and the West have deteriorated significantly following Russia's annexation of Crimea. According to Kuczynski, Russia's increased interest in the region can be observed in the post-2014 period (Kuczyński 2019: 6).

Numerous authors have discussed Russian hybrid activities in the Western Balkans. Authors such as Dimitar Bechev (2019), Grzegorz Kuczyński (2019), Mark Galeotti (2018), and Hänsel and Feyerabend (2018) have discussed Moscow's growing influence in the region in more general terms. All these authors assume that Moscow deploys hybrid strategies to prevent these countries from becoming members of Euro-Atlantic integration structures.

Many case studies also describe the Kremlin's activities in individual Western Balkan states. Kallaba (2017) points to the growing influence of the Kremlin in Kosovo. Gashi and Maqedonci (2017) draw attention to the same phenomenon in their study. In his analysis, for example, Tsalov (2020) refers to Moscow's involvement in North Macedonia. Greene and Asmolov (eds.) (2021) comprehensively analyse the Kremlin's disinformation campaigns in the Western Balkans region. These authors concluded that Russia uses disinformation campaigns in order to promote anti-Western sentiment in these countries.

The Kremlin's influence in BiH was comprehensibly assessed by Brkan and Grdinić (eds.) (2020), who, in addition to Bosnia, also focused on the Russian influence in Montenegro and North Macedonia. In this respect, Stronski and Himes (2019) analysis, chronicling the Kremlin's political and economic impact on BiH and the entire region, represents another valuable contribution to this topic. These authors point out that Serbia is Russia's most vital regional partner. Furthermore, they assume that it stems from the relative cultural proximity of the two nations. However, none of these studies mentioned above focuses comprehensively on BiH. The paper of Brkan and Grdinić (eds.) (2020) addresses only some aspects of Russian influence in BiH without further elaborating them. Even such a brief overview has shown that hybrid threats in the Western Balkans have become an increasingly relevant topic for security analysts and scholars in recent years. This study, thus, aims to provide a comprehensive analysis of the Russian hybrid threat in BiH and to contribute to the theoretical debate on this significant topic.

Conceptualising hybrid threats

Although hybrid threats have been discussed primarily in the context of Russia's illegal annexation of Crimea in 2014, many authors described hybrid strategies, which became increasingly evident in international relations long before 2014. The term hybrid warfare was introduced in the Western context by Robert G. Walker in 1998 (Walker, 1998). However, some researchers have associated the use of the term with Thomas Mockaitis. According to Stojar, Mockaitis used the term three years earlier than Walker (Stojar 2017). The concept of hybrid warfare can also be linked to William J. Nemeth, who described the hybrid tactics of Chechen rebels in their fight against the Russian army in his Master's thesis entitled 'Future War and Chechnya: A Case for Hybrid Warfare' (Nemeth 2002).

The concept of 'hybrid warfare' was first articulated by Frank Hoffman, among other authors. Together with General Mattis, they predicted the nature of future conflicts as early as 2005 and referred to them as hybrid wars in their joint study (Mattis and Hoffman 2005). In his 2007 paper, Hoffman associated the emergence of hybridity in the international environment with September 11th, 2001, when terrorists perpetrated an attack on the United States (US) territory. According to Hoffman, this particular terrorist act can be considered an imaginary breaking point in the concept of warfare. Until then, conflicts had always been resolved by conventional means. However, the aforementioned author uses the example of Hezbollah to point out that such a premise is no longer valid (Hoffman 2007). According to Hoffman, hybrid warfare encompasses 'a whole spectrum of different types of warfare, encompassing conventional means, unconventional tactics and strategies, and terrorist acts, including extreme violence, coercion, and criminal acts. Actors in hybrid warfare include both states and various non-state actors' (Hoffman 2007: 29).

This definition implies that almost anyone can deploy hybrid strategies within the international environment and that hybrid tactics consist of a combination of conventional and unconventional methods of warfare. This understanding of hybrid warfare is opposed by Renz and Smith, pointing out that the concept of hybrid warfare can encompass virtually anything (Renz and Smith 2016: 13). Van Puyvelde (2015) also alludes to the ambiguity of such a concept in his article. It is worth mentioning here that many authors use the terms hybrid warfare, or hybrid threats as synonyms. According to Monaghan, however, it is unacceptable as hybrid warfare and hybrid threats are fundamentally different concepts in terms of their content (Monaghan 2019: 83).

While hybrid warfare is a conflict in the strict sense of the word, involving a confrontation between conventional and unconventional forces using new combat methods, the purpose of a hybrid threat is to exploit the weaknesses of the adversary without declaring war. Monaghan points out that the distinction between hybrid warfare and hybrid threat has been addressed in the past by Hoffman. International organisations (NATO, EU) also discuss the hybrid threat concept. In particular, Russia's recent activities on the international scene have contributed to this. Hence, these organisations seek to answer how to counter hybrid threats. Similarly, hybrid threats are gaining importance at the national level (Monaghan 2019: 85). NATO defines hybrid threats as 'a combination of military and non-military as well as covert and overt means, including disinformation, cyberattacks, economic coercion, the use of irregular armed groups, and the use of regular armed forces' (NATO 2021).

The concept presented by Western analysts is interpreted quite differently in the Russian environment. Russian analysts assume that Russia is a victim of Western hybrid attacks (Clark 2020: 16). In fact, according to Moscow, the idea of hybrid warfare was created by the West. However, hybrid strategies have been used since antiquity (Bartles 2016: 34).

According to Clark, the Kremlin's hybrid operations focus mainly on operations in the information environment (Clark 2020: 15). The concept of Russian hybrid warfare, thus, differs from the Western concept of hybrid warfare. Valery Gerasimov, the Chief of General Staff of the Russian Armed Forces, is considered the alleged father of Russian hybrid warfare. In his 2013 article, he predicted the nature of future conflicts. In his opinion, it will be impossible to distinguish a state of peace from a state of war, just as it will be impossible to discern military forces from civilians. Information and its application in combat will play a vital role in the future. According to Gerasimov, these conflicts will not be announced in advance, as they will become persistent (Gerasimov 2013). It is true that many Western scholars now tend to include the tools of information warfare (propaganda, disinformation, etc.) in the concept of hybrid warfare, connecting Western and Russian concepts of hybrid warfare. See, for example, Hadzhiev (2020), Huhtinen and Rantapelkonen (2016) or Araźna (2015). Generally speaking, Russia uses political influence, information operations (cyberattacks, use of clandestine operations), economic impact and proxies in its hybrid attacks (Chivvis 2017: 3-4). Therefore, the authors will focus on identifying the most significant aspects of hybrid threats destabilising BiH.

Information space

Information space, clandestine operations, and cyberattacks are so closely intertwined that they can be summarised in the following lines. The use of information space to exacerbate divisions between different population groups constitutes the most crucial component of hybrid threats. Various instruments in this area include spreading false news, disinformation campaigns or propaganda. These tools aim to weaken the target society and its culture. Cyberspace plays a very similar role in creating hybrid threats. Attackers seek to obtain sensitive data through Internet technologies. Specific tools include cyber espionage or cyber operations. Attacking states may also use the services of intelligence agencies in their hybrid attacks. In doing so, they may, on the one hand, seek to weaken the intelligence services of the state that is forced to defend itself against the hybrid attack. On the other hand, the attacker may use its intelligence services to coordinate further hybrid attacks. This strategy aims to confuse the enemy (Giannopoulos and Smith eds. 2021: 31-32).

Political and economic influence

Russia seeks to gain political influence by courting selected political leaders in other states to exert its influence (Chivvis 2017: 4). Conversely, Moscow strives to weaken actors in these countries opposing the Kremlin's interests. Through its political actions, Russia seeks to deepen the schisms in the invaded societies and weaken the democratic mechanisms of these states (Giannopoulos and Smith eds. 2021: 32). Moscow's energy diplomacy is frequently mentioned when referring to Russia's economic influence in the context of hybrid threats. Excessive energy dependence on Russia can be perceived as a threat when the Kremlin blackmailed its trading partners in Ukraine in 2006 and 2009. Moreover, Russia is building extensive energy networks, which inherently provide opportunities for corrupt behaviour. More generally, Russian investments can distort free markets and weaken democratic mechanisms in the countries receiving these investments (Chivvis 2017: 4). The fact that the energy sector constitutes a frequent target of hybrid attacks is discussed by Dupuy and his colleagues in January 2021, (Dupuy and Nussbaum eds. 2021) referring to recent Russian activities in Europe.

Proxy organizations

The so-called proxy organisations represent the final instrument Russia deploys in creating hybrid threats. They are groups effectively acting as an extended arm of the Kremlin in targeted societies and helping destabilise the political situation in countries where Russia has interests. For example, Chivvis mentions the motorcycle group Night Wolves, linked to the current Russian political leadership. In the same way, Russia also supports anti-Western organisations based in Europe to achieve its goals (Chivvis 2017: 4). When identifying Russian hybrid activities in BiH, the authors have concentrated on the five areas mentioned above.

Research design

This study aims to identify the nature of hybrid threats posed by Russia in BiH and, subsequently, to identify to what extent the Kremlin is successful in destabilising the political situation in the country. The study relies on qualitative research, characterised by being flexible to the researchers' needs regarding the actual selection of the topic and the conduct of this type of research (Hendl 2005: 49-50). In principle, the researcher can change the research questions flexibly, depending on the research direction. For the purpose of this study, the authors selected a disciplined interpretive study method. In this study, the theory only serves as the basis for interpreting the actual conclusions. Essentially, the researcher modifies the approach and then applies it to the case at hand.

Creswell describes five necessary steps to create a relevant case study in his paper. The first two phases involve determining the method and selecting an appropriate case. The remaining three phases include data collection, followed by data analysis, and finally, the researcher draws the conclusions (Creswell 2013: 100-101). In this study, hybrid threat theory is used to modify the concepts of Christopher Chivvis, who identified five areas that the Kremlin focused on when constructing hybrid threats. They are as follows: information operations, cyberspace, clandestine operations, political influence, economic influence, and proxy activities. The authors here summarise the first three factors under the heading information environment. Furthermore, political and economic influence is also summarised under one aspect. In addition to proxy activities, the authors also discuss the Kremlin's military operations in BiH. The research results are then interpreted and set within the context of Russian hybrid threats in BiH.

The study analyses Russia's hybrid threats in BiH between 2014 and 2021. The fact that hybrid threats were widely discussed following the annexation of Crimea in 2014 has led to this timeframe being chosen. Moreover, the scope of the text precludes any more extensive analysis. The authors base their analysis primarily on four expert interviews conducted in Sarajevo, Bosnia, in August 2021. These interviews varied in length, the shortest lasting 35 minutes and the longest approximately 75 minutes. They were conducted as semi-structured interviews, starting with a brief explanation of the topic by the interviewee. After that, the researcher asked questions about the subject. If necessary, the researchers asked the interviewees follow-up questions. The interviews were conducted in English.

Members of the diplomatic staff in Sarajevo were contacted, together with a person actively involved in Bosnian politics. Last but not least, the authors interviewed Prof. Ivo Komšić, who was instrumental in signing the Dayton Peace Agreement (1995). Komšić, a Bosnian Croat member of the presidency of war-time BiH (1993-1996) also served in the recent past (2013-2017) as the Mayor of Sarajevo. The authors could objectively assess the extent of the Russian hybrid threats in BiH based on interviews. Finally, an NGO interviewee provided the authors with electronic responses to their questions. A gatekeeper helped the researchers in selecting the respondents and was able to facilitate three meetings. In general, respondents were selected based on how much information they could provide to the authors. Given the sensitivity of the data collected, some respondents wished to remain anonymous; therefore, the authors chose not to publish their names. In addition, the paper relies on the analysis of primary and secondary data sources. The primary data include official documents of both the Kremlin and the Bosnian governments or official statements of the highest political representatives of both countries. Following a critical evaluation of the data studied, only relevant data sources were applied in this study.

Information environment and Russian hybrid threats in BiH

The Russian government is aware of the need to pursue its interests using means other than political and economic influence. For this reason, it has also shifted its subversive activities to the information environment, using its media to influence public opinion not only in BiH but the entire region. According to recent research, the Kremlin seems to have almost ideal conditions for these activities. Namely, the fact that more than two-thirds of the RS population distrust the domestic media can be considered problematic. The citizens are generally convinced that media deliberately try to lie (Duffy and Green 2020: 11). This opens up space for foreign media, such as Russian media, to offer alternative explanations[2].

The main goal of the Kremlin's disinformation campaigns in BiH is to keep the

[2] On the other hand, it is worth mentioning that a minority of citizens does not trust foreign media because they are afraid of the growing influence of these external actors (Duffy and Green 2020: 11).

political representation in Republika Srpska (RS) critical of the country's Euro-Atlantic course, currently pursued by President Milorad Dodik. Moscow's secondary objective is to portray Russia and Vladimir Putin as a possible alternative to the West. That is why the incumbent President Dodik was clearly supported by Sputnik, which operates in Serbia, before the presidential elections in RS. At the same time, this media largely vilified his opponent, Mladen Ivanić, as a pro-Western politician (Greene and Asmolov eds. 2021: 24). Moreover, Sputnik attempts to stir up disputes between different ethnic groups. In this respect, Salvo and de Leon recall several articles on the website referring to the possibility of two territorial entities, Serbian and Croatian, should BiH finally split up. Another article on the website dealt with the plight of Croats in BiH (Salvo and de Leon 2018).

However, the West is negatively portrayed by both Russian-owned and Serbian media. Before the presidential elections in RS, the local media spread the news that some Western countries would carry out a terrorist attack in the area. Other reports sought to stir hostility towards Muslim Bosnians (Green and Asmolov eds. 2021: 24). The same phenomenon is also pointed out by Turcalo (2021), who discusses the radicalisation of a part of society encouraged by such stories. In a sense, the Kremlin benefits from these reports without making any significant effort. The general attempt to portray the West and its integration structures as weak and incompetent constitutes a prominent theme in Russian disinformation campaigns, see Doncheva's (2020) detailed analysis of the Russian narratives. Doncheva argues that the RS media mainly adopt the pro-Russian narratives, especially the website Iskra.co with an unclear ownership structure (Doncheva 2020: 36).

Commenting on these reports, one respondent adds: 'Russia does not need its own media here; it only needs Sputnik, which has a branch in Serbia. It practically spreads disinformation here, improves Russia's image and portrays Vladimir Putin as a strong leader (...). Alternatively, Sputnik publishes some news here and the local media, especially in RS, pick it up' (Interview No. 3 with a Bosnian politician 2021). According to this interviewee, Russian influence in the information space began to increase about five years ago, when the Bosnian media started to cover Russian culture, sports or politics more widely. In his opinion, Russia targets these reports mainly at young people in RS, who have fully adopted Russian narratives (Interview No. 3 with a Bosnian politician, 2021). The remaining question is to what extent these reports affect public opinion in BiH and whether the Kremlin can use these reports to instil distrust in the Euro-Atlantic integration structures. According to one interviewee, the support for the country's accession to the European Union is still very high, around 80%. The country's accession to NATO constitutes a much more challenging topic. In his opinion, the Serbs have constantly blocked the accession negotiations (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo 2021).

This topic has been targeted several times in this article. As this interviewee further elaborates, another Russian narrative in the Bosnian media suggests that BiH is merely an artificial state, and that RS should be annexed to Serbia (Interview No. 3 with a Bosnian politician 2021). This would de facto result in the disappearance of BiH within its current borders. However, according to this respondent, such an option is completely unacceptable. In April 2021, a secret document appeared that reignited the debate on the territorial integrity of BiH. According to Suljagic, this document was introduced by Slovenian Prime Minister Janez Jansa. This author also assumes that the Kremlin, Croatia, and Serbia were involved in the preparation of this report[3]. According to this plan, BiH would disappear from the map. Subsequently, it would be replaced by new territorial entities of Bosnian Croats and Bosnian Serbs. As mentioned above, this solution is completely unacceptable.

Intelligence services and their activities form another vital aspect of the Kremlin's hybrid activities. According to a European Values report, whilst there is no immediate danger from Russian intelligence services, recent events in Montenegro, where Russia used subversive methods to thwart the country's accession to NATO, have left security analysts wary. In this respect, the Kremlin's attempt to reinstall Vladislav Filippov[4], expelled from Albania as a diplomat for alleged espionage activities at the Bosnian embassy in Sarajevo, is rather interesting (Brkan and Grdinić eds. 2020: 13). Moreover, Russia made no significant attempts to obtain sensitive data in terms of cybersecurity during the reporting period. However, this does not mean that the threat as such did not exist. In spring 2020, the BiH Ministry of Finance was subject to a hacking attack from Albania (Sarajevo Times 2020). Therefore, BiH should be prepared for this type of subversion in the future. However, as seen from the text by Stojanovic and her colleagues (2021), the Bosnian government does not have a comprehensive cybersecurity approach (Stojanovic and Stojkovski eds. 2021).

Russia's political-economic hybrid threats in BiH

As many examples in recent years have shown, the Kremlin seeks to influence the outcome of the EU elections and target the Western Balkans. There, it tries to prevent individual countries from joining Euro-Atlantic integration structures. A prime example of such an approach is Montenegro, which recently faced Russia's attempt to overthrow the government that sought to integrate the country into NATO. It should be emphasised that this Russian attempt had ultimately failed, and Montenegro actually became a member of the organisation in 2017. On the other hand, the West also failed to respond to this affair adequately, and Russia has continued to conduct subversive actions (Bećirević and Turčalo 2020: 8). Thus, according to the identical scenario, the main goal of subversions in BiH could be to dissuade Bosnia from moving in a pro-Western direction.

Given its complex political system and ethnic heterogeneity, BiH may become an area where foreign powers can more easily exert their influence (Brkan and Grdinić eds. 2020: 8). Another reason is that the US has gradually shifted their attention to other regions after the conflict in the 1990s, leaving open space to expand Russia's activities (Bajrović and Kraemer eds. 2018).

In asserting its political influence, the Kremlin predominantly focuses on RS. Within this entity, Milorad Dodik, an ethnic Serb, a member of the three-member Presidency of BiH and current President of the RS, representing the SNSD party[5], has

[3] This document is known as 'the Western Balkans non paper'. See Suljagic (2021).

[4] Filippov was subsequently appointed military attaché at the Bosnian embassy.

[5] The Alliance of Independent Social Democrats (Serbian: *Savez nezavisnih socijaldemokrata* – SNSD) is a Serb political party in Bosnia and Herzegovina. Founded in 1996. It is the governing party in Republika Srpska, with its leader, Milorad Dodik, serving as the current member of the Presidency of Bosnia and Herzegovina.

been the leading figure for more than 15 years. Dodik has not concealed his sympathies for Russia and the Kremlin leader Vladimir Putin. Ivo Komšić adds on Milorad Dodik: 'Dodik is Putin's most loyal guy. Ironically, he is more pro-Putin than pro-Vucic (Serbian President). He can visit Putin and Lavrov in Moscow whenever he wants' (Interview No. 1 with Prof. Ivo Komšić 2021).

Several examples can illustrate the good relations between Dodik and Putin. Perhaps the most obvious example of good relations was when Putin met with Dodik in September 2018 on the eve of the parliamentary elections in RS. The meeting focused on explaining the good personal relations between both politicians. The Kremlin leader wished his counterpart good luck and expressed his support to Dodik (Putin 2018). Nevertheless, this meeting was by no means the first between the two men. Salvo and de Leon report that Putin met with Dodik eight times between 2015 and 2018 (Salvo and de Leon 2018). Besides other meetings, Dodik also met with Putin shortly before the 2016 referendum on the renewal of the Bosnian Serb day (Salvo and de Leon 2018). Reportedly, Putin promised Dodik a more considerable sum of money at one of those meetings, over € 600 million. It should occur allegedly as early as 2014; however, Dodik said that such a sum had not yet arrived from Moscow. On the other hand, the Western countries imposed sanctions on Dodik in 2016 after he held an illegal referendum; thus, in a way, he depends to a large extent on Moscow's help (Stronski and Himes 2019).

The close relations between the Kremlin and RS stem from supporting the territorial claims of ethnic Serbs in BiH. Indeed, Kremlin uses Serbian nationalism and relative cultural proximity to promote its own interests and establish friendly relations with these actors (Bajrović and Kraemer eds. 2018).

The political support of Milorad Dodik of the RS, a man who does not hide his nationalist tendencies, fits perfectly into the Moscow plan. In 2016, a referendum was organised in RS, despite the Constitutional Court's ban. Almost 100% of the participants voted for the reestablishment of January 9th as the Bosnian Serb Day (Rose 2016). On this day in 1992, the conflict between Bosniaks and Serbs broke out in the former Yugoslavia (Zakem and Rosenau eds. 2017). While the West formally condemned the referendum and imposed sanctions on Dodik, Russian government officials did not denounce such an act and even defended Dodik. These actions have further fuelled speculation that Russia is trying to destabilise the region (Samorukov 2016).

A referendum on the RS independence was expected to be held in 2018. One of our diplomatic sources says of Milorad Dodik's secessionist tendencies, that 'it is more of public discourse than real interest. Dodik himself, in my opinion, does not want the Republic of Srpska to secede because he knows very well what the consequences would be. It could lead to a new conflict' (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo 2021). In principle, the respondent's words suggest that Dodik only responds to the RS political demand, gaining political points. In fact, in the past, the RS President did not support the secession of this territorial entity from the rest of BiH. On the contrary, in the early 1990s, Dodik distinguished himself as a supporter of the Euro-Atlantic orientation of the country (Samorukov 2016).

On the other hand, one cannot take this threat, which is fed by the Kremlin's attitude, lightly. A situation from November 2021 clearly illustrates it: at that time, Dodik expressed the notion that his government would create its own state authorities on the territory of RS, which would, de facto, lead to the secession of RS. The new High Representative for BiH, Christian Schmidt, addressed the affair and warned in his letter to the UN against escalating the situation (Ruge 2021). According to one of the respondents, the matter of secession of the territory is the main obstacle to the country's accession to the Euro-Atlantic integration structures. As long as there are constant demands for secession, Bosnia has a big problem because a state without territorial integrity can hardly join the European Union (...). Ukraine provides clear evidence of how this works (Interview No. 4 with an NGO worker 2021). Fostering these secessionist tendencies allows Russia to ensure that Bosnia does not become a member of the European Union or NATO, which is crucial for the Kremlin.

In addition to Serbian territorial claims, the Kremlin also supports the Croatian ethnic group. In this regard, the vital person for Russia is Dragan Čović, one of the three members of the BiH Presidency, representing the Croatian Democratic Union (HDZ). Čović does not hide that he would establish a Croatian territorial entity within BiH and supports changing the entire electoral law. The Russian Ambassador, Petr Ivantsov, has repeatedly expressed his opinion on BiH, arguing that BiH should not join Euro-Atlantic integration structures. The relationship between Čović and the Kremlin is rather pragmatic. Moscow is aware that it shares many economic interests with Bosnian Croats, especially in the energy sector (Salvo and de Leon 2018).

Apart from secessionist tendencies that directly threaten the political stability of BiH, Milorad Dodik furthermore undermines the functioning of civil society in RS. Following Russia's example, Dodik has proposed to label all foreign-based non-governmental organisations (NGOs) with the term 'secret agents'. By doing so, the RS government could effectively control the funding of the non-profit sector on its territory (Stronski and Himes 2019). This policy can also be interpreted as an attempt to destabilise the country. Moreover, it is evident that he drew inspiration from Russia in this case.

In addition to these activities, Russia also tries to destabilise BiH on the international scene politically. It does so by supporting RS in international politics. A prime example is the Kremlin's attitude towards replacing the High Representative for BiH. After 12 long years, the current High Representative, Valentin Inzko, was replaced by the German candidate Christian Schmidt in 2021. However, Russia questioned his legitimacy, arguing that Christian Schmidt had not been approved by all members of the UN Security Council (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo). Our respondent commented: 'Christian Schmidt is not, in my opinion, problematic as a person. The problem is the presence of the High Representative in BiH. That is what the politicians in RS, who talk about having their future in their own hands and not needing anyone to control their decisions, object to' (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo 2021). In July, Russia, together with China, tried to close the entire Office of the High Representative. However, this proposal was not supported by the other members of the Security Council UN, and it was rejected (United Nations 2021). It occurred even though Russian Foreign Minister, Sergey Lavrov, had tried to convince the French Foreign Minister in a telephone conversation to support it (Ministry of Foreign Affairs of the Russian Federation 2021). One of the respondents pointed out to the authors that 'Bosnian Foreign Minister Bisera Turkovic suddenly appeared at this UN meeting and had this interesting verbal exchange with the Russian ambassador to the Security Council' (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo 2021). This underlines how vital this matter is for the Bosnian government and that Russian influence is seen as a worrying factor in destabilising the domestic situation in BiH.

Russia's support of RS has paid off on the international scene, as reflected in its votes at the UN or on issues of international politics. When Russia annexed the Ukrainian Crimean Peninsula in 2014, BiH was one of the few countries that did not impose sanctions on Russia (Interview No. 2 with a diplomatic official sent by an EU country to Sarajevo 2021). BiH also did not support a resolution condemning this act. The other countries that did not support it were Serbia, Belarus, and North Macedonia. The issue of Russia's growing political influence in BiH has significantly complicated the entire Euro-integration process. One respondent expressed the view that the EU was concerned about the growing impact of the Kremlin in the Western Balkans, especially in BiH, and the fact that it more-or-less halted the integration process (Interview No. 4 with an NGO worker 2021). In this respect, Ivo Komšić adds that Milorad Dodik is the main reason for slowing down the accession negotiations with the EU. According to him, Dodik tries to sever ties with the West and push for closer cooperation with Russia. In doing so, he has repeatedly used the Russian narratives. Recently, according to Komšić, he declared that today's Germany is a neo-Nazi country (Interview No. 1 with Prof. Ivo Komšić 2021).

In addition to political influence, Moscow primary focuses on deepening BiH's energy dependence. Namely, on two commodities, oil and gas. The Kremlin concentrates most of its economic activities in RS, mainly in the energy sector[6]. This economic segment is frequently targeted by hybrid attacks, as was pointed out by Rühle and Grubliauskas (2015), using the Ukraine crisis as an example. Russia became more involved in the energy sector in BiH in 2007, when Neftegazinkor bought Rafinerija Nafte Brod under highly unusual circumstances, as the actual price of the company was much higher than what Neftegazinkor subsequently paid (Center for the Study of Democracy – CSD 2018: 9).

However, the dependence on Russian gas supplies is more important in terms of the hybrid threat, as it poses several undesirable complications, given that each of the two entities can pursue its own energy policy. BiH depends solely on Russian gas supplies. RS exercised its right in 2014 when the head of Gazprom met with Milorad Dodik. At this meeting, the company's new supplies of Russian gas were agreed upon. However, the RS President had not communicated his intention to the central government, which led to gas supply shortages in the entire federation because both entities share only one supply centre (Center for the Study of Democracy – CSD 2018: 5-7).

The Kremlin applies a different standard to the central government of Sarajevo. At the end of 2017, BH Gas, whose headquarters are located in the Federation of BiH, had to pay Gazprom a debt that amounted to more than $ 25 million (Center for the Study of Democracy – CSD 2018: 7). Moscow is aware that all attempts to diversify gas

[6] More than 40% of the money earned flows back to Russia (Center for the Study of Democracy – CSD 2018: 2).

supplies have failed. Partly because both entities are unwilling to admit other solutions – for example, the completion of the South Stream pipeline – and partly because the Kremlin is reluctant to diversify gas supplies to BiH. On the other hand, it is worth mentioning that plans exist to diversify gas supplies within BiH. However, they depend on the political representation of both territorial entities to be willing to reach an agreement; see, for example, the BH Gas plan (BH-Gas 2018).

The reality of the hybrid threat was demonstrated in December 2020, when Russia halved the BiH's natural gas supplies. In January 2021, Gazprom announced that it would again supply gas through the TurkStream pipeline (Čančar 2021). By the way, cutting gas supplies is nothing new for BiH. Already in 2009, BiH lost half of its natural gas supplies due to disagreements between Russia and Ukraine (Center for the Study of Democracy – CSD 2018: 5).

Russian proxies in BiH

In addition to direct political activities, Russia uses proxies to strengthen its influence. These groups often promote radical nationalist opinions, which, generally speaking, are certainly not conducive to the BiH political stability. Cultural proximity plays a crucial role for such organisations. Indeed, the Kremlin stresses the common Slavic roots of Serbs and Russians. In particular, there are two organisations openly favoured by the Kremlin: Serbian Honour – and its offshoot, St. George of Loncari. Both organisations deny war crimes committed by the Serbs during the 1990s war (Turcalo 2021), which is highly controversial.

Nevertheless, not just words but actions confirm the alliance between these radical nationalist organisations and the Kremlin. Moscow funds the Russian Humanitarian Centre operating in Bosnia, which is based in the Serbian city of Niš. This centre provides military training for members of these organisations (Turcalo 2021). Dodik wanted to mobilise members of the Serbian Honour organisation if violence broke out during the 2018 parliamentary elections (Salvo and de Leon 2018) and still maintains excellent personal relations with some members of the Serbian Honour. Allegedly, the group contains approximately 40,000 members (Brkan and Grdinić eds. 2020: 12).

In their analysis, Bajrović and his colleagues point to the military aspect of the cooperation between the RS and the Kremlin. According to their study, Russia has armed the RS with thousands of anti-aircraft missiles and firearms since 2014. However, Dodik has long denied any military cooperation with Russia (Bajrović and Kraemer eds. 2018). Professor Komšić's statement that the Kremlin should not arm either side of the conflict as per the Dayton Peace Agreement also indicates Moscow's military influence. Nevertheless, practice shows otherwise. Russia provides weapons to the Serbs in RS. Moreover, it does not demand any payments for them in return (Interview No. 1 with Prof. Ivo Komšić 2021). These Russian actions can be seen as a significant destabilising element in BiH. Should the conflict arise, one can easily assume that Moscow would continue to support this territorial entity, just as it did in the eastern Ukraine war, supporting pro-Russian separatists with its equipment.

In this respect, Konstantin Malofeev, responsible for the largest Orthodox charity in Russia and many projects in Bosnia and the entire Balkan Peninsula, is a key player in the Russian government[7]. For example, during the Easter holidays in 2015, he organised a pilgrimage carrying the Easter bonfire. The bonfire reached the RS, among others (Stronski and Himes 2019). In organising such an event, one can identify a significant feature of Russian influence in the region. Russia tries to reach out to culturally related peoples using traditional Christian values. Currently, Malofeev is banned from entering the territory of the Federation of BiH (Brkan and Grdinić eds. 2020: 13).

In addition to supporting nationalist tendencies, Russia also uses its compatriots to destabilise BiH. It relies mainly on a motorcycle organisation called Night Wolves and the Cossack cultural group. According to Stronski and Himes, these organisations operate independently, but there is financial support from the Russian government behind the scenes. For example, the Kremlin has provided over US$ 40,000 for the Night Wolves' tour of the Balkans (Stronski and Himes 2019). In 2014, a dance troupe of Russian Cossacks performed before the 2014 parliamentary elections. However, many people were under the impression that the dancers were part of a paramilitary force. There is, in fact, a paramilitary group called the Serbian Veterans, funded by the Dodik government, that cooperates with the Russian veterans' organisation Russian Heirs of Victory (Bajrović and Kraemer eds. 2018). One respondent expressed his view that BiH faces an extreme nationalism problem, and the Bosnian government must deal with it. 'The difficult aspect is that these currents of opinion are promoted by Russia, making the situation even more difficult' (Interview No. 3 with a Bosnian politician 2021). According to this interviewee, the Kremlin's influence in this area is so apparent that it is almost impossible to deal with it.

Night Wolves visited BiH in the relatively recent past, namely, in the spring of 2018, when they visited Banja Luka on their tour of the Balkans to demonstrate the friendship between the Serbs and Russians. Nevertheless, this visit was discussed as an act with strong political undertones, as the central government in Sarajevo was aware of the close ties of these people to the Kremlin (Higgins 2018). The fact that some of its members have been involved in the fighting in eastern Ukraine shows the extent of the Kremlin's ties to this motorcycle group. Among others, the chairman of the Balkan branch of this organisation, Saša Savić, participated in this conflict (Brkan and Grdinić eds. 2020: 12). Exactly one year later, in the spring of 2019, researchers from the Balkan Investigative and Research Network published a report accusing Goran Tadić, a high-ranking member of this organisation (the vice-chairman of this association in BiH), of having won a contract for his own company to build a small hydroelectric power plant for almost 1.5 million euros. However, Tadić's company had no experience with such a project. The case has fuelled speculations that his company won the contract due to favouritism (Brezar 2019). What is disturbing about these Moscow-backed groups is their value base. These groups are radically nationalistic, threatening to destabilise the entire country. In fact, Turcalo (2021) highlights this concern in his text. These groups have been active in RS since their establishment in 2014, and they share extreme nationalism, ties to the Serbian Orthodox Church and, last but not least, funding from an external actor (Russia) (Bajrović and Kraemer eds. 2018).

[7] Konstantin Malofeev is a powerful Russian oligarch, who has close ties to the Kremlin. He is the chairman of the Board of Directors of the media group Tsargrad and he is a zealous Russian Orthodox Christian and mainly a strong advocate of the Russian monarchy before 1917. Malofeev is also called an 'Orthodox oligarch' (Solik and Baar 2019: 30).

In addition to the radical nationalist groups, Russia relies on the support of its Orthodox Church in the region. This aspect is powerful, considering that one-third of the BiH population is Orthodox Christian (Brkan and Grdinić eds. 2020: 11). The Kremlin utilises this instrument to strengthen the 'brotherly bond' between Orthodox Serbs and Russians. In the recent past, a series of construction projects have been organised under the auspices of the Russian Orthodox Church. In 2018, a new church and a Russian Cultural Centre were opened in Banja Luka. The opening ceremony in September 2018 was attended by both Dodik and Russian Ambassador Ivantsov (Bechev 2019: 22). Besides this project, the Russian Orthodox Church is also involved in smaller projects focusing on constructing new churches, meeting members of the Orthodox Church, etc. Russia was pushing for a statue of Tsar Nicholas II to be placed in the RS and financially supported a construction of this statue in 2017 (Brkan and Grdinić eds. 2020: 11). The strengthening of relations in the religious sphere further intensified after recognising the autocephaly of the Orthodox Church of Ukraine by the Patriarch of the Church of Constantinople. The Russian Orthodox Church was angered by this act and severed relations with Constantinople. The leading proponent of the Russian position, in this respect, is the Serbian Orthodox Church, which faces similar attempts from the Orthodox Churches in North Macedonia and Montenegro, both of which demand recognition of complete independence from the Serbian Patriarchate.

Conclusions

After the annexation of Crimea, Russia has been repeatedly mentioned in connection with hybrid warfare or hybrid warfare strategy. However, this concept is often mistakenly confused with other related terms, such as hybrid threat and political warfare. The authors focused on hybrid threats in the Western Balkans, particularly in BiH. The research provided a comprehensive analysis of the Russian hybrid threats in BiH; this topic has not been covered by scholars until now. The present study may contribute to the understanding of how Russia constructs its hybrid threats and may also lead to further research on hybrid threats in the Western Balkans. Russia has become increasingly engaged in the region after 2014, and BiH is no exception. By analysing the interviews, primary and secondary sources, the authors were able to identify hybrid threats concentrating in five key areas of increased Russian activities. The most potent hybrid threat is undoubtedly the Kremlin's political influence, as it affects the territorial integrity of the entire state. Russia's political actions support the secessionist tendencies of political leaders of various ethnic groups in BiH. The closest connection exists between Vladimir Putin and Milorad Dodik of the RS. The two politicians visit each other frequently, and the Kremlin supports Dodik, both financially and politically (through specific political actions), such as Moscow's attempts to abolish the Office of the High Representative for BiH, currently headed by Christian Schmidt, or its support for holding referendums in the RS.

Moreover, the Kremlin supports the secessionist efforts of Dragan Čović, who represents the Croats inside the federation. Moscow's perspective is pragmatic because Russia is linked to the Bosnian Croats by economic interests and may fuel further internal political rifts by supporting their territorial claims. These efforts aid Russia on the international scene, as evidenced in the case of the war in eastern Ukraine, where the Serbian entity has effectively blocked all efforts to adopt a tougher position towards Moscow. Disagreements between the various ethnic groups also affect the question of the country's accession to the Euro-Atlantic integration structures. It is clear that Russia poses a threat to BiH in terms of economic influence, mainly because of its over-dependence on Russian natural gas supplies. Russia can exploit this fact to further its political objectives. Similarly, Russia often employs proxy organisations to destabilise the state. They usually consist of radical nationalist paramilitary groups, primarily concentrated in the RS entity; the Kremlin helps train the members of these organisations and equips the RS with military material. Nationalism constitutes a significant destabilisation factor in BiH, partly because the Kremlin exploits the information environment for its own purposes. It uses its media, particularly Sputnik Srbija, to spread pro-Russian narratives. These disinformation campaigns primarily seek to influence public opinion to prevent BiH citizens from supporting Euro-Atlantic integration. However, according to one respondent, it appears that the majority of the population wants BiH to join the European Union eventually. Another critical topic addressed by the disinformation websites is the incitement of nationalist tendencies that could significantly affect the territorial integrity of BiH.

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The Geopolitical Power of EU in the Making (?): A Question of the War in Ukraine

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Abstract: *This paper looks at the way the European Union has shifted its policymaking process to adapt to the crisis situation in Ukraine and how this serves the EU's goal of increasing its geopolitical power, becoming a global geopolitical actor. Looking at the specific geopolitical dimensions, the paper argues that the EU has upgraded its geopolitical posture, through cohesive policies taken against the aggressor. Following close monitoring of the EU working sessions and the flow of news, and considering focused interviews on the future of the EU, given the current events, this research brings forth two main scenarios for the EU, commenting on the potential risks for the bloc's unity considering the Russian aggression in Ukraine and beyond.*

Keywords: *geopolitical dimensions, EU cohesion, Russian threat.*

Introduction

The current European Commission has called for a stronger, geopolitical European Union (EU) in the world since its very first day in office, in December 2019. The challenges of the global pandemic have set the foundation for a better coordination among the member states, while also testing the boundaries of cooperation and therefore the limits of EU resilience. However, since 24 February 2022, when the current war in Ukraine started, it seems that the EU has intensified its cooperation in key areas, tackling essential issues for the Union's development, as well as important elements meant to deter Russia from advancing its influence into Europe.

It is important that the key elements increasing EU's geopolitical power be examined separately, even if they are converging. This way, we would have a framework for understanding how the EU policymaking is contributing to the strategic goal that the European Commission has announced. Perhaps more importantly, while current events in Ukraine seem to be of utmost importance for the way the global powers will position themselves in the near future, by monitoring the specific dimensions bringing forth the geopolitical power and the subsequent policymaking directions, we can understand the specific risks that the EU encounters in fulfilling its strategy.

1. Literature review

The investigation of how current events are impacting EU policy requires an in-depth reading and monitoring exercise of the works of most prominent European think tanks and media. While most think tanks have organised online events, so far

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there are only a few investigative scientific reports written on the topic, given the still limited amount of time passed since 24 February[2]. However, there are several articles and reports pointing to the potential changes in the EU policymaking as a result of the events in Ukraine. Dylan Macchiarini Crosson from the Centre for European Policy Studies highlights that the EU seemed to have decided on a sort of Defence Union of action when the Council of the EU approved €450 million to Ukraine for (lethal) military materiel and a further €50 million for fuel and protective equipment[3]. Pierre Mirel from Robert Schumann Foundation has written about the effect and the future challenges that the current war in Ukraine might have on the Eastern Partnership[4], the EU's strategy and policymaking tool in relation to its Eastern neighbourhood. At the same time, Francis Ghiles from Barcelona Centre for International Affairs noted[5] that the EU is likely to change its energy strategy, considering the Union's dependency on Russian natural gas and the German *realpolitik* switch in March 2022. Pinar Aktimar from the Turkish Sabanci Business School and Nienke van Heukelingen from the Dutch think tank Clingendael have pointed out, in the research report they have coordinated and published recently[6], that the current war in Ukraine will significantly change the EU's strategy to Turkey and North Africa. Other think tanks and academic institutions have organized debates on the way the war in Ukraine is changing the priorities for the EU. Monika Grzegorczyk and her colleagues at Bruegel have pointed out some of the effects[7] that the current events may have over future trade policies conducted by the EU together with the US, considering the recent sanctions the West has imposed on Russia. All in all, there is already a lot of consideration given to the way the EU will change its approach to the world and adapt its strategy and policymaking tools to the new reality emerging from the war in Ukraine.

2. Methodology

To offer a good review and analytical interpretation for the major trends for the future EU policymaking, this article considers several foundational works on geopolitics. First, because economic warfare is being fought along with the military warfare, this paper used the analytical framework presented by Robert D. Blackwill and Jennifer M. Harris in their book "War by Other Means" published in 2016[8]. At the same time, the methodology has relied upon the geopolitical analysis framework

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[2] The article was developed between March and April 2022 and was last updated on the 6 May 2022.

[3] Macchiarini, C., "The European Peace Facility", Centre for European Policy Studies, 7 March 2022, available at https://www.ceps.eu/the-european-peace-facility/ (accessed 28 March 2022).

[4] Mirel, P., "The Eastern Partnership: Between Resilience and Interference", Robert Schuman Foundation, European Issues no. 589, 31 March 2021, available at https://www.robert-schuman.eu/en/doc/questions-d-europe/qe-589-en.pdf (accessed 2 April 2022).

[5] Ghilès, F., "War in Ukraine and the Gas Crisis Force a Rethink of EU Foreign Policy", CIDOB notes internacionals no. 268. March 2022, available at https://www.cidob.org/en/content/download/80563/2593924/version/11/file/268_FRANCIS%20GHILES_ANG.pdf (accessed on 26 March 2022).

[6] Akpınar, P. et al., "A New Formula for Collaboration: Turkey, the EU & North Africa", Sabanci University, Clingendael Institute, March 2022, available at https://www.clingendael.org/sites/default/files/2022-03/Report_New_formula_for_collaboration_Turkey_EU_NorthAfrica.pdf (accessed 27 March 2022).

[7] Grzegorczyk, M. et al., "The Decoupling of Russia: High-Tech Goods and Components", Bruegel, 28 March 2022, available at https://www.bruegel.org/2022/03/the-decoupling-of-russia-high-tech-goods-and-components/ (accessed 28 March 2022).

[8] Blackwill, R. and Harris, J. *War by Other Means*, Belknap Harvard University Press, 2016.

reviewed and presented by the author in her latest book "Contemporary Geopolitics and Geoeconomics 2.0" along with the method provided by Jonathan S. Lockwood in his textbook for predictive analysis[9].

To validate results and look into the nuances of what may change after the war in Ukraine, the paper also relies on individual, focus interviews with foreign policy and security experts from the EU and its Eastern neighbourhood. The results of the interviews are discussed in the fourth section of the article, which focuses on the scenarios and potential risks for the EU. Given the complex situation in the borderlands, the author could not get permission to disclose identities and answers from most experts living in the proximity of the war in Ukraine. Most of the times, honest answers were conditioned by anonymity. However, this may be perceived as a limit of the current paper as it lacks the details of the interviews conducted. Nevertheless, while the author hopes to address and correct in future research on the topic, the paper provides a good grasp of the major challenges that the EU and its borderlands confront with, making it possible for scenarios to be developed under current circumstances, precisely because honesty could be preserved.

The conclusion of this paper is founded on a qualitative analysis of current events viewed through official public releases of the EU institutions and member states, and specific literature available, as well as on the processed expert interviews. The scenarios developed within the proposed analytical framework need to be adjusted according to the way the conflict in Ukraine evolves.

3. The geopolitical dimensions

There are several elements that need to be considered when we talk about the EU (or any other polity) as a geopolitical global actor. First, there is the economic power – which for the EU is essential, considering the Union has the largest integrated market in the world. Second, there is the political dimension which has been considered to be a building block, taking into account the "soft power" approach that Brussels has developed over the years and the constructivist views which have called for a slowly growing political role of the EU at the international level. The third is the military dimension, which has only recently become a subject of debate within the EU, considering Brexit and the need for a resilient Union in terms of security.

All three dimensions have been underlined since the European Commission announced in December 2019 that it would work for the EU to become a geopolitical actor of global importance. But the war in Ukraine really brought them forward as the EU needed to adapt to geopolitical events unfolding in its Eastern neighbourhood.

3.1. The existing geopolitical dimension: the economy

The EU has employed its economic power in taking its first policymaking decisions with regards to the war in Ukraine. The member states have agreed upon implementing new economic sanctions, on top of those imposed since 2014[10]. As the

[9] Lockwood, J., The Lockwood Analytical Method for Prediction, Bloomsbury Publishing, 2013.

[10] Eur-Lex, "EU measures in solidarity with Ukraine", last updated on 28 March 2022, available at https://eur-lex.europa.eu/content/news/eu-measures-solidarity-ukraine.html (accessed 3 April 2022).

war continues, new sanctions are discussed[11] and with that, economic policymaking has taken priority over other areas. Considering the energy sector is key when it comes to the EU-Russia co-dependence, the European Commission has put forward[12] a legislative proposal requiring that the underground gas storage across the EU to be filled up to at least 80% until the end of 2022 and 90% of its capacity by 1 October each year going forward[13]. At the same time, considering the growing energy prices, the Commission adopted a State aid Temporary Crisis Framework which allows states to further ease the economic burden for both industrial and household consumers[14]. In parallel, the European Commission has not lost focus on pushing forward its green transition goal, by signing grant agreements of €1.1 billion for seven large-scale projects via the EU Innovation Fund[15]. While gas dependencies are high for most countries in the EU, the Commission hopes to get member states to agree on placing an oil embargo on Russia. The EU envoys have been discussing ways to give the countries most affected by such sanctions (Hungary, Slovakia, and the Czech Republic) time to adapt and help them upgrade their refineries, so that they are able to process oil from other sources. Such a decision – if agreed upon – would delay their exit from Russian oil to 2024, according to recent reports in the media[16].

All these decisions, as well as the discussions over sanctions and all economic retaliation measures against Russian aggression have been adopted in an unprecedentedly short timeframe. Not only that the head of the European Commission has been in close contact with the Ukrainian leadership, but the EU has also coordinated and maintained close communication with the American and British counterparts. Built upon the existing premises for cooperation, the crisis decision-making enhanced the transatlantic alliance, while also making the EU more cohesive, enhancing both its political and economic power at the global level. The EU-China summit at the beginning of April[17] has only confirmed the EU position on global affairs: the bloc has made use of its political coordination for the first time since the Union has expanded Eastwards.

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[11] Zinets, N., "Germany says West agree more sanctions on Russia after Bucha killings", Reuters, 3 April 2022, available at https://www.reuters.com/world/europe/ukraine-demands-new-russia-sanctions-over-massacre-2022-04-03/ (accessed 4 April 2022).

[12] European Commission, "REPowerEU: Joint European action for more affordable, secure and sustainable energy", 8 March 2022, available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1511 (accessed 12 March 2022).

[13] European Commission, "Commission outlines options to mitigate high energy prices with common gas purchases and minimum gas storage obligations", 23 March 2022, available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1936 (accessed 27 March 2022).

[14] European Commission, "State aid: Commission adopts Temporary Crisis Framework to support the economy in context of Russia's invasion of Ukraine", 23 March 2022, available at https://ec.europa.eu/commission/presscorner/detail/en/statement_22_1949 (accessed 27 March 2022).

[15] European Commission, "Commission awards over €1 billion to innovative projects for the EU climate transition", 1 April 2022, available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_2163 (accessed 2 April 2022).

[16] Guarascio, F. and Emott., R., "EU tweeks Russian oil sanctions plan in bid to win over reluctant states – sources", Reuters, 6 May 2022, available at https://www.reuters.com/world/europe/eu-tweaks-russia-oil-sanctions-plan-bid-win-over-reluctant-states-source-2022-05-06/ (accessed 6 May 2022).

[17] European Commission, "EU-China Summit: Restoring peace and stability in Ukraine is a shared responsibility", 1 April 2022, available at https://ec.europa.eu/commission/presscorner/detail/en/ip_22_2214 (accessed 2 April 2022).

3.2. Building the political and military geopolitical dimensions

The EU political power increased on the background of the current crisis, as there was more mentioning and underlying of the EU's common voice and decisions, especially in what concerns economic policymaking advances. While the EU has condemned the war in Ukraine, not all EU member states have shared a common vision on what caused the war or on how to tackle the war politically.

The most visible outlier is Hungary, where Prime Minister Viktor Orbán has supported a neutral position for his country with regards to Russia, even if Hungary did not veto the sanctions against Russia. However, considering Hungary was in the midst of an electoral campaign throughout the month of March, it remains to be seen whether its position stays the same or if it changes as the war evolves. Most governments in the EU have remained silent on congratulating Viktor Orbán for another win and the media has even reported that a hold on EU funding may be on the table if the Hungarian government continues to keep good ties with Moscow while the EU is talking increasing sanctions.

At the time of writing, considering expert opinions taken during the interviews, the political consensus within the EU will be determined by the pressure that the anti-Russian states are able to project onto the rest of the EU member states. If the Union's common stance does not determine Hungary to reconsider its position in the first weeks/months after Orbán's re-election, it is likely that the bloc's political power remains fragile. It may be that Hungary will be joined by other countries which are not feeling the threat of war as most of the Eastern Europeans do.

Moreover, as further sanctions will cut into the economic welfare of the European member states, the fragility of the EU political power will be further exposed. The political coordination within the EU depends on the economic stability. Some of the war repercussions relate to increased prices to energy and food alike, since both Ukraine and Russia are major grain exporters. Under these conditions, keeping the momentum in implementing economic policymaking that keeps inflation and unemployment at bearable levels is a key element for EU decision-makers. If states begin to face socio-economic instability caused by the effects of sanctioning Russia, it is unlikely that they will stick together to endorse further sanctions or anything else that could cut into their overall stability. Populist parties will likely exploit such socio-economic instability and their campaigning – which at times comes in direct opposition to EU political coordination – may further weaken the Union. Not to mention that many of the populist movements in Europe are supported directly or indirectly by Russia who has heightened its own campaigning, or better said propaganda, within the EU.

If economic policymaking doesn't keep the momentum, and political coordination becomes hard to achieve among the EU member states, it is likely that plans for common EU defence and security will suffer as well. The EU military power is currently non-existent, but plans about building it are increasingly being discussed. The Europeans are currently dependent on NATO when it comes to defence. NATO has been so far strengthened since the war in Ukraine has started. Not only that it has a common voice, but it has also made decisions to consolidate the Eastern Flank[18], and talks of more coordination are ongoing.

At the same time, discussions about the EU Strategic Compass, the foundation for building the EU security arm, now include the Russian threat[19]. Concomitantly, similar and simultaneous talks are being held within NATO considering the current discussions regarding the 2030 Strategic Concept. In practical matters, the EU has also increased its peacekeeping troops in Bosnia Herzegovina, since a potential political crisis may incur the risk of renewed conflict in the region[20]. The decision was adopted based on the European External Action Service proposal and political discussions on the matter, showing coordination at both the high-level strategic communication and at the tactical level.

Most importantly, the adoption of the Strategic Compass shows that the EU is taking meaningful steps towards establishing the policymaking framework that would fall under the security and defence area of the EU – enhancing the military dimension of the Union. First, the EU is considering three levels: the global level, the regional level and that referring to threats against the EU. The global level considers the main elements that the EU needs to tackle, such as the slowdown of globalization, which is supporting growing economic and political rivalry between global powers, along with climate change which is driving the competition for resources, instrumentalization of irregular migration, and other threats to the multilateral system. The regional level deals with the traditional military threats and armed aggression, but also with the destabilizing interference/actions of state and non-state actors which eventually lead to conflict, state fragility, and inter-state tensions due to external influences. Ultimately, the EU considers the threats against its own existence to be related to the fact that state and non-state actors are targeting the EU with hybrid tools, including the misuse of disruptive technologies, cyber-attacks, disinformation, and other nonmilitary sources of malign influence, and terrorism[21]. The list indicates that the Strategic Compass, while referring to security and defence, will be supported by the multidimensional EU policymaking toolkit. Economic policymaking along with political build-up will need to go hand in hand in order for the EU to find common approaches to fight back the destabilizing interference of external forces for instance, not to mention hybrid threats.

4. Scenarios and potential risks for the EU

Considering the war in Ukraine, its effects on the EU policymaking agenda, and ultimately, the EU's goal of becoming a global geopolitical actor, we can identify potential scenarios regarding EU's action, based on an analysis of the interconnection between the three geopolitical dimensions: the economic, the political and the military aspects presented above. A set of four main questions were selected for focused

[18] NATO Shape, "NATO Allies Reinforcements to the Eastern Flank", 13 March 2022, available at https://shape.nato.int/news-archive/2022/nato-allies-send-reinforcements-to-the-eastern-flank (accessed 22 March 2022).

[19] European External Action Service, "The Strategic Compass factsheet", 21 March 2022, available at https://www.eeas.europa.eu/sites/default/files/documents/2022-03-21_strategic_compass-factsheet.pdf (accessed on 3 April 2022).

[20] European External Action Service, "Press release on J. Borell visit in the Balkans", 22 March 2022, available at https://www.eeas.europa.eu/eeas/hrvp-josep-borrell-western-balkans-your-future-our-future_en (accessed on 4 April 2022).

[21] European External Action Service, "The Strategic Compass factsheet", 21 March 2022, available at https://www.eeas.europa.eu/sites/default/files/documents/2022-03-21_strategic_compass-factsheet.pdf (accessed on 28 March 2022).

interviews with foreign policy and security experts in order to establish main scenarios for how the EU will develop further, as well as the risks associated with the EU's major goal of becoming a global geopolitical power:

- Question 1: please comment on the way the EU has reacted to the Russian war in Ukraine.
- Question 2: what are the main challenges you perceive for the EU that are directly linked with the Russian attack in Ukraine? What about the opportunities that the EU has?
- Question 3: which of the three geopolitical dimensions (politics, economics and military) of the EU have been affected most and in what way?
- Question 4: what do you think will be the most important challenge the EU will face in the next months, considering the Russian war in Ukraine? Do you have a scenario for the EU following the crisis and considering the challenge you have mentioned?

The interviews were conducted with experts from Belgium, France, Germany, Hungary, Italy, Poland, Romania, Republic of Moldova, Ukraine, and Georgia. Conversations were held in an informal manner[22] and the information provided was qualitatively assessed. All interviewees have pointed out that the EU has acted in a coordinated manner to respond to the war in Ukraine. At the same time, all have highlighted the Russian threat as being the most important for the EU in the coming months, although they listed challenges regarding the EU economic security and political stability as well. Their views on the EU vulnerabilities when it comes to the Russian threat are diverse: they view Russia as a threat considering its economic and political penetration into the EU, as well as its use of sophisticated propaganda and hybrid warfare to support its strategy. At the same time, while most experts have pointed out that the EU has an opportunity to increase its influence in the EU neighbourhood, none of the experts believe that the EU will further expand, despite the hopes that Ukraine, Republic of Moldova and Georgia currently share. In turn, most of them have stressed the fact that the EU will likely have to address a potential socio-economic crisis in the Western Balkans, considering the weak statehood of the countries in the region, and the degree to which Russia is able to influence the regional politics. At the same time, the major problem that the experts believe the EU will have to confront refers to the economic consequences of the global pandemic, coupled with the repercussions of the Western sanctions on Russian economy.

The majority of the interviewees consider that, in case the West decides to further limit Russian energy into Europe or if Russia will further retaliate by cutting natural gas flows into the EU, the bloc's member states will find themselves into a difficult position: they will essentially have to establish priorities for their national economies, something that will further weaken their socio-economic stability and, overall will drive political instability. Moreover, the experts have insisted on the timeframe: the longer the military attacks continue in Ukraine, the easier it is for the EU to maintain

[22] All interviews were one-on-one. Most of the experts – all those living in the EU's neighbourhood countries have conditioned their answered on confidential terms on their identity and our conversation, quoting unstable and uncertain conditions for their safety given that the conflict was (and is) undergoing at the time of writing. The summary of findings is based on notes taken by the author which were validated with the experts at the end of each interview.

coordination. If Russia changes tactics and instead decides to use its knowledge about the EU's political and economic system, increasing the already heightened political warfare against the West, the EU will find it more difficult to maintain unity. This reality would result from the fact that Russia will further intensify propaganda at a time when the economic repercussions of the sanctions will start to be felt by ordinary citizens, which may further drive an increase in populist waves and generally, a disconnect between the EU member states.

Therefore, based on the expert interviews and the realities resulted from monitoring the shifts and accelerated decisions in the EU policymaking, two major scenarios take shape. The first one builds on the assumption that the Russian threat in the EU's neighbourhood will continue to grow, maintaining the EU's position united against Russia, despite the economic repercussions of the current package of Western sanctions.

The second scenario is a lot different: it builds on the assumption that Russia will pause its military attacks, leaving time to the EU member states to experience the economic fallout of the sanctions, and, coupled with the already vocal outliers, this will lead to a period of weakening of the EU's stance, not only tempering its policymaking ambitions but also its unity. Ultimately, in this scenario, the EU's potential growth into a geopolitical power, considering all three dimensions geopolitics cover will be significantly impacted. The two scenarios were mentioned by all experts, pointing to the Ukrainian war as a moment of either full unification and build-up for the EU, or, on the contrary, a moment that has the potential to shake its unity.

Most of the experts insisted upon the way that the EU has evolved during the first month of the conflict, and the way Germany has changed its position towards Russia in such a short time despite foreseeable economic troubles[23], as well as the visibly increased role of the European External Action Service in contributing to the bloc's policymaking. Considering these elements, the experts highlighted that it is likely that the EU will strengthen its position as a consequence of the growing Russian threat.

All in all, considering the way that the military attack has evolved in Ukraine, Russia seemingly pausing its operations since the last week of March, it is likely that Moscow reorganizes its forces economically, as well. At the same time, taking into consideration the investigation over some of the Russian operations in Ukraine, of which the massacre in Bucha[24] is likely the most important to note, the West – the EU in particular – has kept united against what it perceived to be horrific acts of war conducted by Russia. As long as Russian military aggression in Ukraine continues and mounts in aggressivity levels, it is likely that the Europeans remain coordinated.

Therefore, the optimistic scenario of the EU member states' continued coordination of their efforts in containing Russia and, by doing so, increasing the EU's geopolitical dimensions (economics, politics and military/security capabilities), is dependent on the Europeans experiencing the repercussions of the war. As soon as

[23] Boutelet, C. "Avec la guerre en Ukraine, l'Allemagne est obligée de repenser son modèle économique" [With the war in Ukraine, Germany is obligated to rethink its economic model], Le Monde, 7 April 2022, available at https://www.lemonde.fr/economie/article/2022/04/07/avec-la-guerre-en-ukraine-l-allemagne-est-forcee-de-repenser-son-modele-economique_6120955_3234.html (accessed 8 April 2022).

[24] BBC Reality Check and BBC Monitoring Service, "Bucha killings: Satellite image of bodies site contradicts Russian claims", last updated on 11 April 2022, available at https://www.bbc.com/news/60981238 (accessed 6 May 2022).

such repercussions cut into the European stability, the EU will get closer to the less optimistic scenario, where political coordination will get increasingly difficult.

Conclusions

The war in Ukraine has increased the EU common awareness about the growing threat of Russia in its neighbourhood. During the first two months, the EU appears to have strengthened its position through accelerated policymaking in response to the Russian aggression, as well as to the potential crisis that the Ukrainian war might bring in other regions, such as the Balkans. Even if for most this indicates that the EU is developing into a truly geopolitical power, the repercussions of the sanctions the EU collectively imposed against Russia may bring forth new challenges, considering the already existing political outliers in the Union (of which the most vocal and prominent is Hungary).

Depending on the way that the war will continue and on whether the EU keeps the current pace of advancing policies which would contribute towards enhancing the unity of the bloc's economic, political and military dimensions, we will be able to say whether the geopolitical power of the EU is further increasing or not. Considering the two scenarios laid out in this paper, the way things evolved during the first two months of the war is bringing positive prospects, if coordination among the EU member states continues, not only that the war in Ukraine will be won by the West, but the EU will increase its geopolitical might.

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Financial Literacy, Economic Development and Financial Development: A Cross-Country Analysis

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Abstract: *An adequate level of basic financial knowledge of the population contributes to achieving individual well-being, ensuring the stability of financial markets, and proper functioning of the economy. This paper aims to identify Romania's position on financial literacy indicators, compared to other European countries, and to investigate the link between financial literacy, economic development, and financial development at a cross-country level. The findings reveal that Romania has the lowest level of financial literacy, although its income per capita is not the lowest in the European Union (EU). The low financial inclusion in Romania is strongly linked to inadequate financial education. Moreover, the population underestimates the benefits of long-term savings. These results challenge Romanian policymakers to develop effective financial education tools and programs, aimed at increasing financial awareness and financial literacy of population.*

Keywords: *financial literacy, economic development, financial development, Romania, European Union.*

JEL classification: *G50, G53, I28.*

Introduction

In recent decades, the international financial markets have grown exponentially. Similarly, the access of population to financial products and services has significantly increased. In these conditions, the level of financial literacy of the population has become a concept of interest for the government strategies, policies, and individuals. The ability to understand financial information in everyday life and to draft financial plans for the future is indispensable for achieving an adequate level of individual well-being. It is also important for ensuring a proper functioning of financial markets and the economy as a whole. A proper understanding of basic financial concepts increases the ability of investing personal money and making financial choices regarding financial services, i.e.,

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savings, investments, loans and more.

In the literature, there are many definitions for financial literacy. In the first instance, it has been defined as the ability to use individual knowledge and skills for an efficient management of financial resources so that financial well-being is ensured (Knoll and Houts, 2012). Subsequently, more comprehensive definitions were developed. Buch (2018) defined financial literacy as an individual trait that reflects the ability of people to understand financial concepts, make sound financial decisions, and balance the risks and benefits of this decision-making process. The World Bank has extended the concept of financial literacy to financial capability. This includes the financial knowledge, but also the attitudes, skills, and behaviours of consumers regarding the understanding, selection, and use of financial services that suit their needs (World Bank, 2014).

In general, the costs and benefits associated with a low and, respectively, high level of financial literacy are well defined. Previous studies have revealed that inadequate financial knowledge generates significant costs for both individuals and financial markets. A detailed description of the benefits of financial literacy can be found in Lusardi and Mitchell (2014) and Hastings et al. (2013). Specifically, people who fail to understand the concept of interest compounding are inclined to spend more on bank charges and fees, get over-indebted, bear higher interest on loans, and face difficulties in repaying loans. In addition, poor knowledge leads to an underestimation of saving benefits, so that these people end up saving less money. Moreover, irrational exuberance could disrupt the stability of financial markets by accumulating excessive risks.

At the same time, financial literacy creates many opportunities. People with developed financial skills are able to make better financial plans for the future and to save for retirement. Investors with a greater level of financial knowledge are also more likely to diversify their risks and actively participate in the capital market. Financial literacy contributes to increased financial inclusion, as more literate consumers are more prone to access financial services. Moreover, existing studies have shown that understanding of financial concepts have a positive effect on the performance of national economies.

Considering the costs and benefits of financial literacy, measuring tools have become increasingly significant. Financial decision-making is based on the following key competencies: (i) numeracy skills (addition, subtraction, and multiplication) and compound interest rate literacy; (ii) understanding inflation and, implicitly, the difference between nominal and real values; and (iii) knowledge of the importance of risk diversification. Based on these hypotheses, Lusardi and Mitchell (2006) designed a standard set of questions, which are known in the literature as the "big three". Although Lusardi and Mitchell (2009) proposed an extended set of questions, those three became the standard for measuring financial literacy, being fielded in many financial literacy surveys.

In view of the importance of financial literacy, in this study we will analyse the level of understanding of the financial concepts in Romania, compared to other EU member states, but also with countries from Central, Eastern, and Southeastern Europe (CESEE). We will also investigate the relationship between financial literacy, economic development, and financial development in Romania, compared to other EU member states.

Literature review on financial literacy

The major role of financial literacy in everyday financial decisions have spurred an important body of research. Studies investigating financial literacy can be divided into two main groups. On the one hand, there are studies providing a comparative analysis of the financial literacy at the international level. On the other hand, there is vast research assessing the determinants of the basic financial knowledge level and its impact on distinct social and economic variables within selected economies.

The first group of studies refers to the financial literacy surveys conducted internationally (OeNB, 2021; OECD, 2020; Klapper et al., 2015). These studies highlight significant disparities in understanding of the basic financial concepts at the international level, but also within economies. According to the most extensive sample survey (Klapper et al., 2015), only one in three adults are financially literate worldwide. At the same time, both in developing economies and in countries with developed financial markets, women, the poor and insufficient educated respondents have less financial knowledge. Moreover, adults with bank accounts and/ or credit cards generally have greater financial knowledge, regardless of their income. These results suggest that the correlation between financial literacy and financial inclusion can work in two directions: high levels of financial understanding can increase financial inclusion, while having an account or using a credit card can deepen consumers' financial skills.

The OECD results (2020) are worrisome as well, revealing that individuals across the surveyed countries on average achieved under 61% of the maximum financial literacy score. Another important finding is that despite relatively high product awareness, less than half of the respondents used a financial service. The situation is also worrying in CESEE, with only one in five adults being considered financially literate (OeNB, 2021). The results also show that the low level of financial knowledge is characteristic for women, older, and lower educated people in these countries.

The second group of research focuses either on variables that influence the level of financial literacy, e.g., the level of economic development, the borrowing and saving behaviour of individuals, education, gender etc., or on the impact of financial literacy on social inclusion, inequality, poverty, well-being, and broader economic growth (Batsaikhan and Demertzis, 2018; Askar et al., 2020; Philippas and Avdoulas, 2019; Grohmann, 2017; Beckmann, 2013; Nițoi et al., 2022). The findings of Batsaikhan and Demertzis (2018) show a stronger link between financial literacy and the level of GDP per capita in developed economies than in developing ones. Additionally, more active interaction with financial institutions determines greater level of financial literacy. On the other hand, the study finds that higher financial literacy performance contributes to lower inequality, reduces poverty rate and social exclusion. The important role of understanding the financial concepts in reducing poverty is also revealed by Askar et al. (2020).

Philippas and Avdoulas (2019) investigate the effect of a series of demographic, socioeconomic, and financial variables on financial literacy and find that financial behaviour characteristics, namely, keeping a record of expenses, is associated with larger possibility of being financially literate. The positive link between financial literacy and borrowing or saving behaviour is also revealed in a number of other studies.

According to Grohmann (2017), financially literate people take improved financial decisions and are more likely to use a wider range of financial services. In the same vein, Beckmann (2013) shows that financially literate individuals, especially with regard to inflation, are more likely to save using more than one interest-bearing saving instrument. Landerretche and Martinez (2013) also confirm that better financial literacy is positively related to higher voluntary savings, while Klapper et al. (2013) shows how it leads to greater use of formal sources of borrowing. Moreover, lower levels of financial literacy are associated with higher-cost of borrowing (Disney and Gathergood, 2013; Lusardi and Tufano, 2015), reduced debt-to-income ratios, and household net worth (French and McKillop, 2016). Another important aspect investigated by Balasubramnian and Springer Sargent (2020) is the gap between objective financial literacy and self-reported (perceived) financial literacy, which predict financial behaviours better than other variables. According to their findings, inflated perceptions of financial knowledge are associated with poor banking behaviour.

The contribution of this paper to the literature is twofold. Firstly, we provide an analysis of Romania's position on financial literacy indicators, compared to other European countries. Secondly, we extend the literature by looking at the relationship between financial literacy, economic development, and financial inclusion in Romania. As we have seen, previous studies did not undertake such comprehensive approach with regard to the financial literacy in Romania. This provides valuable information for policy-makers regarding the development of financial education programs.

Methodology and data

In order to depict the nexus between financial literacy, on one side, and economic development and financial development, on the other side, we will use a simple regression model. Specifically, the model assumes a linear relationship between the variables and takes the following form:

$$Y=\alpha+\beta X+\varepsilon$$

where Y is the dependent variable, X includes the explanatory variable, and ε is the error term.

Given our objectives, the dependent variable is the level of financial literacy in EU member states. To capture the level of economic and financial development, we use several proxies. Specifically, we use income per capita at purchasing power parities (PPP) in order to assess the level of economic development. We use income per capita at PPP instead of GDP per capita, because the former capture better overall households' wealth, while GDP per capita is a better proxy for overall economic strength. For the level of financial development, we resort to several proxies. Firstly, we use the financial assets share to GDP ratio, as a measure for the depth of the financial sector. Secondly, we use the share of persons that have a bank account and persons who have a savings deposit in total population as proxies for financial inclusion. Finally, we also add to our analysis the average historical inflation rates over the last decades, in order to link the inflation persistence with inflation literacy.

Our data set includes country-level data for EU member states. Financial literacy level was extracted from Klapper et al. (2015). Income per capita and inflation rate are sourced from Eurostat database. The share of persons that have a bank account in total population and the share of persons who have a saving deposit in total population are taken from Demirgüç-Kunt et al. (2018) financial inclusion database.

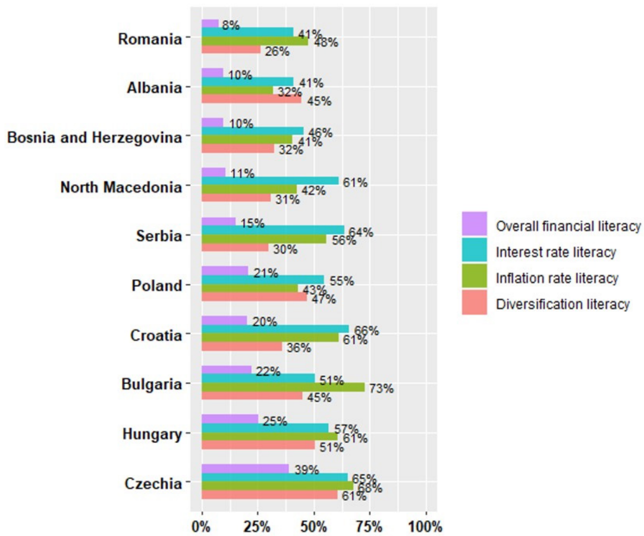
Results and discussions

Financial literacy in Romania: Comparisons with European countries

For achieving the objectives of our study, i.e., to analyse the level of financial literacy in Romania, compared to other EU member states, we approach the most relevant surveys conducted internationally (OeNB, 2021; OECD, 2020; Klapper et al., 2015). The financial literacy survey conducted by OeNB is robust. In this survey, data were collected biannually or annually in the states of CESEE, for the period from 2007 to 2020 (OeNB, 2021)[3]. The OeNB measures the level of financial literacy based on three basic concepts, i.e., interest rate, inflation rate, and risk diversification.

According to the survey, Romania has the lowest percentage of the financially literate population, i.e., only 8% of respondents answered correctly to all three basic concepts (Figure 1). By comparison, the other EU member states, Poland, Croatia, Bulgaria, and Hungary accounted for about three times as much, while Czechia reached a five times higher level. The analysis of the three basic financial knowledge components reveals that Romania's population is more literate in terms of inflation rate, compared to Albania, Bosnia and Herzegovina, North Macedonia, and Poland, recording a level of 48% of the population that answered this question correctly. At the same time, the level of understanding the interest rates and risk diversification remains the lowest in the case of Romania, at 41% and 26%, respectively.

Figure 1. Financial literacy level in CESEE - average for the period 2012-2019 (% of respondents answering questions correctly)



Source: authors' representation based on OeNB data (2021)

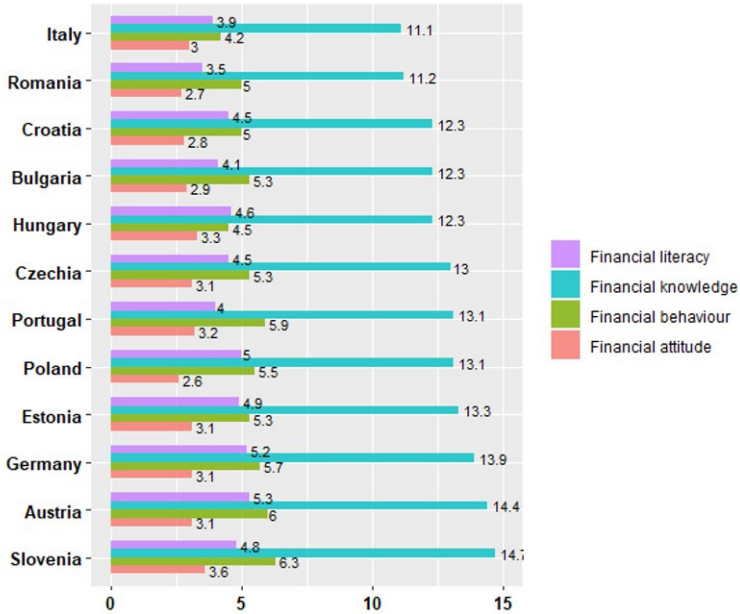
Another conclusive study was conducted by the OECD (2020), which measures the level of financial literacy based on three basic elements: financial attitude, financial

[3] The OeNB survey is currently conducted in six EU member states (Bulgaria, Czechia, Croatia, Hungary, Poland, Romania) and 4 non-EU countries (Albania, Bosnia and Herzegovina, North Macedonia, Serbia). In the period 2007-2014, the survey was conducted biannually. Since 2015, it is held annually.

behaviour, and financial knowledge . According to this survey, achieving the maximum level of 21 means that the individual has acquired a basic level of understanding the financial concepts and has known how to apply prudent principles in financial transactions. From the survey data, we can see that Romania achieved a total score of financial knowledge of only 11.2, ahead only of Italy (Figure 2).

At the same time, other member states in CESEE, such as Croatia, Bulgaria and Hungary, scored 12.3, while Czechia scored 13 points. Romania has the lowest score in terms of financial literacy, being the last country in the list of EU member states included in the survey. However, the data reveal a more favourable position of Romania both in terms of financial behaviour, where Italy and Hungary outperformed, and in terms of financial attitude, outperforming Poland.

Figure 2. Financial literacy and its basic elements in European countries

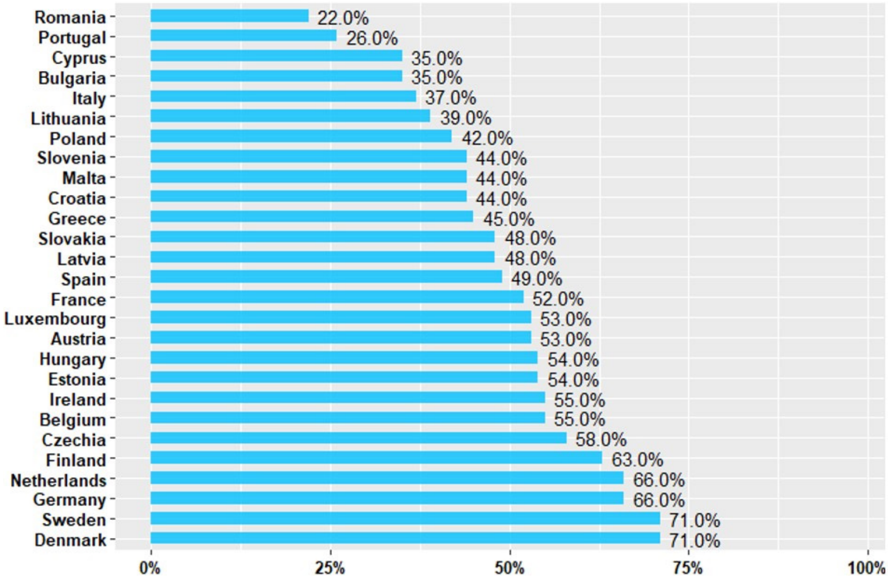


Note: The financial literacy score ranges between 1 and 21 and consists of the sum of three elements: 1. The score of financial knowledge (takes values in the range 0-7), 2. The score of financial behaviour (takes values in the range 0-9), 3 Financial attitude score (takes values in the range 1-5).
Source: authors' representation based on OECD data (2020)

At the sample level, the most extensive survey was conducted by Klapper et al. (2015). The report provides an analysis of financial literacy data for 143 countries around the world, including the 27 EU member states. It measures the level of financial literacy, using questions about four fundamental concepts in financial decision-making: risk diversification, inflation, numeracy, and compound interest. According to the report, a person is financially literate when he or she has correctly answered at least three of the four financial concepts mentioned.

The results reveal deep disparities in the financial literacy within the EU. The highest level is observed in Denmark and Sweden, of 71%, while Romania is on the last position out of the 27 member states, with only 22% of adults who are financially literate (Figure 3).

Figure 3. Financial literacy level in the EU in 2014 (% of adults who are financially literate)



Source: authors' representation based on Klapper et al. (2015)

The results of the financial literacy surveys are convincing, due to the fact that in all three studies Romania ranks last. We can notice a more favourable position of Romania in the OECD study, in terms of financial behaviour and financial attitude of the population, outperforming Italy, Hungary, and Poland. However, regarding basic financial knowledge, Romania ranks the last in this research. Such low financial literacy scores in Romania can be related to a poor performance of its education system. Specifically, Romania is far from having a top position in the ranking of international evaluations related to education. The most eloquent examples are international university rankings and the Programme for International Student Assessment (PISA)[4]. In the QS World University Rankings 2022, no Romanian university is included in the top 1,000 out of a total of 1,300. In the Times Higher Education 2021 ranking, only one university from Romania ranks in the range 601-800, while according to other performance indicators the institution is included in the 801+ category. At the same time, according to PISA results (OECD, 2019), Romania scored the third lowest on reading among EU countries, the lowest on mathematics and the second lowest on science. The important role of education in financial literacy, particularly the numeracy skill, is largely emphasized in the literature (Batsaikhan and Demertzis, 2018).

[4] The Programme for International Student Assessment (PISA) is a triennial survey of 15-year-old students that assesses the extent to which they have acquired the key knowledge and skills essential for full participation in society.

The relationship between financial literacy, economic development and financial inclusion

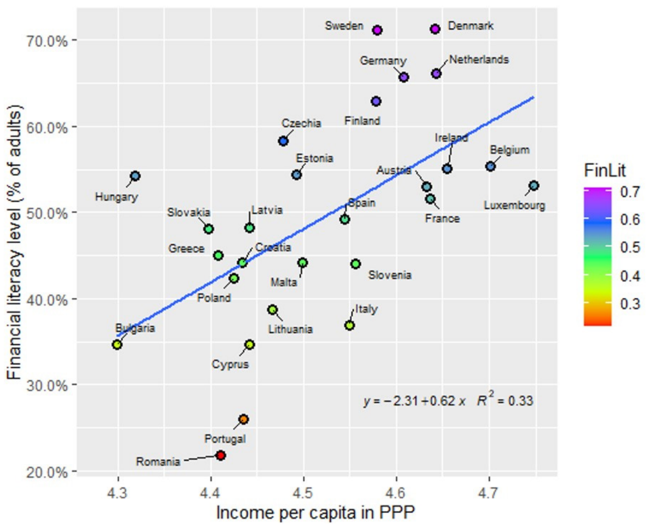
This sub-section analyses the nexus between financial literacy, on the one side, and economic development and financial development, on the other side. The findings will allow us to see whether the latter variables have an effect on the financial literacy level.

Figure 4 investigates the relationship between the level of economic development of EU member states and the percentage of individuals who are financially literate. We can see significant differences between individual EU member states, both in terms of income per capita and of financial literacy. At the same time, we notice a moderate positive relationship between the two variables, as countries with higher level of income generally have a bigger percentage of population with basic financial knowledge.

However, compared to the regression slope, some EU countries have better results in terms of financial literacy, while others are behind. Sweden, Denmark, Netherlands, Germany, Finland, and Czechia have the most financially literate population. Furthermore, these countries are placed well-above the regression slope. At the same time, Romania recorded the lowest percentage, of 22%, although it does not have the lowest level of income per capita at PPP in the EU. For example, Bulgaria, Hungary, and Slovakia have a lower income per capita at PPP compared to Romania, but the population in these countries is more financially literate.

Moreover, Poland, Greece, Croatia, and Latvia have an income per capita at PPP almost similar with Romania, but the level of financial literacy is just about twice higher. Furthermore, Romania is placed well below the regression slope, showing a poor connection between the two variables. These findings suggest that the level of basic financial knowledge of the population is determined not only by the degree of economic development, but also by the efficiency of financial education programs, the existence of a financial education strategy or the extent to which institutions get involved in promoting financial information.

Figure 4. The relationship between financial literacy and economic development



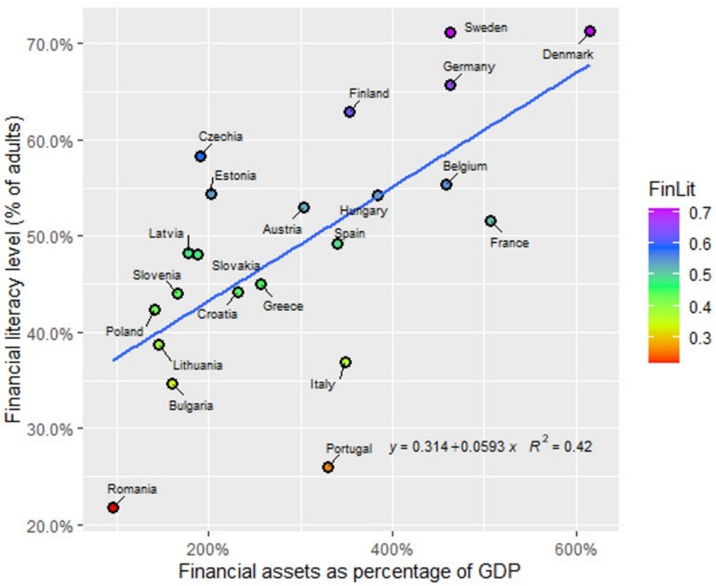
Source: authors' representation based on Klapper et al. (2015) and Eurostat (2021b)

A developed financial system contributes to increasing access to financial services and basic financial knowledge. In this context, we analysed the relationship between the development of the financial system in the EU countries and the percentage of the literate population (Figure 5). The findings reveal a positive correlation, implying that an increase in the financial sector depth leads to a higher financial literacy rate. With some exceptions, most of the countries are close to the regression slope. Positively, Denmark, Sweden, Germany, Finland, Czechia, and Estonia are well-above the slope, while, negatively, Bulgaria, Italy, Portugal, and Romania are well-below.

The results reveal major differences in the degree of financial intermediation and financial literacy in the EU member states. The most financially developed countries with the most literate population are Denmark, Sweden, and Germany. Romania stands out with the lowest level of financial development in the EU, but also of the financial literacy.

This situation is determined, in our view, largely by distrust in financial institutions, preference of the population and companies for cash, high level of poverty, and informal economy, but also by a higher percentage of rural population than the EU average. According to OeNB (2021), only 27% of adults in Romania reported full or partial confidence in banks. At the same time, 42% of Romanians prefer to hold cash rather than keep money in a savings account, which is the highest level in the whole region. In addition, in Romania, the risk of poverty is 31.2% of the population, being outweighed by Bulgaria alone (Eurostat, 2021c). The position is amplified by the high share of the shadow economy which accounts for almost 28% of GDP in Romania (European Commission, 2017). Moreover, the percentage of population in rural areas is the biggest in the EU, 46% of total population (World Bank, 2020). These factors highlight the low interest of the Romanian population in basic financial information.

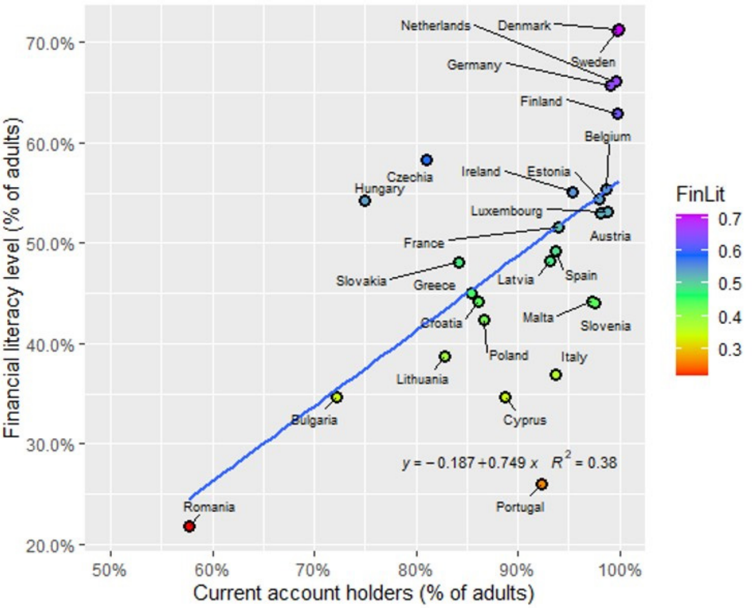
Figure 5. The relationship between financial literacy and financial development



Source: authors' representation based on Klapper et al. (2015) and Eurostat (2021a)

The benefits of financial inclusion are widely recognized in the literature, and holding a current bank account represents the key indicator used to assess the access to financial services. The results on the link between financial literacy and financial inclusion reflect a stronger interdependence between these two variables (Figure 6). Thus, Denmark, Sweden, the Netherlands, and Germany have recorded the largest shares of bank account holders and financial literacy within the EU. Romania is situated at the end of the ranking in both cases. Despite the transposition into national law of the European Directive on access to basic payment accounts in Romania, access to financial services remains scarce due to a lack of effective communication between financial institutions and individuals.

Figure 6. The relationship between financial literacy and current account holders

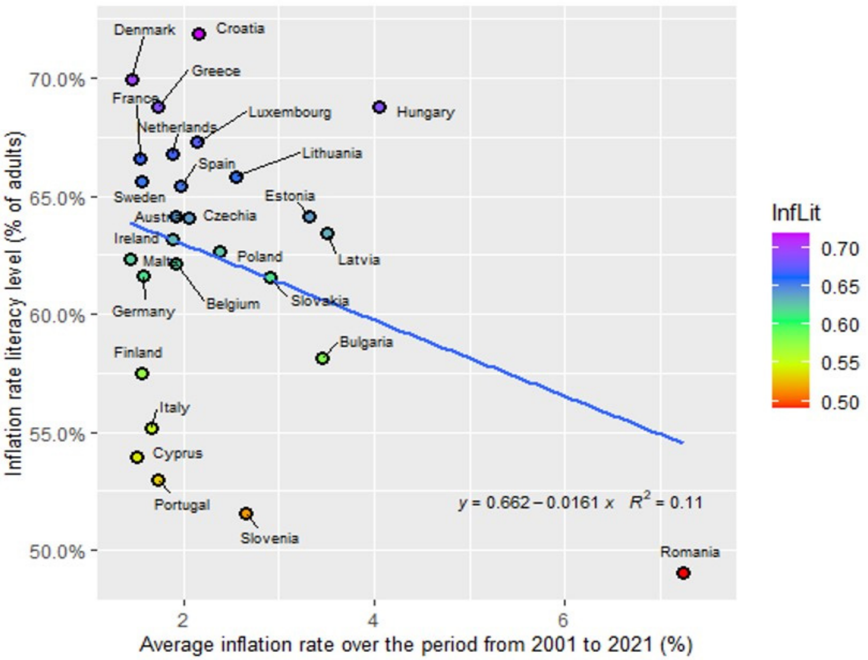


Source: authors' representation based on Klapper et al. (2015) and Demirgüç-Kunt et al. (2018)

Understanding the concept of inflation is also crucial in making individual savings and investment decisions because inflation erodes the purchasing power of nominal income in the long run and can diminish the return on personal investment. In addition, evaluating the difference between nominal and real income is essential to avoiding monetary illusion.

Against this background, we investigate the relationship between historical inflation rates and inflation literacy (Figure 7). The findings reveal a negative slope between the variables, implying that higher inflation leads to lower literacy. However, the slope coefficient is quite low, revealing the weakness of the nexus. We can explain this result by having in view that inflation knowledge is related more to common education, and less to economic environment. The visual analysis of the plot reveals that both developed EU countries and emerging EU countries, e.g., Denmark, the Netherlands, France, Greece, Croatia, Hungary, have the most literate population in terms of inflation, reaching values between 60% and 70%. At the same time, Romania has the lowest level of literacy, of approximately 25%. The results for Romania are quite surprising. Having in mind that Romania experienced two episodes of hyperinflation period in the 1990s, the knowledge regarding the preservation of purchasing power should have been higher than the present situation. Moreover, the inflation rate fell well below 10% in 2005, for the first time since 1989. In our view, this result emphasizes the need for adequate financial education programs in Romania. More details regarding financial literacy, its determinants, and a series of institutional and policy recommendations aimed at improving financial education initiatives in Romania can be found in Nițoi et al. (2022).

Figure 7. The relationship between inflation literacy and historical inflation rates

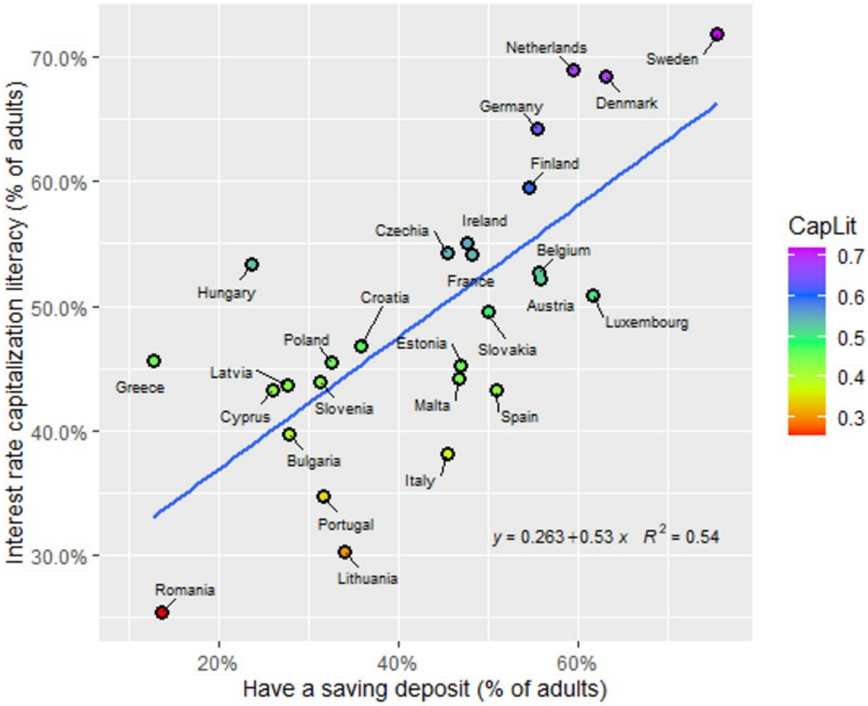


Source: authors' representation based on Klapper et al. (2015) and Eurostat (2021b)

Another important indicator of financial inclusion is the level of bank deposits. Savings help to create safety nets for emergencies, avoid excessive indebtedness, reduce financial stress, but also increase the feeling of financial freedom. Lack of financial knowledge undermines the benefits of long-term savings and causes a lower level of savings (Stango and Zinman, 2009). Furthermore, it is widely acknowledged that people who do not understand the concept of interest compounding spend more on fees, bear higher interest rates and finally find themselves over-indebted (Lusardi and de Bassa Scheresberg, 2013).

In this context, we analysed the link between the level of knowledge about interest compounding and bank deposits (Figure 8). The findings reveal a positive relationship between the two variables, i.e., an increase in the number of persons that have a bank deposit leads to a greater interest rate literacy.

Figure 8. The relationship between knowledge of interest compounding and individuals who have saved at a financial institution



Source: authors' representation based on Klapper et al. (2015) and Demirgüç-Kunt et al. (2018)

Moreover, Sweden, the Netherlands, Denmark, Germany, and Finland are the European countries having over 60% of the population's savings kept in bank deposits, which is the highest percentage in the EU. The population in these countries has the highest share of people who know the effects of inflation rate on the real income. Instead, the Central and Eastern European countries are characterized by a lower extent of savings, which arrays between 20% and 40% of total adults, and also by a reduced level of knowledge, which ranges between 35% and 55% (Figure 8). Romania has registered a percentage of 13% of savings and a degree of only 16% of financial knowledge. These results are determined by the preference of Romanians to keep cash rather than make bank savings (OeNB, 2021).

Conclusions

Our analysis reveals some important aspects. It has unveiled sharp gaps between EU member states, in terms of financial literacy of the population, financial development and financial inclusion. The most developed countries from a financial point of view have the most literate population, while Romania is characterized by the lowest level of financial intermediation and financial literacy.

Romania has the lowest level of financial literacy and understanding of inflation, although its income per capita is not the smallest in the EU. The population of Romania underestimates the benefits of long-term savings, recording the lowest level of savings at financial institutions and of knowledge regarding the interest compounding. This means that basic financial knowledge of the population is not determined only by the level of economic development. It is mainly influenced by the inefficiency of the financial education policies promoted so far, the lack of a strategy on financial education, but also the persistent problems of the Romanian education system, which are reflected by particularly bad results on PISA tests. Additionally, higher percentage of rural population than the EU average maintains the low level of financial literacy in Romania. Individuals living in rural areas have poor access both to financial services and financial education programs. Moreover, if we take into account the two episodes of hyperinflation recorded in Romania in the 1990s, the knowledge of the population regarding the inflation should have been higher. Romania is also characterized by the lowest percentage of the population with a current banking account. This phenomenon is caused by the lack of knowledge about the benefits of having an account, the lack of trust in financial institutions, the preference for cash, but also by the high proportion of the poor population, and the high level of shadow economy.

Our findings have multiple policy implications. Firstly, our study empirically highlights the importance of developing financial education tools and programs in Romania. Secondly, the paper emphasizes the significance of developing and monitoring a financial education national strategy based on realistic and attainable outcome indicators. Specifically, in our view, the level of basic financial knowledge could be improved significantly when financial education is integrated in the general education curriculum. Thirdly, promoting financial access is essential in increasing the financial literacy in Romania, as bank account holders are more inclined to be financially informed and use proper financial services. In this context, specific actions are needed to promote and encourage the opening and use of bank accounts by all categories of individuals.

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The Digital Euro Project. A Preliminary Assessment

Iulia Monica Oehler-Şincai[1]

*"The Eurosystem has no commercial interest in user data or behaviour.
A digital euro could therefore help to safeguard
what has always been the essence of money: trust".*
Dr. Jens Weidmann, former President of the Deutsche Bundesbank

Abstract: *The decrease in physical cash usage, the excessive market power of BigTech companies, the largely unregulated market of crypto assets which poses risks to financial stability, as well as the need for more financial inclusion and for lower-cost cross-border payments are just as many arguments in favour of a central bank digital currency (CBDC). However, there are as many points urging caution. In this context, the purpose of the present paper is to analyse the specificity of the potential digital euro as part of the international payments' architecture. The European Central Bank (ECB) is focusing on the digital euro project, running the investigation phase until October 2023. The debate on the digital euro adoption is in line with the international one, but there are several distinctive aspects. Various scenarios are taken into account, starting from general principles for retail CBDCs, results of the public consultation of a digital euro, experts' opinions regarding privacy, security, usability, costs, offline use, acceptance, potential disintermediation, standards and international implications of the digital euro. The research also outlines the relations between major actors involved, while identifying the prerequisites for a swift functioning of the Eurozone payment system with digital euro at its core.*

Keywords: *digital currencies, central bank digital currency, digital euro.*

JEL Classification: *E42, E51, E52, E58, F33, O33.*

Introduction

Money and payments have continuously evolved, reaching new dimensions in the last years (Panetta, 2022). At present the catalysts of the changing global landscape for payments are the multitude of new actors, innovations and payment solutions, stimulated by and at the same time stimulating consumers' preferences for digital instruments and online shopping (Panetta, 2021a; 2021b).

The key private sector innovations relate to the crypto assets market and the activities of the BigTech companies. Boar, Holden and Wadsworth (2020) remark that crypto currencies "remain a niche means of payment". By contrast, BigTech

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companies'[2] systemic footprint in the financial system is a reality, in contrast to other non-bank payment service providers (PSP), such as FinTechs. Their large-scale access to personalized information reinforces their benefits from network effects. The "data-network-activities" loop – or the "DNA" loop – enables them to multiply data extracted from social networks and e-commerce platforms extremely rapidly once the critical mass of users is formed. This DNA circuit offers BigTechs considerable advantages in terms of market power concentration and data management. New payment solutions fit perfectly with the consumers' needs but there is the risk of excessive concentration of economic and informational power in the hands of a few actors, especially digital platforms (Ehrentraud et al., 2021; FSB, 2019a and 2019b; FSB, 2020; Carstens et al., 2021; Adrian, 2021; Crisanto, Ehrentraud and Fabian, 2021; Crisanto and Ehrentraud, 2021; Restoy, 2021).

To mitigate the risks previously mentioned, to safeguard the monetary and financial stability, and to take full advantage of opportunities associated to CBDC adoption, central banks embarked on a journey of investigating the opportunities and risks associated to the "general purpose" central bank digital currency. This means considering trusted digital money as a public good complementary to cash, that can be used by the public, therefore not restricted to wholesale, financial market payments (BIS, 2020).

Around 100 central banks have been exploring the possibility of launching their own CBDCs (Georgieva, 2022). On a particular note, Sweden was one of the first countries to assess this need, by starting the e-krona project in 2017[3]. This pilot project is based on a Distributed Ledger Technology (DLT) – a blockchain technology. Only the Sveriges Riksbank can create e-kronas, which are then distributed to the general public through intermediaries such as banks and payment service providers (Urbinati et al., 2021). On a general note, most of these projects are in the research phase and more than ten of them have updated to the testing phase (pilot projects in China, Canada, France, Russia, Saudi Arabia, South Africa, South Korea, Sweden, United Arab Emirates, but also Jamaica, Ghana, Uruguay, and the eight island economies under the monetary authority of the Eastern Caribbean Central Bank[4]). Bahamas and Nigeria have already digital currencies. Several countries experienced short-lived trials on CBDC, including Finland and Ecuador (CBDC Tracker, 2022).

In contrast to crypto assets such as Bitcoin, which are privately issued, the central bank electronic money, either wholesale or retail[5], would be free of liquidity risk, credit risk and market risk, resembling cash (House of Lords of the United Kingdom,

[2] In the category of non-bank payment service providers, from which the five giants are distinguished under the new acronym MAMAA: Meta - former Facebook -, Apple, Microsoft, Amazon, and Google's parent company Alphabet. The BigTech business model is based on direct user interactions and data generated as a by-product (but with an essential role) of these interactions. Knowing consumer preferences offers BigTech companies the opportunity to offer personalized services to customers insufficiently served by traditional creditors.

[3] On the Sweden's central bank official home page can be consulted the e-krona reports and testing status: https://www.riksbank.se/en-gb/payments--cash/e-krona/difference-between-e-krona-and-crypto-assets/.

[4] Anguilla, Antigua and Barbuda, Commonwealth of Dominica, Grenada, Montserrat, St Kitts and Nevis, Saint Lucia, and St Vincent and the Grenadines.

[5] Retail CBDCs facilitate payments involving households, small or medium-sized enterprises, while wholesale CBDCs facilitate payments between financial institutions. The most viable retail system is considered the hybrid one (indirect or two-tier), meaning that the central bank maintains a central ledger which records CBDC balances and processes payments, while financial institutions such as commercial banks manage customer account services. The direct retail system assumes that all data and transactions are managed by the central bank (House of Lords of the United Kingdom, 2022; BIS, 2021a).

2022; Weidmann, 2021). A CBDC would be issued by a central bank but the supporting infrastructure would involve both public and private participants (The White House, 2022).

The mission of monetary authorities in the CBDC adoption process can be made easier by learning from past lessons concerning previous CBDC projects. At the same time, the guidance and principles outlined by international organizations, as well as researches by various central banks offer already helpful lines of action. The success of a digital euro project will be determined by its adoption by the end users, as well as the wide participation of the financial industry and, in particular, of the PSPs, who, being directly in touch with customers, can encourage or not the usage of the digital euro (Urbinati et al., 2021). Furthermore, it should be noted that any new digital payment method will need to offer compelling advantages over current options or novel benefits that simplify daily life (ECB, 2022).

In this context, the research question of this paper is whether the adoption of the digital euro is opportune, based on a detailed investigation of its pros and cons.

Digital euro definition starting from general characteristics of a CBDC

According to the Committee on Payments and Market Infrastructures (CPMI), "a CBDC is a digital form of central bank money that is different from balances in traditional reserve or settlement accounts". CBDC is a new form of central bank money, i.e., a central bank liability, but new only for general purpose users, as central banks "already provide digital money in the form of reserves or settlement account balances held by commercial banks and certain other financial institutions at the central bank" (CPMI-MC, 2018). CBDC is fiat currency issued by central banks in digital form (Allen et al., 2020). It is "an electronic form of central bank money that could be used by households and businesses to make payments and store value" (Bank of England, 2020).

CBDC is "a widely accessible digital form of fiat money that could be legal tender" (Mancini-Griffoli et al., 2019). As fiat money, CBDC would keep its three functions: a unit of account, a means of payment, and a store of value.

The best option for creating CBDCs suggested by Adrian and Mancini-Griffoli (2019) is that based on a public-private partnership (PPP), called synthetic CBDC (sCBDC). PSPs would act as intermediaries between the central bank and the end users. Therefore, as long as the end user does not hold a claim on the central bank, these liabilities would not be a CBDC and are instead a form of "narrow-bank" money (BIS, 2021a).

There are two main types of CBDCs: wholesale used by financial institutions, and retail (general purpose), used by consumers and businesses. There are two retail alternatives: (1) digital token currency, circulating in a decentralized way without a central ledger, allowing users to execute transactions anonymously and (2) deposit accounts with the central bank, requiring digital identification to access (Bindseil, 2020). Traceability of transactions is needed to comply with the AML-CTF rules: anti-money laundering and counter-terrorist financing.

The CBDC requires an **appropriate infrastructure** (Bank of England, 2020), which includes **a functional, economic and technological design**. Responsibilities and tasks between the central bank and the private sector should be shared in a two-tier system, public and private, ensuring a balanced functionality of the system, meeting the users' needs (Banque de France, 2021).

Some authors show preference for the minimal central bank's intervention in operational activities related to CBDC. In their opinion, the private sector actors should be responsible with all the operating activities related to regulatory compliance, wallets, underlying technology, settlement platform, customer data, transactions, customer requests, complaints and questions. In this way, the central bank avoids cyber risks and reputational risks, as well as burdensome costs, stimulates further financial competition, innovation and intermediation and offers trust, efficiency and stability (Adrian and Mancini-Griffoli, 2019).

There are **various design choices** for a CBDC, according to: access (wide versus restricted; direct access when the central bank is the sole provider of payment services or intermediated access, when third parties distribute the digital currency; unlimited or capped; available to non-residents or not); degree of anonymity (ranging from complete to none); connectivity requirement (online and offline); interest bearing characteristics (yes or no); technology/ledger types (token- or account-based; distributed ledger technology DLT, centrally controlled infrastructure or other technologies), degree of disintermediation (low if CBDC is a basic functional layer, while existing non-governmental financial institutions interface manage a second layer that interfaces with users, high if the implication of the central bank is larger) (CPMI and Markets Committee, 2018; Auer and Böhme, 2020; Allen et al., 2020; Urbinati et al., 2021). Some of the issues that need a close monitoring address the CBDC impact on: competition, monetary and financial stability, payment system, monetary policy transmissions and implementation, financial intermediation, cross-border transfers.

Digital euro

At a time when the interest in CBDCs is increasing and the process of assessing benefits and risks accompanying the digitalization of the fiat money is at its height, the European Central Bank (ECB) is focusing on its own **digital euro project**. In July 2021, the ECB decided to launch an investigation phase for the possible introduction of a digital euro attractive to consumers. The investigation phase related to the design, distribution and use of the digital euro was opened in October 2021 and will last for two years, until October 2023. The earliest date for launching the digital euro would be 2025, if decided to adopt it.

The digital euro has to be: convertible at par, a liability of the Eurosystem, a European solution, market-neutral and trusted by end users (Urbinati et al., 2021).

The ECB is cooperating with other six central banks (Bank of Canada, Bank of England, Bank of Japan, the Federal Reserve, Sveriges Riksbank, and the Swiss National Bank) and the Bank for International Settlements (BIS) on CBDC. Four reports have been published until now (BIS 2020; BIS 2021b, 2021c, 2021d). Their takeaways are the following:

1. Foundational Principles and Core Features.
2. System Design and Interoperability.
3. User Needs and Adoption.
4. Financial Stability Implications.

Fabio Panetta, the Chair of the High-Level Task Force on a digital euro has described most eloquently the key role of the future digital euro. Cash represents the only form of central bank money citizens hold. As the demand for cash is decreasing due to the acceleration of digital payments, cash seen as a payments anchor might lose its core role. To prevent that, the digital euro is considered the appropriate substitute (Panetta, 2021a). Various scenarios are taken into account, as an orderly adjustment of the financial sector is needed. Either of the two extremes should be avoided: a too successful or an unsuccessful digital euro (Panetta, 2021b).

The digital euro is intended to be a trusted, general purpose fiat currency issued by the Eurosystem (the ECB and national central banks) in digital form, which would complement cash and would accomplish the functions of fiat money: a unit of account, a means of payment, and a store of value. It has to be "riskless, accessible, and efficient" (ECB, 2021a).

Fabio Panetta, Chair of the Eurosystem High-Level Task Force on Central Bank Digital Currency (HLTF-CBDC) defines the digital euro, its potential functions and benefits as follows (Panetta, 2021a; 2021b; 2021c; 2021d):

- Electronic money issued by the central bank, designed as a digital means of payment that is attractive to consumers.
- A way to ensure that central bank money remains at the core of the financial system.
- A reflection of the fulfilment of the central bank's key task, namely money creation, thus accomplishing "public interest objectives such as inflation control and the cyclical stabilisation of the economy".
- A form of digital money that provides "a low-cost, efficient means of payment that is available everywhere" and protects users' privacy.
- A digital currency meeting the needs of consumers and companies, but avoiding any potential risks and preventing illicit activities (consequently, payments in digital euro have to be traceable, in order to avoid illicit transactions, such as those related to money laundering, the financing of terrorism or tax evasion).
- A central bank liability, free of any risk, be it market risk, credit risk, or liquidity risk.
- A "simple, safe and reliable" form of sovereign money, a "monetary anchor" provided by the ECB in electronic format.
- A means to offer households, businesses, commercial outlets access to a payment instrument that is secure, cost-free, easy to use and universally accepted within the euro area.
- A complement to cash, not its replacement.
- A way to promote stability and financial inclusion.
- A digital currency with a value guaranteed by the state, in contrast with the crypto-assets defined as "a bet, a speculative high-risk contract with no supporting fundamentals" and no "socially or economically useful functions" (a means of payment with a highly fluctuating value which prevents them from performing two of the three functions of a currency: store of value and unit of account).
- Through the interoperability with private payment solutions, it would "level the playing field by making it possible for all market participants – bank and non-bank intermediaries and fintechs – to offer, at a lower cost, products that allow people to pay instantly".

- A catalyst for cross-border payments, by ensuring interoperability with foreign digital currencies.
- A means of strengthening Europe's financial sovereignty and international role of the Euro.

The digital euro project should be analyzed in close connection with the larger European framework related to digital finance and retail payments. The Digital Finance Package of 24 September 2020 (including the "Digital Finance Strategy for the EU" and the renewed "Retail Payments Strategy for the EU") is the most significant (European Commission, 2020a and 2020b). Looking at the priorities/pillars of these Strategies (Box 1), one can remark that they pave the way for the eventual digital euro adoption. In its turn, the digital euro would support the implementation of these Strategies.

Box 1: Priorities of the Digital Finance Strategy and the Retail Payments Strategy for the EU

The priorities for the digital transformation of the European financial sector are: (1) to tackle fragmentation in the Digital Single Market for financial services, thereby enabling European consumers to access cross-border services and help European financial firms' scale up their digital operations; (2) to ensure that the EU regulatory framework facilitates digital innovation (e.g. distributed ledger technology DLT or artificial intelligence AI) in the interest of consumers and market efficiency; (3) to create a European financial data space to promote data-driven innovation, building on the European data strategy, including enhanced access to data and data sharing within the financial sector; (4) to address new challenges and risks associated with the digital transformation, paying particular attention to the principle "same activity, same risk, same rules".

The Retail Payments Strategy for the EU focuses on the following four key pillars, which are closely interlinked: (1) high-quality digital and instant payment solutions with pan-European reach; (2) innovative and competitive retail payments markets; (3) efficient and interoperable retail payment systems and other support infrastructures; and (4) efficient international payments, including remittances.

Sources: European Commission, 2020a and 2020b.

Arguments in favour of adopting the digital euro, in balance with potential risks

The arguments for adopting the digital euro are numerous, as there are also plentiful against it. In our opinion, a digital euro, if efficiently and safely designed, might reflect further the symbiosis of the public and private initiatives and actions. The state, beyond the tools of regulation and taxation, has also the prerogative to develop the required infrastructure, according to the needs of the general public and the private sector. Actors, technology, means and instruments of payment evolve in parallel with the optimization of the personalized experience of consumers, taking into account the transformations in terms of their consumption habits and their requirements (Capgemini, 2021). Current monetary arrangements implemented by the private sector (especially banks and non-bank financial actors) continue to serve the public well, and retail payments in the Eurozone are becoming faster, cheaper and more efficient.

At the same time, the Eurosystem already contributes to the payments' infrastructure development. For instance, the TARGET Instant Payment Settlement

(TIPS) service was launched by the Eurosystem in November 2018. It was conceived as a multi-currency platform, with the capability to process other currencies as well as the euro (starting with May 2022, TIPS is expected to settle instant payments in Swedish krona, while instant payments in Danish krone could also become available by November 2025, the latest) (ECB, 2021e). It operates on a full cost-recovery and not-for-profit basis and the price per transaction is set at 0.20 cents. The instant payment transactions are completed within a maximum of 10 seconds and the typical execution time (the "latency") is actually well below the 10 seconds threshold (less than 5 seconds for 99 per cent of the transactions). It enables PSPs to offer fund transfers to their customers in real time and around the clock, every day of the year, on a 24/7/365 basis. TIPS is a public service that does not compete with market solutions, but rather promotes their development by ensuring the interoperability of systems at the pan-European level (Visco, 2020).

British researchers and policy makers summarize the benefits of the CBDC (House of Lords of the United Kingdom, 2022), which are also valid for the digital euro:

- Supporting the central bank's objectives of maintaining monetary and financial stability.
- Maintaining a resilient payments landscape.
- Avoiding the risks of new forms of private money creation.
- Stimulating competition, efficiency and innovation in payments.
- Meeting future payment needs in a digital economy.
- Improving the availability and usability of central bank money.
- Addressing the consequences of a decline in cash.
- Enabling better cross-border payments.

Referring to the digital euro, the fundamental motivation for its adoption is the need to maintain the role of public money in the digital economy, given the decline in the use of cash and the amplification of the process of digitalization of payments (Brunnermeier and Landau, 2022). Experts wonder what central banks should do if all private money were to become digital, in other words, if only private money will be available to the general public (Brunnermeier and Landau, 2022). There is, of course, a long way to go before this extreme scenario, involving zero cash. But its mere presence in the international debate has led to countless studies on the opportunities and risks that accompany CBDC.

The digital euro would not be only a response to the decline in the role of cash as a means of payment, but it could also: (1) support the digitalisation of the European economy and the strategic independence of the European Union; (2) counteract a potential large-scale presence of a foreign CBDC in the euro area, which could affect capital flows and euro exchange rates; (3) become a new monetary policy transmission channel; (4) mitigate risks to the normal provision of payment services; (5) foster the international role of the euro, and (6) support improvements in the overall costs and ecological footprint of the monetary and payment systems (ECB, 2020).

On the one hand, innovations such as crypto currencies and the "walled garden" ecosystems of BigTechs might work "against the public good element that underpins the payment system" (BIS, 2021a). On the other hand, cash use in payments is decreasing and it seems that a key function of the central banks, namely providing cash for public use, loses its importance (BIS, 2020). Besides, in spite of the development of the international system of payments, there are still "unmet user needs" which could be fulfilled by CBDC adoption (BIS, 2021b). Finally, CBDC has the potential to offer new opportunities for innovation (BIS, 2021c).

Panetta (2021b) points out that non-EU payment providers already handle around 70% of European card payment transactions, and that if these providers' footprint continues to grow, it would raise serious questions about Europe's payment autonomy, with potential implications for users. At the same time, the use of cryptocurrencies (including stablecoins) is growing, and large technology companies (BigTech) have considerable advantages in terms of their market power and data management capacity, being of systemic importance (Panetta, 2021b).

Being aware of this context, Panetta (2021a) considers that the digital euro should ensure the European monetary, political, and financial sovereignty. The European level-playing field and sovereignty are at risk if one takes into account the following factors: the total value of crypto-assets, especially stablecoins is increasing, the digital retail payment system is dominated by foreign operators and several foreign Big Tech companies have acquired a significant economic power. A potential removal of traditional intermediaries from the market might lead to higher costs and lower quality of services. The digital euro as a means of payment free, easy to use and available to everyone is beneficial both for the European citizens and companies as well. At the same time, small intermediaries will be able to offer products with a higher technological content at a competitive cost. Therefore, it is evident the role of digital euro as a catalyst for fair competition.

Simon and Schellekens (2021) appreciate that "Fiat digital currencies offer a way to rebalance the asymmetric information economy. A fiat digital currency, as opposed to the current privately created cryptocurrencies, would provide each citizen with their own digital account or wallet that could be used across all digital platforms. This account is expected to record key information for each transaction, the account holder having the sole control of this data – being able to share or not their information as they see fit, levelling the playing field between the digital platforms and their customers. It would also level the playing field between platforms and governments, undercutting the leverage today's corporate behemoths have against the public sector through their control of when and where they pay taxes. Instead, a fiat digital currency could ensure exchange is taxed at the moment of occurrence and in the jurisdiction where the exchange occurs".

On the other hand, the **risks** associated with the adoption of the digital euro are numerous, similar to those associated with the CBDC in general.

Several central banks have published studies that conclude that launching CBDC would turn the central bank into a direct competitor of commercial banks, but without generating more efficient payment alternatives. The core tasks of a central bank are to maintain a secure payment system, to ensure financial stability and price stability through monetary and exchange rate policy. By adopting a CBDC, the central bank would become a retail bank for the private sector, which could jeopardize the stability of the financial system (Danmarks Nationalbank, 2017).

The Bank of International Settlements, in a joint study with other seven central banks (including the ECB), underlines the risk of disintermediating banks or enabling destabilising runs into central bank money, thereby undermining financial stability (BIS, 2020). The study concludes that a central bank should have robust means to mitigate any risks to financial stability before any CBDC is issued (BIS, 2020). Moreover, a "digital dollarisation" could see a national currency substituted by another with the domestic central bank gradually losing control over monetary matters (BIS, 2020). BIS (2021a) underlines: technical failure, counterfeiting and cyber risks; risks associated with the situation when payment systems fail to interoperate, generating fragmentation and "closed loop systems" that are accompanied by user costs from a lack of competition.

British researchers point to: state surveillance of people's spending choices (risks to individual privacy); financial instability as people convert bank deposits to CBDC during periods of economic stress; an increase in central bank power without sufficient scrutiny (also through unconventional monetary policy); the creation of a centralised point of failure (namely the centralised CBDC ledger) that would be a target for hostile state and non-state actors (House of Lords of the United Kingdom, 2022). Bossu et al. (2020) analyse legal, financial and reputational risks. Reputational risk is also underlined by Soderberg et al. (2022), in the situation where there is not a wide acceptance and circulation of CBDC.

If the central bank charges intermediaries for using the CBDC system, there is a risk that intermediaries will in turn pass the cost downstream and raise the price of payments, which may counter initial policy goals (Soderberg et al., 2022). Talking about alternative ways to design the CBDC, when it comes to anonymity, it is evident that "the more anonymity, the larger the risk for illicit use" (Soderberg et al., 2022). Besides, "CBDC projects are resource-intensive and become even more so as their scale increases" (Soderberg et al., 2022). "As technology is still developing, choosing the best technology is deemed a challenge" (Soderberg et al., 2022).

The consequences of adopting the digital euro are so significant, that the decisions regarding its fostering must be well-founded. In the specific case of the digital euro, there are at least three particular risks. One is related to the possibility that one or more central banks from the Eurosystem reject the digital euro. Another one is connected to the scale of the project, which is set to be major. Third, the private sector offers enough means of payment which are safe, rapid and reliable. Therefore, the persuasive power of the ECB has to be strong enough to convince all stakeholders to embark upon the digital euro project.

Key elements to be taken into account upon designing the digital euro

In the seminal "Report on a digital euro" (ECB, 2020), a series of characteristics regarding the digital euro were identified. Five of them are considered core principles, eight are scenario-specific requirements and seven are general requirements (Table 1). These are similar to the features and principles envisaged by the BIS (2020) and G7 (2021). The digital euro should stimulate cooperation, knowledge-sharing, innovation and efficiency in services for end users, and it must meet certain conditions, such as "ease of use, low cost, convertibility, instant settlement, continuous availability and a high degree of security, resilience, flexibility and safety" (BIS, 2020).

Table 1. Principles and requirements related to the digital euro

<table>
<tr><td rowspan="5">Core principles</td><td>P1: Convertibility at par: Not a parallel currency</td></tr>
<tr><td>P2: Liability of the Eurosystem: A digital euro is central bank money and its issuance is controlled by the Eurosystem</td></tr>
<tr><td>P3: European solution: Widely accessible on equal terms in all euro area countries through supervised service providers</td></tr>
<tr><td>P4: Market neutrality: Not to crowd out private solutions</td></tr>
<tr><td>P5: Trusted by end users: Trusted solution from the start and over time</td></tr>
<tr><td rowspan="8">Scenario-specific requirements, if the digital euro is launched:
(1) to support digitalisation;
(2) to tackle the decline of the cash demand;
(3) as an alternative to other payment solutions;
(4) to be a tool of monetary policy transmission;
(5) to improve the resilience of the payment system;
(6) to increase the international role of the euro;
(7) to improve the cost efficiency and
(8) to improve the ecological footprint of the current payments' ecosystem.</td><td>R1: Enhanced digital efficiency: The digital euro should keep pace with state-of-the-art technology at all times in order to best address the needs of the market as regards, among other attributes, usability, convenience, speed, cost efficiency and programmability. It should be made available through standard interoperable front-end solutions throughout the entire euro area and should be interoperable with private payment solutions.</td></tr>
<tr><td>R2: Cash-like features: To match the key distinctive features of cash, a digital euro aiming to tackle a decline in the acceptance of cash should permit offline payments. Moreover, a digital euro should be easy for vulnerable groups to use, free of charge for basic use by payers and should protect privacy.</td></tr>
<tr><td>R3: Competitive features: To provide functionalities at least as attractive as those offered by other payment solutions.</td></tr>
<tr><td>R4: Monetary policy option: It should be remunerated at interest rates the ECB can modify over time.</td></tr>
<tr><td>R5: Back-up solution: It should be transacted via resilient channels that can withstand extreme events.</td></tr>
<tr><td>R6: International use: It should be potentially accessible for non-Eurozone residents, in a way that is consistent with the Eurosystem objectives.</td></tr>
<tr><td>R7: Cost saving: The design should reduce the cost of the current payments' ecosystem.</td></tr>
<tr><td>R8: Environmentally friendly: The technological solutions chosen for the digital euro should improve the ecological footprint of the current payments' ecosystem.</td></tr>
</table>

	R9: Avoidance of imbalances: The digital euro should be an attractive means of payment but its use as a form of investment should be discouraged, in order not to generate large shifts from private money to digital euro.
	R10: Stimulus for cooperation with market participants, according to the best practices in IT project management.
	R11: Compliance with the regulatory framework, including standards.
General requirements	R12: Safety, efficiency and a judicious division of responsibilities and tasks between the ECB and the private market actors. Non-core services should be left to supervised private entities.
	R13: Easy accessibility throughout the euro area: It should be interoperable with private payment solutions and it should be easily accessible by everyone.
	R14: Conditional use by non-euro area residents, in order to avoid excessively volatile capital flows and exchange rates.
	R15: Cyber resilience: The digital euro should be protected of cyber-attacks and in case of such an attack, the recovery time should be short and the integrity of data protected.

Source: ECB (2020).

Besides these principles, it is important to know **what the general public expects from the digital euro**. In the "public consultation on a digital euro", run by the European Central Bank (ECB)[6], both consumers and professionals considered privacy the most important feature of a digital euro (43%), followed by security (18%), usability across the euro area (11%), the absence of additional costs (9%), and offline use (8%) (ECB, 2021d; Weidmann, 2021). Definitely these should be high on the list of the most important design features of a digital euro. According to a more recent study done by the ECB, among the most important features that could underpin the adoption of a new payment method are mentioned the following: its universal acceptance; instant, contactless and open person-to-person payments; a one-stop solution; easy to use, secure, reliable and fast; cost-efficiency (ECB, 2022).

Beyond the pros and cons of adopting a CBDC, the success or failure of this new form of digital currency is ultimately determined by the degree of trust that users will have in it (Fugaru, 2021). The widespread acceptance of the digital euro is crucial. The user trust in the currency starts with its security. This means, on the one hand, a secure platform for transactions, which prevents fraud and, on the other hand, the security of

[6] The public consultation was launched on October 12, 2020 and closed on January 12, 2021. A number of 8.221 respondents submitted their answers. Germany accounted for 47% of the whole sample, Italy and France for 15% and 11% respectively, five additional countries each provided 1-5% of replies, while all other countries account for less than 1%.

the personally identifiable information. Security breaches may lead not only to the loss of trust in the digital currency, but also to the reputational harm of the central bank (Hansen and Delak, 2022).

As regards privacy, it cannot be tackled without the general EU policy objectives, including here anti-money laundering (AML) and combating the financing of terrorism (CFT). Ensuring confidentiality is doable, but not the anonymity, as traceability of transactions is a precondition for AML and CFT.

At the same time, previous CBDCs experiences reveal lessons worth being taken into consideration. Grym (2020) regards the Avant smart card system created by the Bank of Finland in the 1990s as the world's first CBDC, a token-based retail CBDC. Avant cards incorporated smart card technology similar to nowadays debit and credit cards. It was a low-value, pre-funded anonymous e-money payment instrument, where monetary value was stored on the card itself and it was expected to replace coins and small denomination banknotes. It complemented debit and credit cards, which were more appropriate for higher value transactions at the time. The system was initiated, developed, and for the first few years, operated by the central bank, but it was eventually sold to commercial banks. In the third operational year, it was decided that the central bank would retain the role of "overseer in the payment system" and "of participating in the development of standards", while "the business of issuing retail payment instruments would be left to commercial actors". After the cost-free period has ended, at a time when costs of using debit cards were decreasing, and their security features were improving, debit cards gained wider acceptance, and Avant was discontinued. The key lesson learnt from this example is that **only payment instruments which are attractive for consumers (competitive as compared to the others) will survive in the competitive market**.

Another example is given by a CBDC in operation between 2014 and 2018. It was called Dinero Electrónico and was based on a mobile platform developed by the central bank of Ecuador. Any mobile phone owner (not necessarily smartphone owners) could transfer money in real-time. The system was not fully backed by USD, but it was fully backed by USD-denominated assets instead. Accounts were initiated and managed by the central bank, were denominated in USD (the official currency in Ecuador) and population could open them by accessing a dial-in protocol, registering the national identity number and answering security questions. The number of users peaked 500,000, very low as compared to the total population of 17 million. In spite of incentives to use Dinero Electrónico, only 10% of the accounts were used to make payments for goods and services, including public services. In the absence of the critical mass of users and amid criticism from private banks considering Dinero Electrónico as a threat to their intermediation activities, the Ecuadorian central bank gave up on its digital currency. The key lesson learnt from the Ecuadorian experience is: **however attractive their design may be, the CBDC initiatives can be successful only if they meet two cumulative conditions: (1) they are intensely publicized, explained and understood and (2) they are supported by all economic actors, including consumers, public institutions and banks** (Arauz, Garratt and Ramos, 2021).

Consequently, the *sine qua non* preconditions for a successful digital euro project are the effective multi-level cooperation and its acceptance by the public. The public authorities have to build upon a strong relationship with key stakeholders (first consumers, but also financial intermediaries, producers, exporters, importers and merchants). To accomplish its roles, the digital euro will need to be carefully designed. It will have to bring an added value for users, support competition rather than crowd out private innovation, and avoid risks to financial intermediation (Panetta, 2022).

Digital euro experiments

The ECB is the main actor in the digital euro project. The Governing Council of the ECB established in January 2020 the Eurosystem High-Level Task Force on Central Bank Digital Currency (HLTF-CBDC) in order to advance the investigation of the digital euro.

In September 2020 the HLTF-CBDC launched experimental work on the digital euro.

The Directorate Market Infrastructure & Payments (DG-MIP) of the ECB, the Digital Euro Market Advisory Group, the Directorate Market Infrastructure & Payments (DG-MIP) of the ECB and the Euro Retail Payments Board (ERPB) play a significant role in the preparatory stage for the digital euro. A number of 30 senior consultants "with proven experience and a broad understanding of the euro area retail payments market" were hired to provide consultancy services for supporting the digital euro project investigation phase. The newly formed Market Advisory Group for the digital euro project has among its tasks the elaboration of proposals for the digital euro concept, business model and technical solution, and promotion of the project with relevant market providers and stakeholders (including international fora, relevant consumer and industry associations, EU institutions, etc.) (ECB, 2021b; ECB, 2021c). The Digital Euro Market Advisory Group advises the Eurosystem on the design and rollout of the digital euro.

During the formal investigation phase which began in October 2021 and is scheduled to end in October 2023, one can remark the increased interactions between the ECB and other European authorities and institutions – the Parliament, the Commission, the Council, the Eurogroup (as the digital euro will require legislative changes) –, as well as those with private stakeholders.

The ECB is currently working together with the technology providers[7] and banks on the end user features of a digital euro so it could be integrated into the services that they are already offering to their customers. The results of the investigation will be presented to the Governing Council, which will take a decision regarding the digital euro adoption or not (Panetta, 2021d). The general institutional framework of the digital euro project is already established.

According to the European Banking Federation, the ECB should explore together with banks the digital euro design. The primary argument is that European banks have in-depth experience with digital transformation and competences on relevant IT and governance structures such as electronic identification solutions, as well as AML/CTF. Many European banks have specific know-how in already implemented solutions based on DLT, distributed infrastructure and related governance (EBF, 2021).

Considering the *Study on New Digital Payment Methods* (ECB, 2022), it became clear that the ECB has started from the "CBDC Pyramid" (Auer and Böhme, 2020). It analyses the consumer needs that a retail CBDC could address, identifies associated technical design trade-offs, and then drafts the design choices.

The most circulated proposal for the **technological tool** to support the CBDC

[7] For instance, a European fintech payments dialogue took place on 2 December 2021.

implementation is the distributed ledger technology. It has advantages in terms of availability, low failure potential and integrity of transaction records through cryptographic hashes. But at the same time it has also disadvantages related to security risks due to actions which do not require permission (smart contracts include vulnerabilities). The need for a strong information security program is justified by the various forms of attacks, either phishing and malware to obtain credentials or private keys, or insider unfair practices leading to asset theft, or unintentional technical errors embedded in algorithms, or even espionage against critical infrastructure (Hansen and Delak, 2022).

In the preliminary phase, starting from September 2020, the ECB organised four work streams during which were tested the possibilities of running a digital euro with a centralised system, a decentralised one, a mixture of the two, and with offline payments (ECB, 2021f).

A list of questions has to be answered, starting from:

- How large should be the system?
- How is the access (wide versus restricted; direct access when the Eurosystem is the sole provider of payment services or intermediated access, when third parties distribute the digital euro; unlimited or capped; available to non-residents or not)?
- Is the system centralized or decentralized?
- How is the degree of anonymity (ranging from complete to none)?
- Will payments in digital euro be made online, offline or both options will coexist?
- Will the digital euro bear interest?
- Will the digital euro be token or account-based?

Conclusions

This paper highlighted both the European Central Bank's motivations for adopting a digital euro and the existing obstacles. There are still a number of questions that need to be answered. The digital euro should achieve the appropriate trade-off between expectations of all market actors and the objectives of the Eurosystem. The mission of the ECB in the process of adopting the digital euro is facilitated by the lessons learned from previous projects. At the same time, the guidelines and principles outlined by international organizations, as well as the research of the various central banks and institutions, provide useful directions for action.

There are various options for the digital euro, starting with: access level (widespread or restricted, limited or unlimited, available to non-residents or not), anonymity, technology (distributed ledger technology, centralized technology or other technologies), degree of disintermediation (depending on the degree of involvement of the ECB). Probably the ECB will take into account the two-tier approach, with a minimal central bank's intervention in operational activities related to the digital euro. As underlined by the literature, it is the best way to avoid cyber risks and reputational risks, as well as burdensome costs. Moreover, it stimulates further financial competition, innovation and intermediation and offers trust, efficiency and stability.

However, taking into account that the adoption of the digital euro, similar to other CBDCs, is accompanied by potential opportunities and risks, any decision has to be well-founded. When foreseeable risks are overwhelming in relation to predictable benefits or when the general support of the population and of private payment providers for the digital euro is not clear, it is preferable to abstain from adopting it. Instead, it might be recommendable to solve current problems in other ways, for instance by a stricter regulation of the activity of some economic actors, especially those of systemic importance.

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Redefining the Smart City within the European Digital Society

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Abstract: *Based on the understanding that the EU is building a value-based digital society, this research aims to recapture the narrative of the smart city and to introduce the latter as an actor in EU digital policy. It starts from the acknowledgement that smart cities are reduced to mere business-led strategies and lack direct grassroots engagement that would bring value to the urban landscape. Then, it deconstructs the main pillars of the digital society as proposed by the current Commission and searches for areas of congruence between smart cities and the model for the digital society. To illustrate this congruence, the article analyses policy documents at the European and local level and features a case study of Darmstadt, designated Germany's Digital City in 2019.*

Keywords: *European Union, digital policy, digital society, smart city, governance.*

Introduction

European leaders have actively promoted "the European-style digital society"[2] in recent years, this being a new narrative focused on principles and values that distinguish the European Union (EU) from other tech powers. This model has evolved and the story is different now. As with many other policies, the national-European balance still has a good grasp on the governance of digital policies, which disregards other valuable actors for the advancement of this new narrative. Aiming to push the digital policy ecosystem further, this article expands the area of relevant actors in digital policies by introducing the local level into the policy mix. In their own microcosm, cities pursue their own digital transformation by means of smart city strategies, essentially local development strategies with digital at their core. The cities are key actors in the narrative of the digital society given their proximity to the citizens. However, the smart city literature focuses too much on business-friendly smart cities, revealing a narrative built around utopian smart cities[3]. In this sense, the assumption of this research is that the EU digital policy needs to recapture the smart city narrative to translate the principles of the European digital society to the local level.

This article aims to answer the following research questions: what is the congruence between cities and the EU in terms of constructing their digital society models? How can smart cities feed into the value-based digital society? The theoretical

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[2] European Commission, *Berlin Declaration on Digital Society and Value-Based Digital Government*, March 2021, https://digital-strategy.ec.europa.eu/en/news/berlin-declaration-digital-society-and-value-based-digital-government, accessed January 20, 2022.

[3] Ola Söderström, Till Paasche, and Francisco Klauser, "Smart Cities as Corporate Storytelling," *City* 18, no. 3 (May 2014): 307–320.

research is backed up by a case study of Darmstadt, Germany's Digital City in 2019. Darmstadt is a developed city, without any close connections to EU policy or projects. The research will provide valuable insights for translating the principles of the European digital society closer to the citizen, considering the claims that the digital society will be human-centred[4]. This research aims to recapture the narrative of the smart city from a corporate, business-oriented view and bring it closer to the idea of the city as a true community.

Firstly, the conceptual framework of this article is founded on the constructivist paradigm according to which the values and norms of an entity shape the structure of the system. The EU is shaping the digital space by building new values, such as the protection of personal data. Secondly, to address the significance of local actors in digital policies, the research details multilevel governance (MLG). It also reviews smart city literature to highlight the significance of smart cities in digital policies. The article reflects upon the congruence between the model and the EU vision towards the digital society, with the purpose of recapturing the smart city and channelling it in EU policymaking. This congruence is illustrated by the case study analysis of Darmstadt to zoom in on a local digital transformation strategy that mirrors the EU discourse.

A few methodological notes are necessary here. The core of the empirical research is based on document analysis, specifically the policy documents of the digital strategy of the EU and the Digital City strategy of Darmstadt. At the European level, the document analysis is based on documents that help construct the model of the digital society, namely the *Communication on Shaping Europe's Digital Future, the Berlin Declaration on the Digital Society and Value-Based Government, 2030 Digital Compass. The European Way for the Digital Decade, and the European Declaration on Digital Rights and Principles*. The choice of documents is relevant considering that the EU has crystallized a vision for the digital society for the first time, following the accepted equivalence between the online and the offline worlds. In its push both for internal regulation and harmonization and for external validation as a bona fide player in technology issues, the EU has chosen to pursue the value-based discourse. Its application depends not only on the European level, but also on the other decision-making levels.

To maintain this equivalence of analysis, the local level is studied with the help of Darmstadt's digital city strategy. The city's commitment to a different vision of the smart city has not been influenced by the European discourse, but nevertheless it illustrates the commitment of the local level to a set of values that are congruent with the European discourse and narrative. This is the motivation for the choice of Darmstadt as a case study, as it has no direct affiliation and inspiration from the European policy environment, but it reinforces this narrative at the local level and it can serve as an example.

1. Theoretical framework

This research offers a constructivist perspective on how the EU is shaping the digital society by proposing a value-based discourse and implementing it with concrete policy solutions. In the general agent-structure debate, this paper argues that actors, such as the EU and cities, shape the structure of the digital society by offering a foundation based on values and principles that translate into policies. The EU shapes the structure by

[4] European Commission, *Europe's Digital Decade: Digitally Empowered Europe by 2030*, March 2021, https://ec.europa.eu/commission/presscorner/detail/en/ip_21_983, accessed 20 January 2022.

means of Europeanisation, building new values, principles, and policies at the local level. The Europeanisation process offers the theoretical foundation so that it can bring together a clear view of how European integration can be fostered at the local level by creating a congruence between the city and the European digital society. The second layer of the theoretical framework refers to MLG. Its utility stems from its initial conceptualization as a shift of EU governance meant to connect to the local level in different policies. A concise description of its key features is necessary to reflect conceptual clarity and to form the foundation for the empirical analysis.

First, MLG considers several types of authorities that interact in a loose manner to achieve an objective. They are organized in levels or in *spheres of authority*, as Rosenau has proposed[5]. The classification of levels is up for debate. Analyses consider that they are mostly territorial, but they can also be functional.

Second, MLG refers to vertical relations among the three levels or spheres within the EU policymaking, considering the context of innovative governance[6]. According to the authors of this theory, these "nested" levels or spheres of authority do not contain a hierarchical component. MLG has a relaxed structure with no real formalities in the sense of top obligations to be implemented by the lower levels[7]. In terms of structure and the top-bottom or bottom-up directions of policies, there is also no obligation that all levels participate, and this is yet another sign of the relaxed nature of MLG. This can be seen as the basis for the greater involvement of local and/or regional actors within EU policymaking.

The slow development of an open policy environment has opened the door for more actors to be involved in various types of policy issues. The most prominent are regional authorities. This brings the discussion to the third feature of MLG, namely its outreach outside the traditional European-national dichotomy in European studies. As it was not developed to settle the debate between the two levels, researchers used it to explain the growing number of actors involved in EU policies, given that integration expanded to new areas. The emergence of structural funds within the regional policy of the EU marked this transition towards MLG, considering that the funds provided were to be absorbed at a regional level. Marks et al. are the first to develop this model by illustrating the reality of regional policy[8]. The commitment to achieve socio-economic cohesion that required a regional approach was the motivating factor for the involvement of the regional authorities in EU affairs. Nevertheless, the concept has evolved beyond this initial conceptualization and has been used to explain various policy areas, such as environmental policy[9].

Additionally, it has been used extensively with different definitions and approaches. This might cause conceptual confusion for any theoretical or normative

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[5] James N. Rosenau, "Governing the Ungovernable: The Challenge of a Global Disaggregation of Authority," *Regulation & Governance* 1, no. 1 (2007): 88–97.

[6] Liesbet Hooghe and Gary Marks, *Multilevel Governance and European Integration* (Oxford: Rowman and Littlefield Publishers, 2001).

[7] Jon Pierre, "Multilevel Governance as a Strategy to Build Capacity in Cities: Evidence from Sweden," *Journal of Urban Affairs* 41, no. 1 (January 2019): 103–116.

[8] Gary Marks, Liesbet Hooghe, and Kermit Blank, "European Integration from the 1980s: State-Centric v. Multi-Level Governance," *Journal of Common Market Studies* 34, no. 3 (September 1996): 341–378.

[9] Miranda A. Schreurs and Yves Tiberghien, "Multi-Level Reinforcement: Explaining European Union Leadership in Climate Change Mitigation", *Global Environmental Politics* 7, no. 4 (November 2007): 19–46.

analysis. Bache reflects on the fact that there is no single accepted definition of the term within the academic community[10]. Stephenson argues that MLG has been used as a "catch-all" term meant to explain new developments in EU policymaking[11]. At the same time, Scharpf argues for the development of a series of concepts within the 'multilevel umbrella' that can capture the interactions between actors situated at various levels, such as joint decision-making, hierarchical direction, or mutual adjustment[12].

The last relevant issues identified for this research refer to the fluid and perceived dual nature of MLG, first its applicability as a theory of European integration or as a theory of public policy[13] and, second, the focus on territorial and functional governance[14]. Tortola references the duality of the MLG definition, but insists that it is useful for explaining policy developments. These all point to the fact that MLG is developing into a theory of public policy, considering the focus on actors, processes, and structures. On the other hand, Bache also references the lack of normative dimension of MLG, considering that it merely explains the emergence of new actors and provides a framework for new types of actors to interact in policymaking, without developing a path for action[15].

This research aims to tackle the fluid features of MLG. First, the congruence between smart city and digital society narratives will reveal that MLG can be a theory of European integration, based on the transfer of the principles of the European digital society at the local level, within a process of Europeanization. In turn, this transfer can translate into coherent digital policies at the local level. Secondly, the usefulness of the concept resides in its flexibility and ability to help explain regular interactions among actors at various institutional levels in policy areas that are growing increasingly, such as digital policy. In this sense, it can help streamline the knowledge about the application of digital policy at various institutional levels.

Summarizing, the theoretical framework makes use of the general constructivist perspective to indicate the focus on norms and values within the digital society and smart city discourses. The MLG perspective contributes to conceptual and theoretical clarity by providing a foundation for the analysis of European and city discourses related to digital policies.

2. Deconstructing the EU digital society

The European Commission has chosen digital transformation for one of its political priorities for the 2019-2024 mandate. Previously, the Commission completed the Digital Single Market (DSM) by focusing on regulatory reform. The discussions around the DSM were technical, from data protection reform to interoperability or cross-

[10] Ian Bache, *Multi-Level Governance in the European Union* (Oxford University Press, 2012), https://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780199560530.001.0001/oxfordhb-9780199560530-e-44.

[11] Paul Stephenson, "20 Years of Multilevel Governance: Where Does It Come From? What Is It? Where Is It Going?," *Journal of European Public Policy* 20 (2013): 818.

[12] Fritz Scharpf, "Multi-Level Europe – The Case for Multiple Concepts," in *Handbook on Multi-Level Governance*, Elgar Original Reference Series (Edward Elgar, 2010), 66–80, https://books.google.de/books?id=afODmAEACAAJ.

[13] Pier Domenico Tortola, "Clarifying Multilevel Governance," *European Journal of Political Research* 56, no. 2 (May 2017): 237.

[14] Bache, *Multi-Level Governance in the European Union...*, 585.

[15] *Ibidem*.

border commerce[16]. The benefit to the citizen was clear, but the policies had a European and a national outlook, with legislation on copyright, data protection or interoperability. During this time, the Commission undertook policy initiatives to boost uptake of technologies at the local level, with the *Digital Cities Competition* or the current *Intelligent Cities Challenge*[17]. Currently, the Commission is supporting the *Smart Cities Marketplace* as a "a major market-changing undertaking that aims to bring cities, industries, SMEs, investors, researchers and other smart city actors together"[18]. These are examples of network governance encouraged by the European Commission, as they are places where best practices, services or data are shared amongst the cities participating in the project. Nevertheless, the approach is focused on solutions and not on principles and values underpinning them.

The current Commission shifted the discourse towards principles and started the discussion around a model for a digital society with clear benefits for the citizens. This section deconstructs the European digital society that may serve as a model for smart cities.

In 2020, the Commission revealed its vision for digital transformation by presenting a model for a digital society based on principles and values where technology would play a role in enforcing and not in challenging them. Unlike the DSM Strategy, which had a clear regulatory focus with an economic outlook, the Communication entitled *Shaping Europe's Digital Future* unveils a different vision, as the EU claims its choice to "pursue digital transformation in its own way". It announced a new model for the digital society with the three pillars: technology that works for the people, a fair and competitive economy, an open, democratic, and sustainable society[19]. Trust is the centre pillar of this model, as the Communication enforces the idea that citizens need to trust digital solutions so that they can make use of them properly. For this purpose, technology used in the EU must respect the "democratic values, respect fundamental rights, and contribute to a sustainable, climate neutral and resource-efficient economy"[20]. Other values, such as fairness or empowerment, are at the centre of this strategy, but up to this point, the concept is rather vague.

In late 2020, the member states signed the *Berlin Declaration on Digital Society and Value-Based Digital Government*, whose principles shed a light on the foundations of the European digital society, as follows:

- Fundamental rights and democratic values – the rule of law, human dignity, right to autonomy, ethical values, freedom of expression, transparency, privacy
- Social participation and digital inclusion to shape the digital world
- Empowerment and digital literacy – protection of personal data, digital-

[16] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and to the Committee of the Regions. A Digital Single Market Strategy for Europe*, May 2015, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0192&from=EN, accessed 20 April 2022.

[17] Intelligent Cities Challenge, *Intelligent Cities Challenge*, 2020, https://www.intelligentcitieschallenge.eu, accessed 20 April 2022.

[18] European Commission, *Smart Cities Marketplace. About This Site*, 2022, https://smart-cities-marketplace.ec.europa.eu/about, accessed 20 April 2022.

[19] European Commission, *Communication. Shaping Europe's Digital Future*, February 2020, 3, https://ec.europa.eu/info/sites/info/files/communication-shaping-europes-digital-future-feb2020_en_4.pdf, accessed 20 April 2022.

[20] *Ibidem*.

by-default, citizen autonomy, "lifelong learning and development of digital skills"
- Trust and security in digital government interactions
- Digital sovereignty and interoperability
- Human-centred systems and innovative technologies in the public sector – responsibility and accountability in the use of AI, elimination of social and economic biases
- A focus on well-being in the digital society[21]

Finally, the puzzle of the European digital society is completed by the *Declaration on European Digital Rights and Principles*, as well as the *2030 Digital Compass: the European way for the Digital Decade*. They highlight the long-term vision of the digital society and the concrete policies to achieve it. The Declaration clarifies the list of digital rights and principles, as follows:
- Putting people and their rights at the centre of the digital transformation
- Solidarity and inclusion
- Freedom of choice online
- Participation in the digital public space
- Safety, security, and empowerment of individuals
- Sustainability of the digital future[22]

According to the *Digital Compass*, "the European way to a digitalised economy and society is about solidarity, prosperity, and sustainability, anchored in empowerment of its citizens and businesses, ensuring the security and resilience of its digital ecosystem and supply chains"[23]. This definition reflects the principles previously mentioned. The strategy focuses on the concrete steps on four major areas of policy intervention for 2030, namely skills, businesses, infrastructures, and government. Each point provides a concrete target to be achieved, such as a target of 80% of the population that should have basic digital skills by 2030 or that all key public services should be online by 2030. All these targets reflect and reinforce vision expressed by the Commission. For instance, the 80% target points to the empowerment of citizens, as well as making sure that they understand and control the use of their personal data, that they can use digital public services and are not excluded from the digital society.

Policies at the European, national, and local level are necessary for these targets to be achieved and, conversely, for the values to be internalized. The Cohesion Policy priorities for 2021-2027 and the Resilience and Recovery Framework (RRF) are set to implement these values and norms into policy and projects. For instance, the one of the five priorities of the Cohesion Policy is *a more competitive and smarter Europe*[24]. Such a priority sets the tone for the national and regional efforts for accessing funds. Romania's regional development planning includes priorities, such as *A region with smart towns and*

[21] European Commission, *Berlin Declaration on Digital Society and Value-Based Digital Government...*
[22] European Commission, *European Declaration on Digital Rights and Principles*, January 2022, https://digital-strategy.ec.europa.eu/en/library/declaration-european-digital-rights-and-principles, accessed 18 February 2022.
[23] European Commission, *2030 Digital Compass. The European Way for the Digital Decade*, 2021, 2, https://ec.europa.eu/newsroom/dae/document.cfm?doc_id=75375, accessed 20 February 2022.
[24] European Commission - Regional Policy, *Priorities for 2021-2027*, 2021, https://ec.europa.eu/regional_policy/en/policy/how/priorities/, accessed 21 April 2022.

cities or *A digital region*, with proposed actions that emulate major challenges of the smart city[25]. Similarly, the particularity of the RRF is that it requires that 20% of the national funding be spent on digital transition priorities and this has set in motion plans for digital transformation across the European Union. The governance and monitoring mechanism of the Digital Decade states that cohesion programmes and the RRF are sources for the implementation of the changes required by the abovementioned programme. Hence, not only does the EU aim to set the norms and values for the digital society, but it ties them together with funding to ensure that they are materialised.

The discourse on the value-based digital society aims to provide a shift from the tech-led digital society, marked by digital divides, loss of autonomy of citizens, and cybercrime. In this sense, it is a constructivist discourse. At the same time, the concrete steps meant to achieve this vision mirror the interaction of different decision layers or spheres of authority theorized by MLG. The European level creates the vision and collaborates with the national level to achieve it. At the same time, the national level may create its own roadmap for the completion of the policy objectives, but the European level supervises its implementation. Since achieving these objectives and enacting this vision are wide-ranging and have deep implications for society in general, other actors need to be involved in the process. The next section reflects on smart cities as additional actors that can help implement the vision of the European digital society.

3. Deconstructing the smart city. Narratives and governance

Smart city analyses focus on this "fuzzy" concept and lament over a missing unifying definition[26]. Meta-analyses assume certain features of smart cities from the variety of definitions and discourses[27]. Instead of addressing the same claims, this section works towards integrating the city and its smart city governance into the architecture of multi-level digital policies in the European Union. To do so, it will focus on two aspects, the narratives that shape the smart city and smart city governance.

Narratives help build up goals and means to achieve them, shaping the power structures tasked to pursue them[28]. Once the administration establishes the required outcomes for the smart city, it looks towards actors who can fulfil them. In the spirit of technocratic governance and entrepreneurialism[29], their autonomy allows them to shape the smart city, but in collaboration with information and communication technology (ICT) companies who are in possession of the tools to achieve this vision. Since other

[25] The Romanian Regional Development Planning has changed as of the 2021-2027 period. Each NUTS II region, the development region, has drawn up its own Regional Operational Programme. See for instance: http://regio-adrcentru.ro/wp-content/uploads/2022/01/POR-Centru-21-27-noiembrie-2021.pdf or https://www.nord-vest.ro/regio-2021-2027/, accessed 21 April 2022.

[26] Annalisa Cocchia, "Smart and Digital City: A Systematic Literature Review," in Smart City. *How to Create Public and Economic Value with High Technology in Urban Space* (Cham: Springer, 2014), 13–45; Andrea Caragliu, Chiara Del Bo, and Peter Nijkamp, "Smart Cities in Europe," *Journal of Urban Technology* 18, no. 2 (April 2011): 65–82; Margarita Angelidou, "Smart City Policies: A Spatial Approach," *Current Research on Cities* 41 (July 2014): S3–S11.

[27] Simon Joss et al., "The Smart City as Global Discourse: Storylines and Critical Junctures across 27 Cities," *Journal of Urban Technology* 26, no. 1 (January 2019): 3–34.

[28] James A. Throgmorton, "Planning as Persuasive Storytelling in a Global-Scale Web of Relationships," *Planning Theory* 2, no. 2 (July 2003): 125–151; Leonie Sandercock, "Out of the Closet: The Importance of Stories and Storytelling in Planning Practice," *Planning Theory & Practice* 4, no. 1 (January 2003): 11–28.

[29] David Harvey, "From Managerialism to Entrepreneurialism: The Transformation in Urban Governance in Late Capitalism," *Geografiska Annaler. Series B, Human Geography* 71, no. 1 (1989): 3; Rob Kitchin, "The Real-Time City? Big Data and Smart Urbanism," *GeoJournal* 79, no. 1 (February 2014): 1–14.

actors are part of this vision, the power structure grows more complex, and a particular governance structure is necessary. Narratives help shape the governance of the smart city.

There are two main narratives that shape the smart city perspective. The mainstream discourse focuses on business-related aspects. In this vision, companies create the narrative of a utopian city whose problems have all been solved through technology[30]. The city is a system working efficiently by means of ICT innovations[31]. Concerned with a skewed perspective, the literature has fought back with critical perspectives that challenge this overly optimistic view. Researchers describe an alternative view towards smart cities, which should consider citizens equally when introducing technology in the city. Citizens are not only at the receiving end of technology, but they are also partners in decision-making and implementation. For that matter, the search for the smart city should start from an exploration of social problems, social groups, and struggles in urban places[32], which does not happen in a business-led smart city. The contrast with the previous narrative is clear, in the sense that citizens share the same concerns and aspirations, needs, and resources in the utopian city. Based on this assumption, technology is likely to solve everybody's problems just because they are the same for everyone. The ignorance of diverse citizen experiences is the main critique of the mainstream view.

This research elevates cities from being passive entities that merely apply innovations designed by others and await significant changes. Cities shape the local community with technology by enabling transformations based on principles and true collaboration with local actors. In this narrative, the smart city is a fully-fledged actor with a deep understanding of the community it represents and with a balanced vision of digital transformation. The model of the European digital society fits with this vision. Based on this understanding, it sets principles for the use of technology and creates governance structures, mechanisms, and processes to put its vision in practice. The governance of the smart city is significant for this analysis, considering that it can and should respect the principles of inclusion, openness, and transparency, announced by the literature[33]. The model of the digital society emphasizes these principles as well.

The governance pillar is a significant part of the smart city agenda[34]. Authors view it as 'smart governance' that comprises political participation, e-government services or how the administration works[35]. Its components may include participation in decision-making, public and social services, transparent governance, and political strategies[36]. The role of governance is, hence, to support decision-making, implementation, and evaluation of policies at the local level[37]. As opposed to the traditional view of government,

[30] Robert G. Hollands, "Critical Interventions into the Corporate Smart City," *Cambridge Journal of Regions, Economy and Society* 8, no. 1 (August 2014): 61–77; Ola Söderström, Till Paasche, and Francisco Klauser, *Smart Cities as Corporate Storytelling...*

[31] Ola Söderström, Till Paasche, and Francisco Klauser, *Smart Cities as Corporate Storytelling...*

[32] Colin Mcfarlane and Ola Söderström, "On Alternative Smart Cities: From a Technology-Intensive to a Knowledge-Intensive Smart Urbanism," City, June 2017, 2.

[33] Joss et al., *The Smart City as Global Discourse: Storylines and Critical Junctures across 27 Cities...*

[34] Rudolf Giffinger et al., "Smart Cities. Ranking of European Medium-Sized Cities," October 2007, http://www.smart-cities.eu/download/smart_cities_final_report.pdf, accessed 22 April 2022.

[35] *Ibidem*, 11.

[36] *Ibidem*, 12.

[37] Andrea Caragliu, Chiara Del Bo, and Peter Nijkamp, "Smart Cities in Europe," *Journal of Urban Technology* 18, no. 2 (April 2011): 65–82,; Margarita Angelidou, "Smart City Policies: A Spatial Approach," *Current Research on Cities* 41 (July 2014): S3–S11.

governance also entails variety in terms of actors, regardless of their interests.

Several smart governance approaches exist in literature. Meijer and Bolívar designate three types of smart cities, with a focus on technology, on smart people, and on collaboration[38]. Smart cities with a governance focus are only as smart as the collaboration between stakeholders[39]. Also, the focus is on the citizen, while their interaction should result also in innovation[40]. Smart cities need more than open channels of communication with various actors – businesses, academia, the civil society - they also need to take advantage of the benefits offered by technologies enabling their communication and decision-making process. In this sense, there should be a synergy between the use of technology and the governance cycle, aimed at tackling diverse challenges[41].

Civic participation can be considered of high importance for governance, for two reasons. First, the relaxed governance structure would bring other social categories to the decision-making table, making it more democratic. Second, the accumulation of grassroots information is valuable for the development of smart governance processes[42]. In terms of smart governance, the adjective 'smart' refers also to the inclusion of 'grassroots' intelligence that only citizens can provide. Citizens are also producers and owners of data, as well as active actors within the life of the city[43]. They are not passive recipients of the innovative technology; they interact actively with it and the goal is to help them create new digital routines in the relation to the city. Hence, technology should be used both to enhance decision-making processes and to improve citizens' interactions with the city. This comprises a wide array of mechanisms, from the mere possibility to pay taxes online to connectivity across the territory or e-health policies.

Nowadays, the literature trend is to emphasize the role of the citizens in the smart city governance[44]. In this sense, a city is as smart as its citizens[45]. However, this does not refer only to digital skills, but also to their active engagement with the smart city process, which is the basis for the alternative smart city[46]. The city can become smarter if the citizens become an active part of the process, while the authorities adopt a 'learning' culture, being able to integrate the locals' experience into the process. A key value is significant in this respect, namely trust, identified also by the European Union in

[38] Albert Meijer and Manuel Pedro Rodríguez Bolívar, "Governing the Smart City: A Review of the Literature on Smart Urban Governance," *International Review of Administrative Sciences* 82, no. 2 (June 2016): 392–408.

[39] Karima Kourtit, Peter Nijkamp, and Daniel Arribas, "Smart Cities in Perspective – a Comparative European Study by Means of Self-Organizing Maps," *Innovation: The European Journal of Social Science Research* 25, no. 2 (June 2012): 229–246.

[40] Karima Kourtit, Peter Nijkamp, and Daniel Arribas, "Smart Cities in Perspective – a Comparative European Study by Means of Self-Organizing Maps," *Innovation: The European Journal of Social Science Research* 25, no. 2 (June 2012): 229–246.

[41] Zsuzsanna Tomora et al., "Smart Governance for Sustainable Cities: Findings from a Systematic Literature Review," *Journal of Urban Technology* 26, no. 4 (October 2019): 4.

[42] Zsuzsanna Tomora et al., *Smart Governance for Sustainable Cities...*: 3.

[43] Sofia Ranchordas and Abram Klop, "Data-Driven Regulation and Governance in Smart Cities," in *Research Handbook on Data Science and Law* (Edward Elgar Publishing, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3126221.

[44] Walter Castelnovo, Gianluca Misuraca, and Alberto Savoldelli, "Smart Cities Governance: The Need for a Holistic Approach to Assessing Urban Participatory Policy Making," *Social Science Computer Review* 34, no. 6 (November 2015): 724–739.

[45] Meijer and Bolívar, *Governing the Smart City...*: 397.

[46] Mcfarlane and Söderström, *On Alternative Smart Cities: From a Technology-Intensive to a Knowledge-Intensive Smart Urbanism...*

its digital strategy. One key to developing the trust of citizens in technology, as well as in authority, is to have them involved in the process. The choice of governance structures, mechanisms, and processes reflects the prioritization of the citizens or the lack thereof. In turn, citizen involvement in governance reflects towards the European digital society. This paper investigates this alignment of views to recapture the narrative of the smart city.

Congruence between smart city and EU digital society

This section aims to provide an answer to the main research questions, namely what the congruence between the smart city and the European digital society is, and whether the latter can provide insights for a better model for the smart city in the European Union. Two layers provide the answer to these questions, first the theoretical analysis and, second, a small case study on Darmstadt, Germany's Digital City of 2019.

Firstly, the European digital society offers a model for redefining the smart city discourse based on the human-centred approach. The European model underlines this approach, both in its overall vision and in its policy programme and governance. One of the priorities of EU digital strategy stresses that technology needs to work for the people and not the other way around. A closer look at smart cities and the narratives around this concept sees congruence with the so-called alternative approach to smart cities, which is not tech-led, but rather aims to contribute socially as well. A similar model developed in the smart city literature is the human-centric smart city, defined as a collaborative city that practices smart governance and whose ultimate focus is the creation of public value by boosting well-being[47]. Well-being and public value are significant in this conceptualization, and they mirror the vision of the European digital society.

Secondly, the European model for the digital society stresses the importance of trust in technology and the institutions developing and deploying it. Building trust requires openness, transparency, as well as co-design and co-creation of policies in terms of governance. However, the mainstream smart city narrative focuses more on the inevitable positive results that technology will bring and, in this case, trust is self-evident, given that the result of implementation of the smart city strategy will yield only benefits for the citizen. Considering that issues related to autonomy, loss of control or confidentiality have gained more attention along with the deployment of increasingly complex technology, trust is not self-evident. Trust must be built in the smart city, as well. Applying the principles mentioned in the EU declarations should be a prerequisite for the development of smart city strategies, so that citizens can feel empowered, for policies to succeed and truly solve the challenges brought about by technological development at the local level.

Thirdly, inclusion and equal access to the opportunities offered by technology are major priorities of the European digital society, stemming from the human-centric vision. At the local level, as well as the European level, citizens do not share the same opportunities and the same problems. In this sense, smart cities should also target societal issues, such as the digital divide, while making sure citizens are not left out by the sweeping changes in local digital public services, for instance. The alternative vision of smart cities presented in the previous section has based its criticism on the lack of societal outlook of traditional smart city strategies focused mainly on technological deployment

[47] Keegan McBride, Luciana Cingolani, and Gerhard Hammerschmid, *Policy Brief: Human Centric Smart Cities*, Hertie School, January 2022, https://www.hertie-school.org/en/digitalgovernance/news/detail/content/policy-brief-human-centric-smart-cities, accessed 15 February 2022.

regardless of its societal impact.

In addition, the model for the digital society and the smart city includes other dimensions such as sustainability and respect for the environment and even the push towards climate neutrality[48]. This is an acknowledgment of the idea that digital transformation can be an enabler for other transformations, such as the green transition. Moreover, it is proof that digital transformation is not a sectoral policy area, but rather a horizontal one with vast ramifications. The European discourse on the digital society acknowledges this idea, as well as the fact that it does not bring only positive effects, but that it also comes with challenges in various areas. The mainstream view of smart cities relinquishes this balanced view and chooses to focus on the efficiency of the city powered by technology, regardless of what efficiency might mean[49].

The four dimensions provide a foundation for the transformation of the smart city discourse in the European Union to include the values, norms, and principles proposed by the policy documents.

Case study: Darmstadt

The connection between the smart city and the digital society seems to be a given, since both are concepts shaped by the deployment of digital technologies. This is not necessarily a debatable issue, but what is debatable relates to the different narratives about these concepts. Narratives are based in values and principles, and they shape strategies and policymaking. This case study will highlight the idea that cities can and do focus on a value-based smart city strategy by illustrating the areas of congruence identified above, even if the EU is not the direct inspiration.

Located in the Land of Hessen, Darmstadt is a part of the metropolitan region Rhein-Main[50]. The city focused its post-war reconstruction on the development of a science and culture city, earning the title of City of Science. It has a growing population and a booming economic sector, ranked 4th in Germany and 16th in Europe in terms of the regional gross national product per capita in PPS[51]. The economy reflects the title of City of Science, with a major focus on aviation and space engineering, mechatronics, or pharmaceuticals. The three universities contribute to a flourishing partnership with the local business sector and the administration. In 2019, the city won a national competition for mid-sized cities to be selected as the Digital City. Its vision mirrors the value-based discourse developed by the EU, even if they have not been directly inspired by the European level.

First, the vision of Darmstadt can be circumscribed to the idea of human centric smart cities since its approach is collaborative and encourages citizen involvement. Das StadtLabor, the city's Living Lab, is the venue in which cities can test out and interact with the applications developed for the city, based on their stated vision that "more people should be able to profit from the benefits of digitalization" and that it has the task of

[48] European Commission, *EU Mission: Climate-Neutral and Smart Cities*, 2021, https://ec.europa.eu/info/research-and-innovation/funding/funding-opportunities/funding-programmes-and-open-calls/horizon-europe/eu-missions-horizon-europe/climate-neutral-and-smart-cities_en, accessed 22 February 2022.

[49] Robert G. Hollands, *Critical Interventions into the Corporate Smart City*...,: 61–77.

[50] Darmstadt, *Stadtporträt: Darmstadt*, September 2019, https://www.darmstadt.de/standort/stadtportraet, accessed 15 April 2021.

[51] Darmstadt City of Science, *Business Facts*, 2019, https://www.darmstadt.de/fileadmin/Bilder-Rubriken/Standort/Wirtschaft/pdf_downloads_dt-eigene_pubklikationen/Broschuere_Business_facts_1019.pdf, accessed 22 April 2022.

"making the difficult-to grasp digitalization tangible, understandable, and participatory"[52]. By bringing technology closer to the citizens and making it more understandable, the authorities aim to boost trust in the digital solutions implemented that might easily be misconstrued as intrusive or highly complex.

Second, the local administration has developed several other measures meant to boost public participation and create a trustworthy environment. The city's data platform provides details with regards the major indicators of the city and it is improved with requests and feedback from citizens[53]. Most notably, the governance structures include an ethics council, which advises the local administration on potential ethical issues regarding the use of certain technologies and has developed an ethical code to be followed by the public company that oversees the projects. The stated purpose of the Ethics and Technology Advisory Board is to help in the implementation "of the project and to avoid the danger of an almost complete digital control of people, as is the reality in part in the People's Republic of China"[54]. The reference to the digital surveillance system implemented by the Chinese Government has also been used by the European Commission in its strategy on Artificial Intelligence, as well as in its proposed legislation on the same technology[55].

Third, the Digital City project has also emphasized the need to develop digital skills of citizens, with projects, such as *Bleib Wachsam, Darmstadt*, aimed at building the awareness of citizens regarding cyber security and the protection of their personal data[56]. We see a parallel with the empowerment dimension from the EU policy documents analysed in the previous section, all of which stressed the need for citizen empowerment in the online environment. Additionally, the narrative of the alternative smart city looks at the idea that citizens have different needs online and, for this reason, the Digital City project has developed digital skills training for the elderly, as well as tools for adults with learning disabilities in the project entitled *Digital für alle*[57].

Last, sustainability sits at the core of the Digital City strategy, along with the aim to be participatory, prepared for the future, valuable for the citizens, and secure[58]. All major directions of the strategy should be striving for these core aims, as they underpin the entire vision of the project. In this sense, sustainability is not a simple buzzword, as care for the environment influences all the solutions that are developed within the project. A parallel can be drawn between the core principles of the European Commission strategy for the Digital Decade and this approach, considering that all policymaking and projects must be grounded in these principles.

[52] Digitalstadt Darmstadt, *Das Stadtlabor*, 2021, https://www.digitalstadt-darmstadt.de/stadtlabor/das-stadtlabor, accessed 22 April 2022.

[53] Digitalstadt Darmstadt, *Datenplattform Darmstadt*, 2021, https://datenplattform.darmstadt.de/, accessed 22 April 2022.

[54] Digitalstadt Darmstadt, *Beiräte*, 2019, https://www.digitalstadt-darmstadt.de/digitalstadt-darmstadt/beiraete, accessed 22 April 2022.

[55] European Commission, *White Paper - on Artificial Intelligence - a European Approach to Excellence and Trust*, February 2020, https://ec.europa.eu/info/sites/info/files/commission-white-paper-artificial-intelligence-feb2020_en.pdf, accessed 22 April 2022.

[56] Digitalstadt Darmstadt, *Bleib wachsam, Darmstadt!*, 2020, https://darmstadt.bleib-wachsam.de/../index.html, accessed 22 April 2022.

[57] Digitalstadt Darmstadt, *Story: Digital Für Alle*, 2020, https://www.digitalstadt-darmstadt.de/story-digital-fuer-alle/, accessed 22 April 2022.

[58] Digitalstadt Darmstadt, *Strategie der Digitalstadt Darmstadt*, October 2020, https://www.digitalstadt-darmstadt.de/wp-content/uploads/Strategie_Digitalstadt_Darmstadt.pdf, accessed 22 April 2022.

Conclusions

This research has offered a constructivist perspective into the development of the European digital society, given that the EU aims to shape its structure by emphasizing the need for a foundation of values. This model is benchmarked against the local level.

The first research question aimed to identify areas of congruence between cities and the EU related to how they construct their digital society models. By analysing policy documents and the literature on smart cities, the research has found four areas where the smart cities narratives and discourses can be enriched by the European model: the human centred approach, the focus on building trust in society by involving citizens and developing open and transparent frameworks for digital transformation, the focus on digital inclusion, stemming from the human centred approach, and the perception of technology as an enabler for other transformations, such as the green transition. These areas are illustrated in the case study of Darmstadt, Germany's Digital City, seen as a model for a human-centred smart city, focused on ethics, civic participation, and sustainability. The second research question aimed to identify how smart cities can feed into the value-based digital society. The answer relates to the dichotomy in narratives related to smart cities. By adopting a human-centred vision, focused on collaboration, explainable technology, and building trust in innovations, smart cities, such as Darmstadt can contribute to the implementation of the vision for the European-style digital society, where citizens are empowered.

The ideas included in this paper contribute to the empirical development of *human centric smart cities*, where the focus is on well-being, citizen involvement, and the creation of public value. The literature on smart cities laments the mainstream view of smart cities as they are seen as business-led, missing the human approach and are solely focused on building efficiency. In terms of the contribution to the literature, this research aims to build upon the critical literature on smart cities, as well as to create yet another building block to the conceptualization of human centric smart cities.

Considering the research results, policy recommendations can be formulated to enhance the European digital society imagined at the European level and implemented locally. Smart city strategies should base their vision on the model for the European digital society explicitly. If they aim to implement this vision using European structural funds and resilience funds, they should provide arguments for how their projects will help implement the digital society model.

This research has limitations, as well. The deconstruction of the smart city narratives and governance is performed by appealing to the literature and, especially, several meta-analyses on discursive practices of smart cities. It does include a case study for further exploration, but a multiplication of the number of case studies and strategies analysed could deepen the avenues of research. Additionally, further exploration could be warranted into the governance of smart cities and how it could feed into the digital policymaking.

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Responsibility Versus Solidarity? Key Issues for the EMU Reform

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Abstract: *The 2008 economic recession, followed by the sovereign debt crisis, made it clear that the original design of EMU was unsustainable. Together with the most urgent adjustments, the need for a profound reform of the system has been on the agenda for more than a decade. Despite significant steps being taken, no comprehensive reform has yet been delivered. In this paper, the background and the focus of the EMU reform will be reviewed. The research argues that it is necessary to create a better balance between the common shock absorption instruments (i.e., risk sharing) and to give a greater role for markets as incentives for fiscal and financial discipline (i.e., risk reduction). A new synthesis of the two dominant narratives could form the conceptual core of EMU reform. In this way, the need to create a sustainable system of resilience (the ability to respond and adapt) can be the decisive factor. At the heart of the EMU reform there can be deeper economic and financial union, resilient structures, the increase of risk sharing and the reduction of inherited risk.*

Keywords: *EMU, deepening, risk reduction, risk sharing, responsibility of member states, solidarity, resilience, fiscal union, reform package.*

JEL classification: *F02, F15, F17, F43, F55.*

Introduction

The need to create a *"genuine"* Economic and Monetary Union (EMU) provides a framework for a comprehensive reform process. In 2012, Olli Rehn, then member of the European Commission, announced, on the basis of the criticism of EMU 1.0, the need to move towards EMU 2.0[2]. On 28 November 2012, the European Commission published its Blueprint for "a deep and genuine EMU". Based on the previous assessments, the "Four Presidents' Report" was submitted to the December 2012 EU summit. On 20 March 2013, the European Commission revealed its Communication "Towards a Deep and Genuine Economic and Monetary Union". After some pause, the next milestone in this process was the Five Presidents' Report on the programme and roadmap for strengthening EMU, published on 22 June 2015. (Juncker et al., 2015)

The mechanisms and measures of economic governance are largely directed at the euro area and its member states. The scheme envisages a multi-speed approach: the deepest integration (and the delegation of competences to the greatest extent) can be achieved in the core area. Non-participating member states engage in integration at a

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[2] EMU 2.0 refers to the new system of a "complete", "deep" Economic and Monetary Union, which can be built largely in the future. André Sapir, however, considers the system transformed by short-term or systemic measures introduced during the crisis management period as EMU 2.0, which appears to be temporary, and identifies the "complete" (future) system as EMU 3.0. For example, see Sapir, Shoenmaker, 2017. The current transitional regime can be called EMU 1.1, as it goes beyond the limits of 1.0 in many respects, but it does not represent a qualitative shift and cannot be considered a "complete" EMU.

lower level and the transfer of competences is less pronounced.

The reform measures, some of which have already been adopted and introduced, but most of which are planned, indicate the direction of fundamental changes. During the Juncker Commission, a sweeping reform of EMU seemed feasible. In 2017, a Reflection Paper (COM (2017) 291) was firstly published, followed at the end of the year by the comprehensive set of proposals and a "Roadmap" for implementation, issued by the Commission.

Considering the stages previously mentioned, the main objective of this paper is to provide a theoretical background to the reform package and a systematic analysis of the theoretical approaches to the reform package and its possible shortcomings. Key issues for the EMU reform remain relevant, and the functional problems of EMU still need to be addressed.

However, within this framework, the impacts of the coronavirus crisis and its aftermath on EMU reform, as well as the possible interrelationships of crisis management (including reconstruction plans), can be addressed only to a limited extent.

1. Differences in member states' reform positions

The debates on EMU 2.0 focus in no small part on overcoming differences between member states. Some views emphasise national responsibility and risk reduction, others risk sharing and solidarity. These two main dimensions can provide a framework for an overview of the whole issue. Despite the reforms of the last decade, there is a general consensus on the need to take further steps to complete EMU. There are diverging views both on the problems that need to be overcome, and on the measures to be taken.

Building on the proposals in the Five Presidents' Report, the European Commission relaunched the debate with a Reflection Paper (EC, 2017) published in spring 2017. The EMU reform proposed a series of concrete steps on how to complete EMU by 2025. The document marked an important shift: it called for a better balance between common tools for shock absorption (i.e., risk sharing) and a greater role for markets, as incentives of fiscal and financial discipline (i.e., risk reduction). The need for a sustainable system of resilience (the ability to respond and adapt) was included.

After its publication, prominent French and German economists presented proposals for the euro area reforms with similar, but, in some respects, different emphases (Bénassy-Quéré et al., 2017, 2018, commonly referred to as the 7+7 Report). Pisani-Ferry, a French member of the expert group of economists comprising of seven French and seven German leading economists, expressed that the group's fear was that their two countries would settle on a "small bargain" that "would not make the euro area more stable" and that might "induce a false sense of security". (Pisani-Ferry, 2018). However, the starting point for this package of proposals was similar to that of the Commission: (Bénassy-Quéré et al., 2017 – main proposals are summarised in Table 1.)

Table 1. Key proposals of the 7 + 7 Report

1. Reform of fiscal rules, including the enforcement device
- Introduce debt-corrected expenditure rule (acyclical discretional spending) - Ditch EU sanctions, assign more individual responsibility to countries
2. More and better risk sharing
- Reduce home bias in bank sovereign portfolios through concentration charges - Introduce common deposit insurance with national compartments - Promote safe asset based on diversified sovereign debt portfolio (e.g. ESBies) - Create low conditionality access to European Stability Mechanism (ESM) liquidity for pre-qualified countries - Create unemployment/employment insurance fund
3. A targeted role for market discipline
- Enforce the fiscal rule via mandating the insurance of subordinated (junior) bonds for the financing of excess spending - Make sovereign debt restructuring a credible last resort when debt clearly unsustainable
4. Clarify role of institutions
- Separate "prosecutor" (watchdog) and 'judge' (political) - Upgrade ESM to International Monetary Fund (IMF)-like institution, introduce political accountability - Strengthen national fiscal councils

Source: Bénassy-Quéré et al., 2017.

This document did not reflect the views of the French and German governments. France had reservations about the possibility of restructuring national debt as a last-resort option, and feared some form of its automaticity. For Germany, the main areas of concern were the European Deposit Guarantee Scheme and the proposal for a European Stabilisation Fund requiring at least temporary fiscal transfers.

These documents gave rise to a lively debate on possible solutions and their basic elements until the end of the schedule according to the roadmap, in the summer of 2019 (Pisani-Ferry - Zettelmeyer, 2019b). After the temporary pause of the reform, and following a provisional break, a wider debate on this issue has been relaunched in the wake of the COVID-19 crisis. (Krahnen et al., 2021) The following section displays a review of this issue.

2. Unsustainable balance of EMU 1.0

Despite the progress made in the past few years, EMU 1.0 continues to rely on an unsustainable equilibrium. Its main features are: the incomplete nature of the Financial Union (shortcomings of the banking union and the capital markets union), and the lack of a central fiscal stabilisation function[3]. In this context, the system does not include a satisfactory shock absorption mechanism, either for private or government channels. The supervisory procedure is asymmetric: it puts more emphasis on correcting fiscal or external (current account) deficits than on handling significant surpluses. Linking this

[3] These features, notwithstanding the changes so far, are also valid for EMU 1.1.

scheme to fiscal stabilisation mechanisms at the member state level would not allow for the achievement of an appropriate fiscal stance or an optimal distribution of fiscal burden for the euro area as a whole (the latter would allow to strike the right balance between stabilisation and sustainability at the national level). This combination results in an overburdening of monetary policy for stabilisation purposes. Thus, an inappropriate policy mix is emerging, especially near the zero lower bound for policy interest rates. This equilibrium is even more fragile. High public debt and insufficient reforms in several member states create vulnerabilities. This hampers adjustment within and across countries. Moreover, in recent years, this has been achieved as a result of "ultima ratio" decisions with agreements often partial and not fully owned by all the sides.

There is no consensus on the way forward. During the debates so far, **two approaches** have typically emerged. They take different positions in terms of the interaction of solidarity and responsibility, and of risk sharing and risk reduction. The two distinct approaches have sometimes become "a battle of ideas" along the "Rhine-divide" (Brunnermeier et al., 2016). Some saw the need for a 'return to Maastricht'. This would entail the strict implementation of a rules-based fiscal capacity, including its sanctions, and the reaffirmation of the "no bail-out" clause. They stressed the central importance of risk reduction. Others highlighted the need for introducing better, more prudent rules and common risk-sharing instruments, both private and public. More developed financial and capital markets can promote a "bail-in" by the private sector. However, in the absence of fiscal risk-sharing, specific shocks will hit harder, impose higher potential costs on other EMU member states and reinforce the need for ad hoc interventions, and ultimately for a disguised "bail-out".

In fact, solidarity and responsibility are two sides of the same coin. Under a balanced agreement, they could be implemented simultaneously, in principle. Consequently, the new synthesis of these two points of view allows substantive progression. In the financial sector, risk reduction without a proper risk-sharing mechanism is likely to result in higher risks of market instability. Conversely, risk-sharing without an effective risk reduction strategy entails moral hazard and can ultimately increase risk.

The Reflection Paper also attempted to bridge the two dominant narratives. Identifying realistic and desirable solutions can help member states to reach an agreement as soon as possible. However, beyond the issues that can be resolved in the short term, other elements that can only be settled in the longer term – including a new institutional balance – are needed for a profound and effective EMU reform. The possible basic elements for a new synthesis are summarised in Figure 1.

Figure 1. Elements for a new political synthesis

Source: Buti et al., 2017.

3. Main directions of the EMU reform

3.1 In focus: deeper economic and financial union, resilient structures, the increase of risk sharing and the reduction of inherited risk

The convergence of member states towards resilient economic and social structures is a prerequisite for the long-term success of EMU. A high level of economic resilience creates the ability to resist to shocks and recover quickly to the potential output (Giudice et al., 2018). These are fundamental for the EMU. Experience of recent years has shown how lack of resilience can have a lasting impact not only on one or several euro area economies, but also on other member states and the euro area as a whole. Resilience strengthens cyclical convergence (i.e., reduces the divergence of national economic cycles) and the effectiveness of the single monetary policy. Policies that affect economic resilience could become part of the convergence standards in EMU. Compliance with these standards could even be a condition for access the new stabilisation capacity. An integrated and well-functioning financial system is a key feature of an efficient and stable EMU. In particular, the fundamental conditions for progress are: (1) increasing financial market stability, reducing financial market risks; (2) sovereign and banking risk management; (3) creating a truly European safe asset. These factors will be reviewed in the following sections of the paper.

Increasing financial market stability, reducing financial market risks. Completing the banking union and reducing the risks in the banking sector is an ongoing priority[4]. Establishing a Single Resolution Fund and a Single Deposit Insurance Scheme are essential for the functioning of the system together with implementing other elements of the financial union. First, comprehensive strategies need to be adopted and materialised to reduce the rate of non-performing loans. Second, building a capital markets union should be promoted to provide households and businesses with more innovative, sustainable

[4] The banking union is not yet complete. Two important parts are still to be agreed: a common deposit insurance and limits on banks' holdings of sovereign bonds. In his review, Angeloni (2020) emphasised, among other things, the issues of managing sovereign concentration risk and designing a deposit insurance scheme.

and diversified sources of funding. As part of this process, the European Supervisory Authorities needs to be reviewed. A single European capital markets supervisor should be put in place. Progress in the capital markets union could also contribute to increasing the shock absorption capacity of financial markets. There is still little risk sharing through private channels in EMU. Excessive savings, also resulting from persistently different balance of payments positions, could flow back to the member states concerned on the opposite side through capital investment rather than loans. This (i.e., capital investment instead of loans) could significantly reduce the risk of financial instability.

Sovereign and banking risk management. The banking union and the capital markets union could reduce the stress that the banking sector puts on sovereign states. However, the other direction of the "doom loop" – from sovereigns to banks – is only partially addressed by the measures foreseen. Sound fiscal policies and public debt reduction can mitigate the risks to banks from sovereign bond market developments. With a single monetary policy and free capital mobility, a European financial system based on national bond markets creates the possibility of sudden capital flows between these markets. These sudden capital flows represent a significant risk to the stability and convergence of the euro area.

Greater diversification of bank balance sheets can contribute to addressing the issues of credit relationships between banks and the member states concerned. One option to promote greater diversification is the development of *Sovereign Bond-Backed Securities* (SBBS) (Brunnermeier et al., 2017). However, SBBS are unlikely to become a benchmark for European financial markets, with the potential comparable to US Treasury bonds or Japanese government bonds.

A possible reform of the Regulatory Treatment of Sovereign Exposures (RTSE) has emerged during the debates on how to deliver the banking union as an additional measure to break the bank-sovereign loop.

To this end, a number of options have been considered (ESRB, 2015). Reform of the RTSE may be relevant once the banking union is complete (Single Resolution Fund, common deposit insurance) and a common European safe asset is created.

Bénassy-Quéré et al. (2017) recommended the introduction of sovereign (i.e., different for each member state) concentration charges for banks and a common deposit insurance to prevent the vicious circle between bank and sovereign debts. The cornerstone of the 7+7 Report: 'penalising' banks' concentrated sovereign exposures (to specific sovereigns) (Pisani-Ferry - Zettelmeyer, 2018). Its main objective is to price the diversification of the bank portfolio and the country-specific risks. The former could also provide a strong incentive for prudent policies at the national level. At the same time, they urge to achieve a breakthrough in the capital markets union, the cross-border integration of banking and capital markets. The proposed measures could impose sufficient discipline in the "good times" and would not artificially exacerbate the trend of economic recession.

European (euro area) safe (risk-free) asset. In federal states (such as the United States), government securities issued by the central government are generally considered risk-free. They serve as a benchmark, contributing greatly to the efficient functioning of financial markets. In the euro area, however, the volume of securities that can be classified as federal is low. In each euro area member state, sovereign debts issued by the individual member states are considered to be the main benchmark. But there is a significant difference in risk and therefore a substantial widening of yield spreads. This harms the competitiveness of financial institutions operating in different countries.

Experience has shown that during stressed periods, the current structure of sovereign bonds and banks' excessive holdings of sovereign exposures have amplified market volatility. It has an impact on financial sector stability and the real economy of euro area member states.

Breaking the "doom loop", requires a more ambitious solution. The European bond market itself needs to be reformed. In the medium term, this would require the development of a *truly euro area safe asset* (Moscovici, 2017). A *euro area yield curve* could contribute to the maintenance and transmission of monetary policy, and foster long-term investment and risk capital. An essential requirement is that the euro area should also have an asset class commensurate with the weight of its economy, and be able to offer third countries an alternative investment opportunity in the European Union. A truly European safe asset should maintain the possibility for governments to finance themselves at reasonable costs and with continuous market access. At the same time, it should improve the incentives for sound fiscal policies.

To deliver its full potential, a European safe asset should meet a couple of conditions (Buti et al., 2017) It should provide liquidity at the lowest possible cost in Europe and globally compared to other similar assets, without adverse effects and additional risks. Its structure should be transparent, allowing for easy pricing for investors and should also be considered of the safest standard. In addition, a European safe asset should be sizeable enough to become the euro area's benchmark bond for collateral and liquidity purposes, and to meet global demand. Finally, it should cover a wide maturity structure that can serve the objectives of different investors, including those with long-term perspectives.

In recent years, a number of proposals have been made with different design features to create a European safe asset. They ranged from full to partial. Some of these would lead to common obligations, others would not (EC, 2011).

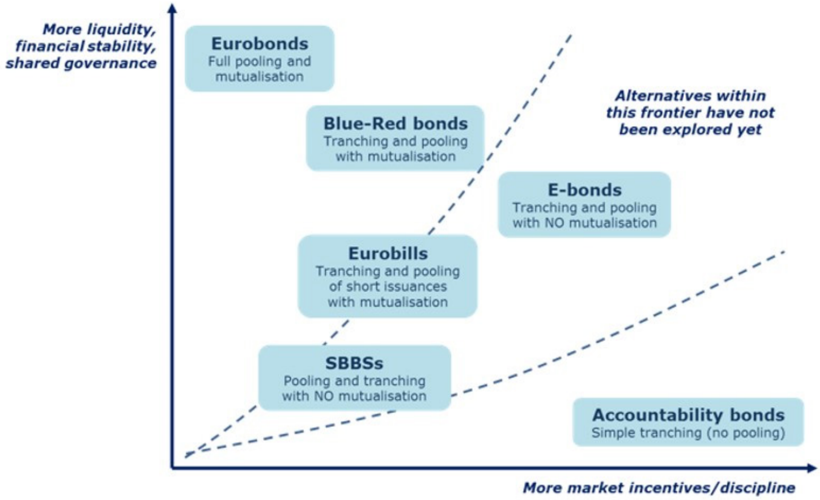
Leandro - Zettelmeyer (2018) argue that safe assets could be created without mutualisation if euro area banks held a more diversified portfolio of sovereign bonds. They would then become even more resilient to sovereign default. Some options, like e-bonds[5] do not embed mutualisation, and can directly raise fiscal discipline (by raising the marginal cost of sovereign bond issuance without raising the average cost for lower-risk operators). It can be a realistic option to overcome the lack of trust between member states: it maintains a balance and imposes a firm obligation to common issuance with strong market discipline. The introduction of a European safe asset would allow for the progressive application of concentration charges. This could help build up a common deposit insurance and a backstop, while allowing the ECB's balance sheet to be reduced without disruption.

A number of proposals have already been put forward to create a risk-free euro area asset (Figure 2). However, member states with sounder public finances are not willing to provide direct guarantees to weaker countries to finance their budgets[6].

[5] They subordinate all national debt to funding from a Common Issuer, the ESM or the European Investment Bank (EIB).

[6] The latest concept is also remarkable in this respect. See Amato et al. 2022.

Figure 2. Possible options for new forms of safe assets in Europe



Source: Buti et al., 2017.

3.2. Market discipline and fiscal surveillance – better balance

More effective market discipline could allow for a better balance in the functioning of economic governance in EMU. Markets have so far been exercising their role in disciplining fiscal policies across the euro area with uneven stringency.

Strengthening market discipline is essential, but it should be addressed without disrupting the recovery process. The risk of "sudden stops" should be avoided (Philippon, 2015). The experience of the recent crisis shows that market discipline operates too late and in an abrupt fashion under the current framework. A new institutional regime (including a truly European safe asset) could increase the degree of linearity in financial market reactions, and help avoid 'cliff effects' (sudden action of pricing of risks) in interest rates. The completion of the banking union and the setting up of the common euro area safe asset could allow risks pertaining to excessive exposures to sovereign bonds to be recognised. Supported by stronger economic, fiscal, and financial integration, it would also pave the way for simplifying the current EU fiscal rules (Buti et al., 2017).

Bénassy-Quéré et al. (2017) argue that fundamental changes to fiscal rules focusing on structural deficit are needed. They point out that current rules lack flexibility in both "bad" and "good" times. They recommend that structural deficit should be replaced by a simple (countercyclical discretionary) expenditure rule guided by a long-term debt reduction target: "government expenditure must not grow faster than long-term nominal output, and should grow at a slower pace in countries that need to reduce their debt-to-GDP ratios."

At the same time, Bénassy-Quéré et al. (2017) suggest that monitoring compliance with the fiscal rule should be devolved to independent national and euro area-level institutions. Governments that violate the expenditure rule would be required to finance excess spending using junior ('accountability') subordinated bonds. "The need to issue such bonds would be far more credible than the present threats of fines, which have never been enforced." The cost at which these junior sovereign bonds are issued would depend on the credibility of government policies to tackle fiscal problems in the future. Financing excess spending would become more costly.

Bénassy-Quéré et al. (2017) foresee the creation of economic, legal and institutional underpinnings for the extraordinary sovereign debt restructuring of member states whose solvency cannot be restored through conditional crisis lending ("last resort"). It is essential to prevent instability in sovereign debt markets. They recommend an ESM lending policy that is conditional but also available for preventive (precautionary) purposes, as well as the use of sovereign concentration charges for banks. The proposed measures need to be combined with other reforms. These could reduce sovereign risk under the proposed risk-sharing mechanism. Pisani-Ferry - Zettelmeyer (2018) explain the 7+7 position by adding that the solvency of euro area member states is not exogenous. The endogenous conditions for national solvency could improve as a result of the proposed policy regime through stronger incentives to fiscal responsibility and the weakening of the doom loop between banks and sovereigns. This could greatly reduce the risk of euro area disintegration[7], and redenomination.

The foregoing was questioned by several participants in the debate. Buti et al. (2018) argue: „As costless defaults are an illusion, rather than forcing defaults it would make more sense to work to reduce the economic, financial, and political costs in the extreme and unlikely case that a sovereign debt default becomes inevitable in the euro area. This alternative approach would involve: (1) making the financial system more resilient to such a default event (see below); (2) improving the EMU architecture to make defaults even less likely; and (3) clarifying ex ante 'who' would bear the cost of a government default."

3.3. Creating a central stabilisation capacity

A central fiscal capacity[8] aimed at improving macroeconomic stability in the euro area could be based on the following *principles*: it should not lead to permanent transfers between member states, should minimise moral hazard, and be strictly conditional on clear criteria and continuous sound policies; it should be within the EU framework; and it should not duplicate the role of the ESM.

There are several options for institutionalising this function: (1) a European *Investment Protection Scheme* would protect investment in the broad sense, in the event of a downturn by supporting well-identified priorities and already planned projects or activities at national level, such as infrastructure or skills development. (2) A European *Unemployment Reinsurance Scheme* could act as a 'reinsurance fund' for national unemployment schemes. The scheme would provide more breathing space for national public finances. It can help economies to emerge from the crisis faster and stronger. The unemployment reinsurance scheme would, however, probably require some prior convergence of labour market policies and characteristics[9]. (3) A "rainy day" fund could accumulate funds on a regular basis. Disbursements from the fund would be made on a discretionary basis to cushion large shocks. The "rainy day" fund would normally limit its payments strictly to its accumulated contributions.

[7] Or the risk of self-fulfilling exit expectations *per se*.

[8] For fiscal union proposals, see e.g., IMF, 2013; Thirion, 2017; Berger et al., 2018.

[9] For an overview of the discussions on the stabilisation mechanism based on unemployment benefits, see Beblavy - Lenaerts, 2017.

These instruments could, as *ultima ratio*, contribute to stabilisation in the event of large shocks. To increase its stabilising effects, the function can be equipped with borrowing capacity. At the same time, it should provide for savings at other times and limit indebtedness. A euro area budget could ensure broader objectives, covering both convergence and stabilisation. This requires a stable revenue stream. A significant transfer of competences to the European level is essential[10].

Bénassy-Quéré et al. (2017) propose the creation of a fiscal stabilisation scheme, a euro area fund financed by national contributions, to absorb the effects of major economic crises. Small fluctuations can be offset through national fiscal policies. Pay-outs from the euro area fund would be triggered only if employment falls below (or unemployment rises above) a pre-set level. To avoid permanent transfers, national contributions would be higher for member states that are more likely to draw on the fund. Good incentives could be maintained through three mechanisms: smaller losses would continue to be borne at national level, participation in the scheme would depend on compliance with fiscal rules and the European semester, and higher drawings would lead to higher national contributions.

3.4. Strengthening euro area institutions and accountability

EMU reform requires greater democratic accountability and higher transparency at each level of governance: who decides what and when. There may be a need to extend and formalise the dialogue between the European Parliament and other institutions of the euro area. Further political integration could involve a rethinking of the functioning of the *Eurogroup* as a more formal and transparent decision-making body. The appointment of a permanent Eurogroup chair could be envisaged, which could be merged with the Member of the Commission responsible for EMU. Increased attention needs to be paid to the external representation of the euro area. A number of competences and functions, including the *Fiscal Union Function*, could be developed and regrouped within the institutional framework of the euro area and the EU. The *Treasury*, preferably with a euro area budget, could be responsible for the fiscal surveillance, the macroeconomic stabilisation function, and the issuance of the European safe asset.

In its current form, the ESM provides liquidity support to member states. In the future, it could act as a common backstop to the Banking Union. The ESM could evolve into a *European Monetary Fund* (EMF). Decoupled from other financial institutions, the EMF can grant greater autonomy to the euro area. There are different possible designs for the creation of a euro area Treasury. For example, the EMF could be the arm of the Treasury for financial stability. A basic pre-condition is that the ESM or the evolving EMF is integrated into the EU Treaties and it is supervised by the European Parliament[11].

3.5. Concerns about fiscal union

The concept of fiscal union is deeply connected to national sovereignty. According to the minimalist interpretation, it can be implemented without transfer of competences

[10] However, Maduro et al. (2021) for example, argues that the current framework of EU primary legislation is sufficient for a central fiscal capacity, i.e., it does not require any amendments to the Treaties.

[11] Buti et al. (2020) underlined the need for the establishment of a Treasury and a European Minister of/High Representative for Economy and Finance in the field of development of the euro area institutional architecture.

in the areas of allocation and distribution, which remain under national control[12]. The fiscal union can be built on fiscal surveillance rules enshrined in a simplified Stability and Growth Pact, as a backstop for the Single Resolution Fund and a stabilisation capacity. An essential structural, efficiency-based argument for fiscal union is: in a currency union, purely national fiscal responses are less effective in response to permanent shocks than an intergovernmental transfer system (Kennen, 1969).

Creating a fiscal union is a key issue for the future of EMU (and the EU). A fiscal union will presumably require the adoption and development of new mechanisms involving further transfer of competences and the extension of supranational institutional responsibilities. The transfer of competences would entail a further loss of national sovereignty. It is unclear when the political and social framework conditions will improve sufficiently for this. It is still not clear what elements would be needed to create a fiscal union, and how competences could be shared between the member states and the Union.

Fiscal "federalism" is the distribution of fiscal functions within an existing fiscal union. The European Union's current common budget does not even reach the pre-federal level. Fiscal federalism would strengthen the economic (more narrowly, the fiscal) side of EMU. It would also lead to a deeper and stronger integration structure. It is typical of federal countries, where the centralisation or decentralisation of budgetary functions is a priority. For federal states, the main question is: which functions should be placed to lower levels? In the case of EMU, the question is rather the other way round: it is necessary to consider *which functions/competences need to be transferred to the supranational level* (what also means limiting the member states' sovereignty), to achieve more effective economic governance and integration. At the same time, the scope for fiscal federalism in the European Union is substantially limited by differences in national preferences and development.

A single, clear definition of fiscal union is still missing. Dabrowski (2015) claims that fiscal union is the transfer of fiscal resources and competences from the national to supranational level. Bordo et al. (2013) state that "fiscal union entails fiscal federalism among its members". They could be either sub-national (regional) political entities or nation states. According to Thirion (2017), the fiscal union comprises five different elements: (1) rules and coordination, (2) crisis management mechanisms, (3) banking union, (4) fiscal insurance, and (5) joint debt issuance. They allow for shared-sovereignty and risk-sharing. The EMU has already made significant progress in the first two areas, while further deepening is underway in the third area. Additional steps are still to be taken.

What are the elements of fiscal union that seem most essential to be created in the context of EMU reform? *Fiscal risk-sharing among euro area member states is a crucial factor.* (Berger et al., 2018)[13] Its possible main elements are: a common fiscal backstop to the banking union, a targeted "rainy day fund", an (initially small) euro area budget, and unemployment insurance. These imply a central fiscal capacity. In parallel with the introduction of fiscal risk-sharing, fiscal discipline and policy coordination should be further strengthened. In particular, it is important to reduce moral hazard (e.g., free-riding) through stronger rules and market discipline. Fiscal union implies a coordinated, system-wide fiscal policy.

[12] However, fiscal union with supranational political responsibility is also conceivable, rather than the minimalist interpretation of it.

[13] The importance of cross-border risk sharing is stressed, for example, by Beetsma et al., 2022.

The main value of the Commission's Reflection Paper is the comprehensive package, the complex approach. (Buti et al. 2018) In addition to the possible options, it is also essential to ensure the right order and timing. The Commission initially proposed two stages in deepening EMU: the first one by the end of 2019 and the second one from 2020 to 2025. In view of the elections, defining and agreeing on a strategy by the final stage of the European institutions' mandate seemed absolutely necessary. Moreover, this period would have coincided with the timing required by the markets. The ECB's adjustment policy was coming to an end. In the absence of further measures to deepen EMU, this could once again give rise to the increased vulnerability of some euro area member states[14].

4. Visions and reality

The development of European integration has always been preceded by bold visions. Although a comprehensive EMU reform has been slow to get off the ground, it is now one of the most fundamental issues to be decided in the European Union. What is the reality of creating a "complete" (2.0) EMU?

First, it needs clarification: what would be included in this reform in terms of content? A wide range of possible reform measures have been reviewed. *The critical mass of measures* could be based essentially on the initiatives launched by the European Commission in December 2017 (*"Roadmap"*): (i) proposal to establish a European Monetary Fund, within the framework of Union law; (ii) proposal to incorporate the Fiscal Pact into the EU legal framework; (iii) proposal to introduce new budgetary instruments in the euro area for stabilisation purposes, embedded in the EU legal framework; (iv) Structural Reform Support Programmes, with support from the EU budget; and (v) European Minister of Economy and Finance.

In fact, there were many other initiatives. (e.g., the Commission's banking union package launched in autumn 2016; initiatives on the capital markets union; the proposal for a common euro area budget as of November 2018, based on Franco-German reform proposals, etc.) The leading European institutions sought to reach a political decision on these issues, i.e., the reform of EMU, before the new European Parliament was formed in 2019.

However, within the timeframe indicated, most of the outstanding issues of the EMU reform were not settled.

Bénassy-Quéré et al. (2019) argue that a limited euro area budgetary instrument may indeed constitute a first step. However, it would not fulfil any macroeconomic stabilisation function in the euro area, nor would it be an appropriate tool to support national fiscal policies in the event of an economic slowdown or recession.

In autumn 2019, the new European Parliament, the Commission and senior officials took office. What are the chances of a breakthrough in EMU reform in the coming period? At the time of writing, no well-founded response can be offered. However, it is worth reviewing some points:

- *Euro area in focus.* The EMU reform concerns mainly the euro area. It is the most important for euro area member states.
- *Slow preparation.* The process so far has been particularly slow in producing working documents. This is due to the great complexity and importance of

[14] This has been put in a fundamentally new light by the coronavirus crisis.

the issues at stake, but in particular to the sometimes radically different views of the actors involved.

- *Prolonged debates, slow and poor decisions.* The overall EMU reform process so far has been extremely slow. For example, the decisions taken during the December 2018 or June 2019 Eurozone summits showed very little progress compared to the Commission's initial proposals. The more ambitious elements of the latter have not been mentioned in the communication.
- *High degree of division.* There are strongly diverging views within and between member states. Even between the French and German positions, which are the most committed to deeper integration, there are significant differences, for example on the issue of solidarity and/or responsibility, or on the common euro area budget. Non-euro area member states opposed the euro area budget, but many member states criticised the concept even within the euro area.
- *Brexit effects.* Brexit is one of the most dramatic events in the history of European integration. At the same time, it can be a textbook example of a "post-factual society" or "post-truth politics". Moreover, it was an "endless horror" for the Commission apparatus: Since the summer of 2016, a significant part of its professional and negotiating capacity has been tied up in managing Brexit for years. After Brexit, the euro area will account for more than 85% of EU GDP. A new geometry could emerge: non-euro area Member States could be pushed to the periphery. Euro area matters can clearly be the defining element of EU affairs.
- *New priorities?* There is also increased attention and political pressure in the EU to strengthen new economic dimensions in the areas of climate change, external security, competition, trade and industrial policy, and, in particular from the end of 2019 onwards, disease management. The four main priorities agreed at the June 2019 summit did not explicitly include the EMU reform.
- *Time factor.* The original timing requiring a comprehensive decision by mid-2019 has failed, although it could hardly be described as hasty, given the directions already outlined in the Four Presidents' Report in December 2012. The fundamental question is whether *there will be a breakthrough* in this area or the decisions will further be delayed.
- *"Hibernated" reform.* Despite progress in several areas, the comprehensive EMU reform agenda, which was formulated in 2012 and became more concrete in 2017, has failed to achieve breakthroughs. The European Commission's programme, which took office in 2019, does not explicitly address the need for a GMU-2. Implicitly, however, incremental reform can be pursued.

Under given conditions and with rampant inflation following external shocks, the ECB's room for manoeuvre is necessarily limited near the ceiling for the potential sovereign bond holdings that do not crowd private investors out of the market. Monetary policy is overburdened in maintaining financial stability. At the same time, a fiscal stabilisation mechanism is missing. The original problems still remain, while new issues (international trade conflicts, slowdown in the fastest growing areas in the world, followed by the coronavirus crisis and, more recently, the war crisis in the wake of Russia's invasion of Ukraine, as well as the growing risk of stagflation) are on the horizon.

From the beginning of 2020, economic governance has focused on tackling the Covid-19 crisis. Crisis management measures have been implemented at EU and national levels. In addition to monetary policy actions, significant fiscal impulse measures have been taken. By having room for manoeuvre under the fiscal framework, temporary exemptions have been granted from the state aid rules and the general escape clause in the Stability and Growth Pact (SGP) has been activated. The EU has adopted new budgetary instruments with a strong supranational element to support recovery in the member states and to safeguard the EU's internal market objectives and the stability of the euro.

The European Commission relaunched the public debate on the review of the EU's economic governance framework in October 2021 (COM (2020) 55, COM (2021) It will revise the changing conditions of economic governance following the Covid-19 crisis. These challenges make a transparent and efficient budgetary framework particularly important, according to European Commissioner for Economy P. Gentiloni. A broad agreement among member states on possible changes to the economic governance framework is sought before 2023. The main focus of this review is thus on fiscal rules. The review of the fiscal framework for economic governance in the EU has been a priority on the French Presidency's agenda. However, efforts to reform the SGP are dividing member states. The ideas put forward so far have not included the need to deepen fiscal union.

In the broader context of economic policy, an extensive theoretical debate on the future of EMU reform has recently been relaunched. (See Krahnen et al. 2021) This debate could contribute to rethinking some contentious issues (e.g., the need for a central fiscal capacity). Clear positions can also provide the impetus for future reform. The brutal shocks of the recent period, the COVID-19 crisis and the geopolitical shock of Russia's invasion of Ukraine, particularly underlines the importance of deepening European integration. Under these circumstances, further incremental reform could move forward, and there is scope for a far-reaching reform of the EMU.

Concerning the euro area as a whole, these priorities on further deepening of EMU are essential conditions for European reform efforts aiming at boosting productivity, growth and fiscal consolidation primarily at national level. Without stronger efforts to reform EMU, both at the euro area and the EU level, Europe will not prosper.

5. "Large package" versus gradual deepening

In the aftermath of the last crisis, remarkable progress has been made towards the establishment of a "complete" EMU. After 2010, it looked as if a comprehensive, far-reaching *'large package'* of EMU reforms could be pushed through the EU decision-making system.

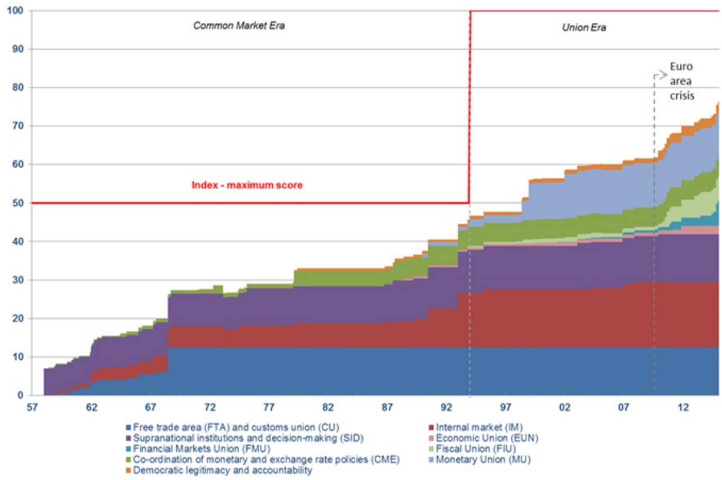
Although there are differences in the economic approaches to EMU reform, as seen before, the main directions of the necessary transformation can be identified. Pisani-Ferry - Zettelmeyer (2019a) rightly point out: „In fact, there is a remarkable convergence of views among economists on what a currency union really entails. While certainly not universal, this consensus is both broad and deep, and provides a basis for comprehensive reforms that would significantly improve the resilience of the euro area and would help turn it into a basis for shared prosperity."

The adoption of a *"large package"* would lead to a significant breakthrough in EMU reform, the completion of EMU. However, given the heterogeneous interests of member states, the adoption of this kind of "large package" in the EU's decision-making system can be achieved only in exceptional circumstances. The EU has supported such a "large package" on several occasions in its history, for example when adopting the internal market or EMU 1.0. The 2008 financial and economic crisis, then its second phase in the EU, the risks and dangers of the sovereign debt crisis, seemed to force a breakthrough towards EMU 2.0. There have been several such periods in the last decade.

However, the experience of European integration also shows that *gradual processes* cannot be underestimated. Using the European Index of Regional Institutional Integration, Dorrucci et al. (2015) took stock of the process of deepening integration from 1958 until early 2015. Their analysis clearly shows that the recent crisis has acted as a catalyst for the rapid acceleration we have witnessed in the pace of European governance reform. *The documents calling for a comprehensive EMU reform* represent a milestone in this process, with setting four broad, complementary goals: the need for a more effective economic union, a fiscal union, a financial union and a commensurate political union.

Figure 3 illustrates the progress in European integration and the components of advancement. A maximum score of 50 points is assigned to each of the periods, the "Common Market Era" from 1958 until 1993, and the "Union Era" thereafter. The cumulative value calculated on 1 January 2015 was above 76 points, as shown in the figure. "The gap between 100 points – i.e., the maximum total score that would be assigned in the index if all objectives of the Common Market and Union Eras were fully accomplished – and the current score, gives an indication of the distance still to be covered until a 'new perceived steady state' is achieved in the process of European economic integration under EMU."[15] The figure clearly shows the shortcomings of the integration process after 1993. At the same time, it shows convincingly that a substantial deepening has taken place since 2010, which attains 16 points in Figure 3.

Figure 3. European Index of Regional Institutional Integration



Source: Dorrucci et al., 2015, 37.

[15] In the applied version of the index, the identified goals for the "Union Era" were based on the Four Presidents' Report of December 2012.

Notes: Concerning the Common Market era, the index draws on the traditional classification of regional economic integration by recognising five 'stages' of integration (Balassa 1961), as shown in Figure 3:

- *A free trade area and customs union (stages 1 and 2);*
- *The gradual build-up of the European internal market (stage 3);*
- *Some degree of coordination of, for instance, exchange rate policies (stage 4); and*
- *A number of institutions, laws, and decision-making processes which can be defined – though to different degrees – as supranational in nature (stage 5).*

The figure shows that in the post-crisis period substantial progress has been made on each of the essential components. The most notable achievements have taken place in the areas of banking union and fiscal union, and much less progress has been achieved in economic union.

Europe has always seen a deepening process of economic integration, which has often been "completed in crises" (Monnet, 1978, 417). This is a natural state of European integration, *provided that the ultimate goals of integration have been well identified and the process has been well understood from the outset*. The former can be promoted by comprehensive documents, including drafts, which correctly indicate the need and the desired direction of reforms. In particular, if they subsequently form the basis for further series of actions (reform measures).

It took three and a half decades to complete the internal market. At that time, there was no doubt about the path to follow for economic integration. However, in the case of EMU, uncertainties and misunderstandings may arise as to the ultimate objectives. This is linked to the understanding of national sovereignty and European democracy. Since the last crisis, significant progress has already been made. Despite the fact that no single, comprehensive and far-reaching reform document has been adopted. Successful integration can be achieved through inclusive reforms that are well explained, fully comprehended and widely accepted. This is not only possible through "large packages"[16].

6. Critical mass of EMU reform. Conclusions

In the light of the foregoing, the minimum set of measures (critical mass) for the EMU 2.0 reform can be defined. (This is known as a "small package".) Achieving critical mass requires, first and foremost, radical reform decisions in three areas: (1) establishing – at least partially – a European Deposit Insurance Scheme (EDIS); (2) new fiscal rules – including risk-sharing – for stabilisation purposes in the euro area, embedded in the EU legal framework; (3) limiting excessive exposures of euro area banks to sovereign bonds, breaking the "doom loop".

These reform decisions are central to a systemic reform ("complete" EMU). There may be political resistance in some member states. It is also possible that the critical mass of measures can only be implemented gradually. But proceeding with caution in the basics could compromise the depth and effectiveness of EMU reform . The process of European integration so far shows that it is not hopeless to introduce sweeping changes.

The three main strategic reform decisions would simultaneously promote risk-sharing necessary for financial stability and resilience, as well as the incentives for fiscal discipline and sound policies. Each of these reform steps, as well as the subsequent

[16] And not just by amending the Treaties, but also by taking smaller steps. However, contractual consolidation of reforms is still necessary.

steps, are subject to the *institutional economics approach*. In other words, it is not only a question of what to do, but also of who should do it and when. What institutions and rules are needed, and when? Financial, fiscal and institutional reforms are needed. The institutional architecture should be more focused than hitherto. Possible principles for reforming euro area institutions are: sovereign member states participate in risk-sharing while maintaining market discipline and minimising moral hazard. To introduce fiscal risk-sharing, a central fiscal capacity is also needed. The EMF could deliver appropriate risk-sharing in the areas of liquidity and solvency of member states, while promoting market discipline. As a result of EMU reform, the ECB could focus on monetary policy and, where necessary, liquidity support to banks.

A gradual introduction of fiscal risk sharing would seem feasible: first in supporting the banking union, then more broadly, as "insurance" against macroeconomic risks between countries. This entails an effective management of moral hazard. Some forms of risk-sharing, such as the provision of a wider range of public goods across the area, may be possible if progress is made towards political union.

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European Digital Sovereignty: An Analysis of Authority Delegation

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Abstract: *The European Commission defines the concept of European digital sovereignty as the capacity to make "autonomous technological choices" and the ambition to shape rules and standards at the international level. The idea of "digital sovereignty" responds to the demands of the European public and private sectors to increase the uptake of indigenous technology. However, neither the official policy and discourses, nor the academic literature analyse the actors involved and the power distribution within this process. This article aims to investigate on what is digital sovereignty and who is the "owner" of this new type of sovereignty and the impact of this rhetoric on European integration. It does that by engaging the theoretic lenses of principal-agent framework, drawing on the development path of the European policymaking in the technological area, from the 1980's until today. The paper concludes that the heterogenous preferences of the member states create the impetus to delegate powers to the European Commission. Furthermore, digital sovereignty rhetoric helps overcome the problems of delegation politics by building coalitions and consensus.*

Keywords: *European digital sovereignty, principal-agent theory, historical analysis, EU institutional architecture, digital policy.*

1. Introduction

Ursula von der Leyen presented in the "Political Guidelines for the Next European Commission 2019-2025" the ambition to achieve "technological sovereignty in some critical technology areas" (2019, p. 14). The "digital sovereignty" policy responds to the demands of the European public and private sectors for European information and communication technology (ICT) products to increase the strategic independence from digital products outside this space. The reliance on non-European critical products, especially semiconductors, cloud services and secure connectivity, creates concerns of vulnerability to the security and stability of the bloc. The COVID-19 pandemic abruptly magnified this phenomenon in the context of a dramatic digitalization of all social and economic sectors.

The European Commission (hereafter "Commission") defines the concept of digital sovereignty as the capacity to make "autonomous technological choices" and the ambition to shape rules and standards at the international level[2]. While the political and economic urgency behind this proposal is well understood, the actual implementation of the concept in the European context is not immediately obvious. The idea of digital sovereignty is loaded with such a strong ambition that it is challenging to imagine it happening at the expense of individual member states' efforts. Lately, some member states started national level discussions on digital sovereignty as a main point on the

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[2] European Commission and High Representative of the Union for Foreign Affairs and Security Policy, 'Joint Communication to the European Parliament, the European Council and the Council: A New EU-US Agenda for Global Change' (2020).

political agenda. However, they are more an exception than a rule. Therefore, the strategic discussion on this topic tends to unfold at the macro-level.

The main "owner" and promotor of the concept at the European-level is the Commission, who introduced the idea in most digital policy pieces in the last years. We are also witnessing public discourses from member states calling for the Commission to take action in materializing the objectives of digital sovereignty. In this context, we can observe instances of delegation of power to the Commission to act on behalf of the member states. The phenomenon can be best analysed through the lenses of principal-agent theory, where the member states as sovereign actors delegate the task of implementing the digital sovereignty policy in Europe to the EU institutions, particularly the Commission. At the same time, it is important to observe that the member states have strikingly different levels of digital development and even more divergent perspectives on the future of Europe in this regard. Therefore, the main question that the article aims to respond is how did the Commission's competences and position in digital policy changed with the adoption of the digital sovereignty rhetoric? A secondary question is to clarify the motivations of the EU member states to delegate powers to the Commission in the digital policy area.

The article begins with a brief overview and definition of the concept of digital sovereignty employed in the rest of the study, followed by a literature review on the principal-agent theory. The next section covers the main elements of the European institutional setting, underpinning the main roles and power relations in the multi-level governance of the process of agenda-setting and policy entrepreneurship[3]. This brief presentation will help identify the hierarchical relations of the main actors in the principal-agent theory. It is essential to understand the historical evolution of the Commission's powers and attributions in the digital sector. Hence, the article takes stock on the origins of the European telecommunications policy in the 1980's. The next section provides an analysis of the principal-agent relations drawing on public discourses from the EU member states and institutions. The final section concludes the article with a discussion on the delegation politics in the context of European digital sovereignty rhetoric. The hypothesis is that, in the context of heterogenic preferences among the EU member states, the concept of digital sovereignty has the role of a "coalition magnet"[4], encouraging further delegation of powers to the Commission.

2. Perspectives on digital sovereignty

There are two major rhetorical trends in the EU regarding the capacity to act and the type of relations the Union should develop with international counterparts, respectively "strategic autonomy" and "digital sovereignty". Both concepts are deliberately underdefined to allow the creation of coalitions around them and the flexibility to compromise on essential European policies. Political leaders provide enough information

[3] Tom Delreux and Johan Adriaensen, 'Twenty Years of Principal-Agent Research in EU Politics: How to Cope with Complexity?' (2018) 17 *European Political Science* 258, 268, http://link.springer.com/10.1057/s41304-017-0129-4 (accessed 5 April 2022).

[4] Daniel Béland and Robert Henry Cox, 'Ideas as Coalition Magnets: Coalition Building, Policy Entrepreneurs, and Power Relations' (2016) 23 *Journal of European Public Policy* 428, 2, https://www.tandfonline.com/doi/full/10.1080/13501763.2015.1115533 (accessed 22 May 2022).

on the two concepts to act as an umbrella for the family of related narratives[5].

While strategic autonomy is out of the scope of the present paper, it deserves a short overview to understand its relation with the concept of digital sovereignty. The concept was born in a context of unpredictable global environment, where gradual dealignment from the post-war international institutions is the optimal choice. Strategic autonomy is about gaining independence and authority over the strategic sectors of the Union, including digital policy. It is therefore a product of rising competition and a form of integration to prepare the EU for the new era[6].

A definitive distinction between strategic autonomy and digital sovereignty is not clearly and unanimously researched. While the first includes a palette of domains of action (industrial policy, operational security, and political), the latter mainly bears a political weight[7]. Charles Michel, the President of the European Council, considers the role of digital sovereignty instrumental in the "greater goal of strategic autonomy" of achieving "more resilience, more influence, and less dependence" necessary for "more level playing field and more fairness"[8]. While strategic autonomy has a wide range of policy issues on its agenda, digital sovereignty concentrates on increasing the ability to act in the digital world[9]. However, the rhetoric framing is the fundamental difference between the two concepts. While digital sovereignty idealizes the European room for action and agency, strategic autonomy acknowledges a certain degree of interdependence and even embraces the international cooperation with its newer "openness" rhetoric[10]. Critics underline that strategic autonomy is free from the vices of protectionism and thorny idealism, while offering at the same time operational tools to protect values and interests[11].

The present study tackles the concept of European digital sovereignty, particularly for its greater ambiguity and for its philosophical connotation of aiming for achieving a "European sovereignty". The study began from the intriguing question of who is the

[5] Daniel Lambach and Kai Oppermann, 'Narratives of Digital Sovereignty in German Political Discourse' (2022) *Governance*, 3, https://onlinelibrary.wiley.com/doi/10.1111/gove.12690 (accessed 23 May 2022).

[6] Ulrike Franke and Tara Varma, 'Independence Play: Europe's Pursuit of Strategic Autonomy' (European Council on Foreign Relations 2019) 3; Scott Lavery and Davide Schmid, 'European Integration and the New Global Disorder' (2021) 59 *JCMS: Journal of Common Market Studies* 1322, 1335, https://onlinelibrary.wiley.com/doi/10.1111/jcms.13184 (accessed 22 May 2022).

[7] European Union Agency for Cybersecurity., Cybersecurity Research Directions for EU Digital Strategic Autonomy (Publications Office 2021) 3, https://data.europa.eu/doi/10.2824/43660 (accessed 22 May 2022).

[8] Charles Michel, 'Digital Sovereignty Is Central to European Strategic Autonomy - Speech by President Charles Michel at "Masters of Digital 2021" Online Event' (European Council, 3 February 2021), https://www.consilium.europa.eu/en/press/press-releases/2021/02/03/speech-by-president-charles-michel-at-the-digitaleurope-masters-of-digital-online-event/ (accessed 22 May 2022).

[9] Maxime Lefebvre, 'Europe as a Power, European Sovereignty and Strategic Autonomy: A Debate That Is Moving towards an Assertive Europe' (Foundation Robert Schuman 2021): 7, https://www.robert-schuman.eu/en/doc/questions-d-europe/qe-582-en.pdf (accessed 22 May 2022); Luuk Schmitz and Timo Seidl, 'Protecting, Transforming, and Projecting the Single Market. Open Strategic Autonomy and Digital Sovereignty in the EU's Trade and Digital Policies' (SocArXiv 2022) preprint, https://osf.io/wjb64 (accessed 14 May 2022); MADIEGA Tambiama, 'Digital Sovereignty for Europe' (European Parliamentary Research Service 2020).

[10] Luuk Schmitz, Timo Seidl, *Protecting, Transforming, and Projecting the Single Market*...

[11] Barbara Lippert, Nicolai von Ondarza and Volker Perthes (eds), 'European Strategic Autonomy. Actors, Issues, Conflicts of Interests' [2019] Stiftung Wissenschaft und Politik -SWP- Deutsches Institut für Internationale Politik und Sicherheit 7; Hannes Werthner, 'Geopolitics, Digital Sovereignty…What's in a Word?' in Hannes Werthner et al. (eds), *Perspectives on Digital Humanism* (Springer International Publishing 2022): 247, https://doi.org/10.1007/978-3-030-86144-5_32 (accessed 6 January 2022).

sovereign in "European digital sovereignty"? The remaining of the section provides an analysis of the European approach on the concept and benchmarking against the U.S. and Chinese perspectives.

Depending on the perspective, the concept of digital sovereignty can be interpreted in two ways. The first is the *normative* understanding concerning the manner in which the states conduct themselves in relation to technology, against their values and core principles. The second approach is linked to the traditional principle of sovereignty translated in terms of *capability*. In the digital context, this perspective is about governing and employing material resources in the cyberspace.

Digital sovereignty in normative terms is translated in ideas, and political and metaphoric understandings. The concept is a discursive tool employed in the geostrategic competition of technological supremacy. When states are claiming their sovereignty in the digital space, what they actually imply is the "ability to maintain [their] own model in competition with others, to achieve both competitiveness and normative principles"[12]. The centrepiece of the decade we entered is the competition over the technological model and the values that should inspire it. In the European context, this battle is held on the value-driven technology that respects individual rights and freedoms, and the economic competition[13].

Digital sovereignty is about using the digital sphere to project influence at international level. Currently, there is a geopolitical battle on the digital "model", largely disputed between the European Union, the U.S., and China. These three models resulted from competing views and interests on the role of technology in the interaction between the state, citizens, and the economy. The essence of the digital geopolitical competition is the normative interpretation of the triangular relationship.

The EU is defending the technological model grounded in "democratic values, respect for the rule of law and fundamental rights"[14]. The Commission pledged to find a "European way" on setting a balance between the data use and security[15]. Artificial Intelligence (AI) plays an important role on EU's global economic agenda. The greatest current challenge is the adoption of fundamental rights and values in the opaque processes of AI applications[16].

In contrast, the U.S. keeps a low level of intervention in the technological development. The American philosophy is to leave the private sector self-regulate and standardize, and have as minimum government intervention as possible. The cyber-libertarian and activist John Perry Barlow envisaged a cyberspace as a "world that is both everywhere and nowhere" and "a civilization of the Mind"[17]. The rising number of users and the creation of assets led to the increase of state intervention in the cyberspace,

[12] Daniel Innerarity, 'European Digital Sovereignty' (Institute of European Democrats 2021): 6.
[13] *Ibidem*: 7.
[14] European Commission and High Representative of the Union for Foreign Affairs and Security Policy, 'Joint Communication to the European Parliament, the European Council and the Council: The EUs Cybersecurity Strategy for the Digital Decade' (2020): 19.
[15] European Commission, 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A European Strategy for Data' (2020): 3–4.
[16] Council of the European Union, 'German Presidency Conclusions - The Charter of Fundamental Rights in the Context of Artificial Intelligence and Digital Change' (2020): 7–8.
[17] John Perry Barlow, 'A Declaration of the Independence of Cyberspace' (Electronic Frontier Foundation, 8 February 1996), https://www.eff.org/cyberspace-independence (accessed 22 May 2022).

testified by the Edward Snowden revelations[18]. The U.S. government keeps a low profile when it comes to digital regulation, however it actively employs obstructing practices in the cyberspace.

At the other end of the spectrum, China is a strong supporter of the extension of classical principles of sovereignty in the digital realm. In the 2010 White Paper, China declared the assimilation of the Internet within its national sovereignty and asserted the extension of the national laws in the digital realm[19]. China's first principle of digital sovereignty is the government's exclusive power over the other governments and over all non-state entities that operate in their national cyberspace[20].

Digital sovereignty can be an extension of the classical idea of sovereignty. The recognition of the cyberspace as a new operational domain extends the obligations of the "general principle of sovereignty" to this newly recognized application area[21]. The authors of the Tallinn Manual 2.0 argue that "cyber activities occur on territory and involve objects, or are conducted by persons or entities, over which States may exercise their sovereign prerogatives"[22]. Although individuals do not perceive any borders when they are browsing the Internet, their actions still remain under state jurisdiction. Many states are currently applying the national law to actions performed in the cyberspace, particularly in situations when cybercrimes have a "physical" analogy (i.e., identity and intellectual property theft, financial losses, trafficking, unauthorized access).

The Commission adopted the interpretation of digital sovereignty as control to justify the basis for its Data Strategy. In this context, the EU institutions are creating a "resource regime" with regards to data, by developing a regulatory environment structuring the interactions between the market actors[23]. Data is at the centre of the European industrial policy as result of its economic catalysing effects. In this sense, the Commissions aims to "ensure better access to data and its responsible usage" for the European enterprises[24]. The Data Governance Act (DGA) proposal is intertwined with elements of digital sovereignty in terms of *control* and as a driver for European global digital leadership. The document includes elements of controlling the data access and

[18] Glenn Greenwald and Ewen MacAskill, 'NSA Prism Program Taps in to User Data of Apple, Google and Others' The Guardian (7 June 2013), https://www.theguardian.com/world/2013/jun/06/us-tech-giants-nsa-data (accessed 22 May 2022).

[19] China's Information Office of the State Council, 'Full Text: White Paper on the Internet in China' (China Daily, 8 June 2010), https://www.chinadaily.com.cn/china/2010-06/08/content_9950198.htm (accessed 22 May 2022).

[20] Creemers R.J.E.H. (2020), China's conception of cyber sovereignty: rhetoric and realization. In: Broeders D. & Berg B. van den (Eds.) *Governing Cyberspace: Behavior, Power, and Diplomacy. Digital Technologies and Global Politics*, Lanham: Rowman & Littlefield. 107-142.

[21] Alaa Assaf et al., 'Contesting Sovereignty in Cyberspace' (2020) 1 *International Cybersecurity Law Review*: 115, 118, https://link.springer.com/10.1365/s43439-020-00004-5 (accessed 6 March 2022).

[22] Michael N Schmitt and Liis Vihul (eds), *Tallinn Manual 2.0 on the International Law Applicable to Cyber Operations: Prepared by the International Groups of Experts at the Invitation of the NATO Cooperative Cyber Defence Centre of Excellence* (2nd edn, Cambridge University Press 2017): 12, http://ebooks.cambridge.org/ref/id/CBO9781316822524 (accessed 6 March 2022).

[23] Pascal König, 'Analyzing EU Data Governance Through the Lens of the Resource Regime Concept' (2022), https://www.ssrn.com/abstract=4050804 (accessed 22 May 2022).

[24] European Commission and High Representative of the Union for Foreign Affairs and Security Policy, 'Joint Communication to the European Parliament, the European Council and the Council: The EUs Cybersecurity Strategy for the Digital Decade' (2020): 4.

localization[25]. Apart from the lucrative aspects of exploiting European data, the localisation provision of the DGA is partially rooted in the Schrems II case. The European Court of Justice Judgement on this case concluded that the standard data protection clauses where breached, thus invalidating the EU-US Privacy Shield ("Privacy Shield decision")[26]. By consequence, there is a stronger support in Europe for data localisation and an increasing impetus for the market uptake of native technology.

The territorial digital sovereignty is also manifested on the topic of cloud security, where the European member states are demanding immunity to non-EU laws on issues of data processing and storage. In this regard, cloud security should ensure that the maintenance, operations of the cloud service and process, and data are located within the EU[27].

3. The principal-agent theory

The intriguing aspect of "European digital sovereignty" is the source that projects this power. In essence, the principle of sovereignty implies the delegation of authority to the state, which in turn will control the territory and the assets in the given space. In the European digital context, the delegation setting is not immediately obvious. There are still looming questions regarding the identity of the agent and the principal.

The bare-bones model of delegation is the principal-agent theory. Hawkins defines delegation as "a conditional grant of authority from a principal to an agent that empowers the latter to act on behalf of the former. This grant is limited in time/scope and must be revocable by the principal"[28]. An act can be considered a delegation when a hierarchical and dyadic relationship is identified. The act of delegation involves the principal and agent as main actors. Moreover, they are mutually constitutive in the sense that it is a relational situation where the two actors create each other.

It is also a hierarchical situation because "principals retain the power to cease the contractual relationship and to undo the delegation of authority to the agent"[29]. Thus, the principal has superior ex ante and ex post powers, and the agent acts under and within the principal's authority. This relationship is built in a sequence of actions, beginning with the principal selecting an agent, then the principal drafting the delegation contract and the agent accepting or rejecting it.

In this context, a conditional grant means that the authority is offered within the limits of a given mandate and specific discretion limitations. An agent has only a certain level of freedom in the activities entrusted by the principal. In theory, if the agent does not comply with the rules set in the mandate, the authority can be rescinded.

Efficiency and specialization are the essential reasons why the principal resorts to delegation to an agent. Authority delegation also increases the legitimacy of the

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[25] European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on European Data Governance (Data Governance Act)' (2020): 15.

[26] Xavier Tracol, '"Schrems II": The Return of the Privacy Shield' (2020) 39 *Computer Law & Security Review* 105484: 5, https://linkinghub.elsevier.com/retrieve/pii/S0267364920300893 (accessed 15 December 2021).

[27] Yann Lechelle, 'It Is Time to Strengthen Our EU Data Sovereignty - Open Letter to EU Institutions | LinkedIn' (LinkedIn, 23 March 2021), https://www.linkedin.com/pulse/time-strengthen-our-eu-data-sovereignty-open-letter-yann-lechelle/ (accessed 7 March 2022).

[28] Darren G Hawkins et al. (eds), *Delegation and Agency in International Organizations* (Cambridge University Press 2006): 7.

[29] Tom Delreux and Johan Adriaensen, *Twenty Years of Principal-Agent Research....*

policy. Delegating the task to an independent body will ensure that sensitive policies are not subject to biased policy-makers. The act of delegation answers to the issue of policy continuity and consistency. Hawkins et al.[30] identified other benefits of delegation, respectively the ability to manage policy externalities (addresses the coordination and collaboration dilemmas), collective decision-making facilitation, dispute resolution, credibility and policy bias.

In the European context, the collective principal consists of separate actors which have heterogenous preferences, making it difficult to take decisions in certain situations. As a collective actor, members are likely avoiding gathering their efforts around common interests and objectives because they are attracted to the option of free-riding[31]. The main solution to this problem is investing an agent with agenda-setting powers to reduce the instability of majority rule.

However, delegation also incurs costs on the principal. The most striking is the control loss over the agent's actions. This occurs in situations of conflict of interest (when the two actors diverge on their policy perspectives or values) and agent's opportunism (the agent hides beneficial information). These risks can be mitigated through contractual controls in the form of incentives (remuneration), opportunities, and sanctions[32].

With the adoption of digital sovereignty rhetoric at the European level, the literature misses a mapping of the main actors and power relations. An obvious question is who is the sovereign? And which are its objects and assets? The principal-agent theory combined with the longitudinal analysis of historical institutionalism, provides the right framework to trace the evolution of the Commission's powers. Furthermore, by adding the digital sovereignty rhetoric as independent variable, the analysis could offer the right tools to trace the change and continuity of the Commission's powers, respectively an evolution towards the federalization of the EU[33].

Additionally, the principal-agent theory helps with understanding the EU member states motivations to delegate further powers to supranational institutions. The main reasons we engage in this article are the transaction costs (informational, bargaining, and enforcement costs) and credibility of policy commitments (create long-term commitment to an important piece of legislation)[34]. In the same vein, the rhetoric of digital sovereignty is a coalition magnet providing further incentives to delegate powers. Hence, the concept facilitates compromise on sensitive policy areas.

4. The European institutional setting

There is a complex set of entities involved in the process of projecting digital sovereignty. Anu Bradford argues that the EU is a regulatory superpower that "shapes the world according to its own image" and Europeanised the global markets, especially with the General Data Protection Regulation (GDPR). The EU wants to become a global digital

[30] Darren G Hawkins et al. (eds), *Delegation and Agency in...*

[31] Kenneth A Shepsle, *Rational Choice Institutionalism* (Oxford University Press 2008) 6, http://oxfordhandbooks.com/view/10.1093/oxfordhb/9780199548460.001.0001/oxfordhb-9780199548460-e-2 (accessed 22 May 2022).

[32] Darren G Hawkins et al. (eds), *Delegation and Agency in...*

[33] Maxime Lefebvre, *Europe as a Power, European Sovereignty...*:6

[34] Renaud Dehousse, 'The Politics of Delegation in the European Union' in Dominique Ritleng (ed), *Independence and Legitimacy in the Institutional System of the European Union* (Oxford University Press 2016): 6, https://oxford.universitypressscholarship.com/view/10.1093/acprof:oso/9780198769798.001.0001/acprof-9780198769798-chapter-3 (accessed 5 April 2022).

leader and largely achieved that objective through regulation and standardization[35].

Historically, the Commission argued for a European approach in the technological sector and asserted its role of policy entrepreneur. The reasons for this tendency are largely related to the functionalism of the opportunities provided by the supranational setting. "Digital sovereignty" in the European context should be viewed from the perspective of shared responsibilities. The source of normative guidance and the capability of projecting power and influence varies across sub-topics, depending on the impact at the national level or on the single market. The EU institutions enjoy considerable power on normative and value-driven issues that have extra-territoriality application, such as the competition policy or data protection. However, EU member states will have the capability and power to implement regulations on issues with high political salience, such as the security of the networks and information systems.

The EU treaties do not include any explicit provisions for the information and communication technologies. However, the EU institutions have the power to adopt sectoral and horizontal policies. This power is grounded in Article 114 of the Treaty on the Functioning of the EU (TFEU) that addresses issues regarding the harmonization of practices that impact the functioning of the internal market.

The EU's interdependent and hybrid system of governance presents a set of intricate legislative decisional layers. The current institutional setting is inherited from the Treaty of European Union (TEU, signed at Maastricht in 1992), and developed in the Treaty on the Functioning of the European Union (TFEU, signed at Lisbon in 2007). The resulting inter-institutional distribution of responsibilities is shared among a handful of actors, varying between intergovernmental and supranational powers. The EU key institutions in the digital area are the European Council, the European Union Council, the European Parliament, and the European Commission.

The European Council and the Commission are highly interdependent and they mutually influence each other in the agenda-setting phase. It is considered the most important stage of the legislative train because of the attention given by the agenda-setters to a salient issue and their influence is projected on the resulting policy[36]. The European Council does not have any legislative functions, however the Art. 15(1) of the TEU provides its authority on defining the "general political directions and priorities" of the Union.

The European Council must request the Commission to initiate legislative proposals. Thus, it has informal agenda-setting powers and its influence is translated in the form and content of the request. The Commission enjoys, under Art. 17(2) of the TEU, the exclusivity of legislative proposal in the Union. It is the formal agenda-setter and has the power to draft and influence the subsequent steps of the adoption. The distribution of responsibilities on agenda setting is subject to the area, varying from high politics (through the heads of governments in the European Council) to low politics (through the technical expertise of the Commission)[37].

The Commission submits its proposal for discussions in the Council and

[35] Anu Bradford, *The Brussels Effect* (Oxford University Press 2020): 18, https://oxford.universitypressscholarship.com/view/10.1093/oso/9780190088583.001.0001/oso-9780190088583-chapter-3 (accessed 4 April 2022).

[36] David Moloney, 'Who Sets the Agenda? The Influence of the European Commission and the European Council in Shaping the EU's Response to the European Sovereign Debt Crisis' (2021) 29 Journal of Contemporary European Studies: 112, https://www.tandfonline.com/doi/full/10.1080/14782804.2020.1823342 (accessed 12 March 2022).

[37] *Ibidem*: 4.

Parliament that act as two parliamentary chambers. The co-legislators should adopt the act based on the ordinary legislative procedure described under Article 294 TFEU. The Council and Parliament draft their internal positions which are presented in the trialogue negotiations. The co-legislators must agree on the same text. Thus, the final piece is a sum of concessions and compromises.

5. The origins of delegation in the EU telecommunications sector

To answer the challenge of navigating the geopolitical competition, the Commission set the ambition to achieve "technological sovereignty in some critical technology areas"[38]. However, from this statement, it seems Brussels is not clear about the direction it plans. Luckily, the EU can learn from its experience of external competitive pressures and the development of antitrust policies. The most notable example is the period of 1980 – 2000 when the European Community was challenged by the Japanese and U.S. dominating strategies on trade, including technology sectors such as computer, telecommunications, and semiconductors.

The development of telecommunications policy on the EU agenda coincides with the process of European integration. With the liberalization of the telecommunications sector, the Commission experienced an increasing foothold in the institutional setting through the adoption in the 1980s of the first acts in the area of antitrust policy *Terminals Directive* (1988) and the *Services Directive*[39]. These two documents are important pieces in the history of European integration because they mark the beginning of European level policy in the digital sector and delegation of tasks to the Commission in a traditionally nationalized area. The digital sector witnessed a succession of iterative and incremental changes, both in terms of institutional powers and regulatory approaches. The added value of this historical perspective is tracing the longitudinal evolution of the Commission's competences. By tracing the development path of the European integration, the independent variable of digital sovereignty rhetoric will add another layer of arguments explaining the policy change.

Historically, telecommunications were a matter of national sovereignty marked by considerable national monopoly. The member states preferred to maintain the status quo of the intergovernmental institutional setting and preserve their authority on the telecommunications discussions. The Post, Telephone and Telegraph Administrations (PTTs)[40] wanted to prevent the inclusion of the telecommunications field on the European level agenda. Although there were international pressures to liberalize the market (notably

[38] 'A Union That Strives for More: My Agenda for Europe. Political Guidelines for the Next European Commission 2019-2024' (European Commission 2019): 14, https://ec.europa.eu/info/sites/info/files/political-guidelines-next-commission_ro.pdf (accessed 12 March 2021).

[39] 'Commission Directive of 28 June 1990 on Competition in the Markets in Telecommunications Services' (Official Journal of the European Communities 1990), https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31988L0301&from=EN (accessed 22 March 2022).

[40] The PTTs were national state-run telecommunication networks and services, managed as natural monopolies. Until the adoption of the *Terminals Directive* (1988) and the *Services Directive* (1990), they have enjoyed exclusive rights over the supply of telecommunications services. The natural monopoly was motivated on the need to limit the operation of the public network to a single operator to ensure the continuity and quality of the service. These companies were often owned by the national telecommunication regulatory entity. Thus, they were managed and regulated by the same authority. Without surprise, the member states were keen on perpetuating this operating model, until international and European pressures triggered the liberalization. For more information, see Joseph Goodman, *Telecommunications Policy-Making in the European Union* (Edward Elgar Publishing 2006), http://www.elgaronline.com/view/9781843768067.xml (accessed 12 March 2022).

from the U.S.), the European PTTs were keen on maintaining their *status quo*. PTTs wanted to minimize the Commission's action, hence they continued to use until 1980s the European Conference of Postal and Telecommunications Administrations (CEPT) as the main forum of "coordination of cross-border European telecommunications issues"[41]. The Commission frequently overlapped and contradicted CEPT on their respective competencies. To counter the member states' resistance to change, the Commission developed an epistemic community to mobilise and support its strategies of institutionalizing the telecommunications on the European agenda. The Commission sought to expand its policy competence and increase its power and legitimacy in this sector. However, until the 1980s, the external economic and technological pressures were mild to incentivize the member states to engage on a policy change track. The Commission lacked the "policy window" that would escalate the need for a coordinated approach. This all changed with the escalation of the Japanese and U.S. dominance in the digital sector and increased pressures to open the telecommunication market[42]. With the geopolitical challenge resulted the need to address the scale effects through a concerted response motivated in the Green Paper on the Development of the Common Market for Telecommunications Services and Equipment[43]. This document was the first "major threshold [event] in the evolution of European telecommunications markets"[44]. By setting the telecommunications regulation at the European level, the Commission was proposing innovative policy in the service of the common interest and changing the nature of national cooperation.

The appointment in 1977 of Étienne Davignon in the position of European Commissioner for Industry and Commission and Vice-President marked the beginning of the change in the European telecommunications policy. Additionally, Davignon's appointment was a window of opportunity for raising the issue of telecommunications at the Community level. His strategy was to transform the Commission into an informal agenda-setter in the telecom sector, first through the epistemic community[45], and then through policy entrepreneurship[46]. Confronted with the resistance of the PTTs, he suggested that the Commission ought to focus on the computer and microelectronics industries, which would become the backbone of the society a few years later.

Furthermore, the Commission sought to develop a central role in the Research and Development in Advanced Communications Technologies in Europe (RACE). While CEPT continued to act as a "damage control" actor (protect national sovereignty in this sector), the beneficiaries of the RACE program supported the Europeanisation of this policy domain and consolidated the Commission's legitimacy. Some argue that this program was the most important development in the European telecommunications

[41] *Ibidem*: 50.

[42] Cosmina Moghior, 'Fear of Technological Dominance: A Longitudinal Analysis of the European Policy Change' (Unpublished manuscript, 2022).

[43] Commission of the European Communities, 'Towards a Dynamic European Economy: Green Paper on the Development of The Common Market for Telecommunications Services and Equipment' (1987) 3, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:51987DC0290&from=en.

[44] Lawrence Garfinkel, 'The Transition to Competition in Telecommunication Services' (1994) 18 *Telecommunications Policy*: 427, https://linkinghub.elsevier.com/retrieve/pii/0308596194900116 (accessed 22 May 2022).

[45] Volker Schneider, Godefroy Dang-Nguyen and Raymund Wrle, 'Corporate Actor Networks in European Policy-Making: Harmonizing Telecommunications Policy' (1994) 32 JCMS: *Journal of Common Market Studies*: 473, https://onlinelibrary.wiley.com/doi/10.1111/j.1468-5965.1994.tb00510.x (accessed 18 March 2022).

[46] Joseph Goodman, *Telecommunications Policy-Making*...

policy, because it was the product of supranational efforts. It established the Commission as "the leader to which diverse liberalizing interests would rally"[47].

The policy window that the Commission needed was the early 1980s Information Technologies Task Force (ITTF) report on the threat of the U.S. and Japanese dominance in the digital sector. The issue was framed in terms of Europe's overdependence on foreign technology and on the monopolistic behaviour from the third-countries companies. In other words, it was an issue which called for a concerted response. The Commission stressed that the required "capacity to meet [the US and Japanese] challenges, and to cope in a timely manner with the opportunities born out of telecommunications, is outside the capability of national operators on their own"[48]. It is argued that the Commission's capability to raise this threat marks the beginning of the EU telecommunications policy and the increase of the European Community impact on the national telecommunication sectors[49].

6. The preference heterogeneity in the EU (digital) context

The EU institutional architecture presents a peculiar political setting that lacks a unitary principal. The history of European Union construction is the result of a number of countries that decided to yield parts of their sovereignty in specific domains to supranational institutions. The EU institutional framework is built on balance and consensus with the aim of creating order without empowering a hierarchical structure. Largely, the EU member states kept their foremost position regarding the treaties, while they have also granted consistent discretionary powers to the executive (the Commission) and the judicial (CJEU) European bodies.

The unique aspects of the delegation politics in the European context are the plurality of the principals and their preference heterogeneity[50]. The discourse on European digital sovereignty is mainly dominated by French, German and EU institutional policy makers.

In the Franco-German context, digital sovereignty firstly emerged as a form of digital security pledge at their Council of Ministers of 7 April 2016. The joint declaration underlined their priority to promote European digital sovereignty around the capacity to defend the European networks, strengthen industry and the ability to take autonomous decisions regarding data security in the context of trade agreements negotiations[51].

While in the smaller EU member states the concept of digital sovereignty does not occupy the priorities on the public agenda, it is considered in the wider debate on "strategic autonomy". Mainly, policymakers framed the concept of "digital sovereignty" in terms of digital capabilities, regulation and policy, and protection of the territorial (traditional) sovereignty[52].

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[47] Wayne Sandholtz and Alec Stone Sweet (eds), *European Integration and Supranational Governance* (Oxford University Press 1998): 150.

[48] Commission of the European Communities, 'Progress Report on the Thinking and Work Done in the Field and Initial Proposals for an Action Programme. Communication from the Commission to the Council on Telecommunications' (1984) EU Commission - COM Document, http://aei.pitt.edu/3673/ (accessed 22 May 2022).

[49] Volker Schneider, Godefroy Dang-Nguyen and Raymund Wrle, *Corporate Actor Networks...*

[50] Renaud Dehousse, *The Politics of Delegation...*

[51] Conseil franco-allemand de sécurité et de défense, 'Déclaration Ur Les Questions de Sécurité et de Défense' (7 April 2016), https://www.diplomatie.gouv.fr/IMG/pdf/_16-04-07_declaration_cfads__cle8eaec8.pdf (accessed 22 May 2022).

[52] Seamus Allen, 'European Sovereignty in the Digital Age' (Institute of International and European Affairs 2021) 5.

During Germany's Presidency of the Council of the EU, the 27 ministers responsible for digital transformation signed the "Berlin Declaration on Digital Society and Value-Based Digital Government", underlying that "strengthening Europe's digital sovereignty and interoperability" is a value at the foundation of the European Union[53].

French President Emmanuel Macron stressed the need for a European solution to the issue of dependence on US digital giants, arguing for the need for a further integration of the European Union[54]. The European digital sovereignty has a strong political importance, because those who gain power in the digital domain set the type of life we live in[55].

Some member states expressed their concerns regarding the evolutions on digital sovereignty and strategic autonomy. The D9+ states[56] published a Joint Declaration stressing that "We should leverage our global competitive advantage in these areas to ensure our technological leadership in the long term while maintaining an open single market, strengthening global cooperation and the external trade dimension"[57]. Two months later, Estonia, Denmark, Finland, and Germany co-signed a letter sent to the European Commission's President, Ursula von der Leyen, underlining that digital sovereignty should be centred around self-determination, jointly with democratic partners, while building on a strong transatlantic relationship. The letter further mentioned that digital sovereignty should reduce weaknesses, while avoiding protectionist approaches[58].

Through these documents, the EU member states have stated their support for capacity building, cooperation, openness and regulation. They further specify that these efforts are aimed at upholding the European values. The link between digitalization and sovereignty occupies a primary position in the priorities of the most pro-liberal market countries. The Netherlands is actively supporting the initiatives on competition and platform regulation[59]. Estonia, the most aversive European country towards the strategic autonomy concept, is vocal with regards to regulation on disinformation, cybersecurity, and digital taxation.

The European Council conclusions in October 2020 asserted that technological

[53] German Federal Ministry of the Interior, Building and Community, '"Berlin Declaration on Digital Society and Value-Based Digital Government" Signed' (*Federal Ministry of the Interior and Community*, 8 December 2020), http://www.bmi.bund.de/SharedDocs/pressemitteilungen/EN/2020/12/berlin-declaration-digitalization.html;jsessionid=33D6519AAAA44CCDA9901B840C1C6DA8.1_cid373?nn=9384552 (accessed 22 May 2022).

[54] Ryan Browne, 'France's Macron Lays out a Vision for European "Digital Sovereignty"' (*CNBC*, 8 December 2020), https://www.cnbc.com/2020/12/08/frances-macron-lays-out-a-vision-for-european-digital-sovereignty.html (accessed 22 May 2022).

[55] Luciano Floridi, 'The Fight for Digital Sovereignty: What It Is, and Why It Matters, Especially for the EU' (2020) 33 *Philosophy & Technology*: 369, 377, https://link.springer.com/10.1007/s13347-020-00423-6 (accessed 6 March 2022).

[56] D9+ gathers the European countries with the highest ranking in the Annual Digital Economy and Society Index (DESI), with the objective of promoting and exchanging best practices on digitization. The Joint paper referred in this article was signed by Belgium, Czech Republic, Denmark, Estonia, Ireland, Luxemburg, the Netherlands, Poland, Portugal, Spain, and Sweden.

[57] 'D9+ Declaration: Leading the Way to Europe´s Digital Decade' (2021), https://tem.fi/documents/1410877/53440649/D9%2B+Declaration.pdf/536c1b37-2b93-57d6-1313-bfe943f3c17e?t=1611759617528.

[58] Germany, Denmark, Finland, and Estonia, 'Letter to Commission President Ursula von Der Leyen on Digital Sovereignty' (1 March 2021), https://www.politico.eu/wp-content/uploads/2021/03/01/DE-DK-FI-EE-Letter-to-COM-President-on-Digital-Sovereignty_final.pdf.

[59] Foo Yun Chee, 'Germany, France, Dutch Want More Say over Tech Giants' Start-up Deals' Reuters (27 May 2021), https://www.reuters.com/business/retail-consumer/germany-france-dutch-want-more-say-over-tech-giants-start-up-deals-2021-05-27/ (accessed 22 May 2022).

sovereignty must be built on a digital single market where the EU has the "ability to define its own rules, to make autonomous technological choices, and to develop and deploy strategic digital capacities and infrastructure". Moreover, the conclusions mentioned that the European market is open to "all companies complying with the European rules and standards". Finally, the document stipulated that technological sovereignty will be projected at the international level through the "EU tools and regulatory powers" with the aim of shaping "global rules and standards"[60].

7. Conclusions: The politics of delegation in the EU digital context

The emergence of the European digital sovereignty rhetoric and the increased foothold of digital policy on the Union's agenda mark a turning point in the evolution of European integration. The concept fosters coalitions and consensus, while creating divergences among the member states at the same time. Who is the *sovereign*? This was the zeitgeist of the present article. Through the literature review and policy and discourse analysis, the study offers an alternative perspective. The concept of digital sovereignty is an idea beyond the traditional Westphalian concept. It is not really about the Leviathan, subjects, assets, and control. It is rather a discursive act instrumentalized (primarily by the Commission) to advance bold policy proposals and encourage consensus around them.

The main objective of the article was to trace the Commission's competence evolution in a longitudinal analysis, and to take stock of the impact of the new rhetoric of digital sovereignty on this process. A secondary objective of the study was to identify the EU member states' motivations to delegate the tasks and powers at the supranational level. The emergence of the digital sovereignty rhetoric highlights two key-aspects of the delegation politics in the European digital framework. First, the decentralized nature of the institutional setting in the EU underlines the difficulties created by the absence of a clear centre of power. The European system features a set of multiple principals that sometimes present heterogenous preferences. Digital sovereignty is an ambition which requires strategic thinking and decision-making. The ambiguity of the concept, as well as the aspiration of the EU member states to achieve the objectives of this rhetoric encourages coalitions and compromise on sensitive topics. The lack of alignment between the EU member states is the foremost motivation for delegating this task to an independent body. In the vein of the principal-agent theory, the former decides to delegate powers to the latter in situations of difficulty to compromise on vital topics. In this way, the agent, through its expertise, independence, and access to resources, achieves the set objectives of digital sovereignty at a reduced transaction cost. Otherwise, unilateral action would have a considerable increased cost and low efficiency. In other words, the EU stands stronger together in the context of geopolitical competition.

Second, the relationship developed between the principals will influence the type of discretion they would apply towards the agent. The member states are aware of their preference heterogeneity, leading them to fear that the other partners will defect, or will capture the agent, or the agent itself will display policy drift. These three elements are the main challenges in the principal-agent theory. Nevertheless, the rhetoric of digital sovereignty comes to rescue the relation between the two sides of the matrix (principal and agent), through its consensus building. Having the confidence of a greater objective,

[60] European Council, 'Special Meeting of the European Council (1 and 2 October 2020) – Conclusions' (2020).

the EU member states decided to delegate the task of achieving it, while ensuring credibility of policy commitments (create long-term commitment to an important piece of legislation). On the other hand, the Commission is not depleted of its agency to act at its own will. Its rational behaviour of seeking to maximize its power is the greatest risk that the principals (the EU member states) are subjected to.

Nevertheless, the EU member states decided to delegate additional powers as a result of increasing external pressures from the geopolitical competition. It is a challenge that they just cannot tackle by themselves and this aspect has two implications. First, the literature acknowledges the effects of the external pressures on creating divergences between the EU member states[61]. One of the many vices of the EU is that it has a difficulty to foster consensus in contexts of crisis. Second, external pressures incentivise further European integration, but not in the classic neoliberal vein. However, it takes a neo-mercantilist or even a protectionist turn, for example through foreign direct investments control[62]. The two elements are indicating an integrated strategic approach at the European level to achieve autonomy and sovereignty. Much of the merits are ascribed to digital sovereignty giving a new objective for European integration. Its main contributions are, as mentioned before, the coalition and consensus builder, with such a strong force that it manages to achieve all this in a context of heterogenous preferences.

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[61] Scott Lavery and Davide Schmid, *European Integration...*; Dorothee Bohle and Béla Greskovits, *Capitalist Diversity on Europe's Periphery* (Cornell University Press 2012); Alison Johnston and Aidan Regan, 'Introduction: Is the European Union Capable of Integrating Diverse Models of Capitalism?' (2018) 23 *New Political Economy*: 145, https://www.tandfonline.com/doi/full/10.1080/13563467.2017.1370442 (accessed 23 May 2022).

[62] Andrew Moravcsik, *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Routledge 2005); Sandholtz and Stone Sweet (n 46).

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Rien ne se crée sans les hommes. Rien ne dure sans les institutions.

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