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in collaboration with

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## **Cold War II**

*July 2023*

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## INTRODUCTION

The world is experiencing a geopolitical recession, characterised by a phenomenon of gradual de-globalisation and balkanisation of global supply chains. The framework in which this geopolitical recession is taking place is what we call Cold War 2. It is between waged between the United States and China, and has several dimensions which we will explore in this article.

This geopolitical recession may become a depression, if the conflict between the two global superpowers intensifies further. In this respect, the war between Russia and Ukraine represents a very concerning signal, since it has fundamentally altered the geopolitical equilibria that had been reached at the end of World War 2. We interpret this conflict as the first proxy war between the US and China.

The war in Ukraine has further accelerated the polarisation of the world, into two sphere of influence: one around the US and their allies, and one around China and its allies. Very few countries, chiefly India and a few in the Global South, will be able to remain “non-aligned” with either of the two superpowers. In this environment, the international fora for global governance have become ineffective.

In this context, we explore the possible role for Europe, and its technological advancement, followed by the necessary regulatory adaptation to accommodate these inroads.

This paper is organised as follows: Chapter One explores the context of Cold War 2, which is the scenery against which all macroeconomic, geopolitical and technological developments are happening. Chapter Two explores the possibility of proxy wars in those countries and regions that have not fallen directly into either sphere of influence. Chapter Three discusses the technological advancements made by Europe in the context of a re-shaped global economy.

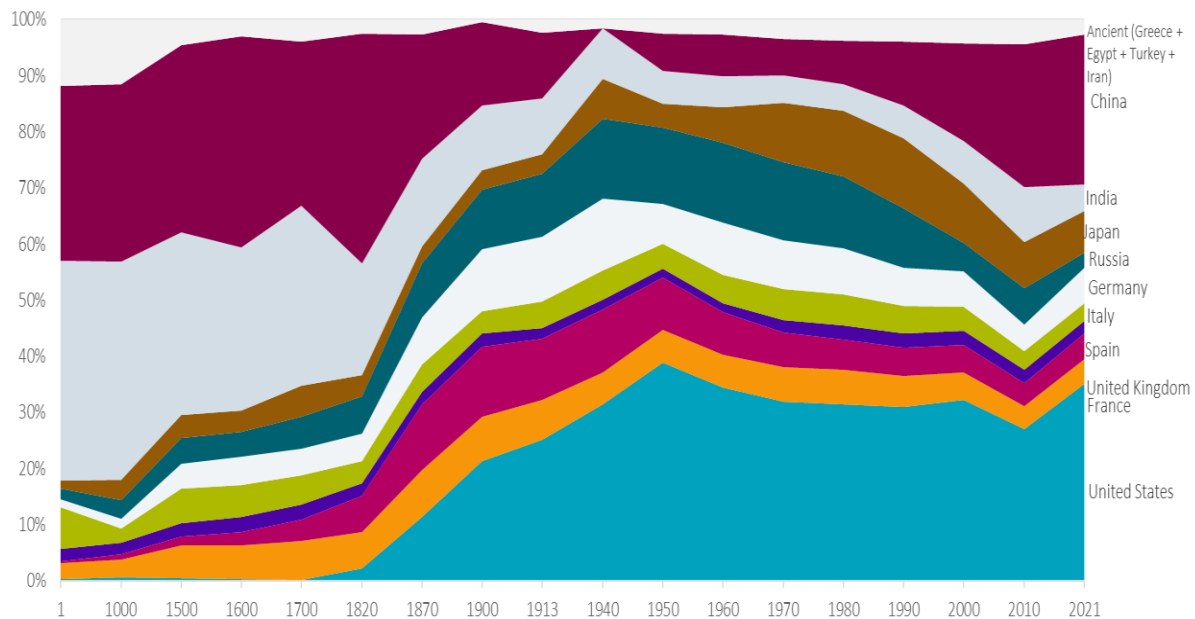
## CHAPTER 1: COLD WAR II – A REPRISE

### Cold War II Is the Backdrop To the Current Geopolitical Environment

In the article [“Towards a Tech Driven Cold War”](#), we discussed the emergence of a new Cold War between US and China, which we labelled Cold War 2. A few years later it is widely recognised that the U.S. and China are currently “de-coupling”, as their strategic interests are diverging; recent agreements among the G7 about “de-risking” rather than de-coupling from China will be harder to achieve if the Cold War between US and China becomes colder. The US is the incumbent superpower, having emerged victorious at the end of its Cold War 1 with Russia. It was able to establish a new, unipolar world order, around the so-called “Washington Consensus.”

China meanwhile saw its share of the world GDP rise, returning towards its long-term average of around 25% (**Figure 1**), similar to the US GDP’s current share of the global economy. This tumultuous economic growth by China has been accompanied by a parallel increase in its geo-strategic ambitions. This increase in the geopolitical reach is now a necessary condition to continue to expand economically.

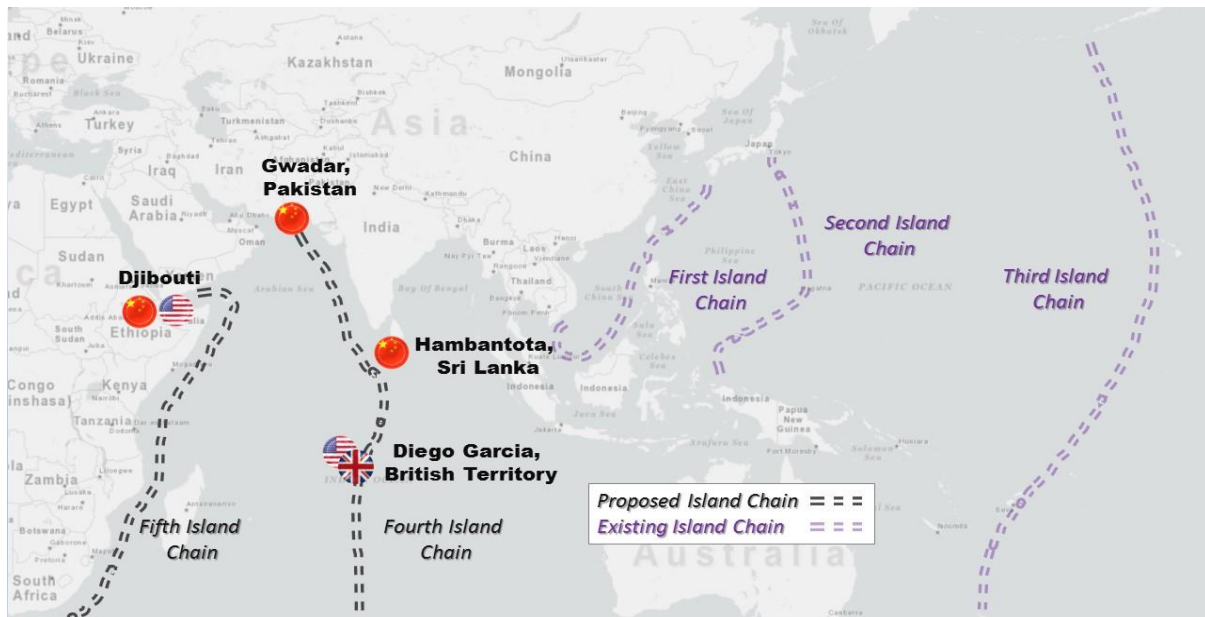
**Figure 1: China’s Share of World GDP is Returning Towards Its Long-Term Average**



Source: Angus Maddison “Statistics on war population, GDP, and per capita GDP, 1- 2008 AD”, IMF

In fact, China does not enjoy the position of the US, which is “protected” by two oceans. The maritime domination of the US has been unconstrained and unchallenged, which allows the US navy to patrol the “seven seas” and assert its role as the “policeman” of the world. By contrast, China’s aim of expanding its maritime influence is constrained by the presence of multiple countries in its immediate maritime radius, including North Korea and South Korea, Japan, Vietnam, the Philippines and, of course, Taiwan. This has caused endless territorial disputes in the South and East China Seas, which have led to the implementation of the “island chains” policy (**Figure 2**).

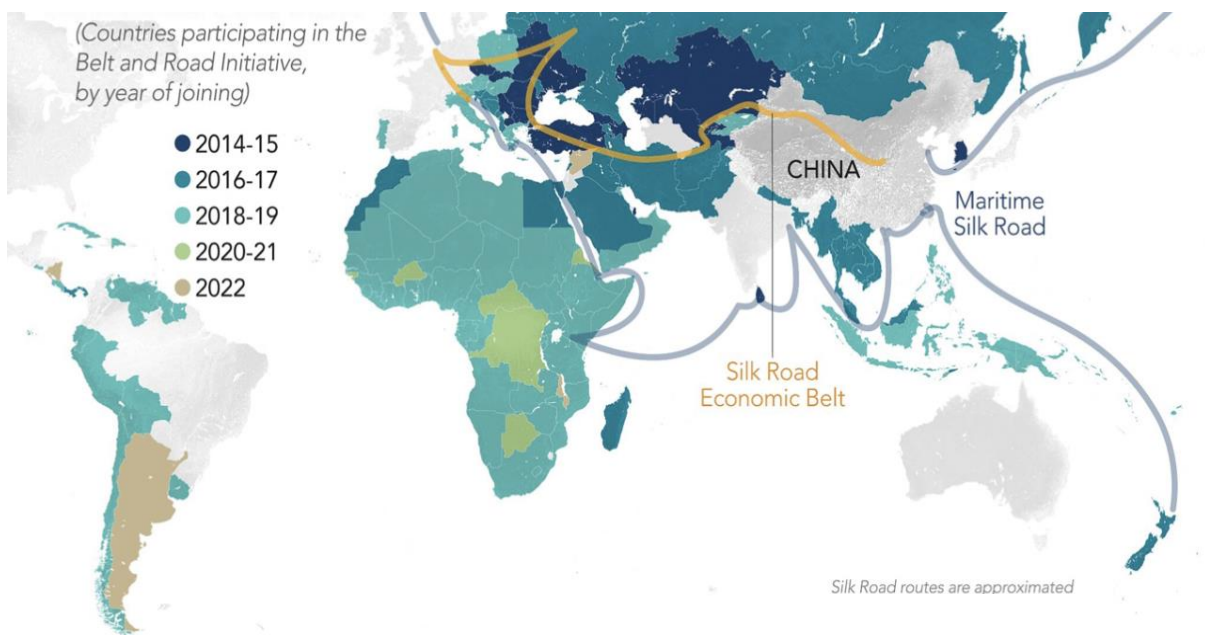
**Figure 2: China’s Island Chains Policy**



Source: [Asia Maritime Transparency Initiative](#)

The chosen way to break this perceived encirclement is the implementation of the Belt and Road Initiative (BRI), the key constituent of which is the establishment of the “maritime road” (Figure 3), which connects various ports across South Asia, East Africa, the Middle East, and, at the end of the road, Europe. These land and maritime roads will allow China to continue to grow and continue to export the overcapacity of production that results from a still-underdeveloped internal market. The opening of commercial roads also allows countries such as China to deploy their navies and armies to defend their exports. This is what frightens the US and its allies in the region, in particular Australia and New Zealand.

**Figure 3: China’s Belt and Road Initiative**



Source: [China’s official BRI Portal](#)



## The Three Dimensions of Cold War 2

### *Balkanization of Global Supply Chains*

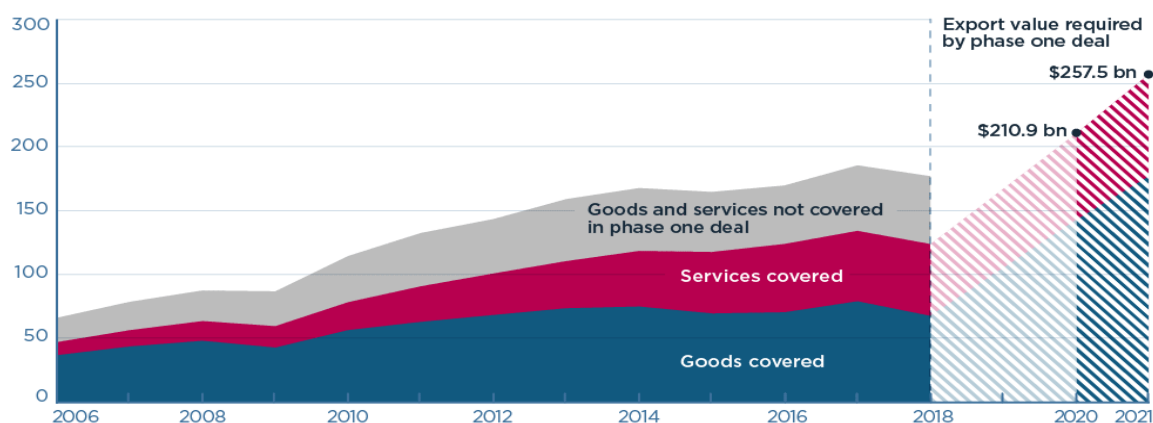
The BRI was the affirmation of the current dominance of global supply chains by China. The Covid pandemic has challenged this dominance, as countries became aware of their dependence on China's goods, even for their essential medical needs. The emerging Cold War 2 between the US and China has further challenged this dominance. Both the US and China now seem to be in favour of the ongoing process of "balkanization" of global supply chains. The processes of "friend-shoring" and "re-shoring" are marking the establishment of shorter, more resilient supply chains that are less dependent on China.

As we discussed in our initial report, the balkanisation of global supply chains was one the three dimensions of Cold War 2. The other two dimensions are the Trade War and the Tech War. They are clearly related to the disruption in global supply chains, as trade occurs over the roads of the supply chains, and a key component of this conflict is the battle over micro-chips/semi-conductors, which are currently produced mainly in Asia and then distributed across the globe via the above-mentioned supply chains.

### *The Trade Conflict*

Regarding trade, a key development was the "Phase 1 deal" that was signed by the US and China on 15 January 2020. The deal included China agreeing to buy USD 200bn of additional US products, and also making commitments on IP, tech transfer, financial services, agriculture, and currency management. Additionally, a new dispute resolution mechanism was established. However, the objectives of the deal appeared immediately to be ambitious, some would even say "aspirational", i.e. virtually impossible to achieve (**Figure 4**). And even if they had been achievable, they would have been obtained at the expenses of the expenses of US allies. For example, China's commitment to increase its imports from the US would have implied a reduction in China's imports from Germany, Japan, Italy and other close allies of the US.

**Figure 4: Total US Goods and Services Exported to China (in USD bn) and the Phase 1 Deal Goals**



Source: [PIIE](#). Constructed by the author Chad P Bown with US export data from the Census Bureau, US Bureau of Economic Analysis, and Annex 6.1 of "Economic and Trade Agreement between the United States of America and The People's Republic of China: Phase one"

To complicate the situation further, the Covid pandemic brought a sudden halt to global trade for several months. China initially said that it would continue to pursue the agreed upon objectives, but over time this commitment faded, under the weight of the repeated lockdowns that were implemented by China as a result of its ill-conceived Zero-Covid Policy. When the Zero-Covid Policy was finally abandoned, the US and China were already on very bad terms given the beginning of the war in Ukraine that was initiated by Russia and tolerated by China. Other more pressing issues came to the fore instead, and the commercial dispute between US and China took the back seat, with the tariffs and sanctions established by the two sides during the [Trump administration remaining largely in place](#).

### *The Tech War*

The third leg of Cold War 2, besides the trade war and the balkanisation of global supply chains, is the tech war. Despite being less visible than the other two aspects, the ongoing tech war between the US and China is by far the most relevant, especially in terms of the size of the market at stake.

Qualitatively speaking, any country that aims at being the leading country in the world has to also be the country that is most technologically advanced. This will be reflected in a military superiority that helps keep strategic rivals at bay. [From a quantitative standpoint](#), the “*total value of daily exchanges that depend on a 7standardized, non-combative and relatively secure global information and communication technology (ICT) environment is almost nine times the annual value of bilateral US–China trade, standing at almost nine trillion US dollars.*” This compares with the bilateral exchange of goods and services between the US and China, which amounts to around USD 1 trillion per year.

The tech war between the US and China began with China’s intention to become the dominant country in the most technologically advanced sectors that will be relevant in the future, from aerospace and advanced manufacturing to robotics and artificial intelligence. According to the plan “Made in China 2025 (a.k.a. Agenda 2025)”, devised in 2015 by Premier Li Keqiang, China aims at having 70% of the technological content of its products made in China, up from 40% in 2020 (these estimates were made pre-pandemic).

In our view, the tech war between US and China can be summarised in four dimensions, which are: a) big data; b) artificial intelligence; c) cyberwarfare; and d) semi-conductors. Since our latest report, there have been numerous developments on these three fronts, and an additional two fronts have also emerged.

*On Big Data*, the big US tech companies (including but not limited to the FAANG) continue to accumulate data from their users. But China’s giant tech companies (primarily Baidu, Alibaba and Tencent, but not only them] are catching up fast by leveraging their roughly 800 million internet users per day.

*On Artificial Intelligence*, needless to say, the most relevant development has been the roll out by Microsoft of Chat GPT from Open AI, fully integrated in its internet browser Edge. The competition responded with Bard, currently being tested by Google, and Ernie, powered by Baidu.

On *Cyberwarfare*, the most relevant development has been provided by the extensive use of cyber-attacks around the time of Russia's invasion of Ukraine. We had already said that Russia is the country that dominates this segment of the tech war, not because it necessarily has a more advanced technology, but because it uses it all the time, and without the self-imposed limitations of liberal democracies. Particularly relevant was the appointment of Valery Gerasimov as Chief of Staff of the Russian Army. Gerasimov is a strong believer of hybrid warfare (conventional coupled with cyber) as a means of attack as well as deterrence.

Regarding *semi-conductors*, China and the US have started a series of restrictions to export of such key components to each other. The US has banned the export of chips and chip manufacturing machines to China, especially at the high-end of the range, such as those used for AI applications (for example produced by Nvidia). China has responded by banning the import of products by Micron, the US largest micro-processor producer, from key infrastructure projects, citing a national security risk.

Recently, besides these four established dimensions, we believe that there are now two additional battlefields of the tech war. These are the so-called RegTech (i.e. the competition to offer the most attractive regulatory environment to Fin-Tech companies) and the emergence of central bank digital currencies (CBDCs).



## Chapter 2: COLD WAR 2, PROXY WARS AND GLOBAL GOVERNANCE

### The International Relations between the US, Russia and China, From a Historical Perspective

On 24<sup>th</sup> February 2022, Russia began its invasion of Ukraine, eight years after its annexation of Crimea. This war has fundamentally altered the geopolitical equilibria that emerged after WW2, and has induced a polarisation of the world that will further boost the Cold War 2 environment discussed above.

Just before WW2, Russia and Germany signed the Molotov–Ribbentrop Pact on mutual non-aggression, which de facto led to the partition of Eastern Europe and in particular of Poland. Before signing this pact, the Soviet Union had tried to form a tripartite alliance with France and Britain, but the negotiations failed. The signing of the alliance between Nazi Germany and Communist Soviet Union alarmed the US, which saw the realisation of Washington’s worst geopolitical nightmare: resource-rich Russia providing commodity inputs for highly industrialised Germany. The nightmare was looking even less bearable considering that two opposing dictatorships (the Nazis and the Communists) were shaking hands, in the face of liberal-democratic US. WW2 became inevitable, first and foremost to break this link.

At the end of the war, when negotiations took place at the conference of Yalta, in Crimea, the leader of the Soviet Union, Joseph Stalin, was pictured together with the two champions of the world’s liberal democracies, the US and the UK. The conferences of Tehran in 1943 and Yalta in 1945 marked the end of WW2, and the beginning of Cold War 1, with the division of the world into two competing spheres of influence.

When the Berlin Wall fell in 1989 and the Soviet Union collapsed in 1991, a unipolar world emerged around the Washington Consensus, but the equilibria born at the end of WW2 were still standing. In particular, Saudi Arabia was still the closest ally of the US in the Arab Middle East, and Russia actually got closer to the US by entering as the 8<sup>th</sup> member of the club of the most advanced economies, with the G7 becoming the G8. BRIC was still an acronym, without the S of South Africa.

### The End of WWII Equilibria

But the same way the post-WW2 equilibria were born in Crimea in 1944 (itself almost exactly a century after the Crimean War of 1853-56, which saw Russia fighting the Ottoman empire, France and the UK), the annexation of Crimea by Russia in 2014 signed the beginning of the end of those equilibria. The meeting between Russian President Putin and Chinese President Xi on the 4<sup>th</sup> of February 2022, when the two leaders signed a joint statement to express their “limitless cooperation” between the two countries, signified the definite end of those equilibria. Three weeks later, Russia began its “special military operation” in Ukraine. On the same occasion, China launched its digital renminbi (e-CNY) and provided a platform to Russia for avoiding the sanctions that would inevitably ensue from its decision to invade Ukraine.

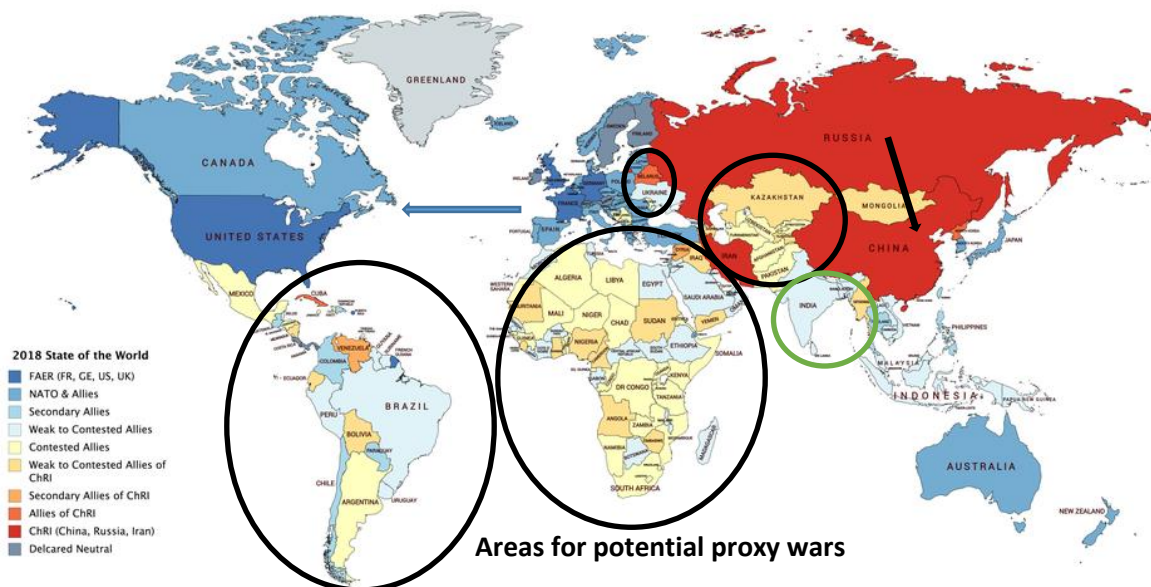
With the beginning of the war, the polarisation of the world had begun. Russia had decided to break its links with the West and tie its fortunes to those of China. Europe was forced to close its ranks and return under the US umbrella (**Figure 5**). Both China and the US were making their counterparts confront the same binary choice: “either with me or against me.” This polarisation of the world has left few areas of the global economy up for grabs: Africa, Latin America, Eastern Europe and the Middle East. These could be places for proxy wars

between the US and China in coming decades; but in all of them, the China-Russia bloc has a clear advantage.

In *Eastern Europe*, Russia will continue to search for its “geopolitical depth”, i.e. the control, if necessary via occupation, of territories that would protect the motherland, with past, present and future potential targets including Belarus, Moldova (Transnistria), Georgia, Armenia, Azerbaijan, and in Central Asia, Kazakhstan.

But, given its internal fragilities, Russia itself risks potentially imploding (as happened to the Soviet Union in 1991), if the objective of achieving this geopolitical depth is not reached. The failed attempt to topple Putin’s regime by the Wagner militia is a proof of the fragility of the architecture in spite of its international aggressiveness. Having said all this, considering the impact on the world’s peace deriving from the dissolution of the Soviet Union (which was followed by decades of regional conflicts), it is in nobody’s interest for an abrupt collapse of the country to take place, in the absence of a viable alternative to the current regime.

**Figure 5: How The World Polarised After The Beginning Of The War In Ukraine**



Source: Reddit, created with mapchart.net.

Regarding the *Middle East*, Russia has joined the OPEC organisation to form OPEC+, with Saudi Arabia clearly switching its allegiance from the US to China, and signing a historical pact with its arch-rival Iran in Beijing on 10<sup>th</sup> March, 2023. Other countries, such as Pakistan, have also been getting closer to China over time. Russia meanwhile has made huge advancements in Syria and Libya, and is flirting with Turkey, a NATO country.

In *Latin America*, Brazil is part of the BRICS, and Lula has brought the country back towards its traditional “non-aligned” position, which in this period is a point in favour of China. Argentina has signed agreements to adhere to China’s BRI, together with Venezuela, Ecuador, Peru, Bolivia, Chile and Uruguay. The US continues to consider Latin America its own backyard, ever since the Monroe Doctrine at the end of the 19<sup>th</sup> century (“*Americas to the Americans*”). But this is not the view of the new left-wing populist leaders of the so-called Pink Tide, elected recently in the region. They remember the impact of the US intervention in Latin America in the 1970-80s, which meant a series of coups and military regimes that are

now associated with American rule. For this reason, they seem more inclined to give a chance to China, which is already by far the biggest export destination for their commodities.

Similarly in *Africa*, the memories of the European colonial past are still vivid, and China's acquisition of strategic positions in several countries (for example via the control of key ports) has made China the preferred interlocutor. Numerous African countries have signed the memorandum of understanding (MoU) to adhere to China's BRI. These are countries in which the comprehensive offer China is able to make, including for the creation of digital payment infrastructure, is most likely to be accepted. It will be hard for the West to make similarly convincing offers.

### **India's Special Position**

In our view, the only country that can actually try to hedge its bets is India. India has a population and an economy large enough (and growing fast enough) to be able to resist both parties for some time without deciding which side to take. During Cold War 1 it was the leader of the so-called "non-aligned" countries, but in the end it sided more with the Soviet Union than the US, especially given the Americans' post-WW2 adventures in Korea and Vietnam.

In the last few decades, India moved more towards the US, eventually becoming part of the so-called Quadrilateral Security Dialogue (QUAD), an informal forum of the "democracies of the Indo-Pacific" together with Japan, Australia and the US. Additionally, India has had clashes with China, which culminated [in a recent military exchange in the Himalayas](#), as India has thousands of miles of disputed borders with China.

At the same time, India remains a key component of the BRICS, together with China and Russia, and internally Prime Minister Modi has inaugurated a more autocratic, nationalistic and religion-driven style of government.

For the time being, India will manage to keep its position between the world's superpowers, but sooner rather than later it will have to decide which party to side with. Our hunch is that it will side with the US and the West. The recent visit by Modi in the US suggests that India gradually get closer to the US as its rivalry with China makes it an effective ally of the West.

### **The Lack of Global Governance and the Emergence of The EM-G7**

In this situation, the presence of effective institutions of global governance would be absolutely necessary, but at the moment, those who could theoretically be available are lacking, or – at least – are ineffective. The UN Security Council (UNSC) is as divided as the world that it aims at representing. The five permanent members are clearly separated: France and the UK with the US and Russia with China. Hence no decisions can be made on a multilateral basis.

Other forums such as the G20, where both G7 and emerging markets were meeting to solve the most pressing issues of the global economy, are equally polarised. Half of the participant countries side with the US and the other half with China, so no meaningful decision can be made by that organisation either.

Thus, decisions tend to be made by informal groupings of countries. For the advanced economies, the natural forum is the G7, which comprises the US, Canada, Japan and European countries such as Germany, France, UK, and Italy, as well as the EU. Within the G7, the weight of the US has grown: in 1990 it accounted for 40% of the G7 countries' GDP, whereas now it's

58%, signalling the relative outperformance of the US versus its European, American and Asian allies.

For the emerging economies, a new grouping is emerging around the BRICS. Recently Saudi Arabia and Argentina have been invited to join the bloc as observers, and they may soon become members. Other countries are asking to be admitted, including large ones such as Nigeria.

The relative weight of the two groupings is changing. The G7 represented 70% of the global economy in 1990, but now is only 45%. The US remains 25% of the world's GDP, despite the growth of China, which is approaching that same mark. Adjusted for purchasing power parity (PPP), China's economy is already larger than that of the US. Indeed, the BRICS represent a larger share of the world's GDP than does the G7, in PPP terms. Going forward, this tendency is meant to increase further, with the growth of population in Sub-Saharan Africa, Latin America, India and South-East Asia, versus the stagnation of the US and the demographic decline of Europe.

### **Potential Future Conflicts**

Seen through the lenses described above, the war in Ukraine is likely the first example of the proxy war between the US and China, wherein Ukraine fights for the US-led Western Alliance, and Russia for the China-led Eastern Alliance.

The US has thus far had an interest in continuing the war, given the gains made since its beginning, including: a) they have re-compacted Western Europe under the flag of NATO; b) NATO itself has further expanded to include Sweden and Finland, the latter sharing thousands of kilometres of borders with Russia; c) the US has acted as a substitute for Russian oil and gas, having become a net energy exporter thanks to its shale oil and gas revolution; d) a sitting US president is more likely to be re-elected during a war; e) a Democratic president commissioning huge orders to the Republican-led "industrial-military apparatus" faces less political attrition by its opposing constituencies.

On the other hand, China is turning the situation to its advantage, presenting itself as a peacemaker between the two contenders, while clearly siding with Russia. China wants to be perceived as an alternative to the US in the eyes of the emerging world, a potential broker of international affairs (as the Iran-Saudi pact showed in March 2023). But its friendship with Russia and position towards Ukraine risks alienating Europe.

Given this background, this war is likely to escalate further and may become unconventional, with the use of tactical nuclear weapons, most likely by Russia first. Whatever the eventual outcome, Russia is unlikely to come out as a loser of the conflict. Rather it will be a highly militarised country with excess military capacity, but one that failed even to control or cause regime change in Ukraine. And its economy will be weakened by the Western sanctions.

It has been said that China is backing Russia's invasion of Ukraine to test the response by the West to a potential invasion of Taiwan, and also to distract the US from the Indo-Pacific, which at the time of Obama's pivot to Asia had been becoming the centre of US strategic attentions.

The elections in the US and Taiwan in 2024 make next year a potential candidate for the Chinese government putting additional pressure on Taiwan. It is also clear that the

[destabilisation tactics by the Chinese against the Taiwanese government have already started](#), first and foremost with cyber-attacks.

Other potential conflicts include the fight for the Arctic. With global warming, the Northeast and Northwest Passages have been opened, and the Arctic is becoming an attractive route for transit. But it is also a potential geo-strategic target, given the vast resources available in the area. Countries interested in the region include the Nordic countries such as Norway, Sweden, Iceland, Denmark (and Greenland), and Finland, but also Canada, the US and Russia.

Seen from a wider perspective, all these conflicts can be read as a war between democracies and autocracies.

In a catastrophic, though low-probability, risk scenario, these conflicts may coalesce to become what will be eventually labelled WW3. In this paper we assume that this nightmarish scenario will not materialise anytime soon.

## CHAPTER 3: THE RESHAPING OF THE GLOBAL ECONOMY

One of the many consequences of the over-dependence of Western countries on China – which became evident initially because of the Covid pandemic, and then was further displayed by the Russia-Ukraine conflict – is the reshaping of the global economy.

A global consensus has built very rapidly around the notion that markets alone cannot be relied upon to solve the type of problems Western economies are facing, such as the management of secure global supply-chains and the need to build trusted technologies and tackle climate change.

Governments around the world, in particular those of Western countries, are taking back control over the definition of economic agenda, by leveraging the whole arsenal available to them: grants, regulation, investments, communication, industrial policies, etc. The strategic rivalry between China and the US is accelerating this path.

### **The US Perspective: Industrial Policy Is Back And Technology Is Central**

Very interestingly, the US perspective on “Renewing American Economic Leadership” was shared on April, 24<sup>th</sup> 2023 via Jake Sullivan, the US National Security Advisor (whose job is typically to advise the president of the United States on a range of options on national security issues). This is a clear indicator of the perception in the US that China represents a threat which needs to be addressed at all levels.

For countries like the US, the foundations of the post-WWII international economic order have cracked as a result of:

- The relocation of businesses to low-cost countries, driving impoverishment for local workers
- A dependence on key components has grown and reached unacceptable levels
- Environmental issues/climate change are increasing inequalities

Some of the past policies have failed to deliver their expected positive outcomes:

- tax cuts and deregulation have not delivered well-being, especially for the middle-class
- entire supply chains of strategic goods have moved overseas
- essential sectors, like semiconductors and infrastructure, have suffered from under-investment.

There was also a belief that economic integration would make some countries, for example China, more responsible and more open. But economic integration did not stop China from expanding its military ambitions in the region, nor did it stop Russia from invading its neighbours. Meanwhile the US has accumulated dependencies that rivals could exploit for economic or geopolitical leverage. Active policymaking is therefore needed to rebalance the status-quo toward a renewed economic consensus.

### **Areas of Intervention: Technology is Central**

According to the Financial Times, public capital and private investment into new industrial capacity will amount to \$3.5 trillion over the next decade.

Regarding semiconductors, the CHIPS and Science Act of 2022 provides \$52.7 billion for American semiconductor research, development, manufacturing, and workforce development. In order to benefit from grants the recipients will have to commit, among other things, not to building facilities in China or other countries of concern.



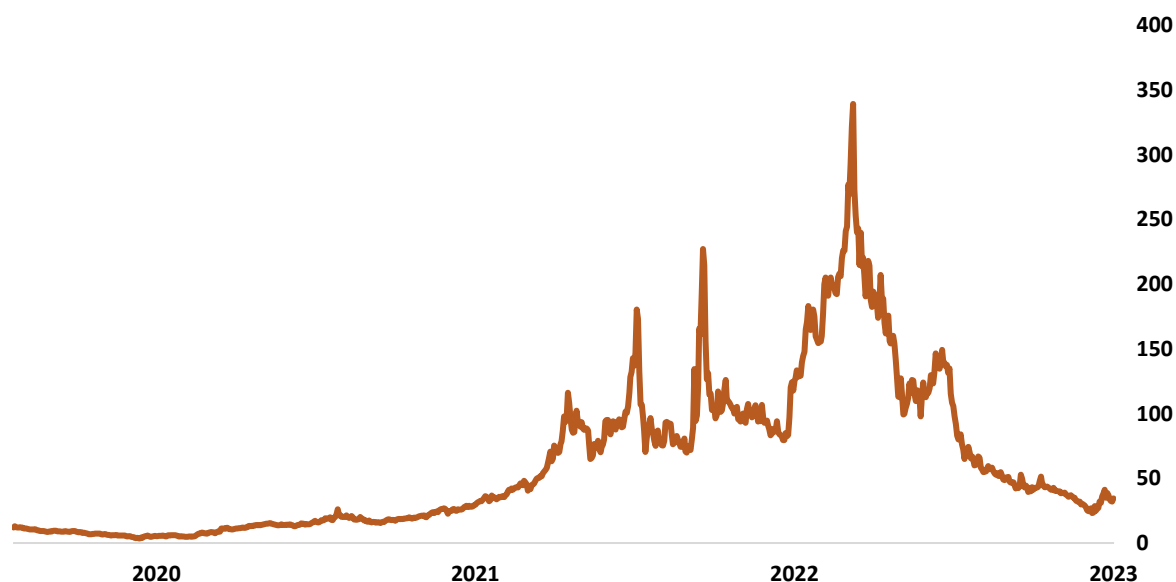
Semiconductors will be one of the first beneficiaries of the investment programme, as they are key to the development of strategic technologies such as artificial intelligence, quantum computing, and synthetic biology.

### The EU Perspective: Defining the Way Forward

Following the crises of masks, respiratory equipment, and medicine during the COVID pandemic, the consequences of spiking energy costs (**Figure 6**) and commodity prices have acted as another wake-up call in Europe. Although an energy crisis could be avoided in the short-term thanks to a coordinated response at the EU level, bold decisions have been made to avoid future crises and reduce energy dependence, especially toward Russia. These include:

- Increasing EU renewable energy sourcing targets to 42.5% by 2030;
- The Pyrenees pipeline between Spain and Germany;
- The decision to build 14 new power plants by 2050 in France; and
- France’s nationalising of the utility company EDF (Electricite’ De France).

**Figure 6: Natural Gas EU Dutch TTF (Euro / MWh)**



Source: Investing.com

### The Central Role of Technology

Following the change in approach taken by the US last summer regarding technology control, China further increased its ambitions of building an independent technological eco-system.

The EU has no other alternative than to continue to work towards defining its own model, and to build the ground for greater control over key pillars of its sovereignty. The EU market remains the richest worldwide, the Commission intends to leverage that strength to work towards the emergence of global champions made in Europe, and to define regulations which have the potential to become global standards. Still, it will be challenging for Europe to become the global regulator if it doesn’t innovate significantly in some of the industries and technologies of the future.

### Investment Programmes and Regulations

A battery of new regulations and new investment programmes have been announced, with the objective of stimulating the EU’s technological ecosystem, while at the same time having an impact at

the global level. This has already been achieved in other areas, such as digital identity (eIDAS) and privacy (GDPR).

#### *Digital Markets Act*

The Digital Markets Act (DMA) aims to combat the anti-competitive practices of Internet giants and correct the imbalances that exist in their dominance of the European digital market. A concrete example of its application is the fact that the billing of data transfer costs by a cloud service provider will be prohibited if they are based on charges for the use of bandwidth. Invoicing of costs will also be regulated for the technical operations required to transfer digital assets. The measure seeks to promote competition between cloud services, and in particular is meant to give European champions in this area, such as OVH cloud, the opportunity to compete with the "hyperscalers", such as Amazon's web services.

#### *Digital Services Act*

The DSA, which modernises part of the directive on e-commerce that has been unchanged since 2000, tackles content (hate speech, child pornography, terrorism, etc.) and illegal products (counterfeit or dangerous) offered online. In particular, it seeks to harmonise the national legislation already in place in the EU Member States, based on the motto: "What is illegal offline must also be illegal online". A concrete example of its application would be the blocking of Russia Today and Sputnik in the whole EU.

#### *EU Chips Act*

The EU Chips Act is a Euro 22bn investment programme involving 56 companies on 68 projects, in 20 countries. It was announced on June, 8<sup>th</sup> 2023.

#### *The AI Act*

This is a European framework coherent with the EU's approach of "technology for good", with three main initiatives:

- Creating a legal framework to AI, to address fundamental rights and safety risks
- A civil liability framework: adapting liability rules to the digital age and AI
- A revision of sectorial safety legislation.

Total investment coming from Horizon Europe, Digital Europe, and the Recovery and Resilience Facility, together with private sector investments, is expected to reach Euro 150bn over the next decade.

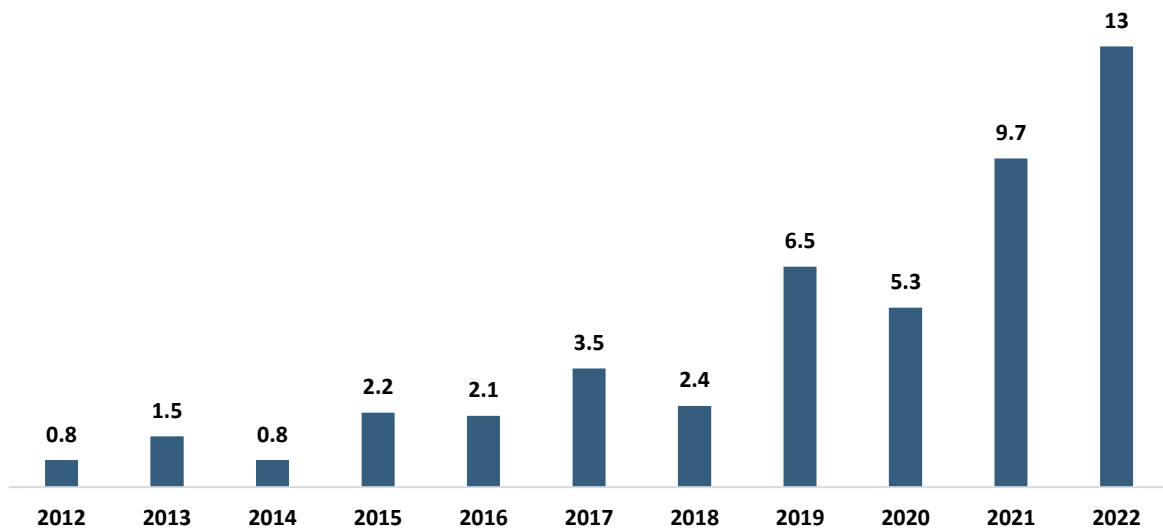
#### *Cybersecurity*

The EU has published a series of rules to increase the common level of cybersecurity across the EU, both for countries and for companies. It is also strengthening the requirements for medium and large-sized entities. The rules have been defined by two directives at the end of 2022:

- The Network and Information Security directive (NIS2);
- The Digital Operational Resilience Act (DORA);

The significance of cybersecurity is confirmed by the private investment realized (**Figure 7** and **Figure 8**).

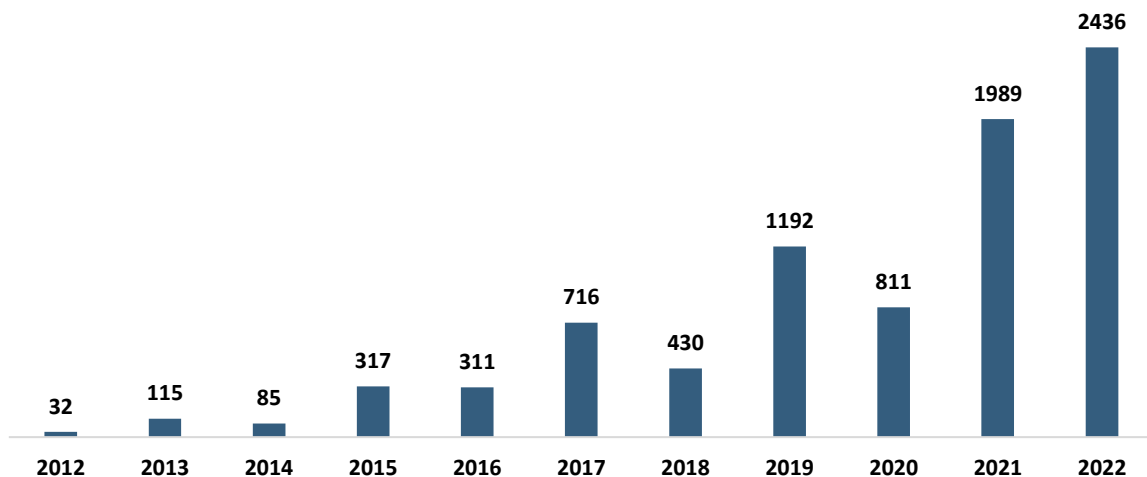
**Figure 7: Average Amounts Raised by European Cybersecurity companies (€m)**



Source: Tikehau Ace Capital

As can be seen on the graph above, the average amount raised by European cybersecurity companies has increased significantly, almost doubling within just the last three years. This continuous growth is an important sign of market maturity, and of cybersecurity becoming mainstream.

**Figure 8: Amounts Raised by European Cybersecurity Companies (€m)**



Source: Tikehau Ace Capital

Despite the slowdown in the financial sector, Europe has set a new record in its continuing investment in cybersecurity.

### **Significant Increases in Military Spending**

In some European countries, the language being used to express the urgent need for taking action has stepped up in intensity. On June 13th, at the inauguration of Eurosatory, one of the world's largest international industry exhibitions for military weaponry, French President Emmanuel Macron presented a "re-evaluation" of the military budget planning law, which budgets military spending until

2025. He said that France must “enter a war economy”, which will require an increase in its military budget, as well as a re-shaping of its productive capacities (Figure 9). The country, which will remain in this “war economy” for a long time, will need to invest further in its defense-related industrial base. It will also need to become more agile and innovative in order to respond to its troops’ needs, while supporting the requests made by its military partners.

**Figure 9: Significant investment made by European countries in their Militaries**



Source: Klecha & Co. analysis, French Senate

France has decided to reinvest heavily in its defence sector. Accordingly, during the period 2024-2030 France will invest €268 billion in equipment, compared to €172 billion during the 2018-2024 period. Overall, over the next six years, France will spend €413 billion on defence. Directly facing the Russian threat, some countries are building up their capacity in an urgent way, such as Poland which ordered 1,400 infantry fighting vehicles in addition to 48 FA-50 light and 1,000 K2 South Korean tanks.

In the meantime, Germany announced a massive investment to rebuild its army and make it one of the best in Europe, with €100 billion to be spent on new equipment. The country first announced its acquisition of 35 F-35 aircraft, while the rest of the spending will stay in Germany, which has a strong weapons industry. Germany is increasing its yearly Defence budget by €10 billion in 2024.

**The European Defence Efforts Also Include A Boost In Production And Sales**

On 3 May 2023, the European Commission unveiled its plans to boost ammunition production. The aim of the plan is to deliver ammunition and other missiles on time to the member states that require them, in order to support Ukraine more effectively. The quantified objective of the plan is to increase the European industry's production capacity to one million munitions per year. To achieve this, the Commission is counting on one billion euro of investments, half from the EU and half from its member states. As the war in Ukraine continues, the European Union (EU) needs to "move into a 'war economy' mode", explained Thierry Breton.

On the business side, the European Commission is considering tax exemptions for European arms programs. In February 2022, Thierry Breton proposed abolishing VAT on the European defence market in order to make it "more competitive" against US bids. According to the proposal, "the Commission will study a number of instruments to encourage the joint acquisition of defence capabilities developed collaboratively within the EU, in particular by proposing an exemption from value added tax (VAT)". For Thierry Breton, this provision is necessary to balance arms contracts in the European Union, and in order to adopt a form of fiscal reciprocity with the United States, where the sales of military equipment abroad are not subject to VAT or customs duties in the recipient country.

## CONCLUSION

The world is undergoing a geopolitical recession, given the ongoing Cold War between the US and China. But we do not believe it will fall into a depression, with the beginning of World War 3, even if a series of proxy conflicts in Africa, the Middle East and Latin America will keep the tension high. International cooperation for global governance (such as the UN security council, the G20, etc.) will remain fractured and ineffective at best.

Given this background, Europe will try to find a space for itself between the two contenders, and to maintain constructive relations (including commercial relations) with both the US and China, even as the two sides will aim at obtaining some form of “exclusivity” (“either with me or against me”). From a technological standpoint, Europe continues to make important advancements, which are followed very closely by regulation and legislation, both at the national and supra-national level. Examples include the acts on Digital Markets, Digital Services, EU Chips, AI and Cybersecurity. Meanwhile, core European countries, chiefly Germany and France, have significantly increased their military spending.

Where will things go from here? From a *normative* standpoint (what we wish to see happen), Europe could play a crucial role in mitigating the conflict between the US and China, acting as a responsible mediator. Europe remembers too well the devastating consequences of world wars, which were both generated within it.

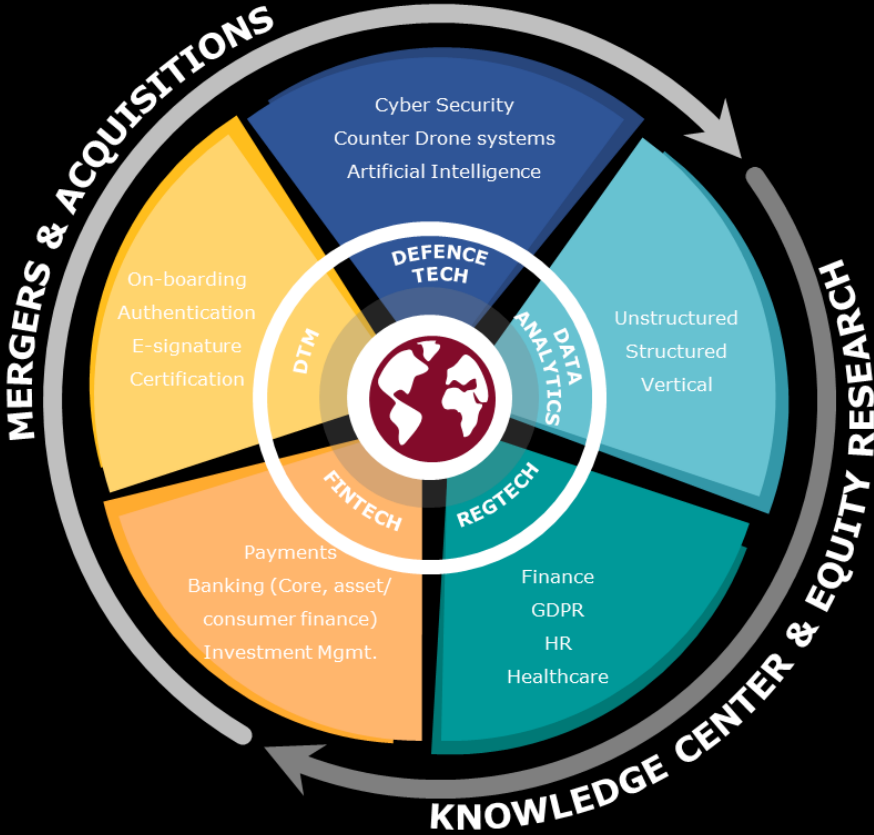
From a *positive* standpoint (what we believe is more likely to happen) Europe will have a great deal of work to do if it wants to establish a real “strategic autonomy” from both the US and China. It requires a completion of its integration process on its various fronts, further investment to be made especially in the semiconductors sector, and much larger military spending, if it is to be able to withstand the threat of Russian aggression, while at the same time gaining some distance from the NATO decisions largely being dictated by the US. For now the goal of a “strategic autonomy” of Europe remains challenging.

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## Klecha & Co.

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**The depth of our industry expertise, sector focus and M&A experience make us truly unique in the market.**





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