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Designing a Geo-Economic Policy for Europe

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Geo-economic policies have become an increasingly important feature of international politics – and not just since the war in Ukraine. The EU has proposed an economic anti-coercion tool to deter third-party coercion. This policy brief analyses the risks and benefits as well as the challenges related to the EU's proposed deterrence policy based on a review of the academic literature on coercion and the effectiveness of economic sanctions.

– **In response to a major crisis, the EU is capable of mobilizing its economic power, as the Russia sanctions show. Under normal circumstances, agreement is more difficult. This is why the EU has proposed creating a geo-economic deterrence policy.**

– **An EU anti-coercion policy requires some degree of delegation to be credible. Germany should ensure that the Commission can act within parameters that balance the need for credibility with the need to limit the risk of an unwarranted escalation.**

– **As a member state with significant economic interests outside of Europe, Germany benefits from EU geo-economic deterrence. As it stands, it will also bear a greater share of the costs in case deterrence fails and retaliation is triggered.**

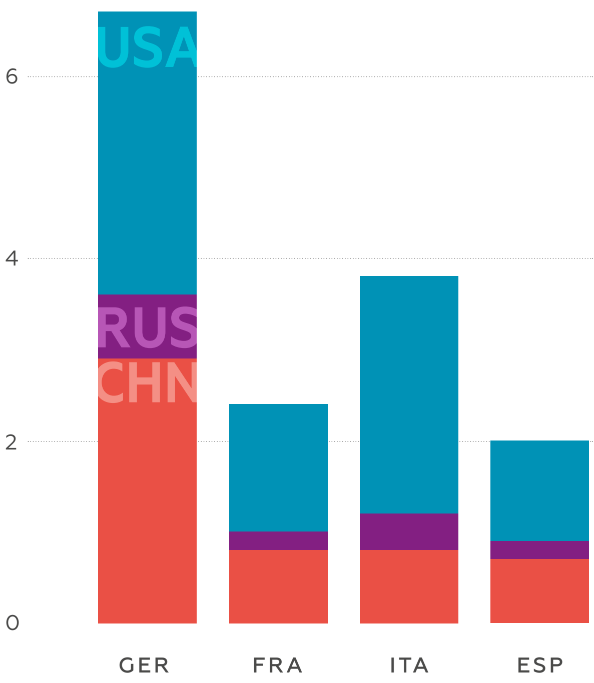
– **Germany should therefore propose an Economic Deterrence Fund to ensure a more equitable distribution of the costs of retaliation policies. This should go some way towards aligning member state interests.**

The EU and its allies have taken extensive measures to punish Russia over its military aggression against Ukraine. These measures have been very effective, but thus far not efficacious: They have imposed significant economic costs on Russia, but they have failed to alter Russia's behavior. It is early days yet, but so far, the results of the EU's policy are ambiguous at best: While they show that the EU is quite capable of mobilizing its considerable economic potential in pursuit of its geopolitical interests, they also point to the limited efficaciousness of geo-economic coercion as a tool of statecraft.

Prior to the war in Ukraine, the EU was mainly concerned with creating a credible defense against third-party economic coercion of the EU and its members in a very different context: the increasing weaponization of economic relations against the backdrop of US-Chinese conflict and competition. The Ukraine war has not obviated the need for such a reflection. On the contrary: The shift from a multilateral, rules-based international economic order to one where bilateral political and economic power plays a more prominent role continues, and it creates new risks for Germany and the European Union. Third-party geo-economic policies may come to target European and especially German economic interests, either directly or indirectly in the guise of secondary sanctions.[1]

The EU therefore needs to pursue the creation of an economic 'anti-coercion' tool. Germany as the most trade-dependent among the larger EU countries stands to gain if the EU manages to successfully harness its economic deterrence potential. But Germany will also incur disproportional costs in case deterrence fails and retaliation becomes necessary.

TRADE SENSITIVITY VARIES GREATLY (Exports by destination, % of GDP, 2020)



Source: IMF

PROPOSED EU GEO-ECONOMIC DETERRENCE POLICY

The EU has proposed the creation of a so-called 'anti-coercion instrument.'[2] The instrument is meant to deter coercion of the EU and individual member states by enabling the Commission to take swift, proportionate, targeted, and temporary economic measures to force the coercing party to withdraw its measures. The tool's primary function is to deter – retaliation only comes into play if that deterrence has failed. According to the proposal, the Commission is supposed to design retaliatory measures that are low-cost but effective from the point of view of the EU as well as individual member states. The triggers that provoke retaliation are meant to be sufficiently broad to also cover informal coercion, like for example consumer boycotts. Importantly, the new tool is to fall under the EU's Common Commercial Policy. This means that deterrence policies would be largely delegated to the Commission. In fact, a qualified majority in the Council of the EU would be required to prevent the Commission from taking action in response to third-party coercion.

Ironically, the EU anti-coercion tool, as it is currently being discussed, would serve little purpose in the conflict with Russia, as it is designed to respond to third-party coercion of the EU and its members – not a neighboring country such as Ukraine. Never-

1 Secondary sanctions threaten to impose penalties on third parties in case they engage in proscribed transactions with a primary sanctions target. Secondary sanctions effectively extend the sanctions regime to third parties to ensure the primary sanctions are not undermined by 'third-party spoilers.' See Bryan Early, Busted sanctions (Stanford 2015).

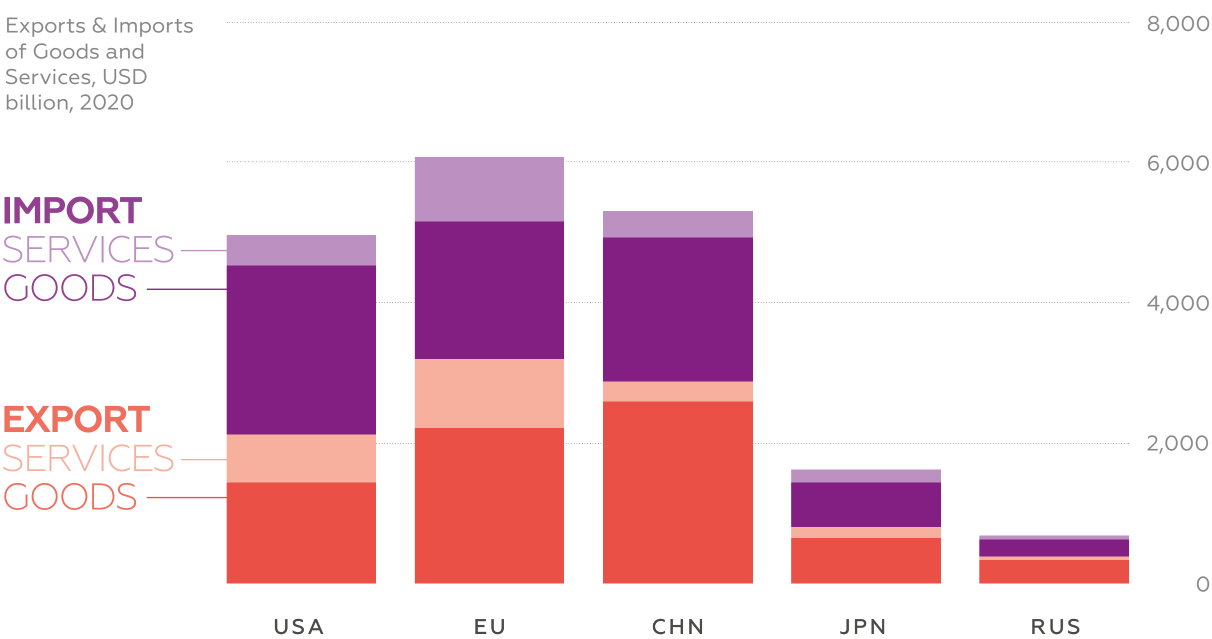
2 European Commission, Commission Proposal for an Anti-Coercion Instrument, December 8, 2021: https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf (accessed March 21, 2022).

theless, harnessing the EU's geo-economic power to defend against third-party coercion is sensible in view of the increased weaponization of economic interdependence. Deterrence can help reduce individual members' vulnerability to coercion by mobilizing the full economic weight of the EU. At present, the effectiveness and credibility of Europe's geo-economic deterrence policy is hampered by the need for unanimous agreement by member states. This makes the formulation and implementation of EU deterrence and retaliation policies vulnerable to third-party 'pre-emption.' Trade-dependent EU countries can quickly become the target of economic threats by a third-party coercer keen to pre-empt EU retaliation. Germany is at particular risk of becoming the focus of such policies due its extensive extra-EU economic interests.

While delegation to the Commission would alleviate this risk, it would also significantly curtail the influence that member states have on policies. The German government should therefore carefully assess the scope within which the Commission should be authorized to formulate policy, including the definition of triggers, the scope and type of retaliatory measures, and escalation strategies, before delegating power. Delegation within wide parameters would help make EU geo-economic deterrence both more effective and credible, allowing the Commission to wield the new deterrence instrument with great flexibility. Yet a very broad mandate could also lead to greater geo-economic conflict. This calls for sensible calibration.

If it does become necessary to retaliate against economic coercion, some damage to the EU and its member states is inevitable. Delegating the decision-making power to the Commission would limit the ability of individual member states to affect the distribution of such costs. One solution would be the creation of a jointly financed compensation mechanism (or Economic Deterrence Fund). Such a mechanism would provide for a more equitable allocation of the costs of EU retaliation measures and give the more trade-dependent members some reassurance that geo-economic conflict will not be fought out on their backs. While successful deterrence benefits all EU members, the economically more outward oriented members face considerably greater costs if it fails. For example, should the EU get drawn into a geo-economic tit-for-tat over China's coercion of Lithuania, Germany would end up shouldering a large part of the cost, not least because Lithuania's exports to China are very small in both absolute and relative terms. Finally, sharing the burden of retaliation more equally would also help align the interests of member states more closely.

BIG THREE GEO-ECONOMIC POWERS



Source: World Trade Organization

WHAT IS GEO-ECONOMIC COERCION?

Geo-economics refers to the use of economic instruments to pursue foreign policy goals. After the end of the Cold War, foreign economic policy was largely geared towards cooperation and the pursuit of what International Relations scholars call absolute economic gains. Today, the intensifying great power competition between the United States and China is taking place in the context of economic interdependence. As a result, geo-economic policies play a more prominent and varied role than, for example, during the Cold War.[3]

The world's most important economic powers are cognizant of the risks attached to the shift towards an economic order where rules matter less and power matters more. Unsurprisingly, they have begun to pro-actively manage their respective economic-financial vulnerabilities. China is shifting towards 'dual circulation' (namely, a lesser dependence on the international economy), the EU is striving for 'strategic autonomy,' and the United States is focused on addressing its geo-economic vulnerabilities by limiting supply chain risks. At the same time, all three powers have become more inclined to exploit other countries' geo-economic vulnerabilities in pursuit of a variety of political objectives, such as punishing human rights abuses or military aggression.

Geo-economic policies can be positive and negative. Negative geo-economic policies involve the deliberate withdrawal (or threat of withdrawal) of customary trade and financial relations in pursuit of broader foreign policy goals. Positive policies offer (or promise to provide) a deepening of economic and financial relations. Although all geo-economic measures thus impose costs on, or offer benefits to the target,[4] not all seek to change the target's behavior. Tighter export controls, for example, may not seek to change the target's behavior, but may simply deny another country (or company) access to advanced technology consistent with the goal of slowing down that country's technological development or weakening its national security. This is a foreign policy goal that does not involve changing the target's behavior. Geo-economic measures may, as seems to be the case with the Russia sanctions, be effective (they have an economic effect on the target) without being efficacious (in terms of realizing the political objective).

A last important distinction: 'Coercion' comes in two forms: compellence and deterrence. Compellence, which colloquially is often equated with coercion, seeks to force the other party to take some specified action. Deterrence consists of persuading another party to refrain from initiating a specified action. Deterrence comes in two forms: deterrence by denial (denying the coercer the opportunity or benefits of their own geo-economic attack) and deterrence by punishment (inflicting unacceptable costs on the coercer). The literature suggests that compellence is more difficult to pull off than deterrence. One reason may be that the targeted decision-makers may be more reluctant to accept a loss than to forego a gain. They will therefore resist changing their policy despite suffering significant economic losses, as Russia appears to be demonstrating at the moment.

GEO-ECONOMIC COERCION CAN AND DOES FAIL

The major powers employ geo-economic compellence. The literature suggests that it is nevertheless not particularly successful in terms of changing a target state's behavior.[5] Three conditions must be met if the likelihood of success of sanctions, for instance, is to be higher:

1. They are aimed at friends rather than foes;
2. the policy goal that is being pursued is relatively minor; and
3. the target is highly economically dependent on the sender country.

It is not surprising that sanctions are more successful with respect to allies than adversaries, for "the higher compliance with sanctions by allies and trading partners reflects their willingness to yield on specific issues in deference to the overall relation-

3 Michael Mastanduno, Trade as a strategic weapon, International Organization, Vol. 42, No. 1, 1988; Randall Newnham, Deutsche mark diplomacy, Penn State University Press, 2002. Alan Dobson, US economic statecraft for survival, 1933-91, London: Routledge, 2002.

4 Sometimes economic sanctions are defined more narrowly as the exclusion from the world economy to uphold international norms. See Nicholas Mulder, The economic weapon (New Haven 2022), p. 14.

5 The literature is focused on compellence as opposed to deterrence. Assessing the success of deterrence involves unobservables and counterfactuals, as the behavioral change is not directly observable. Robert Pape, Why Economic sanctions do not work, International Security 22 (2), 1997: https://www.almendron.com/tribuna/wp-content/uploads/2019/05/why-economic-sanctions-do-not-work.pdf (accessed March 21, 2022); Daniel Drezner, The sanctions paradox, Cambridge: Cambridge University Press, 1999.

CHART: COERCION, COMPELLENCE, DETERRENCE

	ACTION	OBJECTIVE	CHOICES
Compellence/ offensive	Force other party to take specified action	Change status quo	Attack/ not attack
Deterrence/ defensive	Prevent other party from initiating specified action	Preserve status quo	Defend/ give in

Source: Author's compilation

ship with the sender country. In addition, allies will not be as concerned as adversaries that concessions will undermine the government's reputation and leave it weaker in future conflicts."[6] The same arguments explain why geo-political adversaries are often highly resistant to geo-economic compellence.

In terms of geo-economic coercion, the coercer seeks to take advantage of the target's economic vulnerabilities by threatening to impose costs on the target in case of noncompliance with stated aims. Coercive threats in terms of both compellence and deterrence are only credible if the costs to the coercer are lower than the costs to the target. An economically more vulnerable country does not typically seek to coerce a less vulnerable country, or at least it cannot do so credibly. The greater costs it would incur would make such coercive threats neither credible nor effective. Economic dependence makes a country more susceptible to coercion, but greater susceptibility does not automatically translate into successful coercion – if only because the political cost of complying with the demands of the sender country may far exceed the economic costs incurred. This is true in cases of compellence, at least. Geo-economic deterrence is likely to be more successful. But note that if retaliatory policies are aimed at forcing the original coercer to withdraw its measures, retaliation becomes compellence.

Two examples serve to illustrate successful and unsuccessful coercion. Russia seems quite willing to sustain the costs of international economic sanctions, as it appears to value the political gains related to the Ukraine war more highly. By contrast, Iran agreed to limitations to its nuclear program in the guise of the Joint Comprehensive Plan of Action, following a sustained geo-economic pressure campaign that imposed significant economic costs on the Iranian economy. In other words, successful economic coercion is not a given, and if it is successful, it often requires sustained and prolonged coercive pressure.

Coercive failure is variously attributed to signaling failures, cognitive biases, and misperception, as well as the misestimation of the (subjectively valued) costs of compliance versus the costs of non-compliance.[7] Ultimately, the success and failure of coercion simply depends on how badly the coercer wants to impose costs and how badly the target is prepared to absorb them.[8] This is also why 'escalation dominance' (whether vertical or horizontal) makes coercive success more likely, but far from certain.

As George put it, the effectiveness of coercion "rests in the last analysis on psychological factors," even if decision-makers' psychological disposition is affected by material costs and benefits.[9] In other words: "Weakly motivated aggressors are easy to deter; intensely motivated ones (...) can be impossible to deter."[10] By the same token, strongly motivated defenders can be impossible to compel. The costs of coercive measures are nonetheless real, and they are a function of the scope and intensity of economic ties as well as the ability of the target to deflect the coercive measures or limit their costs. To echo the distinction drawn above: Coercion may be effective (in terms of imposing costs on the target), but not efficacious (in terms of deterrence or compellence). The point is this: Deterrence can fail, and the EU and its members must be prepared to make good on retaliatory threats that are economically costly. Worse,

6 Clyde Hufbauer et al., Economic sanctions reconsidered (Washington 2009).
7 For a critical take on rational deterrence theory, Richard Ned Lebow, Key texts in political psychology and international relations Theory (2016), pp. 3-24.
8 Richard Nephew, The art of sanctions (New York 2017).
9 Alexander George, Forceful persuasion (Washington 1991)
10 RAND, What deters and why, 2021: https://www.rand.org/pubs/research_reports/RR3142.html (accessed March 21, 2022).

KEY ELEMENTS OF THE COERCER'S STRATEGY

Proportionality refers to the scope and nature of the objectives pursued and the instruments used in their pursuit. Proportionality does not mean equivalence. Rather it means 'not out of proportion,' as disproportional threats, such as threatening a military invasion in response to higher tariffs, are not credible.

Coercive credibility relates to the coercer's ability to make the target believe that the coercer will make good on its threat if the target does not comply.

Reciprocity implies an explicit (or tacit) understanding of the link between the costs threatened by the coercer and the costs incurred by the target. Reciprocity must also be clear and explicit about the link between coercive action and the target's behavior.

Source: Jentleson and Whytock

they must prepare for a situation in which the subsequent compellence – their attempt to force the other party to withdraw its original measures – could also fail.

DESIGNING OPTIMAL COERCION POLICIES

The EU will increasingly be faced with the challenge of designing effective and efficacious coercion policies. Jentleson and Whytock,[11] two academics, provide a heuristically helpful analytical framework to evaluate the chances of coercive success and failure. Two sets of factors affect the effectiveness and efficaciousness of coercion, one related the *coercer's strategy*, the other related to the *target's vulnerability*. Ideally, the EU's deterrence policy should be capable of incorporating these elements into its design to achieve maximum effect.

As far the *coercer's strategy* is concerned, it is important that the "costs of noncompliance it can impose on, and the benefits of compliance it can offer to, the target state are greater than the benefits of noncompliance and costs of compliance." The ability to create the proper carrots and sticks is in turn affected by three factors: (1) proportionality, (2) coercive credibility, and (3) reciprocity.

For the target, the costs and benefits of compliance and non-compliance are influenced by factors pertaining to the *target state's vulnerability* to coercive measures, such as (1) domestic political support; (2) economic costs; and (3) the role of elites.[12]

DESIGNING EFFECTIVE COERCIVE GEO-ECONOMIC POLICIES

How well-suited is the proposed EU anti-coercion instrument to optimal policy design? Designing deterrent measures that are proportional and reciprocal is a technical exercise, while credibility requires the ability to instill the belief in the target that the EU will make good on its retaliatory threat in case of third-party coercion. Delegating the formulation and implementation of deterrence policies to the Commission helps make them more effective and credible, compared to a policy that requires unanimity and – if agreement can be reached at all – extensive compromises at every turn. Credibility also benefits from delegating the decision to retaliate to the Commission. The more leeway the Commission is given, the more credible and effective deterrence will be.

However, if formulation and implementation are delegated to the Commission and if deterrence fails, the costs of retaliation policies may be spread unevenly among EU member states, despite the Commission's commitment to designing policies that are low-cost to the EU and its members. Countries that rely more on extra-EU trade and finance will generally bear a disproportionate share of the associated costs. On the other hand, if deterrence policies require a high level of member state support, more trade-dependent countries may become the target of counterretaliation threats to dissuade from supporting EU retaliation and escalation. In other words,

11 Bruce Jentleson and Christopher Whytock, Who 'won' Libya, International Security 30 (3), 2006: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1422210 (accessed March 21, 2022).

12 This is the rationale behind 'smart sanctions,' which target specific, politically relevant domestic actors with the intent of minimizing the costs of broader economic measures. However, smart sanctions do not seem to be notably more successful than regular sanctions. Daniel Drezner, Sanctions sometimes smart, International Studies Review 13 (1), 2011: https://doczz.net/doc/8477500/sanctions-sometimes-smart---fletcher-school-of-law-and-di... (accessed March 21, 2022).

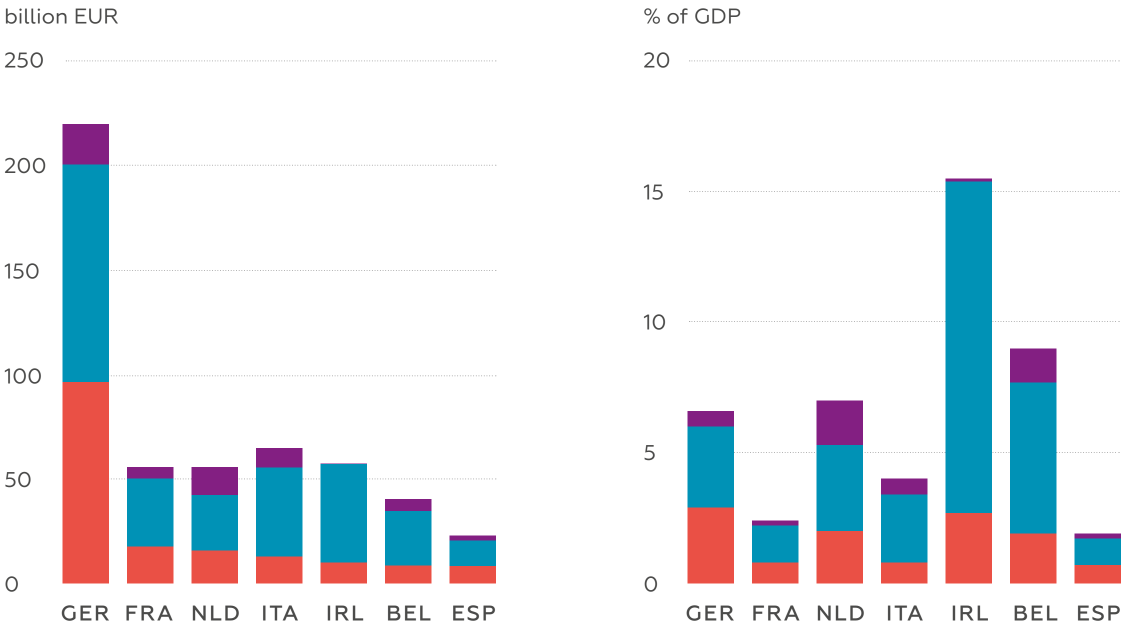
KEY ELEMENTS OF STRATEGY PERTAINING TO TARGET'S VULNERABILITY

- Domestic political support as a function of the costs and benefits of defiance compared to compliance
- Economic costs of the coercive measures as a function of existing vulnerabilities.
- Role of elites as either 'transmission belts' or 'circuit breakers' of coercive policies
- Source: Jentleson and Whytock

the greater the intra-EU consensus necessary to deter and retaliate, the less credible deterrence will be. But the more ex-ante delegation exists, the less control individual member states will retain over policies, including those that affect the costs of retaliation. Automaticity and delegation enhance credibility, but they come at the cost of less control. This is an issue any deterrence policy needs to address.[13] Delegation is helpful to optimize policies in terms of proportionality, reciprocity, and credibility. But it also curtails the ability of member states to influence policies and escalation strategies. The Commission's proposal clearly recognizes that unanimity is too high a hurdle.

Moreover, the less influence individual member states have over policy, the greater the risk becomes to be dragged into geo-economic standoffs against their will. Member states also risk losing control over subsequent policies, including escalation. The Baltic states would not exactly have been thrilled if they had been forced to take retaliatory measures against secondary US sanctions targeting Nord Stream 2. Therefore, economically more outward-oriented countries such as Germany have an interest in unambiguously defining what constitutes coercion. They should aim to set clear parameters with respect to retaliatory measures, including issues such as trade versus financial retaliation, retaliation and counterretaliation, or horizontal versus vertical escalation. These parameters do not need to be made

TRADE SENSITIVITY BY MEMBER STATE
EXPORTS OF GOODS 2020 CHINA USA RUSSIA



Source: Eurostat

13 Thomas Schelling's famous "threat that leaves something to chance" comes to mind.

public, as this might allow third parties to preempt EU policy. But in the case of a country like Germany, the national government needs to be able to set a limit to geo-economic escalation in case retaliation fails. The coercer, of course, must not know what it is, in order not to weaken deterrence policies. And compellence frequently fails.

ADJUSTING POLICIES TO EXPLOIT VULNERABILITIES

The optimal design of measures in terms of the target state's vulnerabilities is also affected by the delegation/ consensus trade-off. Optimal EU retaliatory measures in terms of the target state's politics, economics, and elites, is likely to translate into an uneven allocation of costs. If, for example, the United Kingdom were still part of the EU, it would bear a disproportionate share of the costs of financial retaliation measures due to London's prominence as a financial center. Intra-EU conflict over what measures to take in view of differential costs may result in optimal measures being taken off the table. As a consequence, the EU might be forced to opt for sub-optimal, less effective deterrence policies that fail to mobilize its geo-economic potential. Add to this the possibility of the target engaging in counter-retaliation by focusing on the most economically dependent member states, and the distribution of costs becomes even more uneven.

Delegation within pre-set parameters should therefore be flanked by a compensation mechanism (or Economic Deterrence Fund) financed by all states in proportion to their size. The mechanism proposed here is not meant to fully compensate countries subject to third-party economic coercion. Instead, it is meant to distribute the potential costs of retaliation measures more evenly in case deterrence fails and retaliatory measures are triggered. If Germany, for example, gets dragged into a geo-economic tit-for-tat with China over Lithuania, Lithuania's financial contributions to the fund are never going to compensate Germany for its economic losses. Nevertheless, all members would be obligated to share in the costs more equitably. The fund would thereby help align costs and benefits more closely, which would limit moral hazard. It would also make it less likely that anti-coercion policies become hijacked by protectionist interests, as some of the more free-trade-oriented EU members fear. Finally, such a fund would facilitate the design of more nearly optimized retaliation measures and thereby make the EU deterrence posture more effective.

Limiting the ability of third-party coercers to preempt EU deterrence and retaliation measures is important to make them credible and effective. Delegation helps address this problem. To limit the risks associated with delegation, a more equitable burden sharing of EU anti-coercion measures is desirable. The flexibility that comes with delegation is important not just with regard to optimization. It is also important in terms of being able to scale up or scale down retaliatory threats and measures as the situation demands. Delegation within clearly defined, pre-set parameters flanked by a compensation mechanism would help make the EU's anti-coercion toolbox more effective and credible. Yet even the best combination of tools cannot eliminate all the associated risks. There is no free lunch, and that holds true for geo-economics, too.

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