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DGAP REPORT

Defense and Deterrence Against Geo-Economic Coercion

What Germany and the EU Can Learn from China and the United States

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ABOUT THE PROJECT

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This report is part of a research project funded by the Springer Foundation. The project focuses on the future of transatlantic relations in the wake of the Trump administration's America First policy and in view of America's strategic shift to Asia. The military conflict in Ukraine has alleviated concerns about America's commitment to transatlantic security and the transatlantic alliance – at least in the short term. It has demonstrated the importance of geo-economic policies (including sanctions), if not necessarily their effectiveness. And it has laid bare German economic vulnerabilities and underlined the urgency with which Germany needs to address them.

Germany's economic prosperity and national security rest on a stable, rules-based, liberal multilateral order. This order has been under stress for some time, and the Ukraine conflict is exacerbating the situation. As geopolitical competition and conflict lead to the increased 'weaponization of economic interdependence,' Germany's economic vulnerabilities are becoming an increasing liability, as the Ukraine conflict demonstrates.

This report provides a high-level overview of German economic vulnerabilities vis-à-vis other major powers. It also analyzes US, Chinese, EU, and German geo-economic policies and instruments. The comparison shows that the greater centralization and flexibility of US and Chinese geo-economic policymaking provide them with an important advantage. This insight should inform German and EU policies and reforms aimed at mitigating geo-economic vulnerabilities.

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EXECUTIVE SUMMARY

The geo-economic conflict between the United States and China as well as uncertainty about America's longer-term commitment to a liberal and rules-based multilateral order pose risks to Germany's economic prosperity and national security. The new German government must systematically identify economic dependencies and develop a forward-looking and comprehensive strategy to address vulnerabilities.

- Structurally, China and the United States are better equipped to deal with geo-economic conflict than Germany or the EU. Both countries benefit from greater centralization and flexibility of geo-economic policymaking.

- Germany, due to its extensive economic relations with both China and the United States, is even more vulnerable to geo-economic coercion than other EU countries. EU membership helps mitigate but does not eliminate German vulnerabilities.

- The new German government should seek to reduce the most critical geo-economic risks and improve geo-economic instruments both at the national and the European level. It should also support EU-US attempts to address common vulnerabilities.

Introduction

The three decades following the end of the Cold War were characterized by an international security environment conducive to economic cooperation. Today, US-Chinese geopolitical rivalry portends much more competitive and conflict-oriented international dynamics. While countries increasingly rely on adversarial foreign economic and geo-economic policies, multilateral institutions like the WTO have become less important. Even if the EU and Germany do not become a primary target of Chinese or US geo-economic policies, they risk incurring substantial economic costs. US secondary sanctions as well as Chinese countersanctions, for example, can hurt German and European economic interests.[1]

The challenge for Germany and other heavily trade-dependent countries is to preserve the benefits of economic interdependence while limiting the economic-political vulnerabilities associated with it. International Relations scholars refer to this as the challenge of managing economic interdependence. In addition to addressing vulnerabilities at the national and EU level, Germany and the EU should pursue transatlantic cooperation to alleviate common vulnerabilities vis-à-vis third parties, as is already happening in several areas.[2]

Historically, the security externalities associated with economic cooperation have facilitated close economic relations within alliances. Critical technology, for example, is more likely to be shared among allies than between adversaries. Relations between allies are not a zero-sum game, and the security externalities of economic cooperation have the effect of increasing the aggregate strength of an alliance. This does not mean that there can never be any conflict. But shared national security objectives will tend to limit the degree to which allies will exploit each other's economic vulnerabilities, as the transatlantic disagreement over export controls in the 1950s or the failure of the Reagan-era pipeline sanctions demonstrate.[3]

However, Germany and Europe should prepare broader contingency plans in case transatlantic cooperation falters. Those plans should focus on addressing the most critical vulnerabilities as well as on creating credible geo-economic instruments capable of deterring third-party coercion. After all, transatlantic relations may yet take a significant turn for the worse after the 2024 presidential election, and the intensifying US-Chinese competition will have negative implications for Germany and Europe.[4]

1 Markus Jaeger, Germany between a rock and a hard place in China-US competition, DGAP Commentary, March 17, 2021: https://dgap.org/en/research/publications/germany-between-rock-and-hard-place-china-us-competition (accessed: February 20, 2022).

2 European Commission, EU-US Trade and Technology Council, October 18, 2020: https://ec.europa.eu/commission/presscorner/detail/en/IP_21_5308 (accessed: February 20, 2022). Department of State, Joint Statement on the US-EU Energy Council, February 7, 2022: https://www.state.gov/joint-statement-on-the-u-s-eu-energy-council (accessed: February 20: 2022). European Commission, Launch of the Joint EU-US Covid Manufacturing and Supply Chain Taskforce, September 22, 2021: https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_4847 (accessed: February 20, 2022).

3 In the 1950s, the transatlantic dispute over export controls targeting Warsaw Pact countries was resolved in part because Washington was keen to strengthen the Western alliance. In the 1980s, the Reagan administration stepped back from imposing sanctions affecting Western European allies in relation to the construction of a Soviet gas pipeline. Michael Mastanduno, Trade as a strategic weapon, International Organization 42 (1), 1988.

4 Markus Jaeger, The logic (and grammar) of US grand strategy, DGAP Research, June 2, 2021: https://dgap.org/en/research/publications/logic-and-grammar-us-grand-strategy (accessed: February 20, 2022).

GERMAN ECONOMIC VULNERABILITIES

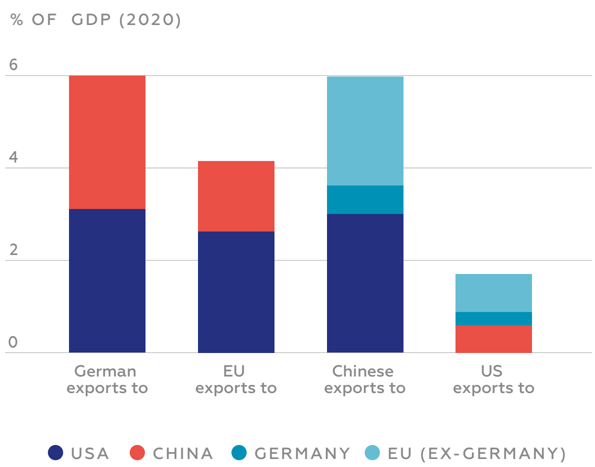
Countries that are characterized by a low level of economic dependence can take advantage of the vulnerabilities of economically more dependent countries. Economic vulnerabilities can be leveraged for political and economic ends through the imposition of restrictions on the cross-border flows of goods, services, and capital as well as information and data. Geo-economic policies seek to exploit bilateral dependencies or what is also called asymmetric interdependence. This typically requires that the costs imposed on the target country exceed the costs incurred by the so-called sender country.[5] The ability to impose relatively greater costs does not mean that the sender country will necessarily realize its political objectives.[6] Nevertheless, the economic costs to the target country are real, and in the context of zero-sum geopolitical competition, it is the pursuit of relative rather than absolute gains that tends to inform foreign economic policy.

Given its extensive dependence on the international economy, this is a particularly salient issue for Germany. It raises three important issues: How significant are Germany's economic vulnerabilities vis-à-vis the other major economic powers? What tools do Germany and the EU currently have at their disposal to mitigate vulnerabilities? What policies and instruments should be created at the national and EU level to more effectively contain political-economic vulnerabilities?

How do geo-economic policies leverage vulnerabilities, and how vulnerable is Germany to such policies by third countries such as China and the United States? First, countries can restrict the import of goods and services through tariffs and non-tariff barriers. Such measures reduce exports from the target country and harm its economic growth. The country that imposes restrictions also typically suffers economic losses due to the higher costs of imported goods. The greater the relative dependence of the exporting country on the importing country (and the less able it is to divert its exports to third countries), the more vulnerable the exporting country is to import restrictions.

Roughly two thirds of German trade is with the EU-27 and the UK. Nevertheless, German exports to the United States and China correspond to a significant share of Germany's GDP (see chart). They are also considerably larger than American and Chinese exports to Germany. In the event of a bilateral trade conflict, Germany is therefore far more vulnerable than either the United States or China. Germany does benefit from EU membership and the EU's trade-related influence. China currently depends more on the EU market than the EU does on the Chinese market (at least as measured in gross exports).[7] It is therefore unlikely to engage in an escalatory trade conflict with the EU if it is convinced that the EU will manage to respond in kind. The transatlantic relationship is different. The EU is more dependent on exports to the United States than vice versa, and this makes it relatively more vulnerable in the event of a bilateral conflict.

1: COMPARISON OF EXPORT DEPENDENCE



Source: OECD, World Trade Organization (2020)

Second, countries can restrict exports. The more a country depends on critical goods (or services) produced by another country, the more vulnerable it is to that country's export controls (provided it cannot acquire the goods elsewhere). Reduced access to critical imports can entail significant costs and even

5 Note that such measures may target individuals, companies, or entire countries. If I subsequently refer to target countries, this is intended to include companies headquartered and natural persons resident in these countries as targets of geo-economic measures.

6 Clyde Hufbauer et al., Economic sanctions reconsidered (Washington 2009).

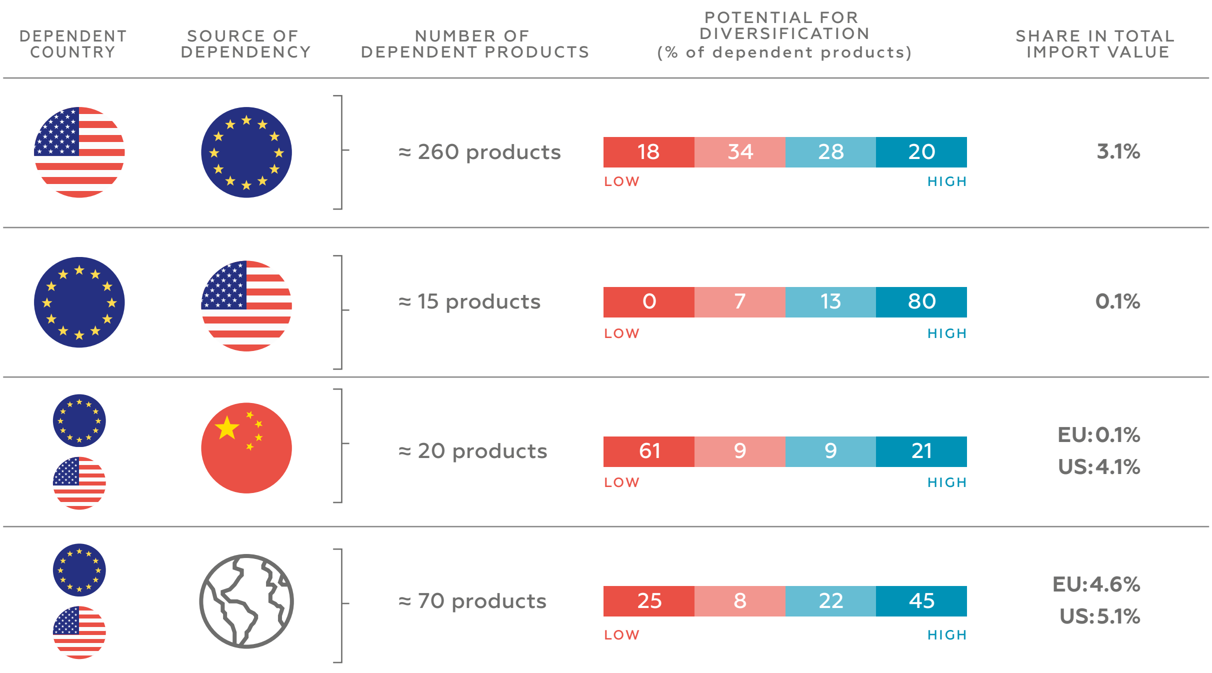
7 The value-added embedded in export is a more accurate measure. But OECD data shows that the domestic value-added in gross exports in China, Germany, and the United States is remarkably similar. Therefore, gross exports are a reasonable proxy for export dependence.

lead to broader economic disruption. (Think of the Arab oil embargo of the early 1970s.) Export controls can also hold back another country's economic and technological development by placing restrictions on the export of advanced technology. The exporter of critical goods typically suffers only modest losses compared to the importer. Unlike export dependency, vulnerability associated with critical imports is less well captured by total import volumes or values. Instead, it is best described in terms of a combination of import volumes of critical goods and their degree of substitutability.

According to the European Commission, the United States depends more on the EU for critical goods than vice versa, at least in quantitative terms. But both Americans and Europeans are relatively more dependent on China, if not in terms of the number of items, then certainly in terms of import values and substitutability. Importantly, US and EU dependency on Chinese rare-earth exports is significant, as China currently controls up to 90 percent of global supply. And Germany, as Europe's dominant manufacturer, is more dependent on rare-earth imports than other EU members. Third, in addition to international trade, countries can restrict cross-border financial flows. Such measures may affect both flows and stocks and can include asset freezes, forced divestments, and outright expropriation. Restricting inward investment makes it more difficult for the target country to hold savings or raise investment in the sender country's domestic financial market. At the same time, it reduces the demand for the financial assets of the sender country, while restrictions on outflows limit the ability of residents to invest in the target country. (Restricting financial flows also harms the economic interests of domestic financial service providers in terms of their ability to sell services to non-residents.) Like in all other cases, imposing geo-financial restrictions only makes sense if the target country is both significantly more dependent on the sender country than vice versa and if it cannot easily offset any losses by switching to third countries (including financial offshore centers).

Financial flows and stocks can be divided into foreign direct investment (FDI) and non-FDI, such as portfolio flows and cross-border loans and deposits. As with trade, the bulk of German outward FDI is in the EU-27 (and the UK). Again, the United States and China are the top two destinations

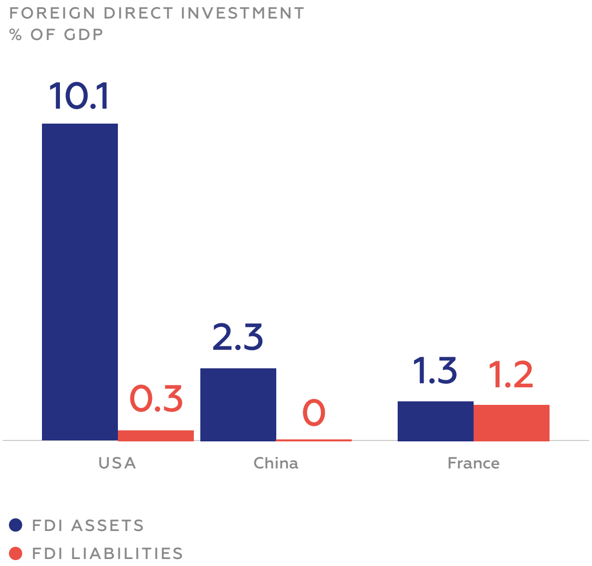
2: CRITICAL IMPORTS FROM OUTSIDE THE EU



Source: European Commission 2020

for German FDI outside Europe. German FDI in the United States is much larger than in China. American and Chinese FDI in Germany is much smaller in both dollar and GDP terms than German FDI in the United States and China. It is important to note, however, that to the extent that FDI is a critical part of international supply chains, a mere quantitative comparison only captures part of a country's overall vulnerability, even if it remains indicative of bilateral financial vulnerabilities.

3: FDI ASSETS AND LIABILITIES



Source: Bundesbank (2020)

A good if imperfect proxy of vulnerability to cross-border restrictions of non-FDI financial flows is bank lending, if only because bank-related financial vulnerabilities have a greater potential to cause economic instability in the target country (due to their greater systemic importance) than do non-bank financial institutions' risks. Cross-border bank lending is difficult to measure accurately and comprehensively. But based on consolidated cross-border claims, German bank lending to the United States is quite large, while US lending to Germany is relatively small. In comparison, both US and German cross-border lending to China is negligible.[8]

Last but certainly not least, restricting a target country's access to the domestic financial system also limits its ability to use the sender country's currency offshore. Such restrictions prove even more effective if secondary sanctions, which threaten third parties with penalties or market exclusion if they do business with the target, force third parties to stop transacting with it. When the restrictions are imposed by a country whose currency is widely used internationally, the target country's ability to engage in international trade and financial transactions can be severely curtailed.

It is mainly the United States and the EU (or euro area) which can gain leverage from this instrument. If they impose restrictions, banks will refrain from transacting with the targeted party, lest they lose access to important capital markets as well as their ability to engage in hard-currency-based international trade and financial transactions. In this

4: BIS CROSS-BORDER BANK LENDING
(CONSOLIDATED BANK CLAIMS, IMMEDIATE COUNTERPARTY BASIS)

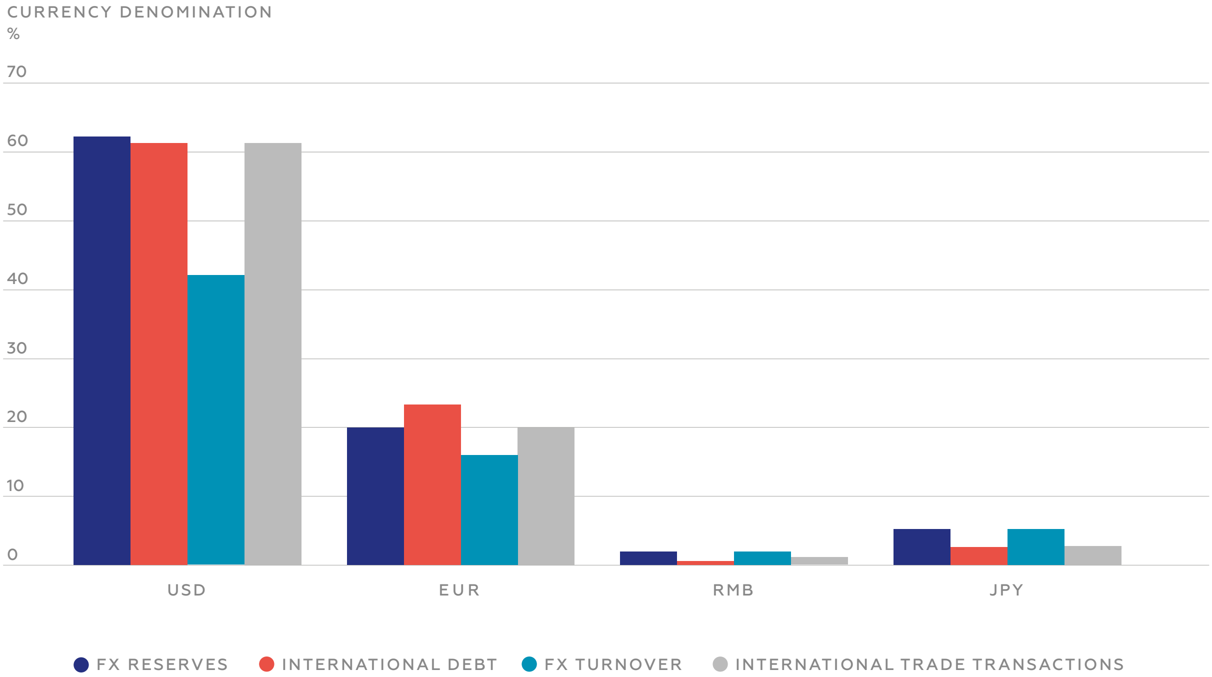
(PERCENT OF GDP)

	US	Euro Area	Germany	China
US bank lending to	–	4,9	1,6	0,5
German bank lending to	12,4	22,2	---	0,6

Source: Bank for International Settlements (2020)

8 The BIS does not provide comparable data for cross-border lending by Chinese banks.

5: INTERNATIONAL USE OF DOLLAR AND EURO

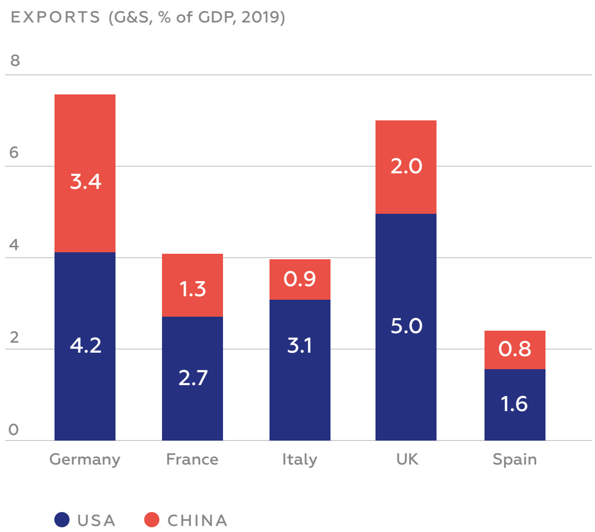


Source: International Monetary Fund, Bank for International Settlements (2020)

respect, the relatively insignificant international role of the Chinese yuan makes Chinese restrictions much less consequential than comparable US or EU measures. And, of course, Chinese banks' relatively greater reliance on the euro and the dollar makes the broader use of a 'yuan weapon' targeting US and EU interests rather non-sensical.

To sum up, Germany is more vulnerable to Chinese and US bilateral trade and financial restrictions and geo-economic measures than vice versa. This vulnerability is somewhat mitigated through Germany's EU membership. In terms of exports and FDI, Germany is nevertheless relatively more dependent on both China and the United States than vice versa, at least in purely quantitative terms. Germany is also relatively more vulnerable to the United States in terms of non-FDI and the dollar. Importantly, Germany is more vulnerable to Chinese and US geo-economic policies than virtually all other EU members. This provides Berlin with good reasons to seek greater EU cohesion and integration. At the same time, it makes it a primary target of third-party geo-economic measures aimed at weakening EU cohesion.

6: GERMANY IS THE EU'S MOST TRADE-DEPENDENT MEMBER



Source: International Monetary Fund (2019)

A few caveats are in order. Macro-level dependence does not translate one-to-one into exploitable geo-economic vulnerabilities, let alone coercibility. First, so-called 'issue linkage' means that a simple analysis of bilateral sectoral vulnerabilities is insufficient to evaluate overall vulnerability. Sectoral vulnerability matters, but a country keen to employ coercive measures may be able to pursue a strategy of 'horizontal escalation.' That means that a threat in one area (trade) can be leveraged to extract concessions in another area (finance), or that unfriendly geo-economic measures in one area can be deterred by credibly threatening retaliation in another.

Second, relative vulnerability does not directly translate into coercibility, as the success of coercive policies ultimately rests on the resolve of the target. And resolve is not simply a function of economic loss, relative or absolute. It is therefore important to distinguish between the efficacity (realization of political ends) and the effectiveness (imposition of costs) of geo-economic measures. However, even when geo-economic policies do not meet their political objective, they are capable of imposing losses on the target.

Third, it is not possible to exploit vulnerabilities or defend against geo-economic coercion without creating the necessary policies and tools to do so. Take, for example, a bilateral relationship in which the EU is economically less vulnerable than the other country. But if that other country can block EU retaliatory policies, it may get away with imposing geo-economic costs on the EU (or individual member states) despite being the relatively more vulnerable party. The same holds true if the target country lacks the necessary policy tools to mobilize its geo-economic power. The EU, for instance should be able to stand up to China as far as trade is concerned. But if it does not have the appropriate policy tools, or if it fails to generate sufficient intra-EU consensus for a sufficiently convincing geo-political response, China will be able to avoid EU retaliation. That is what seems to be happening in the case of the recent China-Lithuania spat. Nevertheless, assessing bilateral economic dependencies is a necessary step to gauge economic and potential political susceptibility to geo-economic coercion.

GERMAN AND EU GEO-ECONOMIC POLICIES AND TOOLS

Power relies not just on the degree of asymmetric economic interdependence, but also on the ability and willingness to leverage it. In this domain, Germany and the EU are at a disadvantage vis-à-vis China and the United States, and here is why:

EU trade policy is largely under the purview of the European Commission. But unilateral, non-WTO-authorized retaliatory measures are classed as foreign policy and require unanimous approval by all member states.[9] Such unanimity is hard to achieve because member states often face different cost-benefit calculi in relation to trade retaliation, particularly if the original 'unfriendly' trade measures only affect a subset of EU members. This makes it difficult to generate consensus in support of retaliatory measures.

In terms of critical imports, the EU has begun to identify and address some of its vulnerabilities.[10] But as of now, risk mitigation policies still depend on cooperation and coordination among EU member states, which makes it challenging to establish effective mitigation policies.

Export control policy largely remains under the purview of national authorities in the EU. Recent EU reforms have sought to enhance intra-EU coordination and cooperation. But overall, the reform falls far short of mobilizing the EU's significant geo-economic potential with respect to critical exports. EU member states can introduce tougher and broader controls than what has been proposed under EU export control policy.[11] But a national approach is far less effective than an EU-wide strategy.

Inward FDI regulation in the EU is under the purview of national authorities as far as investment from third countries is concerned. Germany has tightened its inward FDI regulations several times over the past few years, recently adding 20 sectors to its screening regime. New sectors include many emerging technologies, such as satellite systems, artificial intelligence, quantum mechanics, etc. This provides the German government with greater oversight and discretion

9 European Commission, Trade Defence: https://ec.europa.eu/trade/policy/accessing-markets/trade-defence (accessed: February 20, 2022).

10 European Commission, Critical Raw Materials: https://ec.europa.eu/growth/sectors/raw-materials/areas-specific-interest/critical-raw-materials_en (accessed: February 20, 2022). European Commission, EU Chips Act, February 8, 2022: https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_730 (accessed: February 20, 2022).

11 DLA Piper, Export controls: the EU's new dual-use regime, September 27, 2021: https://www.dlapiper.com/en/slovakrepublic/insights/publications/2021/09/export-controls-the-eus-new-dual-use-regime (accessed: February 20, 2022).

than before.[12] Meanwhile, the EU has just created a new FDI screening mechanism. However, the new regime is not a stand-alone mechanism akin to CFIUS (Committee on Foreign Investment in the United States) and does not provide for a comprehensive EU-wide export control regime. Rather it is an enhanced information sharing regime that does not even mandate the creation of national-level FDI reviews.[13]

As far as non-FDI investment is concerned, the European Commission has rightly recognized that threatening third parties with market exclusion in the context of its proposed anti-coercion policy might serve as a potentially effective deterrent. But geo-financial measures (commonly referred to as sanctions) require the support of all EU members. This makes them less effective than they could be.[14] What applies to non-FDI-related sanctions is also largely true for currency-related measures. Sanctions require unanimous support, and the implementation of policies largely rests with national authorities. As in most other economic areas, this limits the EU's ability to harness its geo-economic potential more effectively and more credibly.

GEO-ECONOMIC POLICYMAKING IN CHINA AND THE UNITED STATES

Both the American and Chinese governments are in a much better position to pursue effective geo-economic policies, given the greater centralization of decision-making in both countries. In most cases, the two governments also dispose of more flexible policy instruments which can be used under fewer domestic political constraints. In the United States, trade policy is broadly controlled by the president (who directs the Commerce Department and the United States Trade Representative), except for trade liberalization measures, which are a matter for Congress. As the Trump administration demonstrated with its trade policy towards both China and US allies, the domestic checks on unilateral geo-economic trade policies are very weak. Various statutes provide the government with significant leeway in terms of trade restrictions.[15] If all else fails, the government can simply invoke a national security exemption.[16] The relative autonomy of the executive combined with the country's limited vulnerability to foreign trade measures provides the United States with significant geo-economic power.

In China, the government also faces few if any domestic constraints in terms of trade policy. China's continued dependence on international trade does represent a constraint – at least vis-à-vis the United States and the EU. Yet as China is moving to reduce its dependence on international trade, it may become more willing to resort to geo-economically driven trade policies. Both the United States and China have demonstrated their willingness to use their 'trade power' vis-à-vis 'smaller' (that is, more dependent) countries (United States against China; China against Australia, Japan, and Korea), as has the EU.

In terms of import dependence, the United States is exploring ways to strengthen its supply chains and reduce its dependence on critical imports.[17] Centralized executive decision-making and deep financial pockets are helpful. Congress rarely fails to fund economic policies deemed essential for national security, as the proposed US Innovation and Competition Act currently under debate in Congress demonstrates. Meanwhile, China is also seeking to reduce its dependence on the international economy, and especially vital imports, through its 'dual circulation' and 'Made in China 2025' strategies. To this end, large amounts of financial resources have been made available. The Belt and Road Initiative and the creation of a blue water navy can also be rationalized in terms of supply security, especially regarding foodstuff and energy. The recent experience of geo-economic conflict with the United States has further strengthened China's desire to reduce geo-economic vulnerabilities. Compared to the EU, the United States and China are far better positioned to pursue a whole-of-government approach to managing import-related dependencies.

12 Gibson & Dunn, Germany further strengthens foreign direct investment regime, May 13, 2021: https://www.gibsondunn.com/germany-further-strengthens-foreign-direct-investment-fdi-regime (accessed: February 20, 2022)

13 Kirkland & Ellis, New EU foreign investment regulations take effect, October 29, 2020: https://www.kirkland.com/publications/kirkland-alert/2020/10/eu-fdi-regulation (accessed: February 20, 2022)

14 European Commission, Restrictive Measures (Sanctions): https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/restrictive-measures-sanctions_en (accessed: February 20, 2022).

15 Congressional Research Service, US Trade Policy Functions: Who Does What? January 14, 2022: https://sgp.fas.org/crs/misc/IF11016.pdf (accessed: February 20, 2022).

16 Congressional Research Service, Section 232 of the Trade Expansion Act of 1962, November 4, 2021: https://sgp.fas.org/crs/misc/IF10667.pdf (accessed: February 20, 2022).

17 White House, Building Resilient Supply Chains, Revitalizing American Manufacturing and Fostering Broad-Based Growth, 100-Day Reviews under Executive Order 14017, June 4, 2021: https://www.whitehouse.gov/wp-content/uploads/2021/06/100-day-supply-chain-review-report.pdf (accessed: February 20, 2022).

Like in trade, the US government has also significant latitude in terms of export control policy.[18] Under the so-called foreign direct product rule, for example, the government can even prohibit third-country exports that make use of American equipment or intellectual property rights, in addition to more typical measures, such as restrictions on re-exports and in-country transfers. Moreover, US technological leadership gives Washington's export control policy significant reach and heft, as several Chinese technology companies have recently learnt. The Chinese authorities similarly face few domestic political constraints with respect to export controls. However, China's own import dependence may cause Beijing some reluctance to go up against the bigger economic powers for fear of retaliation. China, like the United States, has demonstrated its willingness to use export controls. US controls include restrictions of semiconductor exports to selected Chinese companies, while China temporarily embargoed rare earth exports to Japan.

The United States has also tightened its FDI regulations several times in the past few years.[19] The so-called CFIUS process led by the Treasury establishes an inter-agency review of foreign FDI in sectors related to national security. The scope of sectors and types of investment has been broadened. Even after partial liberalization, China is much more restrictive in terms of FDI than the United States or Germany, and the authorities retain significant discretion and control over inward FDI in sectors deemed to be of strategic importance. Tighter national security guidelines also give the Chinese authorities extensive control over investment in critical sectors.

The United States administers financial sanctions through the Treasury's Office of Foreign Asset Control based on various elements of sanctions legislation. While US financial measures largely target entities involved in criminal and terrorist activities, Washington has recently also taken aim at Chinese companies. Existing legislation gives the president broad authority to impose sanctions. Similarly, China faces few bureaucratic or legal constraints when it comes to financial sanctions, even though the relatively closed nature of its financial systems provides it with limited leverage vis-à-vis other countries.

Last but not least, American dollar-based sanctions, thanks to the dominant role of the dollar in the global economy, have proven a powerful geo-economic tool. Through the Treasury's Office of Foreign Asset Control, the president has a fair amount of discretion about applying currency sanctions based on specific legislation or broader economic emergency powers.[20] In contrast, China is in a much weaker position concerning currency-related sanctions. The country's capital account is relatively closed, and the yuan is rarely used offshore. China can certainly restrict access of foreign institutions to its financial system, but the dependence of foreign banking and financial institutions on the Chinese market is limited. Restricting access to the yuan would have only a negligible effect and therefore does not lend itself as a geo-economic tool, given China's far greater dependence on the dollar and the euro. China has recently made changes to its countersanction policy by introducing a blocking statute and a countersanction tool. This allows the government to prohibit Chinese companies, including foreign companies with a presence in China, from complying with foreign sanctions. Should they disobey, significant penalties can be imposed. This is meant to undercut both primary and secondary sanctions. It is difficult to see how the EU could ever agree to such a bold deterrence and retaliation policy.

In brief, China and the United States have more flexible geo-economic tools at their disposal. Centralized decision-making with few effective domestic checks on the use of existing instruments gives both governments significant flexibility. EU-level policymaking, by comparison, is much more cumbersome and too dependent on the need for consensus or extensive coordination among members.

This situation allows third countries to target the proverbial weakest link – the country with the most to lose in economic terms – to weaken or even completely undermine European geo-economic deterrence and retaliatory policies. And Germany, economically speaking, is often the weakest link. Meanwhile, German national-level policies and instruments remain too rules-based and are frequently subject to intra-government, party-coalitional disagreement. This limits their effectiveness. While

18 Congressional Research Service, The US Export Control System and the Export Control Reform Act of 2018, January 28, 2020: https://sgp.fas.org/crs/natsec/R41916.pdf (accessed: February 20, 2022)

19 Congressional Research Service, CFIUS Reform under FIRRMA, February 21, 2021: https://crsreports.congress.gov/product/pdf/IF/IF10952 (accessed: February 20, 2022).

20 Congressional Research Service, The International Emergency Economic Powers Act, July 14, 2020: https://sgp.fas.org/crs/natsec/R45618.pdf (accessed: February 20, 2022).

Germany should allow for a more flexible and strategic use of its geo-political instruments to enhance its potential for geo-economic deterrence, the EU needs to coordinate national policies more closely and streamline decision-making procedures to make its policies both more credible and effective. (see table 7 on page 14)

ENHANCE EU COHESION AND IMPROVE NATIONAL TOOLS

In terms of trade policy, the Commission has proposed an anti-coercion tool that would be designated as a trade rather than a foreign policy instrument.[21] This would mean that proposals for retaliatory measures would only require a qualified majority in the Council of the EU to come into force – a very different situation from foreign policy measures that require unanimous support to be approved. The Commission proposal also links its 'trade defense' policies to a broader cross-sectoral anti-coercion strategy which includes financial and other trade-related sanctions. However, such 'horizontal retaliation' carries a risk of politicizing international trade relations too much. It may also be unnecessary, given that in many cases the EU is reasonably well-positioned to fend off unfriendly trade policies by trade-related countermeasures. At the same time, a broader anti-coercion policy would allow the EU to mobilize its geo-economic power through linkage politics.

The challenge is to create a decision-making mechanism which can prevent third parties from pursuing a 'divide-and-rule' approach towards EU members while maintaining credible economic deterrence. Member states also face the challenge of deciding how much power and autonomy to grant the Commission in terms of both 'vertical' and 'horizontal geo-economic escalation.' From their perspective, there is a real risk of ending up in an out-of-control retaliation-counterretaliation cycle if no limits are imposed. Of course, any deterrence policy has to address the issue of automaticity (or pre-delegation) and discretion: Automaticity lends credibility but creates a greater risk of escalation. Given its greater extra-EU trade dependence and vulnerability, automaticity should be of particular concern to Germany.

The EU's anti-coercion policy needs to be calibrated in a way that strengthens EU unity and the credibility of its geo-economic policies without having individual member states lose all control over them (for optimal policy design, see forthcoming Policy Brief).

In terms of import dependence, managing dependencies vis-à-vis third countries at the EU level is preferable to national-level policies. Even if Germany managed to address its extra-EU dependence, it would remain vulnerable because it would still depend on imports from other EU member states, which in turn rely on critical imports from outside Europe. National-level policies can therefore only provide a second and less complete line of geo-economic defense and vulnerability reduction.

The EU must also accelerate its efforts to reduce critical vulnerabilities through a combination of import diversification, reshoring, and the creation of strategic reserves.[22] The optimal balance will be a function of the trade-off between economic costs and the desired reduction of vulnerabilities. One major factor in this equation is how critical a specific import is to the EU as a whole. Greater intra-EU coordination of purchases of critical goods, at least as far as EU-level strategic reserves are concerned, would also provide the EU with greater market and pricing power in international markets. The cost of financing stockpiles could be allocated based on member states' consumption shares. Although the private sector is typically much better placed to manage supply chain risks – the so-called European Materials Alliance, an industrial alliance, certainly has a role to play here – the official sector can help overcome collective action problems.

Moving production of critical inputs onshore is being pushed by the Commission, as in the case of semiconductors.[23] Such policies may lead to international trade tensions, and related industrial policies are fraught with risks in terms of rent-seeking. Both EU and national-level policies should be based on a detailed and careful assessment in terms of their prospective cost-benefit balance. They should also be compared to alternative mitigation policies, such as international cooperation and import diversification. Making critical energy imports more fungible by

21 European Commission, Proposal for a Regulation of the European Parliament and the of Council on the Protection of the Union and its Member States from Economic Coercion by Third Countries, 2021: https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf (accessed: February 20, 2022).

22 Reshoring and/ or self-sufficiency does not necessarily reduce economic risks, and concomitant economic decoupling may create its own set of problems, including oversupply and higher input costs.

23 European Commission, EU Chips Act, February 8, 2022: https://ec.europa.eu/commission/presscorner/detail/en/qanda_22_730 (accessed: February 20, 2022).

7: SELECTED GEO-ECONOMIC POLICIES AND INSTRUMENTS IN CHINA, EUROPE, AND THE UNITED STATES

	USA	CHINA	EU / GERMANY	SOURCE OF GEO-ECONOMIC VULNERABILITY
Trade Policy	Executive (Commerce Department, United States Trade Representative) Trade Expansion Act (1962); Trade Act (1974); North American Free Trade Act (1993); Bipartisan Congressional Trade Priorities and Accountability Act (2015)	State Council (Ministry of Commerce) Foreign Trade Law, Customs Law	EU Directorate General for Trade 'Trade defense' policy/ Anti-coercion tool (proposed)	Export dependence
Export Control Policy	Executive (Commerce Department/ Bureau of Industry and Security) Export Control Reform Act (2018)	State Council (Ministry of Commerce, Central Military Commission Chinese Customs Bureau) Chinese Export Control Act (2020)	**Government (Federal Office of Economics and Export Control)** EU Export Control Regulation (2021)	Reliance on difficult-to-substitute imports
Exchange Rate Policy	Executive (Treasury, Federal Reserve) Omnibus Foreign Trade and Competitiveness Act (1988); Trade Facilitation and Trade Enforcement Act (2015)	State Council (People's Bank of China, State Administration of Foreign Exchange)	European Central Bank	Export dependence
Foreign Direct Investment	Executive (Committee on Foreign Direct Investment in the United States, consisting of nine departments chaired by Treasury) Foreign Investment Risk Review Modernization Act (2018)	State Council Foreign Investment Law (2020) Special Administrative Measures for Foreign Investment ('negative list') (2019)	**Government/Interagency process consisting of Ministry of Economic Affairs, Ministry of Defense, Ministry of the Interior** **Foreign Trade and Payments Act; Foreign Trade and Payments Regulation** EU FDI screening framework (2020)	Financial risks related to relative value of inward/ outward FDI Supply chain risks in case of expropriation, forced divestment etc.
Non-FDI	Executive (Treasury – Office of Foreign Asset Control)	State Council (People's Bank of China)	**Government (Ministry of Finance, Bundesbank, BaFin)** Council of the European Union (unanimity) EU sanction tool under EU Common Foreign and Security Policy (Directorate-General for Financial Stability, Financial Services, and Capital Markets Union)	Financial risk related to foreign assets/liabilities Especially: Access to currency funding and clearing
Economic Sanctions and Counter-sanctions	Executive (incl. State Department, Treasury, Commerce) International Emergency Economic Powers Act (1977); various	State Council (various agencies) National Security Law; 'unreliable entity list'; blocking statute; countersanction tool	**Government (Ministry of Finance, Bundesbank)** See non-FDI Blocking statute "Anti-Coercion" Policy	All of the above

Source: Author's compilation (2022)

improving energy connectivity or creating strategic reserves can also help mitigate individual and collective import dependencies.

As for export control policy, the more active, national security-oriented approach taken by both the United States and China should induce Germany to consider making its export control regime more flexible. It should also be turned into more (but not too much) of a political tool. This might require shielding it to some extent from party politics within the governing coalition. Germany's export control regime should be integrated into a broader geo-economic strategy to enhance its political effectiveness. Turning export controls into a more flexible tool is meant to signal to third countries that they are the addressees of an overarching strategy of geo-economic deterrence. Greater flexibility is not meant to make international financial relations less predictable. Instead, it is meant to signal Germany's willingness to impose costs on countries whose policies weaken predictable, rules-based cooperation.

At the EU level, enhanced transparency and closer consultation and coordination of national export control policies is highly desirable, not least to avoid the situation of a prisoner's dilemma in case other EU members produce close substitutes of the goods to be controlled. Recent reforms do not go far enough.[24] As with trade, diverging interests (and vulnerabilities) of EU members may make it difficult to find consensus. But without agreement, at least among countries that produce close substitutes of goods to be controlled, national export control policies become ineffective.

Regarding geo-financial policies, the German government should continue to support enhanced FDI screening policies at the European level but should not shy away from imposing tighter national oversight (if not necessarily restrictions) than other members. After all, Germany has more high-technology assets likely to become the target of non-market bids by state-supported foreign companies than other EU countries. A more political-strategic rather than legalistic-bureaucratic approach might also offer the opportunity to extract greater reciprocity in terms of overseas FDI access.

As far as non-FDI flows are concerned, the creation of a US-style Office of Foreign Assets Control (OFAC), which implements financial sanctions under guidance from the president and the Treasury, would lend EU geo-economic policies greater heft and credibility. But to be effective, this would require members to largely if not completely delegate decisions on financial sanctions. Again, this is difficult, for unless a sensible calibration of policies and decision-making procedures can be found, geo-financial policies will tend to be either too weak or risk being unnecessarily escalatory.

In terms of currency-related sanctions, including secondary sanctions, the EU (euro area) should strengthen its monetary union through greater financial, banking, and capital market integration. The goal should be to make the euro coequal to the dollar and thus increase the effectiveness of euro-based financial sanctions.[25] In the short term, few if any effective mitigation policies are available, as the re-instauration of US Iran sanctions and the failure of INSTEX has demonstrated.[26]

In brief, greater EU cohesion is desirable to strengthen Europe's geo-economic deterrence potential. The problem is that the EU is not a unitary actor and consensus among member states is often difficult to reach. So far, most important geo-economic decisions require the member states' unanimous approval. National policy tools are less effective, but they offer greater flexibility. If EU solutions remain out of reach, reforms allowing for a more flexible use of existing national instruments would be useful. If handled responsibly, they would help enhance credibility by creating some 'strategic ambiguity' – a desirable effect in view of the far more flexible and political tools at the disposal of the other major geo-economic powers.

PREPARE FOR GEO-ECONOMIC CONFLICT

International economic relations are at risk of further politicization. Germany, more than many other countries, has a huge stake in the survival of the post-WWII multilateral, rules-based economic

24 European Commission, Foreign Direct Investment EU Screening Framework, 2020: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1867 (accessed: February 20, 2022).

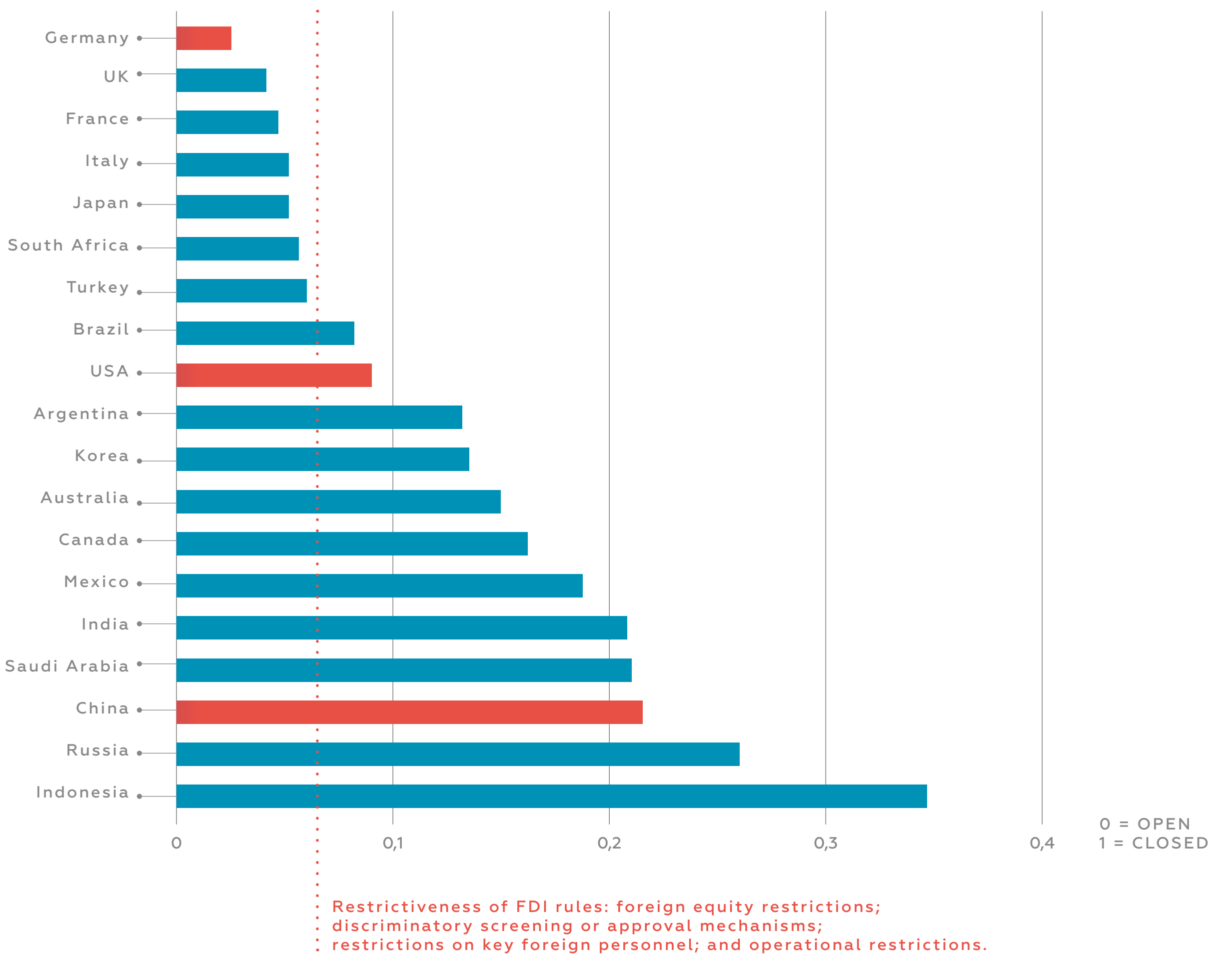
25 Markus Jaeger, Promoting the euro - countering secondary sanctions, DGAP Policy Brief, February 8, 2022: https://dgap.org/en/research/publications/promoting-euro-countering-secondary-sanctions (accessed: February 20, 2022).

26 INSTEX is the special purpose vehicle established by European countries to circumvent US dollar- and SWIFT-related sanctions.

order. Even if the global economic order does not break down entirely like it did in the 1930s, greater fragmentation and conflict can cause significant economic harm. As a country that is highly dependent on the international economy, Germany needs to put in place policies to mitigate the effects of increased international economic instability and the mounting risk of geo-economic coercion. Autarky is by far the economically most costly strategy and does not necessarily eliminate all economic risks. Diversifying economic and financial relations and actively managing economic interdependence is a much better strategy. Where expedient, this should involve close cooperation with trusted partners to address shared vulnerabilities.

Yet policy and strategy must not be based on the most desirable scenario but on the most likely one. The rivalry between the United States and China will escalate, and continued US support for the multilateral, rules-based economic order is becoming more uncertain. Germany and Europe must take those risks very seriously. Other trade-dependent middlepowers like Japan and Korea are already actively preparing for such a scenario. Japan has even created a Ministry for Economic Security. The new German government can no longer rely on the fragmented ad hoc approach taken to date. It urgently needs to devise a comprehensive and forward-looking national strategy to deal with intensifying geo-economic conflict and the weaponization of economic interdependence.

8: OECD FDI RESTRICTIVENESS*



Source: OECD (2020)

*Composite indicator: Foreign equity restrictions; discriminatory screening or approval mechanisms; restrictions on key foreign personnel; and operational restrictions

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