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Don't Get Caught in the Middle

A Geo-Economic Strategy for Germany to Survive US-Chinese Rivalry

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The economic fallout from the war in Ukraine has been very significant. The consequences of a war in East Asia involving the United States and China would be much worse. And even if a Sino-US military confrontation can be avoided, geo-economic conflict between the two powers is going to intensify. Washington will put increasing pressure on Germany and Europe to align their policies with Washington's geo-economic strategy.

- As US-Chinese competition intensifies, so will American demands on Germany and the EU to support its China balancing strategy. A high degree of economic dependence on both China and America puts Germany into a particularly difficult position.

- Germany must urgently devise a strategy for coping with intensifying US-Chinese geo-economic conflict. The war in Ukraine is an urgent reminder of the significant economic costs armed conflict can cause to third parties.

- Germany should (1) streamline its bureaucratic-institutional capacity to identify, assess, and monitor geo-economic risks. It also needs to devise and implement mitigation policies; (2) address its most critical economic vulnerabilities; and (3) accelerate efforts to mobilize the EU's latent economic power to mitigate vulnerabilities and deter third countries from exploiting them.

WHY GERMANY IS PARTICULARLY VULNERABLE

As Karl Marx observed, history repeats itself, first as tragedy, then as farce. Russia's war in Ukraine demonstrates the risks associated with economic dependence on a potential geopolitical antagonist. A US-Chinese military confrontation in East Asia over, for example, Taiwan would be even more costly for Germany than the Ukraine war – at least in the longer term. But even if war can be avoided, Germany will be vulnerable to intensifying US-Chinese geo-economic conflict.

Last year, German trade with Russia amounted to EUR 60 billion. Trade with China was nearly EUR 250 billion. German foreign direct investment in Russia was EUR 24 billion, while investment in China amounted to EUR 90 billion. True, Germany's vulnerability vis-à-vis Russia is magnified by its energy dependence. But Germany (directly or indirectly) also relies on, for example, Chinese rare earth exports, which magnifies the dependence beyond what is captured by trade volumes. A voluntary or involuntary Chinese export or import stop would be hugely consequential. But how consequential?[1] And what can be done to mitigate this and other economic risks? These are questions that the German government urgently needs to answer.

Even if an armed conflict in Asia does not come to pass, the prospect of geopolitical competition and geo-economic conflict between Germany's two most important economic partners provides a good reason for addressing economic vulnerabilities and the concomitant political coercibility. Among EU members, it is Germany that has the most extensive economic relationship with both China and the United States. It will therefore be a particular focus of both American and Chinese policies.

Germany is also the country most susceptible to US and Chinese geo-economic pressure, given the importance of its bilateral trade and investment relationship, measured as a share of GDP. German exports of goods and services to China and the United States amount to a hefty three percent and four percent of GDP, respectively. Total trade with the United States is worth nearly EUR 200 billion, and German foreign direct investment exceeds EUR 400 billion. What shall Germany do when faced with pressure to support American geo-economic policies as well as the prospect of Chinese retaliation against German economic interests in case Berlin aligns its policies with America's geo-economic strategy? Pressure would likely come in the guise of export controls and selective import restrictions. At least in the Chinese case, 'unfriendly' measures targeting German investment in China are also to be expected.

US-CHINESE RIVALRY WILL INTENSIFY

Germany should not hope for US-Chinese rivalry to miraculously dissipate. The United States is going to remain focused on countering China's rise. Ever since the United States emerged as a great power in the late 19th century, it has sought to prevent the eastern (and western) end of the Eurasian landmass from falling under the domination of a single power – most recently during the Cold War.

It is therefore no coincidence that American goals have been relatively constant across various administrations, beginning with Barack Obama's 'pivot to Asia' to Donald Trump's 'great power competition' and Joe Biden labelling China 'the greatest geopolitical test of the 21st century.' Meanwhile, China is intent on changing the status quo in its favor by weakening America's position, particularly in East Asia. 'Peaceful rise' and 'peaceful development' have given way to a policy of territorial revisionism, military modernization, geo-economic rivalry, and even 'wolf warrior diplomacy.'[2] Neither side is going to back down. At best, there will be 'managed strategic competition;'[3] at worst, military conflict.

Assuming China continues to rise, resource constraints will force Washington to mobilize greater external as opposed to domestic resources to counter Beijing. In International Relations theory speak, Washington will pursue a strategy of both 'internal' and 'external balancing,' namely, mobilizing domestic resources and relying on resources provided by allies to balance a rival power. Washington will expect its allies to support its China policy. A military conflict between the United States and China would

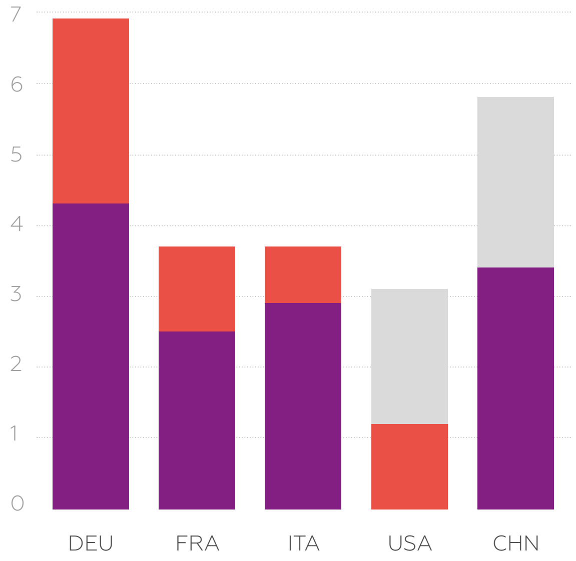
1 China accounts for about 40 percent of global rare earth exports and produces 85 to 90 percent of all rare earths globally.

2 Bonnie Glaser & Evan Medeiros, The changing ecology of foreign policy-making and the demise of the theory of "peaceful rise", The China Quarterly 190, 2007.

3 Kevin Rudd, The Avoidable War (New York 2022).

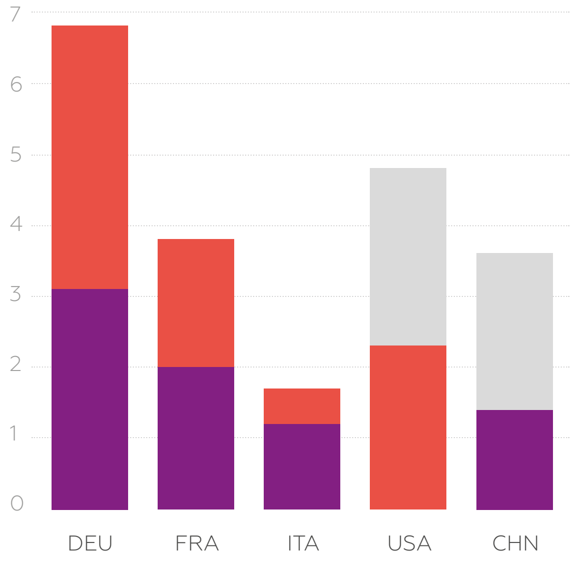
GERMANY'S EXPORT DEPENDENCE ON AMERICA AND CHINA IS RELATIVELY HIGH

Exports of Goods & Services, % of GDP, 2020
To USA | To China | To EU-28



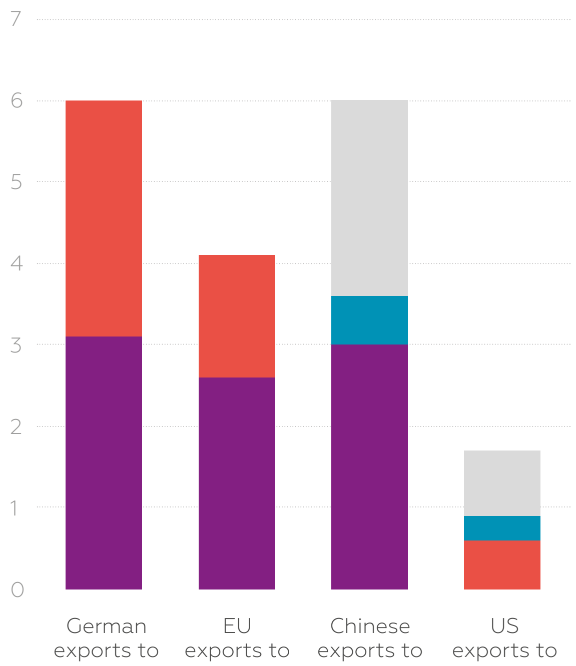
SO IS GERMANY'S DEPENDENCE ON IMPORTS FROM AMERICA AND CHINA

Imports of Goods & Services, % of GDP, 2020
From USA | From China | From EU-28



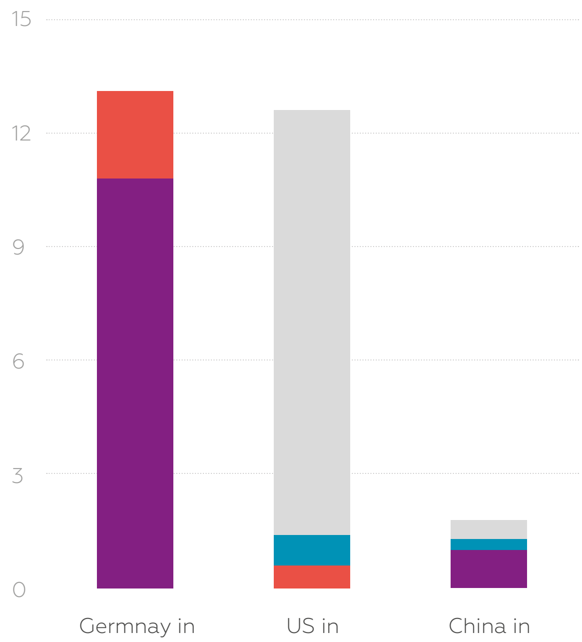
EU TRADE VULNERABILITY VIS-A-VIS CHINA IS MORE MANAGEABLE

% of GDP, 2020
USA | China | Germany | EU (ex-Germany)



GERMAN OUTWARD FOREIGN DIRECT INVESTMENT IS VERY SIGNIFICANT

FDI Assets, % of Sender Country GDP
USA | China | Germany | EU (ex-Germany)



Source: WTO; Bundesbank, Bureau of Economic Analysis, Congressional Research Service leave Europe little choice but to support Washington. But even if it does not come to war, intensifying US-Chinese security competition and geo-economic conflict mean that Germany and Europe will face increasing pressure to align their policies with US strategy. [4]

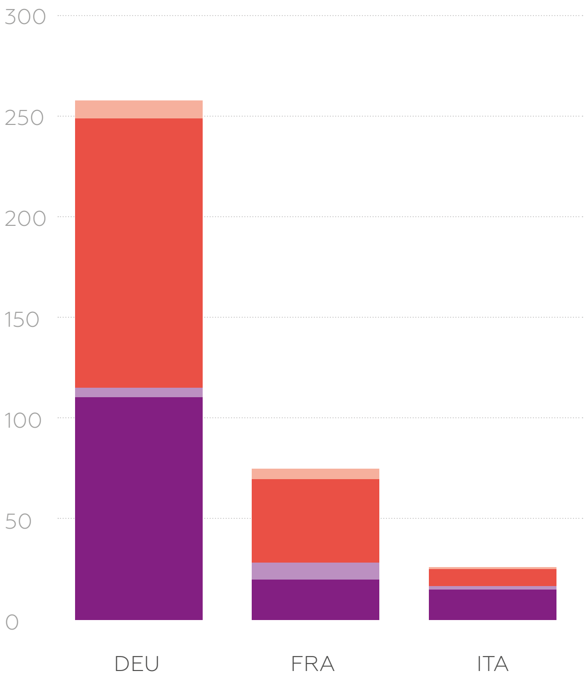
GERMANY WILL BE UNABLE TO SIDESTEP CONFLICT

Germany maintains an extensive economic relationship with China. Washington will therefore be especially keen for Berlin to fall in line with the economic part of its China strategy, including trade and investment restrictions, particularly regarding technology and other critical goods. But this will increase the risk of Chinese retaliation against German economic and financial interests. China would be unlikely to retaliate by waging an outright trade war. After all, it remains fairly dependent on the EU market, and the EU might retaliate in kind. But Beijing would likely retaliate against German interests through targeted trade and investment measures if Berlin geo-economically aligned with Washington. Beijing has imposed politically motivated trade restrictions on more than one occasion (e.g., Korea, Taiwan, Australia, and Lithuania) and will not hesitate to do so again.

These cross-cutting pressures already exist and will only intensify over the coming years. Admittedly, Beijing will not want to sink the bilateral economic relationship with Germany wholesale. But to

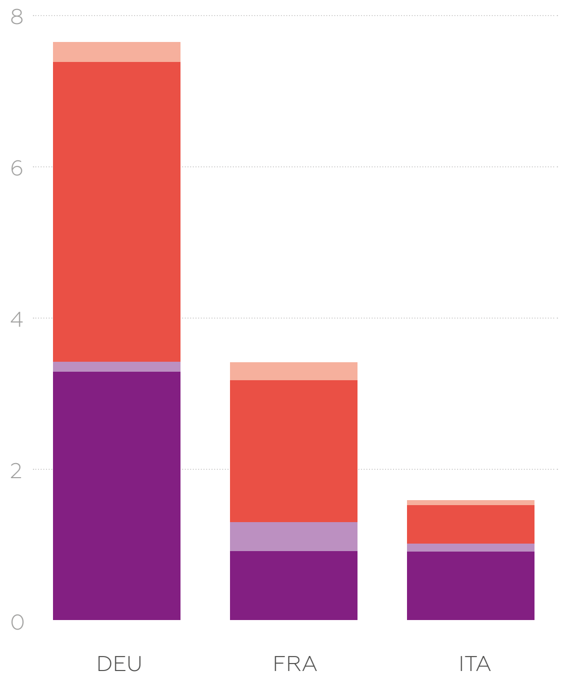
GERMANYY'S TRADE RELATIONSHIP WITH CHINA IS EXTENSIVE

Goods & Services, **USD bn**, 2020
Exports Goods / Services | Imports Goods / Services



GERMANY'S TRADE DEPENDENCE ON CHINA IS RELATIVELY HIGH

Goods & Services, **% of GDP**, 2020
Exports Goods / Services | Imports Goods / Services



Source: WTO

4 "Over the past four centuries, the most powerful nation-states have fought global wars four times. These conflicts have occurred at approximately 80- to 100-year intervals. In the periods between the major wars, well-ordered liberal economic subsystems have emerged, only to collapse as a major war approaches (...). Liberal international subsystems emerge from periods of widespread warfare because the victor of global war can use its power to organize and then then maintain a stable international community. Over time, as the organizer or leader weakens relative to other nation-states, cohesion and order in the subsystem decline." Mark Brawley, Liberal Leadership (Ithaca 1993), p. 1. This is bad news for a middle power like Germany, given its dependence on rules-based, multilateral economic governance.

preserve credibility, Beijing will have no choice but to retaliate if Berlin follows US policies. And as time goes by, the geo-economic risks for Germany will increase as the Chinese economy will continue to grow and become relatively less dependent on trade with Germany, while Germany's relative dependence is likely to increase.

Admittedly, trade dependence is not simply a function of bilateral import and export volumes and related asymmetries. A more sophisticated analysis requires a more thorough assessment of the substitutability of (critical) imports as well as the ease with which exports can be diverted to third countries. (This is often referred to as the difference between sensitivity and vulnerability dependence.)[5] But such an analysis is beyond the scope of this policy brief.

SUPPORTING A LEVEL PLAYING FIELD IS NOT A STRATEGY

Germany and the EU largely share America's goals as far as preserving the territorial status quo in Asia and creating an economic level economic playing field are concerned. The EU has labelled China a 'systemic rival' and an 'economic competitor.' But Germany's extensive economic relationship with, and its less immediate security concerns in relation to, China will make it less keen to support US policies it deems overly confrontational (whatever this might mean in practice). Germany will also be reluctant to support US policies to the extent that they weaken the very rules of multilateral economic cooperation that Berlin wants to be seen upheld.

By comparison, Washington's policies will be driven by a more immediate need to counter China's economic and military rise, and they will be facilitated by a much lower degree of US economic vulnerability vis-à-vis China. America will not – the Biden administration's strong criticism of the EU-US Comprehensive Agreement on Investment suggests as much – take kindly to its European allies, advertently or inadvertently, undermining US geo-economic policies, let alone entering the fray as a so-called 'third-party spoiler.'[6]

Washington does have reasons to prefer a joint, cooperative approach to countering China in the economic realm, not least because such an approach is more effective and less costly to enforce than a coercive one. But it will not hesitate to resort to unilateral measures, including secondary sanctions, to bring its European allies into line. This holds true especially in areas where the United States has leverage, such as with respect to critical and emerging technologies or the dollar. Washington – and especially Congress – is not going to accept Europe undermining the effectiveness of US geo-economic policies vis-a-vis China, let alone benefitting economically from it. As US-Chinese competition intensifies, US policy is bound to become less accommodating.

DEALING WITH US-CHINESE GEO-ECONOMIC CONFLICT

The German government therefore needs to devise a plan to deal with these challenges. The previous government's Indo-Pacific Strategy was long on goals but vague on effective means to realize them, while barely mentioning China or US-Chinese competition.[7] But Germany's policy toward China or the United States cannot be divorced from the broader strategic context represented by US-Chinese rivalry. What is Germany to do?

At the diplomatic level, a joint transatlantic approach is generally desirable. Naturally, the prospect of a possible return to an America First Policy, should Donald Trump or a like-minded presidential candidate win office in 2024, makes it advisable to adopt a cautious approach. Germany needs to make sure that any cooperative agreement does not lend itself to exploitation by a future, unilateralist-minded US administration. The focus should therefore be on areas of common vulnerability, where the risk of future 'defection' is more limited.

Transatlantic cooperation is already under way, most visibly in the guise of the EU-US Trade and Technology Council.[8] Berlin and Brussels should offer Washington continued support for geo-economic policies that seek to establish a level playing field. They

5 Markus Jaeger, The Logic (and Grammar) of US Grand Strategy, Part III, 2021: https://dgap.org/en/research/publications/logic-and-grammar-us-grand-strategy (last accessed: August 16, 2022).

6 Bryan Early, Sleeping with your friends' enemies, International Studies Quarterly, 53(1), 2009

7 Auswärtiges Amt, Leitlinien zum Indo-Pazifik, 2020: https://www.auswaertiges-amt.de/blob/2380500/33f978a9d4f511942c241eb46020 86c1/200901-indo-pazifik-leitlinien--1--data.pdf (last accessed: 25 June 2022).

8 Among other things, the TCC seeks to establish a common approach to such issues as supply chain security, technological cooperation and standards, coordination of export control, and investment policies. Office of the United States Trade Representative, US-EU Trade and Technology Council: https://ustr.gov/useuttc (last accessed: 25 June 2022).

should also support a coordinated approach to export controls and investment restrictions as far as 'dual use' and other critical technologies are concerned. Washington will certainly want these restrictions to be defined much more narrowly than its European partners, as the United States will be much more immediately affected by the potential military application of advanced technologies than Berlin or Brussels. As a case in point. Washington has tightened restrictions effectively targeting Chinese investment in the United States as well as US exports of critical technologies to China. And Washington may even introduce restrictions on US investment in China.[9]

Where America and Europe will probably be able to agree, is on the 'defensive' part of a new joint strategy. That would mean strengthening American and European resilience and addressing selected geo-economic vulnerabilities in the context of the EU-US Trade and Technology Council. The 'offensive' part that Washington will wish to add will prove much more contentious, particular in terms of the means. The United States will want to employ geo-economic – possibly international-rule-violating – policies aimed at coercing China to modify its behavior. Germany feels more than queasy about deploying discriminatory policies in violation of established international rules. Moreover, China, in view of intensifying security competition, is not likely to make any significant concessions in terms of creating a level playing field. Tactically, Beijing will not want to be seen to be responsive to coercion, and strategically, it will not want to make any concessions that would weaken government control over critical economic sectors.

Nevertheless, Washington will not hesitate to resort to policies that fall afoul of multilateral rules and provoke Chinese retaliation, not least because 'national security' exemptions can be invoked to justify virtually any discriminatory trade measure, as US trade policy under the previous administration demonstrated. The WTO has proven ineffective at preventing or moderating the trade conflict between the United States and China or even that between the EU and China (which explains the EU's enthusiasm for trade defense and 'anti-coercion' policies intended to remedy WTO ineffectiveness.)

Washington, intensely involved in security competition with China, will deem such 'offensive' measures a success if they weaken China's economic growth or at least its technological development. For Berlin, the economic costs related to such measures will be far greater and the security benefits far smaller. Nevertheless, the merit of a joint approach is that it may provide Germany with some cover to deflect Chinese geo-economic retaliation, as China will be reluctant to take on all the advanced economies simultaneously. The geo-economic dilemma remains: Germany's economic dependence on China and the United States makes it vulnerable to US pressure as well as Chinese retaliation. What should Berlin do to manage the concomitant risks?

Step One: Create Institutional Framework to Assess Geo-Economic Risks and Propose Solutions

Germany must enhance its institutional capacity to identify and assess vulnerabilities as well as formulate effective mitigation policies. It must also strengthen its political-institutional capacity to coordinate and implement mitigation policies. In addition to a National Security Council, the German government should create a National Economic Security Council (attached to the NSC) to allow for the close coordination of national security and economic security policies.

The creation of these two councils should be complemented by a policy unit attached to the chancellery charged with identifying, assessing, and monitoring economic vulnerabilities. Its second task would be to devise risk mitigation strategies based on prospective geopolitical and geo-economic scenarios. Attaching the policy unit to the chancellery would give it visibility, underline its importance, and remove it somewhat from the more tactical, day-to-day concerns of the line ministries and party politics. The division of labor could be the following: The policy unit would serve as a high-level advisory body and propose strategy and policies, the cabinet would accept or reject the proposed strategy, and the National Security Council would be charged with coordinating policy implementation with the support of the relevant line ministries.

9 Such a proposal has been floating around Congress for several years, most recently in the guise of the National Critical Capabilities Defense Act. This provision is currently the subject of negotiations in the context of the US-China Innovation and Competition Bill (Senate) and the America COMPETES Act (House).

AVAILABLE ECONOMIC RISK MITIGATION OPTIONS

IMPORT DEPENDENCE	EXPORT DEPENDENCE	OUTWARD INVESTMENT
Set up domestic production capacity	Reduce exports to potentially hostile country (difficult to do for a large economy)	Limit, block, or reduce investment in potentially hostile country pro-actively
Diversify imports	Divert exports to third countries (difficult to do for a large economy)	Diversify overseas investment to limit single-country exposure
Deter third-party export control measures by threatening to withhold 'critical' exports (or other retaliatory measures)	Deter protectionist threats by threatening import restrictions or other retaliatory measures	Deter hostile action by threatening geo-financial or other retaliation
Create a strategic reserve of critical goods	Absorb excess supply through expansionary macro-policies	

Source: Author's compilation

Step Two: Address Critical Vulnerabilities

What are major vulnerabilities? And which general mitigation policies are available?

Import dependence refers to a country's reliance on imports of 'critical' (aka difficult-to-substitute) goods or services, for example, those necessary to support domestic production or safeguard public health such as medical supplies.

Export dependence stems from the economic costs that arise when access to foreign markets is restricted. Restrictions imposed by another country negatively affect domestic economic growth and employment.

Outward investment is also at risk of discriminatory treatment by a host country, including expropriation. Such hostile measures lead to financial losses and can disrupt supply chains (see import dependence). In extremis, such losses can be financially destabilizing if companies are over-exposed to a geopolitical antagonist.

These economic vulnerabilities become national security risks in the context of intensifying geo-political competition, not least because of the so-called security externalities of economic cooperation. The table summarizes available mitigation policies.

Diversification is typically the most desirable option in terms of the trade-off between economic risk reduction and economic costs. A robust and credible deterrence policy is another, if not necessarily fool-proof, 'cost-effective' option for limiting economic vulnerability. Reshoring is often economically very costly, and while it may reduce dependence on foreign markets, it can also increase so-called concentration risks, potentially outweighing the benefits of reduced overseas dependence. Much depends on the specifics and on the desired economic cost/ risk reduction trade-off.

Step Three: Mobilize EU Geo-Economic Power

Germany must endow itself with the requisite bureaucratic-political capacity to implement economic vulnerability mitigation policies at the national level. Preparations at the national level are needed in case joint EU policies go nowhere or make insufficient progress. Yet German interests would be better protected under the roof of the EU. Therefore, Germany should continue to push for a common EU approach to geo-economic defense and deterrence as well as to mitigation policies. While many important policy areas, such as inward investment screening and export control policies, remain under the purview of national governments, EU members are moving toward closer coordination and cooperation in many areas. Closer coordination and greater integration of policies in these areas are needed.

The EU Is the second largest economy in the world. It is a major importer and exporter as well as a major creditor and debtor. The euro is the second most widely used international currency. All this gives Europe significant geo-economic and geo-financial leverage, provided it manages to mobilize it.[10] In the context of the quest for 'European strategic autonomy,' the EU has begun to assess its dependence on critical imports, and it has put forward an action plan.[11] But it needs to accelerate and intensify these efforts, not least in view of its recent experience with Russian energy imports. The EU is working to agree an economic toolkit to address its vulnerabilities. It will include the following instruments:

- An anti-coercion instrument[12] which would allow the EU to retaliate against trade restrictions without waiting for a WTO ruling, using trade, investment, and other economic restrictions and retaliatory measures.
- An anti-subsidy instrument[13] which would limit the subsidies that companies from outside the EU can receive if they want to acquire EU companies.
- An international procurement instrument[14] which would limit non-EU companies' access to the EU's public procurement market if the company's home country did not grant reciprocity.
- A so-called single market emergency instrument[15] which would allowing the EU to impose export restrictions on a variety of goods.

Importantly, as mentioned, the EU has also sought to streamline and coordinate national export control policies as well as national-level inward investment policies. [16]

The EU should also think about making it easier to impose not just EU-wide trade but also financial sanctions, such as limiting third-party access to EU financial markets and the euro.[17] There are, of course, limits for how far Europe can go down this road. European financial sanctions targeting America would be neither credible nor very effective, let alone politically feasible or desirable. China's leverage, too, will grow to the extent that the country continues to open its domestic financial markets to foreign investment, including foreign financial service providers It nevertheless makes sense for the EU to endow itself with adequate instruments to deter or retaliate against third-party geo-financial coercion. Similarly, a common, more integrated sanctions policy would at least allow the EU the option of taking forceful action, regardless of whether it would be opportune to do so in a specific instance. Institutionally, Europe would also benefit from the creation of an EU-wide equivalent of America's Office of Foreign Assets Controls charged with sanction implementation.

In brief, the EU should seek to integrate and centralize relevant foreign economic policy areas to preempt third parties from leveraging the economic vulnerabilities of individual member states, such as Germany, and to strengthen the EU's economic and political deterrence potential and power vis-à-vis third parties.[18]

Germany should continue to support the strengthening of EU competencies as long as the parameters under which delegation occurs allow for calibrated and effective geo-economic deterrence. A sensible and effective joint policy capable of mobilizing the combined economic size of the EU in terms of trade, investment, and finance would go some way toward addressing German and European economic vulnerabilities. But Germany and the EU must also be cognizant of the fact that deterrence can and does fail, and if it does, economic vulnerabilities will be exposed. Hence, it is imperative to push forward with

10 Markus Jaeger, Designing Geo-Economic Policy for Europe, DGAP, 2022: https://dgap.org/en/research/publications/designing-geo-economic-policy-europe (last accessed: 25 June 2022).

11 European Commission, Strategic Dependencies and Capacities, Commission Staff Working Document, 2021: https://ec.europa.eu/info/sites/default/files/swd-strategic-dependencies-capacities_en.pdf (last accessed: 25 June 2022). European Commission, Action Plan on Critical Raw Materials, 2021: https://ec.europa.eu/docsroom/documents/42852 (last accessed: 25 June 2022).

12 European Commission, Trade Defence, April 17, 2020: https://ec.europa.eu/trade/policy/accessing-markets/trade-defence/ (last accessed: 25 June 2022). European Commission, EU strengthens protection against economic coercion, 2021: https://ec.europa.eu/commission/presscorner/detail/en/ip_21_6642 (last accessed: 25 June 2022).

13 European Commission, Trade Defence Instruments, 2018: https://trade.ec.europa.eu/doclib/docs/2018/may/tradoc_156892.pdf (last accessed: 25 June 2022).

14 European Parliament, EU International Procurement Instrument, 2022: https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649403/EPRS_BRI(2020)649403_EN.pdf (last accessed: 25 November 2022).

15 European Parliament, Single Market Emergency Instrument, 2022: https://www.europarl.europa.eu/legislative-train/theme-a-europe-fit-for-the-digital-age/file-single-market-emergency-instrument: (last accessed: 25 June 2022).

16 Kirkland & Ellis, New EU foreign investment regulations take effect, October 29, 2020: https://www.kirkland.com/publications/kirkland-alert/2020/10/eu-fdi-regulation (last accessed: 25 June 2022).

17 European Commission, Restrictive Measures (Sanctions): https://ec.europa.eu/info/business-economy-euro/banking-and-finance/international-relations/restrictive-measures-sanctions_en (last accessed: 25 June 2022).

18 Markus Jaeger, Defense and Deterrence Against Geo-Economic Coercion – What Germany and the Eu Can Learn from China and the United States, 2022: https://dgap.org/en/research/publications/defense-and-deterrence-against-geo-economic-coercion (last accessed: August 15, 2022).

the mitigation of economic vulnerabilities at both the EU and the national level. This is the only way to limit economic harm, should trade and investment relations with third countries break down completely, as they might in case of a war in East Asia.

Whether or not war breaks out in East Asia, and whether or not Germany goes along with Washington’s geo-economic policies targeting Beijing and runs the risk of Chinese retaliation, Berlin needs to adopt a more strategic approach to national economic security. This must involve national bureaucratic-institutional reform and the formulation and implementation of cost-effective risk-reduction policies as well as a much more effective mobilization of the EU’s latent geo-economic power. There will be economic costs, but the reward is to reduce Germany’s and Europe’s economic vulnerabilities and concomitant political coercibility. The Ukraine war should serve as a reminder of just how urgent this task has become.

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