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DGAP POLICY BRIEF

Economic Equidistance is Not an Option

Germany and the US-Chinese Geo-Economic Conflict



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Intensifying US-Chinese rivalry will increase pressure on Germany to support a more hawkish US geo-economic policy. The new German government should give Washington support in as far as US policies seek to create an economic level playing field vis-à-vis China. Given its dependence on international trade and investment, Germany should seek to resist a broader politicization of international economic relations.

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- In the face of intensifying US-Chinese competition, Germany needs to be able to deter, and, if necessary, retaliate against geo-economic measures affecting its interests. At a minimum, it must be able to reduce the negative impact of such measures.

 - As a first step, the new German government should conduct a broad and wide-ranging National Economic Security Review of all critical economic, financial, and technological vulnerabilities vis-a-vis economic partners outside the EU.

 - Ideally, Germany would cooperate with the EU or at least other EU member states to mitigate those vulnerabilities. Where this proves ineffective or impossible, national policies need to be devised.

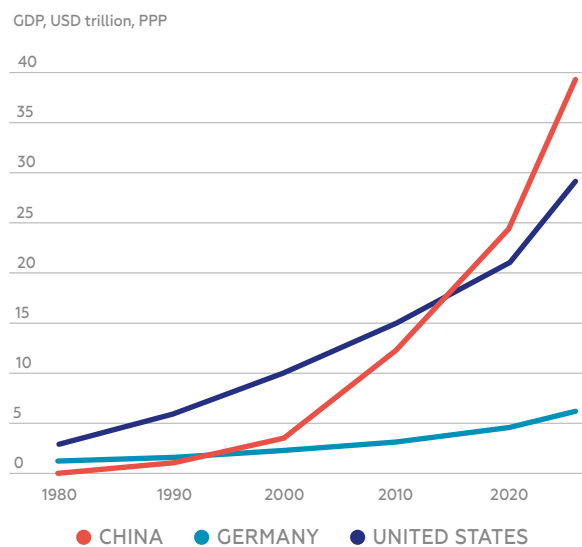
 - Such policies should include a smart, targeted investment program aimed at addressing technological vulnerabilities as well as critical import dependencies.
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CAUGHT BETWEEN TWO GREAT POWERS

Germany is at risk of sustaining collateral economic damage in the face of intensifying US-Chinese competition and conflict. China's ascendance and America's desire to preserve the geo-political status quo have locked Beijing and Washington into a classic security dilemma. The United States sees China's rise as a threat to the status quo in Asia. It also sees China as a nascent global systemic challenger.¹ As a matter of fact, security competition is already well underway in East Asia (and further afield),² as is geo-economic³ and geo-technological conflict.⁴

economic partner – to align with US geo-economic policies. A failure to do so would negatively affect German-US relations and German economic interests, as Washington is unlikely to shy away from pursuing its geo-economic goals unilaterally, including via export controls, secondary sanctions, and other similar measures. However, if Germany does fall in line with US policies targeting China, it risks provoking Chinese economic retaliation. This could take the guise of trade and investment restrictions, regulatory discrimination, or even countersanctions. The potential for economic damage is significant, given that the United States and China are Germany's two most important economic partners outside the EU.

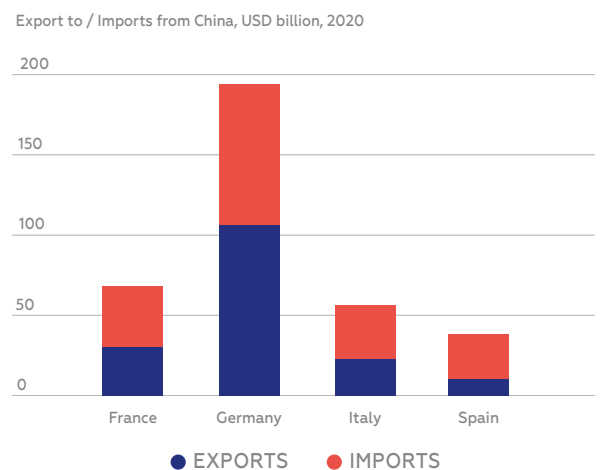
CHINA'S GDP GROWTH SPURT



Source: IMF World Economic Outlook

Intensifying US-China competition will have profound consequences for Germany. Not only will security competition limit the amount of resources Washington will be willing and able to commit to European security. US-Chinese geo-political rivalry will also have negative economic consequences for Germany. Geo-economic conflict will lead Washington to increase the pressure on Europe and especially Germany – China's most important European eco-

GERMANY IS CHINA'S MOST IMPORTANT ECONOMIC PARTNER IN EUROPE



Source: IMF Direction of Trade Statistics

Germany's ability to affect the overall course of US-Chinese relations will be very, very limited at best. Its ability to influence individual policies will also be very circumscribed. To the extent that US geo-economic policies vis-à-vis China are driven by security interests, Washington will consider any economic collateral damage caused to German and European economic interests a secondary concern. In particular, Germany's continued security

1 Systemic in the sense of challenging the dominant position of the United States in the international system as well as in the sense of China challenging the norms and rules underpinning the present system.
 2 Department of Defense, Summary of the 2018 National Defense Strategy: <https://dod.defense.gov/Portals/1/Documents/pubs/2018-National-Defense-Strategy-Summary.pdf> (accessed January 16, 2022).
 3 Geo-economics can be defined as the use of economic means to pursue geopolitical ends.
 4 Congressional Research Service, US-China Relations, September 3, 2019: <https://crsreports.congress.gov/product/pdf/R/R45898> (accessed January 16, 2022).

dependence on the United States limits the extent to which Berlin can afford to deviate from US positions, let alone align itself – even if only economically – with China. Washington would be reluctant to underwrite German security to the extent that it does if Berlin sided economically with Beijing.

A position of relative economic neutrality or economic equidistance is not a viable option for Germany, either. For US geo-economic policies to be successful, Washington will require German cooperation, or at least compliance, lest Germany act as a so-called ‘third-party spoiler.’⁵ Washington is highly unlikely to accept German economic neutrality, as this would effectively allow Germany to indirectly benefit from US geo-economic policies while weakening their heft. The more intense US-Chinese competition, the more pressure Europe, and especially Germany, will be under to align with US geo-economic policies towards China.

US-CHINESE COMPETITION AND GERMAN INTERESTS

Germany does share many of Washington’s goals, including the preservation of the territorial status quo in East Asia, freedom of navigation, and the creation of an economic level playing field, namely reciprocal market access, an end to regulatory discrimination, a reduction of government subsidies, the elimination of technology transfer requirements, and so on.⁶ However, it does not necessarily agree with the way the United States goes about pursuing these objectives, including via unilateral measures which violate the very rules-based order Germany wants to see being upheld. Berlin is also afraid of provoking Chinese retaliation against German economic interests if it confronts Beijing too forcefully and too directly. After all, the more hawkish US geo-economic policies become and the more Germany aligns itself with the United States, the greater the risk is to German economic interests. Yet it is also true that the broader the international coalition is that confronts China economically, the less effective and costlier it becomes for China to retaliate against individual members of such a coalition.

Germany should be wary of US–China rivalry leading to a more general weaponization of economic interdependence and to international economic instability. A broader politicization of US-Chinese and, by extension, international economic relations is not in Germany’s interest. Policies aimed at nudging China to level the playing field are consistent with German interests. Policies that risk fragmenting international economic relations and lead to economic, financial, and technological decoupling are not.

The rules-based multilateral economic order is an important factor underpinning German prosperity, and preserving it is a core German interest. Economic decoupling along geopolitical fronts, where Germany is forced to closely align itself with one side or the other, is to be avoided. Nonetheless, some ‘smart decoupling’ would make sense if it was aimed at limiting critical economic vulnerabilities and at keeping Germany’s technological leadership from being undermined by mercantilist or state-capitalist practices. Such measures could help prevent longer-term damage to the country’s economic and national security interests – provided they are smart, selective, and strategic. As a consequence, decoupling should be limited to sectors that are characterized by critical vulnerabilities and closely tied to national security.

STRATEGIC REASONS FOR SIDING WITH WASHINGTON

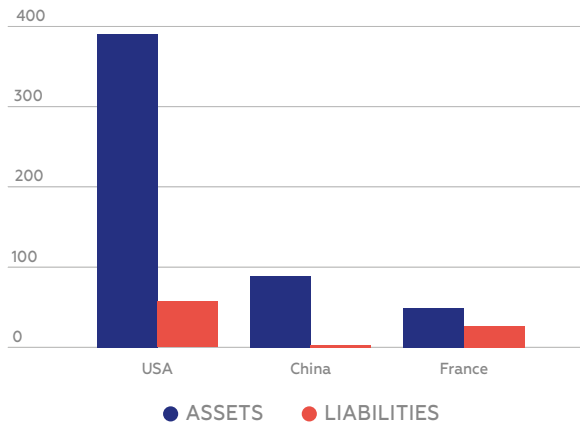
Even a completely realpolitik-oriented Germany would have good reasons to remain broadly aligned with the United States. Not only does Germany depend on the United States for its security. The transatlantic partnership is also a crucial economic relationship, covering not just trade and investment (German FDI in the United States far outstrips German FDI in China), but also, critically, offering Germany access to advanced technology. While China is catching up fast technologically, it currently still lags behind the United States. Critical technology is also more likely to be shared within alliances than across, making it less likely that the United will exploit technological dependencies extensively.

5 Bryan Early, *Sleeping with your friends’ enemies*, *International Studies Quarterly*, 53(1), 2009. A third-party spoiler is an actor (typically a state) that undercuts the effectiveness of another state’s sanctions by engaging economically with a sanctioned state.

6 Germany has tightened FDI legislation and lent its support to a variety of EU-level initiatives aimed at making the level playing field less uneven, including trade defense measures, anti-coercion instruments, an EU FDI screening mechanism, and so on.

GERMAN OUTWARD FDI FAR EXCEEDS INWARD FDI

German FDI by country, EUR billion, 2019



Source: Bundesbank, Direct Investment Statistics

Longer-term, the United States also looks 'great power competitive' in spite of China's impressive ascent. The country stands a good chance of maintaining its geo-strategic and geo-economic position in Asia and beyond. China suffers from important structural weaknesses, including adverse demographics, the infamous middle-income trap, dependence on critical foreign technology, and uncertainties concerning the longer-term domestic political outlook. While the United States admittedly also faces important political and economic challenges, geopolitically it has one critical advantage: allies. Washington has security alliances with most of the world's major powers. Beijing has no formal alliance with any country (except for North Korea), at least as far as formal mutual defense treaties are concerned.

Furthermore, China's geographic position puts it at a disadvantage vis-à-vis the United States. While China faces out on two island chains, the United States benefits from an unfettered access to both the Atlantic and the Pacific. While the United States has friendly and far less powerful neighbors to its North and South, China is surrounded by reasonably powerful states, few of which it is on very friendly terms with. The United States acts as an offshore balancer in the region, while China is embroiled in a significant number of territorial and maritime disputes. Short of an armed conflict, a major geopolitical realignment in Asia is unlikely.

While it is certainly true that countries in the region would prefer not to have to choose between the

United States as the principal security provider and China as their most important economic partner, security is, in the end, bound to trump economics. And as long as Washington is perceived to be committed to upholding the regional status quo, the present geopolitical constellation and existing security alliances will not change much. Therefore, even if Germany were a perfectly realpolitik-oriented actor (it isn't, for sound historical and political reasons), it would nonetheless have good reason not to opt for a policy of economic equidistance and instead remain broadly aligned with the United States.

Finally, the United States has a solid track record of relatively liberal leadership. By comparison, the prospect of Chinese leadership or indeed hegemony creates greater uncertainty – not just for security competitors like Japan or Australia, but also for economic partners like Germany. All of which is to say that Germany has plenty of reasons to broadly support the United States. To the extent that US policies aim to preserve the territorial status quo in Asia, maintain an open international economic architecture, and establish an economic level playing field, German has every reason to lend support. The challenge for German decision-makers will be to selectively support US policies, namely where US and German interests align, while deflecting intensifying pressure to also conform to more hawkish US policies.

PROVIDE WASHINGTON WITH SELECTIVE SUPPORT

Germany should consider pursuing a multi-track approach consisting of offering Washington limited and conditional support for its China policy. Where US objectives include the establishment of a level playing field and the imposition of narrow restrictions in sectors critical to economic and national security, Germany should lend its support. Where policies endanger the broader multilateral economic architecture, Germany should seek to withhold its support. Equally, Germany should not endorse a broader economic decoupling in the context of a weaponization of economic interdependence. Conditional support should be flanked by a policy aimed at minimizing, or making more manageable, critical German and European economic, financial, and technological vulnerabilities.

Such a strategy should also be accompanied by efforts to resolve important outstanding US-EU economic disputes as well as efforts to deepen trans-

atlantic economic cooperation. Major trade and investment deals will remain out of reach, given domestic political obstacles on both side of the Atlantic. But issue-oriented cooperation is possible, including politically less onerous regulatory coordination, technological cooperation, standard setting, safeguarding of critical supply chains, and so on (for instance with the EU-US Trade and Technology Council).⁷

Such cooperation and coordination should help Americans and Europeans move towards a joint position with respect to reform of the multilateral trading system and the levelling of the playing field vis-a-vis China. Broad agreement between the United States and the EU might improve the chances of getting China to agree to at least some reform. Conveniently, such a broader transatlantic and multilateral coalition would also provide Germany with some diplomatic cover and make it somewhat less vulnerable to Chinese retaliation.

More specifically, Germany and the United States should be able to agree on common policies pertaining to emerging technologies in light of their potential security externalities and implications for international leadership. National security is undoubtedly a more sensitive issue for the United States, given deteriorating US-Chinese security relations. Washington is therefore bound to define national security more expansively. But, like the United States, Germany also has an interest in preserving technological leadership against unfair competition and state-led, discriminatory economic practices. It is, or should be, equally concerned about the potential security implications of emerging technologies. Disagreement may nonetheless arise due to Germany's preference for more narrow restrictions and hence more selective technological decoupling.

The United States is also far less sensitive to Chinese geo-economic retaliation than Germany and will therefore be more willing to weaponize the existing economic and technological interdependence in pursuit of broader political and strategic objectives. Germany's greater economic sensitivity and the fact that it has fewer security-related concerns will make it less inclined to support an extensive, hawkish geo-economic agenda. It is precisely Germany's

greater economic vulnerability that opens it up to direct and indirect geo-economic pressure from the United States as well as China.

While Washington and Berlin will not see eye to eye on all issues, reaching wide-ranging, if imperfect transatlantic agreement on inward investment and export control policies should be possible. To the extent that many of these policies are only effective if they benefit from multilateral support, Germany and the EU may have some limited influence, which they might be able to use to nudge Washington away from maximalist policies. The United States would prefer to win German and EU support rather than having to resort to more acrimonious and potentially less effective secondary sanctions to bring German (and EU) policies in line. However, the more intense US-Chinese competition becomes, the less influence Germany and the EU will have.

ACCELERATE EFFORTS TO REDUCE VULNERABILITIES

This is why the new German government (and the EU) should also intensify efforts to reduce critical economic, financial, and technological vulnerabilities. Berlin (and Brussels) urgently needs to enhance its ability to deter, and, if necessary, retaliate against geo-economic measures affecting its interests.⁸ At the minimum, it must try to reduce the negative impact of such measures.

At EU level, the Commission has proposed trade defense and anti-coercion policies.⁹ EU efforts have also focused on understanding existing supply chain vulnerabilities, especially concerning technology and commodities.¹⁰ The next steps should be about making the anti-coercion measures operative and credible as well as addressing (rather than merely identifying) supply chain related vulnerabilities. Risk mitigation policies related to trade should generally be pursued at EU level, given that most aspects of trade policy fall under EU purview. More importantly, a common or at least coordinated EU policy both helps mitigate risks more effectively and acts as a greater deterrent vis-à-vis third parties.

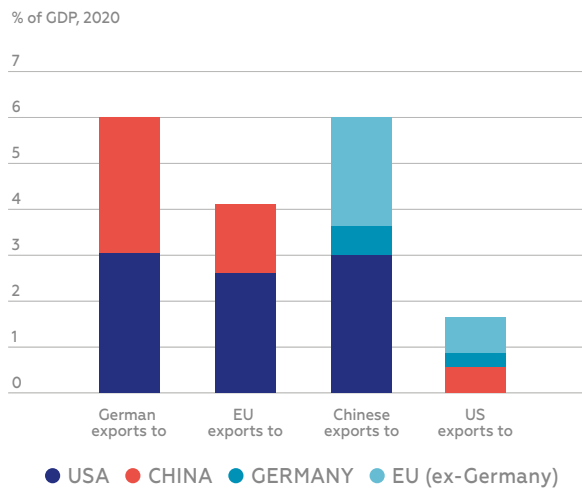
7 European Commission, EU-US Trade and Technology Council, 2021: https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_21_4951 (accessed January 16, 2022).

8 Markus Jaeger, Countering Secondary Dollar Sanctions, DGAP (forthcoming).

9 European Commission, Trade Defence, April 17, 2020: <https://ec.europa.eu/trade/policy/accessing-markets/trade-defence> (accessed January 16, 2022); Financial Times, EU plan to tackle 'coercion' against member states faces resistance, December 7, 2021.

10 European Commission, Study on EU's list of critical raw materials, 2020; European Parliament, Extraterritorial sanctions on trade and investment and European responses, November 20, 2020. [https://www.europarl.europa.eu/thinktank/en/document/EXPO_STU\(2020\)653618](https://www.europarl.europa.eu/thinktank/en/document/EXPO_STU(2020)653618) (accessed January 16, 2022).

GERMANY IS HIGHLY TRADE DEPENDENT



Source: IMF, own calculations

The European Commission has also launched several initiatives in terms of investment and technology policies.¹¹ However, these are domains where it has far fewer prerogatives, particularly in relation to third parties. Therefore, it will be more difficult to find agreement on a common EU approach. This was amply demonstrated by recent intra-EU disagreement regarding FDI screening. Nonetheless, the EU's anti-coercion policy may be helpful in addressing investment- and technology-related coercion, though it is far from clear at the moment how effective it will turn out to be (see forthcoming Policy Brief).

Some of the investment- and technology-related vulnerabilities will need to be addressed at the national level or, where expedient, at the inter-governmental level in cooperation with other like-minded countries. Comprehensive coordination at EU level may simply be too onerous and time-consuming if any agreement on a sensible and effective policy is to be reached at all. The new German government should therefore consider launching an investment program aimed at identifying and mitigating risk related to existing technological dependencies as well as a policy aimed at identifying and addressing critical import dependencies. Both policies need to be closely coordinated with the private sector. Policies aimed at mitigating export-related vulnerabilities,

such as discriminatory import policies of third countries, remain under the purview of the EU.

DEVELOP AN INTELLIGENT, FORWARD-LOOKING NATIONAL ECONOMIC STRATEGY

This will require a thorough and comprehensive cost-benefit analysis of both existing vulnerabilities and the economic and financial costs of risk mitigation policies. The new German government should therefore conduct a broad and wide-ranging National Economic Security Review of all critical economic, financial, and technological vulnerabilities vis-a-vis economic partners outside the EU. Ideally, such vulnerabilities should be mitigated in cooperation with the EU or at least other EU member states. Once more, where this proves ineffective, national policies need to be devised.

The German government should approach international trade and economic policy more strategically. Given the rapid pace of technological development, future dependencies are bound to emerge sooner rather than later. In light of accelerating US-Chinese strategic competition and intensifying state-supported technology competition (Made in China 2025, China Standards 2035, US Innovation and Competition Act), Germany should study very carefully the potential costs and benefits of government-supported innovation and technology policies. Particular attention needs to be paid to transformative technologies including AI and quantum computing.

Designing successful industrial policy is tricky and fraught with risks, and ordo-liberal thinking remains prevalent in Germany. Nevertheless, the German government should appoint an independent export commission to make proposals on how to design such policies and which technologies to focus on. The Ministry of Economics with its Industrial Strategy 2030 has already taken a first step towards a national industrial policy.¹² In light of America's and China's innovation capacity and the huge amounts of public and private financial resources being deployed in both countries, industrial policy and innovation policies deserve greater and more detailed consideration in the German context.

11 European Commission, Foreign Direct Investment EU Screening Framework, February 2019: https://trade.ec.europa.eu/doclib/docs/2019/february/tradoc_157683.pdf (accessed January 16, 2022).
 12 Federal Ministry of Economic Affairs, Made in Germany: Industrial Strategy 2030, November 29, 2019: <https://www.bmwi.de/Redaktion/EN/Dossier/industrial-strategy-2030.html> (accessed January 16, 2022).

Reducing critical economic, financial, and technological vulnerabilities will afford Germany greater flexibility by making it less susceptible to geo-economic pressure and coercion, wherever they may come from. Reduced vulnerability will in fact enhance the prospect for transatlantic and international – including transatlantic – cooperation, as economic exchange becomes less risky and more difficult to exploit politically. Yet mitigation policies will not come for free, and policymakers need to carefully evaluate their costs and benefits in a comprehensive, strategic rather than piecemeal, haphazard manner.

US-Chinese competition is going to intensify, as is the geo-economic pressure that Germany will face over the coming years and decades. The weakening of the multilateral, largely non-discriminatory international economic regime calls for a more strategic and more political approach to foreign trade, investment, and technology policy. Preparing for more conflictual international economic relations will require astute diplomacy flanked by astute risk mitigation strategies.



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