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Promoting the Euro - Countering Secondary Sanctions: Germany Should Push to Complete Monetary Union

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DGAP POLICY BRIEF

Promoting the Euro – Countering Secondary Sanctions

Germany Should Push to Complete Monetary Union

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US-Chinese rivalry will increasingly play out in the geo-economic realm. The use of secondary sanctions – especially secondary dollar sanctions – negatively affects German economic interests. The new German government should therefore intensify efforts to promote the euro as an international currency coequal to the dollar in addition to lending its qualified support to EU anti-coercion policies.

– **Washington can unilaterally impose dollar sanctions with relative ease. Such dollar-based sanctions, even though they may target Chinese entities, will harm Germany's international commercial relations in the guise of so-called secondary sanctions.**

– **In the face of US financial statecraft, Germany's options are limited. Promoting the international role of the euro by completing monetary union and advancing capital markets union offers the best prospect of deterring and deflecting secondary dollar sanctions.**

ECONOMIC STATECRAFT AND SECONDARY SANCTIONS

The ability to restrict the cross-border flow of goods, services, capital, people, and data, and thereby to inflict economic damage on others, is a source of coercive power. In terms of trade, a government that sits atop a large domestic market or controls the flow of difficult-to-substitute goods, such as rare commodities or critical technology, is especially well-placed to exert influence. From the point of view of the economic actors targeted by such restrictions, this power is a source of economic and political vulnerability.

Export controls allow governments to prevent sanctioned entities, whether companies, individuals, or entire countries, from obtaining specific goods. Import restrictions similarly impose economic costs on designated exporters. Financial sanctions allow governments to prevent sanctioned entities from engaging in designated types of transactions with the domestic financial system or with residents.

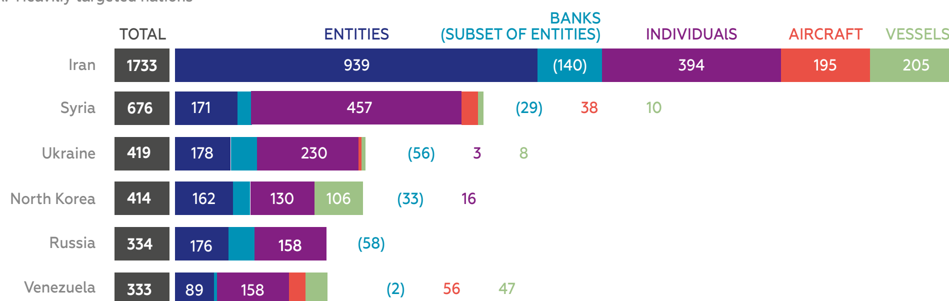
Measures solely targeting designated actors are called primary sanctions. Measures threatening third parties with market exclusion or the imposition of other penalties in case they engage in proscribed transactions with a primary sanction target are called secondary sanctions. Such measures effectively extend the sanctions regime to third parties. Secondary sanctions are often necessary in order to make the primary sanctions effective by preventing so-called "third-party spoilers."[1]

In the context of US-Chinese competition, the United States has imposed export controls and transfer restrictions to prevent certain Chinese companies from gaining access to American technology.[2] These sanctions not only prohibit US companies from selling, for example, semiconductors to designated companies. They also prohibit third parties that use US-produced or -licensed components in the production of these semiconductors from selling them to these same Chinese companies. If third parties fail to comply with US export controls, they risk losing access to their US suppliers. US secondary sanctions, in particular, are often quite effective because the potential costs for third parties (or secondary sanction targets) are typically far greater than the economic losses incurred by complying with US sanctions. Companies that refuse to comply risk stiff penalties or even complete loss of access to US markets and goods.

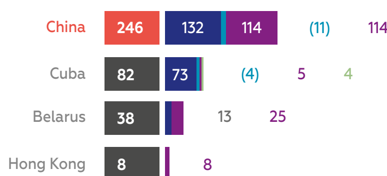
US FINANCIAL SANCTIONS

Recent targets of US financial sanctions by country and type

A. Heaviliy targeted nations



B. Other recent targets



Source: PIIE 2021
Note: Data report designations based on the Specially Designated Nationals and Blocked Persons List from the Office of Foreign Assets Control (OFAC) program tags by country. China and Russia data cover country-specific and other OFAC programs. Data as of January 4, 2021. Data do not cover all countries subjects to US sanctions.
Primary Source: OFAC Sanctions List Search

1 A third-party spoiler is an actor that weakens the effectiveness of a sanctions regime by engaging economically with a sanctioned entity. See Bryan Early, Sleeping with your friends' enemies, International Studies Quarterly, 53(1), 2009

2 Department of Commerce, Entity list: https://www.bis.doc.gov/index.php/policy-guidance/lists-of-parties-of-concern/entity-list (accessed: January 22, 2022)

US-CHINESE GEO-ECONOMIC CONFLICT IS INTENSIFYING: SELECTED MEASURES AND POLICIES

	UNITED STATES	CHINA
Trade Policy	Trump-era trade policies largely left remain in place, including US-China trade deal Multitude of policies and initiatives seeking to strengthen supply chain security	'Dual circulation' (economic rebalancing towards domestic consumption as well as greater reliance on domestic innovation) Founding member of the Regional Comprehensive Economic Partnership (RCEP); application to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) Consolidation of rare earth miners to enhance market power
Investment, Finance & Currency Policies	Tightening of foreign direct investment rules and granting of greater authority to the Committee on Foreign Investment in the United States (CFIUS) to screen foreign investment Threat to delist from NYSE Chinese companies refusing to submit to US audit inspections Ban on investment in debt, equity, funds containing securities linked to Chinese companies in sectors linked to defense and surveillance Build Back Better World (as the G7's alternative to China's Belt and Road Initiative)	Security checks on overseas listings (in order to prevent sensitive data from being obtained by foreign regulators) Delisting of selected Chinese firms from US stock exchange Belt and Road Initiative (BRI); Asian Infrastructure Investment Bank (AIIB) RMB internationalization; creation of e-yuan; development of a cross-border interbank payments system (CIPS), originally envisaged as an alternative to SWIFT
Technology & Export Control Policies	Proposed Investment and Competition Act and various other laws to support US technological leadership Strengthened export controls, targeting Chinese companies Restrictions on transfer of 'foundational and emerging technologies' (e.g., quantum computing, aerospace, semiconductor technologies)	National strategic development plan to develop manufacturing/ high-technology sector and reduce dependence on foreign technology (Made in China 2025) Strategic plan to set global standards for emerging technologies (China Standards 2035) Data localization requirements under updated national security legislation
Sanctions Policy	Sanctions targeting Chinese entities (see chart above)	Unreliable entity list Blocking statute (prohibiting companies from complying with foreign sanctions) Anti-foreign sanctions law (allowing companies that suffered losses due to third-party compliance with foreign sanctions to sue for compensation; applies to Chinese subsidiaries of foreign companies)

Source: Author's compilation

Similarly, the costs incurred by a foreign bank in case of loss of access to the US financial system typically far outweigh the damage caused by having to terminate a commercial relationship with a sanctioned entity (or even a whole country). Access to US financial markets and especially access to dollar funding and clearing is a difficult-to-substitute 'economic' good, for the dollar remains by far the most important currency for international trade and finance. It is the fact that the US currency is so difficult to substitute that makes dollar sanctions, including secondary sanctions, so effective.

EU TOOLKIT TO COUNTER SANCTIONS

In the past, the EU proposed various largely legal remedies to cope with the threat of extra-territorial and secondary sanctions,[3] including resorting to inter-state dispute settlement mechanisms or, in the case of companies and citizens, bringing complaints to US and EU courts. However, such legal recourse is costly, time-consuming, and not necessarily successful. The EU also proposed policies aimed at helping companies and individuals affected by secondary sanctions, for instance by sharing information and providing support. This, however, does not solve the problem either.

On its face, the so-called EU blocking statute looks like the most promising tool to counter secondary sanctions, including dollar sanctions. A blocking state is meant to shield companies in a given jurisdiction against sanctions by prohibiting them from complying with them. If the EU ever enforced its statute vigorously – which it has so far been reluctant to do – it might in theory deter foreign governments from imposing secondary sanctions. Yet if such deterrence fails, there will be considerable fallout: European companies – and especially banks in the case of dollar sanctions – will not have gained any protection from the hefty penalties foreseen by US sanction laws, including denial of market access. Furthermore, an unsuccessful EU attempt to block secondary sanctions could jeopardize transatlantic financial relations more broadly, as it is far from clear that enforcing the statute would lead US policymakers to refrain from imposing dollar sanctions. Given the currently limited costs of dollar sanctions to the United States (for example, European banks exiting the US market) and the significant costs for individual European companies (particularly European banks which would largely lose the ability to conduct dollar transactions), the balance of power strongly tilts in America's favor.

With specific regard to countering secondary dollar sanctions, various proposals have been put forward,[4] including the creation of a public bank to prevent European financial institutions from falling afoul of dollar sanctions; creating an EU resilience office to support affected European entities; and enhancing the international role of the euro to avoid having to use the dollar. However, the creation of a special purpose vehicle to circumvent US Iran sanctions (the so-called INSTEX)[5] has fallen far short of expectations, to say the least. Furthermore, creating a resilience office is more of a palliative than an effective remedy. It certainly is not an effective deterrent or a policy that meaningfully mitigates risks and costs.

The EU is continuing its efforts to remedy the relative ineffectiveness of its remedies against secondary sanctions in the context of its 'trade defense' and 'anti-coercion' policies. The European Commission defines coercion as "seeking to pressure the union or a member state into making a particular choice by applying, or threatening to apply, measures affecting trade and investment."[6] The latest Commission proposal proposes imposing tariffs and quotas, restricting intellectual property rights, and even locking out offending countries from EU financial markets as well as its procurement market in case of economic coercion (see also forthcoming Policy Brief on Economic Coercion).

In order to make this strategy both credible and effective, the Commission seeks to designate its new proposals as trade policy. This is meant to enhance its deterrence effect, as EU trade policy actions can only be blocked by a qualified majority of member states. In contrast, if the anti-coercion policies were to be designated a foreign policy instrument, they

3 European Parliament, Extraterritorial sanctions on trade and investment and European responses, 2020: https://www.europarl.europa.eu/thinktank/en/document/EXPO_STU(2020)653618 (accessed: January 22, 2022)

4 EUCFR, Meeting the challenge of secondary sanctions, 2019: https://ecfr.eu/publication/meeting_the_challenge_of_secondary_sanctions (accessed: January 22, 2022)

5 INSTEX (or Instrument in Support of Trade Exchanges) is a European special purpose vehicle created to facilitate non-SWIFT transactions with Iran to avoid US dollar sanctions. It is widely considered a failure.

6 European Commission, Commission Proposal for an Anti-Coercion Instrument, December 8, 2021: https://trade.ec.europa.eu/doclib/docs/2021/december/tradoc_159958.pdf (accessed: January 22, 2022)

would need the unanimous approval of all member states.[7] It remains to be seen whether and in what exact form the proposal will be approved by the member states. From the perspective of individual EU countries, such a policy risks entangling them in geo-economic conflicts they have little or no interest in. At the same time, an anti-coercion policy that requires unanimity would put the EU at a disadvantage, as other governments can pursue a selective 'divide-and-rule' approach to neutralize the potential EU countersanctions/retaliation threat.

The credibility and effectiveness of such a policy also remain constrained because it does not change the fact that European companies have little interest in falling afoul of US secondary sanctions as long as the potential costs of violating sanctions far exceed the costs of terminating their commercial relationship with a sanctioned entity. The EU could force European companies not to comply with US sanctions via the blocking statute. But, again, unless this actually deters US sanctions, EU companies will nonetheless incur significant costs. And with the dollar playing a far more important role in terms of international and trade and finance than the euro, a policy of proportional retaliation will not be very credible, as the EU lacks 'escalation dominance.'

DOLLAR DOMINANCE AND DOLLAR SANCTIONS

Fundamentally, it comes down to this: As long as the costs of complying with US dollar sanctions are significantly smaller than the costs of violating them, companies and especially banks will have a strong interest to comply. And as long European companies are more dependent on the dollar than US entities are on the euro,[8] European threats of retaliation will lack credibility. In order to deter secondary sanctions, retaliation has to be credible, and credibility typically requires the ability to impose economic costs which are at least equivalent to the costs incurred. From the point of view of an individual company threatened by secondary sanctions, it is almost always the least bad option to forego sanctioned business rather than risk violating US sanctions, given the size of the US markets and/ or the reliance on the dollar. From the EU's point of view, it is very risky to assume that the United States will refrain from imposing (secondary) sanctions due to EU retaliation threats.

In this context, it is worth noting that China has just introduced a blocking statute and a countersanction policy instrument. Chinese companies that suffer losses because a foreign company or bank is complying with another country's secondary sanctions can take that company or bank to court for compensation. This includes seizing that operator's assets. In effect, this allows Chinese companies subject to primary US sanctions to retaliate against German companies in case they opt to comply with US sanctions. In practice, of course, the Chinese authorities have many other instruments to retaliate against or threaten companies that comply with US secondary sanctions, including regulatory discrimination. In case of a full-blown US-Chinese commercial conflict involving sanctions, German companies might be forced to choose which country's sanctions to comply with, thereby also defining which market access they will possibly have to forego.

In the case of dollar sanctions, this is prima facie not a difficult choice for German banks. Losing access to the US financial system is much costlier than losing access to China's financial system, should China restrict the already limited access of German banks. (Of course, the Chinese authorities may decide to retaliate in other ways.) The dollar is of far greater importance than the renminbi in international trade and finance.

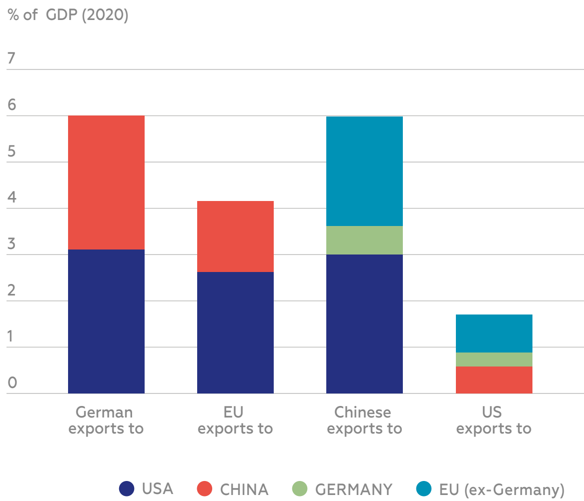
The effectiveness of dollar sanctions is closely tied to dollar dominance and so-called asymmetric interdependence.[9] This effectively undermines Europe's, let alone Germany's, ability to deter secondary dollar sanctions. EU deterrence and retaliation also lack credibility because the United States has escalation dominance given how much more important the dollar is than the euro. The present EU proposal explores the possibility of 'horizontal escalation,' whereby the EU would retaliate in, for example, the trade sphere. But such a policy would be risky and lack credibility vis-à-vis the United States, given how much less Americans depend on bilateral trade with the EU and particularly Germany. Such a policy might be more credible vis-à-vis China.

7 European Commission, Trade defence, 2021: https://ec.europa.eu/trade/policy/accessing-markets/trade-defence (accessed: January 22, 2022)

8 Congressional Research Service, Iran Sanctions, US grand strategy, chapter 3, 2021: https://sgp.fas.org/crs/mideast/RS20871.pdf (accessed: January 22, 2022)

9 Markus Jaeger, The logic (and grammar) of US grand strategy, 2021: https://dgap.org/en/research/publications/logic-and-grammar-us-grand-strategy (accessed: January 22, 2022)

LIMITED TRADE DEPENDENCE IS A SOURCE OF US LEVERAGE AND GERMAN/ EU VULNERABILITY

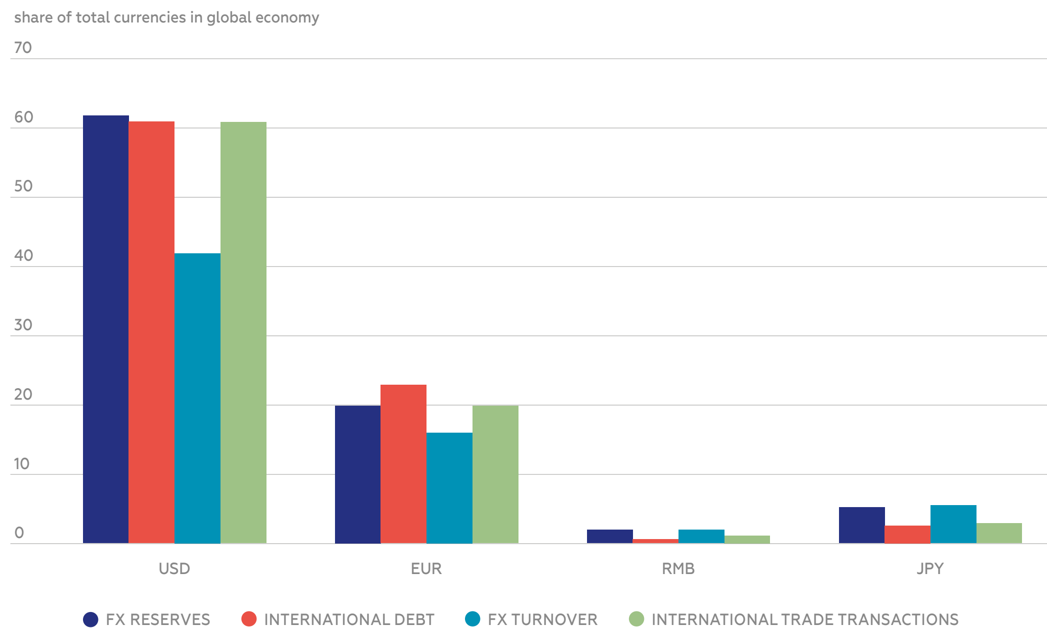


Source: IMF Direction of Trade Statistics

ONE DAY, THE EURO COULD RIVAL THE DOLLAR

The dominance of the dollar as an international currency is a source of US power and European vulnerability. The dollar makes up 60 percent of global central bank reserve holdings – three times the euro's share. For the official sector, the dollar is far more important than the euro in terms of FX pegs and FX reserves. For the private sector, this is true, too, even if the euro plays a slightly bigger role in terms of trade invoicing. Otherwise, the dollar is clearly dominant (FX market turnover, cross-border lending, commodity pricing). Few international financial intermediaries can afford to be excluded from dollar transactions or to lose access to US financial markets. This is precisely why secondary dollar sanctions are so effective. Meanwhile, and in spite of Beijing's internationalization efforts, the renminbi will not be rivalling the dollar as long as China is not prepared to open its capital account more fully, modernize its financial markets, and improve governance.[10]

DOMINANT DOLLAR IS A SOURCE OF GEO-ECONOMIC LEVERAGE



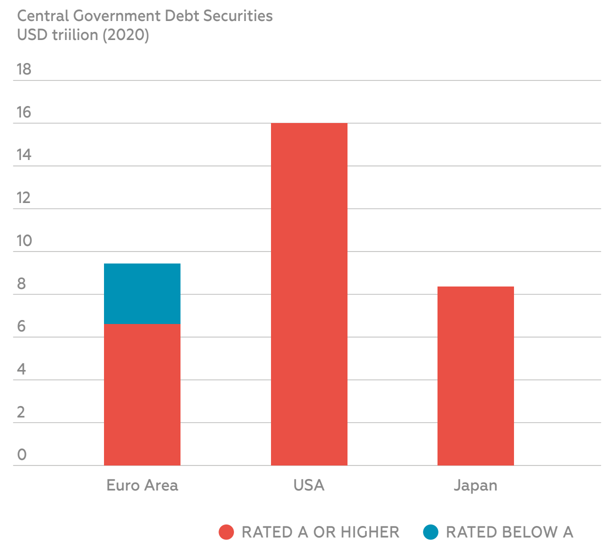
Source: BIS, IMF COFER

10 Markus Jaeger, Yuan as a reserve currency, Deutsche Bank, Research Briefing, 2010: https://www.dbresearch.com/PROD/RPS_EN-PROD/Research_Briefing%3A_Yuan_as_a_reserve_currency%3A_Lik/RPS_EN_DOC_VIEW.calias?rwnode=PROD0000000000454704&ProdCollection=PROD0000000000480994 (accessed: January 22, 2022)

Historically, international reserve currency status has been underpinned by a number of factors,[11] including economic size, financial development, effective governance, foreign policy ties, and military reach. The euro area meets most of the conditions necessary for the euro to become the dominant international currency, or at the very least an international reserve currency coequal to the dollar – but not all.

The US economy and the euro area are roughly comparable in terms of size. Good governance, rule of law, and respect of property rights are all in place. EU foreign policy ties may be somewhat weaker than those of the United States. But Europe's foreign policy ties are sufficiently strong so as not to represent an obstacle to the rise of the euro. Similarly, Europe is sufficiently strong in military terms to alleviate concerns about its geopolitical position and stability – even if the present crisis in the Ukraine raises some doubts about its political will and if the United States continue to be a far superior military power. The structural requirements for the euro to play a more important and ultimately coequal role appear to be in place, with the exception of financial market development.

LIMITED SIZE AND FRAGMENTATION CONSTRAINS EURO



Source: BIS, Government Debt Statistics

In order to promote a greater international role of the euro and reduce Europe's susceptibility to dollar sanctions, it is essential to create a large pool of safe and liquid euro-denominated assets. At present, there are several problems besetting euro-denominated government bond markets: They are too fragmented; a sizeable share of bonds is rated too low; there is much less liquidity than in the US government bond market; and investors have residual (and not unreasonable) concerns about the euro's long-term stability.[12] To ensure that assets are safe, monetary union will have to be completed, and this will invariably require greater risk pooling and fiscal-financial cooperation and integration among euro area members. Yet monetary union will provide a foundation for euro-denominated financial markets that are sufficiently large, liquid, and sophisticated to rival the dollar.

Not only are US financial markets larger than euro area markets, but dollar-denominated financial markets are also more sophisticated in terms of development and liquidity. European private capital markets also remain very fragmented. National regulation makes it more difficult and burdensome for euro-area banks, financial service firms, and investors to operate in the pan-European markets, thereby limiting the scale, efficiency, and diversification necessary to compete with US capital markets as well as US financial services providers. In order to make the euro more attractive for private sector agents, it is necessary to create a pan-euro capital and banking market (on the back of a euro-denominated safe asset) comparable to US financial markets. This in turn would enhance the euro as an international as well as a reserve currency.

HOW TO MITIGATE THE RISKS OF DOLLAR SANCTIONS

If the euro were successfully promoted to coequal status, this would help transform what today is an asymmetrical interdependent relationship between the United States and the EU, at least in terms of currency and financial relations. The balance of power would become more symmetrical as far as dollar sanctions are concerned. As a consequence, the use of secondary dollar sanctions would become less effective and potentially more costly to the United

11 Elias Papaioannou and Richard Portes, Costs and benefits of running an international currency, European Economy Economic Paper (348), 2008

12 IMF, Measuring liquidity in financial markets, Working Paper (232), 2002: https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Measuring-Liquidity-in-Financial-Markets-16211 (accessed: January 22, 2022)

States. The more US banks and companies come to rely on the euro and euro area capital markets, the more effective and credible European retaliation would become in response to US financial sanctions.

Similarly, the EU would risk less damage from dollar sanctions if more international trade and finance was conducted in euros. Sanctions would nonetheless remain costly, particularly for individual companies and especially banks. But deterrence and retaliation would become more credible, which should help reduce the risk of secondary dollar sanctions being imposed in the first place.

Promoting the euro as an international currency is the only realistic longer-term option to reduce, if not necessarily to completely neutralize, Europe's vulnerability vis-à-vis dollar sanctions. The only alternative and potential short-term remedy for the EU would be to threaten retaliation against 'dollar coercion' in other areas such as trade. The new EU proposal hints at this possibility. But this is a risky and potentially escalatory policy that needs to be analyzed very carefully before even lending qualified support to it (see forthcoming Policy Brief). Given the asymmetric trade relationship between the EU and the United States, let alone between Germany and the United States, threatening to provoke a trade war over targeted dollar sanctions may also lack credibility.

GERMANY SHOULD PUSH FOR COMPLETION OF BANKING AND CAPITAL MARKETS UNION

Historically, Germany (or at least the Bundesbank) opposed the deutsche mark from becoming an international currency for fear of losing control over monetary policy – and perhaps due to an adherence to ordo-liberalism. The EU and Germany have also been largely passive as far as the international role of the euro is concerned.[13] Proactively promoting the euro would represent an important policy shift. From an international perspective, it would nonetheless be a logical response to the politicization of international economic relations and the increasing use of secondary dollar sanctions.

This is not the place to lay out a detailed agenda of how best to complete monetary union, banking union, and capital markets union and thereby promote the euro. Germany, like most so-called creditor countries, has been reluctant to pool risks for fear of moral hazard, absent greater control over the finances of other euro area member. Debtor countries have been reluctant to give up control over their economic policies and only did so when they had no other choice in the context of the euro area crisis and rescue programs. The German government should nevertheless evaluate the costs and benefits of not completing monetary, banking, and capital markets union. Completing monetary union and successfully promoting the euro as a currency coequal to the dollar will undoubtedly require far-reaching compromises between creditor and debtor countries. But completing monetary, banking, and capital markets union is desirable – both in view of strengthening euro area stability and as in light of the intensifying US-Chinese geo-economic conflict and the concomitant the threat of secondary (dollar) sanctions.

In brief, proactively promoting the euro as an international currency would serve the EU's quest to reduce its geo-economic vulnerability. It would also help strengthen the political-economic foundation on which the EU's anti-coercion policy will need to rest, mainly by making currency-related countersanctions both more credible and effective. Completing the monetary and banking union as well as advancing the capital markets union would help make the euro area more resilient and therefore more attractive to non-European economic actors. Last but not least, a more symmetrical international monetary system would make Europe and Germany less susceptible to both unfriendly financial statecraft and the politicization of international economic relations against the backdrop of intensifying US-Chinese rivalry.

13 Benjamin Cohen, Currency statecraft (Chicago 2019)

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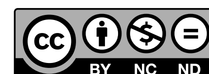

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