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Geoeconomics and Foreign Economic Policy – Quo Vadis EU?

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Key Messages

- Growing protectionism and geoeconomic tensions in the global economic environment pose major challenges, especially for the EU.
- International trade with countries outside Europe is a key factor for European prosperity. In the EU alone, 32 percent of manufacturing jobs and 36 percent of value-added in manufacturing depend on exports to non-member countries.
- In terms of economic security, the approach of targeted de-risking is generally pointing in the right direction. The focus should be on reducing dependencies in critical areas, not on cutting trade relations per se.
- Intensifying international trade, rather than protecting domestic production, is often the key to strengthening economic security.

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Geoeconomics and Foreign Economic Policy – Quo Vadis EU?

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The global economic environment has changed fundamentally over the past decade. The Brexit referendum in 2016 and the trade war between the United States and China launched by US President Trump were already clear signs that protectionism and economic nationalism have also become increasingly popular in Western countries. The weakness of the rules-based, multilateral trading system was further exacerbated by the US blockade of the WTO dispute settlement mechanism. Another profound shock to the global economy was the COVID-19 pandemic, whose global supply chain disruptions raised fundamental doubts about the stability of global supply chains and led to calls for greater regionalization or even nationalization of production networks. Since then, questions of economic "resilience" and "dependency" have moved to the center of economic policy discourse.

The Russian war of aggression against Ukraine ultimately marked a profound turning point for European trade policy in particular. From a European perspective, the suspension of Russian gas supplies was a painful reminder of how quickly trade relations can be weaponized. With geopolitical tensions on the rise around the world, there is also growing fear that economic interdependence will be used by geopolitical rivals for coercive measures to achieve political concessions. The International Monetary Fund (IMF) already sees the first signs of a geoeconomic fragmentation of the global economy, in which trade between geopolitical blocs is increasingly restricted in order to reduce the risk of economic coercion (Gopinath et al. 2024). Geoeconomics and economic security are thus increasingly shaping the way we think about globalization and how we design trade policies. But what do these changing conditions mean for the trade policy of the European Union (EU), whose foundations are based on openness, multilateralism and cooperation? This policy brief presents **four basic propositions** on the future direction of the EU's foreign economic policy.

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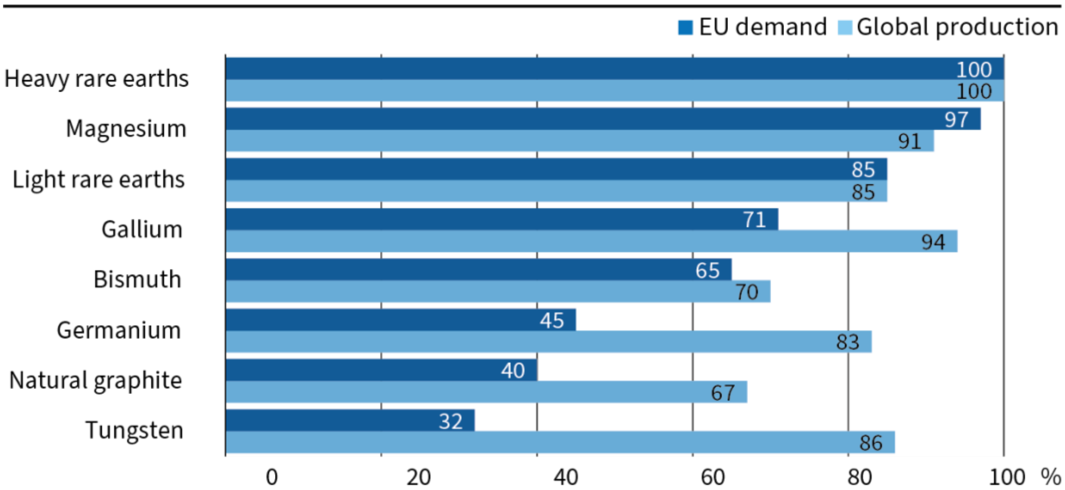
The Geoeconomic Ambiguity of Interdependence Requires a Balancing Act for Trade Policy

When the German government presented its long-awaited China strategy last summer, in which de-risking of German-Chinese trade relations played a central role, this quickly drew the attention of the Chinese embassy in Germany. In a statement, it issued an urgent warning against the "securitization" and "politicization" of trade relations (Chinese Embassy in Germany 2023). And indeed, quite a few people seem to wish for a time when geopolitics and economic coercion were simply not an issue in international economic relations. However, the example of China in particular shows that European foreign economic policy cannot afford such nostalgia. The cases in which the People's Republic has deliberately used economic relations as a means of exerting political pressure in recent years are numerous and well documented (Reynolds and Goodman 2023).

Figure 1

Strategic Critical Raw Materials with China as the Most Important EU-Supplier
China's Supply Share in %



Source: European Commission (2023); ifo Institute presentation. © ifo Institut

For example, the EU member state of Lithuania faced massive restrictions on its exports to China when it allowed Taiwan to open a representative office in the Lithuanian capital of Vilnius in 2021. Critical raw materials are another strategic chokepoint where Beijing is already flexing its muscles. As shown in Figure 1, the EU relies on China as a dominant supplier for a number of critical raw materials. In June 2023, China introduced export controls on gallium and germanium, followed by additional export controls on graphite in December. The geoeconomic risks associated with China's dominant position in many critical raw materials are hard to ignore in this context.

In a recently published book, Axel Springer CEO Mathias Döpfner proposes a radical response to the growing geoeconomic risks: The joint economic decoupling of all democracies from autocratic states such as China in the form of a "freedom trade alliance" (Döpfner 2024). He does not deny the enormous economic costs of such a decoupling, but in his view these costs are justified as the price of "protecting our values and sovereignty".[1] Could the cost of cutting trade ties with China and other autocracies be seen as a kind of insurance premium against economic coercion?

Such a view ignores the ambiguity of economic interdependence in security terms: It is true that deep trade interdependencies can have potentially high costs in the event of conflict. But it is precisely due to these opportunity costs in the event of conflict that profitable trade relations provide economic incentives for cooperative behavior on both sides.[2] So if one tries to justify the economic costs of decoupling from autocracies as a kind of insurance premium, one should also take into account that paying this premium tends to increase the probability of the insured event occurring. Due to this trade-off, the approach of targeted de-risking advocated by EU Commission President von der Leyen is generally pointing in the right direction: the focus should be on reducing dependencies in critical areas, not on cutting trade relations per se. However, implementing such a de-risking strategy in practice without falling prey to protectionist special interests is a challenging balancing act for trade policy.

Firms Respond to (Geopolitical) Risks - Government Intervention Requires an Economic Rationale

Discussions about how to reduce geopolitical and other risks in trade relations and how to strengthen the resilience of supply chains tend to focus on the options available to governments. However, it is often forgotten that firms themselves have a strong interest in resilient supply chains in order to avoid costly supply disruptions. For example, a recent firm survey conducted by the ifo Institute shows that the majority of German companies have invested in the resilience of their supply chains in the past year in order to reduce the risk of supply chain disruptions (see Fig. 2, cf. Aksoy et al. 2024). In particular, firms invested in diversifying supplier structures, increasing stock levels and improving supply chain monitoring. In order to strengthen the economic security and resilience of the European single market, a major task for policymakers is therefore to create the appropriate framework conditions for such business investments in supply

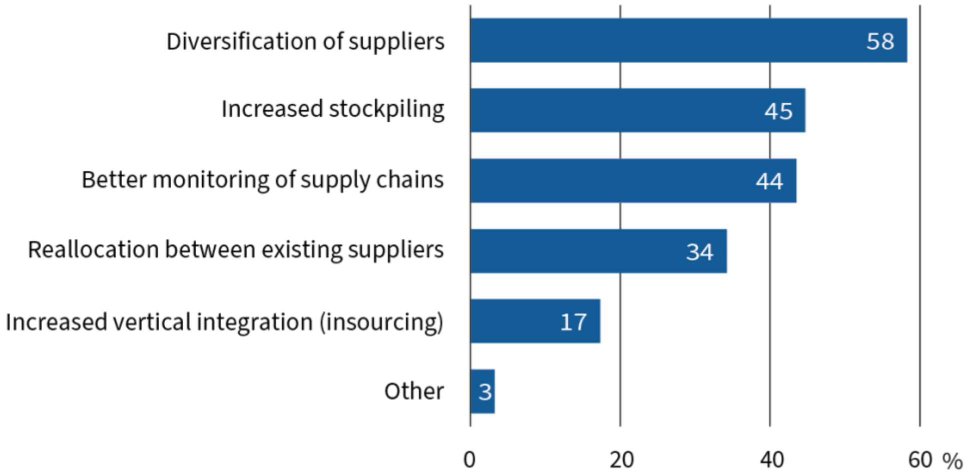
[1] The economic consequences of different decoupling scenarios have recently been analyzed in several simulation studies by the ifo Institute (Baur et al. 2023, Dorn et al. 2022).

[2] For a more in-depth discussion, see Thoenig (2023) and Copeland (2015).

chain resilience. Reliable and stable international trade conditions that support firms' efforts to diversify are an important building block.

Figure 2

Measures to Reduce the Risk of Supply Chain Disruptions
Manufacturing, multiple responses possible, share of German companies in %



Source: ifo Business Survey November 2023, Aksoy et al. (2024) . © ifo Institut

For more comprehensive government intervention in supply chains, however, the key question is to what extent firms have sufficient incentives to ensure the resilience of production networks to a socially desirable degree. First economic studies on this topic suggest that the answer to this question is complex and depends heavily on the specific production and market structures (Grossman et al. 2023, Elliott and Golub 2022). For example, a market failure might exist if supply shortages for certain products (such as pharmaceuticals) are significantly more serious from the perspective of society than from an individual firm's perspective, and the public risk assessment therefore differs significantly from that of the private sector (Baldwin and Freeman 2022). Also, the expectation of firms to be supported or even rescued by the state in the event of supply disruptions or loss of sales markets (*too big to fail*) could lead to excessive dependence on individual suppliers or markets (Scientific Advisory Board at 2023).

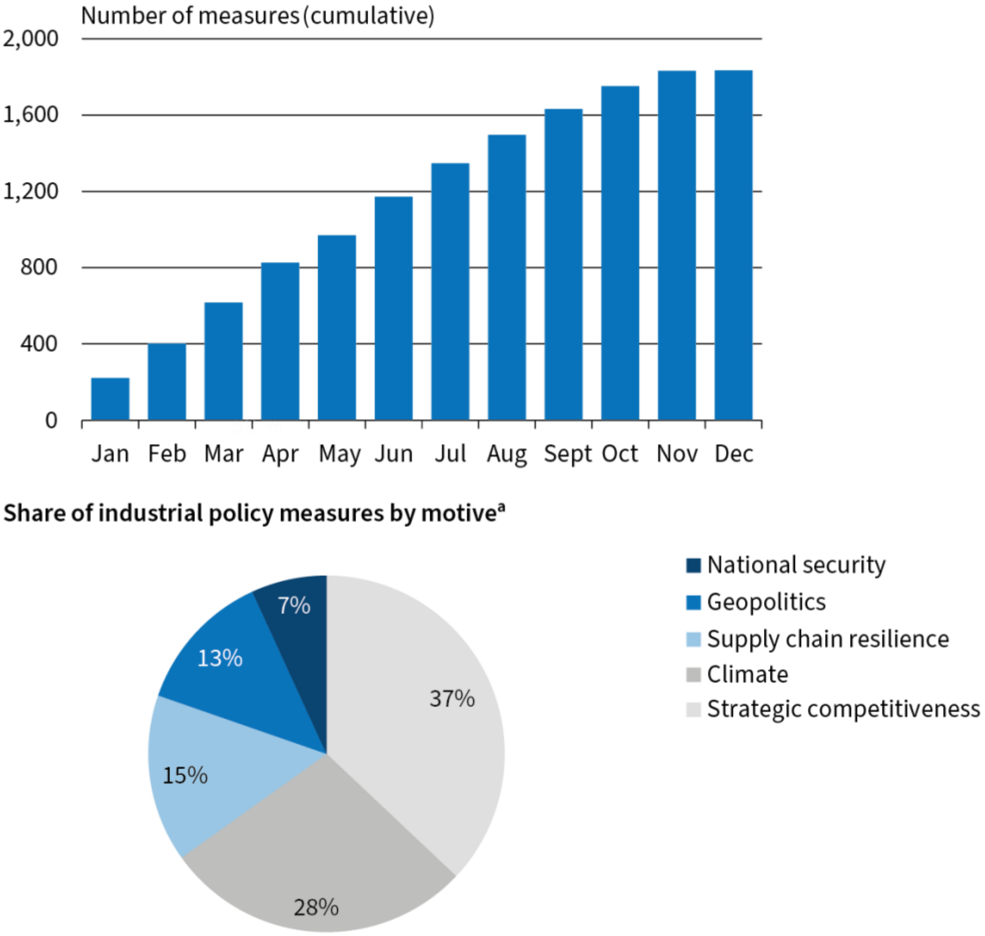
On the one hand, these examples show that government intervention to strengthen economic resilience can be economically justified in certain cases. On the other hand, they also illustrate that such a justification has to serve as a starting point for the design of corresponding economic policies.

Reducing Trade Dependencies Does Not Automatically Require Industrial Policy

At least since the outbreak of the COVID-19 pandemic, there has been a global revival of industrial policy, which has gained further momentum over the past year (see Fig. 3). Many new industrial policy initiatives are being launched for geopolitical and security reasons, with the aim of strengthening the resilience of supply chains.

Figure 3

New Trade Distortive Industrial Policies in 2023



[a] Where measures have multiple motives, each motive was weighted equally.
Source: New Industrial Policy Observatory (NIPO); Calculations by the ifo Institute. © ifo Institut

The focus tends to be on products that are considered "critical" from an economic policy perspective, for example because they are difficult to replace as inputs for the domestic economy, or cannot be dispensed with for other health, food or security reasons. If such products are sourced from only one or very few countries of origin, individual supply disruptions can result in high economic costs. In addition, such critical dependencies have great potential for economic coercion. The logic behind the use of industrial policy therefore seems obvious: they are intended to secure the production of strategically important goods domestically through state subsidies or protectionist measures and thus reduce critical dependencies.

This line of argument, for example, can be found at the core of the European Net-Zero Industry Act, drafted in response to the US Inflation Reduction Act (IRA) and passed by the European Parliament last April. The stated aim of this legislation is to secure the EU's access to key green technologies such as solar panels, wind turbines and batteries by ensuring that at least 40 percent of Europe's demand is met by European production capacity. This is to be achieved, for example, through the inclusion of so-called "resilience criteria" in public procurement, which can give preference to European producers – a de facto "Buy European" clause by the back door (Baur and Flach 2023).

The diagnosis that there is a high degree of dependence on individual suppliers for certain green technologies is hard to deny. For example, 95 percent of EU imports of solar panels alone come from China. However, it does not necessarily follow from such dependencies that it is necessary, in the interests of economic security, to safeguard domestic production capacities through industrial policy measures. Such an argument would be a classic case of *non sequitur*, a fallacy. There is a whole range of economic policy instruments available for strengthening economic security and reducing dependencies, and these need to be weighed against each other. In the case of solar panels, for example, McWilliams et al. (2024) show that a state-mandated stockpiling of solar panels could already make an important contribution to economic security and would be significantly more cost-effective than directly subsidizing domestic production in the EU. In addition, strengthening the circular economy through improved recycling could reduce dependence on imports from dominant supplier countries, not only in the case of solar panels.

In many cases, the key to strengthening economic security lies in deepening international trade relations. After all, the diversification of supply chains, which is needed to reduce strategic dependencies on dominant supplier countries, is not only possible within the domestic market but also through a variety of other trading partners. The more diversified the sources of supply for strategically important goods, the lower the risk of a complete supply failure or the danger of economic coercion. Therefore, promoting targeted diversification of procurement and sales markets is crucial for economic security. Expanding the European network of trade agreements can make a significant contribution in this regard.

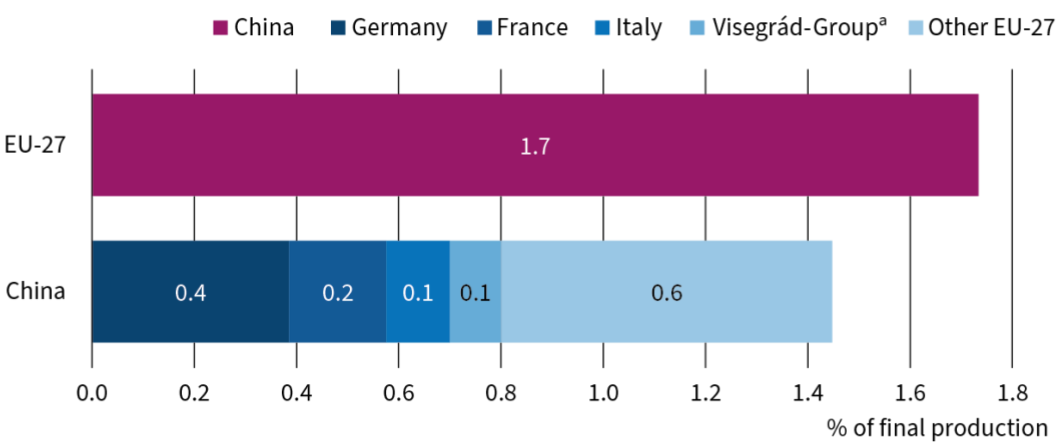
Compared to such alternatives, subsidizing domestic production through industrial policies is many times a very expensive and not always effective way of ensuring economic security. Even if critical trade dependencies make domestic production capacities necessary in specific cases, they are by no means an argumentative wild card that justifies the general subsidization of domestic production across the board. Additionally, there is strong support for directing industrial policy measures towards the promotion of innovative production processes and the diffusion of new technologies, rather than expensively subsidizing production processes that are already established in the market (IMF 2024).

European Unity is Crucial for Geoeconomic Competition

The weakening of the rules-based multilateral trading system means that the power of the strongest is increasingly important in the global economy. This makes the unity of the European Union on the global stage all the more important. Even large EU economies like France or Germany are increasingly losing economic weight on the international stage and can only act on an equal footing with major economic players like China or the United States as part of a united Europe. Figures 4 and 5 illustrate the importance of European unity using trade relations with China as an example. The figures show that from a Chinese perspective, all European member states together are as important as China is for the EU as a trading partner.

Figure 4

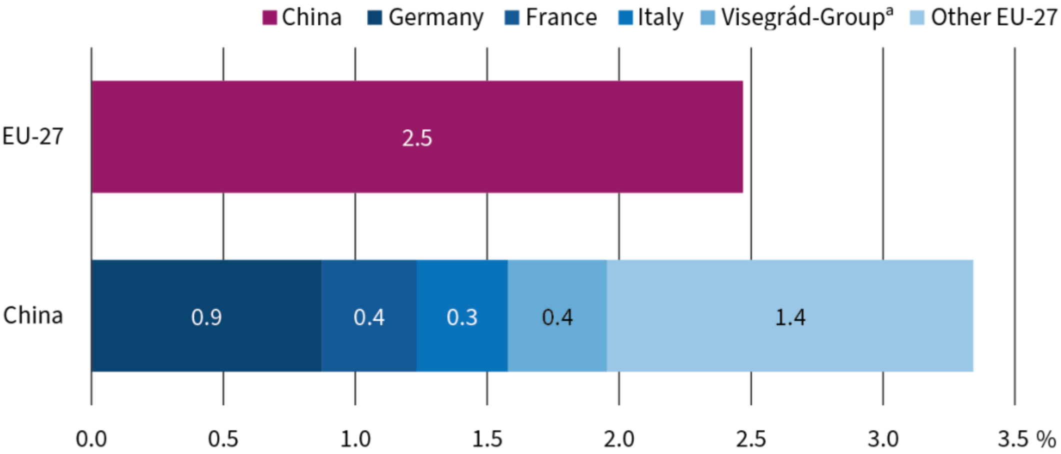
EU-China: Mutual Importance as Suppliers of Inputs
Imported inputs by origin of value added (in % of final production)



[a] Visegrád-Group includes Poland, the Czech Republic, Slovakia, and Hungary.
Source: ADB MRIO 2023; Calculations by the ifo Institute. © ifo Institut

Figure 5

EU-China: Mutual Importance as a Sales Market
Value-added exports by sales market (in % of the GDP)



[a] Visegrád-Group includes Poland, Czech Republic, Slovakia, and Hungary.
Source: ADB MRIO 2023; Calculations by the ifo Institute.

At the level of individual member states, however, there are clear asymmetries in their mutual economic importance. Even Germany, the EU's largest economy, plays only a comparatively limited role as a sales and procurement market for China (Baur and Flach 2022). Such asymmetries at the level of individual member states increase the potential for economic coercion and are the reason why disunity and uncoordinated national initiatives weaken European economic security in the long term. By contrast, if the European Union acts as one and speaks with one voice, it can effectively represent European interests at the international level and be an attractive strategic partner. In addition, European deterrence against coercive economic measures by third countries increases if potential aggressors have to expect a unified and coordinated response from European member states.

Policy Conclusion

Just as it would be wrong to ignore the security dimension of Europe's external economic relations, it would be equally wrong to view the global economy as merely another geopolitical arena.

International trade with countries outside Europe is a key factor for European prosperity and is particularly important for European manufacturing: In the EU, 32 percent of manufacturing jobs and 36 percent of value-added in manufacturing depend on exports to non-member countries.[3] From a European perspective, it is therefore particularly important not to let external economic relations be dominated by a geoeconomic zero-sum thinking, which carries the risk of protectionist escalation spirals. US National Security Advisor Jake Sullivan has publicly spoken several times of a *small yard* in external economic relations that must be surrounded by a *high fence* for security reasons while the majority of external trade should not be affected by this. One of the central tasks of European foreign economic policy in the future will be to define this small yard with prudence and to communicate the intelligently placed fences to the outside world as transparently as possible. Furthermore, despite or precisely because of the first signs of geoeconomic fragmentation in the global economy, it is in the best interest of EU member states to continue to jointly advocate for open global markets and a fair, rules-based trading system.

[3] These statistics are based on FIGARO data provided by Eurostat and refer to the year 2021.

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