Strength in numbers: How can Europe most effectively balance economic security and openness to trade and investment?

Commissioned by the UK Mission to the EU, as part of its Open Trade Project

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Flint Global wrote this report as part of the UK Mission to the EU's Open Trade Project. The report, published in April 2023, is authored by Sam Lowe, Claudia Catelin, Felix Peckham, Emily Binchy and Thomas Grandjouan.

Executive Summary

- In 2021, China responded to Taiwan opening a representative office in Vilnius under the name "Taiwan" rather than "Chinese Taipei" by removing Lithuania from its customs system, effectively banning imports of Lithuanian goods. This attempt at economic coercion is in keeping with a recent pattern of behaviour that includes China imposing a series of trade restrictions on Australian wine and barley, in response to Australia banning Chinese vendors from operating in its 5G network and the then Australian Prime Minister endorsing an independent investigation into the origins of Covid-19.

- While international trade and economic interdependence can be a catalyst for deeper political cooperation and engagement between countries, interdependence, or rather, overdependence, can also grant leverage to those governments seeking to impose their political will on others. This is particularly true when a country controls access to critical energy sources, resources or components. Russia's efforts to weaken Western support for Ukraine by throttling gas supplies to Europe, and the resulting soaring energy costs, supply chain friction and general price inflation, are an acute example of a country weaponising its economic ties, albeit one that has so far failed to achieve its primary objective.

- Alongside increased exposure to economic coercion, the economic security of Europe is threatened by a rise in unfair competition, stressed supply chains and the economic fallout of Russia's invasion of Ukraine. Ensuring the measures taken to address these concerns are proportional, targeted, and effective is crucial if Europe is to balance its twin goals of economic security and openness to trade and investment and avoid unintended consequences.

- Interventions to enhance economic security can be broadly grouped under three headings: unilateral, plurilateral and multilateral. Unilateral interventions benefit from being quick to implement but are often less effective or more readily bypassed. Multilateral interventions are often more impactful but can take a long time to agree and, assuming agreement is reached, implement. For example, multilateral cooperation to significantly bring down industrial carbon emissions and prevent carbon leakage would be more effective than a unilateral carbon-border adjustment mechanism by one country or bloc, but is also arguably unachievable, at least in the short-medium-term.

- Unilateral interventions also increase the risk of unintended consequences. For example, the new EU Foreign Subsidies Regulation exists predominantly to ensure the Commission has the tools necessary to intervene when state-subsidised Chinese firms compete unfairly within the EU single market. However, the Regulation's design means that all foreign companies

engaging in large M&A and procurement activities within the EU now face additional costs and bureaucracy – with companies in allied countries such as the US, Canada and the UK most exposed.

- Plurilateralism, or cooperation between smaller groupings of countries, offers a pragmatic middle way. In the absence of global agreement, like-minded states can and should work together to coordinate their efforts to address economic security. Recent coordination between the US, EU, Japan and UK on Russia sanctions offers an illustrative example of effective multi-country cooperation. Where states are required to act unilaterally, better care should be taken to ensure that individual tools or measures are targeted, proportionate, and do not penalise allies.

Introduction

International trade generates national prosperity and contributes to global development. However, economic interdependence inevitably grants some countries leverage over other states that rely on them for essential resources such as energy, food or critical minerals.

Russia's invasion of Ukraine and the resultant sanctions and economic restrictions offer an acute example of the US, EU, UK and others using trade restrictions to penalise and constrain Russian aggression. The economic fallout of the invasion – soaring energy costs, supply chain issues, and inflation – demonstrates why policymakers must carefully consider the interplay between national security, foreign policy and trade policy.

This intersection is not new. China's illiberal trade and economic practices – including forced technology transfer, economic coercion, and unfair subsidisation of its domestic industry – have long drawn the ire of Western politicians and officials. As China's role in global trade has grown, so has its ability to set the terms of its interactions and extract an economic cost from countries and companies which criticise its policies and politics.

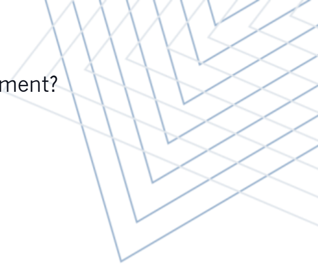
Democratic governments must carefully consider both the economic tools utilised by China and other non-democratic regimes to advance their political interests *and* the countermeasures and policy arsenal at their disposal. Russian sanctions have shown that imposing economic penalties is not cost-free. Identifying potential unintended and intended consequences is vital for building policy proposals optimised for effectiveness.

The US' decision to introduce export controls restricting the ability of US companies to supply high-end Chinese chipmakers is instructive. While the controls will probably delay Chinese chip development (an intended consequence), the measures will also create challenges for the US, Europe (including the UK), and any country that relies on Chinese chip production. For example, increased Chinese production of less sophisticated chips (not captured by the ban) could exacerbate dependencies in adjacent sectors, such as automotive manufacturing (an unintended consequence). A further consideration is China's response, which could - for example - close its domestic market to Western exporters or limit exports of critical materials and components, such as photovoltaic solar cells.

As seen following Russia's invasion of Ukraine, coordinated responses are fundamental to improving Europe's response to security and economic challenges. The collective strength of a likeminded bloc of nation states is a stronger deterrent to those who seek to subvert the rules-based system than unilateral action. This is particularly true given the World Trade Organization's (WTO) inability to prevent market distortions or economic coercion.

This report, authored by Flint Global as part of the UK Mission to the EU's Open Trade Project, assesses trade practices, relevant case studies and policy options. It identifies both the direct and indirect consequences of trade interventions, as well as intended and unintended ones, and the suite of associated policy responses. We look at three broad types of trade interventions:

- **Pillar One: Economic coercion** – We examine how governments inflict economic damage on another country in the pursuit of political objectives. Examples include imposing tariffs, customs formalities and regulatory barriers. Case studies referred to are US steel and aluminium tariffs,



the EU's proposed Anti-Coercion Instrument, and China's trade tensions with Lithuania and Australia.

- **Pillar Two: Fair competition** – This section assesses how the concept of 'fair competition' (or level playing field) works in practice through, for example, market-distorting practices and supply chain resilience. We analyse case studies such as the Organisation for Economic Co-operation and Development's (OECD) taxation initiatives, the EU's Foreign Subsidies Regulation and the Carbon Border Adjustment Mechanism, and wider EU efforts to onshore production.
- **Pillar Three: Strategic interventions** – We analyse actions such as the recent evolution of the export controls regime in the US and Europe. Case studies include US export controls on Chinese semiconductors, Western allies' sanctions on Russia, the UK's approach to Newport Wafer Fab, and Germany permitting a Chinese entity to purchase a stake in the Port of Hamburg.

Pillar One: Economic coercion

Trade interdependencies make it easier for states to inflict economic damage on other countries in pursuit of political objectives, so-called economic coercion. Economic coercion usually consists of trade restrictions - such as imposing tariffs, customs formalities, license denials and regulatory barriers on foreign countries or businesses. Other examples of economic coercion are tourism restrictions, boycotts against specific companies and other, sometimes empty, threats[1].

China, Russia and the US under Donald Trump have each used economic coercion to pursue policy objectives in recent years, with varying success. For instance, Russia's refusal to supply gas through the Nord Stream pipeline inflicted substantial economic pain on EU countries and citizens. Russia did this to push up energy prices and deter Europe from actively opposing Moscow's invasion of Ukraine, but the EU (and other Western allies) still strengthened its support for Ukraine. As explained in **case study 1**, President Trump levied tariffs on steel and aluminium imports from the EU, China and elsewhere to protect the US against global steel and aluminium overcapacity and force other countries to buy more American products.

Case Study 1 – US steel and aluminium tariffs

Prior to taking office, Donald Trump pledged to reduce the trade deficit and to repatriate manufacturing jobs to the US – these efforts constituting a significant plank of his 'America First' economic policy. In 2018, President Trump used Section 232 of the Trade Expansion Act of 1962 to impose tariffs on Chinese imports, including on steel (25%) and aluminium (10%). The initial value of goods subject to tariffs was around $50bn. In retaliation, China cancelled US soybean orders. Following further escalation, the US and China agreed a standstill and China committed to purchase set quantities of US products (a promise which it did not follow through). Through a series of escalations, total trade between US and China subject to tariffs increased from just under 2% in January 2018 to 66.4% (Chinese exports to US) and 58.3% (US exports to China) by January 2020 – tariffs remain at over 50% for both.

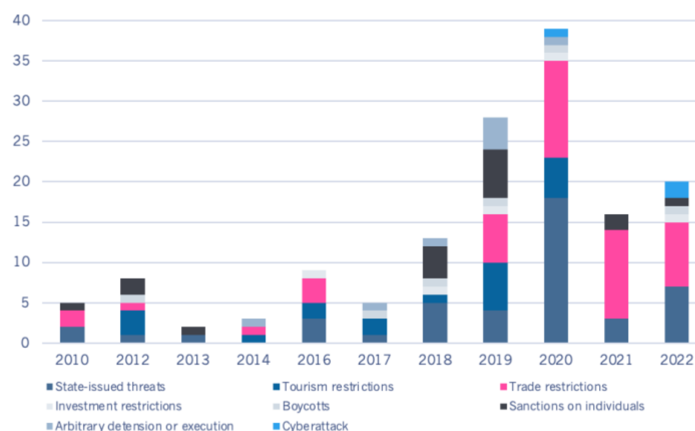
[1] Mercator Institute for China Studies, August 2022

Also in 2018, the Trump administration levied tariffs on EU steel and aluminium, arguing that these products coming onto the US market constituted a national security threat. In response, Brussels imposed tariffs on some US exports to the EU, such as bourbon and motorcycles.

While these unilateral efforts were an attempt to protect against global steel and aluminium overcapacity, they did not succeed – Chinese steel overcapacity has increased since the introduction of Section 232 measures, and steel businesses in the US saw their costs rise (studies have found the tariffs were almost entirely absorbed by importers, squeezing profit margins)[2]. In October 2021, the Biden administration and the EU agreed to work together to redouble efforts to resolve steel and aluminium issues – mainly centred on China (though this was not explicitly referenced in the agreement) - to remove Trump era steel and aluminium tariffs[3]. The US and EU also announced joint action through a new Global Arrangement on Sustainable Steel and Aluminium (GASSA), which is intended to restore market-oriented conditions and support the reduction of carbon intensity of steel and aluminium[4].

But since President Xi's reappointment in 2018, it is China that has most engaged in economic coercion[5]. Prominent examples include China imposing economic restrictions on Lithuania (due to the naming of the Taiwanese embassy in Vilnius) and Australia (following Canberra's support for an independent inquiry into the origins of Covid-19). China has also introduced a range of new legislative reforms which are yet to be applied, including sweeping powers over data and the Anti-Foreign Sanctions Law. Government control over foreign companies' operations is particularly prominent in China – it compels companies to abide by specific and strict terms in return for access to its huge consumer market. China can essentially 'switch off' a company's Chinese revenue easily, swiftly, and unilaterally[6].

Figure 1: Chinese use of economic coercion against foreign states, 2010-2022



Source: 'Countering China's coercive diplomacy: Prioritising economic security, sovereignty and the rules-based order', *Policy Brief Report No. 68/2023*, Australian Strategic Policy Institute, 2023

[2] Peterson Institute for International Economics, November 2021
[3] European Commission, June 2021
[4] UK Trade Policy Observatory & Centre for Inclusive Trade Policy, June 2022
[5] SEO Economisch Onderzoek, December 2022
[6] Mercator Institute for China Studies, August 2022

Economic coercion often falls into a 'grey' area of international trade law – countries implementing coercive policies are under no obligation to admit, confirm, or deny their actions. Coercive measures can be ratcheted up and down swiftly, be informal and, in the case of empty threats associated with China's attempts to safeguard its companies' access to 5G network markets in France, Germany, the UK, and the US, can be implemented without the aggressor having to incur any economic costs. Coercive measures may also produce supplementary (perceived) benefits, such as the protection of domestic industries. In terms of the private sector reaction, businesses may seek to mitigate the detrimental effects of economic coercion by relocating their production, finding an alternative customer base, or developing new/different products[7].

Policy responses

Countries often resort to unilateral action when faced with economic coercion. Unilateral action does not necessarily require international consultation or agreement and can be deployed quickly at the sole discretion of the affected state. At a time when international forums such as the WTO are widely perceived as being cumbersome and ineffective, unilateral responses are a necessity. The European Commission has argued that economic coercion falls beyond the scope of WTO disputes, as the WTO does not address the infringement of international law that lies in the coercive action. As outlined in **case study 2**, the overarching reason the EU has developed the proposed Anti-Coercion Instrument (ACI) is to ensure Europe has a trade defence tool that can be used swiftly and can act as a deterrent[8]. The EU hopes the mere *existence* of the tool in its trade defence arsenal is enough to deter the likes of China from engaging in economic coercion.

Case Study 2 – EU Anti-Coercion Instrument

The EU has embraced a policy of 'open strategic autonomy'. This is an attempt to find a balance between being open to trade and investment with/from the rest of the world and a greater willingness to tackle (perceived) unfair and coercive practices by foreign governments. The EU decided to develop a new trade defence instrument as a deterrence against perceived Chinese interference and threats, and in recognition of the EU falling behind China in strategic areas such as artificial intelligence.

In December 2021, the European Commission tabled a legislative proposal for the new Anti-Coercion Instrument. The tool garnered fresh momentum after China's blockade on Lithuanian exports - the EU feared that it does not always have the necessary tools to hand to deter aggressive economic actors, nor does it have one that can be deployed swiftly.

The Anti-Coercion Instrument would allow the EU to apply countermeasures if it, or its member states, is deemed to be subject to economic coercion from a foreign actor. Proposed countermeasures include the imposition of tariffs, restricting the market access of foreign services providers and investors, and restrictions on the registration and authorisations of chemicals. The design remains uncertain due to opposition from pro-free trade EU member states (e.g., Sweden), who fear the tool will be used too extensively. The EU would likely try to avoid the auto industry (as a major exporter) being adversely affected. However, if agreed upon and used against China, it has

[7] Mercator Institute for China Studies, August 2022
[8] UK Trade Policy Observatory, October 2022

the potential to significantly increase tensions and lead to escalating retaliatory measures, for instance, Chinese restrictions on exports to the EU.

The Anti-Coercion Instrument is currently making its way through the EU's legislative process, and at the time of writing is close to completion. Once the Anti-Coercion Instrument is in force, its use is likely to be highly restricted – the Commission has called its deployment a 'last resort'.

On the other hand, the proposed Anti-Coercion Instrument is not without drawbacks from an EU and member state perspective. There is an international debate about whether the tool itself violates international law given the deployment of the ACI would see the EU suspending its international obligations, for instance, WTO market access commitments. It is important to note, however, that some trade policy experts suggest international law should be updated to reflect the changing nature of legal harm created through trade practices[9]. Moreover, the proposal itself emphasises that the EU would only seek to deploy the tool as a 'last resort' – which can, from the European Commission's perspective, be seen as an inherent weakness in its effectiveness as a deterrent[10].

After a series of diplomatic and then trade escalations, the EU initiated a WTO complaint against China in January 2022, focusing on Chinese restrictions on trade with Lithuania. The EU has since escalated two trade disputes with China, by asking the WTO to convene panels to rule on them. These panels constituted the first cases that Brussels has brought against China in three years, at a time of rising geopolitical tensions. As **case study 3** shows, the benefit, from an EU/Lithuania perspective, of opting for this multilateral approach is that it sees Brussels using the international rules-based system to (seek to) address trade disputes, and it is therefore firmly within the confines of international law, unlike the EU's proposed Anti-Coercion Instrument. It also presents an opportunity for allies to intervene jointly – the UK formally joined the case against China in January 2023.

Case Study 3 - China/Lithuania

Relations between China and Lithuania have worsened quickly since 2021, when Lithuania banned Huawei equipment from its 5G network and passed a parliamentary motion calling China's activities in Xinjiang "genocide". Lithuania further aggravated China by allowing Taiwan to open a representative office in Vilnius under the name "Taiwan" rather than "Chinese Taipei"[11].

At the end of 2021, China downgraded diplomatic relations with Lithuania and took steps to prevent the import of Lithuanian goods (including goods produced elsewhere containing Lithuanian content). China claimed that local businesses were choosing not to buy goods from countries that had "attacked China's sovereignty", though Chinese government involvement has been all but certain.

In January 2022 the EU initiated a WTO dispute regarding discriminatory practices in Chinese trade with Lithuania. Other allies, such as the UK, US, Australia and Taiwan, joined the challenge after. China has continued to enact economic coercion against Lithuania, for example suspending imports of Lithuanian beef, dairy products and beer over a "lack of documentation". As a result,

[9] UK Trade Policy Observatory, October 2022
[10] European Commission, December 2021
[11] Center for Strategic and International Studies, May 2022

export levels fell more 90% between December 2020 and December 2021. The European Commission estimates China cut trade with Lithuania by 80% in 2022.

The EU's response is a positive example of countries working together to coordinate action to address economic coercion, and using the international rules-based system effectively rather than pursuing unilateral means. Politically, there have been several ramifications of Chinese-Lithuanian tensions. Souring relations between China and Lithuania prompted more fervent EU support for the Anti-Coercion Instrument. The '17+1' cooperative framework of Central and Eastern European countries seeking to expand cooperation with China is falling apart[12]. The decision to allow Taiwan to open a representative office remains hotly contested in Lithuania but, while the opposition Social Democrats say they oppose the decision, the party has not committed to reversing it and has implied that standing up to China has brought few gains in Lithuania's interests[13].

Economically, China's actions have inadvertently engendered an opportunity for Taiwan to deepen its own relationships with Europe - Taipei has announced investments in Lithuania's laser and chip industries, which are key components in photonic chips, through the likes of joint ventures. In turn, Chinese companies have lost access to Lithuania's laser and chip sectors. Lithuania was able to shift production of exports to China to its subsidiaries in third countries, effectively circumventing trade barriers and minimising economic impairment to Lithuania[14]. Looking ahead, the China-Lithuania situation is likely to result in a more institutionalised focus on industrial policy (e.g., de-risking, limiting interactions) in an effort to reduce Chinese dependencies.

At the same time, however, the distinct disadvantage in relying on WTO arbitration is that it can take a long time. WTO panel proceedings, once established, can last up to 18 months, after which either party can appeal the verdict. Hence, the joint approach exemplified by the WTO Lithuania case is not as swift as acting unilaterally. As a result, Lithuania continues to endure adverse economic effects and trade disruption arising from China's actions – for instance, Chinese restrictions have had a "chilling effect", deterring businesses from using Lithuanian products in their supply chains[15]. It is worth noting that there is also an issue with the Anti-Coercion Instrument regarding time and process: the nature of EU policymaking means it has taken years to come about - there have been significant objections along the way, for example Ireland, Portugal and Hungary are amongst member states having argued the tool goes too far.

Comparing joint and unilateral approaches, it is important to note that unilateral action is not without some fallout. This is conveyed in **case study 4** about Australia's approach to Chinese economic coercion. In economic terms, China effectively cut Australia off from its most important export market and some sectors, such as lobsters, have fared very poorly as a result. Geopolitically, Australia has lost its so-called 'golden partnership' with China, the biggest power in the region, and the new Labor government is trying to mend bridges as a result[16].

Still, unilateral action in response to economic coercion did, in the case of China/Australia, precede Canberra strengthening its geostrategic, diplomatic and defence ties with the UK and the US. AUKUS,

[12] Politico, May 2021
[13] Financial Times, November 2022
[14] Center for Strategic and International Studies, May 2022
[15] Financial Times, December 2022
[16] Australian Financial Review, November 2022

announced in 2021, is a trilateral security pact which is a very deep partnership involving key defence and security technologies. Canberra decided that, in the face of growing Chinese pressure in the Asia-Pacific region, the US was the most reliable defence and security partner. For President Biden, AUKUS is an opportunity to show that the US remains the main security provider in the Asia-Pacific region. AUKUS represents an important building block in the US strategy to counter China and to demonstrate that international cooperation can act as a deterrent to Chinese aggression. For the UK, this new alliance furthered its Global Britain agenda.

Case Study 4 - China/Australia

The China/Australia relationship deteriorated rapidly in recent years. Despite entering into a free trade agreement (FTA) in 2015, relations began to sour in 2017 when Australian media reported extensively on alleged interference and spying operations by Chinese authorities. The following year, Australia banned Chinese vendors from operating in the country's 5G network. The onset of the Covid-19 pandemic further exacerbated strains in the relationship, with then Australian Prime Minister Scott Morrison endorsing an independent investigation into the origins of the virus.

China retaliated over 2020/2021, imposing a series of trade restrictions including: an 80.5% tariff on Australian barley; a 107-212% tariff on Australian wine; an unofficial ban / sanctions on Australian coal lobsters, beef, timber and other products; a halt in purchases of Australian cotton; and actively discouraging Australia as a destination for Chinese tourists and students (albeit at a time when Australia's borders were closed). During this period, China presented a list of 'grievances' that Australia must address before relations can return to normal, such as: banning Huawei from the 5G network; rejecting the legal basis of China's claim to the South China Sea; calling for an inquiry into the origins of Covid-19; highlighting human rights allegations in Xinjiang; and backing foreign interference laws deemed to be targeting China.

In terms of unintended economic consequences, Australian exports have boomed since China, its largest export market, imposed the sanctions: the economic consequences have not been as dire as they otherwise might have been. While certain Australian sectors (e.g., lobsters) have struggled, the overall economic fallout has been offset with exporters shifting to new markets (for instance, wine) or adjusting their business models (such as barley producers pivoting to wheat). Iron ore, a strategically important sector for Australia, was not targeted by China's economic coercion, as China sources 60% of its iron ore from Australia and has no reliable alternative suppliers[17]. China also continues to purchase Australian natural gas[18].

Politically, China's actions against Australia prompted the latter to strengthen its defence and security ties with Western allies: the nuclear-propelled submarines now at Canberra's disposal because of the trilateral AUKUS pact signed in 2021 by Australia, the UK and the US, raises Canberra to a completely different level in terms of defence and security in the Asia-Pacific region.

Pillar One Conclusion

There are a range of policy mitigations and responses that states take to mitigate the impacts of economic coercion. For instance, they may opt for the unilateral route, which sees them leveraging

[17] Bonnie S. Glaser, statement to the Congressional-Executive Commission on China, December 2021
[18] Financial Times, November 2022

and devising their own tools for inflicting retaliation (e.g., the EU's proposed Anti-Coercion Instrument). The other options see like-minded countries working together – either plurilaterally or multilaterally – for example the EU bringing a WTO dispute against China over Lithuania, and allies such as the UK, US and Australia corralling around them in support.

Pillar Two: Fair competition

Free trade is rarely a free-for-all. A prerequisite for most countries opening their domestic markets to foreign competition is that the competition is 'fair' and that all economic actors are bound by the same set of rules[19]. This notion of fair competition is enshrined in the WTO's founding charter and is a cornerstone of the EU's single market. In principle, 'fair competition' means that both domestic and foreign actors are subject to the same rules. While simple in theory, varying policy responses to a myriad of challenges, such as managing strategic rivalries, tackling climate change, eliminating forced labour and bolstering supply chain resilience, all tilt the playing field in different directions.

In the US, under the Trump presidency, the narrative that low-cost Chinese labour was directly responsible for American job losses and that past US trade policy had led to the offshoring of American jobs gained bipartisan support. This led to, for example, President Trump renegotiating the North American Free Trade Agreement (NAFTA) with Canada and Mexico and inserting new clauses conditioning tariff-free trade in automobiles on workers being paid at least $16 per hour[20].

The EU, reacting to the unpredictability of the Trump presidency, the rise of China, the failure of WTO processes, and a growing sense that other countries were taking advantage of its relatively open market, has introduced new unilateral measures to impose its own concept of a level playing field on its trade partners. These include measures such as the Foreign Subsidies Regulation and International Procurement Instrument; a Carbon Border Adjustment Mechanism; enhanced supply chain due diligence and forced labour rules; anti-deforestation rules; and the updated enforcement regulation, which strengthened the EU's capacity to act in situations where dispute settlement is blocked. In **case study 5**, we examine the EU Foreign Subsidies Regulation, which is an attempt to keep Europe open to trade, while also preserving fair competition within the Single Market.

Case Study 5 – EU Foreign Subsidies Regulation

The new EU Foreign Subsidies Regulation (FSR) illustrates some of the limitations and risks posed by unilateral responses[21]. The FSR entered into force on 12 January 2023 and will apply as of 12 July 2023. The FSR aims to simultaneously enable the EU to remain open to trade and investment, while preserving a level playing field for companies operating in the Single Market[22]. This new instrument gives the Commission a wide range of investigative powers to examine contributions to companies active in the Single Market granted by non-EU countries and, if necessary, to remedy the distortive effects these might create.

While the FSR *de jure* applies to all foreign investments from third countries, it can reasonably be anticipated that subsidised companies from certain jurisdictions, for example from strategic rivals,

[19] For example, WTO members commit not to directly subsidise exports on the basis that doing so could confer an unfair advantage on the beneficiaries.
[20] US Department of Labor
[21] EUR-Lex - 32022R2560 - EN - EUR-Lex, December 2022
[22] European Commission, January 2023

will be considered more problematic than those from allies[23]. This politicised aspect of the FSR is rooted in concern over the increasing presence of Chinese state-owned enterprises in the EU internal market[24]. However, while China may be the target of the FSR, traditional trading allies of the EU, namely the US and UK, provide far more investment in the EU and therefore are the unintended targets of its effect[25]. In compelling investors and firms looking to engage in large M&A activity or procurement bids in the EU to notify authorities of the process, this unilateral conduct significantly increases compliance costs. In 2021, the US was the top foreign investor in the EU, accounting for 32.3% of M&A activity and 39.4% of greenfield investments, followed by the UK at 25.6% and 20.9% respectively. By contrast, China accounted for 2.3% of foreign acquisitions and 6% of greenfield investments making it, in reality, far from the main country that endured the negative effects of the FSR[26].

The FSR imbues the Commission with powers to impose redressive measures including required divestment, sharing of assets with competitors, restricting their activity, or repaying subsidies[27]. Furthermore, the wide scope of the FSR gives credence to those who argue that the EU could be attempting to impose its state aid rules on third countries through a 'back door'[28].

Chinese state subsidies are an acute fair competition concern of the US, EU, and other European countries. While by no means a practice uniquely undertaken by non-democratic regimes, China's use of subsidies and related market-distorting practices is on an unparalleled scale and presents unique security concerns. For example, the widespread dumping of strategic metals such as steel and aluminium – typically from heavily state-subsidised producers – has the potential to undermine Western production. This could leave countries at the mercy of international markets for strategically important inputs that underpin manufacturing and construction industries that are vital for economic well-being. Chinese production is also typically more carbon-intensive than Western production, so environmental risks are increased by allowing the former to substitute for the latter. The interplay between environmental, trade, and security objectives – evidenced by the EU's proposed Carbon Border Adjustment Mechanism, referenced in **case study 6** – is particularly important given these considerations.

Case Study 6 – EU Carbon Border Adjustment Mechanism (CBAM)

The EU CBAM intends to mitigate against climate change and protect domestic manufacturing – by introducing a levy on carbon-heavy imports, including iron, steel, cement, fertiliser, and aluminium. The countries most exposed to the CBAM include Russia, Turkey, China, Ukraine and the UK.

The CBAM will compel trading allies to implement policy responses in order to insulate themselves from potentially adverse consequences. In this vein, the EU CBAM could precipitate a domino effect as regions seek to avoid a scenario whereby carbon-intensive products, initially destined for the EU, are offloaded on their markets. The unilateral introduction of measures in response to the

[23] Kluwer Competition Law Blog, January 2023
[24] Kluwer Competition Law Blog, January 2023
[25] Most Favoured Nation: Who Did It Better? - by Sam Lowe, July 2022
[26] Register of Commission Documents - COM(2022)433, September 2022
[27] Centre for European Reform, September 2022
[28] DWF Group, January 2023

CBAM could vary considerably, ranging from ramping up anti-subsidy or safeguard duties, to introducing new taxes or regulatory restrictions, to bringing in labelling requirements[29]. Australia, the US, the UK, Japan, India and Canada are exploring their own policy responses to the CBAM, in varying guises. The US has suggested the GASSA framework, in which members would impose tariffs should steel and aluminium fail to reach certain standards.

Similarly, at the G7 summit in June 2022, leaders established an open and cooperative international Climate Club. While initiatives such as climate clubs can be preferable to the unilateral measures referred to above, they are also more challenging to achieve and implement[30]. Frictions can also arise within these clubs with, for example, EU members of the G7 and the UK already having emissions trading schemes in place, while the US and Japan have made little to no progress on this front[31]. If the Climate Club is to feasibly encompass emerging economies, it will be necessary to engage in talks about the benefits of carbon pricing and the provision of reliable climate finance contributions[32].

Supply chain resilience

Covid-19 and the invasion of Ukraine drew public attention to the sensitivities of global supply chains and equally raised questions regarding fair competition. Shortages of critical components such as microchips have hampered major EU producers – particularly in the automotive industry – demonstrating the risks of reliance on a small coterie of suppliers. However, building domestic industries from scratch can be highly complex and prohibitively expensive, requiring substantial government subsidies. Ensuring supply chain resilience is an important facet of reducing trade dependencies on hostile actors and has accordingly been cast into the spotlight of late.

Businesses are often the best judges of their own strategic dependencies in terms of supply chains, potential critical junctures and chokepoints and logistics networks. However, the context in which they operate of free-and-fair trade is increasingly contested and politicised. The trend towards elevated levels of public intervention into industrial policy necessitates a close working relationship between policymakers and industry to identify and mitigate new risks and alleviate pressures.

In September 2022, President von der Leyen announced the Critical Raw Materials Act, which would aim to reduce Europe's dependency on China for the metals and minerals necessary for manufacturing products central to the green and digital transitions. Specifically, it sets out measures to: strengthen EU capacities for each strategic raw material by 2030; diversify the supply to ensure that, by 2030, no more than 70% of the EU's annual consumption of each strategic raw material at any relevant stage of processing originates in a single country; improve the ability to monitor and mitigate supply risk related to critical raw materials; and ensure the free movement of critical raw materials placed on the EU market while ensuring a high level of environmental protection by improving circularity and sustainability. The Act was presented in March 2023, on the same day as the Net Zero Industry Act, with both of them forming part of the EU's response to the US Inflation Reduction Act (IRA).

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[29] Most Favoured Nation: CBAM Dominoes - by Sam Lowe, December 2022
[30] Most Favoured Nation: CBAM Dominoes - by Sam Lowe, December 2022
[31] Stiftung Wissenschaft und Politik, May 2022
[32] Stiftung Wissenschaft und Politik, May 2022

The Commission aims to achieve its own supply of up to 30% of its needs for certain material and is exploring the agreement of "strategic partnerships" in lieu of free trade agreements. Solutions to issues such as these, by virtue of many materials critical to achieving the green and digital transitions only being available in certain regions, underline the need for multilateral cooperation and coordinated responses among allies in order to reduce dependencies on hostile actors. The EU has developed a Critical Raw Materials Alliance in this regard, based on the premise of diversification of third country suppliers to the EU, increasing domestic extraction and production, and greater efficiency in recycling and reducing the volume of rare earth metals and critical materials needed in production processes. For more information on the EU's attempts to onshore production, see **case study 7**.

Relying on domestic production alone is unlikely to ensure supply of essential goods. Ensuring that supply chains of critical raw materials are reliable and predictable requires enhanced levels of cooperation, with a view to developing international agreements. Therefore, reducing distortions and promoting fair competition play an important role in building supply chain resilience.

Case Study 7 - EU efforts to onshore production

In line with its objective to achieve greater strategic autonomy, the EU is increasingly trying to onshore and re-shore production, particularly in strategic sectors such as pharmaceuticals and sectors important to the green transition. Targeted investment support is often necessary to close supply chain gaps.

Semiconductors are essential components of modern electronic devices, from computers to mobile phones, to batteries, and in so doing they underpin financial services, medical devices, energy generation and transport. The EU is increasingly attempting to onshore production, which is currently highly globalised, with supply-chains stretching around the world. The *Made in China 2025* strategy and the US CHIPS and Science Act evidence the strategic importance of semiconductors in an increasingly politicised world trading system[33].

This landscape presents a strategic challenge for industry and policymakers within the EU. A stable and resilient supply of semiconductors is vital for realising the EU Green Deal and the EU's digital ambitions, and the EU has accordingly set itself a goal of achieving a 20% share of global semiconductor production by 2030. The vehicle through which it plans to achieve this is the EU Chips Act which is premised upon R&D investment, chip manufacturing and production subsidies. Alternative options, such as the introduction of quotas, tariffs or export restrictions, could exacerbate geopolitical tensions between trading blocs and are in this respect less favourable routes to strategic autonomy[34].

The automotive sector, and accelerating the transition to electric vehicles, has featured prominently in the supply chain resilience debate in the EU, due to its importance in the EU economy and its multiplier effect in the Single Market[35].

[33] South China Morning Post, May 2018
[34] European Commission, 2022
[35] Bruegel, January 2019

In parallel with its efforts to legislate against adverse effects on EU industry from the US IRA, the EU has been seeking concessions to the legislation. A particular concern for the EU[36] is the IRA provision for tax credits for locally made vehicles, which complicates the EU's efforts to stimulate battery production in the Single Market[37]. Examples of relocation of EU industry to avail of IRA funding is evident in BMW's announcement that it will invest €800mn in building an electric vehicle production plant in Mexico, which is included in the subsidy package[38].

Policy responses

While multilateral solutions are preferable to unilateral policy responses; they are more challenging and time-consuming to agree and implement. Coordinated trade policies to address fair competition concerns at WTO level or more ambitious WTO reform are unlikely to happen. Multilateral solutions are further hampered by the current proliferation of unilateral measures and a growing disdain for the WTO at a political level globally. This is evident from remarks by US Trade Representative Katherine Tai that the WTO was on "very thin ice" in December 2022, and the Biden administration's decision to reject a WTO ruling that US steel and aluminium tariffs on alleged national security grounds violate WTO agreements.

Unilateral policy responses to distortions of fair competition, whilst arguably more expedient in terms of implementation, need to be appropriately targeted or else risk harming trading allies. Current EU measures increase the cost base for all – not just hostile actors. Foreign subsides rules and climate instruments, such as CBAM and climate clubs, hit allies hardest. This is illustrated in Figure 2, which highlights that the top three regions involved in M&A activity in the EU, and therefore likely to be subject to new foreign subsidies rules, are the US, UK and Canada. While the practical implications of the FSR have yet to be felt, its effects on traditional trading allies could be wide-reaching.

Figure 2: Foreign M&A transactions by nationality of the investor's ultimate owner, 2019-2020

	Percentage change 2020 over 2019	Share over total (in %), 2020
USA and Canada	-35	34.9
United Kingdom	-21	30.5
EFTA	-25	12.1
Offshores	-34	6.9
Developed Asia	-47	5.6
China	-63	2.5
Central and S. America	-37	1.7
India	-44	1.4
AUS and NZ	-50	1.2
Gulf Coop Countries	0	1.2
Turkey and other Middle East	-50	0.9
Other Asia	-73	0.4
Russian Federation	-83	0.1
Rest of the World	-54	0.6

Source: 'European Commission tracks investments and acquisitions using data from Orbis', Bureau van Dijk, 2022

[36] White House, August 2022
[37] Politico, January 2023
[38] Financial Times, February 2023

Unilateral responses such as the FSR in the EU and the US IRA, although both reactions to Chinese industrial policy, have exacerbated trade tensions among allies, further eroding the likelihood of cooperation at WTO level and avenues for reform. A further measure designed in response to Chinese state subsidies, but which inadvertently creates tensions with allies, is US export controls on Advanced Computing and Semiconductor Manufacturing Items to the People's Republic of China[39]. Such export controls have limited impact in the absence of cooperation with allies and therefore require diplomatic pressure on states with chips manufacturing industries, such as the Netherlands and Japan. Strikingly, both China and the US now impose stringent controls over trade in the tech industry, formerly championed by free trade idealists. In flexing its extraterritorial reach through mobilising export controls, the US Bureau of Industry and Security (BIS) has caused unease among allies, encapsulating the perils of unilateral approaches to ensuring economic security.

Unilateral approaches also result in a proliferation of different frameworks, creating compliance burdens. On the other hand, an effective example of cooperation which, once implemented, would avert a compliance headache akin to those from unilateral measures, is the OECD/Base Erosion Profit Shifting (BEPS) deal. Although this has been slow to achieve and continues to be slow to implement, it is likely to have a more significant impact than the alternative of countries acting unilaterally. For more detail, see **case study 8**.

Case Study 8 – OECD taxation

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) is a two-pillar solution to address the tax challenges arising from the digitalisation of the economy. The proposal illustrates the preferability of coordinated action with allies over unilateral action. Ostensibly, the OECD taxation case is a fair competition issue which grew partly out of many countries introducing domestic Digital Services Tax (DST) regimes, resulting in fragmentation and trade conflicts between trading partners. While multinationals will pay more in corporate tax as a result, they will equally benefit from a level playing field, ensuring that competitors do not pay less than them[40].

Prior to agreement of the OECD deal, countries had tried various ways to address aggressive tax avoidance. Half of all European OECD members had either announced, proposed, or implemented a DST; India, Turkey, and the African Tax Administration Forum were also in the process of developing their own regimes. This uncoordinated approach risked creating tax competition and exacerbating uncertainty in the global economy[41]. Unilateral actions can lead to double taxation, retaliation, and the weaponisation of taxation, increasing the prospect of trade wars and inevitably passing extra costs onto consumers[42].

Although a positive step towards multilateral cooperation, there are still challenges around the implementation of the deal and transforming the existing network of bilateral tax treaties into a multilateral framework. To circumvent making time-consuming amendments to bilateral treaties, the OECD is working on a binding multilateral convention, on which it aims to reach an agreement by April 2023[43]. Each of the 137 signatories to the deal would then need to ratify this convention

[39] US Bureau of Industry and Security, October 2022
[40] Financial Times, January 2022
[41] Carnegie Europe, February 2022
[42] Carnegie Europe, February 2022
[43] Financial Times, January 2022

in their own legislatures, which may prove problematic for major economies party to the deal, notably the US.

Efforts to implement a global corporate tax regime is an eminent example of multilateral cooperation to level the playing field, which increases predictability, and promotes financial stability in developing countries. US Treasury Secretary Janet Yellen hailed the deal as signalling the end of a "30-year race to the bottom on corporate tax rates"[44].

Pillar Two Conclusion

In the conclusions of the special meeting of the European Council on 9 February 2023, EU leaders reaffirmed a commitment to pursuing an "ambitious, robust, open and sustainable trade agenda and supporting the WTO and a multilateral rules-based system"[45]. Moreover, they identified fair and transparent free trade and investment agreements that ensure fair competition as central to building resilient and reliable supply chains. These aims are additional to other EU objectives which trickle into trade policy and distort the level playing field, such as achieving climate goals and eliminating forced labour. However, the imposition of myriad unilateral policy responses to distortions in the level playing field can both harm trading relations with allies and create onerous compliance obligations.

Multi-country cooperation, akin to the OECD global tax deal, ensures that allies are not harmed inadvertently, as can happen in cases of unilateral conduct, and is therefore the optimal policy response. The EU Foreign Subsidies Regulation, although designed with hostile trading partners in mind, is likely to harm trading allies to a greater extent, and while aimed at protecting economic security, can hamper investment and make trading relationships more fraught. Efforts to secure supply chains and increase their resilience, through policies such as reshoring, can further skew the playing field and give rise to complaints of protectionism. This places a heavy onus on policymakers to strike a balance between reinforcing national economic security whilst achieving specific policy goals on the one hand and preserving fair competition and symbiotic trading relations on the other.

Pillar Three: Strategic interventions

Strategic economic interventions - which this report defines as actions intended to curtail the activities or prosperity of another state to secure legitimate international political, military and economic goals - are increasingly difficult to orchestrate effectively. The common thread linking strategic interventions with economic coercion and fair competition is that strategic interventions are also a practice used by governments to secure policy objectives by inflicting economic damage. The precise distinction is hard to define, although strategic interventions - per this report's definition - often mean severing trading relations rather than trying to establish more favourable trading terms.

These are amongst the sharpest economic tools available to policymakers: they are designed for fundamental realignments and course corrections. Given the protectionist undertones that run through a number of strategic interventions, it is difficult to reconcile their use with the principles of free and open trade, and investment. The reactive nature of these interventions - for example to penalise and deter an aggressive state from an armed conflict, or to prevent contributing to the military-industrial upgrading of a competitor - means they typically run counter to the promotion of

[44] Washington Post, July 2021
[45] European Council, February 2023

free trade and investment. In the longer term, however, these interventions are commonly intended to facilitate and enforce a rules-based global economic order, conducive to free trade and international commerce.

Policymakers should heed the three central challenges to using strategic interventions effectively.

- Firstly, national economies and global supply chains are intertwined to the extent that any intervention is likely to instigate unintended consequences on the enacting state or its allies. Inflicting economic self-harm can undermine the rationale behind the intervention.

- Secondly, unilateral strategic interventions - even by the largest economies - are unlikely to be successful.

- Thirdly, coordinating genuine multilateral interventions is challenging. Ever-increasing geopolitical polarisation narrows the resolve of marginal allies to accept potential economic hardship in service of a distant ally (for example, South Africa has caused some consternation by choosing to partake in military exercises with China and Russia, despite Russia's de facto military blacklisting by the West following its invasion of Ukraine[46]).

Economies are difficult to disentangle from one another, and major military and security 'adversaries' are often reliant on the manufacturing facilities, consumer base or intellectual property of their foes. For example, in the first half of 2022, Germany's trade deficit with China reached a new peak, with the fallout from Russia's invasion of Ukraine underscoring the challenges resulting from Germany's reliance on Russian gas imports[47]. Meanwhile, in the first half of 2021, the US ran a $141bn goods trade deficit with China, an economy and security competitor with which it is increasingly attempting to economically decouple[48]. Germany's political debate around Chinese investment in vital domestic port infrastructure clearly underscores the challenges faced by Western powers who have complex relationships with states that are increasingly becoming security adversaries.

This illustrates a central problem in the use of strategic interventions: the extent to which they can be genuinely strategic correlates with the degree to which they are coordinated effectively between like-minded states.

Policy responses

The Biden administration's recent decision to introduce export controls to prevent US companies from supplying Chinese chipmakers is instructive: demonstrably, national security, foreign policy and trade policy are in constant interaction with one another. This is *the* most significant peacetime trade policy move made for national security purposes by a Western power in recent years. The US' export controls are designed to stymy the speed at which China can industrially upgrade and block Chinese military-industrial ambitions.

The US' political will to slow China's growing geopolitical prowess was sufficiently strong for the US to incur direct financial costs, whilst imposing a series of indirect consequences on the US' economic and security allies. These consequences - intended and otherwise - need to be reviewed as a package,

[46] BBC, February 2023
[47] Reuters, August 2022
[48] CNBC, September 2020

to understand the combined effectiveness of measures. Interconnectedness and complex economic dependencies generate a domino effect: the US' export controls reverberate through not just the US, but also China and much of Western Europe.

In this instance, the most direct path to achieving the US' security policy objective - preventing China from having access to advanced semiconductors - was using export controls and undermining free market principles through government intervention in the US domestic semiconductor industry, as demonstrated in **case study 9**. While it will likely delay Chinese chip development (an intended consequence), the measures will also create challenges for the US, Europe, and any country that utilises Chinese chip production. For example, additional Chinese production of less sophisticated chips (not captured by the ban) could exacerbate dependencies in certain sectors such as auto manufacturing (an unintended consequence).

A further consideration is the response from China, which could - for example - close its domestic market to Western exporters, or limit access to critical inputs such as photovoltaic solar cells which would be economically detrimental and could, for example, undermine Western net zero ambitions. Whilst difficult to accurately measure, the US' unilateralism will have significant material ramifications for the growth of the global economy as Western countries have to rapidly onshore and upgrade domestic chip manufacturing.

An additional risk - an unintended consequence - of US efforts to decouple from China's advanced manufacturing sector is that military conflict could become *more* permissible. A paradox of mutual economic dependency between the US and China is that this creates a degree of security between the two. Interwoven and interdependent economies are theoretically less likely to enter into military conflict with one another because the opportunity cost - which is the disruption to their economies and the standard of living for their respective populations - is usually unacceptably high. As the US distances itself from China, this opportunity cost falls. Therefore, as the US shores up its economic security, its wider geopolitical security could move in the opposite direction.

The unilateral export controls will also inflict harm on the US consumer: the cost of cars, smartphones, computers and a wide variety of household goods will increase as the supply of chips falls.

Case Study 9 – US export controls on Chinese semiconductors

In August 2022, President Biden signed into law the CHIPS and Science Act. The White House described this legislation as positioning the US to "win the race for the 21st century" by establishing a policy programme for the US to become the "leader of the industries of tomorrow"[49]. The legislation promises approximately $77bn to boost the US' domestic semiconductor industry, to reduce reliance on chips manufactured by China. This significant government intervention in securing the US' primacy in advanced technology, industrial strategy and military prowess was followed by a suite of US export controls targeting semiconductor exports to China. These controls are substantial in their scope, complexity and global impact[50].

[49] White House, August 2022
[50] Flint Briefing Call, Sir Julian King, Katie Whitting, Francois-Joseph Schichan, October 2022

The controls target different vulnerabilities in China's chip sector. Much of the progress made by China in recent years could be reversed and restrictions on technology transfer mean that it could struggle to ever catch up with the West's relative technical advantage. Chinese chip stocks lost $8.6bn immediately following the announcement in October.

In terms of the impact on US and global businesses – in practice, US high-end semiconductors now face a de facto ban on trade with China and most semiconductor companies globally may face restrictions due to their links with US technology, companies and people. The controls will indirectly affect a range of sectors, in part because of a likely squeeze in supply chains as businesses adjust. The US is also considering the introduction of outbound investment screening.

Collectively, these measures demonstrate a shift in thinking away from maintaining a 'relative advantage' over China when it comes to technology towards achieving what US National Security Adviser Jake Sullivan called "as large a lead as possible". While the recently revised US National Security Strategy did not contain any major surprises, the US clearly sees China as its primary threat, and places a greater emphasis on the role of industrial strategy in achieving national security.

The US' measures have had a direct impact on the EU's China policy, including the new EU's Foreign Direct Investment (FDI) coordination mechanism and tighter export controls. While China is not explicitly the target of these restrictions, the intent is clear. The emphasis on resilience extends to technology – the EU Chips Act aims to increase EU production of semiconductors from 10% to 20% of world production in cutting-edge semiconductors by 2030. There has been some speculation as to whether the EU may follow US restrictions.

At the 10th National Congress of the Chinese Community Party in October 2022, China indicated that it is likely to retaliate against US chip control in some way. China could refer to its well-established trade war playbook and target specific US companies. Other possibilities include targeting Western dependencies on China, such as rare earths or pharmaceutical ingredients (for example, China processes 65% of the world's lithium)[51]. China could also look to use Chinese jurisdiction to intervene more in global M&A.

The US' economic security objectives could have been *better* served through coordinated multilateral action by the US, EU and other aligned security allies, to collectively pool financial, intellectual and manufacturing expertise. Ultimately the effectiveness of these export controls will be reliant on the goodwill of US allies: will the Dutch and Japanese companies stop supplying advanced semiconductors and tools as well?[52] The US could have pushed for a 'semiconductor development alliance', securing greater economies of scale than the US acting unilaterally. Such a proposal has parallels with the idea for like-minded democracies to band together and defend economic security - floated by some commentators in the wake of Russia's invasion of Ukraine - which reflects the fact that economic security principles are increasingly on a level footing with core geopolitical objectives.

Sanctions

[51] The Economist, October 2022
[52] The Economist, January 2023

Sanctions are direct and unambiguous in their demand for a state to issue a course correction. As discussed, their effectiveness is closely linked to the extent to which they are coordinated. Aside from a small number of circumstances, unilateral sanctions are not going to be effective. Richard Haass, the former American diplomat and advisor to Colin Powell, remarked in 1999 that "as a rule, unilateral sanctions tend to be little more than statements or expressions of opposition"[53]. The strength of sanctions lies in the number of sponsoring states.

However, even multilateral, coordinated and extensive sanctions regimes are not a guarantor of success. Russia's persistence and doubling down on its war in Ukraine, despite the unprecedented sanctions designed to incapacitate its economy, are testament to the limited utility that multilateral sanctions offer. At the same time, however, the economic consequences for Russia have been marked: according to analysis by the World Bank, the International Monetary Fund (IMF) and the OECD, in 2022 Russia's gross domestic product (GDP) fell by at least 2.2% in the best-case scenario and by up to 3.9% in the worst-case scenario. Russia's economy may continue to shrink in 2023, with its GDP expected to decline by 5.6% in the worst-case scenario (OECD) or by 3.3% according to the World Bank. The IMF anticipates slight growth in 2023 (0.3%)[54].

The sanctions against Russia following its invasion of Ukraine, as described in **case study 10**, illuminates the fundamental problem encountered by states that look to shore up their economic security: global economic inter-dependencies mean that domestically incurred costs for the consumer and economy can be significant. A recent report by McKinsey states that "no region is close to being self-sufficient [...] Every region has been importing 25% or more of at least one important type of resource or manufactured goods that it needs, and often much more"[55]. The cost-of-living crisis, which much of Western Europe continues to grapple with, is a testament to this.

Case Study 10 – sanctions against Russia following the invasion of Ukraine

The sanctions levied against Russia by an international coalition of countries, following Russia's invasion of Ukraine in February 2022, were unprecedented for the EU in their scope, ambition, speed of adoption and level of coordination. This sanctions regime is designed to be more than a warning shot across Russia's bow: they are an effort to force Russia into capitulation by damaging their economy and destabilising their war effort. Coalition countries have used sanctions to underline that an illegal invasion of a sovereign nation state would not be tolerated.

The sanctions package which was initiated in February 2022 includes the following measures:

- Export controls preventing the export of aircraft parts, energy industry equipment, cutting-edge technology, semiconductors and other dual-use items to Russia.
- Sanctions against Russian individuals and entities. To date, the EU has sanctioned 1386 individuals and 171 entities, including President Vladimir Putin and Minister for Foreign Affairs, Sergey Lavrov.
- Suspension of Russian financial institutions from Swift, the international payments system.

[53] Richard Haass, statement to the House Ways and Means Committee, May 1999
[54] European Council, 2023
[55] McKinsey Global Institute, November 2022

There are few comparable instances which demonstrate such ambitious international coordination against the actions of a nation state. Operation Desert Storm (the first Gulf War, 1991) is broadly comparable, drawing 35 coalition countries from across the Middle East, Europe and North America to liberate Kuwait from Iraqi forces.

This case study also illustrates the difficulties in achieving coordinated economic action. For example, the decision to exclude Russia from Swift came following significant internal European discord and debate. One European camp - lead by the UK - advocated a swift and unequivocal economic strike against Russian economy, to fundamentally destabilise Russia's economy, for which suspicion from Swift was a key policy measure. The other camp - led by Germany - favoured an incremental approach, with some economic measures kept in reserve to threaten Russia and apply leverage; they argued that deferring on the Swift exclusion decision could be used as leverage to compel Russian compliance.

Pillar Three Conclusion

This divergence in favoured approach illuminates a key challenge in the effectiveness of sanctions: economic dependency and national economic self-interest. Germany's favoured incremental approach is as much a product of their dependency on the import of Russian gas (55% of which was imported from Russia prior to Russia's war in Ukraine), as it is a product of a divergence in foreign policy. Russia's leverage in Germany's energy portfolio - versus the almost non-existent role that Russia plays in the UK's energy supply - is instructive in understanding why even likeminded security allies can diverge on the implementation of economic security policy.

There have also been second-order implications for those states that are not directly reliant on Russian imports: namely, a 'cost of living crisis' with spiralling double-digit inflation for much of Europe. The complex web of economic interdependence wrought by globalisation has meant that policymakers' decision-making when it comes to the use of sanctions is very difficult.

And, indeed, Europe has considerable structural advantages in the design of multilateral sanctions. Europe has robust shared institutions which specifically address and facilitate economic, political and security integration (namely the EU and NATO); and shared norms which are vital to compel countries to unite in the face of perceived wrongdoing, for example the rule of law and the mandated collective responsibility to defend which is instituted by NATO. Given the lack of institutionalism throughout much of the international system, it is improbable that this type of coordinated response could realistically be instituted elsewhere.

The effectiveness of sanctions is further limited by the lack of cohesion within the international community of states. The international system is inherently multipolar, and increasingly bipolar. This is illustrated by the fact that there was not unanimous outrage and condemnation following Russia's invasion of Ukraine. Outside of states broadly aligned to the West, the reaction was more ambivalent and muted. The BRICS, for example, have largely abstained from voting for resolutions condemning Russia at the United Nations. For some of these countries, Russian patronage and cooperation is a compelling element of their economic and foreign policy.

Case Study 11 – UK government blocks Nexperia's acquisition of Newport Wafer Fab

In November 2022, the UK government exercised its powers under the National Security and Investment Act to order Nexperia - a Dutch-headquartered but Chinese-owned semiconductor company - to unwind its acquisition of 86% of the Welsh semiconductor manufacturer, Newport Wafer Fab (NWF).

The UK government's rationale in blocking the acquisition as a national security risk was two-fold: firstly, the risk of a "potential reintroduction of compound semiconductor activities" at the site undermining UK capabilities; and, secondly, the fact that NWF is located near to the South Wales semiconductor cluster, which "may prevent the cluster being engaged in future projects relevant to national security".

This decision on NWF was long-awaited and had been the subject to significant political pressure from China-sceptic Members of Parliament. The decision to block NWF's acquisition is indicative of the increasing influence of political considerations on investment clearance in the UK, as well as the prominence of economic security concerns in critical technology sectors[56].

There is a growing consensus across the Conservative Party in support of a more hawkish position on China, hence, recent steps taken by the UK government to introduce a Foreign Influence Registration Scheme (part of the National Security Bill currently making its way through the parliament). The Labour Party has also pivoted, albeit with a greater focus on human rights. As a result, Chinese investment is facing much greater scrutiny.

Since the National Security and Investment Act was introduced in January 2022, two transactions have been blocked – both of which involved Chinese acquirers. Other transactions involving Chinese acquirers have been subject to tough conditions, which in some cases appear to be designed to force a disposal. The government has also issued a Designated Vendor Direction (DVD) regarding Huawei – effectively banning Huawei equipment from use in UK 5G networks[57].

Case Study 12 – Port of Hamburg: Germany's economic dependence on China

In October 2022, the German government allowed the Shanghai-headquartered China Ocean Shipping Company (COSCO) to purchase a stake - up to 25% - in Hamburg's Tollerort container facility, Germany's largest seaport. COSCO Shipping Ports is a subsidiary of COSCO and is listed in Hong Kong. Subsidiaries of the COSCO parent organisation have been flagged for their support for China's navy[58]. They are one of the only shipping companies to have continued servicing Russian ports in the wake of Russia's invasion of Ukraine[59].

The deal came after significant political debate within Germany about the relationship between Germany and China. Germany's economy ministry tried to block an earlier deal, in 2021, on the basis that the shipping terminal constituted part of Germany's "critical infrastructure" and there would therefore be a security risk were it to be partially owned by a security competitor such as China. COSCO has stakes in a number of other key European ports, including Antwerp, Zeebrugge and Rotterdam[60].

Germany's economy is closely linked to China, which has fuelled much domestic political debate, including China labelled as a "systemic rival"[61]. Katharina Dröge, the leader of the Greens in the German Bundestag, was critical of Chancellor Olaf Scholz at the time of the COSCO decision and said that Germany should not make themselves dependent on China. For the past six years, China has been Germany's biggest trading partner.[62] During the first half of 2022 alone, China invested a record €10bn in Germany's economy[63].

Conclusion

In striving for economic security while maintaining openness to trade and investment, there are a suite of policy concerns to consider. From espousing free trade to protecting strategic core industries, to reducing carbon emissions to fostering new technologies and innovation, policymakers must grapple with trade-offs and a range of intended, and unintended, economic, and political ramifications.

The case studies demonstrate the decision about which policy levers to use depends on a range of factors, including wider political objectives, offensive and defensive interests, and the level of support from third countries. Behind all of these measures, there is a wider, geo-strategic significance – whether that be to counter Chinese dominance, to better guard against the US or to pursue legitimate domestic policy objectives. They also show that, while isolated actions taken to protect economic security might not inflict significant damage, it is only when assessing them in the round that the consequences of these policy levers become clear. There is an underlying risk that these policy levers may lead to unintended consequences.

Multilateral solutions, followed by plurilateral solutions, are preferable. Multilateral solutions send a strong political signal about the merits of the international rules-based trading system, demonstrating the effectiveness of countries banding together in international forums to mitigate potential detrimental economic consequences inflicted by countries acting maliciously.

However, it is important to recognise that when faced with such challenges, governments must balance the trade-offs of different types of policy response options and a range of political and economic considerations and therefore, the unilateral approach is sometimes the *only* option. Nevertheless, when opting for the unilateral approach, policymakers must carefully consider the potential for *unintended* consequences, some of which are outlined in this report.

Policy recommendations

Policymakers would benefit from a more robust treatment of the economic security realm - akin to the perspective used to view military and defence policy, which benefits from deep and entrenched

[56] Flint Analysis, Zachary Spiro, November 2022
[57] Flint Briefing Call, Sir Julian King, Katie Whitting, Francois-Joseph Schichan, October 2022
[58] Financial Times, October 2022
[59] Financial Times, May 2022
[60] Financial Times, October 2022
[61] Council on Foreign Relations, November 2022
[62] Reuters, November 2022
[63] Council on Foreign Relations, November 2022

international cooperation. The nascent concept of like-minded countries coming together to form an alliance and protecting economic security has some intellectual weight to it, and it could be an effective preventative treatment to cure unilateral tendencies.

Policymakers looking to further their states' interests in the era of economic security should set their sights high: ingrained multilateral forums and institutions are the ultimate antidotes to unilateralism.

Multilateral approaches

- **Promote coordinated WTO action, particularly restoring the dispute resolution mechanism**, thus bolstering the strength of the international rules-based system, serving as a deterrent to countries acting maliciously and better protecting members against economic coercion.

- **Redouble efforts to engage in existing conversations in the international fora**, for instance ongoing discussions at the United Nations about 'unilateral coercive measures' to define different types of coercion. There is merit in leveraging – and refocusing efforts on - diplomatic and multilateral infrastructure that already exists, rather than focusing solely on developing new mechanisms.

- **Shape international standards setting in relevant areas**, such as supply chain management, social responsibility and sustainability, with a view to agreeing harmonisation and (recognition of) common best practice, and demonstrating the 'soft power' of collaborative approaches in the face of countries acting maliciously.

- **Encourage the OECD to devise a robust evidence base** for economic security threats and their real-world impacts, thereby raising awareness of these challenges and their effects and improving the international evidence base.

Plurilateral approaches

- **Create a taskforce of like-minded countries** to promote dialogue, share policy proposals and encourage data-sharing on economic security threats, and endeavour to be a sounding-board for potential responses to coercive practices. The taskforce could also engage in activities such as producing joint statements condemning coercive practices and coordinating joint action at the WTO.

- **Encourage strategic trade diversification through FTAs** – policymakers should work with businesses to identify sectors that are overly dependent on foreign supplies (and, by extension, trade disruption) and promote trade diversification where possible through international agreements.

- **Continue to engage in sanctions cooperation**, akin to the West's collective sanctions on Russia following the invasion of Ukraine, while bearing in mind any lessons learned from past experience, such as promoting better supply chain tracing and country of origin determination. The G7's proposed 'Enforcement Coordination Mechanism', aimed at improving information sharing and sanctions enforcement directed at governments and companies suspected of

helping Russia in Ukraine through circumvention of sanctions, is a welcome step in establishing a dialogue to discuss these kinds of issues.

Unilateral approaches

- **Promote better collaboration between policymakers and business** on immediate and potential economic security threats, such as convening government-to-industry councils with a view to raising awareness of potential challenges and sharing real-time information on possible threats.
- **Produce business-facing guidance** on how to approach risk assessments and assess exposure to potential economic security threats, for instance in respect to critical materials, supply chain disruption and sanctions, and encourage businesses to report coercive practices encountered to the relevant authorities.
- **Improving the design of unilateral tools to best mitigate against unintended / adverse consequences**, in recognition of the fact that governments will inevitably continue to develop these instruments. This could involve, for instance, policymakers aiming to consult (more) with international partners prior to the development of the given tool.
- **Take steps to diversify sources of critical supplies**, starting with an assessment of exposure to supply shocks and potential vulnerabilities, and then working with business to identify ways to diversify sources with a view to avoiding over-dependence.