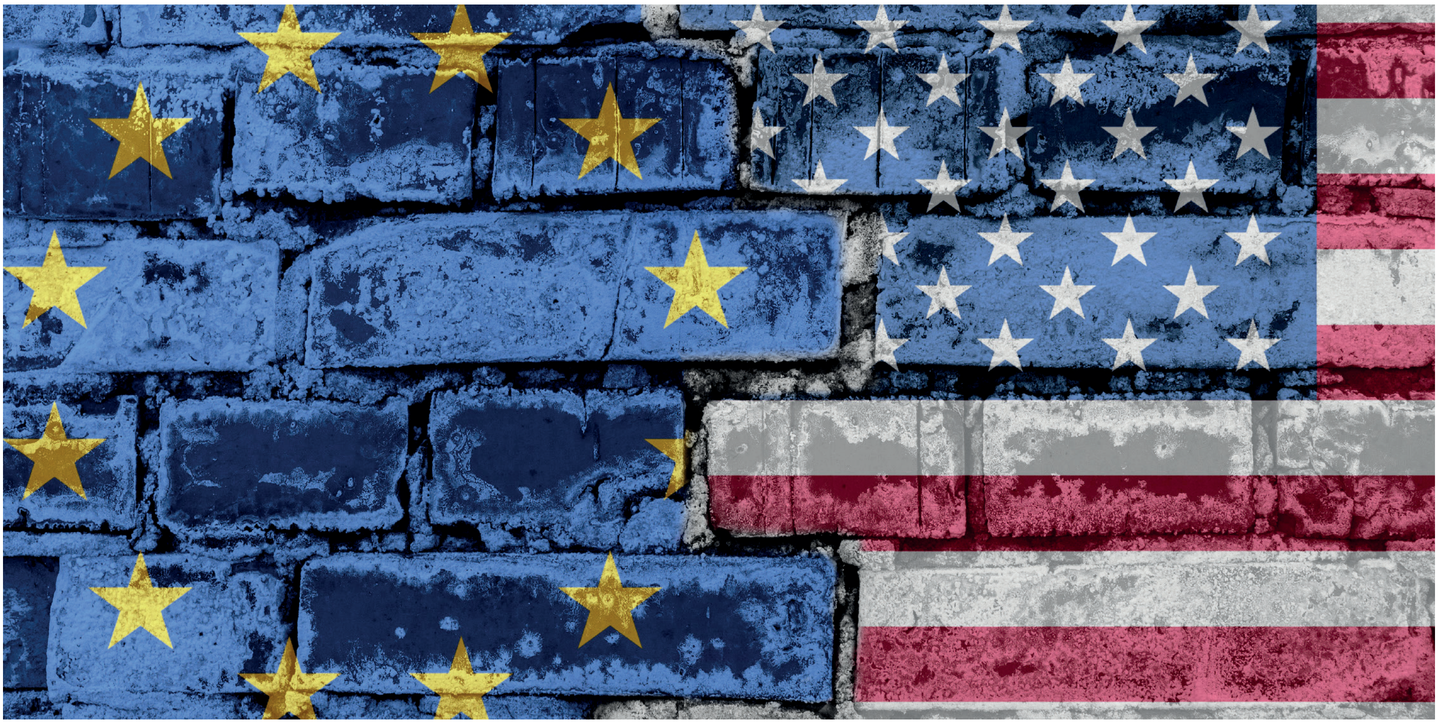


Transatlantic Expert Group | #2023.02

A Transatlantic Economic Security Alliance to deter geo-economic coercion

Europe and the United States should create a defensive economic security alliance to deter third-party geo-economic coercion. Well-designed, successful deterrence policies would help weaken the incentives to weaponize economic interdependence, thereby strengthening the rules-based international economic system.

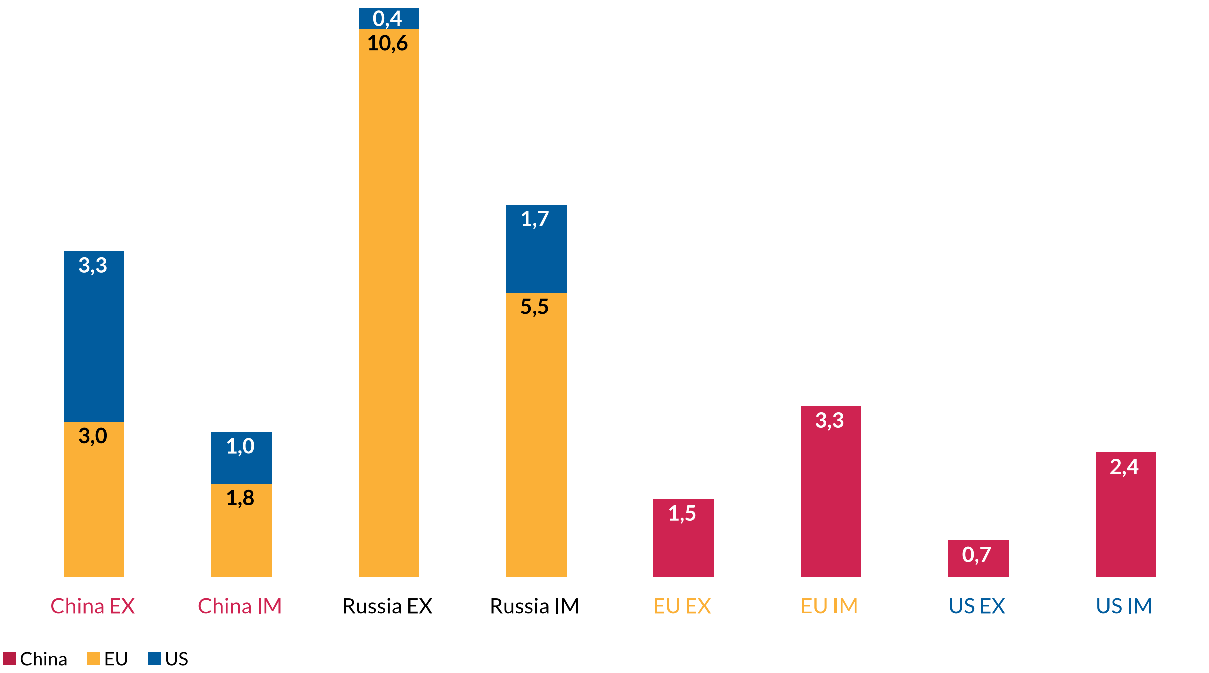
Markus Jaeger

The EU and the United States should create a defensive economic security alliance to deal with the 'economic security dilemma' in the context of the current trend toward the weaponization of international economic relations. Such an alliance would harness the aggregate economic, financial and technological power of its members to deter (politically-motivated) third-party geo-economic coercion. If deterrence proves successful, it will help strengthen the rules-based international economic system. If it fails, it will nonetheless help limit the vulnerability of the alliance and its members to geo-economic

Bertelsmann FOUNDATION
GED Global & European Dynamics
BertelsmannStiftung

EU & USA are less trade dependent than China

By destination, % of respective GDP, 2021



Source: WTO, author's calculation,

BertelsmannStiftung

coercion, while increasing the costs to potential coercers (Chen 2021: 246–259).

The establishment of a transatlantic defensive economic security alliance would help deter third-party geo-economic aggression. Such an alliance should commit its members to providing economic assistance as well as coordinate retaliatory policies in case of geo-economic coercion targeting any of its members. A geo-economic attack is defined as a politically motivated discriminatory economic measure.

Alliance policies should combine 'deterrence by denial,' such as creating shared reserves of critical goods and a jointly financed fund to mitigate the economic effects of targeted third-party export and import restrictions, with 'deterrence by punishment,' such as retaliatory, cost-imposing trade and financial measures. It is imperative to define the conditions under which mutual economic assistance and joint retaliatory policies are triggered in order to avoid 'entrapment' and limit the risk of geo-economic conflict and escalation. If deterrence is successful, it will help stabilize international economic relations *provided* deterrence policies are designed in such a way as to discourage offensive geo-economic actions by alliance members.

Main pillars of a Transatlantic Economic Deterrence Strategy[1]

At a minimum, the defensive alliance policies should comprise:

Mitigating the effects of third-party import restrictions by setting up a jointly financed fund to purchase goods affected by third-party import restrictions and/or by reducing alliance members' import restrictions, such as lowering tariffs or non-tariff barriers, to boost demand for the affected goods (deterrence by denial). This is meant to offset the economic impact of third-party import restrictions.

Deterring third-party import restrictions by threatening to retaliate through the imposition of alliance-wide, retaliatory import measures. If this is impractical due to a high degree of dependence on the coercer's exports, more elaborate schemes, such as price caps or a buyers' cartel (deterrence by punishment), should be devised. This is meant to impose costs on the third-party coercer.

Mitigating the effects of third-party export controls by creating jointly financed reserves of critical goods and by putting in place an equitable access agreement (deterrence by denial). This should help to (somewhat) mitigate concomitant economic vulnerabilities, thus reducing the coercer's geo-economic leverage. (It can also help address problems in terms of collective action problems).

Deterring third-party export restrictions by threatening to impose retaliatory export control measures targeting a coercer's economic and political vulnerabilities (deterrence by punishment). It would be desirable to establish a compensation mechanism so that the costs of export controls are shared somewhat equitably among alliance members rather than have them fall exclusively on the countries producing the restricted good. This is a cost-imposing policy.

Deterring third-party discriminatory economic, financial and regulatory measures, including asset freezes, expropriation and all other (politically-motivated) financial and non-financial measures, by threatening 'in-kind' joint financial retaliation, but also including restrictions on the use of the dollar and the euro (deterrence by punishment). In principle, financial measures can also be used to deter third-party coercion related to trade, financial and all other types of discrimination targeting alliance members' economic interests (incl. domestic regulatory discrimination of American and European companies).

Dealing with entrapment and abandonment in an alliance context

In light of recent transatlantic disagreements, ranging from Trump-era protectionism to the Biden administration's Inflation Reduction Act,

[1] The European Union has published its first economic security strategy (European Commission, Joint Communication to the European Parliament, the European Council and the Council on "European Economic Security Strategy," June 20, 2023). The strategy does propose, among other things, greater bilateral and plurilateral cooperation to enhance economic security and resilience, including in the context of the EU-US Trade and Technology Council (TTC), the EU-Japan High Level Dialogue and the G7. The EU-US TTC, in particular, offers a platform for transatlantic economic coordination and cooperation, even though little progress seems to have been made hitherto. The EU's proposed security strategy effectively seeks to embed in a more coherent framework various already existing initiatives, such as policies relating to trade defense (e.g. anti-coercion tool), the mitigation of import-related vulnerabilities (e.g. Raw Materials Alliance, Chips Act), inward investment screening and regulation (e.g. Foreign Subsidies Regulation) as well as greater intra-EU coordination of national-security- and technology-related export control and inward FDI policies. It also proposes greater coordination with respect to outbound investment related security risks.

fostering closer economic security cooperation may look like wishful thinking. Moreover, the EU-US Trade and Technology Council, which seeks to address some economic security issues, seems to have made little progress so far, despite twenty-seven months of talks. However, the United States and Europe do share broadly similar economic interests in terms of supply-chain security and access to critical goods. Their economies are highly interdependent in terms of trade and investment. The existence of a transatlantic security alliance also facilitates economic cooperation, including cooperation on economic security, due to its favorable security externalities.

However, the United States and Europe clearly diverge in terms of their willingness to pursue offensive geo-economic policies, particularly vis-à-vis China. Washington is less dependent on China economically, and it is more directly affected by Beijing's military rise, given Washington's extensive security commitments in Asia. By contrast, Europe would rather avoid getting embroiled in a US-China geo-economic conflict. Either way, Washington is not going to let itself be constrained by a transatlantic economic security regime.

To address the risk of 'entrapment,' it will therefore be necessary to define as clearly and unambiguously as possible what constitutes 'unprovoked' third-party geo-economic coercion as well as what constitutes third-party retaliation that is taken in response to geo-economically offensive measures. In the latter case, alliance members should have the right to invoke an exemption to limit the risk of entrapment as well as to restrain offensive policies by alliance members. This would allow the United States to continue to pursue its hawkish geo-economic strategy vis-à-vis Beijing without entrapping the alliance. Nevertheless, alliance membership would benefit Washington by shoring up economic security within the transatlantic security alliance and by strengthening deterrence in case of 'unprovoked' third-party aggression.

Critical elements of successful geo-economic deterrence

The literature on coercion distinguishes between deterrence and compellence (Schelling 1960). Compellence (forcing an actor to take a specified action) is generally less successful than deterrence (dissuading an actor from taking a specified action), which is why economic sanctions are typically inefficacious in terms of their political objectives, particularly when they target a geopolitical adversary (Hufbauer, Schott and Elliott 2009). Another important distinction concerns deterrence by punishment and deterrence by denial. The former threatens to impose costs on a coercer by way of retaliation; the latter seeks to deny the coercer its objective by limiting one's vulnerability.[2]

Following Jentleson, two sets of factors are important in designing successful deterrence policies: the defending state's deterrence policies need to be characterized by proportionality, reciprocity, and credibility, and they should take advantage of the attacking state's economic-political vulnerabilities, thereby making deterrence policies more effective (Jentleson 2022). In the context of geo-economic deterrence, mitigating one's own vulnerabilities vis-à-vis a potential coercer also

[2] Deterrence by denial is more WTO compatible than deterrence by punishment.

increases the likelihood of successful deterrence (by denial).

Proportionality means that the defending state's objective must be commensurable with its available policy options. A threatened response that is extremely disproportional, whether too weak or too strong, will not be sufficiently credible or effective. (However, in case a state possesses escalation dominance, threatening more than proportional retaliation can be desirable.) Reciprocity requires an unambiguous common understanding of the link between the aggressor's actions and the deterrer's response. It is imperative to make a coercer aware that aggression will elicit retaliation. Credibility requires threats to be sufficiently believable for the aggressor to expect that the threatened retaliatory response will materialize. In this context, deterrence is more credible in case the deterrer possesses 'escalation dominance.' But escalation dominance is not necessary for deterrence to be successful, nor does it guarantee its success. But it enhances its credibility and therefore its chances of success.

Generally speaking, deterrence can and does fail. Deterrence is ultimately about psychology, not material advantage. And the success or failure of geo-economic deterrence is not exclusively determined by the balance of economic costs and benefits. Rather, it is determined by how highly motivated the deterrer and the coercer are. Nevertheless, well-designed policies will make deterrence success more likely.

Designing deterrence policies – within an alliance

Designing effective and credible policies is even more of a challenge in the context of alliances. In alliances, the risk of entrapment (being drawn into a conflict) and abandonment (not receiving alliance support in case of third-party aggression) is ever present, which risks undermining both credibility and effectiveness. Designing geo-economic deterrence policies in the context of a transatlantic security alliance should hence take the following criteria into account:

Define as unambiguously as possible what constitutes third-party geo-economic coercion and the condition under which the obligation of alliance members to assist and support retaliation is triggered. Not all discriminatory measures rise to the level of geo-economic (politically motivated) coercion.

Agree on well-defined thresholds for triggering both mitigating and retaliatory actions. If the threshold is too low, the risk of geo-economic coercion will be high. If the threshold is too high, deterrence will become less credible because retaliatory measures will be more difficult to trigger. (To some extent, these thresholds can and maybe should be left ambiguous in order to pre-empt a third party from 'gaming' them).

Balance risk of entrapment and abandonment by opting for (defensive) mitigating rather than (offensive) retaliatory measures in case the alliance fails to reach broad agreement on whether a third-party measure was politically motivated or not. (This can be done by, for example, introducing different majority thresholds in case an allied response requires a vote by alliance members).

Design obligations and policies in such a way as to minimize entrapment. This can be done by limiting or even waiving mutual assistance and joint retaliation obligations in case third-party action is a response to prior 'offensive' action by an alliance member. Not only is it imperative to define precisely what constitutes third-party coercion, but it is similarly important to define what constitutes offensive geo-economic measures on the part of alliance members vis-à-vis a third party. (This will be tricky, but only because it is tricky does not mean that it cannot be done. Traditional security alliances are faced with similar challenges in terms of hybrid warfare).[3]

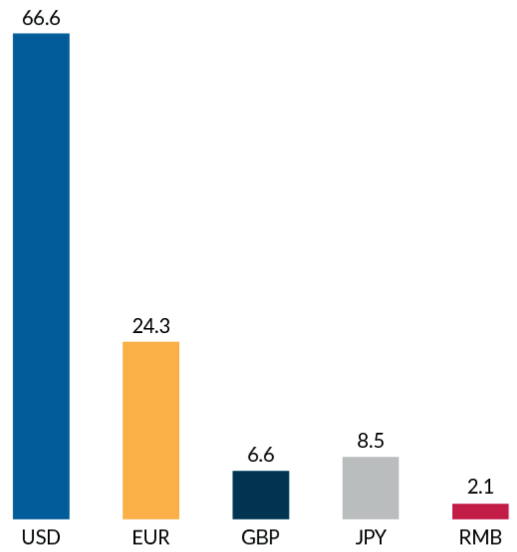
Communicate clearly to would-be coercers that discriminatory economic measures risk eliciting a retaliatory response without laying out in detail what this retaliation will consist of. This is meant to limit the coercer's ability to take pre-emptive defensive measures or otherwise 'game' the alliance's deterrent posture (see above).

Devise effective, credible and proportionate joint retaliatory policies targeting a coercer's economic-political weaknesses. Policies should target the aggressor's politically salient economic vulnerabilities, while limiting the costs to the alliance in aggregate and individually.

Opt for 'in-kind retaliation', rather than horizontal retaliation and escalation, if possible and opportune to do so, thereby emphasizing the link between an aggressor's actions and retaliatory measures. If the alliance does not possess 'escalation dominance' in a specific area and cannot credibly and effectively threaten retaliation, horizontal economic-financial escalation should remain on the table. Horizontal escalation would allow the alliance to retaliate financially to respond to discriminatory trade measures, for example. The threat of horizontal escalation should be communicated in advance.

Dollar and Euro dominate

Index of International Currency Usage, 2020*



* Index is a weighted average of each currency's share of globally disclosed FX reserves (25 %), FX transaction volume (25%), foreign currency debt issuance (25 %), foreign currency and international banking claims (12.5 %), and foreign currency and international banking liabilities (12.5 %).

Source: Federal Reserve | BertelsmannStiftung

Seek as equitable as possible an intra-alliance distribution of the costs of both mitigation and retaliation policies ('burden-sharing'). The costs of joint mitigation measures, such as acquiring reserves of critical goods or acting as a 'buyer-of-last-resort' in case of import restrictions, should reflect economic size, per capita income and country-specific vulnerabilities. Countries with a greater vulnerability should make a contribution relative to their economic size and per capita income, as they benefit more from such an "insurance scheme." A similar mechanism should be devised in terms of retaliatory policies to ensure

3 I would like to thank Peter Sparding from the German Marshall Fund for drawing my attention to this point.

that their costs do not fall disproportionately on only one or a handful of alliance members. Aligning costs and benefits will limit the incentive for the 'weak to exploit the strong,' which will help enhance alliance credibility and may even help mitigate entrapment risks. It is not necessary to compensate fully the alliance members who incur costs for such compensation to align incentives and enhance credibility.

Get alliance members to commit, individually and jointly, to limiting 'single-country economic and financial risk' exposure in order to weaken third-party coercive power. This would help strengthen deterrence by denial and it would reduce the need for retaliatory policies.

Concluding remarks

This policy brief has sketched in a largely conceptual way what a transatlantic economic defense alliance might look like. Specifically, it has laid out what the main pillars of such a regime should consist of, how policies should be designed to enhance the prospect of successful deterrence, and how the United States and Europe should address problematic issues related to alliance politics. As such, it is very programmatic and meant to provide the conceptual foundation for formulating actual transatlantic geo-economic defense and deterrence policies.

In order to assess the practical and political feasibility of such a proposal, it will be necessary to consider the following steps:

Seek agreement on a common position among EU members (or at least among the economically and financially most important members) in terms of the commitments to be made in the context of a transatlantic alliance (mitigation / retaliation; trade / finance, imports / exports etc.).

Push for further intra-EU coordination and integration of policies, particularly in areas that largely remain under the purview of member states, such as export control and inward FDI policies. This will help strengthen the credibility and effectiveness of European deterrence policies and create greater incentives for Washington to sign on to a transatlantic defense alliance.

Create relevant bureaucratic and administrative structures at the national and European level to facilitate transatlantic coordination, allowing for effective and credible defense and deterrence (e. g. strengthen role and capacity of EU sanctions agency to facilitate cooperation with the US Treasury's Office of Foreign Assets Control).

Identify the relevant political stakeholders as well as potential veto players in Washington, whose buy-in is required to make a defense alliance a reality (executive, congress).

In terms of negotiation, Europe should consider seeking a high-level political agreement first (top-down), rather than pursue negotiations at the technocratic level (bottom up). After all, the EU-US Trade and Technology Council is meant to deal with several economic security challenges but seems to have made little progress so far.

Bibliography

Chen, Frederick R. (2021). "Extended Dependence: Trade, Alliances, and Peace." In *Journal of Politics* 83 (1): 246–259.

Hufbauer, Gary Clyde, Schott, Jeffrey J. and Elliott, Kimberly Ann, Economic sanctions reconsidered. Washington, DC: The Peterson Institute for International Economics.

Jentleson, Bruce W. (2022) Sanctions. Oxford University Press

Schelling, Thomas (1960) The strategy of conflict, Cambridge, Mass.: Harvard University Press.

Agenda for transatlantic security

Economic vulnerability	Mitigation policies	Deterrence policies	Alliance policies
Import restrictions			
Risk: Reduces exports and economic growth	Pursue export diversification through (1) free-trade agreements, (2) guarantees for trade-related outward FDI to support supply chain diversification	Leverage size of combined EU-US economy by threatening joint, coordinated retaliatory import restrictions	**Retaliation:** Commit to joint, coordinated retaliatory import restrictions **Mitigation:** Set up intra-alliance 'insurance scheme' to act as 'buyer-of-last-resort'
Export restrictions			
Risk: May limit access to critical goods; disrupts vital supply chains	Reduce critical import dependence through (1) import diversification (incl. FTAs), (2) creation of domestic production capacity, (3) building of emergency stockpiles	Leverage ability to withhold critical exports by threatening targeted export controls	**Retaliation:** Coordinate joint retaliatory policies targeting critical goods export to coercing country **Mitigation:** Set up a joint fund to finance emergency stockpiles of critical goods, offering access to alliance members in case of emergency; coordinate joint purchases/ create buyers' cartel to source critical goods
Inward foreign direct investment			
Risk: unauthorized technological leakage; national security at risk	Screen and restrict, inward foreign direct investment (and other investment like JVs) that seeks to acquire and/ or lock up critical technologies, capabilities Focus screening on countries deemed to be (1) 'non-market' economies and (2) non-allies	Leverage position as provider of advanced technology by threatening to force sale by foreign owner of critical assets, including 're-nationalization'	**Retaliation:** Coordinate retaliatory measures restricting coercing country's present and future ability to acquire critical assets **Mitigation:** Coordinate inward investment restrictions to prevent technological leakage and national security related risks
Discriminatory measures targeting outward foreign direct investment			
Risk: Forced technology transfer; regulatory discrimination; expropriation, leading to supply chain disruption	Establish outward FDI screening mechanism with a focus on (1) countries lacking sufficient legal safeguards, (2) non-allies Support FDI diversification through (1) investment guarantees, (2) bilateral investment agreements	Leverage position as provider of technology goods by threatening to restrict further outbound investment in coercing country and/ or force divestment from it	**Retaliation:** Joint retaliatory action restricting present or future outward FDI **Mitigation:** Coordinate outward screening policies to limit technological leakage and limit national security risk
Discrimination targeting outward financial investment			
Risk: Asset freezes; expropriation; other discriminatory actions, leading to financial losses	Consider mandatory disclosure of country risk related financial exposure for companies to encourage market monitoring Create incentives to manage country risk with a view to limiting concentration risk, especially for countries not subject to market monitoring	Leverage central role of US and European financial markets by threatening financial retaliation, such as (1) limiting/ prohibiting access to financial markets (flows), (2) freeze existing assets (stocks), (3) limit use of euro/ dollar	**Retaliation:** Coordinate joint financial sanction policies, including financial retaliation in terms of currency, asset freezes, cross-border financial flow restrictions

Source: Author's compilation

BertelsmannStiftung

About

This policy brief is a product of the Transatlantic Expert Group which was established by the Bertelsmann Stiftung together with the Bertelsmann Foundation in Washington, DC. The Transatlantic Expert Group identifies vulnerabilities arising from economic interdependencies, analyses the consequences for the political capacity of the EU and the US to act, and develops strategies to improve transatlantic cooperation in order to increase mutual resilience. The findings of the expert group are published in a series of policy briefs.

You can find all policy briefs here.

Author

Dr. Markus Jaeger is a research fellow at DGAP (German Council on Foreign Relations) and an adjunct professor at Columbia University in the City of New York.

Legal Notice

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh
bertelsmann-stiftung.de

Mark Fischer
Senior Project Manager
Program Europe's Future
Phone: +49 30 275788-136
mark.fischer@bertelsmann-stiftung.de

Titelbild: © stock.adobe.com