



CONNECTIVITY

WARS

**WHY MIGRATION,
FINANCE AND TRADE
ARE THE GEO-ECONOMIC
BATTLEFIELDS
OF THE FUTURE**

Edited by **MARK LEONARD**





**EUROPEAN
COUNCIL
ON FOREIGN
RELATIONS**
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© ECFR January 2016.

ISBN: 978-1-910118-55-9.

Published by the European Council on Foreign Relations (ECFR), 7 Kings Building, 16 Smith Square, SW1P 3HQ London, United Kingdom

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A PUBLICATION MADE POSSIBLE BY

RETHINK: EUROPE

Rethink: Europe is an initiative of the European Council on Foreign Relations and Stiftung Mercator. The project examines the underlying forces shaping European cohesion and our continent's capacity to act on the global stage. Rethink: Europe offers spaces to think through and discuss Europe's strategic challenges. We do this by inviting thought leaders and policy practitioners from national capitals, the European institutions, as well as from outside Europe, to reconsider and reflect upon European integration and exchange new ideas and forward thinking on Europe.

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Contents

List of acronyms	9
FOREWORD	10
<i>Michael Schwarz</i>	
INTRODUCTION: CONNECTIVITY WARS	13
<i>Mark Leonard</i>	
THE BATTLEFIELDS	
ECONOMIC WARFARE	
1. THE NEW GEO-ECONOMIC GAME	31
<i>Juan Zarate</i>	
2. HOW THE EU LEARNED TO LOVE SANCTIONS	36
<i>Clara Portela</i>	
3. THE RETURN OF THE VISIBLE HAND	44
<i>Simon J. Evenett</i>	
4. ECONOMIC REPRESSION AS A FOREIGN POLICY TOOL	54
<i>Michael Hessel</i>	
5. CURRENCY WARS WITHOUT END	63
<i>James Rickards</i>	
6. DIVESTMENT CAMPAIGNS: BOTTOM-UP GEO-ECONOMICS	68
<i>Atif Ansar & Ben Caldecott</i>	
7. THE WEAPONISATION OF MIGRATION	76
<i>Kelly M. Greenhill</i>	

WEAPONISING INSTITUTIONS

- 8. CHINA'S SHADOW WORLD ORDER** **83**
Moritz Rudolf

- 9. GATED GLOBALISATION** **93**
Hina Rabbani Khar

- 10. HOW GEOPOLITICS WILL END GLOBALISATION
AS WE KNOW IT** **98**
Thomas Wright

INFRASTRUCTURE COMPETITION

- 11. THE ERA OF INFRASTRUCTURE ALLIANCES** **103**
Parag Khanna

- 12. THE GEO-ECONOMICS OF THE DIGITAL** **110**
*Carla Hobbs, Andrew Puddephatt
& José Ignacio Torreblanca*

- 13. THE CHINESE CYBER-SOVEREIGNTY AGENDA** **120**
Rogier Creemers

THE WARRIORS

ESTABLISHED POWERS

- 14. THE US: DECLINING MIGHT?** **129**
Ian Bremmer

- 15. THE EU AS A REGULATORY POWER** **133**
Anu Bradford

- 16. THE REINVENTION OF GERMAN POWER** **141**
Stephen F. Szabo

17. GERMANY: A PRIVATE SECTOR PERSPECTIVE	150
<i>Stefan Mair</i>	
18. EUROPE'S LIMITATIONS	156
<i>Hans Kundnani</i>	
19. HOW TO INCREASE EUROPE'S CLOUT	164
<i>Sebastian Dullien</i>	
CHALLENGERS	
20. WHY EMERGING COUNTRIES ARE HEDGING AGAINST THE GLOBAL SYSTEM	179
<i>Ulrike Esther Franke</i>	
21. CHINA: TURNING MONEY INTO POWER	189
<i>James Reilly</i>	
22. RUSSIA: A DIVERSE ARSENAL	198
<i>Andrey Mouchan</i>	
23. SAUDI ARABIA: HARNESSING THE OIL MARKET	204
<i>Dag Harald Claes, Andreas Goldthau & David Livingston</i>	
About the authors	215
Acknowledgements	220

List of acronyms

ADB – Asian Development Bank

AIIB – Asian Infrastructure Investment Bank

ASEAN – Association of Southeast Asian Nations regional group

BRICS – Brazil, Russia, India, China and South Africa

CFSP – The EU’s Common Foreign and Security Policy

CSDP – The EU’s Common Security and Defence Policy

EBU – European Banking Union

ECB – European Central Bank

IMF – International Monetary Fund

NDB – The BRICS’s New Development Bank

OBOR – China’s “One Belt, One Road” initiative

OPEC – Organization of the Petroleum Exporting Countries

PBOC – People’s Bank of China

SCO – Shanghai Cooperation Organization regional group

TPP – Trans-Pacific Partnership trade deal

TTIP – Transatlantic Trade and Investment Partnership trade talks

WTO – World Trade Organization

Michael Schwarz

Foreword

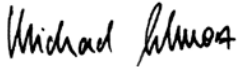
No country is more connected to the world than Germany, the proverbial *Exportweltmeister*. But precisely because of its prominent position within the global economy, German companies and citizens are now facing challenges. Sanctions against Russia have reduced companies' profits and endangered jobs, and banks have paid billions for not complying with US sanctions against Iran.

Globalisation and the knitting together of the global economy has lifted a billion people out of poverty, helped businesses grow, and coincided with a period of peace between the great powers. However, we are now beginning to realise that there is another side to the coin: the same interdependence that has brought the world closer together has also created new vulnerabilities and threats.

Until today, few people have thought about this in a strategic way. This groundbreaking collection of essays endeavours to do just that, bringing to life the challenges and opportunities arising from geo-economics. More than 20 highly respected authors – including top-level academics and former government ministers and advisors – explore in detail how countries use economic asymmetries to achieve geopolitical goals, examining the consequences for businesses, politics, and the people.

Exploring these hitherto understudied questions and facilitating debate on them is part of our mission at Stiftung Mercator. We believe in a cohesive Europe that has the ability to act together on the challenges of a globalised world. Stiftung Mercator and the European Council on Foreign Relations share this vision and have joined forces through their Rethink: Europe initiative. The project, which funds this publication, examines the underlying forces that shape European cohesion and our continent's capacity to act collectively. It does this by engaging with thought leaders and policy practitioners from across as well as outside Europe.

This timely collection of essays is one of the outcomes of this ongoing process. I hope it will inform readers in policy, business, and the public alike, and help us understand in greater detail the dynamics that shape Europe's global environment and future.

A handwritten signature in black ink that reads "Michael Almos". The script is cursive and fluid, with the first letter of each word being capitalized and prominent.

Executive director - Stiftung Mercator

Mark Leonard

Introduction: Connectivity wars

When Turkey shot down a Russian fighter jet in November 2015, the image of the falling plane went viral. Calls for revenge exploded across the Russian media and internet. Protesters hurled stones and eggs at the Turkish embassy in Moscow. And the high-profile host of Russia's main political TV talk show compared the downing of the jet to the 1914 assassination of Archduke Franz Ferdinand that triggered the First World War. So how did Russia's hawkish leader, Vladimir Putin, respond to the battle cries of his people?

He signed a decree halting fruit and vegetable imports from Turkey, banning charter flights and the sale of package holidays, and scrapping Russia's visa-free regime with the country. His proxies warned about possible escalation involving energy imports, while the media speculated about cyber-attacks (Moscow had used this tool to powerful effect against Estonia in 2007, Georgia during the 2008 war, and then against Ukraine as it annexed Crimea in 2014). The most important battleground of this conflict will not be the air or ground but rather the interconnected infrastructure of the global economy: disrupting trade and investment, international law, the internet, transport links, and the movement of people. Welcome to the connectivity wars.

This form of warfare is not uniquely Russian – quite the contrary. As Putin signed his sanctions decree, the Turkish government was holding a summit on refugees with the European Union. President Recep Tayyip Erdogan has realised that the movement of refugees to Europe changes his power dynamic with the EU. Using his ability to control the flow of migrants as a weapon, Erdogan has gone from being a supplicant for membership of the EU club to being a power player who can extract money and political favours.

The EU is equally adept at instrumentalising economic interdependence for geopolitical ends. When Russia annexed Crimea, the EU did not send troops to defend Ukrainian territory. Instead it introduced an array of sanctions, including visa bans and asset freezes against targeted individuals, as well as commercial measures aimed at specific sectors of the Russian economy, such as the financing of energy exploration. The United Nations has also used sanctions for decades, and the United States has reshaped the very nature of financial warfare since it launched its War on Terror.

While sanctions are vastly preferable to conventional warfare in humanitarian terms, the ease with which countries are weaponising the structures of the international system raises dark omens for the current world order. In 1914, globalisation collapsed because the world's most powerful nations went to war. A hundred years later, it is the reluctance of the great powers to engage in all-out war that could precipitate a new unravelling of the global economy.

Some may say that this is an exaggeration: sanctions have been with us since the time of the Peloponnesian Wars, and mercantilist behaviour is as old as the state. What is so dangerous about the phenomenon?

The short answer is: hyper-connectivity. During the Cold War, the global economy mirrored the global order – only limited links existed across the Iron Curtain, and the embryonic internet was used only by the US government and universities. But with the collapse of the Soviet Union, a divided world living in the shadow of nuclear war gave way to a world of interconnection and interdependence. Some hailed the end of history. The world was largely united in pursuing the benefits of globalisation. There was talk of win-win development as Western multinationals made record profits and emerging

economies boomed. Trading, investment, communications, and other links between states mushroomed. And these interstate links have been amplified further by the ties between people powered by technology: by 2020, 80 percent of the planet's population will have smartphones with the processing power of yesterday's supercomputers.¹ Almost all of humanity will be connected into a single network.

But, contrary to what many hoped and some believed, this burgeoning of connections between countries has not buried the tensions between them. The power struggles of the geopolitical era persist, but in a new form. In fact, the very things that connected the world are now being used as weapons – what brought us together is now driving us apart. Stopping short of nuclear war, and not prepared to lose access to the spoils of globalisation, states are instead trying to weaponise the global system itself by utilising the disruption of various links and connections as a weapon. Mutually Assured Disruption is the new MAD.

Interdependence, once heralded as a barrier to conflict, has turned into a currency of power, as countries try to exploit the asymmetries in their relations. Many have understood that the trick is to make your competitors more dependent on you than you are on them – and then use that dependency to manipulate their behaviour.

Like when a marriage goes wrong, it is the innumerable links and dependencies that make any war of the roses effective – and painful. Many of the tools look familiar to those employed during the globalisation of the 1990s, but their purpose is different.

The global trading regime, once a tool of integration, has been riven by economic and financial sanctions. Likewise, global multilateral institutions are increasingly sidelined by a new generation of competing friendship clubs. Rather than using infrastructure and the construction of physical links as a way to maximise profits, China and the US are using them as a tool for power projection. Even the internet is being used as a weapon, and fragmented because of concerns about privacy and security.

¹ "Planet of the phones", the *Economist*, 28 February 2015, available at <http://www.economist.com/news/leaders/21645180-smartphone-ubiquitous-addictive-and-transformative-planet-phones>.

This means that countries that do not depend too much on any single other country (those with a diversified economy, who are able to import energy from many places) will be shielded from most geo-economic attacks. Few countries will follow North Korea into a world of autarchy – but reacting to the exploitation of interdependencies, they will try to carve out spheres of independence. The US is on a quest for energy independence; China is shifting towards domestic consumption, diversifying its foreign holdings away from the dollar, and developing an alternative to the SWIFT payment system; Russia is building pipelines to Asia to lessen its dependence on European markets.

The new battlegrounds: Three domains of disruption

When the Berlin Wall came down in 1989, a new wall was erected between the management of the global economy and the battles of geopolitics. The economy was pure business, and foreign policy focused on managing geopolitical crises in parts of the world that are economically marginal.

But the reality is that in today's world, all parts of the global system are ripe for disruption, be they economic, political, physical, or virtual. The wall between economics and politics has fallen, and political conflicts are fought through the system that manages the global economy. This essay collection examines three battlegrounds in this struggle.

Economic warfare

First, *economic warfare*. All types of economic activity – trade, access to finance, and investment – are being used as weapons and tools of disruption. Faced with war-weary publics and tightening budgets, Western powers are projecting power through their influence over the global economy, finance (including the dollar and euro), and trade, and through their control over multinational corporations domiciled in their countries. As British Foreign Secretary Philip Hammond recently said: “There is a question about whether the EU – which does not have and won't have a military capability – wants to develop a genuinely powerful alternative source of strategic power in the sanctions weapon”.

For the Obama administration, ever more sophisticated financial sanctions are the new drones – offering devastating effective and allegedly surgical interventions without running the risk of sending in ground troops.² Non-Western countries also impose sanctions, though these usually aren't called sanctions and are sometimes disguised as stricter sanitary controls or customs-related delays, as Ulrike Franke argues in her essay: Russia has introduced sanctions on Georgia, Moldova, and Ukraine to prevent their drift Westwards; Turkey is sanctioning Syria and blockading Armenia; and China has used sanctions against Japan and the Philippines over maritime disputes.³

Sanctions disrupt and distort global trade, and can hurt domestic businesses as well as their targets. US companies have had to stay away from Iran, while sanctions on Russia have hurt German businesses that are forced to reduce their exports to the country (58 percent of German firms have been negatively affected by the sanctions⁴), and French shipyards, which have suffered through the cancellation of the sale of Mistral warships. They can also provoke counter-measures. In 2014, Moscow retaliated against the West by banning food imports from countries that had joined sanctions against it.

Governments also tap into their populations' spending power and incite public boycotts. Turkey used this tactic in 1998 and 2001 after the Italian and French governments recognised the mass killings of Armenians as genocide. Beijing encouraged public boycotts of Japanese goods in 2005 as a response to the Japanese prime minister's visit to a controversial shrine honouring the empire's war dead, and against France in 2008 after anti-China protests disrupted the Olympic torch relay in Paris. And states are not the only relevant actors in this new world disorder: Atif Ansar and Ben Caldecott argue in their essay that civil society campaigns

2 Although, of course, Obama did not invent sanctions. Juan Zarate's book, *Treasury's War*, describes a new kind of warfare that "involves the use of financial tools, pressure and market forces to leverage the banking sector, private-sector interests, and foreign partners in order to isolate rogue actors from the international financial and commercial systems and eliminate their funding sources".

3 When the Japanese government purchased three of the disputed Senkaku/Diaoyu islands in September 2012, Japanese workers suddenly had difficulties obtaining working visas, and companies with investments in China experienced delays in gaining regulatory approval. Following Western sanctions, Russian health and safety authorities closed several McDonald's restaurants in Moscow.

4 "Auswertung Umfrage zu den Auswirkungen der Sanktionen auf das Tagesgeschäft in Russland", Deutsche-Russische Auslandshandelskammer, Moscow, 18 December 2014, available at http://russland.ahk.de/uploads/media/2014_12-18_Umfrage_Sanktionsauswirkungen_Auswertung_Presse.de.pdf.

to pressure investors to pull their money from targeted industries – such as fossil fuels, tobacco, and arms – have a significant impact.⁵

This economic warfare is turbo-charged as states return to or continue to use the tactics that globalisation tried to leave behind, manipulating currencies, and deploying regulations and subsidies to disadvantage foreign competitors. The fact that the success of the BRICS has been widely attributed to their willingness to intervene in the market has encouraged policies of “state capitalism” worldwide, which could lead to a nominally open but increasingly bastardised world trade system, as Simon Evenett argues in this collection. For James Rickards, the concept of state capitalism now has little relevance as countries ranging from the US to China pursue similar policies in terms of intervention in banking and in capital markets.

Another kind of economic coercion is on display in efforts to weaponise migration flows. Erdogan is only the most recent leader to use the ability to direct population flows as a tool against rivals. Kelly Greenhill, writing in this collection, has identified more than 75 attempts by state and non-state actors to use population movements as political weapons since the 1950s. Leaders from Muammar Gaddafi to Slobodan Milošević have threatened to displace or expel groups, demanding financial aid, political recognition, or an end to military intervention.

This economic warfare is likely to include the retreat from globalisation of countries and companies alike. Trying to shelter themselves from disruption, they further distort the market. It is not only countries with reason to fear that they will be targeted by sanctions that are hedging; the hyper-connectedness of the global market means that many fear that they are vulnerable to ripple effects. This has caused a global push to decrease vulnerabilities and interdependence. India, for example, has been trying to diversify its energy suppliers since the UN Security Council imposed sanctions on Iran. The rush to decrease dependencies may be sound for individual countries, but it leads to economic inefficiencies and reduces the economic benefits of globalisation.

⁵ The fossil fuel divestment campaign for instance, which started only three years ago, has led to announced disinvestments by 400 institutions and over 2,000 “ultra-high net worth individuals” who together hold \$2.6 trillion in assets. (Numbers given by the campaign).

Weaponising institutions

The second battleground is the *weaponisation of international institutions*. Optimists had hoped that global trade relations would help socialise rising powers such as Russia and China into “responsible stakeholders” in a single global system under shared laws and norms. But multilateral integration at times seems to be a source of division rather than unity.

Some countries undermine the international system by gridlocking institutions or pushing for a selective application of the rules. Emerging powers such as India, Russia, and China have sought to frustrate the established powers by disrupting their use of existing institutions – from the WTO’s Doha Round of trade talks, to the Organization for Security and Co-operation in Europe (OSCE) on election observation. They claim – although this is contested in Western capitals – that this has been mirrored by the US and its allies, which have increasingly sought exceptions from the rules for themselves. For example, Washington calls on other countries to abide by the law of the sea, although it has not itself ratified the relevant UN convention. The EU and the US talk about the inviolability of borders and national sovereignty, but tried to change both norms through their intervention in Kosovo (which they tried to retroactively legitimate by coining the “responsibility to protect”).

Hina Rabbani Khar notes in her essay on “gated globalisation” that there is a global trend towards forming competing, exclusive “mini-lateral” groupings, rather than inclusive, universal multilateral projects. These groupings, bound by common values – or at least common enmities – are made up of like-minded countries at similar levels of development. The “world without the West” groupings include the BRICs (Brazil, Russia, India, and China) and the Eurasian Economic Union (EEU), and a host of sub-regional bodies. China is working to promote parallel institutions – such as the Asian Infrastructure Investment Bank (AIIB) and the Shanghai Cooperation Organization (SCO) – some of which complement the existing order and some of which compete with it, as Moritz Rudolf argues in this collection. Meanwhile, the West is also creating new groupings outside the universal institutions – such as the Trans-Pacific Partnership (TPP) in Asia and the Transatlantic Trade and Investment Partnership (TTIP) – that exclude China and

Russia. Hillary Clinton referred to TTIP as an “economic NATO”⁶ while President Barack Obama, speaking about the TPP, declared: “We can’t let countries like China write the rules of the global economy. We should write those rules”.⁷

As the world grows increasingly multipolar, smaller states find themselves forced to choose between competing great powers’ spheres of influence, as major regional powers strengthen themselves at the expense of the periphery. Look at Russia’s relationship with its “near abroad”, Germany’s role in Europe, and China’s posture in Asia. All three have economic as well as diplomatic and security consequences. Chinese institutions are not really multilateral bodies that give states representation under binding rules, but rather a cover for a series of bilateral relationships between smaller countries and a powerful Beijing. Russia’s “near abroad” policy does not reduce its neighbouring countries to vassal states, as some claim, but it does try to use asymmetries in the relationship to bind them into a Russian system. Competition between rival projects can spill into conflict; the Ukraine crisis came about because of a clash between two incompatible projects of multilateral integration – the European-led Eastern Partnership and Russia’s Eurasian Economic Union (EEU).

International law was intended to be a way of de-escalating disputes between countries, but analysts are also speaking about its use as a weapon against hostile countries – “lawfare”. The multilateral institutions that were supposed to be the benign invigilators of a new era of win-win cooperation are becoming a battleground for geopolitical competition.

Infrastructure competition

The third battleground is competition through the *infrastructure of globalisation* – both physical and virtual.

Countries have learned that, if they cannot be independent, the next

6 David Ignatius, “A free-trade agreement with Europe?”, the *Washington Post*, 5 December 2012, available at https://www.washingtonpost.com/opinions/david-ignatius-a-free-trade-agreement-with-europe/2012/12/05/7880b6b2-3f02-11e2-bca3-aadc9b7e29c5_story.html.

7 “Statement by the President on the Trans-Pacific Partnership”, The White House, 5 October 2015, available at <https://www.whitehouse.gov/the-press-office/2015/10/05/statement-president-trans-pacific-partnership>.

best thing is to make their partners more dependent on them than the reverse. If all roads lead to Rome, they are best served by becoming Rome. This quest for “asymmetric independence” is encouraging leading regional powers – Russia, China, Germany, Brazil, South Africa, and Nigeria – to try to entrench their role as core economies, reducing neighbouring countries to the status of periphery.

Transport infrastructure is a key weapon in this fight, and China is leading in its use. In 2013, President Xi Jinping announced the “One Belt, One Road” project, intended to link China to cities as far as Bangkok and Budapest, and develop the Eurasian coast. This is just one example of the infrastructure projects aimed at exporting China’s surplus capacity while expanding its access to raw materials and export markets.

This approach to regional integration differs from ASEAN-style or EU-style regionalism. Rather than using multilateral treaties to liberalise markets, China promises to facilitate prosperity by linking countries to its continuing growth through hard infrastructure such as railways, highways, ports, pipelines, industrial parks, border customs facilities, and special trade zones; and soft infrastructure such as development finance, trade and investment agreements, and multilateral cooperation forums.

The establishment of new links may at first glance not appear like a disruption, quite the opposite. But China’s “One Belt, One Road” project creates dependencies that can then be exploited, while it also bypasses certain countries. It will be a core-to-periphery structure of connectivity, regional decision-making, and membership status, a hub (Beijing) and spokes (other countries) arrangement. The practice of reciprocity between the core and the periphery will be that if others respect China, China will reciprocate with material benefits; but if they do not, China will find ways to punish them. China’s infrastructure projects could be as important to the twenty-first century as the US’s protection of sea lanes was to the twentieth.

If transport links are the hardware of globalisation, the internet is its software. Like physical infrastructure links, the virtual infrastructure of the internet is also being weaponised by states competing for power. As a result, rather than being the global public square “wholly indifferent to international boundaries” it was once thought to be, the

internet is splintering along national lines. Putin might have offered Edward Snowden refuge, but it is Washington's closest allies – such as Chancellor Angela Merkel in Germany and President Dilma Rousseff in Brazil – who are the most concerned about the US prying into their citizens' private lives. Countries such as Australia, France, South Korea, India, Indonesia, Kazakhstan, Malaysia, and Vietnam have already moved to keep certain types of data on servers within their national borders. Deutsche Telekom has suggested a German-only "Internetz", while the EU is considering a virtual Schengen area. Andrew Puddephatt, José Ignacio Torreblanca, and Carla Hobbs address the digital revolution and argue that it has sparked a new "Great Game", analogous to the race for control of Asia in the nineteenth century.

The new G7: The geo-economic players and their powers

In the new age of geo-economics, some countries and regional blocs will do well, and some will suffer. The US dominates on several fronts, but other players exert considerable influence in their respective niches. We have identified seven archetypal forms of power in the world of geo-economics, a new G7.

The financial superpower: The US

The US remains the world's sole superpower and can still project military might with greater ease than any other country. But recently it has been using the role of the dollar as the world's reserve currency to develop a new type of instrument for projecting power. After 9/11, when the president declared a global "War on Terror", officials in the US Treasury started exploring how Washington could leverage the ubiquity of the dollar and US dominance of the international financial system to target the financing of terrorism. What started as a war against al-Qaeda grew to encompass measures against North Korea, Iran, Sudan, and even Russia. The enormous fines imposed on banks accused of breaking the sanctions – such as France's BNP Paribas – sent shockwaves through global financial markets and acted as a powerful deterrent to future deals. In the words of the then-CIA director Michael Hayden, "this was a twenty-first-century precision-guided munition".⁸

⁸ Juan Zarate, *Treasury's War: The Unleashing of a New Era of Financial Warfare* (New York: PublicAffairs, 2013), p. 244.

The regulatory superpower: The EU

Because the EU has the world's largest single market, most multinational companies depend on access to the region – which means complying with EU standards. The Union has used this power at various times over the years in the economic realm – blocking the merger of General Electric and Honeywell, forcing Microsoft to unbundle its Explorer browser, and challenging US agri-business in Africa and other global markets over the use of genetically modified organisms. This export of regulations has extended into the political sphere on issues such as climate change – and most dramatically through the EU's accession process and neighbourhood policy.

These policies make access to EU markets and membership conditional on other countries adopting EU legislation and standards. To join the Union, candidates need to integrate over 80,000 pages of law – governing everything from gay rights and the death penalty to lawnmower sound emissions and food safety – into domestic legislation. What is more, as Anu Bradford argues in this collection, regulatory power is less costly, more durable, more deployable, and less easily undermined by competitors than more traditional foreign policy tools.

The construction superpower: China

China today is using economic statecraft more frequently, more assertively, and in more diverse fashion than ever before. Even though China's trade and economic power is growing, its most innovative geo-economic tool is infrastructure – both physical and institutional. Stretching from Hungary to Indonesia, Beijing's budget for the AIIB is \$100 billion – as much as the Marshall Plan spent in Europe, in inflation-adjusted dollars – which mostly goes to finance roads, railways, pipelines, and other infrastructure across Eurasia, smoothing China's westward projection. Chinese sources claim it will add \$2.5 trillion to China's trade in the next decade, more than the value of its exports in 2013, when it was the world's top exporter.

In addition, while Beijing remains an active player within existing international institutions, it is also promoting and financing parallel structures such as the AIIB and the SCO. The overall goal of these efforts is greater autonomy, primarily from the US, and an expansion

of the Chinese sphere of influence in Asia and beyond.

China's ambitions go beyond the physical to the virtual world where it is pushing a cyber-sovereignty agenda, challenging the multi-stakeholder, open model for internet governance defended by the US, to allow national governments to control data flows and control the internet within their jurisdiction. Rogier Creemers argues in his essay that the Chinese leadership is strengthening its control over the internet and technology suppliers. With the largest community of netizens (nearly 700 million Chinese citizens now use the internet regularly, some 600 million of them through mobile devices), China has weight.

The migration superpower: Turkey

In an age of mass migration, the ability to control flows of people is a source of power. The Turkish authorities used the threat of people flows to change the balance of power between them and the EU – demanding the lifting of visa restrictions, financial aid to mitigate the burden of hosting more than two million Syrians, and the reinvigoration of their EU membership bid.

The spoiler superpower: Russia

As its empire receded after the end of the Cold War, Russia turned itself into a pioneer of disruption. Its foreign policy of the last few years has successfully shaped the behaviour of its neighbours and other powers through tactics including gas cut-offs, sanctions, expelling workers, cyber-attacks, disinformation and propaganda campaigns, and attempts to gridlock Western-led international organisations from the UN to the OSCE. In parallel, it has worked to establish new organisations to extend its power, such as the BRICS, the SCO, and the EEU. But because Russia has not done enough to strengthen and diversify its economy – which relies overwhelmingly on hydrocarbon exports – its share of the global economy has been on a downward trajectory. This will limit its ability to act as a spoiler over time.

The energy superpower: Saudi Arabia

Saudi Arabia's geo-economic power rests on the 10 million barrels of oil it extracts every day, and it is now responsible for a fifth of the global oil trade. For decades it has converted its hydrocarbons into economic and geopolitical power, fostering the Organization of the Petroleum Exporting Countries (OPEC) as the primary instrument for translating market power into broader international economic leverage. It has used its willingness to take short-term hits to shape global markets to its advantage (and to the disadvantage of rivals such as Iranian or US shale companies). What's more, it has been willing to invest billions of petro-dollars in support of its foreign policy goals – supporting counter-revolutionary regimes during the Arab uprisings as well as waging a regional proxy war against Iran.

The people's power

The connected economy and society is much more vulnerable to disruptions from below – whether incited by hostile governments, terrorist groups or teenagers in their bedrooms. And the ability of people to cluster on the web – in imagined majorities – makes both democratic and autocratic politics more volatile and prone to campaigns against particular courses of action (Francis Fukuyama has talked about the birth of a vetocracy as skittish leaders bend to public pressure). Hacking, public boycotts and disinvestment campaigns – whether autonomous or staged by governments – are becoming more common, more effective, and take less time and less resources to stand up.

Where does this leave Europe?

In theory, the EU should fare better in a geo-economic world than a classic geopolitical one. Economically, the EU is a giant. It sits at the heart of a eurosphere of 80 countries that depend on it for trade and investment, and even align themselves with its currency. It is a regulatory superpower. What's more, some of its leading member states – such as Germany, the world's foremost export nation – are particularly well-suited to wield power in a geo-economic world.

However, there are questions about how durable Europe's geo-economic power is. As its share of the global economy shrinks, how

long will its regulatory power last? And will the EU – which, unlike the other great powers, is not a state – be able to overcome its structural divisions and pool its ample resources behind common policies? Much of its foreign policy depends on unanimous support from all 28 member states – which have divergent views and different levels of vulnerability to blowback. For example, while Russia doesn't even appear in the list of the most important trading partners of Portugal, over 17 percent of Estonia's exports go towards the east, as Sebastian Dullien explains.

But most importantly, Europe is hobbled by the fact that, more than any other power, its inhabitants live at the “end of history”, subscribing to the ideological orthodoxies of “win-win” globalisation. Many of its governments still think the economy should be protected from politics and geopolitics and that inter-state conflict can be avoided through integration and interdependence, and have faith in the ability of institutions to “socialise” the rising powers.

To counter these disadvantages, European states need to realise that – in the face of geo-economic challenges from other powers – state intervention can be the best way to promote an open global economy. For example, Western countries could learn from China's infrastructure-first model, but adapt it to their strengths. They should also develop ways of compensating member states that lose out from particular geo-economic policies, so that they can more effectively wield their collective power. They need – at both a national and an EU level – to set up a machinery for economic statecraft similar to that of other great powers. The EU should develop an economic statecraft taskforce and a sanctions bureau to coordinate this increasingly powerful tool.

Above all, Europeans should be at the forefront of the movement to develop the rules of engagement for economic warfare. When governments use the infrastructure of the global economy to pursue political goals, they challenge the universality of the system and make it more likely that other powers will hedge against this disruption. They can also provoke retaliation. In the same way that states have developed a series of agreements and conventions that govern the conduct of conventional wars between countries, principles of conduct must be applied to the economic arena. Of course, this kind of coordination will prove difficult, given the wariness of all-out conventional war that makes economic disruption so attractive and widespread in the first place.

As part of this movement, Europeans should encourage their businesses to become stronger advocates for trade liberalisation and foreign investment in the Global South. More than anyone else, Europeans have an interest in developing more political, regional and creative forms of collective action to fight the spirit of atomisation that is increasingly defining the world.

THE BATTLEFIELDS

ECONOMIC WARFARE

The new geo-economic game

The United States and the international community have begun to wrestle with the complications of an interconnected global environment, where economic power, access to resources, and cutting-edge technologies are redefining national power. There is a growing recognition in the US that the myriad vulnerabilities and opportunities in this shifting landscape require a new national economic security strategy.

Countries such as China and Russia are already playing a new geo-economic game, where economic power is leveraged aggressively for national advantage.

They continue to steal billions of dollars of intellectual property from US and other government and private sector networks. Certainly, the internet has accelerated and amplified vulnerabilities with the ease of digital access to mass amounts of data, low barriers of entry to cyber-intrusion, and the useful cloak of online anonymity.

But economic battles are not confined to cyberspace. During a diplomatic spat with Japan in 2010, China suspended its export of rare earth minerals – necessary for key high-tech manufactured items such as hybrid engines and solar panels. China has also used its undervalued currency, subsidies, and the weight of its market –

both current and future – to demand local content and partnership concessions from foreign companies.

The resulting transfer of technology and marginalisation of multinational companies has allowed Chinese companies to take larger chunks of the global solar, wind turbine, and high-speed rail markets. At the same time, Chinese infrastructure and extraction projects in Africa, Central Asia, and Latin America are facilitating Chinese access to both raw materials and political influence.

Russia hasn't hesitated to play the game either, using its oil and natural gas resources to exert political pressure while padding the Kremlin's coffers. In 2006 and again in 2009, Russia shut off natural gas supplies to Europe through Ukrainian pipelines to extract concessions and pressure Ukraine. Russia – through Gazprom – has also followed an acquisition pattern of “plugging the holes” of alternate channels of energy supply to Europe in the Balkans and Poland.

In the more recent conflict with Ukraine and Russia's annexation of Crimea, Russia has continued to use its oil resources and financial influence to pressure Kyiv, while also threatening neighbours such as the Baltic countries. In the face of Western economic sanctions and pressure, Moscow has used its own economic measures and threats as a sword and shield. Russia is now using direct sanctions against Turkey after that country's downing of a Russian aircraft on the Turkish-Syrian border.

Both China and Russia have begun to create and explore alternative institutions, trading relationships, and payment platforms to displace the dollar and the US-centric global financial order. China's promotion of the Asian Infrastructure Investment Bank (AIIB) as an alternative to the US and Japanese-led Asian Development Bank (ADB) is an example of Chinese designs to create parallel or competing structures in the global economic system. China is also working to grow its influence in the current international construct. The International Monetary Fund's (IMF) inclusion in 2015 of the yuan in its Special Drawing Rights is an example of China's graduation into the global club of currencies and economies.

The US faces a direct challenge to its economic predominance from an alternate state-driven capitalist model, and from systemic and economic threats from a panoply of state and non-state actors. US economic reach and influence have been taken for granted as a function of the free trade paradigm that the US helped establish and the competitive advantages of the US market and companies against foreign competitors. This is now in jeopardy, with not only economic advantage but also international influence at risk. The newly signed Trans-Pacific Partnership (TPP) trade pact is an attempt to regain economic advantage and influence in the critically important Asian and Pacific markets, in the face of a rising China.

Even with the new trade pact, the US remains unprepared to play this new geo-economic game. Its current approach to economic security abroad reflects a reticence to meld political and economic interests. This underscores a longstanding structural divide between national security policies and the role of the US private sector in the international commercial and financial system. In 2015, the contentious debate in Congress on whether to re-authorise the Export-Import Bank (Exim Bank), which provides financing, loans, and insurance to US exporters and brokers, was a reflection of this dynamic.

The most egregious examples of this failure to combine national and economic security interests have occurred recently in the war zones of Iraq and Afghanistan. US blood and treasure have been spent to establish security and functioning economies, but US companies and interests are often left on the sidelines as Chinese, Russian, and other countries' companies profit from oil, mineral, construction, and other sectors.

The US government's approach to these vulnerabilities is also scattered – with strategies to protect supply chain security, combat transnational organised crime, secure the cyber domain, protect critical infrastructure, and promote US private sector interests abroad to compete with state-owned enterprises. As the Venn diagram of economic and national security overlaps ever more exactly, the US should craft a deliberate strategy that aligns economic strength with national security interests more explicitly and completely. It should also design this strategy with its allies squarely in mind.

The intelligence community should prioritise collection and analysis to focus on the global landscape through this lens. The Departments of Commerce, Energy, and Defense should sit down together – and then with the private sector – to determine how to maintain investments and access to strategic materials and capabilities critical to national security. Our homeland security enterprise should be focused less on defending against specific actors and more principally on protecting and building redundancies in the key infrastructure and digital systems essential for national survival. Law enforcement and regulators should have access to beneficial ownership information for suspect investments and companies formed in the US.

International alliances should be recast to ensure key resource and supply redundancy, while trade deals should create new opportunities for influence and economic advantage. The Trans-Pacific Partnership (TPP) is a major step in the right direction. Washington should deploy new doctrines of deterrence like a “boomerang deterrent” making it patently unwise for countries to try to attack or weaken the US given the entanglement of the international commercial and financial systems.

The US president should also review the traditional divide between the public and private sectors where cooperation is essential, as is happening in the cyber domain. We should view the relationship between government agencies – such as the Ex-Im Bank, Overseas Private Investment Corporation (OPIC), and USAID – and businesses as core to the promotion of US interests, creating alliances based not just on trade and development but also on shared economic vulnerabilities and opportunities. The White House needs to ensure that its national security and economic experts are sitting at the same table crafting and driving the strategy while consulting the private sector.

In doing this, the US and Western liberal democracies must reaffirm their core principles. Western capitalist societies should not strive to be like either China or Russia, and analysts should not automatically overestimate the strength of such alternate systems and inadvertently create structures that move us towards a state authoritarian model. On the contrary, the US should commit to remaining the vanguard of the global free trade, capitalist system, while preserving the independence of the private sector and promoting ethical US business practices. The US and its allies should not retreat from the globalised environment

they helped shape but instead take full advantage of the innovation and international appeal of US and Western business and technology.

In the twenty-first century, economic security underpins the nation's ability to project its power and influence. The US must remain true to its values but start playing a new, deliberate game of geo-economics to ensure its continued security and strength.

How the EU learned to love sanctions

It is only recently that the European public has woken up to the use of sanctions in EU foreign policy, though they have been employed since the early 1980s. They became more frequent following the 1992 establishment of the Common Foreign and Security Policy (CFSP), the EU's intergovernmental forum for foreign policy coordination. While the EU's Common Security and Defence Policy (CSDP) was launched with fanfare in 1999, and was intended to break new ground in European foreign policy by allowing the Union to carry out joint military operations, it is sanctions that have taken centre stage. They, rather than military force, are being wielded to address Europe's key security and foreign policy challenges.

Part of the reason why the EU's use of foreign policy sanctions went unnoticed for decades, while those by other actors consistently received attention, is that EU sanctions do not look much like sanctions. The popular understanding of sanctions is of full economic blockades *à la* Cuba, conjuring up images of a suffering, powerless civilian population, as with the draconian United Nations embargo on Iraq in the 1990s. This is what economic sanctions were originally meant to be: the total interruption of trade and investment with the target, with the infliction of considerable harm on its population as an intended outcome. However, what the EU has been doing under the label of "restrictive measures" is very different. Almost the entirety of CFSP sanctions practice during the 1990s consisted of visa bans prohibiting listed individuals travelling to European territory. The

same individuals were often banned from holding bank accounts in Europe, while their assets were frozen. Beyond that blacklist, the only measure routinely applied was an arms embargo.

Targeted sanctions

The discrepancy between these measures and popular beliefs about sanctions is due to the novel notion of “targeted sanctions”. In response to the humanitarian disaster provoked by the UN embargo on Iraq in the 1990s, a number of European countries lobbied the UN to modify its sanctions policy and adopt measures that hit the individuals and elite groups responsible for the policies being condemned, as well as their sources of funding, while minimising the impact on the general population.¹ Their efforts prospered, and in 1995 this became UN Security Council (and EU) policy.² In an interesting parallel between the UN and the EU – otherwise very different in their approach to sanctions – the same measures are often applied by both, namely arms embargoes, visa bans, and asset freezes.³

Most conspicuously, the EU sanctions of the 1990s and 2000s were not economic in nature. Trade between the EU and sanctions targets remained perfectly legal. Save for trade in weapons, no restrictions were placed on economic exchanges between the EU and Zimbabwe, Uzbekistan, Sudan, or Belarus. The only exceptions are the fabulously creative sanctions against Yugoslavia during the Kosovo crisis, which entailed a range of financial measures and even an oil embargo; and the sanctions against Myanmar, which banned investment in the country and, for some time, trade in timber, gold, and precious stones.

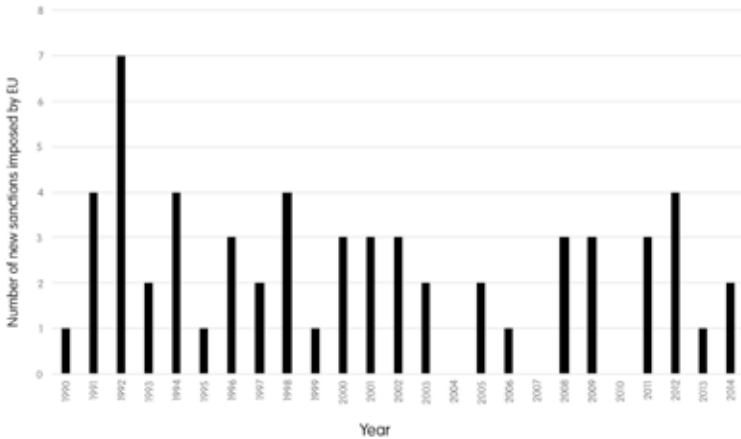
Another interesting feature of EU sanctions policy is that it does not preclude all cooperation and assistance to the target. Indeed, the EU increased its humanitarian aid to Zimbabwe despite the presence of sanctions. Myanmar continued to receive EU aid to develop its health sector while sanctions were in place. Trade between the EU and Belarus increased while the latter was under sanctions, and

1 Michael Brzoska, “From Dumb to Smart? Recent Reforms of UN Sanctions”, *Global Governance*, 9(4), 2003.

2 UN Security Council Doc. S/1995/300.

3 Enrico Carisch and Loraine Rickard-Martin, “Global Threats and the Role of United Nations Sanctions”, FES International Policy Analysis, December 2011, available at <http://www.fes.de/cgi-bin/gbv.cgi?id=08819&ty=pdf>.

Number of new autonomous sanctions regimes imposed by the EU per year (1990-2014)



Source: Author's elaboration

limited cooperation initiatives were launched with Belarus in the energy sector.⁴ The EU arms embargo on China did not impede the development of a burgeoning economic relationship and cooperation with Beijing. In view of this apparently contradictory picture, it is no wonder that hardly anybody realised that the EU has been “doing” sanctions for all this time. Illustratively, some ten years ago, an Asian journalist responded to a survey on the EU claiming: “I think their economic sanctions could have a lot of power”.⁵

Assessments of EU sanctions’ efficiency pre-2010 point to low success rates.⁶ This is hardly surprising in view of the difficulty of conclusively demonstrating that sanctions have contributed to particular outcomes. Yet there is little indication that sanctions were actually intended to compel a policy change in the targets. In fact, the EU has never instituted capacities for planning sanctions regimes or developed any metric to

4 Clara Portela, *European Union Sanctions and Foreign Policy* (Routledge: London, 2010).

5 Quoted in Clara Portela, “The EU, Human Rights and Burma/Myanmar: Stakeholders’ Perceptions in South East Asia”, in Martin Holland and Natalia Chaban (eds) *Europe and Asia: Perceptions from Afar* (Nomos: Baden-Baden, 2014), p. 45.

6 Clara Portela, *European Union Sanctions and Foreign Policy* (Routledge: London, 2010).

evaluate the impact and effectiveness of its measures.⁷ Institutionally, two sanctions units are tasked with preparing sanctions legislation, but the impact of sanctions on the targets is not systematically monitored and evaluated. The formulation and review of sanctions policies rely entirely on assessments by member states, delivered in Council meetings. This situation suggests that the political message conveyed by the sanctions has been the main consideration, rather than the actual effects of the measures. Indeed, the CFSP sanctions practice of the 1990s and 2000s undoubtedly positioned the EU as a firm advocate of human rights on the international scene.

A new willingness to pay the price of sanctions

The picture started to change from 2010, when the EU agreed sanctions on Iran that went far beyond the requirements of the UN Security Council. Adopted at Washington's instigation, measures such as the oil embargo and a range of financial sanctions replicated some US restrictions, magnifying their impact. For the first time, they adversely affected European enterprises across a number of sectors, some of them severely.⁸ The Iran sanctions, however, did not remain an isolated case. The electoral crisis in Côte d'Ivoire compelled the EU to enact unusually far-reaching measures in early 2011, including a ban on the import of Ivorian cocoa and a prohibition on European companies trading through the country's international harbours. Given that the crisis proved short-lived, sanctions were lifted before serious effects materialised – but the economic nature of the package nonetheless marked a departure from earlier practice. Around the same time, the EU initiated sanctions against Syria that escalated fast: in less than a year, Brussels deployed almost the entirety of its sanctions toolbox, including a ban on the import of Syrian oil and gas.⁹ In contrast to the cases of Iran and Côte d'Ivoire, EU autonomous measures against Syria were imposed on a target that was not already under UN sanctions – underlining the audacity of the move.

7 Anthonius W. de Vries, Clara Portela, and Borja Guijarro-Usobiaga, "Improving the Effectiveness of Sanctions: A Checklist for the EU", CEPS special report 95, Brussels, November 2014, available at <https://www.ceps.eu/publications/improving-effectiveness-sanctions-checklist-eu>.

8 Anisheh Bassiri Tabrizi and Ruth Hanau Santini, "EU Sanctions against Iran: new wine in old bottles?", ISPI Analysis No. 97, March 2012, available at http://www.ispionline.it/it/documents/Analysis_97_2012.pdf.

9 Clara Portela, "The EU's sanctions against Syria: conflict management by other means", Egmont Institute, Security Policy Brief, Number 38, September 2012, available at <http://www.egmontinstitute.be/wp-content/uploads/2013/09/SPB38.pdf>.

This evolution of the EU's sanctions regime is crowned by the measures taken against Russia in 2014 in response to its annexation of Crimea and support to separatist forces in eastern Ukraine. While the current package falls short of the severity of previous EU sanctions, it is the first time that the EU has adopted economic restrictions against its powerful eastern neighbour. Compared to recent regimes, the timid pre-2010 practice appears as a "rehearsal" in which the Council socialised its members into managing sanctions collectively in preparation for the day that its harmless restrictions would involve real costs for them. That day has already come and gone. Where the EU initially preferred narrowly targeted sanctions, it is now moving towards a broader interpretation of what measures can be employed for and whom they may affect. This indicates an emerging consensus within the EU that sanctions should have a serious economic impact, and a growing acceptance that individuals and entities not directly involved in the policies being condemned may suffer from the measures.

Does this shift represent the EU's increasing maturity in applying coercive tools? Its ability to agree and sustain sanctions, and their economic and political costs, is an unprecedented achievement in terms of member states' commitment to the CFSP, and its leading role in the resolution of the Iranian nuclear file has dramatically upgraded its image as an actor on the international security stage.¹⁰ However, the application of economic sanctions highlights challenges for the EU that did not exist when its sanctions merely consisted of preventing a handful of people from visiting and holding bank accounts in the continent.

Challenges for the EU

The key challenges that lie ahead for the EU's sanctions policies are interconnected. First, the EU needs to source more information on the impact of sanctions – both intended and unintended. The Commission recently started to evaluate the impact of sanctions on the Russian economy. However, monitoring efforts do not yet cover the consequences for the wider population, the impact on the political landscape, or the extent to which the measures are helping the EU to achieve its policy goals. This is particularly important because targeted

¹⁰ Riccardo Alcaro and Aniseh Bassiri Tabrizi, "Europe and Iran's Nuclear Issue: The Labours and Sorrows of a Supporting Actor", the *International Spectator*, 49(3), 2014, available at <http://www.iai.it/en/publicazioni/europe-and-irans-nuclear-issue>.

sanctions have unintended consequences, including humanitarian impacts, as this runs contrary to the *raison d'être* of targeted sanctions.

Granted, the effects of EU sanctions, even those on Iran, Syria, or Russia, are still far removed from the magnitude of the humanitarian disaster witnessed with comprehensive UN sanctions on Iraq.¹¹ While broader than they used to be, EU sanctions remain targeted. But now that the EU is imposing sanctions which can harm the target's economy as a whole, it should start to systematically monitor the impact on its targets. EU blacklists are often accused of hitting the wrong people and entities.¹² In order to avoid being held responsible for humanitarian hardship, the EU should be able to show that it is monitoring impacts and that no humanitarian effects are attributable to its measures. When asked about the impact of the sanctions on Myanmar during a hearing at the UK's House of Lords, a high-ranking EU official conceded that while "there may be some unintended and incidental ... collateral impact on ordinary people", they – presumably referring to the EU – were "*not aware* of this being a significant problem" (italics added for emphasis).¹³

Closely connected with this is the issue of over-compliance. The EU devotes great effort to designing sanctions so that they only affect specific individuals, the elites that constitute their power base, and the entities and sectors that supply them with funds. However, the problem for the private sector is that sanctions legislation often obliges it to expend resources finding out which deals are prohibited. This is compounded by the role of US restrictions. Because Washington applies its sanctions extraterritorially and closely monitors compliance, European companies often adhere to them in addition to EU bans. European measures do not have similar effects on third countries because EU bans only bind its own members; indeed, the EU has traditionally opposed the extraterritorial effects of US bans. This situation pushes firms to interpret the restrictions broadly for fear of unknowingly breaking the law, or to forego business with targeted

11 UN General Assembly Doc. A/69/941 – S/2015/432.

12 "Who are you calling a rogue?", the *Economist*, 20 June 2015, available at <http://www.economist.com/news/business/21654599-companies-are-fighting-inclusion-sanctions-listsand-winning-sort-who-are-you-calling>.

13 House of Lords Select Committee on Economic Affairs, reply by Deputy Director of DG External Relations, European Commission, Mr Karel Kovanda, to Q268, 17 October 2006, available at <http://www.publications.parliament.uk/pa/ld200607/ldselect/ldeconaf/96/96i.pdf>.

countries altogether. As a result, sanctions designed to be targeted do not remain targeted in the implementation phase. This is not a new phenomenon, and had already been witnessed pre-2010. However, Brussels has done little to ascertain the scope of the problem, including the extent to which European or US bans account for it, and it has not yet done anything to address it.

Finally, efforts to de-legitimise the unilateral use of sanctions are currently underway in UN forums. Besides the well-known UN General Assembly resolution, issued each year, that demands an end to the Cuban blockade,¹⁴ a campaign claiming that unilateral sanctions are contrary to human rights has recently gathered steam in the UN Human Rights Council.¹⁵ So far, the EU has not responded. Yet the threat posed by this campaign should not be dismissed. As sanctions gradually become less targeted, there are ample grounds on which they can be discredited. The disastrous impact of sanctions on Iraq, which provoked the move to targeted measures, demonstrates that the international reputation of sanctions matters.

The author thanks Anthonius de Vries and Aleksii Pursiainen for their comments. Any errors are hers.

¹⁴ UN General Assembly Doc. A/61/132.

¹⁵ UN General Assembly Doc. A/HRC/RES/24/14.

The return of the visible hand

John Maynard Keynes may have been right when he argued that “practical men” often unwittingly reinvent the views of “some defunct economist”.¹ However, that insight doesn’t explain the timing of abrupt shifts in views of what constitutes good economic policy. While it might flatter professors to think that such shifts occur through seminar discussions, the reality is markedly different.

Major economic crises often discredit the prevailing wisdom in the eyes of policymakers and the commentariat, and the revival of interest in state capitalism over the last few years fits this pattern. This essay assesses state capitalism’s implications for geo-economics over the coming decade.

How the visible hand came back into fashion

The term “Washington Consensus” describes the package of pro-market and pro-business policies that grew in popularity across the globe in the 1980s and reached peak influence in the 15 years after the fall of the Berlin Wall. The Consensus took a dim view of state intervention. Industrial policy was particularly frowned upon. To the extent that governments ran enterprises, it was to prepare them for eventual privatisation. Markets, not states, had the upper hand.

The degree to which governments in any country – industrialised or emerging – were faithful to the Washington Consensus can be debated.

¹ John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Palgrave Macmillan, 1936).

What is certain, however, is that the current generation of Western senior corporate executives were educated at a time when the state was in retreat. Consequently, few private sector decision-makers were trained in managing political and regulatory risks, leaving them wholly unprepared for the changes to come.

The first major blow to the Washington Consensus came with the East Asian financial crisis of 1997/1998. Eager to deflect blame from their own shortcomings, the affected governments blamed the advice of the International Monetary Fund (IMF) and the World Bank for their problems. This triggered a search for alternative development paradigms, resulting in the embrace of a more active industrial policy in the first decade of the twenty-first century. The baby (the Washington Consensus) was thrown out with the bathwater.

The global financial crisis of 2008/2009 and subsequent dramas drove a stake through the heart of what was left of the pro-market Washington Consensus. As many industrialised economies undertook far-reaching state intervention, it became harder to make a credible case to emerging economies that markets should take the lead in allocating resources. Of course, privatisation and free trade did not cause the crisis – but that hardly mattered in the ensuing blame game. For better or worse, the invisible hand of the market as a respectable organising principle for economic policy lost currency with decision-makers.

The contrast between the pain inflicted by Western policies and the opportunities created by the fast growth in emerging markets, in particular the so-called BRICS,² was not lost on many observers. Success is a potent marketing tool, and the BRICS's fast growth was associated with their embrace of state capitalism. The visible hand of the state was increasingly seen as a viable and, for some, worthy successor to the Washington Consensus.³

² The term was originally coined by Jim O'Neill in 2001. BRIC stands for Brazil, Russia, India, and China. South Africa was later added to the list.

³ Part of the mini-industry associated with the search for a replacement has debated whether there is a Beijing Consensus and whether the lessons from China's phenomenal growth over the past four decades can be transferred to other countries. A notable contribution in this regard is Stefan Halper, *The Beijing Consensus: Legitimizing Authoritarianism in Our Time* (New York: Basic Books, 2012).

What does state capitalism entail?

State capitalism represents a shift in mindset away from the acceptance that market forces determine the fate of industries, jobs, and national living standards. This mindset shift is, however, clearer at the point of departure than at the point of destination, which accounts in part for the wide variety of forms of state capitalism that can be witnessed today.

At a practical level, state capitalism involves:

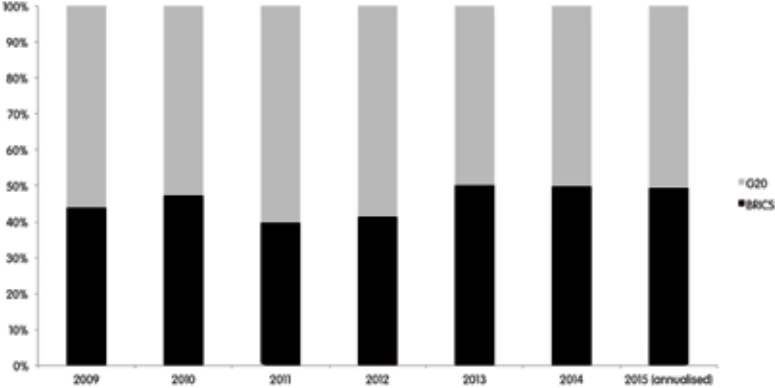
- The purposeful management of state-owned enterprises
- The coaxing and promotion of “state-linked” firms (where the state does not have an ownership stake but still holds significant influence over decision-making)
- The strategic use of sovereign wealth funds to attain goals other than shareholder return
- Mercantilist policies to advance national commercial interests abroad, including exchange rate manipulation
- Traditional tools of industrial policy that favour specific firms or sectors

When tiny Singapore (often seen as the initiator of modern state capitalism) used these policies, no one minded terribly. Even the implementation of state capitalism by mid-sized emerging markets, such as Egypt, did not represent a threat to the Washington Consensus. However, once the large emerging markets’ success had been attributed to state intervention rather than to market forces, the visible hand regained its central place in deliberations on economic policy.

Innovation in information technology and developments in commodity markets have added geopolitical bite to state capitalism. Huawei’s perceived links to the Chinese military were enough to get it banned from selling telecoms equipment in Australia, the United States, and the United Kingdom.⁴ Forced technology transfers, denials of access to critical infrastructure, local data storage requirements, and active state promotion of local rivals are among the departures from competitive neutrality faced by international business.

⁴ “The company that spooked the world”, the *Economist*, 4 August 2012, available at <http://www.economist.com/node/21559929>.

Protectionist measures imposed by BRICS countries as a percentage of those imposed by G20 countries



Source: Global Trade Alert, data accessed 14 November 2015.

The fear that lack of resources might hold back national economic growth has induced aggressive strategies by certain state-owned firms. While much attention has focused on the activities of Chinese firms in Africa, the contest for resources is not confined to China or to that continent. The negotiation of free trade agreements, the aid packages offered to poorer commodity exporters, and foreign direct investment flows have been influenced in many cases by the race to secure access to raw materials.

The fact that state capitalism has so many potential facets highlights its potential to disrupt long-standing assumptions and norms espoused by businesses, investors, and governments. Firms' risk assessments are affected. For governments, the fact that state capitalism can take many forms – varying across countries as well as sectors – casts doubt on whether responses are sufficient. In the following, three implications of state capitalism are outlined.

Implications for geo-economics

A nominally open but bastardised world trading system

The perception that competition in national and international markets is no longer based on merit fundamentally alters business and governmental decision-making. State-owned enterprises, as well as export promotion policies and the like, have of course long existed. But what matters is the perception that the range of political and regulatory risks has expanded, that the consequences of those risks could be graver than before, and that governments are more frequently taking decisions to advance certain competitors' interests. That almost half of the G20's crisis-era policy interventions which discriminated against foreign commercial interests were implemented by the BRICS adds a "rising powers" dimension to the ongoing fragmentation of the world trading system (see graph).

Elevated risks are an important enemy of investment, trade, and innovation. They induce corporate decision-makers to act more cautiously; plenty of economic research has demonstrated, for example, that exchange rate uncertainty holds back trade flows and limits international economic integration. Policy risks are harder to measure than exchange rate variation, but the available research does point to the harmful effects of greater uncertainty.

The impact of greater state intervention is not confined to home markets. The policies of the BRICS to promote their firms' exports and investments abroad affect foreign markets by design, so the political risk created spreads well beyond national borders. While export incentives make selling abroad more attractive and should enhance global trade, the uncertainty created by opaque tax incentives, financing by export-import banks, and the like will discourage other firms from competing in third markets. A firm may well feel confident about competing on its merits with a rival from the BRICS – but a lot less confident about competing successfully against the national treasuries of the BRICS.

A second round of effects follows from the recognition that competition in export markets is being distorted. Some firms will ask their governments to match the export incentives offered elsewhere,

thereby creating a subsidy race. If such subsidies are not offered, firms may move production abroad. General Electric recently announced the reallocation of the manufacture of certain products from the US to France after Paris offered generous export financing, while Congress has refused to re-authorise the US Export-Import Bank. This puts considerable pressure on the global trade rules on subsidies, in particular state export incentives.

Another reaction to the increased risk in exporting is for firms to seek to expand market share at home, potentially at the expense of foreign rivals. Pressures grow to reserve domestic markets for local firms – including government purchases. The resort in recent years to “buy national” government procurement measures and a wide variety of localisation requirements speaks to this trend.

It is important to note that these tendencies are unlikely to put pressure on existing import restrictions (such as tariffs and quotas). Those restrictions are far too transparent for clever policymakers and for businesses seeking favours from government. Instead, they will resort to measures that are not well regulated by the rules of the World Trade Organization (WTO). As a result, a nominally open but increasingly bastardised world trading system is one likely consequence of state capitalism.

Cross-border commerce fragments along national security lines

The increasing interaction between developments in information and communication technology, national security, and the state promotion of firms, accounts for state capitalism’s second consequence for the world economy. The use of the internet and advanced communication technologies by those seeking to disrupt societies has meant that national security services seek access to communication infrastructure.

The fact that some of that infrastructure is supplied by firms with explicit or implicit links to foreign governments inevitably raises questions about cybersecurity. The risk here is that the large information and communication technology sector (ICT) (which encompasses not just software but also hardware and associated parts and components) becomes “securitised” and that the associated policy-induced risks

result in less cross-border trade and investment. The consequent reduction in inter-firm rivalry will diminish the incentive to innovate, holding back one of the factors thought to have raised living standards worldwide over the past 25 years.

Blocs of countries aligned on national security grounds are likely to emerge that will only accept ICT products – and, importantly, sensitive manufactured goods containing those ICT products – made within their group. It is not difficult to conceive of an English-speaking group being formed, containing Australia, Canada, New Zealand, the UK, and the US. Counter-groups would be likely to follow.

In sum, there is a danger that national security considerations – driven by geopolitical rivalry associated with the rise of China and India, as well as a revanchist Russia – will trump trade policy concerns. Unless steps are taken to curb this dynamic, global markets for many products will fragment.

Stalemate at the WTO and pressure from mega-regional trade deals

It has been 15 years since WTO members launched the Doha Round of multilateral trade negotiations in the wake of the September 11 attacks. This is not the place to recount the debate over the reasons for the negotiating impasse that ensued. What is often overlooked, however, is that it has been impossible to reconcile the three following elements:

- The principal tool employed in multilateral trade agreements are bindings (limits) on the actions of governments
- The conclusions of such agreements require universal assent
- In an era of state capitalism it is far from clear for many governments that they are prepared to give up further discretion in policymaking

Unless perceptions change in key trading nations about the efficacy of certain policies, it is difficult to see how the corporate political risks created by state capitalism and other state interventions can be tackled. Sustained state capitalism is a recipe for continued stalemate in Geneva.

Not to be deterred, some governments are negotiating trade deals

elsewhere. The recent conclusion of the Trans-Pacific Partnership (TPP) is a case in point. Other major trade negotiations are taking place across the Atlantic, in a regional grouping involving India and China, and between the EU and Japan.

Optimists argue that these groupings will ultimately result in renewed pressure to negotiate a multilateral trade deal. Such hopes are no more than that. It is far from clear how governments could be convinced to change their minds and accept having their policy options bound by the WTO. Without a good strategy on how to do this, the ongoing push towards regional trade agreements is a further source of fragmentation within the world trading system.

Having laid out the geo-economic consequences of state capitalism, this essay will turn to the factors that might limit this interventionist impulse.

Three threats to state capitalism

However, there are at least three factors that could limit the shelf life of state capitalism. This essay started by noting that major economic crises can result in abrupt shifts in what is thought of as best practice in economic policy. No analyst should rule out another shift, especially if substantial corporate over-borrowing in emerging markets results in financial crises there. Coming on top of the growth slowdown in Brazil, China, and Russia, which has already taken the shine off their “growth models”, a sharp reassessment of the merits of state capitalism could follow in those countries and elsewhere.

A second, related threat is that the governments in some of the leading emerging markets could over-extend themselves and need to be bailed out. Although not on the same scale as the BRICS, it should not be forgotten that an early proponent of state capitalism, Dubai, had to be bailed out twice (in 2009 and 2012) by neighbour Abu Dhabi. Here, analysts should track borrowing and refinancing by all levels of government, not just the central government.

Low oil prices and, more generally, sustained low commodity prices also put pressure on the budgets of many emerging nations. In response, governments in those countries may respond by cutting subsidies to local firms. Moreover, emerging markets with sovereign

wealth funds may start drawing down assets and demanding higher returns on their investments. The latter may make such governments less tolerant of local firms that underperform on global markets. Greater competitive discipline could ensue, and the enhanced role for market forces would amount to a retreat, albeit a potentially partial one, from state capitalism.

Conclusion

For better or for worse, views on what constitutes best practice in economic policy have shifted since the onset of the global economic crisis. This matters to firms, governments, and international organisations alike. That such a shift in economic policy has led to a revival of interest in government intervention – taking the form of state capitalism in the largest emerging markets – is particularly shocking to cohorts of decision-makers educated in the West in the last 35 years.

The purpose of this chapter has been to draw out three important implications of state capitalism for the global economy and geopolitics. The associated dynamics have not yet played out fully, and further fragmentation of global commerce, sharp trade disputes, and the “securitisation” of leading sectors of the world economy should be expected. Until state capitalism falls out of favour – and this essay has identified three factors that might trigger this – the prognosis is for more zero-sum thinking that is likely to result in growing tension between governments, greater unwillingness to accept bastardised market processes as legitimate, and further pressure on pro-market governments to join the interventionist fray.

Economic repression as a foreign policy tool

Even in the depths of the global financial crisis, the lessons of the 1930s Great Depression were remembered and the temptations of protectionism were resisted. However, as global growth has remained low, states have adopted policies of “economic repression” – intervening in the economy using unconventional policy tools in pursuit of short-term national interests, often at the expense of other countries. While geo-economics often emphasises how “trade follows the flag”, the reverse is also true.¹ Economic repression is a geo-economic trend – it does not just have an impact on economics but also creates tensions between states, not unlike those caused by more traditional foreign policy tools.

Initially, cooperation rather than competition characterised the response to the crisis from the world’s largest economies. Central banks cut interest rates and provided unprecedented amounts of liquidity to the global financial system. Fiscal policy was loosened, even in fiscally conservative economies such as Germany. Informal international forums such as the G20 sprang up to facilitate these policies. Global economic institutions, such as the World Trade Organization (WTO), proved up to their task – as much for what they prevented (the

¹ Sanjaya Baru, “Introduction: Understanding Geo-economics and Strategy – A New Era of Geo-economics: Assessing the Interplay of Economic and Political Risk”, IISS Seminar, 23–25 March 2012, available at <https://www.iiss.org/-/media/Images/Events/conferences%20from%20import/seminars/papers/64319.pdf>.

imposition of tariffs) as anything else. Moreover, the episode did not, at first, trigger a more fundamental rewiring of the relationship between state and market. Although the crisis shone a light on the relative economic success of China, the developed economies did not look to Chinese-style “state capitalism” as a model to emulate.

Yet in a perverse way the policy response was *too* successful.² Just a year after the announcement of unprecedented fiscal expansionary measures at the 2009 G20 summit, the economic recovery was deemed sufficiently strong for the 2010 summit to herald a return to “normal”. For governments of most developed economies, this meant fiscal consolidation. In some countries this response was demanded by the circumstances – including high levels of debt and projected costs of borrowing – but for others it was self-imposed.

The United Kingdom, for example, had ample space to maintain a fiscal deficit. Yet once austerity had been identified as the “responsible” path, the political costs of backtracking were too great. With fiscal policy excluded by political considerations, central banks were left with only one remaining traditional policy lever to generate growth: monetary policy.

Central banks experimented with monetary policies that were largely unprecedented in the major economies, but failed to generate a strong and sustained recovery. The global economy remained in a funk, and policymakers found themselves in an underwhelming macroeconomic environment. Wage growth has been sluggish, investment has been low, and the appetite or capacity to coordinate stimulatory policies has consistently been lacking. As the prognosis of this economic environment has shifted from cyclical to long term,³ and as political elites have internalised fiscal “discipline” as the only game in town, the global policy environment has seen the proliferation of what I call “economic repression”.

Economic repression describes how, in today’s policy-constrained environment, states intervene in the market in order to boost domestic economies – often at the expense of growth elsewhere. This involves

² As Barry Eichengreen argues in *Hall of Mirrors* (Oxford: Oxford University Press, 2015).

³ See Lawrence H. Summers, “U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound”, *Business Economics*, Volume 49, Number 2, available at <http://larrysummers.com/wp-content/uploads/2014/06/NABE-speech-Lawrence-H.-Summers1.pdf>.

somewhat unconventional economic policy tools, using a mixture of corporate, monetary, and financial regulation policies to compensate for the fiscal and monetary policy constraints described above. Economic repression implies, almost by definition, “second best” policies; measures that seek to achieve their goals indirectly.

The effect of these policies in the developed world has been twofold. First, having avoided a turn towards traditional “state capitalism” immediately after the crisis, they have nonetheless upset the relationship between state and market in new and innovative ways. Second, at an international level, these policies increasingly give the impression of a zero-sum world replacing a positive-sum one.

Corporate policy

In a world where fiscal and monetary policy is off the table, corporations have been leant on, with a mixture of legislation and “moral” pressure, to play the role of government. In the absence of a direct policy tool, the authorities use other instruments to indirectly achieve the desired economic outcomes, be they higher wages or increased investment.

At first glance, it does not appear that developed economies’ relationship with the corporate sector has changed since the global financial crisis. Governments continue to court large companies in the hope of hosting their headquarters, factories, or offices. Changes to national corporate tax regimes suggest that the race-to-the-bottom continues: of 37 OECD countries, 23 have lowered their corporate tax rate over the last decade; in 14, the decrease has been more than 5 percent.⁴

However, the implicit contract between states and corporations has been breached. Before the crisis, states created favourable conditions for companies in return for private investment, employment, and, ultimately, tax revenue. But companies, rather than investing in a low-growth world, tended to sit on large cash surpluses.⁵

⁴ Corporate income tax, OECD Tax Database (2015), available at <http://www.oecd.org/tax/tax-policy/tax-database.htm>.

⁵ Adrian Blundell-Wignall and Caroline Roulet, “Long-term investment, the cost of capital and the dividend and buyback puzzle”, *OECD Journal: Financial Market Trends*, Volume 2013, Issue 1, available at http://www.oecd.org/finance/Long-term-investment_CapitalCost-dividend-buyback.pdf.

The response to this trend has varied across borders, but signs of economic repression are everywhere. Several states in the US have seen minimum wage hikes.⁶ In the UK, a commitment to raise the minimum wage by 40 percent by 2020 accompanied a cut in corporate tax rates.⁷ The governor of the Bank of Japan stated publicly that he expected “action” on turning profits into wages.⁸ The Korean government took an even less conventional approach; in a bid to stop cash hoarding, it applied a “use it or lose it” tax on unused retained profits.⁹

These interventions reflect a loss of faith in the market to achieve a mutually beneficial outcome, in stark contrast to the conventional pre-crisis wisdom. “Pre-distribution” – the idea that a government should intervene in the market itself rather than levelling the playing field afterwards through tax credits and other subsidies – has proved more popular in practice than as a political buzzword (notably, and unsuccessfully, by the Labour Party in the 2015 UK general election).

Monetary policy

Since the crisis, financial repression by central banks has evolved into economic repression. Monetary policies that originally aimed at reducing government debt repayments today appear like a strategy aimed at boosting growth at the expense of others.

All major central banks have engaged in financial repression – using monetary policy to push down the cost of borrowing, with the aim of giving governments some breathing space. This willingness to do “whatever it takes” has arguably kept the global economy afloat since the global financial crisis. For example, commitments from ECB head Mario Draghi at the height of the euro crisis reassured markets that the eurozone would not be allowed to fail. In the US, the Federal Reserve’s dual mandate allowed it to make economic growth the target

6 Katie Reilly, “New York governor pushes for \$15 statewide minimum wage”, *Reuters*, 10 September 2015, available at <http://www.reuters.com/article/2015/09/10/us-usa-new-york-minimum-wage-idUSKCN0RA2RC20150910>.

7 “Budget 2015: Osborne unveils National Living Wage”, *BBC News*, 8 July 2015, available at <http://www.bbc.co.uk/news/uk-politics-33437115>.

8 “Japan’s Economy and Monetary Policy”, Speech by Haruhiko Kuroda, Bank of Japan, 25 November 2014, available at http://www.boj.or.jp/en/announcements/press/koen_2014/data/ko141125a1.pdf.

9 Kyungji Cho and Cynthia Kim, “Samsung Told by Korean Tax Man to Use Apple-Topping Cash”, *Bloomberg*, 21 August 2014, available at <http://www.bloomberg.com/news/articles/2014-08-20/samsung-told-by-tax-man-to-use-apple-topping-cash-korea-markets>.

of unconventional policy. In China, the central bank-sponsored credit expansion has seen China account for almost half of global credit growth and 25 percent of global GDP growth since 2008. Monetary policy's outsized role is indicative of the (partly self-imposed) policy straitjacket restraining elected politicians from deploying fiscal tools.

However, while the easing of global monetary policy was originally a coordinated strategy by central banks, historically low interest rates have proven less successful than hoped in reflation the world's major economies. Monetary policy is a blunt instrument, and – as the economy has shown few signs of a return to normal and politicians have shown few signs of becoming more proactive – it has started to create tensions.

As a result, interventions have become far less coordinated, operating far more through the exchange rate channel and giving a strong impression of being zero-sum – examples of economic repression. First, quantitative easing in the UK and US pushed down the pound and dollar, providing a basis for these economies' recoveries. Then, Shinzō Abe's electoral victory in Japan was followed by unprecedented political intervention at the Japanese central bank – and the yen depreciated by 25 percent against the US dollar over a year. The ECB eventually followed suit, with Draghi explicitly stating that the aim was to lower the exchange rate.¹⁰ More recently, the People's Bank of China's (PBOC) decision to let its currency fall against the dollar was arguably motivated by weaknesses in its economy, rather than a desire to liberalise.

This may not amount to a currency war, as some have called it, but it speaks to the economically repressed policy environment that we find ourselves in. Policymakers believe that only by “stealing” growth from other economies can they boost their economic outlook. As economist Fred Bergsten writes, “it is just as economically distorting to artificially depress currency values ... as it is to impose high import tariffs and subsidise exports directly”.¹¹ This shift may have been the result of complacency by policymakers. While the WTO prevented the

¹⁰ Draghi said the expectation was that asset purchases would “generate scarcity in the market in which we buy, which encourages investors to shift holdings into other asset classes – e.g. from sovereign to corporate bonds, from debt to equity, and across jurisdictions, reflected in a falling of the exchange rate”. See “The ECB's recent monetary policy measures: Effectiveness and challenges”, Speech by Mario Draghi, ECB, 14 May 2015, available at <https://www.ecb.europa.eu/press/key/date/2015/html/sp150514.en.html>.

¹¹ C. Fred Bergsten, “The Truth About Currency Manipulation: Congress and the Trans-Pacific Partnership”, *Foreign Affairs*, 18 January 2015, available at <https://www.foreignaffairs.com/articles/ united-states/2015-01-18/truth-about-currency-manipulation>.

imposition of the traditional policy channel for protecting national commerce – import tariffs – generals are always fighting the last war. Essentially, interventions in financial markets have replaced interventions in the markets for goods and services.

Financial regulation

Another covert form of protectionism – or economic repression – prevalent in developed economies has taken place via the regulation of financial institutions, aimed at defending the market access of domestic banks, both at home and abroad. As Simon Evenett has discussed elsewhere in this essay collection, the extent to which regulatory policy has been used to protect national commercial interests (particularly by emerging markets) has been serially understated.

Since the global financial crisis, many governments have ceded regulatory power to an independent institution (such as the ECB) in order to strengthen the global financial system as a whole. A number of new regulatory structures have emerged, including Basel III and the European Banking Union (EBU). But pooling regulatory power comes at a price for governments. Banks have historically been tools of clientelism, extending credit to certain projects in return for favourable treatment from governments. For example, the build-up of subprime debt in the US, which was in part the product of these special relationships, saw banks carrying out a quasi-governmental function at a time when the appetite for funding or subsidising individual mortgages was lacking. In many developed economies, the size of the financial sector and its contribution in the form of employment and tax revenue also means that its protection and promotion is of strategic importance to the state.

The tension between governments wishing to pool financial risk to international regulatory bodies and those wishing to retain oversight of their national banks – while free-riding off the risk-sharing of others – now defines the regulatory landscape. Individual governments have ducked opportunities to pool financial risk in favour of boosting a strategically important sector of their economy – harming financial stability for all. The UK government opted out of the EBU, ostensibly to maintain regulatory control over the British banks and ensure their stability. But, at the same time, it sought safeguards against exclusion

from the eurozone's financial services market.¹² The regulatory inconsistencies implicit in this arrangement could make the European banking system less stable. The potential for regulatory arbitrage between the Bank of England and the ECB, possible tensions between differing resolution regimes, and the concentrated fiscal burden placed upon the UK government in the event of a failure could all become sources of systemic weakness – not just for the UK banks.¹³

Similarly, Germany has taken advantage of variations in the European banking structure, and its dominance in negotiations over the construction of the EBU, in order to shelter its banks from oversight, and allow their close links with local governments to continue. It pushed for the EBU to exclude small banks from the Single Supervisory Mechanism (SSM), thereby excluding Germany's network of small savings banks, the *Sparkassen*, which comprise almost 50 percent of Europe's small banks,¹⁴ and have historically enjoyed close links with local governments.

Conclusion

Economic, not foreign policy, goals are the primary motivation for governments engaging in economic repression. Shorn of their conventional policy tools, states interfere in the market in new ways, taking a more hands-on approach to business and politicising central banks. Sluggish wage growth and a discrediting of laissez-faire policies has made electorates more tolerant of economic repression, and this is reflected by the growing popularity of politicians such as Jeremy Corbyn, Bernie Sanders, and Viktor Orbán, who advocate a greater role for the state in economic life.

In contrast to historic periods of protectionism, many of the measures of economic repression described in this essay are covert in nature. Others, such as China's devaluation of the yuan, can be interpreted

12 For example, the UK government successfully petitioned for the City to continue clearing euro-denominated trades and won a concession from the ECB to provide emergency swap lines of euro liquidity to Central Clearing Counterparties in the event of a "shock". So it seems that maintaining the City's international "competitiveness" was something of an ulterior motive.

13 Angus Armstrong, "UK Finance and the EU", National Institute of Economic and Social Research blog, 26 May 2015, available at <http://www.niesr.ac.uk/blog/uk-finance-and-eu#.VfLqVhFVhBd>.

14 Nicolas Véron, "Europe's Single Supervisory Mechanism: Most small banks are German (and Austrian and Italian)", Bruegel blog, 22 September 2014, available at <http://bruegel.org/2014/09/europes-single-supervisory-mechanism-most-small-banks-are-german-and-austrian-and-italian/>.

ambivalently. As a result, they have received less attention – from policymakers, executives, and electorates.

As the global economy remains in its current state of low growth, the international policy environment appears to be increasingly zero-sum in its outlook. Tools of economic repression, while aiming to redress imbalances that have built up post-financial crisis, clash with the spirit of multi-nationalism and cooperation that defined the successful response to the crisis. By going down the road of achieving growth at one another's expense, rather than achieving coordinated growth, policymakers, having won the war, risk losing the peace.

Today, state capitalism is a quaint and obsolete term. The economies of the United States and China are difficult to distinguish in terms of state intervention in capital markets and banking. The Communist Party of China bailed out its banking system in the early 2000s. The US Treasury and Federal Reserve bailed out its banking system in 2008. Major banks such as Morgan Stanley, Goldman Sachs, and Citibank were days away from complete collapse in late September 2008 when the US government intervened to guarantee all money market accounts, all bank deposits, and all derivatives exposure to embattled insurer AIG. China prohibited short selling to prop up its stock market in 2015. The US prohibited short selling to prop up its stock market in 2008. The list goes on. The point is that there is no significant difference today between a liberalising socialist society (China) and a socialising liberal society (the US). To paraphrase Richard Nixon, “We are all socialists now”.

As late as the 1990s, the term “state capitalism” was somewhat useful as a way to distinguish emerging economies in former communist states (such as China) from more pure capitalist states (such as the US). But, in opposition to Simon Evenett’s essay in this collection, I contend that the term has little meaning today.

This discussion must begin with definitions in order to avoid the dual pitfalls of ideological tendentiousness and false dichotomy. When private actors intervene in markets with the intent to deceive or defraud other market participants, the word “manipulation” may be appropriate. Yet when state actors are involved, manipulation loses its meaning. What outsiders call manipulation is simply policy, from the perspective of the state. States have tax policy, interest rate policy, regulatory policy, trade policy, and more. Currency policy is no different. Exchange rates can be fixed, floating, or pushed up or down to serve the economic interests of the state. Those with naïve views of markets or on the losing side of market bets may call it manipulation. Still, currency market intervention is just another branch of state economic policy. Using a pejorative term like “manipulation” serves no purpose. We will use the term “intervention” instead as a more neutral way to describe state policy action in currency markets.

Convergence on socialism

The convergence of communist and capitalist societies towards a socialist paradigm fulfils the 50-year prophecy made by Joseph A. Schumpeter in his 1942 classic, *Capitalism, Socialism and Democracy*. Schumpeter was a great admirer of Karl Marx because of the latter’s understanding of the deep historical processes of economic change; but he considered Marx’s prediction of a proletarian revolution against the bourgeoisie to be nonsense. While Schumpeter shared Marx’s view that capitalism would fail and be replaced by socialism, in Schumpeter’s view this would happen not because of revolution, but because capitalism itself would create so much wealth that society would lose touch with its capitalist roots and mistakenly conclude that it could afford a socialist system.

The ultimate irony is that by 2000, actual Marxian systems had failed and were converging on capitalism just as capitalist systems had lost their vision (as Schumpeter predicted) and were converging on socialism. The Russian, Chinese, European, and US economies now all exemplify heavily regulated, heavily subsidised, heavily taxed, quasi-capitalist systems that are best described as socialist. Accordingly, the “state capitalist” label can be safely abandoned. Socialism is ubiquitous.

Currency wars

Instead of currency manipulation in state capitalism, we are thus left with currency intervention in socialist economies. This intervention will inevitably have an inflationary bias, since inflation is the most effective and least understood way to transfer wealth from savers (bourgeoisie) to debtors (proletarians). As money is devalued by inflation, the saver owns less in savings, and the debtor owes less in debt. This is a kind of wealth redistribution that does not require direct taxation – so much the better from the state’s perspective. The way to achieve inflation via currency intervention is to cheapen your currency relative to your trading partners. This imports inflation (via higher import prices), exports deflation (via lower export prices), and stimulates growth (via greater exports and job creation). This effort to cheapen currency cross rates gives rise to currency wars.

Currency wars are designed to devalue a currency for the sole purpose of importing inflation, exporting deflation, and promoting exports at the expense of trading partners. Much of the action in a currency war does not involve direct intervention in currency markets. It is done through interest rate cuts, quantitative easing, bank reserve ratio cuts, forward guidance, inflation targeting, and other central bank policy tools. A weaker currency is the result of these policies, not a direct object of intervention (although such intervention is possible in more extreme cases).

The difficulty with currency wars is that they are a negative-sum game as actors steal growth from trading partners without adding to global growth. It is true that a party devaluing its currency can get a short-term and temporary boost to growth. This happened to China in 2009, the US in 2011, Japan in 2013, and Europe in 2015. In each case, the country benefitting had engaged in market intervention (through interest rate cuts, direct market purchases, or quantitative easing) to cheapen its currency. But trading partners soon struck back. This beggar-thy-neighbour dynamic is an almost exact replay of the sequence from 1921 to 1936 when first Germany (1921), then France (1925), the UK (1931), the US (1933), then the UK and France again (1936) devalued their currencies against those of their trading partners.

Because of this tit-for-tat dynamic, currency wars have no logical conclusion. They only end through systemic reform or systemic collapse. Systemic reform involves a major international monetary conference of the kind that took place in Bretton Woods (New Hampshire, 1944), the Smithsonian Institution (Washington, DC, 1971), the Plaza Hotel (New York, 1985), or the Louvre (Paris, 1987). Systemic collapse can involve either a world war (1914, 1939) or a global financial panic (1998, 2008).

The financial panics of 1998 and 2008 were covered over with bailouts and monetary easing and did not lead directly to systemic reform. However, the 2008 panic did invigorate the G20 and International Monetary Fund (IMF) to pursue significant new initiatives. The G20 summit in Pittsburgh in September 2009 was the launch-pad for both a rebalancing of the Chinese economy and the cheap dollar policy that played out in 2010 and 2011. The IMF issued its world money (the Special Drawing Rights, SDR) in August 2009 as a dry run in case larger issuance is needed in a future financial panic.

The current round of exchange rate intervention is both temporary and unstable. Volatility in US equity markets in August 2015 was a direct consequence of the Chinese devaluation of the yuan on 10 August. That devaluation was prompted by the expectation of even tighter monetary policy by the US Federal Reserve. With US and Chinese markets (fixed-income, currency, and equity) this tightly wound, a global financial collapse is just a matter of time.

Which will come first to the international monetary system – reform or collapse? The outcome is uncertain, but given the continued attractions of exchange rate intervention, and official misapprehension of the statistical properties of risk, collapse seems more likely.

Divestment campaigns: Bottom-up geo-economics

Divestment is a form of economic sanction that aims to pressure a company or industry to change its practices. But rather than being imposed by governments, divestment campaigns are geo-economic tools wielded by individuals and organisations. These groups withhold capital from firms engaged in activity deemed socially unacceptable, by, for example, selling shares, private equity assets, or debt. The campaigns can bring about wider changes in legislation, and in practices. The tobacco, munitions, adult services, and gambling industries, as well as corporations based in apartheid South Africa, were all targeted by divestment campaigns in the twentieth century.

Since 2012 a campaign for divestment from fossil fuels has gathered momentum in the United States, Europe, and Australia. Initiated by *350.org*, a climate action NGO, the campaign aims to encourage institutions to “freeze any new investment in fossil fuel companies, and divest from direct ownership and any commingled funds that include fossil fuel public equities and corporate bonds within 5 years”.¹ It has reported substantial successes, including the announced divestments of \$2.6 trillion in assets.²

¹ “Campaign Demands”, GoFossilFree.org, available at <http://gofossilfree.org/uk/campaign-demands/>.

² The campaign has influenced the announcement of divestment by 436 institutions and 2,040 ultra-high net worth individuals across 43 countries, which together hold \$2.6 trillion in assets. This includes 40 educational institutions, along with 49 cities and municipalities, two counties, 126 religious institutions, and 116 philanthropic foundations. Large public and private pension funds account for over 95 percent of assets committed to divestment. Fossil fuel campaigns are ongoing at more than 400 educational institutions worldwide. (As information correct as of September 2015.) See “Measuring the Growth of the Global Fossil Fuel Divestment and Clean Energy Investment Movement”, Arabella Advisors, September 2015, available at <http://www.arabellaadvisors.com/wp-content/uploads/2015/09/Measuring-the-Growth-of-the-Divestment-Movement.pdf>; see also Emily Gayfer, “Get with the times, divest”, GoFossilFree.org, 2 October 2015, available at <http://gofossilfree.org/get-with-the-times-divest/>.

This essay analyses the process by which divestment campaigns impact their targets, and makes three arguments. First, that the fossil fuel divestment campaign has gathered momentum with greater speed and magnitude than comparable previous campaigns, suggesting that the number of these campaigns could multiply in the future. Second, that the direct impact of the fossil fuel campaign is likely to be minor on the oil and gas sector, though coal-related firms listed on major stock exchanges appear to be negatively affected. Third, that the divestment campaign's most likely impact will be indirect, though still substantial, and will take place through a process of stigmatisation.

The evolution of divestment campaigns

Divestment campaigns typically evolve over three waves, each of which involves different groups and has a different reach.

The first wave begins with a core group of investors divesting from the target industry. So far, most major divestment campaigns have originated in the US and have initially focused on US-based investors as well as international multilateral institutions. The amounts divested in the first phase tend to be small, but serve to raise public awareness about the issue in question.

Previous campaigns have often taken years to gather pace during the first wave, until US universities – often disposing of large endowments – announced divestments, marking the beginning of the second phase. Previous research typically credits divestment by these prominent universities as heralding a tipping point that paved the way for other universities and select public institutions to divest.³

In the third wave, the divestment campaign becomes international and begins to target large pension funds, aiming to change market norms, such as through the establishment of social responsibility investment (SRI) funds. The expected trajectory of a divestment campaign thus entails small outflows from lead investors in early phases of a campaign, followed by a deluge once a tipping point has been reached.

³ Slew Hong Teoh, Ivo Welch, and C. Paul Wazzan, "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott", *Journal of Business*, Volume 72, Number 1, 1999, available at http://www.middlebury.edu/media/view/443860/original/effects_of_socially_activist_investment_policies.pdf.

Like the previous campaigns, the fossil fuel divestment campaign began in the US and focused first on US-based investors. In the last three years, the campaign has built global momentum and, despite its relatively brief history, it is already entering the third wave of divestment. This is evidenced by the fact that several large and prominent institutions have already announced divestment, particularly from thermal coal mines and coal-dependent power generators and utilities. In addition to the prominent academic institutions mentioned previously, large and mainstream investors such as AXA (€1,277 billion in assets under management (AUM) in 2014), Aviva (£246 billion in AUM in 2014), and the Norwegian Global Pension Fund (\$857 billion in AUM in 2014) have announced coal company divestment.⁴

The fossil fuel divestment campaign's momentum and increasing social diffusion suggests it is here to stay for the foreseeable future, and that more divestment campaigns are to be expected.

Direct impacts of divestment

The direct impact of fossil fuel divestment on equity or debt is likely to be limited. The maximum possible capital that can be divested by university endowments and public pension funds is relatively small, and unlikely to have a major effect on their share prices. Divested holdings are likely to quickly find their way to neutral investors. Looking back at earlier divestment campaigns also suggests that only a very small proportion of total divestable funds are actually withdrawn. For example, despite the huge interest in the media and a three-decade evolution, only about 80 organisations and funds (out of a likely universe of over 1,000) have substantially divested from tobacco equity, and even fewer from tobacco debt. Consequently, oil and gas companies are unlikely to find that investor-led economic sanctions in the form of divestment have much direct impact on their business.

Greater direct effects on coal valuations are, however, being felt. Coal is a less liquid market than oil stocks: there are fewer buyers and

4 See "Climate change: it's no longer about whether, it's about when", AXA, 22 May 2015, available at http://www.axa.com/en/news/2015/climate_insurance.aspx; Pilita Clark, "Aviva orders coal companies to clean up", *Financial Times*, 24 July 2015, available at <http://www.ft.com/cms/s/0/fc4de232-321e-11e5-91ac-a5e17d9b4cff.html>; John Schwartz, "Norway Will Divest From Coal in Push Against Climate Change", the *New York Times*, 5 June 2015, available at <http://www.nytimes.com/2015/06/06/science/norway-in-push-against-climate-change-will-divest-from-coal.html>.

sellers, and transaction costs are higher. Divestment is thus more likely to impact coal stock prices since alternative investors cannot be found as easily as in the oil and gas sector. The fact that coal companies have seen their share prices fall significantly since divestment actions were announced – the Dow Jones Total Market Coal Sector Index is down 76 percent in the last five years compared with the Dow Jones Industrial Average, which grew 69 percent in the same period⁵ – suggests that coal divestment might be having an impact. Further research is required to determine causality, but even Peabody Energy, one of the largest coal mining companies in the US, reported the following in regulatory filings: “Concerns about the environmental impacts of coal combustion, including perceived impacts on global climate issues, are resulting in increased regulation of coal combustion in many jurisdictions, unfavourable lending policies by government-backed lending institutions and development banks toward the financing of new overseas coal-fuelled power plants and divestment efforts affecting the investment community, which could significantly affect demand for our products or our securities”.⁶

Moreover, due to its public prominence and exposure, the fossil fuel divestment campaign has sparked a broader debate about the risks of investing in assets that contribute to climate change. This has probably resulted in climate risk being priced more accurately by some financial institutions, leading to less capital flowing into companies exposed to these risks. This is not a “socially motivated” divestment, but an improved capital allocation based on a better understanding of risk.

Indirect impacts of divestment

Even if the direct impacts of divestment outflows are meagre in the short term, a campaign can have long-term impact on the value of a target firm if it causes investors to lower their expectations of the firm’s net cash flows. This type of stigmatisation process, which the fossil fuel divestment campaign has now triggered, poses the most far-reaching threat to companies.

⁵ “US coal crash serves as warning to investors betting on carbon”, Carbon Tracker, 23 March 2015, available at <http://www.carbontracker.org/in-the-media/us-coal-crash-serves-as-a-warning-to-investors-betting-on-carbon/>.

⁶ “Advanced Energy – the Power of 21st Century Coal”, Peabody Energy 2014 Annual Report, available at <https://mcsusppegrs01.blob.core.windows.net/mmfiles/files/investors/2014%20peabody%20annual%20report.pdf>.

Stigmatisation

Divestment campaigns hurt their targets' image, which in turn can impact profits. Firms heavily criticised in the media develop a negative reputation that can scare away suppliers, subcontractors, employees, and customers.⁷ Governments and politicians prefer to engage with "clean" firms to avoid damage to their reputation. Shareholders can demand changes in management or the board of directors of stigmatised companies. They may be barred from competing for public tenders, acquiring licences or property rights, or be weakened in negotiations with suppliers. Negative consequences of stigma can also include the cancellation of contracts or of mergers and acquisitions.⁸ Stigma attached to even one part of a company may threaten sales across the board.

Stigmatisation can prevent share prices rising in line with the value of a target company, by permanently reducing its share price to earnings ratio. For example, Rosneft produces over two million barrels of oil per day, slightly more than ExxonMobil. Considering that oil is a global commodity, one would imagine that Rosneft and ExxonMobil would have similar market values if they produced similar amounts of oil. Rosneft has, however, persistently traded four to six times below ExxonMobil in terms of market value, because it suffers from the stigma of investors believing that it is under weak corporate governance. Investors thus place a lower probability on its reserves being converted into positive cash flows. If ExxonMobil (and other publicly traded fossil fuel firms) was stigmatised by the divestment campaign, its enterprise value to reserves ratio might slide towards that of Rosneft, permanently lowering the value of the stock.

Restrictive legislation

One of the most important ways in which divestment campaigns could impact fossil fuel companies is through legislative change. In almost every campaign analysed in our research – with targets ranging from tobacco to adult services, South Africa to Darfur – divestment campaigns were successful in lobbying for restrictive legislation.

⁷ Jean-Philippe Vergne, "Stigmatized Categories and Public Disapproval of Organisations: A Mixed Methods Study of the Global Arms Industry (1996–2007)", *Academy of Management Journal*, Volume 55, Number 5, 2012, pp. 1027–1052.

⁸ *Ibid.*

If anti-fossil fuel campaigners are able to create the expectation that the government could impose a carbon tax – which would have the effect of depressing demand – then they will considerably increase the uncertainty surrounding the future cash flows of fossil fuel companies. This will indirectly influence all investors – not just those considering divestment due to moral outrage but also those who are neutral – to reduce the proportion of fossil fuel stocks and debt in their portfolios.

There is an interesting parallel to state-imposed economic sanctions. Stigmatisation also plays an important role for sanctions, but while for sanctions the stigmatisation comes after the fact – i.e. the imposition of sanctions – for divestment campaigns stigmatisation is a means to compel states to act.

Stigmatisation changes market norms over longer time periods, closing off previously available channels of money. In particular, the withdrawal of debt finance from fossil fuel companies by some banks or an increase in the discount rate can pose debt re-financing problems (either in terms of short-term liquidity or capital expenditure) for fossil fuel companies.

The response from industry

While the above negative consequences are economically relevant, stigma does not necessarily drive whole industries out of business. Target firms take steps to counteract it, particularly when their whole industry is being stigmatised. For example, in stigmatised industries such as arms or tobacco, some players are largely able to avoid disapproval, while others face intense public vilification.

Stigmatisation will slow down fossil fuel companies, but is unlikely to threaten their survival. The impact of stigmatisation is more severe for companies seen to be engaged in wilful negligence and “insincere” rhetoric, i.e. saying one thing and doing another.⁹ Moreover, a handful of fossil fuel companies are likely to become scapegoats – and, as explained above, coal companies are likely to be more vulnerable than oil and gas companies.

9 Yeosun Yoon, Zeynep Gürhan-Canli, and Norbert Schwarz, “The Effect of Corporate Social Responsibility (CSR) Activities on Companies With Bad Reputations”, *Journal of Consumer Psychology*, Volume 16, Issue 4, 2006, pp. 377–390; Ingvild Andreassen Sæverud and Jon Birger Skjærseth, “Oil Companies and Climate Change: Inconsistencies Between Strategy Formulation and Implementation?”, *Global Environmental Politics*, Volume 7, Issue 3, August 2007, available at http://www.fni.no/pdf/ins_jbs_gep_2007.pdf.

The achievements of the fossil fuel divestment campaign suggest that bottom-up, public-driven divestment campaigns have the potential to grow in number. The public, rather than being only consumers, have become actors. Investors, target companies, and governments should pay close attention.

The weaponisation of migration

In November 2015, one of Libya's two rival governments issued a lightly veiled threat to Europe. If it was not offered diplomatic recognition and financial assistance by the European Union, it might actively assist migrants and asylum seekers trying to reach the region.¹ This came close on the heels of analogous threats made by Turkish authorities just a few weeks previously. Turkish demands included the lifting of visa restrictions, financial aid to mitigate the burden of hosting more than two million Syrians, and the reinvigoration of their EU membership bid. By some accounts, the Turks also renewed an earlier demand for the creation of a "safe zone", cleared of Islamic State (ISIS) fighters, along the Syrian border.² While Turkish and Libyan demands

1 Colin Freeman, "Libya warns it could flood Europe with migrants if EU does not recognise new self-declared government", the *Telegraph*, 2 November 2015, available at <http://www.telegraph.co.uk/news/worldnews/africaandindianocean/libya/11970313/Libya-warns-it-could-flood-Europe-with-migrants-if-EU-does-not-recognise-new-Islamist-government.html>.

2 Matthew Holehouse, "EU chief: Migrant influx is 'campaign of hybrid warfare' by neighbours to force concessions", the *Telegraph*, 6 October 2015, available at <http://www.telegraph.co.uk/news/worldnews/europe/eu/11915798/EU-chief-Migrant-influx-is-campaign-of-hybrid-warfare-by-neighbours-to-force-concessions.html>; Valentina Pop, "EU Seeks Turkish President's Help to Stop Refugee Flow", the *Wall Street Journal*, 5 October 2015, available at <http://www.wsj.com/articles/eu-seeks-turkish-presidents-help-to-stop-refugee-flow-1444068094>; Raf Casert and Jamey Keaten, "EU, Turkey seek better relations at emergency refugee summit", *Associated Press*, 29 November 2015, available at <http://bigstory.ap.org/article/60805ef1dc514199ac2bfd9257a0401f/eu-turkey-seek-better-relations-emergency-refugee-summit>.

differed in content, their underlying messages were strikingly similar: concede to our demands or face (possibly severe) migration-related consequences. And the two cases are anything but unique.

Since the 1951 Refugee Convention came into force, there have been at least 75 attempts globally by state and non-state actors to use displaced people as political weapons. Their objectives have been political, military, and economic, ranging from the provision of financial aid to full-scale invasion and assistance in effecting regime change. In nearly three-quarters of these historical cases, the coercers achieved at least some of their articulated objectives. In well over half of the documented cases, they obtained all or nearly all of what they sought, making this rather unconventional instrument of state-level influence more effective than either economic sanctions or traditional, military-backed coercive diplomacy.

Sometimes attempts to weaponise population movements have simply comprised threats to generate outflows, such as former Libyan leader Muammar Gaddafi's colourful and rather dramatic promises to "turn Europe black" if the EU failed to meet his demands.³ Gaddafi used this tool with varying degrees of success in 2004, 2006, 2008, and 2010, before fatally overplaying his hand in 2011. (Although the EU/NATO intervention in Libya that year was not primarily driven by this unique brand of coercion, Gaddafi aggressively employed it against the interveners: first, as an instrument of deterrence, in the form of threats against EU officials in the earliest days of the uprising; and later, as an instrument to compel nearby NATO member states, after the bombing campaign had commenced and the civil war had erupted).⁴

Migrants rather than bombs

In other instances, coercion has entailed forcing large numbers of victims across borders, as then-Yugoslav President Slobodan Milošević did in the spring of 1999 in an attempt to compel NATO to stop its bombing campaign during the Kosovo War. Former German Foreign Minister Joschka Fischer later admitted his regret in not taking

³ "Gaddafi wants EU cash to stop African migrants", *BBC News*, 31 August 2010, available at <http://www.bbc.co.uk/news/world-europe-11139345>.

⁴ See, for instance, Kelly M. Greenhill, "Open arms and barred doors: Hypocrisy and schizophrenia in the European migration crisis", *European Law Journal*, volume 22, number 2 (forthcoming, March 2016).

Milošević seriously when he said he “could empty Kosovo in a week”.⁵ Thus, while NATO was seeking to compel Milošević to cease his offensive against the Kosovans through the use of air strikes, Milošević was engaged in his own intensive game of counter-coercion against NATO and its allies. Displaced people, rather than bombs, were his political and military weapons of choice.

On still other occasions, coercers have merely opened (and later closed) borders that are normally sealed. One such example is provided by former Cuban President Fidel Castro, who used this tool against the United States on at least three occasions: in 1965, 1994, and, most famously, during the Mariel boatlift of 1980.⁶ In still other cases, coercion has been effected by exploiting and manipulating outflows created by others, whether intentionally or inadvertently. This was the case in the late 1970s when a group of Association of Southeast Asian Nations (ASEAN) states threatened to push Indochinese boat people out to sea, where they would likely drown, if the group’s demands were not met.

Despite its prevalence, this kind of coercion is often under-reported; indeed, it is a phenomenon that has been hiding in plain sight. This is for a few reasons. For one thing, coercive threats are often issued privately and bilaterally. For another, this kind of coercion is sometimes embedded within outflows caused by other factors. For instance, Ugandan leader Idi Amin expelled most Asians in 1972, in what has commonly been interpreted as a naked asset grab. Far less well known is the fact that about 50,000 of those expelled held British passports, and that these expulsions happened at the same time that Amin was demanding that the British halt their drawdown of military assistance to his country. In short, Amin announced his intention to foist 50,000 refugees on the British, with a convenient 90-day grace period to give them a chance to rethink their decision on aid.⁷

⁵ Lara Marlowe, “War and peace revisited”, the *Irish Times*, 25 March 2000, available at <http://www.irishtimes.com/news/war-and-peace-revisited-1.259905>.

⁶ Approximately 125,000 Cubans emigrated to the US between April and October 1980, after Castro allowed departures from the port of Mariel.

⁷ See, for instance, Mark Curtis, *Unpeople: Britain's Secret Human Rights Abuses* (London: Vintage Books, 2004).

Targeting liberal democracies

The vast majority of known targets of this kind of coercion have been liberal democracies (over 70 percent); another 11 percent have been mixed multilateral targets that include liberal democracies. This is no accident. Liberal democracies are particularly vulnerable because they often find themselves trapped between conflicting imperatives. On one hand, such states generally have normative and legal commitments to protect those fleeing violence and persecution. On the other hand, as recent events within many EU member states make clear, segments of democratic polities are often strenuously opposed to accepting displaced people, for a variety of economic, political, or cultural reasons, or simply xenophobia. This clash of commitments with public opinion may make the incentives to concede to coercers' demands (and make the problem disappear) compelling indeed.

So what options do (potential) targets of migration-driven coercion have? There are several; all with drawbacks. Targets can concede, but this carries the risk that coercers may repeat and escalate their demands, as Gaddafi did in the 2000s. Alternatively, targets can take military action to change conditions on the ground in countries of origin. But wars are costly, and their outcomes often uncertain. Again, the Gaddafi example is instructive: as noted at the outset, the threat of coercion from Libya did not disappear with his ouster, and subsequent instability within both the country and the region does not inspire confidence in the virtues of regime change as a solution.

Alternatively, target governments can proactively appeal to their polities to welcome the displaced, emphasising the long-term economic virtues of migration, particularly for countries suffering declining birth rates and shrinking tax bases. If this succeeds, coercion becomes impossible because threats of "flooding" will, in theory, be met with a welcome for the incoming population flow. Unfortunately, effecting this kind of attitude change would be a long-term proposition and not effective in the midst of an emergency. For Europe today, such an approach may become more challenging still in the wake of claims that at least one of those responsible for the attacks in Paris in November 2015 might have travelled to Europe in the midst of a stream of displaced people.

Finally, targeted states can abrogate their commitments, close their borders, and lock their doors. This too makes successful migration-driven coercion difficult, if not impossible. But such a stance would represent an abandonment of some of liberal democracies' most enviable values. In the end, the long-term costs to liberal morals, philosophy, and identity may be far greater than any short-term humanitarian and assimilation-related costs inherent in accepting inflows of people. The closed-border approach is also very unlikely to solve migration-related security concerns. Indeed, if Europe closes its borders to migrants and refugees from Syria and the region, it may feed extremist narratives about liberal democracies, which in turn could sow the seeds of a different kind of weaponisation of the displaced.

This essay is drawn in part from Kelly M. Greenhill, Weapons of Mass Migration: Forced Displacement, Coercion and Foreign Policy (Ithaca, NY: Cornell University Press Studies in Security Affairs, 2010 and 2016).

WEAPONISING INSTITUTIONS

China's shadow world order

Thirty consecutive years of economic growth have boosted Chinese confidence and awakened its ambitions to play an active role in the establishment of a multi-polar world order. The global financial crisis of 2008 further convinced the Chinese leadership that its development path could be a feasible alternative to the Western liberal model. By promoting new parallel institutions that follow transparent procedures and abide by international law, Beijing aims to strengthen the legitimacy of its rise and avoid the mistakes made by the rising Germany and Japan in the twentieth century. With great caution, it is transforming itself from an international rule-taker to an international rule-maker.

While Beijing remains an active player within existing international institutions, it is at the same time promoting and financing parallel structures such as the Asian Infrastructure Investment Bank (AIIB) and the Shanghai Cooperation Organization (SCO). The overall goal of these efforts is greater autonomy, primarily vis-à-vis the United States, and an expansion of the Chinese sphere of influence within Asia and beyond.

The existing global institutional order has not been adequately adapted to accommodate a rising China. The protracted reforms to the World

Trade Organization (WTO), the International Monetary Fund (IMF), and the World Bank further created an incentive for China to develop its own institutions in order to pursue its economic interests without interference from the US.

Beijing identifies gaps in the international order and fills them with its own initiatives. Some of these parallel structures complement existing structures, for instance in the development aid and security sectors. But some, especially in the trade and finance sectors, may come to compete directly with existing institutions.

These initiatives are still in an early phase. But already, novel China-centred structures with varying degrees of coverage and sophistication can be identified over a broad spectrum of policy areas, including:

- Financial and monetary policy
- Trade and investment
- Trans-regional infrastructure projects
- Security policy¹

The most advanced Chinese undertakings abroad are driven by the country's capacity to construct physical infrastructure – especially railways, roads, electricity, and telecommunication networks – in regions of the world that have been, or have felt, neglected by multilateral and Western development assistance, as Parag Khanna argues elsewhere in this collection.²

Countries that have been politically and economically marginalised are particularly drawn towards Chinese institutions, which promise comprehensive investment without (Western) political strings attached. While working to harmonise economic standards, Beijing remains determined to uphold the right of every state to choose its own development path. This enables other states to reduce their dependency on the US.

1 Sebastian Heilmann, Moritz Rudolf, Mikko Huotari, and Johannes Buckow, "China's Shadow Foreign Policy: Parallel Structures Challenge the Established International Order", Mercator Institute for China Studies, *China Monitor*, Number 18, 28 October 2014, available at http://www.merics.org/fileadmin/templates/download/china-monitor/China_Monitor_No_18_en.pdf.

2 Also see Maximilian Mayer and Mikko Huotari, "China: Geopolitik durch Infrastruktur", *Blätter für deutsche und internationale Politik*, July 2015, p. 37, available at <https://www.blaetter.de/archiv/jahrgaenge/2015/juli/china-geopolitik-durch-infrastruktur>.

Current challenges to the US-dominated post-Cold War order, from the crisis in Ukraine to the expansion of Islamic State (IS) in the Middle East, favour the expansion of the parallel structures facilitated by Chinese foreign policy. Russia, isolated from the West, serves as an important partner for China in these endeavours.

These parallel structures cover a broad spectrum of policy areas.

Financial and monetary policy

China has advanced financial structures that to some degree duplicate the Bretton Woods institutions (the IMF and World Bank), as well as aiming to internationalise the Chinese currency. In addition, Chinese companies such as UnionPay and United Credit Rating Agency are currently challenging the monopoly of US credit card companies (Visa, MasterCard) and rating agencies (Moody's, Fitch, Standard & Poor's).

These Chinese initiatives aim to break up the monopoly of existing multilateral development institutions in Asia, in particular the World Bank and the Asian Development Bank (ADB). Both the BRICS New Development Bank (NDB) and the AIIB concentrate on funding infrastructure projects. The establishment of the AIIB in 2015 showed that China is able to gather a large number of states – 57 from five continents – to join a China-centred institution.³ Even major Western economies such as Germany and the UK became founding members, despite concerns that international standards would not be met. The US was one of the few major powers that decided to abstain.

Beijing has repeatedly declared that the AIIB complements existing institutions. Representatives from the World Bank, the IMF, and the ADB openly expressed their willingness to cooperate with the AIIB.⁴ According to ADB estimates, about \$8 trillion in infrastructure investment will be needed in the Asian region between 2010 and 2020.⁵ The AIIB helps to fill the huge supply gap for infrastructure

3 Australia, Austria, Azerbaijan, Bangladesh, Brazil, Brunei, Cambodia, China, Denmark, Egypt, Finland, France, Georgia, Germany, Iceland, India, Indonesia, Iran, Israel, Italy, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Laos, Luxembourg, Malaysia, Maldives, Malta, Mongolia, Myanmar, Nepal, Netherlands, New Zealand, Norway, Oman, Pakistan, Philippines, Poland, Portugal, Qatar, Republic of Korea, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Tajikistan, Thailand, Turkey, UAE, United Kingdom, Uzbekistan, and Vietnam.

4 Shawn Donnan, "World Bank chief endorses rival AIIB", *Financial Times*, 7 April 2015, available at <http://www.ft.com/cms/s/0/c58cbd66-dcee-11e4-975c-00144feab7de.html#axzz3kcgOrDaW>.

5 "Infrastructure for Supporting Inclusive Growth and Poverty Reduction in Asia", Asian Development

investments in Asia, and is therefore a valuable and complementary addition to the development of the region.

The Chinese government is also striving to internationalise its currency through a step-by-step expansion of the use of the yuan in Chinese foreign trade and investment. To this end, Beijing has built a worldwide network of agreements on central bank currency swaps, direct exchange of the yuan with other currencies, and yuan clearing hubs. The declared goal is to limit the use of the US dollar and compete with it as a globally predominant reserve currency.

Trade and investment policy

China's efforts to create bilateral or regional alternatives to existing structures can be interpreted as a response to the standstill at the WTO's Doha Round and to US trade policy. In addition, from a Chinese perspective, the US is excluding it from rulemaking on international trade policy in order to defend its dominant role in the global economy. In particular, the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) deals threaten to establish standards for global trade in the twenty-first century while excluding China, the world's biggest trading nation.

In Asian regional trade initiatives, China can bring its interests to the negotiation process. For example, the proposed Regional Comprehensive Economic Partnership (RCEP), initiated by ASEAN in November 2011 (based on a joint Japanese-Chinese proposal in August 2011) is a competing initiative to the TPP. It would include the ten states of ASEAN and the six states with which ASEAN already has signed free trade agreements (Australia, China, India, Japan, South Korea, and New Zealand).

“Belt and Road” infrastructure initiative

In autumn 2013, Chinese President Xi Jinping announced the “One Belt, One Road” (OBOR) initiative. OBOR is Beijing's key geostrategic attempt to alter Eurasian trans-regional trade in its favour. It comprises

Bank, May 2012, available at <http://www.adb.org/publications/infrastructure-supporting-inclusive-growth-and-poverty-reduction-asia>.

the land-based “Silk Road Economic Belt” and the “Twenty-first Century Maritime Silk Road”, which are linked via trans-regional economic corridors.⁶ Vice Premier Zhang Gaoli announced in May 2015 that China plans to invest around \$900 billion to make OBOR a reality.⁷

Six proposed economic corridors⁸ will be the main focus of OBOR in its initial stage.⁹ OBOR goes far beyond the development of linear transport and trade connections between Europe and Asia. In fact, Beijing is trying to establish a comprehensive and multi-layered Eurasian infrastructure network. As the primary investor and architect, Beijing is creating new China-centred pipeline, railway, and transport networks. In addition, the Chinese leadership is focused on the expansion of deep-sea ports, particularly in the Indian Ocean. This helps China to export the products of domestic overcapacity, open up new markets, reduce its dependency on existing trade partners, and politically stabilise its western provinces.

The OBOR initiative is not embedded into an overarching international framework and remains primarily an evolving concept, a meta-strategy without concrete details. Beijing promotes OBOR on a bilateral as well as a multilateral level. Official Chinese statements present OBOR as inclusive and complementary to existing international institutions, and the vision of increased connectivity in Eurasia complements the ambitions of other regional players such as Russia and Europe. However, given the lack of detail on the initiative and the absence of specific institutional cooperation formats to include potential partners in shaping the OBOR concept, the initiative can also be regarded primarily as a tool to expand Chinese influence in Eurasia. Since the infrastructure networks are entirely designed by China, OBOR challenges the status quo in Eurasia and, among other things, Russia’s traditional sphere of influence.

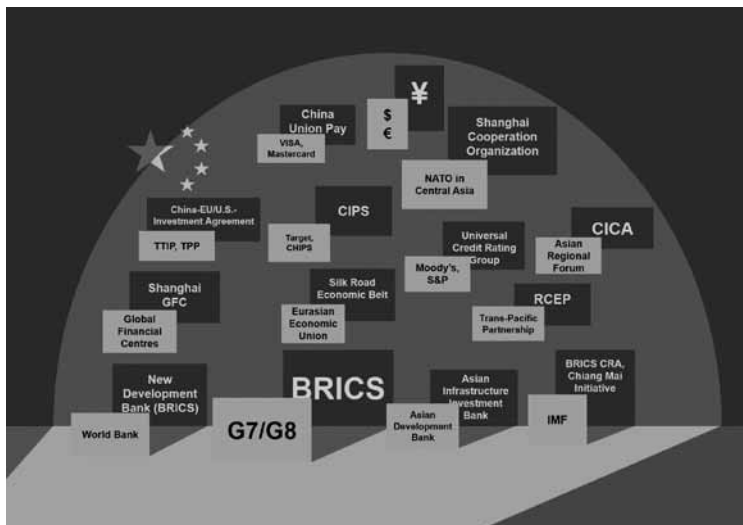
6 “Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road”, National Development and Reform Commission, 28 March 2015, available at http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html.

7 “一带一路”六大经济走廊有多长”, *Xinhua*, 1 June 2015, available at http://news.xinhuanet.com/fortune/2015-06/01/c_127863749.htm.

8 China–Mongolia–Russia Economic Corridor (CMREC); New Eurasian Land Bridge (NELB); China–Central and West Asia Economic Corridor (CCWAEC); China–Indo–China Peninsula Economic Corridor (CICPEC); China–Pakistan Economic Corridor (CPEC); and Bangladesh–China–India–Myanmar Economic Corridor (BCIM–EC).

9 “张高丽：中国规划一带一路六大经济走廊(名单)”, *news.ifeng*, 27 May 2015, available at http://news.ifeng.com/a/20150527/43848783_0.shtml.

Chinese shadow institutions



Source: Johannes Buckow © - MERICS Berlin

Security policy

Finally, China is expanding cooperation mechanisms in order to address regional security challenges, in particular terrorism, separatism, and extremism (as defined by the Chinese government).

The China-backed SCO, founded in 2001, is not directed against NATO. Instead, it is based on the idea that Asian states need to solve regional security issues on their own. This implies the reduction of US influence as a security actor in Eurasia. During the SCO summit in July 2015, the leaders of Russia, China, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan decided to launch accession procedures for India and Pakistan. Belarus was granted observer status, while Azerbaijan, Armenia, Cambodia, and Nepal became dialogue partners.¹⁰

Furthermore, China has called for the SCO to serve as an umbrella organisation linking the Eurasian Economic Union and the Silk Road

¹⁰ Lidia Kelly, Denis Pinchuk, and Darya Korsunskaya, "India, Pakistan to join China, Russia in security group", *Reuters*, 10 July 2015, available at <http://in.reuters.com/article/2015/07/11/china-russia-india-pak-sco-idINKCN0PK20520150711>.

Economic Belt, and has advocated for deepening economic cooperation among SCO member states.

The SCO could develop into an organisation for security and economic cooperation under Chinese leadership, enabling China to pursue its agenda in Central Asia (stability and access to natural resources), without appearing to be a hegemon. Due to its low level of integration, the SCO is unlikely to act as competition to established security institutions. It could, however, fill a security gap, especially with regards to counter-terrorism in Asia. The common threat of Islamist terrorism opens opportunities for more in-depth cooperation, especially with the Organization for Security and Co-operation in Europe (OSCE).

Parallel structures and the existing order

On its path to re-emerge as a world power, Beijing aims to avoid the mistakes of the rising Germany and Japan in the twentieth century. Parallel structures serve as tools for Beijing to gradually increase its influence, while avoiding a military trial of strength with the established powers.

Generally speaking, China does not seek to demolish or to exit current international organisations and multilateral regimes. China's shadow institutions operate in compliance with international law, and Beijing is not, at present, openly questioning the fundamentals of the system.¹¹

In trade and finance, Chinese shadow institutions are already competing with the established structures. China's international currency and financial initiatives are contributing to striking changes in the global financial and monetary order, while competition from China-centred parallel mechanisms is already palpable and has weakened the once dominant position of Western currencies and Western-led international organisations. In addition, competition with the US over free trade areas in Asia is already taking place.

New opportunities for cooperation with China are emerging in development aid and security policy. Chinese shadow institutions

¹¹ Andrew Nathan, "China's Rise and International Regimes: Does China Seek to Overthrow Global Norms?", in Robert S. Ross and Jo Inge Bekkevold (eds), *China in the Era of Xi Jinping* (Washington, DC: Georgetown University Press, 2016).

complement the existing order in the development aid sector, and China can help to fill supply gaps, especially via infrastructure investments. In the security sphere, China-centred institutions such as the SCO have the potential to complement the existing order, for instance via cooperation in counter-terrorism.

With regards to trans-regional infrastructure projects, China's parallel structures have both competitive and complementary elements. On the one hand, more connectivity in Eurasia offers new opportunities for the region, for instance by tapping into new markets and integrating them into the world economy. On the other hand, OBOR can also be regarded as a tool for China to expand its influence, and diversify trade routes and energy imports. Competition among states such as Russia, Japan, and India over influence in Eurasia is already emerging.

Looking ahead

As China's rise continues, Beijing is demanding to play an active role in reshaping the world order. If the US withdraws from Eurasia, China is likely to fill this vacuum, and could develop Eurasia into the core region for Chinese shadow institutions.

China's initiatives will have the greatest impact where its large infrastructural projects can be combined with its novel funding schemes. As well as expanding trans-regional transport corridors beyond Asia and into Europe, China is integrating surrounding states diplomatically and including them in security cooperation, while increasing their economic dependency. Despite the Chinese government's claim to be creating win-win relationships, Beijing gains disproportionately from these projects.

China has yet to show, however, that it can maintain efficient shadow institutions. Due to its lack of soft and smart power, as well as communication problems with potential partners, China is still facing big obstacles before it can develop into the dominant rule-maker in Eurasia. Beijing's assertive stance on territorial disputes (e.g. in the South China Sea) raises concerns among its neighbours that China is pursuing a hegemonic agenda. Furthermore, the evolving economic slowdown could prove that a Chinese model is in fact unsustainable, threatening the success of the Chinese shadow institutions altogether.

Chinese-sponsored organisations and mechanisms have the potential to challenge US and European predominance in important international institutions and policy areas. Efforts to keep China at bay in international rulemaking, however, will almost certainly backfire and reinforce Chinese determination to build alternative structures.

Western capitals should consider cautious involvement and participation in selected China-backed mechanisms that address pressing needs in targeted regions like development cooperation and counter-terrorism. If the new shadow institutions are ignored, important new areas of international engagement could be left to Chinese initiative and control.

Hina Rabbani Khar
Gated globalisation

9

Perhaps the truest manifestation of globalisation is that unrest, strife, and war know no borders. While the refugee outflow from the first phase of the “War on Terror” in Afghanistan and Iraq remained largely limited to its immediate neighbourhood, the global coalition for regime change in Syria has created large numbers of refugees who are seeking shelter further afield. They are knocking on the doors of countries that have been protected from hunger, chaos, and instability. The developed world’s resistance to accepting this wave of humans fleeing persecution and terror – barring a few exceptions such as Germany – speaks to the instinct of states to protect themselves from disorder spilling over from outside.

The unprecedented refugee crisis facing Europe, combined with the attacks in Paris, the downing of a Russian airliner, and bomb attacks in Beirut and Ankara, has had a profound impact on the outlook of people all over the world. As a result, it is natural that attitudes towards globalisation are going through an important transformation as well.

This is in some ways a clash of order with disorder. The inhabitants of the “orderly” world are tempted to build stronger protection around their borders to keep the populace of the “disorderly” world from bringing turmoil in their wake. This shift towards national protectionism against global flows of human beings parallels changing attitudes towards globalisation in the realm of trade and investment. We have moved into an era of managed globalisation, or “gated globalisation”, where states pick and choose whom to trade freely with, and whom to restrict their trade with.

Globalisation and power

National views on globalisation are shaped by history and geography. The structures of global governance reflect the power that countries wielded when these structures were formed. The permanent members of the UN Security Council, the always-US president of the World Bank, the always-European president of the International Monetary Fund (IMF) – all show that rules of globalisation are based not on fair play and democracy, but on power and might.

Global trade liberalisation requires the presence of a hegemonic power that ensures compliance to the multilateral trading regime. Its authority has to be broadly accepted by all players, and it has to invest in promoting the multilateral system and enforcing compliance. The post-Cold War era presented exactly these conditions, with the US and many other developed allies not only pursuing a multilateral trading regime, but also supporting it diplomatically.

Throughout the 1990s and early 2000s, globalisation progressed, largely unchallenged, as the agreed common good that all states – big and small, developed and underdeveloped – sought to pursue. Since the financial crisis of 2008/2009, however, this world is no more.

The ebbs and flows of globalisation are not new. The last century saw profound changes in attitudes towards globalisation. After moves towards an international free trade regime pre-1914, there was a wave of consolidating economic power through political gains between the two world wars, and then an effort to ease trade restrictions and create an architecture based on transparency, equality, and efficiency in the post-Cold War period.

Gated globalisation

What is different about today is that countries are not only moving slowly in World Trade Organization (WTO) negotiations, but are actively pursuing alternatives that are likely to obstruct an easy return to the largely abandoned WTO agenda of full trade liberalisation.

From its inception in 1995 until the financial crisis of 2008, the WTO's progress tells a story of how the attitudes of individual countries towards

globalisation have changed. The 1990s was a decade of breakthrough trade deals, permeated by the belief that the countries that were most integrated into the global system would prosper the most. The media was filled with stories of the benefits of globalisation, such as the epic rise of the free-market Asian Tigers.¹ Grand free trade agreements emerged in that decade: ASEAN (the Association of Southeast Asian Nations) in 1992, NAFTA (the North American Free Trade Agreement) in 1994, and the European Union Single Market in 1992.

Despite pursuing these regional trade deals, the same countries were simultaneously pursuing the WTO agenda of trade liberalisation, and making real progress. The Uruguay Round of multilateral trade talks in the 1980s and 1990s – possibly the most ambitious trade liberalisation effort to date, which led to the creation of the WTO – was successful because powerful countries were willing to spend diplomatic capital in pursuit of its goals. Many less powerful countries were also keen to support the process, as they considered globalisation to be beneficial.

Today, however, there are headlines about economies that create protective walls against the effects of the global economic meltdown. The world economy has been so volatile that governments are in no mood to expose themselves and their economies to any unintended consequences of grand trade deals. With or without a tacit agreement, they have moved to the more secure realm of managed, or gated, globalisation.

As a result, we have seen a wave of preferential trade agreements, free trade agreements (FTAs), and regional trade agreements. What is different about this wave is that the push towards FTAs is not accompanied by advances on the WTO framework. The lack of progress on the WTO's Doha Round, launched in 2001, is a telling example of this. Countries, powerful and weak, are finding solace in opening up one at a time, selectively. It is true that the plethora of trade negotiations and their accompanying standards and compliance have many costs, but clearly it is a price that most developed and developing countries are willing to pay.

¹ Hong Kong, Singapore, South Korea, and Taiwan.

Setting the world agenda

International competition to set the global economic agenda and architecture is fierce. The US's push for the finalisation of the Trans-Pacific Partnership (TPP), and the fact that the Obama administration has made it a top foreign policy priority, is a manifestation of the strategic war about who defines the global economic architecture and plays a leadership role within it. President Barack Obama's comments on TPP – “we can't let countries like China write the rules of the global economy. We should write those rules” – are revealing about the underlying motives behind many of these regional agreements.

Nowhere is today's trend more clearly represented than in the pursuit of two mega trade deals by the two mega competitors for global space. The US-led TPP and the Regional Comprehensive Economic Partnership (RCEP), an FTA between ASEAN and six other states including China, represent the reality of gated globalisation like nothing else. Both were conceived post-2007, and both represent the fears and inhibitions that have arisen against globalisation. The two blocs represent an intent to streamline doing business within a certain set of countries, as well as the desire to determine and demarcate supremacy in leadership of the architecture of global economic cooperation.

There is no easy answer as to whether regional trade agreements are stumbling blocks or building blocks of a non-discriminatory trading regime. It is, however, clear that while regional trading blocs make trading within them easier, they are by their nature discriminatory towards non-participants. This is by no means an optimum solution for world trade, but it is a course that has been charted by the changing world order. Gates to restrict the movement of goods and people will continue to be the overwhelming global trend.

Thomas Wright

10

How geopolitics will end globalisation as we know it

For almost 20 years, the United States and all the other major powers pursued greater global economic, financial, and technological integration as an end in itself. Global integration held the promise of peace, stability, and mutual prosperity. On several occasions, most notably after the financial crisis of 2008, many experts predicted the end of integration and the return of protectionism – but it never came. The reason was simple: despite the turbulence, states continued to benefit from interdependence and globalisation and saw no reason to exacerbate their economic difficulties by reversing it, especially when they had so much else to worry about.

Now that calculation has changed, because of geopolitics.

As tensions rise between the great powers, they look for non-military tools to influence each other – and to fight. They will use the leverage provided by economic interdependence as a weapon, imposing trade sanctions, freezing assets, or cutting off access to key parts of the international financial system, to name just a few options. Major powers must now worry that their interdependence with rivals represents an open flank of major strategic vulnerability.

In theory, all countries are made equally vulnerable by interdependence. In reality, however, the US, with the support of its democratic allies in Europe and Asia, enjoys an asymmetric advantage in the global economy, as discussed by Ian Bremmer elsewhere in this collection. It exerts enormous influence over key infrastructure, including the banking system, the SWIFT payment system, and trade. It has also been refining the use of financial sanctions, which it has used against North Korea, Iran, terrorist networks, and now Russia. The West's use of economic weapons should not be surprising. Economic warfare is far more attractive than the use of force because it entails a lower risk of escalation, fewer casualties, and is less controversial domestically.

Russia, China, and a geopolitical safety net

The key question is how other states will react. If geopolitical competition between the major powers is returning, as many experts argue, then Russia and China will worry about being so dependent upon a global economy dominated by the US and Europe. They will be alarmed by Washington's ability to convert this into usable advantage in a crisis.

President Vladimir Putin has long been suspicious of Russia's integration into the global economy. He has taken several steps to reduce Russian dependence on the West, and even wrote his student dissertation on the importance of self-reliance. He has long complained about the international order being a fig leaf for US strategic ambition. The sanctions imposed on Russia in response to its aggression in Ukraine have caused him to redouble his efforts to create an alternative order. Russia has created its own payments system and is pressing for an international version, prioritising resilience over growth.

Chinese experts and policymakers also worry about the imposition of economic sanctions by the West in retaliation for aggression abroad or human rights abuses at home. This may seem far-fetched, but it is hardly less likely than the prospect of a full-scale war between the US and China, which is, after all, a contingency both countries plan for. There is also precedent in recent history. The US imposed sanctions on China after the Tiananmen Square massacre in 1989. China need not worry about economic warfare when relations are generally stable, but it must be factored into planning for security crisis contingencies.

Much has been made of the limits to Russian and Chinese cooperation. But they do share one vital interest – they want an international economic order in which they cannot be punished and expelled if they do something the West does not like, whether it is the annexation of Crimea or large-scale domestic repression. This is a message that resonates with others – including the rest of the BRICS. At the Brazil summit in July 2014, the other BRICS embraced Putin at a time when the US was trying to isolate him, and they have pushed for new international economic institutions.

Their goal is not to replace the existing global economic order. It is to create a parallel infrastructure so that they are not entirely dependent on Western structures – a safety net that they can fall back on if they are pushed out of the US-led order. This includes reducing the dominance of the dollar, creating regional arrangements that exclude the US, diversifying sources of financing, and disengaging from parts of the existing order. It will be slow and difficult, but we can expect this effort to continue and intensify over the next decade.

Meanwhile, Russia and China will also continue to develop their own ways of exploiting interdependence to their benefit. They will take advantage of the US's dependence on information networks to launch sophisticated cyber operations designed to give them a strategic advantage. They will seek to use economic pressure against smaller neighbours. And China will explore ways of taking advantage of its status as a major purchaser of US Treasury bills in a time of crisis.

The fact that the US and Europe are also vulnerable will cause their leaders to hedge. They will impose additional restrictions on technological transfers for fear that these may be used for military purposes. European states will reduce their dependence on Russian sources of energy. Washington will have to game out the impact of a crisis with China on the stability of the US financial system.

Dual international economic orders

We are entering a period where the major powers will hedge against integration for geopolitical reasons. They will make key economic decisions with one eye on foreign policy, and this may lead to two (or more) international economic orders.

The first order would be Western-led, and very similar to what we have now. The US and Europe would dominate the financial sector, the dollar would be the key currency, and the International Monetary Fund (IMF) would continue to largely reflect US and European concerns. This bloc would use financial power to enforce global norms, such as preventing nuclear proliferation and territorial conquest.

The second order would be largely run by China with the support of other non-Western powers, including Russia. The adherents of this order would work together to reduce their reliance and dependence on the US and its allies. The yuan would be a regional reserve currency in Asia, and would be more widely held and used by non-Western powers than it is now. There would be an alternative international payments system. This second order would encourage trade and investment between non-Western states and would rely on a series of new institutions and initiatives like the Asian Infrastructure Investment Bank (AIIB). This second bloc will not be built overnight and will not replace the existing order. However, it will function as a type of geopolitical safety net for non-Western states.

Unlike in the Cold War, these two blocs will interact with each other, sometimes intensely, but they will each provide their members with some measure of protection from the other. Globalisation will continue, but not as we have known it.

INFRASTRUCTURE COMPETITION

The era of infrastructure alliances

Nothing tells us more about the future of geopolitics than tracing the outlines of planned infrastructure projects. Since the 1950s, China has been building across the western provinces of Tibet and Xinjiang – minority-populated areas with secessionist ambitions. Now, these projects appear as a harbinger of what is to come across China’s western borders.

The United States’ wars in Iraq and Afghanistan provide ample reminder of the limited role militaries play in ultimate victory. Meanwhile, after centuries of relations that amounted to little more than trading fruit, China has begun to pave its way across Afghanistan with infrastructure projects. China is already Afghanistan’s largest foreign investor, and technocratic President Ashraf Ghani made his first state visit to China to lure his newly discovered neighbour into still more investment in roads, railways, and mines. For the first time, China is converting its proximity into connectivity. Soon, the US occupation of Afghanistan will seem a mere footnote by comparison.

A Marshall Plan for Eurasia

In their first two years at the helm, the Chinese leadership duo of Xi Jinping and Li Keqiang visited more than 50 countries to sign investment deals. Western scholars have wasted more than a decade pretending that Chinese participation in the World Bank, International Monetary Fund (IMF), World Trade Organization (WTO), and other

institutions signalled its desire to play along with the Western-centric order, all the while failing to notice that China joined these institutions mostly to water them down, and at the same time created separate frameworks such as the Asian Infrastructure Investment Bank (AIIB) to advance its own agenda. The \$100 billion AIIB budget is approximately as much as the Marshall Plan spent in Europe (in inflation-adjusted dollars), and mostly goes to finance roads, railways, pipelines, electricity transmission, and other connectivity projects across Eurasia, smoothing China's westward expansion.

The timing of this "One Belt, One Road" initiative is propitious. Just as the crumbling post-colonial and former Soviet republics on its periphery desperately need new infrastructure, China is converting its piles of cash into credit for distressed neighbours to rebuild themselves – while buying up China's over-production of steel and cement, and employing its huge labour force.

The AIIB also represents a reform of the international system from the outside – since Western powers were unwilling to reform from within. Indeed, the AIIB's creation has provoked Western countries to adapt to it rather than the reverse: Britain, Germany, Australia, and South Korea have all joined. Even Japan's announcement of a separate \$110 billion infrastructure fund for Asia will actually accelerate the smoothing of Asian bottlenecks for China's benefit.

The new military alliances

The AIIB is the first major institution of what might become known as an era of "infrastructure alliances", in which the economic and the diplomatic are two sides of the same coin. The strength of ties is measured not by colour-coding countries according to membership in clubs such as NATO, but by mapping connectivity and the volume of flows between them. Infrastructure alliances are not necessarily corrupt deals among autocratic regimes. In fact, they represent job-creation projects that enhance the ability of poor and landlocked countries to participate in the global economy. As traditional Western aid projects have demonstrated, unrealistic conditions for financing commodity and infrastructure projects have unnecessarily delayed development and failed to create jobs in ways that only these sectors can. Sharing infrastructure is sharing wealth.

Westerners have long presumed – correctly, for the large part – that security is the most important global public good, and that the world looks to the US to provide it. After the Second World War, the US military umbrella allowed Europe to peacefully integrate, forming the world’s largest economy. Today, the US’s military “pivot” to Asia deters Chinese aggression in the region – but China has diverted that energy into building more infrastructure in partnership with its neighbours (and those further afield) to bind them more closely to itself, something the US can do little to deter. On the contrary, infrastructure provision – and the connectivity it represents – has become a global public good on a par with security. It is something countries desperately want, and China is the leading provider. With much of the world lacking core infrastructure, China is out to become the largest infrastructure contractor on the planet. Many countries still want the US military to protect them, but they want China’s infrastructure finance and low-cost telecoms equipment even more. Instead of troops, China sends large contingents of construction crews to live on foreign soil.

The US measures its power by its military spending, and Europeans and Asians measure theirs by their infrastructure spending. European and Asian firms (especially those from China, Japan and South Korea) dominate the global engineering–procurement–construction nexus, with Bechtel, Fluor, and KBR as the only recognisable US names in the field. However, because Asia’s global infrastructure contractors heavily utilise technology from GE, Siemens, and Alstom, you won’t hear these firms grumbling about “China in Africa”. Western companies, unlike their diplomats, have long seen China’s infrastructure plays abroad as a win-win.

Of course, China is not building all this new infrastructure in order to be perceived as generous, but to access raw materials and bring them home for the manufacturing and construction industries – and then to use export processing zones near major markets to accelerate its rate of turnover. This has become the standard playbook of Chinese neo-mercantilism.

China’s global supply chain

China’s power does not lie in its international military footprint or alliances – which remain relatively limited – but in its ability to apply the

power it derives from its global supply chain. In Latin America, China negotiates long-term contracts to purchase Venezuelan oil, and offers currency swaps to Argentina and cross-continental railway projects to Brazil. China has offered Ecuador \$11 billion in loans since 2008, with \$9 billion more promised, in exchange for the sale of almost all of Ecuador's oil exports. China is also the main foreign investor in Ecuador's mining sector. Particularly during resource slumps such as that which began in 2013/2014, commodity-dependent economies rely more than ever on Chinese loans, which are disbursed much faster than the IMF's, and are tailored to allow repayment in raw materials if countries cannot meet the terms. Indeed, as Ecuador's debts mount, it is effectively selling one-third of its Amazon rainforest to Chinese oil companies.

Trade is how China builds ties overseas; investment is how it builds leverage. China the trading power benefits from a weak yuan to boost exports, while China the superpower takes advantage of the strong yuan to buy more assets abroad. Indeed, China's outbound foreign direct investment has skyrocketed as its currency has appreciated. Even if its commodity imports slow, it wants to own the assets that supply these commodities – like mines or oil wells. By establishing joint ventures in host countries where it has a strong financial position, China is hedging itself against host-country demands for more ownership over their industries. Should African countries require that smelting, refining, manufacturing, assembly, or other production processes take place on their own soil, China will still be needed to finance and staff such upgrades, while training local workers along the way, and sharing the revenue generated from these offshore exports.

Even some Western nations face a similar fate. When capital markets abandoned Greece during the financial crisis, the country was forced to outsource management of its crown jewel, Piraeus Port, to China's COSCO shipping company in 2010. The \$230 million China funnelled in to the port's expansion is the largest single investment in Greece since 2007, and part of a planned network of Mediterranean logistics hubs that will smooth the distribution of Chinese exports. Greece's strategic Mediterranean geography – at the intersection of Europe, the Middle East, and Africa – has not changed, but Chinese investment has enabled Greece to make the most of its connectivity. With the addition of a third terminal and the completion of a rail connection that links the port to the national and European rail networks, Piraeus has risen

up the rankings to become one of Europe's ten busiest ports. In 2013, technology company HP decided to switch the European terminus point for its Asian shipments from Rotterdam to Piraeus. Though the flags of Greece, the EU, and China now fly side by side there, there is no doubt about who is in charge.

The risk of pushback

Infrastructure alliances are not a one-way street. Because infrastructure assets are often built in far-off countries, they can be expropriated or transferred to other partners, with consequences that are hard to predict. Sri Lanka stands out as an evolving case study in this regard. A full 600 years since Zheng He's Indian Ocean journeys, China has returned to Sri Lanka, underwriting the modernisation of its ports as transshipment hubs for its gargantuan export volumes. China's "string of pearls" strategy has been to develop maritime access points on either side of India, such as at Myanmar's Mada Ywa Island, Sri Lanka's Hambantota Port, and Pakistan's Gwadar. Hambantota, which was devastated by the Indonesian tsunami of 2004, has been thoroughly rebuilt. China also invested \$1.5 billion in the port complex of Sri Lanka's capital Colombo – where a Chinese nuclear submarine docked in September 2014 – and upgraded most of the national highways and roads, cutting the travel time between any two major Sri Lankan cities by half.

With Chinese-built infrastructure, Sri Lanka has already made big gains in tourism and exports of textiles, garments and tea. Under the former president, strongman Mahinda Rajapaksa, infrastructure and weapons made Sri Lanka into China's best friend in the Indian Ocean, especially as China helped him to brutally terminate the country's civil war. But just as Myanmar has capitalised on global investor interest to boost its leverage in the tug-of-war with China, so too has Sri Lanka, whose current President Maithripala Sirisena warned his countrymen that Rajapaksa had put their country on the path to becoming a "slave colony" to China, to which it owes more than \$8 billion.

India is making the most of Sri Lanka's growing suspicions of China. Now, it is leveraging Chinese infrastructure to more efficiently deliver its own projects for Sri Lanka, from railways to housing, as well as using the island as a back office and outsourcing site for call centres and car-part assembly for the huge south Indian market of 300 million

people. In 2015, Prime Minister Narendra Modi also settled decades-old border disputes with Bangladesh through land swaps, allowing India to focus on snatching the neighbouring country's Sonadia Port project away from China.

Alliances without ideology

We have just lived through a quarter century of gravely mistaken assumptions about the world, beginning with the “end of history” and the “clash of civilisations”. The past decade alone has witnessed the stupendous demise of what was expected to be another century of *Pax Americana*. When scholars and intellectuals seek to define an era by ideologies, they mistakenly presuppose that there must always be two or more coherent visions of the world in a struggle to assert themselves. But the supply chain world is a post-ideological landscape. Russia no longer exports communism, the US scarcely proffers democracy, and China has abandoned Maoism for hyper-capitalist consumerism. From Africa to Asia – the lion's share of the world's population – it's all business, all the time.

It may seem paradoxical for alliances to be devoid of ideology, but this is the norm in the era of infrastructure alliances. Traditional alliances have been replaced with dalliances, ephemeral partnerships based on supply–demand complementarities. Russia and China are the archetypical case: Russia fears no country more than China, yet it feigns an anti-Western front for media consumption while China buys up growing volumes of Russian resources. Similarly, it is far too lofty to speak of a “Confucian-Islamic axis” – as did Samuel Huntington, who coined the phrase “clash of civilisations” – when it is more accurate to simply state, “Asians buy the most Arab oil”. China and India could very conceivably intervene in the Middle East to protect their oil and gas supplies – not to defend any so-called allies.

*Carla Hobbs, Andrew Puddephatt
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12

The geo-economics of the digital

The digital revolution has sparked a geo-economic battle. Some countries, industries, and companies are poised to reap the benefits of the revolution, while others are set to sustain major losses, and the distribution of global power will alter as the cards are reshuffled. Market logic continues to govern on this battlefield, from the struggle between regulators and tax-smart global companies, to the fight put up by entire economic sectors and professions that are in danger of disappearing.

The major powers now appreciate the significance of the internet as a site of geopolitical competition, collaboration, and confrontation. Envisaged by its libertarian developers as existing outside politics and working for the benefit of all, the internet is now steeped in politics of the most traditional kind. These struggles are being waged across a number of fronts: from intellectual property theft to distributed denial-of-service (DDOS) attacks, and from weaponised viruses to demands to establish a global regulatory body for the internet.

We are engaged in a new “Great Game” – a phrase first used to describe the intense rivalry in the nineteenth century between the Russian and

British Empires for control of Asia, and generally applied today to describe the geopolitical manoeuvrings of nations or regions in pursuit of power and influence in a certain area. Today, the Great Game is digital.

Geo-economic winners and losers

For many major industries such as transport and hospitality, the cards have already been shuffled by the emergence of “sharing” networks like Uber and Airbnb. However, even these highly disruptive changes pale in comparison with the impact digital will have on manufacturing. “Industry 4.0”, a term coined by the German government, involves the application of increasingly sophisticated technology to production processes, generating hyper-connected, decentralised, and streamlined products.

The social and political impact of these changes on industrial societies will be dramatic, as the workforce is radically reshaped and many middle-ranking jobs are replaced by low-wage employment. Meanwhile, in enabling global manufacturing firms to reabsorb global supply chains and move them to countries where consumers are located, it fundamentally undermines “sweatshop” countries banking on cheap labour and raw materials. This will have a profound impact on the power balances and economic relations that have underpinned the current wave of globalisation.

For developing economies struggling to catch up on manufacturing and job creation, the impact could be devastating: countries such as India and China are already expressing concern about how the introduction of robots in manufacturing could, by making skilled workers redundant, trump the emergence of a middle class and block the countries’ progress to the upper tier in terms of per capita incomes. This particularly threatens Chinese aspirations to match the US as a superpower.

This offers an immense opportunity for countries that had been predicted to be the losers of the twenty-first century, a century whose biggest winners were presumed to be Asian. The US stands to gain the most, due to its capacity to innovate and to fund innovation. Of the 103 venture-backed private companies valued at almost €1 billion worldwide, 69 are in the US, 25 in Asia, and just eight in Europe. Facilitating this is the unrivalled availability of venture capital in the

US. US venture capital funds have invested \$160 billion since 2012, \$70 billion of which was directed at Silicon Valley alone.¹ Meanwhile, venture capital funding for European digital groups in 2014 was a fifth that of the US (\$7.75 billion to \$ 37.9 billion).

The game has begun

The US has been similarly savvy in applying geopolitical logic to the digital domain to further its strategic objectives. It has defined its digital infrastructure as a “strategic national asset”, doubled the budget of the National Security Agency (NSA) intelligence body since 2001, and quadrupled in two years the personnel assigned to its new US Cyber Command, now standing at somewhere between 3,000 and 4,000 cyber soldiers. The very architecture of the internet is shaped by US ideology and interests. As the place where the internet was built out of a desire to construct a communication network resilient enough to survive nuclear attack, and now the home of some of the most powerful and wealthy technology companies on the planet, it has long been the dominant power online, and its political and business culture, as well as its emphasis on free speech, have formed the governing ideology of the internet.

Compared to the US, China is more focused on establishing a state-centric model of internet governance while using the internet to project itself internationally, as Rogier Creemers points out in his essay. President Xi Jinping has taken direct control of digital policy with the aim of shifting China from being a “large internet country” to a “strong internet country”, with greater national control over the internet and more active foreign engagement. The Chinese government is increasingly dominant in international debates about internet governance, deploying soft power initiatives like the World Internet Conference to bolster its push for internet sovereignty rather than the open multi-stakeholder approach advocated by the West. These moves are explained not only by fears of an unbridled internet, but also by China’s wider aim of taking an active role in shaping and establishing international rules.

As for Russia, it is also concerned with securing control over the global architecture of the internet to further its domestic and foreign policy.

¹ According to the National Venture Capital Association.

On the national level, the Kremlin seeks to impose “Westphalian” principles over the internet – i.e. based on traditional principles of national sovereignty; while on the international level it employs the internet as a foreign policy tool to target some EU member states, such as the Baltic countries, with asymmetric digital criminal activities, espionage, and propaganda aimed at intimidation and destabilisation. In May 2014, Russia announced the creation of its rather revealingly named “information troops”, employed to fight these digital wars. Russia, meanwhile, has a lower dependency on information systems than the West, due to its focus on information security, which has afforded it greater protection from cyber threats.

Other examples of how the digital revolution is disrupting politics abound in the Middle East. It is widely recognised that the self-immolation of Mohamed Bouazizi, a Tunisian street vendor whose protest helped spark the Arab uprisings, would not have had such a rapid and massive effect if the youth in these countries had not had access to Facebook, Twitter, YouTube, and other social media that allowed protesters to organise and share videos and information. But the digital field is one on which all actors can play. As exemplified by the propaganda campaigns of Islamic State (ISIS), the internet has also allowed jihadists to significantly reduce the time and effort required to recruit new fighters to their cause.

Challenges for Europe

Europe faces two immediate geo-economic challenges arising from the digital revolution. The first is market access, relating to its capacity to take part in, and benefit from, the new digital world. The second concerns the nature of the internet itself, and the need to ensure that it remains open and does not develop into a Westphalian model, split into regional or national sectors.

Improving market access

With regards to the first challenge, Europe must rapidly address its absence from the digital market. A comparison of the EU’s global economic position and its presence in the digital economy reveals a striking disjuncture. Four European countries are present in the list

of countries with the highest GDP: Germany, the United Kingdom, France, and Italy. Yet of the 20 internet companies with the greatest market capitalisation, just one is European.

Europe is in a precarious position, currently lacking key tools to profit from the digital revolution: a single digital market, venture capital investment of the requisite scale, regulation that keeps pace with digital changes, and security integration. It also suffers from a huge digital divide between its members. According to the Digital Economy and Society Index (DESI),² member states are at hugely different stages (running from Romania, with the region's lowest score, up to Denmark). With some members poised to progress to Industry 4.0, other European countries may prove incapable and sink, potentially opening yet another wealth and productivity gap between northern and southern Europe, which would make the EU project very difficult to sustain.

Despite these asymmetries, Europe need not fall on the loser's side of the digital revolution. Innovation is becoming more inclusive, with many of the important inputs for start-ups migrating online, such as venture capital and computing capacity, mentorship, and collaboration. With the appropriate incentives, Europe's huge and wealthy internal market, comprising more than 500 million people, could provide seamless opportunities for creating value. Even its welfare state, which is usually described as an obstacle preventing Europeans from competing efficiently with others across the globe, could turn into a goldmine if Europeans were able to successfully apply the digital revolution to healthcare, education, and care for ageing members of society.

Transatlantic cooperation and an open internet

The international rules governing the internet have yet to be fixed, and the process of doing so provides high risk of conflict. Currently, the US-based Internet Assigned Numbers Authority (IANA) oversees global IP address allocation and other technicalities for the functioning of the internet. Much of the international community sees US monopoly on IANA functions as undemocratic, and there have been widespread calls

² A measure developed by the European Commission to evaluate the region's digital performance.

for this to be transferred to a more representative body. The transition to a multi-stakeholder international framework is currently underway but there are fears that truly international internet governance could be dysfunctional, unable to reach consensus due to lack of leadership, or dominated by countries that do not support freedom of speech.

Cyber-security threats and revelations about the extent of surveillance by the US government abroad pose another danger for both internet openness and transatlantic relations. There is a risk that the mistrust arising from this surveillance and hacking of telecommunications could lead governments and the public to push for a more protectionist and closed internet. Revelations concerning the US and UK intelligence services caused outrage in Germany (even though its intelligence service, the BND, collaborated with the NSA). Meanwhile, a recent decision by the European Court of Justice that invalidated the US–EU Safe Harbor Framework – which allows the transfer of Europeans’ data to the US – has added another layer of conflict to transatlantic relations. Another risk is that the antitrust battle being waged between Google and the Commission could escalate into political tensions and rising protectionist instincts in Europe.

Much as the 1990s saw transatlantic tensions emerging when Brussels’s competition authorities started to take on US companies (Boeing, Microsoft), a new wave of transatlantic mistrust is emerging precisely at a moment when cooperation is most important. While China, Russia, and their allies represent a genuine threat to an open and interconnected internet, through the Westphalian construction of walls and restrictions on the free flow of information, it would be fatal for the US and Europe to fail to work together to defend those core principles.

What should Europe do?

In the late 1980s, European actors mobilised to tackle an economy plagued by unemployment, rising inflation, and declining growth, through further integration and the creation of a single market. The famous Cecchini reports of 1983 and 1988 estimated “The Cost of Non-Europe” at 200 billion European currency units (some €800 billion in today’s money). Today, the European Commission estimates that the construction of a Digital Single Market could contribute €415 billion per year to the economy. It is essential that Europe meet the challenge of moving from analogue to digital.

The economic misfortune of Japan provides a cautionary tale on the consequences of failing to make such a transition. Just two decades ago, seven of the world's top ten companies by value were Japanese, while only two were US-based. In 2015, following the digital shift, the US has catapulted ahead of Japan, with the top ten now all US companies. It is an important lesson for Europe on the costs of remaining analogue. To truly engage in the digital world, Europe must build an alliance between the private and public sectors, engage political elites and citizens, build a strategic alliance with the US, and change the rules of the game itself.

Establish public-private partnerships

An environment that is inherently international and cuts across both the public and private domains does not respond easily to traditional policy-creation mechanisms. The internet's blurring of traditional demarcations renders a government-led, top-down approach anachronistic and unproductive. The digital environment demands a multi-stakeholder approach, defined particularly by an effective liaison between government and the private sector. In the area of cyber-security, for example, public-private partnerships, particularly in intelligence-sharing, are a vital instrument for securing cyberspace.

The Internet Governance Forum (IGF) has taken significant steps in this direction. The IGF is an open forum that brings together various stakeholder groups in discussions on internet public policy issues. Maximum representation of the diverse global actors embroiled in internet debates is sought, and participants take part on an equal footing. The debates seek to inform policymakers on how to maximise the opportunities provided by the internet while minimising risks. It is an instructive model for Europe.

Build a strategic relationship with the US

The EU and the US cannot afford to become competitors in the new Great Game, and must work together to ensure a digital divide does not open between them, on either industrial or security issues. The EU must be very cautious in setting up a Digital Single Market. As a strategy that seeks to create the regulatory and market conditions in which companies can innovate and drive growth, it could well serve to

align the EU further with the US. Reforms would foster a flourishing transatlantic digital economy in which both EU and US businesses could prosper. However, overregulation or discriminatory regulation towards US companies would damage transatlantic relations and could lead to an insular and defensive digital economy in Europe.

Healthy competition must be fostered for a robust digital economy, and rhetoric must focus less on the EU's need to counter US technological might and instead emphasise the need to match it and find areas for cooperation.

Change the rules

Power has been redefined in the digital era and Europe is well poised to obtain it. As Moisés Naím observed in his recent book, *The End of Power*, “in the 21st century, power is easier to get, harder to use – and easier to lose”. Recent developments, he argues, are undermining traditional sources of power, now vulnerable to attacks from smaller actors. This is particularly evident in cyber warfare, for example, where offence is much easier and cheaper than defence. It is likely that soft power will greatly gain in importance in this new era, with the ability to persuade and attract more significant than the ability to attack or control. This provides fertile ground for Europe to excel, given its traditional strength in exercising and deploying influence via soft methods.

Digital power is now the underpinning of all soft power, both as an environment and a set of capacities, and so Europe must focus on setting the rules of the digital game. It needs to develop its own vision of how it sees the internet developing as a free, open, and secure medium – one that supports post-war European values of democracy and human rights. It must stand for an open, multilateral, rules-based governance system, and fight attempts to nationalise, close, or privatise the internet. A look at how China, Russia, and other actors use the internet to promote their values and interests makes it palpably clear that the internet is the place where the great ideological battles of our time will be won and lost: Europe must not lag behind.

The new Great Game has begun, but its players are still playing by the old rules. Europe, neither a state nor an integrated market, should not attempt to compete on the basis of Great Game geopolitics or geo-

economics. What it can do is play by a whole new set of rules defined by a twenty-first century vision, far removed from the territorial conflicts of the past.

The Chinese cyber-sovereignty agenda

Since the early 1980s, technological catch-up has been at the heart of the Chinese leadership's growth strategy. Censorship and information control notwithstanding, Beijing has energetically pushed connectivity, with plans to link even the smallest villages to national broadband networks, expand the delivery of government services through networked means, and foster world-leading internet enterprises. Nearly 700 million Chinese citizens now use the internet regularly, around 600 million of them through mobile devices.¹

Yet the Chinese leadership also sees information technology as a risk. In the past two years, the leadership has moved swiftly to strengthen control over the internet no longer merely over content, but also over technology suppliers.

Its propaganda and media control model, which had been developed for an environment dominated by radio, television, and newspapers, was seriously challenged by the rise of microblogging platform Weibo from around 2011. The user-generated and crowd-sourced nature of

¹ China Internet Network Information Center (CNNIC), "CNNIC releases 36th Statistical Report on Internet Development in China", 27 July 2015, available at http://www1.cnnic.cn/AU/MediaC/rdxw/2015n/201507/t20150727_52663.htm.

Weibo took the authorities by surprise. They faced a series of public relations disasters and online scandals around incidents such as the 2011 Wenzhou train crash,² and many revelations of official corruption and abuse. However, the adaptability of the Chinese political architecture should not be underestimated: starting with a high-profile crackdown on social media, a wave of organisational and regulatory reform has pushed political discourse out of the publicly visible sphere that Weibo generated, and into private environments such as WeChat. A new government body has been established to coordinate internet policy. Online discourse is increasingly subject to state surveillance, and it has become much more difficult to rapidly disseminate information to large numbers of Chinese “netizens”.³

With the social media environment under control, the new cyber-leadership has rapidly turned its attention to information technology’s broader threats to national security and political stability, often spurred by events that showed how much China still has to catch up with in terms of technology. Developments like the Snowden revelations and Microsoft’s ending of security support for Windows XP at a time when it still powered over two-thirds of Chinese computers demonstrated China’s dangerous reliance on foreign software and hardware.

The leadership developed a two-pronged response, expanding policies to stimulate the development of home-grown alternatives to foreign technology products, and increasing security checks on imports. In the banking sector, for instance, regulators demanded that technology suppliers hand over source code for inspection, and issued new rules that would in effect force buyers to purchase indigenously developed products in many areas of network, storage, and security technology.⁴ The draft cyber-security law requires that personal data of Chinese citizens must be stored on servers located within China.⁵ Apple and

2 In July 2011, two high-speed trains collided near Wenzhou due to faulty signaling and management shortcomings, killing 40 people. News about the disaster spread rapidly on Weibo, which also served as a platform lampooning the ineptness, and sometimes mendaciousness, of the official response.

3 For an in-depth description of this process, see Rogier Creemers, “Cyber China: Updating Propaganda, Public Opinion Work and Social Management for the 21st Century”, *Journal of Contemporary China*, forthcoming.

4 Guiding Opinions concerning Using Secure and Controllable Information Technology and Strengthening Cybersecurity and Informatization in the Banking Sector, 3 September 2014, translation available at <https://chinacopyrightandmedia.wordpress.com/2014/09/03/guiding-opinions-concerning-using-secure-and-controllable-information-technology-and-strengthening-cybersecurity-and-informatization-in-the-banking-sector/>.

5 Cybersecurity Law of the People’s Republic of China (Draft), 6 July 2015, translation available at <https://chinacopyrightandmedia.wordpress.com/2015/07/06/cybersecurity-law-of-the-peoples->

IBM are among the large Western businesses that have complied with new review requirements.⁶ United States company Cisco has announced a partnership with Chinese domestic server manufacturer Inspur, after sales declined 30 percent since 2012.⁷

To many Western technology companies, the Chinese market is crucial, as one of the few where significant growth is still possible. Consequently, the tensions between the lure of the Chinese market for businesses and the US government's geopolitical concerns are creating a rift between the private and the public sector that China is eagerly exploiting. Cisco executives have warned the US government that tensions in cyberspace, particularly with regard to cyber-espionage, would hurt business prospects in China.⁸ The Seattle US–China Internet Industry Forum, organised in conjunction with President Xi Jinping's state visit to the US, sent a thinly veiled signal about the extent of China's leverage.⁹

Cyber-sovereignty

These various efforts are part of a bigger push: China's cyber-sovereignty agenda. The core assertions in this agenda are that national boundaries should exist in the virtual environment just as they do in the real world, and that governments should be the dominant norm-setters. This runs counter to the multi-stakeholder, open model for internet governance defended by the US, and espoused by many in the global internet governance community. The Snowden revelations have greatly harmed this open internet agenda – strengthening those in China who believe that wholesale cyber-intrusions have become a hallmark of great power status – and have brought security concerns to the forefront of the international debate.

[republic-of-china-draft/](#).

6 Eva Dou, "IBM Allows Chinese Government to Review Source Code", the *Wall Street Journal*, 16 October 2015, available at <http://www.wsj.com/articles/ibm-allows-chinese-government-to-review-source-code-1444989039>.

7 Eva Dou and Don Clark, "Struggles in China Push Cisco to Strike Deal", the *Wall Street Journal*, 22 September 2015, available at <http://www.wsj.com/articles/struggles-in-china-push-cisco-to-strike-deal-1442965527>.

8 Richard Waters, "China tensions 'hurting US tech groups'", *Financial Times*, 14 May 2015, available at <http://www.ft.com/intl/cms/s/0/f6810628-f9c9-11e4-ae65-00144feab7de.html#axzz30vnZpu6j>.

9 Paul Mozur and Jane Perlez, "China Flexes Tech Muscles Before a State Visit", the *New York Times*, 9 September 2015, available at http://www.nytimes.com/2015/09/09/science/china-flexes-tech-muscles-before-state-visit-with-meeting-of-industry-giants.html?_r=1.

In this debate, China's position is built on a more solid foundation than those of many Western nations. China's call for internet sovereignty is, to a certain degree, a demand to recognise the current status quo: the government is already the dominant actor on the Chinese internet, and it is unlikely that this will change any time soon. It also reflects the reality that governments around the world are taking a closer interest in how the internet is run, with the recent European Court of Justice ruling on the so-called right to be forgotten as one example.

Nevertheless, broad recognition of the principle of internet sovereignty might, in some ways, be to China's detriment. Whereas Beijing seems to define the notion of sovereignty as self-determination, autonomous from foreign interference, an equally important element is the obligation to prevent domestic actors from causing harm elsewhere. In particular, it might raise more questions about economic espionage by hackers allegedly taking orders from the Chinese state.

Sino-US cyber-competition

Unsurprisingly, the US government has been most vocal on the topic of economic cyber-espionage. It has condemned the exfiltration of information from US businesses in increasingly vociferous terms, and indicted five People's Liberation Army officers on suspicion of hacking.¹⁰ Recently, in response to the alleged capture of large quantities of sensitive data on persons with US security clearance, President Barack Obama announced sanctions against foreign companies that profited from stolen information.¹¹

This is unlikely to have an impact on Chinese hacking. It is notoriously difficult to identify the perpetrator of cyber-attacks, and to do so publicly might reveal technical capabilities that the US prefers to keep classified. It is also difficult to draw the line between "traditional" state-to-state intelligence gathering and espionage for economic benefit. It has, for instance, been documented that the US government routinely

10 "U.S. Charges Five Chinese Military Hackers for Cyber Espionage Against U.S. Corporations and a Labor Organization for Commercial Advantage", US Department of Justice, Office of Public Affairs, press release, 19 May 2014, available at <http://www.justice.gov/opa/pr/us-charges-five-chinese-military-hackers-cyber-espionage-against-us-corporations-and-labor>.

11 Executive Order – "Blocking the Property of Certain Persons Engaging in Significant Malicious Cyber-Enabled Activities", The White House, Office of the Press Secretary, 1 April 2015, available at <https://www.whitehouse.gov/the-press-office/2015/04/01/executive-order-blocking-property-certain-persons-engaging-significant-m>.

bugs foreign trade delegations, likely with the intent of getting better terms for US businesses. The economic utility of this is questionable: in some high-end industries, reliance on using purloined information may prevent Chinese businesses from becoming truly competitive in the global marketplace, locking them into a technology path in which incumbent companies maintain superiority.

The US has accused China of ignoring its concerns. The fact is that US opinion on this issue is of limited importance to policymakers in Beijing, who have their own concerns with regard to the internet. There is a profound disconnect between the primarily economic US worries about an emerging power eroding its commercial and technological predominance, and the primarily political Chinese concerns that the US will seek to derail its rise through efforts at regime change, ideological infiltration, and subversion. Within the hawkish Party press, US accusations of economic espionage are derided as hypocritical attempts to contain China from regaining its rightful place in the concert of nations.¹²

Implications

The US and China are facing two challenges with regard to the internet and information technology. First, they must agree on a global internet governance structure that is palatable to both sides. Second, they must find a common understanding of the nature of online security in order to manage growing tensions and conflicts. This will be a difficult process, but it is crucial for the continued prosperity of both nations. The alternative – increasing irritation and fragmentation – could seriously harm economic prosperity and political concord at a time when the international system is already undergoing profound change.

China's chief concern is domestic: that the internet might be used as a conduit for political destabilisation and economic immobilisation. Its primary target in this regard is the US, and it pays considerably less attention to Europe. This has resulted in a strategy that is largely defensive: the introduction of barriers to trade for foreign technology

12 Rogier Creemers, "China's Response against U.S. Cyberespionage Indictment of PLA Staff", *China Copyright and Media*, <https://chinacopyrightandmedia.wordpress.com/2014/05/20/chinas-response-against-u-s-cyberespionage-indictment-of-pla-staff/>.

suppliers, as well as the assertion of a sovereignty-based framework for global internet governance.

At the same time, state-affiliated hackers continue to pry into the data of foreign corporations in order to steal information. China's partners should explore the structure of China's cost/benefit calculations concerning hacking, particularly in view of the sensitivity around military involvement. Controlling the economic interests of the military has long been difficult for the Party leadership. Moreover, the Snowden revelations have encouraged the idea that acquiring information through espionage is crucial to China's security. If this trend goes unchecked, escalation will be increasingly likely.

THE WARRIORS

ESTABLISHED POWERS

The United States remains the world's sole superpower, the only nation capable of projecting military, economic, and soft power in every region of the globe. The US consumer market is still the world's largest, bolstering the government's diplomatic and economic influence. The dollar remains the world's most important currency. The US is the world leader in spending on research and development. Its companies are among the most innovative. Its universities draw from among the world's finest students and faculty members. Its workforce is not ageing nearly as quickly as counterparts in Europe, Japan, or China. The country's openness, the reliability of its rule of law, and the ability of its corporations and investors to prosper in spite of Washington's partisan political paralysis provide lasting competitive advantages. The US will remain the world's sole superpower for the foreseeable future.

These advantages arm US policymakers with tools that do not depend for their effectiveness on support from others. US cyber capacity remains unrivalled. Its drone technology is without peer. Washington's ability to "weaponise finance" – for example, inflicting severe damage on other countries by denying them access to the world's largest consumer market, to key technologies, and to the use of the dollar to facilitate

commerce – is without historical precedent. These tools have become increasingly important because the wars in Iraq and Afghanistan, the longest in US history, leave the public deeply reluctant to support any overseas intervention that might require long-term commitments of troops and taxpayer dollars. This is why the architects of US foreign policy have turned in recent years to “economic statecraft” or “geo-economics” – the use of economic tools to advance political goals.

As secretary of state, Hillary Clinton effectively made the case for a geo-economic approach to foreign policy. That approach is sure to continue if she is elected president, and indeed it is the most likely path for next-generation US foreign policy no matter who wins in 2016. This is at least as much a matter of necessity as of political expediency. Europe’s most powerful governments are likely to follow a similar path, because the sheer range of internal and external challenges facing European policymakers will leave its peoples unwilling to accept the costs and risks that come with a more traditional foreign policy. China has already invested deeply in the geo-economic model, because it is the country’s market weight and economic power, not its military potential, which confer its growing international influence.

Unfortunately for the US, the Chinese and German governments are much better positioned than it is to implement effective economic statecraft. In Washington, it is the Pentagon, the intelligence community, and, to a lesser extent, the State Department that receive the lion’s share of government resources. The Commerce Department, the Energy Department, and the Office of the US Trade Representative face much better resourced competitors in other leading developed and developing countries. The Japanese government directly supports trade in ways that are not part of the US political culture. The Russian government uses energy exports as weapons of coercion in ways that are impossible in the US, where these resources lie mainly in private hands. The Chinese government supports corporate espionage on a scale unrivalled in the US or anywhere else.

In the US, it is the Treasury Department that implements economic sanctions. The Justice Department imposes fines on foreign banks and companies, but the motives for these penalties tend to be regulatory rather than political. This is another area where Secretary Clinton worked to sharpen the tools of economic statecraft, but the

State Department is still organised on a regional basis rather than by economic sectors, and there are surprisingly few officials within its bureaucracy with a background in business and investment.

Further complicating Washington's ability to accomplish foreign policy goals through economic statecraft is the practical and cultural aversion many corporations have towards government involvement in their strategic planning. Here, the contrast with China and its 112 centrally controlled state-owned enterprises is most obvious. Decision-makers in US companies operating overseas must abide by Washington's rules and regulations, but they ultimately answer to shareholders, not officials.

Most alarming for those who favour a forceful and coherent US foreign policy is the growing tendency of Congress to actively sabotage elements of the president's foreign policy agenda. It is one thing to oppose a major trade deal that the Senate has the right to vote on. It is quite another for a member of Congress to send a letter to a foreign leader designed to sabotage a deal before it is brought to lawmakers for a vote, as Republicans did in part of an effort to block the Iran nuclear deal. Long gone are the days when "politics stopped at the water's edge". Petty partisanship and post-Cold War complacency have plainly eroded any US president's ability to build support for a durable foreign policy agenda – whether built on the projection of hard power or on grand geo-economic strategy.

US policymakers cannot afford to accept this sorry state of affairs if the country is to reverse the loss of its international influence. The challenge from China will grow in coming years, and competition and conflict are more likely to take place in financial markets and cyberspace than in traditional arenas of confrontation like the Taiwan Strait or the East China Sea. Washington must recognise this and adapt to meet the demands of a world in which power will increasingly be defined in geo-economic terms.

Today, most commentators describe the European Union as a power of the past. Europe's relative economic power is declining and its common currency has all but disintegrated, shattering confidence in the entire European project in the process. On the world stage, the EU is thought to be waning into irrelevance due to its deepening internal divisions and inability to speak with one voice. There is no common European army to respond to the security threats that abound, both near and far. Given its seemingly declining power status and inability to get its way alone, the EU is left to retreat to weak multilateralism and international institutions, ceding the stage of world politics to more potent actors.¹

Yet this narrative underestimates a critical aspect of European influence: the EU's unilateral power to regulate global markets. It is no secret that the EU likes rules and regulations. What is less well understood is the extent to which these rules and regulations have penetrated global markets and influenced economic life abroad, affecting many of the products foreign consumers use every day, including computer software, children's toys, cosmetics, and household appliances. The EU's influence over global production patterns and business practices takes place through a process that I have described as unilateral regulatory globalisation, or the "Brussels Effect".²

1 See the discussion of this conventional view in Anu Bradford and Eric A. Posner, "Universal Exceptionalism in International Law", *Harvard International Law Journal*, Volume 52, Number 1, 2011; and Jed Rubenfeld, "Unilateralism and Constitutionalism", *New York University Law Review*, Volume 79, 2004, pp. 1971, 1975–76, 2005–06.

2 Anu Bradford, "The Brussels Effect", *Northwestern University Law Review*, Volume 107, Number 1, 2013.

Because the EU has the world's largest single market, most multinational companies depend on access to the region. This requires compliance with EU standards. While multinationals could, in principle, adopt one set of standards for Europe and other sets of standards for the rest of the world, scale economies and other benefits of uniform production make this unlikely. By choosing the most stringent standard to govern their global conduct or production, companies can ensure regulatory compliance worldwide. In this way, market forces alone are often sufficient to convert the EU standard into a global standard – without the need for the EU to engage in international cooperation or unilateral coercion.

The unilateral power to set standards for the global marketplace is not merely a function of the size of an economy. Of course, any jurisdiction willing to exert global regulatory influence must have a large domestic market and hence a sizeable domestic economy.³ But a global regulator must also possess significant regulatory capacity, together with the political will to enact strict regulatory standards.⁴ Further, to have global clout a regulator must pursue immobile targets that cannot easily relocate to another jurisdiction (e.g. consumer markets) as opposed to mobile targets that can (e.g. capital). Finally, the benefits of adopting a uniform global standard must exceed the benefits of adhering to multiple, including laxer, regulatory standards. This is particularly the case when it is not legally or technically feasible, or economically viable, for a firm to maintain different standards in different markets – known as “non-divisible” production.

These five determinants of unilateral global regulatory power – market size, regulatory capacity, preference for strict standards, immobile targets, and non-divisibility of production – explain why the EU has become a predominant regulator of global commerce. The EU has the world's largest internal market, supported by strong regulatory institutions. Trading with the EU requires foreign companies to adjust their conduct or production to EU standards – which often represent the most stringent standards – or else forgo the market entirely. Rarely is the latter an option. In addition, companies cannot undermine EU

3 Daniel W. Drezner, “Globalization, harmonization, and competition: the different pathways to policy convergence”, *Journal of European Public Policy*, Volume 12, 2005, pp. 841, 841–59.

4 David Bach and Abraham L. Newman, “The European regulatory state and global public policy: micro-institutions, macro-influence”, *Journal of European Public Policy*, Volume 14, Issue 6, 2007, pp. 827, 831.

rules by moving regulatory targets to another jurisdiction because the EU primarily regulates immobile consumer markets as opposed to more mobile capital markets. While the EU regulates only its internal market, multinational corporations often have an incentive to standardise their production globally and adhere to a single rule. This converts the EU rule into a global rule, expanding its influence across the global market.

The EU's regulatory influence cannot be matched by other economic powers, such as the United States or China. China's regulatory capacity will take time to build, and it is unlikely to be willing to elevate the protection of consumers and the environment over wealth creation any time soon. The US does have well-entrenched and highly capable regulatory institutions, but lacks the political will to deploy these to maintain a highly regulated economy. And when the US regulates, it often focuses on more mobile targets such as capital, which can easily move jurisdictions to evade strict regulations.

Foreign governments are often unenthusiastic about the EU's ability to diffuse its regulations abroad. Critics depict the EU as a "regulatory imperialist" that overrides consumer preferences and democratic processes in other jurisdictions.⁵ Yet other countries can do little to counterbalance the EU's regulatory hegemony. Those whose regulatory preferences are superseded by the EU's standards gain nothing by entering into a regulatory race. Outpacing the EU will only leave them with even higher, and hence less desirable, regulatory standards. They also have limited ability to dampen the EU's regulatory ambitions with sanctions or by resorting to international institutions. This makes them passive spectators of the process where the markets are unleashed to spread EU norms and entrench them in global markets.

A new type of power

If you were to ask national security experts whether the EU is powerful, they would say no. If you were to ask economists whether the EU is powerful, they would probably discuss how the relative power of the EU is diminishing with the rise of China. But if you were to ask General

⁵ "Europe v. U.S. Business", the *Wall Street Journal*, 17 January 2008, available at <http://www.wsj.com/articles/SB120053154686996085>; "Regulatory Imperialism", the *Wall Street Journal*, 26 October 2007, available at <http://www.wsj.com/articles/SB119334720539572002>.

Electric, Microsoft, Google, Monsanto, Dow Chemical, or Revlon whether the EU is powerful, the answer would be a resounding (and likely bitter) yes.

A key question is what type of power matters today. While traditional tools of power have waned in importance – it is increasingly difficult to exert influence through raw military power or rely on economic sanctions or conditional incentives – regulatory power still matters.⁶ Today, the EU sets the rules for the global marketplace across a range of products and policies, including food, chemicals, the environment, competition, and the protection of privacy. These regulations have a tangible impact on the everyday lives of citizens and corporations around the world, dictating what manufacturers produce and what consumers buy.

In the world of multiple powers and heterogeneous interests, the exercise of unilateral economic power is rarely possible. The struggling climate talks or World Trade Organization (WTO) negotiations serve as reminders that in a world where many are powerful, nobody is powerful enough alone to get anything done. When power is defined in terms of the actual influence that a country can wield, the EU's ability to penetrate vast areas of global commerce is relevant. Unlike traditional contours of influence, the Brussels Effect is a phenomenon where the EU does not have to do anything except regulate its own market to exercise global regulatory power. The size and attractiveness of its market do the rest. By virtue of being the world's largest trading bloc, the EU can dictate what is traded. This is one of the few areas of influence where unilateralism still works. Regulatory power is less costly, more durable, more deployable, and less easily undermined by others.

Another advantage of regulatory power is its ability to generate leverage that has the greatest impact with the lowest political profile. Many regulations appear merely technical but have major implications on countries, corporations, and consumers around the world. Conflicts over regulatory power rarely go as high as the political level. Trade is a much less controversial way of pursuing foreign policy objectives, especially when the EU always, in principle, offers the choice of not complying with its rules. Subscribing to EU rules is the price of trading

⁶ Leslie H. Gelb, "GDP Now Matters More Than Force", *Foreign Affairs*, November/December 2010, available at <https://www.foreignaffairs.com/articles/united-states/2010-10-21/gdp-now-matters-more-force>.

with Europe. All the EU is doing is exercising its right to protect its own consumers. Thus, in falling between coercion and cooperation, regulatory power strikes a balance of legitimacy and potency that makes it more effective than its alternatives.

The EU's regulatory clout shows that it can be a superpower without a super state. It is a shrewd and influential actor that projects its values and shapes the world to its liking by playing to its strengths. While the EU portrays itself as a champion of multilateralism,⁷ it selectively supports multilateralism in areas where it lacks unilateral power. The more the EU bolsters the authority of the United Nations Security Council, the more it can constrain the exercise of unilateral power by the US. But when it comes to the regulation of global markets, the EU is less concerned about pursuing multilateral, institutional cooperation.

The EU's ability to "go it alone"⁸ on this front has several – somewhat surprising – consequences. One is that the EU's increasing regulatory clout and impact on US businesses may lead the the government to support greater oversight by international institutions. Though often sceptical about the ability of international treaties or international institutions to regulate markets, the US may come to see international cooperation as an opportunity to have some influence over regulatory standards, rather than ceding influence to the EU altogether. Ongoing negotiations over the Transatlantic Trade and Investment Partnership (TTIP) offer a rare opportunity for the US to persuade the EU to rein in its regulatory standards. Given the low level of existing transatlantic tariff barriers, the gains from the prospective free trade agreement are expected to stem from the ability of the parties to overcome differences in their regulations. But this, of course, requires that the EU be prepared to forgo unilateralism for jointly set standards, enhancing the EU's bargaining power in the negotiations.

Another implication of the Brussels Effect is to challenge the narrative that the EU is a "normative power" that leads by example.⁹ The EU is often viewed as a power that relies on persuasion to change "hearts

⁷ See European Commission, *Communication, The European Union and the United Nations: The choice of multilateralism*, at 1.1, COM (2003) 526 final (10 September 2003).

⁸ Lloyd Gruber, *Ruling the World: Power Politics and the Rise of Supranational Institutions* (Princeton, NJ: Princeton University Press, 2000).

⁹ Mark Leonard, *Why Europe Will Run the 21st Century* (London: Fourth Estate, 2005).

and minds” and thereby the preferences and identities of other actors, steering away from coercion in favour of positive incentives and soft power.¹⁰ But normative power is merely one facet of the EU’s foreign policy strategy. The Brussels Effect embodies a vast, unappreciated, and perhaps the most controversial aspect of the EU’s global role: the EU’s unilateral employment of tools of soft coercion that go against the preferences of its trading partners.

Will the Brussels Effect last?

One interesting question is whether the Brussels Effect is time-bound, and what it would take to erode it. As much as the Brussels Effect is the product of market forces, markets and corporate interests may ultimately weaken the phenomenon. With advances in technology, it is likely to become technologically feasible and economically viable to produce a greater range of product varieties to serve the different consumer tastes and regulatory requirements prevailing in different markets.¹¹ This will mean that companies can more easily adapt their product to different regulations, rather than following the highest standards. The Brussels Effect should further incentivise companies to develop technologies that allow for increased divisibility of production and hence greater diversity of standards at lower costs. Such a development, to the extent that it applies to a significant number of product markets, may gradually erode the EU’s ability to exert global regulatory clout in the future.

Foreign governments and international institutions have a limited ability to constrain the EU’s regulatory agenda, today and in the near future. A much greater check on its regulatory powers comes from within the Union itself. As the EU’s regulatory powers grow, divisions within the EU also grow. It becomes harder for the EU to pass new regulations amid the growing heterogeneity of its population. Enlargement magnifies this problem as preferences within the EU become more diverse, while its institutions fail to adjust to more complex decision-making. Today, the EU faces a distinctive internal challenge to its authority. The euro crisis has fuelled deep resentment among Europeans, contributing to a

¹⁰ Hugh Richardson, Head of the Delegation of the European Commission to Japan, Speech at Waseda University, “The European Union and Global Governance symposium: Smartening the EU’s Soft Power”, 16 May 2008.

¹¹ “A third industrial revolution”, the *Economist*, 21 April 2012, available at <http://www.economist.com/node/21552901>.

severe political backlash, and the migration crisis further compounds the challenges facing the EU. This may eventually lead to a repatriation of some regulatory powers from Brussels to the member states. Thus, the limits of the EU's regulatory authority will likely be set by its own evolving conception of these limits.

To add to the internal political challenges, the economic and geopolitical reality outside Europe is changing. Today, corporations are rarely able to avoid the EU as a market for their products and services and divert trade elsewhere. But, as demand grows in emerging markets like China, businesses' dependence on access to the EU market may gradually diminish, reducing its regulatory clout. It is difficult to imagine a future state of the world where genuinely multinational companies like General Electric would choose to forgo trade in Europe and thus avoid clearing their transactions and conduct with the EU's competition authorities. But the opportunities for trading elsewhere will increase, reducing the opportunity costs of forgoing the European market, at least with respect to some products and activities.

Still, the growing might of Chinese consumers is an imperfect threat, at best, to the EU's near-term ability to continue on its chosen path. While China has blocked a few high-profile global mergers, it has by no means overtaken the European Commission as the most ardent guardian of competitive markets. China may soon be the largest consumer market, yet GDP per capita is a better predictor of a country's likelihood to impose strict regulations than overall GDP.¹² Affluence and regulation are often correlated, suggesting that domestic demand for high levels of regulation is likely to be weak for some time to come. And by the time China was able to overtake the EU as a de facto global regulator, the EU might already have entrenched its norms in other jurisdictions and institutions, and changed the way business is conducted in a lasting way.

A long version of this article, entitled "The Brussels Effect", appeared in 107 Northwestern University Law Review 1 (2013).

¹² See David Vogel and Robert A. Kagan, "Introduction", in David Vogel and Robert A. Kagan (eds), *Dynamics of Regulatory Change: How Globalization Affects National Regulatory Policies* (Oakland, CA: University of California Press, 2004).

The reinvention of German power

If the United States is from Mars, Germany is not from Venus but rather from Mercury – after the Roman god of commerce. It is a geo-economic power that tends to define its interests primarily in economic terms, giving priority to economic over non-economic interests and values; cedes a good portion of agenda-setting to the private sector, especially exporters; and uses economic power to impose national preferences on others, as we have seen during the euro crisis.¹

Germany has emerged as the West's biggest winner from globalisation and is striving to become what its policymakers label a "shaping power" (*Gestaltungsmacht*) – one which has the ability to shape outcomes and events through the development of economic networks, in a less Western-centric world.² Berlin is reordering its priorities to reflect new global realities, most notably in its relationship with China.

¹ For an early elaboration of the concept of Germany as a geo-economic power, see Hans Kundnani, "Germany as a Geo-economic power", the *Washington Quarterly*, volume 34 (Summer 2011), pp. 31-45.

² On the concept of Germany as a *Gestaltungsmacht*, see Die Bundesregierung, *Globalisierung gestalten-Partnerschaften ausbauen-Verantwortung teilen: Konzept der Bundesregierung* (Berlin: German Foreign Office, 2012), p. 4. See also Thomas Bagger, "The Networked Diplomat", *Internationale Politik*, 3 August 2013, and Stephen F. Szabo, *Germany, Russia, and the Rise of Geo-Economics* (London: Bloomsbury, 2014), chapter 7 (hereafter, Szabo, *Germany, Russia, and the Rise of Geo-Economics*).

Commercial realism and geo-economics

First as West Germany and now as the unified *Bundesrepublik*, Germany has outsourced security policy to the US and NATO. It has consistently downgraded military force as an instrument of statecraft and has relied both on the soft power of its multilateralism and social model, and on the hard power of economics. These tendencies accelerated after unification and the end of the Cold War. When Germany was divided it had an important security role, not only as the major potential battlefield but also as a shaper of NATO strategy. West Germany was a driving force in crafting the NATO strategy of defence and détente.

Re-unification and the end of the Soviet Union liberated Germany from this security dimension and allowed it to focus almost exclusively on the economic dimension of statecraft. In 1989, West Germany spent \$33.9 billion on defence (2.8 percent of GDP), with armed forces of close to 500,000 personnel.³ In 2016, Germany will spend about €33 billion (about 1.2 percent of GDP) on defence, with armed forces of less than 200,000 personnel.

The end of the Cold War opened the doors to globalisation, the expansion of markets, and a liberal international economic order, which played to German strengths. While it was not immediately apparent in the wake of German reunification and the costs of close to \$2 trillion that it imposed on the German state, the country was able to take advantage of this open economic order to become one of the most connected and interdependent countries in the world, and a great economic success story.

With only 81 million inhabitants, Germany ranks third in the world in exports, just behind China and the US, and ran a current account surplus of €200 billion in 2014.⁴ Germany is more reliant on manufacturing than the US and other advanced industrial economies, and is a major investor, ranking third in the world after the US and just behind the UK, with half going outside Europe.⁵

³ The East German figures were \$13.9 billion (8.8 percent of GDP). See Catherine Kelleher and Cathleen Fisher, "Germany", in Douglas J. Murray and Paul R. Viotti (eds), *The Defense Policies of Nations: A Comparative Study*, 3rd edition (Baltimore, MD: The Johns Hopkins University Press, 1994), p. 178.

⁴ In that year, it exported \$1.5 trillion of goods, which made up 41.7 percent of GDP, with exports accounting for two-thirds of GDP growth over the past decade. Germany's per capita exports were \$18,657 in 2014 compared to \$5,-91 for the US. In absolute numbers, the US barely exported more than Germany, with a total of \$1.6 trillion or 9.3 percent of GDP. These figures can be found at <http://www.worldstopexports.com/united-states-top-10-exports/2001>.

⁵ Industry makes up almost a quarter of Germany's GDP, employing more than five million people. See

This success is vulnerable to outside factors, however. The country is heavily dependent on the import of natural resources, including energy, and so has to maintain secure and predictable relations with other states – both for the import of energy and other raw materials for its industrial machine, and as markets for its exports. This means it has to maintain a reputation for reliability, through a cautious policy of commercial realism, with limited emphasis on the promotion of democracy and human rights, and a strong preference for engagement over confrontation. Germany hardly stands alone in this regard, and most EU member states, including Britain, are pursuing similar strategies. The growing Chinese role in the British economy, for example, has opened a debate in the UK over the balance between economic and other values.⁶

Russia, Germany, and geo-economics

While Germany puts great store on accumulating trade and monetary surpluses, it is not a mercantilist power in the traditional meaning of the term, in that it does not aim to build a war chest in a zero-sum pursuit of advantage. It also has not pursued economic nationalism, as the state follows the private sector rather than guiding it. Firms act as de facto instruments of geo-economic states and create a set of material incentives for policymakers, with commercial motivations underpinning great power politics.

In the case of Russia, German firms, as well as those from France, Britain, and Italy, have drawn Europe closer to Moscow, at the expense of both the geopolitical concerns of Eastern European countries and of multilateral relations within the EU.⁷ Thus German firms shape German geopolitical interests and strategic culture. Commercial logic saw opportunities to invest and to exploit the world's largest gas reserves, and treated both Russia and Gazprom as geo-economic actors driven by the logic and incentives of profits. As Rawi Abdelal sets out

Mundi Index, available at <http://www.indexmundi.com/g/r.aspx?c=gm&v=2199>; see also Ulrich Grillo, "Deutschland als Globalisierungsgewinner", Executive Letter, Berlin, *Bundesverband der Deutschen Industrie*, 4 April 2015, p. 1 (hereafter, Grillo, "Deutschland als Globalisierungsgewinner").

⁶ See, for example, Steven Erlanger, "Before Palace Banquet for Xi Jinping, a Snub From Prince Charles", the *New York Times*, 19 October 2015, available at <http://www.nytimes.com/2015/10/20/world/europe/before-palace-banquet-for-xi-jinping-a-snub-from-prince-charles.html?ref=world&r=1>.

⁷ Rawi Abdelal, "The Profits of Power: Commerce and Realpolitik in Eurasia", *Review of International Political Economy*, volume 20, number 3, June 2013, pp. 421–456, available at <http://www.hbs.edu/faculty/product/42270> (hereafter, Abdelal, "The Profits of Power").

in his study of European energy firms, Western companies held the view that Gazprom needed West European revenues to be profitable, that Russia needed Gazprom's profits and taxes to keep the country's budget in the black, and therefore that Russia would not jeopardise its economic relationship for geopolitical gain.⁸ This commercial logic is now confronted, however, by the strategic logic of a Russian military challenge to the European order.

Germany's relationship with Russia prior to the outbreak of the Ukraine crisis in 2014 was a case study in this geo-economic approach. German policymakers developed a deep economic relationship with an increasingly authoritarian Russian state with the rationale of "change through trade" (*Wandel durch Handel*). This was a mutation of the principle, previously embraced by Berlin, of "change through rapprochement" (*Wandel durch Annäherung*). It had the long-term goal of transforming Russia, alongside a geo-economic rationale, in the idea that engagement would slowly modernise Russia, and that this economic modernisation would eventually lead to political modernisation. The relationship created a substantial Russia lobby within the German business community, which developed significant clout in Berlin. The result was an excessive willingness to tolerate or ignore concerns about human rights and democracy in Russia.⁹

The Ukraine crisis has reopened the question of whether Germany will have to act as a more traditional geopolitical power, with a stronger military dimension. The use of Russian military force in Europe, as well as the rise of nationalism in China, Japan, and other countries, has raised questions about the assumption that globalisation is benign and will continue to shape the landscape of the international system. The Germans have bet that the traditional military powers will lose influence this century to the geo-economic powers. Berlin's reaction to Russian aggression in Ukraine has been to emphasise economic instruments of statecraft, primarily sanctions, and to rule out substantial military options. Although defence spending is due to rise over the next couple of years, no real changes have yet been made in German security policy and there is little prospect that the nation will become a serious military power, in contrast to the trend in Japan.

⁸ Abdelal, "The Profits of Power".

⁹ For more, see Szabo, Germany, Russia, and the Rise of Geo-Economics, chapter 4.

The coercive use of economic instruments is a new approach, however. In the past, Germany has taken a “win-win”, positive-sum approach and avoided sanctions, which were seen as undermining its reputation as a reliable economic partner. Chancellor Angela Merkel’s role in pushing German and European sanctions against Russia is relatively new, though Germany did impose sanctions on Iran, and is a signal that even the ultimate geo-economic power cannot always define strategic interests in economic terms. Even segments of the German business community have recognised that a threat to the European security order takes precedence over profits.¹⁰ Germans believe that their approach is best suited to the international politics of the twenty-first century, in which postmodern economic powers will have an advantage over modern military powers such as Russia and the US. War and threats will not override interdependence. Networks will replace alliances, economics will subsume force. When Germany looks at Europe it sees traditional modern military powers such as Britain and France cutting back on their militaries and becoming more geo-economic.

Furthermore, Germans believe that President Vladimir Putin’s strategy will be defeated by economics. Not just sanctions but the structural weaknesses of the Russian economy and global trends in energy will trump the use of military force – in much the same way that the economic weakness of the Soviet Union led to the end of the Cold War. Berlin does not see Putin as a military threat to the West, and views his overreaction to events in Ukraine as an indication of deep insecurity and pessimism about Russia’s future. However, this aggressive use of economic instruments for state purposes has opened up the possibility that globalisation will be challenged more by economic warfare than by military means.¹¹ Germany has a rather unimpressive military, but a substantial economic arsenal. This has been witnessed in both the Russian and Greek cases in very different ways, via sanctions in the former, and fiscal and monetary policy in the latter.

10 Ulrich Grillo, “Deutschland als Globalisierungsgewinner”, pp. 3, 5; “Gesprächskanäle müssen offen bleiben”: Der BDI-Hauptgeschäftsführer Markus Kerber setzt im Umgang mit Russland auf Deeskalation”, *Handelsblatt*, 20 May 2014, p. 16; “Für die Wirtschaft ist Polen wichtiger als Russland”, *Frankfurter Allgemeine Sonntagszeitung*, 26 October 2014, p. 6. The position of the BDI, which represents all German firms and thus has a global outlook, contrasts with that of the *Ost-Ausschuss der Deutschen Wirtschaft*, which represents German companies working in Russia.

11 As outlined in a report by the World Economic Forum: “Recent Western sanctions against Russia signalled the beginning of the first great-power conflict since the end of the Cold War”. See Mark Leonard, “Geopolitics vs Globalization: How Companies and States Can Become Winners in the Age of Geo-economics”, in *Geo-economics: Seven Challenges to Globalization* (World Economic Forum, 2015), p. 5, available at http://www3.weforum.org/docs/WEF_Geo-economics_7_Challenges_Globalization_2015_report.pdf.

Germany's future Russia policies depend not only on Moscow's foreign policy but also on the state of the Russian market. Russia is important to Germany in terms of energy and provides significant markets for German companies, but it is not one of its top trading or investment partners.¹² German business will assess the Russian market in terms of investment risk and the rule of law. Even before Ukraine, elements of the legendary German small to mid-sized businesses, or *Mittelstand*, were souring on Russia due to corruption and the lack of the rule of law, but the big players like Siemens and Daimler are likely to want to deepen their engagement if conditions improve. The agreement to construct a Nord Stream Two gas pipeline is an indication of Germany's longer-term interests, although the revolution in energy markets caused by an increased use of renewables and US shale oil production is also likely to devalue the Russian connection.

China: The new special relationship

Russia is a mere blip on the German geo-economic screen compared to China, and this along with other emerging markets is likely to be where German geo-economics will be most clearly in play in the future. China is now Germany's fourth-largest trading partner after France, the US, and the UK, and Germany makes up nearly 50 percent of Europe's exports to China. The German stake in China dwarfs that of any of its European partners and Germany has clearly privileged its relationship with China over EU priorities and policies. The most obvious example is the role Germany played in blocking EU actions against China over solar panel production and imports. Germany's willingness to go against US policy (with the UK and other European countries) and join the China-led Asian Infrastructure Investment Bank (AIIB) is another example of how Germany and Europe's geo-economic interests are replacing old alliances with commercial networks. It also raises questions about Germany's role in dealing with the strategic challenges emanating from China's rise and increasing nationalism in East Asia.

Germany continues to rely on the US navy guaranteeing open sea lines of communication, vital to its global production chain. Wolfgang Ischinger has noted that, "if a war were to break out in Asia, BMW would have to

¹² "Foreign trade – Ranking of Germany's trading partners in foreign trade, 2014", Federal Statistical Office, 22 October 2014, available at https://www.destatis.de/EN/FactsFigures/NationalEconomyEnvironment/ForeignTrade/TradingPartners/Tables/OrderRankGermanyTradingPartners.pdf?__blob=publicationFile.

shut down its production”.¹³ Thus, as one observer put it, “the American rebalancing to the Asia–Pacific ... could be viewed as safeguarding German geo-economic interests in an unstable region of the world rather than as a strategic retreat from Europe”.¹⁴ However, there are likely to be more concerns from Berlin that US policy vis-à-vis China is overly confrontational, as Germany has worried in the past about the US’s willingness to use military force as its preferred policy tool.

Iran is another case where Germany sees both a commercial and strategic logic in reopening the market. Berlin, despite its economic interests in Iran, was a key player in the group of nations which imposed the sanctions regime – alongside the permanent members of the UN Security Council – but it will be one of the first Western powers to re-enter the Iranian market after the nuclear agreement of summer 2015. As one report noted, “the lure of the Iran market was no doubt one factor that European nations and the US weighed in deciding to support a deal”.¹⁵ It is also likely to reset the German strategic logic with regard to Iran policy, and makes a return to sanctions unlikely.

Germany has an existential stake in an open and rules-based international economic order, as the leader of the German employer’s association (BDI) has noted. The rise of China is in some respects a threat to this order, as it does not support a number of key elements, including the integrity of intellectual property rights, environmental and labour standards, and the prohibition on protectionist practices. As he put it, “our companies must remain standard setters. They cannot descend to being standard takers”.¹⁶ For this reason the completion of a Transatlantic Trade and Investment Partnership (TTIP) remains a high geo-economic priority.

The future of Germany as a shaping power

As noted, Germany is not a classic mercantilist power, in that it is not accumulating economic power for state ends. Rather, its foreign policy has been driven by economic goals and economic actors. However, the

13 In comments at a German Marshall Fund luncheon in the autumn of 2014.

14 James Sperling, “Book Review of Germany, Russia and the Rise of Geo-economics”, *German Politics*, 2015, volume 24, number 2, p. 206.

15 Alissa J. Rubin, “After Deal, Europeans Are Eager to Do Business in Iran”, the *New York Times*, 2 August 2015, p. 6, available at <http://www.nytimes.com/2015/08/02/world/europe/after-deal-europeans-are-eager-to-do-business-in-iran.html>.

16 Ulrich Grillo, “Deutschland als Globalisierungsgewinner”, p. 6.

recent use of economic instruments in the form of sanctions and financial policies represent a change in this approach, as does its threat to cut off economic development funds to those Central European EU member states that have refused to take their share of refugees from the Middle East. This harder edge to German policy may be a sign of a strategic maturation in the face of demands for more German leadership.

To this point, Germany's version of geo-economics has been rather parochial. Germany has not used its resources to provide public goods in security and economics the way the US did after the Second World War. Its single-minded pursuit of an "ordoliberal" economic approach – which emphasises the need for a degree of government regulation to help the market achieve the best results – and the accumulation of current account surpluses have put great constraints on its European partners. As Hans Kundnani has put it, "Germany has exported rules but not norms".¹⁷ Despite its major stake in an open international political and economic system, Germany continues to free-ride on the US to provide the muscle, while criticising its surveillance techniques.

Germany will face a growing tension between its purely economic interests and demands for it to play a larger strategic role that will force it to subordinate economic to other political priorities. Its economic interests will pull it towards emerging non-Western markets, but its base in the transatlantic world will create strains and dilemmas for future policymakers. The changed nature of its security interests is likely to diminish its ties to the US, but its economic interests mean that the US will be an important part of its global network, a network quite different from that which shaped its strategy during the Cold War. This more dynamic and fluid international environment will raise questions not only about Germany's role in the West, but also about the future of the West itself.

¹⁷ Hans Kundnani, *The Paradox of German Power*, cited in Yascha Mounk, "A Sheep in Wolf's Clothes", the *Wall Street Journal*, 10 March 2015, available at <http://www.wsj.com/articles/book-review-the-paradox-of-german-power-by-hans-kundnani-1426028861>.

Germany: A private sector perspective

The discussion on the role of geo-economics in international relations is in its infancy. But one consensus has already been reached: if there is a role model for the successful use of geo-economic power, it is Germany. Hans Kundnani wrote in 2011: “Germany seems to be emerging as a particularly pure example of a new form of power in international relations: a geo-economic power”,¹ and Stephen Szabo has concluded – including in this collection – that Germany’s Russia policy substantiates Kundnani’s assessment. For Szabo, Germany meets four of the five characteristics of a geo-economic power: Berlin defines its national interests in economic terms; elevates economic interests over other interests such as human rights and the promotion of democracy; uses economic power to impose national preferences; and gives business a predominant role in shaping its foreign policy.²

From a private-sector perspective, this assessment is quite puzzling – not because it is altogether wrong, but because it is based on a very selective interpretation of the interplay between the business community and politics in Germany. This essay will reassess how far

¹ Hans Kundnani, “Germany as Geo-economic Power”, *The Washington Quarterly*, Summer 2011, pp. 31-45, p. 32.

² Stephen Szabo, *Germany, Russia and the Rise of Geo-Economics*, London 2015, (Kindle version, 2,669-2,698); and Hans Kundnani, “Germany as Geo-economic Power”, *The Washington Quarterly*, Summer 2011, pp. 31-45.

Germany meets these criteria, and consider the role of the country's business community in German geo-economic policy.

Sanctions and “soft balancing”

Germany's current policy towards China, and its previous policy towards Russia, provide evidence for the claim that economic interests play a centrally important role in German foreign policy – but not an exclusive or even a predominant one.

In fact, Germany's policy towards Russia was shaped less by economic considerations than by history, and the conviction that such a major power in the immediate neighbourhood should be integrated into European structures. This “change through rapprochement” approach³ was based on the hope that reconciliation with Russia would promote political and economic liberalisation there. The intensification of economic links was intended as a contribution to these efforts, rather than being their goal. Hence, when the Russian-Ukrainian conflict undermined this approach, signalling that Russia was far from being integrated into the European system, the German government took note and changed course. It played a leading role in imposing sanctions and in maintaining a common European position on this policy, supported by the great majority of German businesses despite the significant domestic impact of sanctions. (It is also worth noting, however, that in practice businesses could also support sanctions against Russia on economic grounds, as they are the only available peaceful response to a violation of international and legal norms whose preservation is crucial for German businesses.)

The case of China is more complicated, because business was clearly the prime motivation for the German-Chinese relationship at one point. But the subsequent efforts of the German government to make China a priority in its foreign policy were only partly business-driven. Angela Merkel realised early in her chancellorship that China would play a crucial role in shaping world affairs and that a soft-balancing, non-military approach to the emerging superpower would be far more promising than ignoring or even rejecting China's demands to have a say in world politics.

³ The famous “Wandel durch Annäherung”.

Deconstructing Germany's interests

A deconstruction of the economic interests of liberal democracies makes clear that they cannot easily be separated from human rights, the promotion of democracy, and other non-economic interests. German business leaders are well aware that economic freedom is fundamentally tied to political freedom, and that rule of law is an indispensable prerequisite for long-term economic development. In addition, there is hardly any other business community in the world that is as sensitive to social inequality, environmental protection, and climate change. Nor can it be argued that the German government does not invest in democracy promotion or development aid, or that it is a blocking power on climate policy and other issues of international sustainability.

Deconstruction also helps assess the assertion that business shapes Germany's foreign policy. The private sector in Germany is – as in any other market economy – a very heterogeneous, complex, fragmented, and pluralistic body, from big business to the famous mid-sized manufacturers, the *Mittelstand*, private-sector interest groups, international companies, and small firms confining themselves to the domestic market. Efforts to identify and aggregate business interests consume much of the resources of business federations, and have repeatedly produced only a low common denominator, which has limited effects on government policy. Big multinational companies that are usually regarded as highly influential in politics have a similar problem, as the interests of their units and national subsidiaries often differ greatly. As a result, it is often very difficult to define a strong German business position on foreign policy issues.

Indeed, even if this were possible, the position would have to compete with strong non-business interests, including other interest groups, NGOs, and the public. The present debate on the Transatlantic Trade and Investment Partnership (TTIP) is an example of the latter. The German business community is almost unanimously in favour of the free trade agreement and has clearly communicated this to the government. Nevertheless, it is not certain that the final decision made by the German members of the European Parliament and the members of the *Bundestag* will favour TTIP.

Germany uses economic instruments to impose national preferences, but this is more by default than a strategy. After the Second World War, the use of military means by the German government was strictly limited by its constitution, and broadly politically delegitimised. This has changed only slowly after reunification, and public support for the use of military force remains meagre. As a result, Germany has had to resort to diplomatic means. But diplomacy without the capability to provide incentives or to punish is toothless. Economic tools were for a long time the only remaining means to make German diplomacy effective. Germany invested in development aid, was for a long time considered the paymaster of Europe, paid a ransom for not taking part in the Gulf War, and complied with various sanction regimes. But again: these actions were only of limited strategic nature and not embedded in a comprehensive economic diplomacy. Free trade agreements, for example, have – at least until recently – hardly been considered as strategic means to pursue national preferences.

A geo-economic power by chance

To qualify Szabo's judgment, as quoted at the beginning of this essay: Germany has geo-economic power – but is barely aware of it, and lacks a strategy for using it. There has been little discussion of which economic interests should shape national interests; or of how their pursuit relates to human rights, the promotion of democracy, and other non-economic issues – at least not beyond the foreign policy community. The use of security policy for the pursuit of economic interests remains taboo. And the use of economic instruments to impose national preferences has lacked strategic context. German business expresses its interests but does not regard itself as a player in foreign policy, nor see itself as being in a position to define national interests. Germany has not pursued a deliberate strategy of making maximum use of its economic strengths in order to establish itself as a geo-economic power. It achieved this status by historical chance, through shifts in world affairs and in the definition of what constitutes power.

Germany could afford to continue this less thoughtful approach to its geo-economic power as long as the European Union was stable and ever-closer, violent conflicts remote and peripheral, and the United States willing and able to cope with challenges to international security. But this is changing, and fast. Germany, and especially its

economy, is too exposed and vulnerable to foreign affairs for the country to forgo the strategic and deliberate use of its main source of power: economic strength.

Europe's limitations

When Edward Luttwak first wrote about the shift from geopolitics to “geo-economics” in the early 1990s, his argument was essentially that economic power was displacing military power. Though international relations would continue to follow the “logic of conflict”, which was “adversarial, zero-sum, and paradoxical”, he believed, the “methods of commerce” were displacing military methods.¹ Luttwak imagined that states would use “disposable capital in lieu of firepower, civilian innovation in lieu of military-technical advancement, and market penetration in lieu of garrisons and bases”. Thus geo-economics referred to the use of economic means for strategic objectives – what he called “the logic of war in the grammar of commerce”.

Since around the time of the global financial crisis, there has been a second wave of thinking about geo-economics.² Although the term has been primarily used in the context of the rise of China, it has also

¹ Edward Luttwak, “From geopolitics to geo-economics”, the *National Interest*, Summer 1990, pp. 17–24.

² See Sanjaya Baru, “Geo-economics and strategy”, *Survival*, June–July 2012, pp. 47–58.

been increasingly applied, both descriptively and prescriptively, in debates about European foreign policy. However, when Europeans use the term geo-economics, they often mean something rather different, and softer, than what Luttwak had in mind. In particular, they use the term to describe a foreign policy in pursuit of economic objectives (an approach that is often also, confusingly, referred to as “mercantilism”). Meanwhile, there has been relatively little discussion of whether Europe is – or should be – a geo-economic power in the “hard”, Luttwakian sense.

A world that is geo-economic in this hard sense might at first glance seem good for the European Union. After all, although the EU cannot compete with the United States in terms of military power, as the world’s largest trading bloc it should be able to compete with it in terms of economic power. Indeed, during the first wave of thought on geo-economics in the early 1990s, the concept tended to focus on Japan and the EU, which seemed to be using economic power to challenge US primacy. Thus Samuel Huntington argued in 1993 that: “In the coming years, the principal conflicts of interests involving the US and the major powers are likely to be over economic interests. US economic primacy is now being challenged by Japan and is likely to be challenged in the future by Europe”.³

In some ways, the EU has been remarkably effective in its use of geo-economic power in the “hard” sense. Some have even seen the EU as an “empire” because of the way it has used economic power to transform its neighbourhood, primarily through the promise of membership of the EU itself.⁴ The EU has also used development aid to pursue long-term strategic objectives in developing countries. However, it is reaching the limits of possible enlargement and other actors such as China, Russia, and the Gulf states are increasingly competing with it for influence – even in the EU’s “neighbourhood”. Meanwhile, the EU struggles to use its economic power in relations with major powers. In this context, it is increasingly apparent that the EU faces limitations in the use of geo-economic power in the hard sense that Luttwak had in mind.

³ Samuel P. Huntington, “Why International Primacy Matters”, *International Security*, 17, number 4, Spring 1993, pp. 68–83.

⁴ See Jan Zielonka, *Europe as Empire. The Nature of the Enlarged European Union* (Oxford: Oxford University Press, 2007).

The EU at a disadvantage

States can use a variety of economic means for strategic objectives in the way Luttwak described – in particular, currency policy, trade and investment policy, and energy policy. The EU could use these to pursue strategic objectives such as security, or to promote values such as democracy, human rights, and the rule of the law. But while the EU has huge economic resources, it faces particular limitations when it comes to converting them into its desired outcomes.⁵ These difficulties, which spring from the EU's own nature and structure, put it at a disadvantage compared to authoritarian states such as China, Russia, and the Gulf states, and democratic states – with a central government – such as the US.

Democracies with open economies do not control economic resources in the same way as authoritarian states do. In particular, they cannot use state-owned enterprises (SOEs), state-owned banks (SOBs), sovereign wealth funds (SWFs), or national oil corporations (NOCs) as instruments of foreign policy in the same way as authoritarian states. Of course, some EU member states do have SOEs and SOBs, especially since the de facto nationalisation of some European banks following the financial crisis, and even small SWFs (such as France's Fonds Stratégique d'Investissement). But, in general, EU governments have sought to limit the involvement of these groups in the economy to regulation, tax, and some limited subsidies. As a result, in terms of trade and investment and energy policy, EU members do not have the same options as authoritarian states.

European critics of the idea of geo-economics were aware of these limits on the opportunities for democratic market states to use economic power strategically. For example, in the early 1990s, Hanns W. Maull questioned whether Germany and Japan would use their economic resources to challenge US power, as some such as Huntington had worried that they would. “The fear about German or Japanese economic domination [...] fails to take adequately into account the nature of technological and economic power. Such power today differs profoundly from traditional state power. First,

⁵ On “power conversion”, see Joseph S. Nye, *The Future of Power* (New York: PublicAffairs, 2011), pp. 8–10.

the resources of these forms of power are in the hands of economic actors such as firms or banks, which pursue their own objectives and strategies. Economic ‘power’ thus cannot be easily manipulated and targeted by governments”.⁶

Other democratic states such as the US are similarly limited in the way that they can use economic power. But the EU is also at a disadvantage compared to them because it is not even a state. Rather, it is a project of regional integration that has become “something more than an intergovernmental organization but less than a fully-fledged European ‘state’”.⁷ It has transferred some foreign policy powers from the national to the EU level and now even has a foreign minister and a diplomatic service. Nevertheless, many of Europe’s collective economic means are controlled by member states, which have divergent interests, and are therefore difficult to deploy strategically. In some ways, EU member states are more likely to use geo-economic power individually – and even against each other – rather than collectively.

Perhaps the best example of this is currency policy. The dominant role of the dollar in the global economy gives the US exceptional power to delay or deflect balance of payments adjustment and to coerce other powers through the imposition of economic sanctions.⁸ The euro, which many Europeans hoped would become a reserve currency to rival the dollar, seemed to create the possibility of using currency policy strategically in the same way as the US uses the dollar. But because it is a currency without a state, no government “owns” it.⁹ The various members of the single currency have conflicting interests: creditors generally want a stronger euro; debtors want a weaker euro. As a result, the EU is unable to use one of its greatest assets strategically.

On top of these difficulties in deploying economic power, the use of “hard” geo-economic power goes against what might be called the

6 Hanns W. Maull, “Germany and Japan: The New Civilian Powers”, *Foreign Affairs*, Winter 1990/91, available at <http://www.foreignaffairs.com/articles/46262/hanns-w-maull/germany-and-japan-the-new-civilian-powers>.

7 Christopher Hill and Michael Smith (eds), *International Relations and the European Union* (Oxford: Oxford University Press, 2005), p. 4.

8 See Alan Wheatley, “The origins and use of currency power”, in Alan Wheatley (ed.), *The Power of Currencies and the Currencies of Power* (London: International Institute for Strategic Studies, 2013), pp. 17-43, here pp. 18-19.

9 Alan Wheatley, “The Pretenders to the dollar’s crown”, in Wheatley (ed.), *The Power of Currencies and the Currencies of Power*, pp. 45-73, here p. 50.

DNA of the EU. European foreign policy is an extension of European integration itself and is based on the same technocratic approach to international relations. The EU tends to seek to depoliticise geopolitical problems by turning them into technical questions – not least in order to overcome divisions between EU member states themselves. In particular, an implicit objective of European foreign policy has been to limit the ability of states to use economic means for strategic objectives – for example, through the rules of the World Trade Organization (WTO). The rules-based international order that the EU stands for, exemplified by the WTO, is the antithesis of a geo-economic world.

A good example of this is energy policy. While Russia has long used energy as a weapon in what it thinks of as its “near abroad”, in particular through differential prices and the threat of cut-offs, the EU has sought to depoliticise energy policy. In order to reduce the dependence of some EU member states and Eastern Partnership (EaP) countries on Russian gas, it has sought to complete and extend its own internal energy market. But the effect of this liberalisation of the energy market is to limit the potential for states to use energy policy as a coercive tool. Thus there is a question not just about whether the EU is able to use geo-economic power in the hard sense, but also about whether it is even willing to do so.

Sanctions: Exception or model?

Despite these limitations, however, over the last decade the EU has increasingly used one specific type of coercive economic tool as part of its foreign policy: sanctions.¹⁰ The EU has followed, and cooperated with, the US in extending and expanding the use of “smart” sanctions against individuals such as Serb leader Slobodan Milošević, non-state actors such as al-Qaeda, and countries such as Iran and Russia. What made these different from traditional trade sanctions was that they sought to leverage the role of private sector actors, and in particular banks and other financial institutions – the arteries of the international financial system.¹¹ In a sense, they are a twenty-first century version of the naval blockade, and thus fit Luttwak’s idea that economic tools would replace military tools.

¹⁰ See Clara Portela’s essay in this volume.

¹¹ See Juan Zarate, *Treasury’s War. The Unleashing of a New Era of Financial Warfare* (New York: PublicAffairs, 2013).

The sanctions imposed on Russia since 2014 represent a significant policy change for the EU. Since the end of the Cold War, the EU had sought to increase economic interdependence with Russia and to integrate it into the international system. The culmination of this approach was Russia's accession to the WTO in 2012. But following the annexation of Crimea and destabilisation of eastern Ukraine, the EU reluctantly agreed to reverse course. Economic sanctions – which Russia alleges violate WTO rules – were much harder for the EU to impose than for the US, not just because of the greater level of economic interdependence and therefore greater costs for EU member states, but also because of the structural difficulties in deploying economic power discussed above.

The question now is whether the EU should see the harder, geo-economic approach to Russia that it has reluctantly taken during the last year as an exception or as a model. Some Europeans worry about the effect of sanctions against Russia, particularly the effect on the WTO, and want to return to the EU's default approach as soon as it is possible. Others, however, see the Ukraine crisis as a "geopolitical awakening".¹² They argue that the debacle that followed the 2013 Vilnius Summit illustrated that the EU's technocratic approach does not work when it is faced with geopolitical competition from an aspiring great power such as Russia. In an increasingly geo-economic world, the EU must adapt its approach and be prepared to fight fire with fire – and use sanctions against powers like Russia.

Some Europeans argue that, had the EU taken a more geopolitical – or, perhaps more accurately, geo-economic – approach much sooner, it might have been able to influence Russian behaviour and avert the annexation of Crimea. This raises the question of whether it may be possible to use the threat of economic sanctions as part of a kind of geo-economic version of deterrence. The Ukraine crisis illustrated that the structural difficulties the EU faces in deploying economic power limit its ability to quickly respond to unexpected actions by other states. But a clear framework for the future use of sanctions, including pre-determined "red lines", might allow economic resources to be used to proactively shape the actions of states in the way military resources are.

¹² See Piotr Buras, Anthony Dworkin, François Godement, Daniel Levy, Mark Leonard and Kadri Liik, "Ten global consequences of the Ukraine crisis", European Council on Foreign Relations, 16 June 2014, available at http://www.ecfr.eu/article/commentary_ten_global_consequences_of_ukraine272.

A further question is whether the EU can use its economic power in a more positive way. For example, is it possible for the EU to find ways to use positive trade sanctions as well as negative ones – in other words, incentives as well as threats? The EU has long used the promise of opening its vast market in this way, both in its neighbourhood and beyond. But powerful as free trade agreements can be, they tend only to influence the behaviour of states in the long term. In the short term, they are not very effective. The challenge for the EU, therefore, is to become more agile in the use of incentives without undermining its liberal principles – and to find other tools it can use within the rules of the WTO that would expand its room for manoeuvre.

Sebastian Dullien
How to increase
Europe's clout

19

Economically, the European Union is a giant. Despite the recent difficulties of some of its member states, it is the world's largest economy, with a GDP of \$18.5 trillion in 2014 – more than Brazil, Russia, India, and China combined. The United States, by comparison, had a GDP of \$17.4 trillion.

Yet, when it comes to geo-economic clout, the EU often seems to punch below its weight. While global companies fear the reach of US regulators, supervisors, and courts, the cases in which the EU goes after multinational companies are rare and seldom end in real pain for the targets.

Of course, it is true that – as Anu Bradford discusses in this collection – the EU has become the most important regulatory power for many markets. It is also true that this gives European businesses a certain advantage in being able to shape these regulations. Yet this power seems more of a side effect of the single market project, and is not used strategically to achieve long-term goals.

This lack of a geo-economic approach is also evident when it comes to negotiating free trade agreements: for the public, it is not clear what strategy the European Commission follows when selecting countries to pursue trade deals with. While many of these agreements arguably have strategic potential or at least strategic consequences (as in the case of the currently disputed Transatlantic Trade and Investment Partnership (TTIP)), the Commission sells them mainly on their economic benefits to the public (even though these are often marginal).

Moreover, the EU has so far been reluctant to use its economic power to force companies or individuals outside its territory to comply with its strategic interests. While there are some high-profile cases such as the 2001 intervention by the EU's competition authorities into the proposed merger of General Electric and Honeywell (both non-EU companies), in general these are considered to have purely economic rather than strategic goals, and to be neutral as to the company's national base.¹

The US, by contrast, has often used marginal links to its territory to claim jurisdiction over foreign companies. For example, in 2015 the French bank BNP Paribas was fined almost \$9 billion for violating US sanctions against Sudan, Iran, and Cuba, even though the transactions had been arranged outside the US, and only the payments had been made through the US dollar-clearing system. In the 1996 Cuban Liberty and Democratic Solidarity (Libertad) Act (also known as the Helms-Burton Act), US sanctions against Cuba were extended to foreign companies that traded with Cuba but had no direct links to US territory.

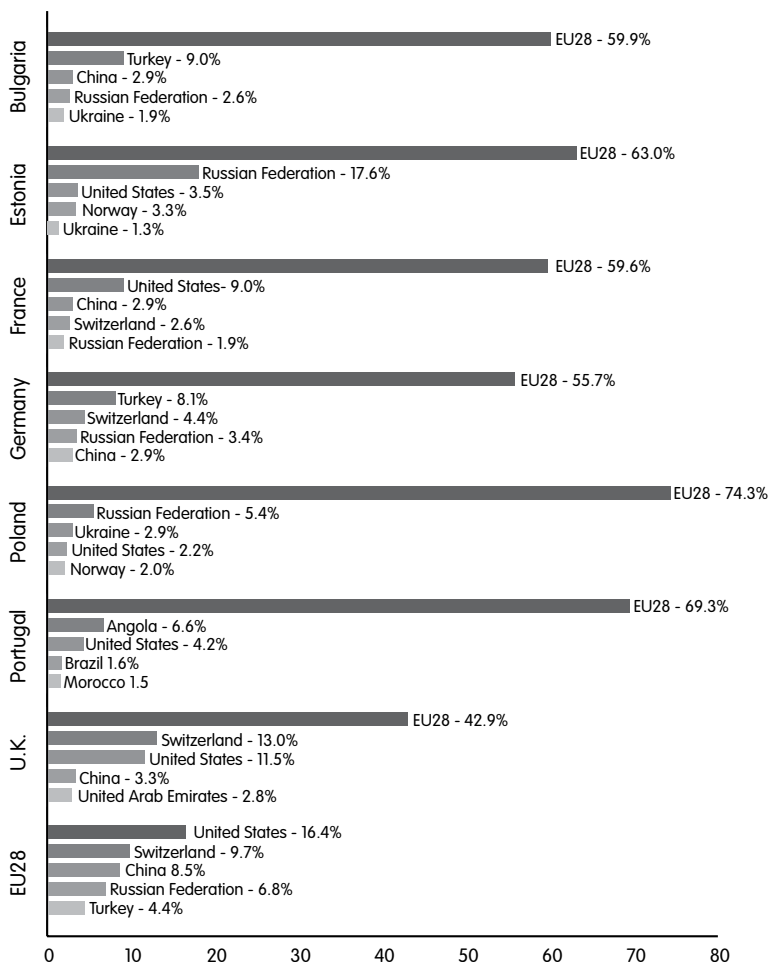
When it comes to currency and macroeconomic questions, EU members have also been surprisingly silent. In the US, debates about possible "currency manipulation" by China have raged for years, with Congress threatening repeatedly to impose punitive tariffs on Chinese imports.² In contrast, the EU has been mostly mute, though both regions have been almost equally affected by China's trade imbalances.³

1 The *Economist* claims it was mainly US-based competitors of GE and Honeywell who provided the European Commission with arguments against the merger. See "Engine failure: How the Americans helped block GE's merger with Honeywell", the *Economist*, 5 July 2001, available at <http://www.economist.com/node/687696>.

2 In fact, the Senate passed a bill against currency manipulation in May 2015, after more than a decade of debate on the issue. See Steven Mufson, "Senate passes bill targeting currency manipulators", the *Washington Post*, 14 May 2015, available at https://www.washingtonpost.com/business/economy/as-senate-targets-currency-manipulators-economists-say-step-is-unnecessary/2015/05/14/56dd70d0-f9b9-11e4-a13c-193b1241d51a_story.html.

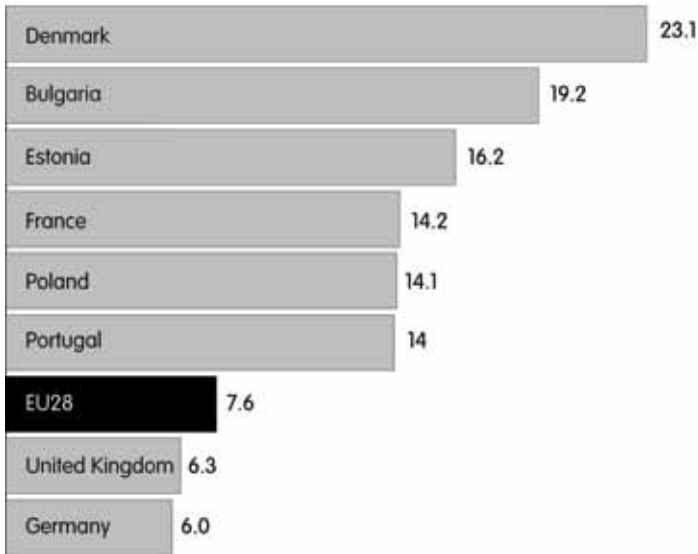
3 At the peak, in 2008, EU member states recorded a bilateral trade deficit of €170 billion with China.

Figure 1: Main export partners for selected countries (2013 - selected countries)



Source: World Trade Organization

Figure 2: Share of agricultural products in a country's merchandise exports in % (2013 - selected countries)

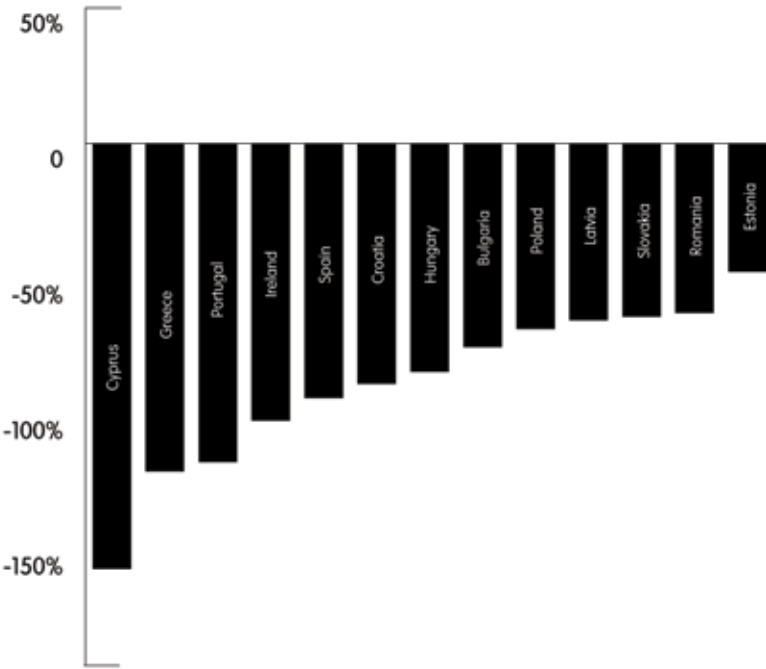


Finally, when it comes to economic sanctions, Congress seldom denies the executive the power to go after foreign countries, nationals, or companies if national security interests are at stake. In Europe, these discussions are much more complicated. In the conflict with Iran, for example, the EU finally put sanctions in place which were judged by the nonpartisan Congressional Research Service to be “nearly as extensive as those of the United States”, but it took the member states much longer to agree on the sanctions. In the case of economic sanctions against Russia in the Ukraine conflict, the election outcome in one country – Greece – seemed for a moment to put the entire Union’s sanction strategy in jeopardy.⁴

During the same period, the corresponding figure for the US was €185 billion (\$268 billion at the exchange rate of that time).

⁴ James G. Neuger and Nikos Chrysoloras, “Greece’s Coming Clash in Europe Starts With Russia Sanctions”, *Bloomberg*, 27 January 2015, available at <http://www.bloomberg.com/news/articles/2015-01-27/greek-government-questions-eu-bid-for-russia-sanctions>.

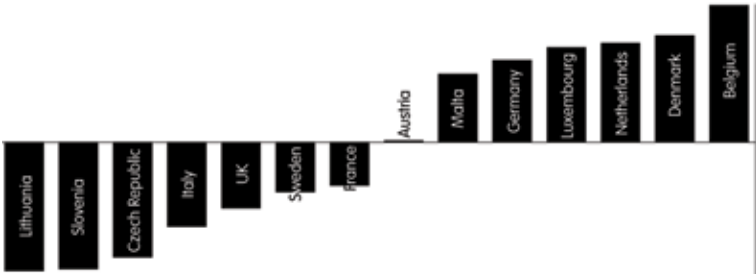
Figure 3: Net international investment position of EU28 countries in % of GDP (2013)



The reasons for Europe’s geo-economic weakness

There are a number of reasons for the EU’s failure to fully make use of its geo-economic power. In this collection, Hans Kundnani writes about the “EU’s DNA” – its in-built characteristics. The EU might be reluctant to use geo-economic power for cultural reasons, while Article 4 of the Treaty on the Functioning of the European Union (TFEU) states that “national security remains the sole responsibility of each member state”, and most activities need unanimous support by the member states.

For issues such as currency questions, the problem is a split of competences between different actors: while the European Council is responsible for deciding international exchange rate agreements for the euro (Art. 219 TFEU), the European Central Bank is responsible for the day-to-day management and proposing exchange rate agreements

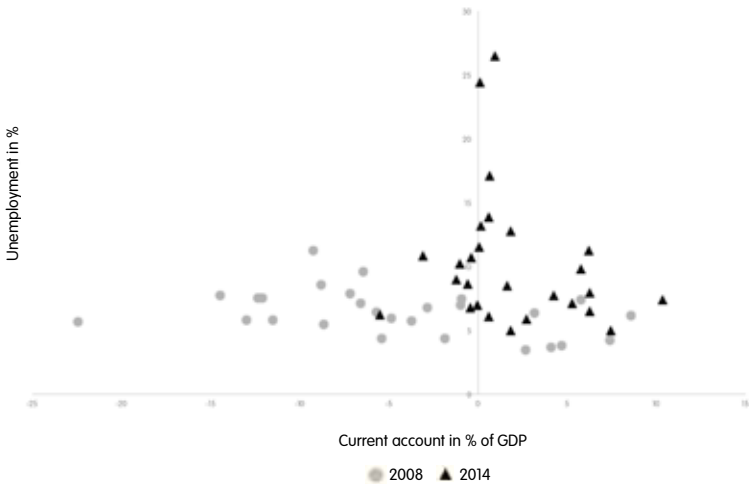


to the Council. However, trade policy, which in the US is often linked to the debate of exchange rate policy, is the responsibility of the European Commission. Given that these actors answer to slightly different constituencies, it is not surprising that they often fail to come up with a coherent and timely geo-economic approach.

Another obstacle in the way of a coherent geo-economic strategy is the – sometimes staggering – divergence in EU member states’ economic and trade interests. The countries differ widely not only in their level of income, but also in their economic structure, their main export products and destinations, their growth model, and their macroeconomic vulnerabilities.

Figure 1 and Figure 2 illustrate this point for trade dependencies. Figure 1 summarises the most important export destinations for a representative selection of member states. For some countries, trade

Figure 4: External and internal economic vulnerabilities of EU28 countries



with the US and China is most important, while for others eastern neighbours such as Ukraine and Russia are central. For some countries, more than two-thirds of exports remain in the EU, while for others this proportion is less than half.

Figure 2 shows the share of agricultural goods in selected EU countries' exports. In some, agricultural goods account for almost a quarter of the exports, while for others it is a mere 6 percent. Going deeper into the details, one finds that some countries (such as Germany) mainly export cars, machinery, and chemicals – products which have a global market and for which demand is often considered to be price insensitive, while others export agricultural goods or simple manufactured goods, which are highly price sensitive.

Figure 3 gives an indication that interests also diverge when it comes to exchange rate policies and the protection of investments abroad: some EU members (Ireland, Greece, and Portugal) have foreign liabilities that exceed their foreign assets by more than the country's annual economic output. These large net debtors tend to have an interest in policies that

lower the value of external debt. In contrast, some countries (such as Belgium, the Netherlands, and Germany) have large net claims against the rest of the world, which they naturally seek to protect.

Figure 4 illustrates the macroeconomic vulnerabilities of the EU member states for 2008 (prior to the global financial crisis) and for 2014. For countries with large current account deficits – i.e. buying more from abroad than they sell to the rest of the world – their biggest economic vulnerabilities are external. For countries most worried about high unemployment, their biggest economic vulnerabilities are domestic. In Figure 4, external vulnerabilities are represented on the horizontal axis and internal vulnerabilities on the vertical axis. In 2008, most of the divergence between the member states was in terms of external vulnerabilities (topped by Bulgaria with a current account deficit of more than 20 percent of GDP on the one extreme, and by Luxembourg with a surplus of more than 7 percent of GDP on the other). However, by 2014, the divergence in vulnerabilities had shifted to the internal front, with Germany recording an unemployment rate of less than 5 percent and Greece one of more than 26 percent.

These different economic structures reflect not only the varying costs of the use of geo-economic tools such as sanctions, but also different priorities when it comes to partners for free trade agreements. If a country sends large quantities of exports to Iran, for example, it might be more reluctant than other member states to pass sanctions against its trading partner. If a country already has a high level of external debt and is a net energy importer, it might refrain from actions which are likely to lead to higher energy costs. If a country has large net external debt, and exports mainly goods whose demand is price sensitive, it might be more willing to accept measures leading to a depreciation of the euro, thereby boosting its exports. In contrast, if a country has a large stock of foreign assets and exports whose demand is less price sensitive (as Germany does), it will be reluctant to see the euro depreciate. If a country already has a high level of unemployment and is experiencing an economic crisis, it might be less willing to expose its economy to additional shocks to its export sector.

Clearly, one cannot draw straightforward connections between pure economic interest and a country's decision to vote for or against the use of geo-economic tools such as sanctions. Economic interests are but

one dimension of any country's interests, and are not always the most important one. For example, if a country feels threatened militarily by another state, it might be willing to forego its economic interests in order to protect itself. This explains why, for example, Poland might be more willing to vote for sanctions against Russia than Spain, even if it might lose more in economic terms.

Hence, while economic interests are not the sole determining factor for a country's willingness to vote for the application of certain geo-economic measures, they define the potential costs of the instruments' use, and governments will balance these costs against perceived benefits of geo-economic action. The European economic cacophony might go a significant way in explaining its problems in developing a coherent geo-economic strategy.

The divergence of economic interests within an economically integrated region such as the EU is not unique. The federal states of the US, for example, do not have uniform economic structures. GDP per capita in Alaska, Delaware, and Connecticut is more than twice as high as in Mississippi, for example – the difference is similar to that between EU member states.⁵ Production structures also differ greatly. California's economy has a heavy bias towards the IT industry, while the Great Lakes region has specialised in cars. In New York, agricultural output accounts for 0.2 percent of GDP, while in North Dakota the figure is 7.7 percent.

Yet, when it comes to economic vulnerabilities, US states are much more uniform than EU member states. West Virginia, currently the state with the highest unemployment rate, recorded 7.6 percent unemployment in July 2015, while Nebraska, the state with the lowest unemployment rate, recorded a mere 2.8 percent – a difference of only 5 percentage points, compared to a difference of more than 20 percentage points between the unemployment rates of Germany and Greece.

In addition, in the US there is a certain degree of risk-sharing between states: if one state is hit by an adverse economic shock and its economy contracts, federal tax revenue from this state also falls. Part of the cost of the downturn is hence borne by the federal level. Moreover, it is not uncommon for projects targeted at certain districts to be negotiated in the US legislative process, especially if a district is hit by

⁵ The Netherlands' GDP per capita is roughly 2.5 times that of Bulgaria.

an event of national interest. For example, after the terrorist attacks of September 11, New York received almost \$20 billion in federal aid.⁶ Hence, when it comes to geo-economics, districts especially hard hit by a particular measure can expect to receive additional federal funds, reducing the net economic costs.

How to quieten the cacophony

Given these impediments, how can the EU achieve a more coherent use of geo-economic power to further its foreign policy goals?

A European government

With regards to the decision-making procedure, the straightforward solution would be to move foreign and security policy even further to the European level. This would imply removing the principle of unanimity for decisions on common foreign and security policy, and creating a real European government that could design a coherent foreign policy with economic elements.

This option seems completely unrealistic at present. First, hardly any major politician would argue for it. Second, as is evident in the Eurobarometer surveys and widely discussed in policy circles, the population's trust in European institutions has dwindled in recent years. The willingness to cede more powers to Brussels is absent in almost all member states. Given British Prime Minister David Cameron's resolve to renegotiate EU treaties, it is more likely that certain powers will be devolved to the nation states than that substantial further elements of national sovereignty will be transferred to the European level. Finally, as issues of national security are often seen as key to sovereignty, they could be expected to be the last that national governments will hold on to. At best, one could hope for a common representation of the euro area in international bodies such as the International Monetary Fund (IMF), and link this representation to the European Commission's trade body to better connect exchange rate and trade issues. In fact, these issues should be part of any reform package on euro-area governance reform, and are already being discussed in some of the proposals.

⁶ United States General Accounting Office, *Overview of Federal Disaster Assistance to the New York City Area*, Washington, DC, 2003, available at <http://www.gao.gov/new.items/do472.pdf>.

Wait for interests to align

Another option would be to wait for economic convergence in the EU to bring economic conditions closer together so that economic interests also align. However, both the empirical experience of the past and theoretical considerations hint that the wait for sufficient convergence in economic structure will be a long one.

First, while there has been a certain convergence in GDP per capita among the 28 member states, this process has come to a standstill or even reversed since the onset of the global financial crisis of 2008/9, with lower-income countries harder hit than higher-income countries. Moreover, when it comes to structural economic questions, there is little evidence that the member states have converged. As can be seen in Figure 4 above, member states might have converged in one dimension of economic vulnerability (external liabilities), but diverged in another dimension of vulnerability (unemployment). Trade and financial links between member states (which might be expected to eventually lead to a convergence of business cycles) have actually become less important since the onset of the euro crisis.

Finally, there is the argument that in an integrated market such as the EU, economic structures will become more diverse. Each region or country can be expected to specialise in what it does best, with certain industries clustering in certain regions.

Share risk

Another option would be to increase risk-sharing between the 28 member states, for example through the implementation of a general transfer system.⁷ For the euro area, there has been a very active debate on this issue, both in the early 1990s, before the euro was created, and then again in recent years after the onset of the euro crisis.

Some of the proposals envision rules-based transfers between national budgets. For example, one could introduce transfers linked to the output gap. Countries which are in a better position in the business

⁷ See, for example, Henrik Enderlein, Lucas Guttenberg, and Jann Spiess, "Making One Size Fits All. Designing a Cyclical Adjustment Insurance Fund For the Eurozone", Notre Europe Policy Paper 61, 23 January 2013, available at <http://www.institutdelors.eu/media/cyclicaladjustmentinsurancefundenderlein-guttenberg-spiessne-jdijan13.pdf?pdf=ok>.

cycle would have to pay transfers to countries which are in a worse position. Alternatively, some envisage the introduction of a common unemployment system for the euro area,⁸ in which part of each country's unemployment benefits would be covered by a European fund.

While the general aim of these proposals would be to increase the macroeconomic stability of the euro area, and the case for joining such systems is much weaker for countries with independent currencies, all of these proposals could be expanded to the EU member states. Such a step would move member states' economic interests closer together as a surge in unemployment in one country would be partly paid for by the other member states. The costs of geo-economic actions would not be entirely borne by the member states most affected because of their specific export structure, but at least partly by the EU as a whole.

However, at the moment, the political odds for the introduction of such a system are slim. The so-called Five Presidents' Report, published in summer 2015, which proposed a timeline for reform of euro-area governance structures,⁹ does not represent progress from earlier European Commission papers. In fact, when it comes to transfer systems, the new paper only proposes discussing the issue further, with no guidelines as to how and when transfers might actually be realised.

Moreover, especially in member states with low unemployment rates such as Germany or the Netherlands, scepticism against transfer systems is running high, with economists warning that they might create moral hazard and remove the incentive for governments to do their share to fight the recession and unemployment domestically.¹⁰ While this argument is probably overstated, it is clear that in potential net payer countries, proposals for transfer systems will be met with resistance.

⁸ See, for example, Daniel Gros, László Andor, Sebastian Dullien, H. Xavier Jara, and Holly Sutherland, "Forum: Designing a European Unemployment Insurance Scheme", *Intereconomics*, Volume 49, Number 4, July/August 2014, pp. 184–203, available at <https://www.ceps.eu/system/files/IEForum42014.pdf>.

⁹ Jean-Claude Juncker, "Completing Europe's Economic and Monetary Union", Brussels, 2015. The paper was written by the president of the European Commission in close cooperation with the president of the European Council, Donald Tusk, the president of the Eurogroup, Jeroen Dijsselbloem, the president of the European Central Bank, Mario Draghi, and the president of the European Parliament, Martin Schulz.

¹⁰ See, for example, "Konsequenzen aus der Griechenland-Krise für einen stabileren Euro-Raum", Sachverständigenrat zur Beurteilung der gesamtwirtschaftlichen Lage, Sondergutachten, Wiesbaden, July 2015.

A geo-economic compensation fund

A final possibility would be to introduce a permanent special fund to compensate those who lose out from geo-economic actions. This is an approach well used in many countries' trade policies. In the US, for example, workers, firms, and farmers hurt by rising imports because of trade liberalisation can apply for federal support under the Trade Adjustment Assistance (TAA) programme, introduced in 1962.¹¹ While its efficacy in helping the concerned firms and workers to cope with the structural change induced by trade is disputed, the programme is generally credited with having helped to increase public acceptance of trade deals.

A European geo-economic compensation fund could work similarly: it would pay compensation to workers, firms, and farmers who could prove that they had been hurt by the EU's geo-economic activities, avoiding ad hoc negotiations and bargaining in specific cases. This might even be more effective than traditional US-style trade adjustment assistance programmes. While changes due to trade liberalisation tend to be permanent, changes due to geo-economic policy are often only temporary – and so can be redressed with limited payments.

The working of the compensation fund would be similar to that of traditional trade adjustment assistance programmes: by providing some remedy for the worst hit, the payments would help to increase the population's (and hence national governments') willingness to employ geo-economic instruments.

Conclusions

Europe's relative weakness in geo-economic terms is not necessarily set in stone, and it is not only the result of a specific European approach to foreign policy and geopolitics. Instead, to a certain extent, it can be explained by a combination of existing economic and governance structures in the EU member states.

¹¹ For a good overview on the history of the programme, see J. F. Hornbeck and Laine Elise Rover, "Trade Adjustment Assistance (TAA) and Its Role in U.S. Trade Policy", Congressional Research Service, R41922, 19 July 2011, available at <http://fpc.state.gov/documents/organization/169173.pdf>.

As some of these structures are difficult to change due to policy constraints, it is very unlikely that the EU will soon play in a similar geo-economic league to the US. However, small changes at the margins – a more coherent governance structure for the euro area, and a geo-economic compensation fund – might increase the EU voters' and leaders' willingness to engage in geo-economic activities, and eventually help to increase the EU's influence in the world.

CHALLENGERS

Ulrike Esther Franke

20

Why emerging countries are hedging against the global system

Economists don't agree on much. But there is a broad consensus that emerging countries have been the chief beneficiaries of globalisation. Trading, investment, communications, and other links between states mushroomed and lifted over a billion people out of poverty. Globalisation has turned the BRICS and other rising members of the Global South into actors with serious political clout.

But more and more emerging countries are losing faith in the global system. Increasingly aware of the web of interdependence that lies at the heart of globalisation, they are exploiting the asymmetries in their relationship with others to their advantage. Like the West, which has long used sanctions and other tools, emerging countries are using economic coercion to pressure political opponents. In addition, these countries are hedging against the same dependencies they exploit, aiming to become more self-sufficient and independent, in order to be less vulnerable to coercion themselves. Together, these trends are endangering globalisation as a whole – the very thing that allowed the countries to emerge.

Economic coercion and the exploitation of asymmetries

The media coverage and scholarship produced in the West could give the impression that economic and financial sanctions are an exclusively Western tool. The United States' blockade on Cuba, the wide-ranging European Union and US sanctions against Iran, the recent measures against Russia: sanctions appear to be Western countries' favoured instrument against their opponents. War-weary liberal democracies prefer to rely on their economic might than to fall back on their shrinking military power: the EU had only six sanctions regimes in force in 1991, but by 2014 their number had grown to more than 25. In the US, the Treasury's "guerrillas in gray suits"¹ have developed increasingly sophisticated financial sanctions since 9/11. And the UN has, since 1991, introduced on average one new sanctions regime every year – exclusively targeting non-Western groups and states.

However, economic and financial sanctions are also widely used by emerging countries. Of the seven countries studied – Brazil, China, India, Iran, Russia, South Africa, and Turkey – more than half have over the last two decades imposed unilateral sanctions² and coercive economic measures against opponents. These range from tightened custom controls, economic blockades, and suspension of aid, to travel bans and the cancellation of government-level and multilateral meetings.

The map beginning on page 182 shows which emerging states employ which measures,³ with US and EU economic coercive measures added for comparison.

As the map shows, once a country decides to use economic coercion, it often employs a range of forms of coercion rather than relying on a single one. Countries play to their strengths – Russia uses its gas exports to put pressure on its neighbours, Turkey leverages its geographic position by cutting Armenia off from trade with the West, and China restricts

1 Juan Zarate, *Treasury's War – The Unleashing of a New Era of Financial Warfare* (New York: PublicAffairs, 2013), p. xi.

2 All seven countries other than Iran support UN sanctions, though some have voiced criticism of them.

3 While every effort has been made to make this overview as accurate as possible, one should note that quantifying economic coercion is not an exact science, as what is counted as an instance of coercion in one analysis may not be in another.

access to its large consumer market and imposes export sanctions on rare earth minerals, used in electronic devices. Some states have found particularly creative measures: in 2014, Russia imposed a ban on US adoptions of Russian children, and India has more than once banned its cricket team from playing with or in Pakistan.

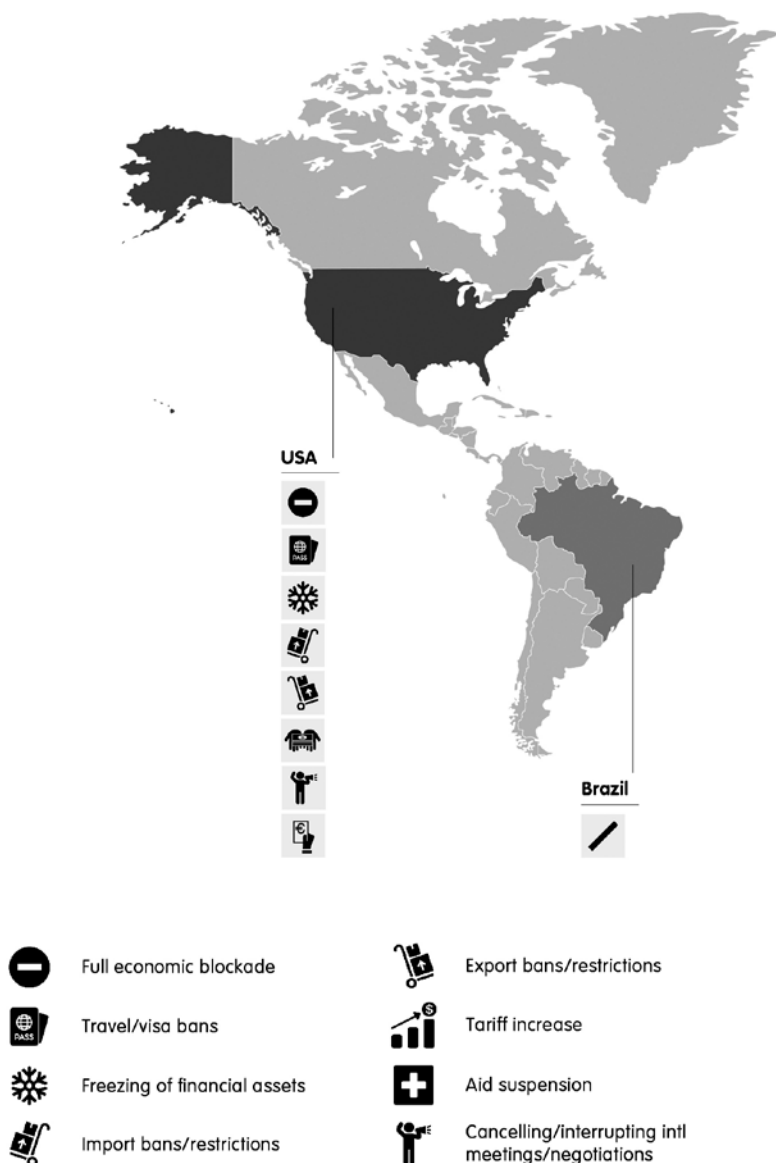
What the map does not show is that many countries choose to employ economic coercion only for specific policy issues or against particular opponents. India's sanctions are almost exclusively directed against Pakistan. China mainly targets states that disagree with its Tibet, Taiwan, or maritime policies, and Turkey employs economic coercion predominantly to punish those who recognise the Armenian mass killings as genocide. Among the emerging countries studied, only Russia has a global outlook, targeting countries from Georgia and Ukraine, to the EU and the US.

But not all emerging countries agree with these policies – or so they say. Brazil, South Africa, and Iran state that they have made a policy decision not to rely on economic coercion. For Iran and South Africa, this decision may be motivated by their experiences of being at the receiving end of sanctions regimes and thus having first-hand experience of their devastating consequences – Iran has been under international sanctions since the fall of the Shah in 1979, while South Africa faced sanctions during the apartheid regime (pre-1994). Others, such as Brazil, question the effectiveness of economic coercion: “In Brazil we oppose any policy based on sanctions [...] sanctions, as a rule, end up punishing the population rather than the government”, President Dilma Rousseff has stated. However, even the countries that officially say they are not using economic coercion are still playing the game of geo-economic power. They may not be well-positioned to impose sanctions, but they are nevertheless geo-economic players, using other tools such as strategic alliances.





Retreat from globalisation

Emerging countries have always been somewhat wary about full integration into the global economic system. Many have used capital controls and similar measures in order to retain some control over their economies. More recently, however, these economic anxieties have been exacerbated by geopolitical ones. The system is increasingly

Tools of geo-economic coercion employed by selected countries

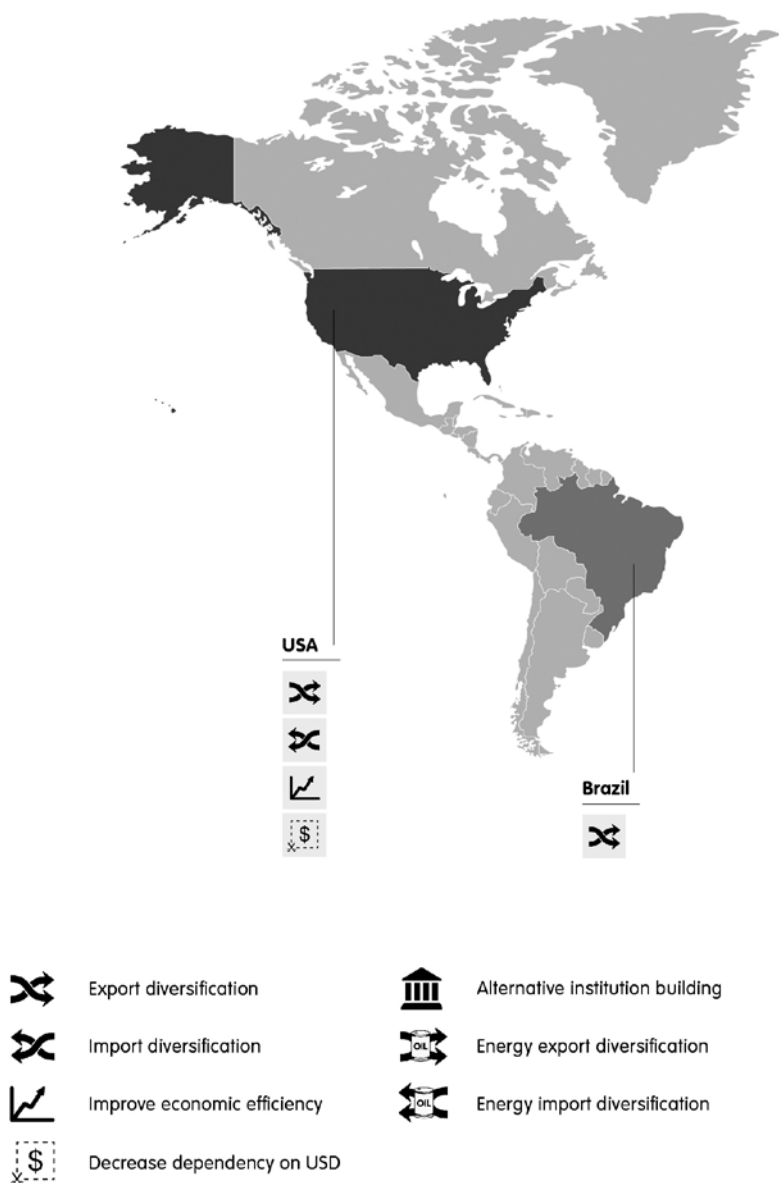




-  Unfavourable taxation
-  Increase import/export inspections
-  Withholding agreed loans
-  Closing businesses/expropriation

-  Unfavourable taxation
-  Encouraging public boycotts
-  Denying regulatory approval/licenses
-  Cutting transportation links
-  Financial sanctions

Tools of geo-economic hedging employed by selected countries





perceived to be little more than the extended arm of the West, and particularly of the US State Department.

Reacting to the growing use of economic coercion and to the global financial crisis of 2008/9, which has heightened fears of close global economic integration, emerging countries are pursuing efforts to decrease their dependencies and to strengthen their positions with regard to other countries. They are seeking alternative sources of imports and new markets for exports, and grouping together with like-minded countries in new multilateral institutions that allow them to carve out safe niches for themselves.

While these strategies may appear sound from a national perspective, they could prove to be more dangerous to the international system than the use of economic coercion. They undo, step by step, the links that allow the global system to function.

There are two main motivations for hedging. First, some countries have an anti-Western motivation. China, Russia, and Turkey have actively pursued a policy of de-dollarisation or de-euroisation, avoiding the use of the dollar or the euro, and aiming to trade predominantly in their own currencies. China and Russia are also building alternatives to Western-led institutions, such as the Asian Infrastructure Investment Bank (AIIB), which is rivalling the Bretton Woods institutions; the UnionPay system, an alternative to Visa or Mastercard; or the BRICS's alternative to the SWIFT international payments system. In part, these hedging measures are also motivated by these countries' fears of becoming targets of Western sanctions.

But it is not only countries that have been targeted by Western sanctions that are pursuing hedging strategies to make themselves less vulnerable. The international sanctions against Iran, for example, prompted India to reduce its oil imports from Iran and to diversify its energy sources. The financial crisis has added to the general feeling of uncertainty: facing its economic ripple effects, most countries are trying to diversify their markets and strengthen their national economies in order to limit their vulnerability.

Conclusion

When countries entered the era of globalisation, many were wary of losing control over their own affairs. But globalisation proved to be highly beneficial for some less-developed countries, which soon became known as “emerging”.

Today, emerging countries’ view of globalisation has changed, not least because there is a growing sense of Western hypocrisy in the Global South. Having signed up to an international system that was supposed to be governed solely by economic concerns, they have increasingly realised that the system is being used for political ends. But while the Western use of sanctions and economic coercion gets more attention, it is not an idiosyncrasy of the West alone. Emerging countries are also weaponising the system’s constituent parts in order to gain an advantage over their political opponents. Of seven emerging countries – six of which are members of the G20 – more than half employ coercive economic measures.

All members of the global economic system should be aware that taking advantage of the system by using its components as a weapon endangers its foundations. The more economic coercion is used, the more countries will hedge against it, undoing step by step the links on which the system is based.

ECFR would like to thank the following researchers, on whose work this overview is based: Deborah BL Farias (Brazil), Ondrej Wagner (China), Stephanie Lee (China), Rishika Chauhan (India), Ali Ghezlbash (Iran), Jamal Ibrahim Haidar (Iran), Dawid Jarosz (Russia), Altay Atli (Turkey), Gustav Venter (South Africa).

China: Turning money into power

In November 2008, French officials announced that President Nicolas Sarkozy would meet the Dalai Lama. Beijing responded sharply, refusing to attend the 11th annual EU–China summit in Paris and cancelling its order for 150 French Airbus planes. Two Chinese trade delegations quickly crossed France off their travel agendas: the first delegation alone signed \$15 billion worth of trade deals in other European countries. Before his 2009 European tour, Premier Wen Jiabao noted: “I looked at a map of Europe on the plane. My trip goes around France ... We all know why”.¹ Yet after Paris issued a statement recognising Tibet as an integral part of China’s territory, a Chinese trade delegation soon landed in Paris. A China Daily article chortled, “France goes back on China’s shopping list”.²

Such strategic use of China’s financial resources causes anxiety around the world, and with good reason. Never in history has one government

This chapter draws upon the author’s essay, “China’s Economic Statecraft: Turning Wealth into Power,” Lowy Institute for International Policy, 27 November 2013.
1 She Zhan, 达赖问题与绕法之路 [“The Dalai issue and ‘circling France trip’”] 世界经济与政治 [World Economics and Politics] 3, no. 423 (2009): 45–6.

2 Ding Qingfen, “France goes back on China’s shopping list”, *China Daily*, 29 October 2009, available at http://www.chinadaily.com.cn/cndy/2009-10/29/content_8864372.htm.

had so much control over so much wealth. China's leaders govern a country that has the world's largest capital surplus and its second-largest economy, a highly coveted domestic market, and a currency with growing regional appeal. The temptation to deploy China's economic might for strategic benefit has proven irresistible. Today, China is using economic statecraft more frequently, more assertively, and in a more diverse fashion than ever before.

Economic statecraft is the use of economic resources by political leaders to exert influence in pursuit of foreign policy objectives. Three main strategies predominate: providing or withdrawing capital through foreign aid and direct investment; expanding or blocking trade via preferential trade agreements or economic sanctions; and altering monetary policies, such as by purchasing foreign bonds or intervening in currency markets.

China's economic statecraft is best understood as the selective application of economic incentives and punishments designed to bolster Beijing's diplomacy. In some cases, China exerts influence through reciprocity, rewarding desired behaviour and punishing unwelcome behaviour. In other instances, Beijing provides benefits unconditionally, in the hope that "sustained economic engagement will eventually produce a political transformation and desirable changes in target behaviour".³ Such influence is less direct, as China hopes that the benefits of trade and investment empower a "commercial fifth column" within the target country that will urge the accommodation of China's preferences.⁴

The degree of political influence that China is able to wield varies but, above all, size matters. Given China's economic heft, a minor shift in its trade, aid, or investment can have a massive effect on the economy of a smaller country. This chapter begins by tracing the origins of China's interest in economic statecraft, followed by the key actors and techniques deployed by Beijing. The final section denotes the limits of China's economic statecraft.

3 Michael Mastanduno, "Economic statecraft, interdependence, and national security: agendas for research", *Security Studies* 9, no. 1-2 (1999), pp. 288-316.

4 Albert O. Hirschman, *National Power and the Structure of Foreign Trade* (Berkeley, University of California Press, 1980), p.16.

New thinking on new wealth

As China's economic might has risen, its power, and the temptation to use that power, has grown. As a major study from the China Institute of Contemporary International Relations⁵ concludes: "Given the fact that our nation has increasing economic power, we should prudently use economic sanctions against those countries that undermine world peace and threaten our country's national interests".⁶

China's national wealth is certainly imposing. Its agricultural and industrial outputs are the world's largest. It is the world's largest exporter (\$2.3 trillion) and its third-largest importer (\$1.9 trillion). China's overall trade surplus has enabled it to run up the world's largest current-account surplus (\$219 billion) and amass foreign-exchange reserves of \$3.9 trillion.⁷ This economic heft confers considerable trading leverage. China is the largest trading partner for over a hundred countries, including Australia, Japan, South Korea, Vietnam, Malaysia, Indonesia, and India. More significant than aggregate wealth, however, is the pervasive government control over these resources.

China's political-industrial complex

China's socialist legacy and state-led development model have left its leaders with enormous influence. Five government agencies sit at the apex of the state's economic apparatus:

- The Ministry of Commerce (MOFCOM) oversees companies and policies on foreign trade and investment, and directly administers foreign aid.
- The National Development and Reform Commission (NDRC) sets industrial policy and approves major development projects.
- The State-owned Assets Supervision and Administration Commission (SASAC) is the "owner" of China's large state-owned enterprises (SOEs), tasked with increasing the value of these assets.
- The Ministry of Finance (MOF) dominates the financial sector,

⁵ The China Institute of Contemporary International Relations is an influential think-tank associated with China's Ministry of State Security.

⁶ Liu Jianping and Liu Weishu, 美国对外经济制裁问题研究—当代国际关系关系政治化的个案分析 [Research on the US's use of economic sanctions: a case study of the politicization of current international economic relations] (Beijing: Renmin Publishers, 2009), p. 36.

⁷ *The World Factbook*, Central Intelligence Agency, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>.

managing the national budget, setting fiscal policy, issuing economic regulations, and shaping macroeconomic policies.

- The People's Bank of China (PBoC), China's central bank, manages currency flows, sets banking policies, and, along with the China Banking Regulatory Commission (CBRC), oversees all banks.

Capital for China's economic statecraft comes primarily from the banking sector. Two "policy banks", tasked with implementing government policies, play key roles.

- The China Development Bank (CDB) helps finance infrastructure and energy projects in China and abroad.
- The Export-Import Bank of China (Exim Bank) finances trade deals and provides subsidised loans for China's aid programmes.

China's commercial banks are also owned by the state, though they are expected to be profitable. The four largest are the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the China Construction Bank (CCB), and the Agricultural Bank of China (ABC).

The China Investment Corporation (CIC) is China's sovereign wealth fund. Short-term foreign reserves are held by the State Administration of Foreign Exchange (SAFE).⁸

The world's four largest banks are all Chinese and state-owned.⁹ The nation's leading foreign-currency lender, CDB, has more assets than the World Bank and the Asia Development Bank combined.¹⁰ Over the past decade, Exim Bank's loans to sub-Saharan Africa vastly surpassed those of the World Bank.¹¹ CIC is the world's fifth-largest sovereign wealth fund.¹² In 2015, three Chinese SOEs made Fortune's top ten: Sinopec (2nd), China National Petroleum Corporation (CNPC) (4th), and State Grid Corporation of China (7th).¹³

8 The preceding overview draws in part from William J. Norris, "Economic statecraft with Chinese characteristics: the use of commercial actors in China's grand strategy" (PhD diss., MIT, Cambridge, MA, 2010), pp. 265–69.

9 See Liyan Chen, "2015 Global 2000: The World's Largest Banks", *Forbes*, 6 May 2015, available at <http://www.forbes.com/sites/liyanchen/2015/05/06/2015-global-2000-the-worlds-largest-banks/>.

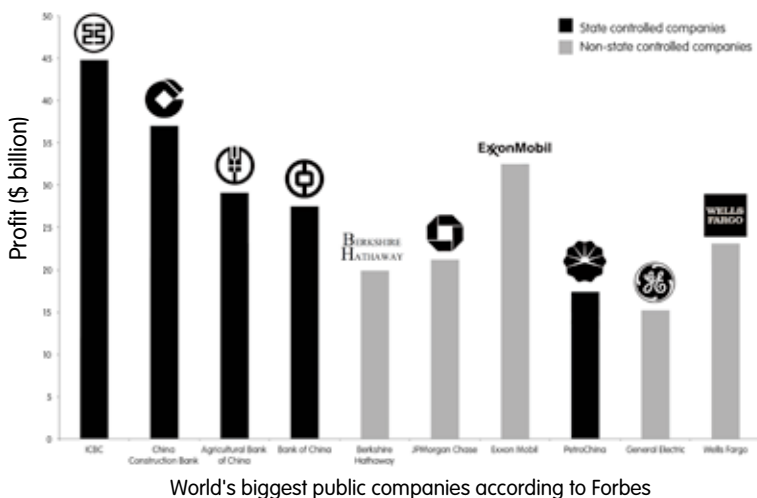
10 "China Development Bank", International Development Finance Club, available at <http://www.idfc.org/Members/cdb.aspx>.

11 Simon Rabinovitch, "A new way of lending", *Financial Times*, 24 September 2012, available at <http://www.ft.com/intl/cms/c1628ce2-03a3-11e2-bad2-00144feabdco.pdf>.

12 "Fund rankings", SWF Institute, available at <http://www.swfinstitute.org/fund-rankings/>.

13 "Fortune Global 500", *Fortune*, available at <http://fortune.com/global500/>.

The world's biggest public companies and their status as state or market controlled



Source: Forbes

Understandably, the temptation to deploy these formidable economic assets to advance China's foreign policy interests has proven irresistible.

Diplomacy by other means

China's economic statecraft often relies upon selective "purchasing diplomacy", in which state-owned enterprises make or forgo purchases of prominent commercial goods to either reward or punish foreign states for their diplomatic policy, or to help temper foreign disquiet over China's rising power. On his May 2013 visit to Germany, Premier Li Keqiang faced mounting German criticism over China's subsidies of solar panels. In response, Li opened his chequebook, overseeing major commercial deals and dangling the possibility of German firms obtaining contracts as part of China's transition to a "green economy".¹⁴ When delivering economic benefits, Chinese leaders pay careful

¹⁴ "Chinese, German PMs agree to promote cooperation", *China.org.cn*, 27 May 2013, available at http://www.china.org.cn/world/2013-05/27/content_28938423.htm.

attention to timing. “Sending coal in the midst of a snowstorm”, as the Chinese saying goes, maximises political benefits. The global financial crisis was a major snowstorm – and an opportunity for Beijing to purchase political capital cheaply. In October 2010, Wen promised to purchase Greek government bonds, encourage investment and tourism, and establish a \$5 billion fund to help Greek shipping companies buy Chinese ships. In exchange, Wen explained: “We hope the EU recognises as soon as possible China’s full market-economy status, and will relax restriction on high-technology exports to China and oppose trade protectionism”.¹⁵

The scale of Beijing’s ambitions has also grown as China seeks political influence commensurate with its economic weight. In 2007, for instance, Beijing created the China-Africa Development Fund, providing \$1 billion from the China Development Bank to support Chinese firms’ investments in Africa. Three years later, the China-ASEAN Investment Cooperation Fund was established with \$1 billion, largely from China’s Exim Bank.¹⁶ In 2012, Beijing pledged \$10 billion to fund projects under the China and Central and Eastern European Countries (CEEC) initiative.¹⁷ Most recently, Beijing’s ambitious “Silk Road Economic Belt” linking China with Central Asia and the “21st Century Maritime Silk Road” across Southeast Asia – the two components of “One Belt, One Road”, will receive support from the \$40 billion Silk Road Fund.¹⁸

Chinese leaders generally prefer to use such carrots rather than sticks. Economic incentives enable Chinese firms to benefit while also easing diplomatic relations, tempering public anxiety over China’s rise, and fostering closer economic and diplomatic ties. Yet Beijing remains willing to deploy punitive economic measures in defence of core national interests.

China rarely declares such economic sanctions openly, relying instead on vague threats, variations in leadership visits, and other informal or indirect measures. In March 2012, for instance, Xinjiang province’s

15 Nick Skrekas and Andrew Batson, “Beijing Offers Support to Greece”, the *Wall Street Journal*, 4 October 2010, available at <http://www.wsj.com/news/articles/SB10001424052748704380504575529523835140714>.

16 See <http://www.china-asean-fund.com>.

17 See: <http://www.china-ceec.org/151/2015/01/26/41s5605.htm>.

18 See <http://www.silkroadfund.com.cn>.

Party Chairman Nur Bekri decried “countless” links between local terrorists and Pakistan. A few weeks later, the ICBC bank withdrew promised financing for a gas pipeline from Iran to Pakistan, signalling Beijing’s displeasure.¹⁹ After jailed dissident Liu Xiaobo received the 2010 Nobel Peace Prize, Norway’s salmon exports to China dropped by half.²⁰ Hollywood film studios, French supermarkets, Italian car manufacturers, and British universities have all apologised for “hurting the feelings of Chinese people”, in hope of avoiding consumer boycotts.²¹

Beijing’s blunt instrument

China’s aid, investment, and trade benefits are designed to signal Beijing’s benevolent intent and highlight the benefits of accommodation. Yet China’s generosity often feeds fears of over-dependence, particularly among its smaller Asian neighbours. As US Secretary of State Hillary Clinton told a Cambodian audience: “I think it’s smart for Cambodia to be friends with many countries. Look for balance. You don’t want to become too dependent on any one country”. A number of Southeast Asian states, including Beijing’s erstwhile ally, Myanmar, have taken Clinton up on the offer, welcoming the US’s “pivot” back to Asia as a hedge against rising Chinese influence. Similar anxieties are rising in Taiwan. In March 2014, university students critical of the government’s close economic ties with the mainland occupied the legislature’s building for several weeks.

Beijing’s ability to use Chinese companies in pursuit of foreign policy interests also requires coordination across a vast and complex array of state-owned corporations and government bureaucracies with unsynchronised rankings. It is often difficult, if not impossible, for Chinese diplomats to order powerful state-owned enterprises to take steps that may compromise their commercial interests. Promoting overseas investments for political purposes also engenders a moral hazard: firms may feel free to invest in risky ventures, confident that Beijing will cover any losses incurred. Domestic actors may even hijack

19 Raffaello Pantucci, “Break Up Time for Pakistan, China?”, the *Diplomat*, 7 June 2012, available at <http://the-diplomat.com/china-power/2012/06/07/break-up-time-for-pakistan-china/>.

20 However, overall bilateral trade between China and Norway experienced “no Nobel effect”, according to Statistics Norway. Pierre-Henry Deshayes, “Norwegian salmon off the menu in China”, *Agence France-Presse*, 4 October 2011, available at <https://sg.news.yahoo.com/norwegian-salmon-off-menu-china-065639469.html>.

21 Gilles Castonguay, “Fiat apologizes to China for TV ad for new car”, *Reuters*, 21 June 2008, available at <http://www.reuters.com/article/2008/06/21/industry-fiat-china-de-idUSL2030648920080621>.

the policy process, manipulating strategic concerns or promoting policies to advance their own economic interests.

Conclusion: Keep calm and carry on

Chinese leaders sit astride the world's second-largest economy, enjoying political control over vast swathes of the nation's wealth. The temptation to deploy this wealth for strategic purposes has proven irresistible. The allure of economic statecraft for Chinese leaders derives from their influence over China's massive domestic economy. Yet the same two factors also undermine the effectiveness of China's economic statecraft. The dispersal of power and diverging preferences across the multiplicity of actors involved in the state sector results in incoherent and often contradictory approaches to economic statecraft. Similarly, China's rapid growth and regional prominence exacerbates anxiety among its neighbours, generating backlashes and balancing responses across the region. For all these reasons, the anxiety over China's economic influence now rising across Europe should be tempered by a more realistic understanding of the limitations facing China's economic statecraft.

Russia: A diverse arsenal

Russia has succeeded in taking on the geopolitical role of the former USSR, mainly as a result of the retention of its position in the United Nations Security Council, its military and especially nuclear power, and its continuing influence in its neighbourhood. But Russia has not done enough to strengthen and diversify its economy, relying mainly on the export of hydrocarbons. This imbalance is reflected in the tools Russia deploys to protect its interests. Its use of geo-economic tools remains inefficient, and, when facing serious challenges, Russia eagerly returns to the geopolitical toolbox again and again.

Russia's economic policy has been simplified by its enormous reserves of natural resources. When oil and gas were expensive, Russia turned its economy into a single product enterprise. Though official figures suggest that oil-related revenue makes up only half the federal budget, the correlation between the budget and the price of the Urals oil benchmark is close to 100 percent. Thanks to the amount of oil and gas exported, Russia maintained a positive trade balance even after the oil price fell.

Russia's economic focus has been on securing the loyalty of its hydrocarbon buyers. In the past, this was not difficult. Before c. 2012, 88 percent of Russian oil exports went to the European Union; 30 percent of the EU's oil was supplied by Russia.¹ By 2013, however, Moscow was worried. Talks within the EU about alternative suppliers coincided with the failure of negotiations over the South Stream gas pipeline from Russia to Europe, the emergence of new energy sources, tough discussions about the role and position of Gazprom in Europe, and growing tensions about NATO expansion, alongside the rapid development of US shale oil and gas production. Russia's initial reaction was short-sighted – officials neglected forecasts of decreasing oil prices and failed to realise that increased gas production in the United States would lead to exports of coal to Europe and a price decrease there, while decreased imports of oil to the US would redirect the Middle East's oil supply to the EU.

Once the change became impossible to ignore, Russian decision-makers decided to pursue a consumer diversification strategy. Great efforts were dedicated to developing the market for Russian oil and gas in the Far East, including trying to secure large sales to China. After two years it became clear that China – a highly diversified consumer – had little interest in providing favourable conditions for this trade. Securing Chinese demand would require substantial Russian investment and the development of massive infrastructure, without any guarantee of the price or volume of sales.

Russia's zone of influence – a geo-economic safe haven?

At the same time, Russia has actively but rather unsuccessfully followed its traditional strategy of trying to secure dependent markets within its “zone of influence” through trade preferences, working to control gas transit flows, and exerting political pressure. Russia has retained the Armenian market for its electricity, oil, and gas exports by supporting the country in its everlasting conflict with Azerbaijan and against the (somewhat overestimated) Turkish threat. In Georgia, Russia's military actions, followed by successful political brokering,

¹ *Energdialog Russia–EU*, 12th report, Minenergo, 2011.

brought a Russia-neutral party to power, replacing the pro-European party led by Mikheil Saakashvili.

But beyond this and a few smaller “victories”, like the reduction of the US military presence in the Middle East, Russia has gained little from this strategy. The Eurasian Economic Union ties Belarus, Armenia, Kyrgyzstan, and Kazakhstan to Russia, but the Kyrgyz have mainly used it to ease the “grey” re-export of Chinese goods to Russia, and to develop their own financial and business relations with China. Kazakhstan enjoys preferential trade with Russia, but is steadily reducing imports from the country (including those in transit to China) while increasing its own exports to China, as well as sales of Turkmen gas, by building pipelines between Turkmenistan and China.

The situation in Russia’s south-western neighbourhood is even worse. Moldova is under partial Russian control through the influence of Moscow-sponsored Transnistria, but it has little economic or strategic importance. Russia’s major former ally, Ukraine – a large market with high demand for Russian gas and extensive exchange of labour and technology with Russia – has, after 20 years of bouncing back and forth, abandoned Russia to pursue the faint chance of joining the European Union. The Russian reaction has been counterproductive: Russia’s attempt to use geopolitical tools from the past left Ukraine severely injured but alive, and even more alienated from its former protector. The policy brought Moscow a whole set of new economic problems: in particular, it prompted the EU to reinvigorate the slow and indecisive process of diversifying hydrocarbon suppliers away from Russia. Russian rivals such as Saudi Arabia, also hurt by the fall in oil prices and trying to pump and sell as much as possible, immediately stepped in.

A geopolitical rather than geo-economic power

Modern Russia – with only a few small and not very loyal economic allies, an inefficient economy, and undiversified exports both in terms of products and consumers – cannot play a great power role anywhere in the world, and cannot lift its economy out of a continuing nosedive. Russia relies mainly on two well-tested geopolitical tools. It also employs two geo-economic tools, but continues to approach these with a geopolitical mindset.

The first geopolitical tool is military might. Russia still has nuclear weapons and large armed forces. This makes a direct conflict with the major powers unlikely, and allows Russia to use its military strength both to defend its economic interests (which has proved largely inefficient) and to interfere with the interests of its rivals. Russia's recent actions in Syria are seemingly aimed not only at maintaining the high domestic popularity of President Vladimir Putin, but also at ensuring instability in the region. Its intervention helps prevent the creation of trans-Syrian pipelines and hinders Saudi attempts to increase their share of the European energy market. It is not inconceivable that Russia will undertake further actions that increase the probability of a major war in the Middle East. It could increase its military presence and the territorial scope of its operations, arm Iran, and try to draw other parties into the action – all in the belief that more turmoil could result in a significant rise in oil prices and cut Middle Eastern supply lines to Europe.

The second geopolitical tool is Russia's relatively strong position in the international political system. This is bestowed by its veto power in the UN Security Council, and strengthened by its "funds in exchange for loyalty" policy towards many smaller countries. Russia behaves as a minority shareholder with blocking rights in the enterprise called "the world" and tries to apply standard minority shareholder tactics, such as "greenmail"² (or even blackmail) and slowing decision-making in order to force larger players to exchange relief for better security or trade conditions, or other benefits.

Besides these geopolitical strategies, Russia is employing two geo-economic strategies: looking for markets outside the Western zone of influence, and leveraging its own power as a market.

First, having been defeated in the majority of markets where it competed directly with larger economies, Russia has mastered the strategy of targeting markets where the economic superpowers of the US and EU do not freely operate. It develops trade relations with traditional enemies of the West, and countries the West does not want extensive relations with, partnering with countries that want to hedge against superpower dominance and/or diversify their trade partners

² Greenmail is the practice of purchasing enough shares in a firm to threaten a takeover, forcing the target to buy shares back at a premium.

(particularly with regard to arms). Russia uses every chance to turn smaller countries away from larger ones – through political intrigues, through offering very beneficial trade terms and financial conditions (in most cases incurring losses for Russia itself), and through the provision of a few developed technologies and goods (from oil and gas to nuclear power stations) at favourable prices. Its relations with Angola – including the supply of arms and ammunition financed by Russia’s VTB Bank, aid for Angola’s domestic oil and diamond industries, and consistent Angolan support for Russian moves in the UN – provide an example of such policy. (However, Angola has surpassed Russia in oil sales to China in 2015 – illustrating that Russia’s political manoeuvring does not always bring positive economic results.)

Second, in the new era, when businesses compete not for resources but for markets, Russia, as a midsize market, is trying to use its consumer power to influence its partners. Examples include regular bans on the import of various goods, pressure on certain international companies (as in recent cases involving French supermarket Auchan and home-furnishings retailer IKEA³), recent “anti-sanctions” targeting countries that have imposed sanctions on Russia, and current plans to impose unprecedented economic measures against Turkey. These measures openly aim to influence the behaviour of suppliers and even countries, to punish “bad” partners – and reward loyal ones (like Belarus).

Although none of these four tools work particularly well, Russia does not seem to be developing a new toolbox. Instead it has started to prepare itself for a long-lasting recession, shifting the focus of defending its economic security from diversification to isolation, and the “sovereignisation” of major infrastructure – from IT and transportation to payment systems.

This will not solve Russia’s problems, which means that it will soon have to look for new sources of growth. Two such sources are easy to name – a role as a transit point between China and the EU, and cheap industrial production based on the massive import of cheap labour from poor regions. Many others can be identified. These alternative generators of growth rely on access to large-scale investment, which would be readily available if Russia could modernise its political and

³ Both were accused by Russian authorities of violating legislation, in the context of tensions in Russian-French relations, and IKEA’s refusal to pay bribes, respectively.

legal system, and modify its foreign policies from their current hostile form to a more cooperative one. But so far there are no signs that this will happen in the near future, leaving Russia stuck in old patterns of geopolitical strategy without a geo-economic foundation.

*Dag Harald Claes, Andreas
Goldthau & David Livingston*

23

Saudi Arabia: Harnessing the oil market

Oil is localised – it cannot be produced where reserves don't exist – and yet it is the lifeblood of globalisation. A country that dominates the oil market, which is the world's largest commodity market, is automatically an influential player in international economic affairs and, by proxy, international politics. Oil is, in other words, a perfect example of the intertwined nature of geography, economics, and politics. This relationship is usually framed in terms of geopolitics, with grand strategic thinking dominating economic rationales in the oil market. In short, energy is seen as a means to an end. A geo-economic perspective on oil, by contrast, appreciates that actors are constantly balancing their economic and political interests, and that economic considerations can drive politics.

Saudi Arabia is the pivotal actor in the global oil market, thanks to its output of roughly 10 million barrels of oil per day. The kingdom's geo-economic power rests on its strategic positioning in the oil market and its ability to exert influence in this market. In order to understand the

political role of Saudi Arabia, one needs to understand its *economic* role in the world's prime energy market.

Saudi Arabia's geo-economic might

The key element in Saudi Arabia's geo-economic rise was its fostering of the Organization of the Petroleum Exporting Countries (OPEC), which catapulted the developing state of minor economic size onto the international stage. Saudi Arabia has used OPEC as a platform for increasing its prestige and projecting itself beyond the Arab region, translating its market power into broader international economic leverage.

OPEC gained prominence in 1971, when a lack of unity among the Western international oil companies met a newfound unity among most OPEC members, and market dominance shifted from the companies to the oil-producing states. Since then, OPEC has had a major impact on the size and structure of the oil market, along with managing the economic ebbs and flows of market cycles. For Saudi Arabia, the leading OPEC nation, the organisation came to be the key channel through which its policy priorities were enacted.¹

The organisation has faced challenges. OPEC underestimated both the negative demand effects and positive effects on non-OPEC production during the high price period of 1980–1981, and the resilience of the non-OPEC producers as the oil price fell again in 1986. Internal cohesion among OPEC members has been consistently weak, as demonstrated by repeated violations of allocated production quotas.² Even the Arab countries' oil embargo of 1973 – the “oil price shock” – was an unsuccessful attempt to use OPEC's market power to reduce the United States' support for Israel during the Yom Kippur War. In public perception, however, the events of 1973 firmly established OPEC as an influential international force, with Saudi Arabia as its unofficial leader.

The foundation for Saudi Arabia's leadership in OPEC and the global market lies in Riyadh's unusually farsighted behaviour, forsaking short-term gains and even bearing short-term losses if they are perceived to serve long-term goals. For this reason, the country took the strategic

¹ Robert Mabro, “OPEC and the Price of Oil”, the *Energy Journal*, 13 (2), pp. 1–17, 1992.

² Andreas Goldthau and Jan Martin Witte, “Assessing OPEC's Performance in Global Energy”, *Global Policy*, 2 (Special Issue), pp. 31–39, 2011.

Figure 1: Saudi oil production vs oil price 1972-2014



Source: BP Statistical Yearbook 2015

decision to aggressively exploit its reserves and expand its production and export capacity.³ Since 1980, approximately one in every five barrels of oil on the global market has come from Saudi Arabia. A large reserve base has not only provided the kingdom with market leverage, but has allowed Riyadh to influence OPEC decisions, to discipline the notoriously disunited organisation, and hence to project political power (including a longstanding tacit alliance with the US). Its large reserve base also provides the basis for Saudi Arabia's more recent positioning and strategy: its spare capacity (created by strategic underproduction) serves as an important deterrent to substantial investment by fringe suppliers, as a decision by the kingdom to open its taps could quickly undermine the profitability of any new or planned project on the upper end of the cost curve.

With this strategy, Riyadh seeks to balance short-term revenue maximisation against the long-term goal of ensuring sustained demand

³ Dag Harald Claes, *The Politics of Oil—Producer Cooperation* (Boulder: Westview Press, 2001), p. 210.

for its oil over many decades. Given that it must weigh the strategic behaviour of other actors, such as Iran's re-emergence as a key player in global energy or the increased unconventional oil production in North America, Saudi Arabia's economic positioning necessarily involves political methods, though it has not used oil as an *explicitly* political tool since the 1973 crisis. As the Saudi deputy oil minister commented in 1972: "You always hear that you can't separate oil from politics. I simply do not see why not".⁴

Saudi Arabia has demonstrated its willingness to take bold strategic decisions to develop the market. A case in point is the events surrounding the 1986 "counter-shock": demand had softened following price increases caused by the Iranian Revolution and, later, the outbreak of the Iran–Iraq war. Saudi Arabia took up the burden of cutting production, far more than any other OPEC member, as a means to sustain prices, reducing its output from 10.3 million barrels per day (mbd) in August 1981 to 2.3 mbd in August 1985. Then, in December 1985, it flooded the market, pitting producers both inside and outside of OPEC against one another. The oil price dropped from \$26 per barrel in December to \$10 in July 1986. With this move, Saudi Arabia became the architect of a market-share strategy which had a material impact on global economic fortunes, locked in a hydrocarbon-based development model, and moved the oil market to where it is today (see Figure 1).

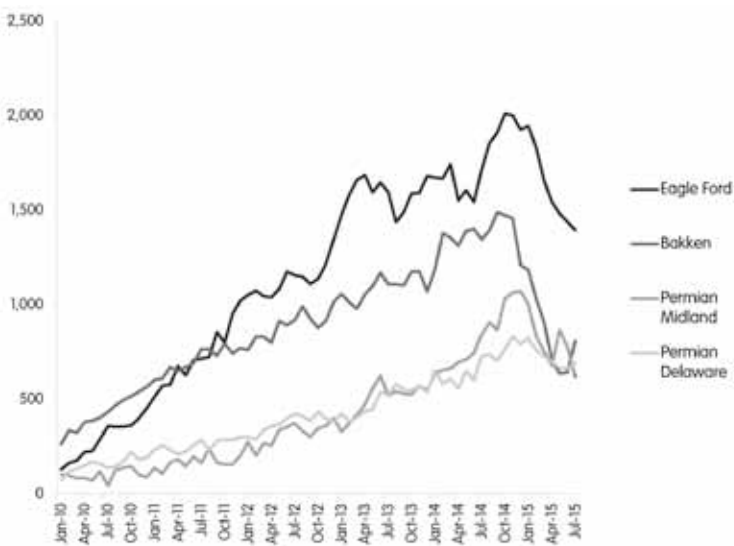
The threat from shale

Today, Saudi Arabia's market position and leverage is being challenged by various upheavals. Domestically, booming oil demand threatens to cannibalise its exports. The country's crude oil consumption has been rising by 6 percent per annum over the last decade, driven by growing demand for petrol and diesel, as well as increased electricity generation from crude oil. Total domestic crude burnt for power generation is on track to reach 1 mbd within five years – 10 percent of the country's current output – up from 0.8 mbd today.⁵ Another 1.4 mbd of crude production that was available for export prior to 2013 will be needed to feed new domestic refineries that have come online

⁴ Deputy Oil Minister Saud al-Faisal in *Petroleum Intelligence Weekly*, 20 November 1972.

⁵ Jim Krane, "A refined approach: Saudi Arabia moves beyond crude", *Energy Policy*, Volume 82, July 2015, pp. 99–104.

Figure 2: Drilled but uncompleted (DUC) trends for major US shale oil plays 2010-2015



Source: Rystad Energy NASWellData

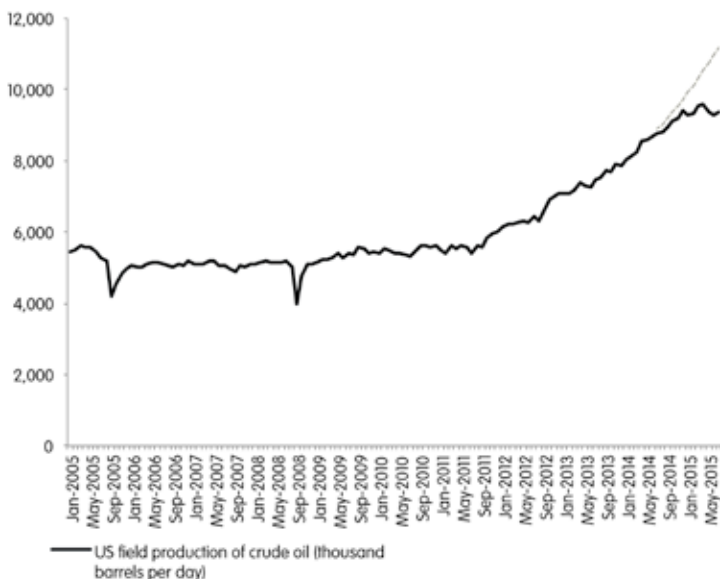
or will be completed in the next several years. By 2018, Saudi Arabia's refining capacity will have increased by almost 60 percent since 2013, to 5.7 mbd, up from 3.3 in 2013.⁶

This build-up of domestic refining capacity is the result of a number of geo-economic factors: Riyadh's desire to muscle its way up the global petroleum value chain and appropriate a larger share of the rents; the threat of its heavy and medium crude oil being squeezed out of the strategic US Gulf Coast refining market amid increased competition; and the need to drive industrial and job growth for continued domestic stability. The expanded capacity could mean that Saudi Arabia's crude oil export capacity will decline to less than 5 mbd by 2020, despite it recently registering record production capacity of 10.3 mbd.⁷ This

⁶ Saudi Aramco, *Annual Review 2013*, available at <http://www.aramcoservices.com/Publications/Annual-Review.aspx>.

⁷ OPEC, *OPEC Monthly Oil Market Report: April 2015*, available at http://www.opec.org/opec_web/en/publications/338.htm.

Figure 3: US crude oil production trends 2005-2015



Source: US Energy Information Administration

threatens the country's spare capacity, a key tool that has been called upon in recent years to balance supply and demand when prices spike. It could undermine the kingdom's role as the world's swing supplier and thus place in question the international political status it derives from its dominance of the oil market.

Many have argued that, as Saudi vacates the role of traditional swing supplier, the US shale oil sector is stepping in to take its place. After all, shale demonstrates a number of key characteristics that position it to play a unique role in the oil market, including low upfront capital costs (approximately \$5–8 million dollars per well), short times from drilling to production (as well as rapidly declining output rates), and the ability to turn production “on and off” relatively quickly in line with price movements.⁸ As the oil price started to fall in 2014, many shale

⁸ EY, “US upstream: costs, prices and the unconventional treadmill”, 2014, available at [http://www.ey.dk/Publication/vwLUAssets/EY-US-upstream-costs-prices-and-the-unconventional-treadmill/\\$FILE/EY-US-upstream-costs-prices-and-the-unconventional-treadmill.pdf](http://www.ey.dk/Publication/vwLUAssets/EY-US-upstream-costs-prices-and-the-unconventional-treadmill/$FILE/EY-US-upstream-costs-prices-and-the-unconventional-treadmill.pdf).

companies continued to drill while halting completion activity, leaving a vast backlog of “drilled but uncompleted” (DUC) wells that could be brought into production even more rapidly – days, rather than weeks – if prices rise sufficiently.

As prices fell further in 2015, however, shale production growth unexpectedly continued – albeit at a reduced pace. This owed in part to substantial cost reductions and efficiency improvements on the part of a US shale industry under strain, and also in part to futures market hedging that protected a portion of shale oil production from the immediate effects of falling prices. However, a significant portion of gravity-defying growth in US shale supply in the first half of 2015 is due to the use of DUC wells that had been built up over the previous year. From its peak in 2014, the number of DUCs fell 35 percent across the top three US shale plays (see Figure 2) by July 2015, as they were quickly tapped – not amid rising prices, but simply to keep production running in order to service debt accumulated through low-grade bonds.⁹

The marvel of the US as a new swing producer is fast revealing itself to be a myth. Not only is the putative US equivalent of Saudi spare capacity, the DUC backlog, quickly diminishing, but the collective production decisions of hundreds of individual shale firms cannot be compared to the centralised strategic thinking of the Saudi oil policy apparatus.

There is no doubt that shale has added new competition to the oil market and forced Saudi Arabia’s hand to some degree, but it would be a gross exaggeration to suggest that it is assuming the role of the oil market’s new swing supplier. Indeed, Riyadh has played a clever geo-economic hand by forcing the shale industry to reveal its price elasticity and decision-making patterns in a low-oil environment, all the while ensuring stable (albeit diminished) oil rents for itself. US shale production has switched from a paradigm of growth to one of survival, as shown by comparing recent production trends to a counterfactual scenario in which growth trends prior to the oil price crash are extrapolated (see Figure 3).

⁹ Asjlyln Loder, “The Shale Industry Could Be Swallowed By Its Own Debt”, *Bloomberg*, 19 June 2015, available at <http://www.bloomberg.com/news/articles/2015-06-18/next-threat-to-u-s-shale-rising-interest-payments>.

Nevertheless, this comes at a time when cohesion and coalition-building within OPEC is arguably more critical for Saudi Arabia than ever before. There is the threat that the unconventional oil revolution in the US could be replicated elsewhere, from Argentina to China and beyond. Deep offshore oil and heavy oil sands, though struggling with high costs, wait in the wings. The diversity of producers has grown, production has diffused, and efficiency and lower input costs lead to overall lower breakeven costs. Moreover, the shifting fortunes of key producers previously relegated to the sidelines (such as Iran and Iraq) threaten to dramatically reshape intra-OPEC dynamics. OPEC did away with individual production quotas in 2008, making it less capable of identifying and holding accountable those who contribute to overproduction.

What next for Saudi dominance?

The geo-economics of energy, and particularly of oil, cannot be considered as merely another arrow in the quiver of statesmen and stateswomen. As the case of Saudi Arabia demonstrates, it is instead the story of how actors, through the choices they make with respect to their resource endowments, shape the institutions and markets in which these resources are traded, which in turn bestow leverage and power upon the actors.

Saudi Arabia's *sui generis* position in global oil markets continues to be the country's primary geo-economic instrument (the other being its significant accrued financial capital). Today, rapidly changing global oil markets present fundamental challenges to Saudi Arabia's ability to use its resource endowment to project global market power. Yet, even if Saudi Arabia's star is set to fade, there is no actor – whether the US shale sector or otherwise – lined up to take its place. While the geo-economics of oil present a study of power, they also involve a study of market governance and of how to stabilise notoriously volatile commodity cycles. Saudi Arabia losing its dominant position in the geo-economics of oil, then, might be considered as the study of an incumbent power reconciling itself with a newly multi-polar oil market, rather than the oversimplified and overdone analysis of North American unconventional oil production as a newfound geopolitical tool.

Saudi Arabia's geo-economic dominance will increasingly come under scrutiny. One should not sound the bell too early, however. The country has proven flexible, adaptive, and opportunistic when faced with previous market upheavals. A changing market structure in the years ahead is almost inevitable, but the diminishment of Saudi geo-economic strength is not.

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Acknowledgements

This essay collection is an attempt to lay out a different prism for thinking about global order, economics, and geopolitics in the hope that it might lead Europeans to think about their foreign policy in a new way. It is a product of an ongoing programme with Stiftung Mercator called *Rethink: Europe*. We would like to thank Stiftung as a whole but in particular Michael Schwarz and Verena Ringler for their important inputs on the project. Josef Janning has been the instigator, leader, and driving force of that project within ECFR, and has been ably assisted by Christoph Klavehn.

ECFR's geo-economic voyage has involved lots of fruitful discussions within the organisation. We would particularly like to thank Sebastian Dullien, Anthony Dworkin, José Ignacio Torreblanca, Carla Hobbs, and Hans Kundnani for their input on the broader concept, while Susi Dennison, François Godement, Daniel Levy, Kadri Liik, Vessela Tcherneva, and Nick Witney have helped us work out how it relates to ECFR's practical agenda. One of the most exciting learning experiences on these issues has been the privilege of chairing the Global Agenda Council on Geo-economics for the World Economic Forum. I would like to thank Karan Bhatia, Ian Bremmer, Nik Gowing, Sergei Guriev, Victor Halberstadt, Parag Khanna, Hina Rabbani Khar, Paul Laudicina, Michael A. Levi, Kishore Mahbubani, Takashi Mitachi, Moisés Naím, Pan Wei, Douglas Rediker, Gideon Rose, Dmitri Trenin, and Wu Xinbo for being so generous with their ideas and for challenging so many of my pre-conceptions in our various discussions in Abu Dhabi, Dubai, Davos, and the virtual realm of conference calls. I am also very grateful to Anja Kaspersen and Isabel de Sola at the World Economic Forum for all of their ideas, and the inspirational Espen Barth Eide for getting me roped in at the outset.

Apart from that, I have had enlightening exchanges with Stuart Levy on sanctions, while Joe Nye has been my mentor for a number of years on many aspects of power, including the idea of economic statecraft.

Ulrike Franke's chapter is an attempt to complement the widespread academic work on economic coercion carried out by the West with a picture of the tactics, strategies, and responses developed by other established emerging powers in the G20. She relied on a group of researchers who completed detailed questionnaires on the relevant countries. We would like to thank Deborah BL Farias (Brazil), Ondrej Wagner (China), Stephanie Lee (China), Rishika Chauhan (India), Ali Ghezlbash (Iran), Jamal Ibrahim Haidar (Iran), Kazuto Suzuki (Japan), Dawid Jarosz (Russia), Altay Atli (Turkey), Gustav Venter (South Africa), and Yunhee Choi (South Korea) for their role in this survey.

As the scope, length, and ambition of this volume have grown, so too has the challenge for our editors. We would like to thank Hannah Stone and Gareth Davies for lending greater clarity and elegance to the ideas and language, and Richard Speight for making sure that the volume as a whole and the introduction in particular tell clear and understandable stories.

Above all, I must thank Ulrike Franke, my remarkable co-pilot, who has shaped and led all the stages in this enterprise, from the design of the volume and the selection of authors, to the editing of the texts. Her intellectual curiosity and range have given this collection far greater depth and coherence, while her organisational flair, discipline, and good humour have inspired everyone involved. Without her this volume would quite simply not exist.

Icons used for the infographics in this volume were designed by FreePik.

When Turkey shot down a Russian fighter jet in November 2015, calls for revenge exploded across the Russian media and internet. Protesters hurled stones and eggs at the Turkish embassy, and a leading TV talk show host compared the incident to the assassination of Archduke Franz Ferdinand, which triggered the First World War. So how did Putin respond to the battle cries of his people?

He signed a decree halting fruit and vegetable imports from Turkey, banning charter flights and the sale of package holidays, and scrapping Russia's visa-free regime with the country. His proxies warned about possible escalation involving energy imports, while the media speculated about cyber-attacks.

The most important battleground of this and future conflicts will not be the air or ground but rather the interconnected infrastructure of the global economy: disrupting trade and investment, international law, the internet, transport links, and the movement of people.

Welcome to the connectivity wars.

MARK LEONARD

With contributions by:

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A publication made possible by:

ECFR/155

ISBN: 978-1-910118-55-9

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