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In the Clutches of Dictators?

Why We Must Reduce Economic Dependence
while Resisting Isolationist Tendencies

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The fatal dependence on Russian energy supplies has quite rightly catapulted trade and economic policy into the centre of the German debate. But criticism of German energy policy over the last few decades must not encourage isolationist illusions. Harmful dependencies must be identified and reduced, but economic policy focused on broad trade remains central for Germany and Europe.

The current debate on the impact of economic interdependence with foreign powers is primarily focused on the associated political risks, while the opportunities are largely ignored. The risks should not be overlooked, of course. However, it is important to adopt a nuanced perspective that distinguishes between harmful dependencies and beneficial economic relationships.

Whenever a company decides against producing necessary goods itself, and instead purchases them from another company, a dependence on this supplier arises. In principle, dependencies can be neutralised with preferably long-term supply contracts and functioning rule of law. The company can also mitigate them by purchasing from several different suppliers, allowing it to cope with the loss of a single supplier.

The situation becomes more difficult when there are only a few suppliers, and all of them are abroad. In this case, the German state has few options for enforcing contracts if there is a conflict. This problem can be addressed through trade agreements with other countries. Provided there is long-term legal security in the other country, as in EU states, there is not much need to worry. This condition is least fulfilled in authoritarian countries, where legal certainty scarcely exists at all. So, it is not surprising that precisely these states give rise to the greatest risks – not just business risks for individual companies, but risks that threaten the entire German economic system if such dependencies are concentrated. This was impressively demonstrated in the case of

Russian gas. The difficulty of avoiding business relations with autocracies and other problematic partners was illustrated when German Federal Minister for Economic Affairs Robert Habeck visited Qatar (not exactly a model democracy) to try to arrange a replacement for gas supplies from another authoritarian state, Russia.

But there is also a plethora of non-political risks that may arise in friendly states, or even domestically: natural disasters, pandemics, supply route blockades, and others. So even in a world in which we would only purchase goods from friendly states, these risks would remain. And even the political risks in trade relations are not limited to authoritarian states: Brexit, which has almost been forgotten, quickly changed rules governing trade with the United Kingdom, for instance.

However, and this is often overlooked at the moment, economic interdependence invariably entails not only risks, but also opportunities. The classical economist David Ricardo recognised this more than 200 years ago and expressed it in his famous comparative advantage theory: if companies from different countries trade with one other, each can focus on producing the goods for which it is the most competitive. The resources in both countries are thus used more efficiently, and prosperity increases. No matter which country is more competitive, both benefit. Trade also leads to exchange of knowledge and innovations, which is important for a leading industrial nation like Germany.



Federal Chancellor Olaf Scholz visiting Saudi Arabia and other Gulf States in September 2022: For the time being, Germany cannot dispense with non-democratic partners in its attempt to decouple from Russian energy supplies. Source: © Andreas Rinke, Reuters.

As long as it is not compelled militarily, and thus becomes robbery, trade is always economically advantageous in the medium term – otherwise the partners involved would not engage in it. On average, trade with authoritarian states is actually particularly lucrative: since it involves higher risks for the companies involved, they engage in it only when profits are correspondingly high. Trade therefore always implies risks as well as economic gain. The greater the risk of a business deal collapsing, the greater the profit if it succeeds. The risk of dependency on authoritarian states is attracting great attention in current debates. How serious is the risk in reality, and what is the best way to react to it?

The Extent of Dependencies

First, it is worth examining the extent and structure of economic interdependence with authoritarian states: only in the event of a high proportion of individual authoritarian states, problematic dependencies may arise. On the other hand, if the overall volume of trade is distributed across several such states, the overall outlook is unproblematic, at least economically, since trade with one problematic supplier can be replaced with trade from another. Theoretically, autocrats could coordinate with each other and form a “cartel of authoritarian countries”. But this seems unlikely since authoritarian rulers



do not tend to engage in long-term cooperation – not even with other autocrats.

Economic interdependence can be subdivided into three different dimensions:

1. according to sales markets;
2. according to supplier parts imports;
3. according to raw and basic materials imports.

The US followed by China are the most important individual sales markets for Germany, closely followed by France and the Netherlands. But if the EU were a single country, it would be Germany's most important export market by far. Germany's exports to EU countries are about seven times larger than those to China.

Any attempt to determine the proportion of German exports that go to authoritarian states encounters the difficulty of clearly defining what an authoritarian state is. There is no unambiguous nor universally acknowledged definition of an authoritarian country or of a dictatorship. We will therefore use the widely recognised indicator of the non-governmental organisation Freedom House¹, which divides states into the “free”, “partly free”, and “not free” categories. We will consider “not free” states to be authoritarian countries.

Dependence on supplier parts from China is often overestimated.

Germany's 100 most important export destinations include 22 states that fall into the “not free” category. Taken together, they constitute almost 13 per cent of the value of exports to the 100 most important countries. In 2021, the only truly significant ones were China and the Russian Federation, the latter ranking 14th. The next “not free” states are the United Arab Emirates in 34th place, Saudi Arabia in 38th place, and Thailand in 43rd place. Excluding China, the

authoritarian states account for only five per cent of exports to the 100 most important countries. Thus, there does not appear to be a significant dependency on such states.

But the general overview is not everything. Large individual companies, and with them their suppliers, are much more strongly dependent on the Chinese market. The data relevant to this question is sparse, and those concerned obviously do not like discussing it. Extensive research by the Handelsblatt² from February 2021 concluded that China is the largest single market for BMW, Daimler, Infineon, Adidas, and Volkswagen. It showed that Volkswagen sells 41 per cent of its vehicles in China. Yet the 40 DAX (German stock index) companies average only 16 per cent of turnover in the People's Republic. This indicates that other important German companies are much less dependent on business in China than Volkswagen is, for instance. Even if the overall economy is only moderately dependent on China as a sales market, and not at all on other authoritarian states, it is still true that individual, and very important, companies are in the clutches of China's Communist Party.

The question of import dependence, on the other hand, is much more complex. For one thing, dependence on supplier parts from China is often overestimated. The overall share of German imports from China is quite high, as a study by the German Economic Institute shows.³ For instance, China's proportion of the EU's value added is 13.6 per cent. But an ifo Institute for Economic Research study⁴ commissioned by the Konrad-Adenauer-Stiftung shows that a large percentage of these imports can be sourced relatively easily from other countries or replaced by similar parts. Problematic dependencies on China or other authoritarian states are only present for well below one per cent of these imports.

Yet the raw materials import dependency situation is much more worrying. It is widely known that Germany imports almost all its fossil fuels from abroad, with a large part of those purchases



Rare earth metals mine in China: Several metals important for industrial production – and even more so, their respective processing capacities – are concentrated in the People's Republic. [Source: © Reuters.](#)

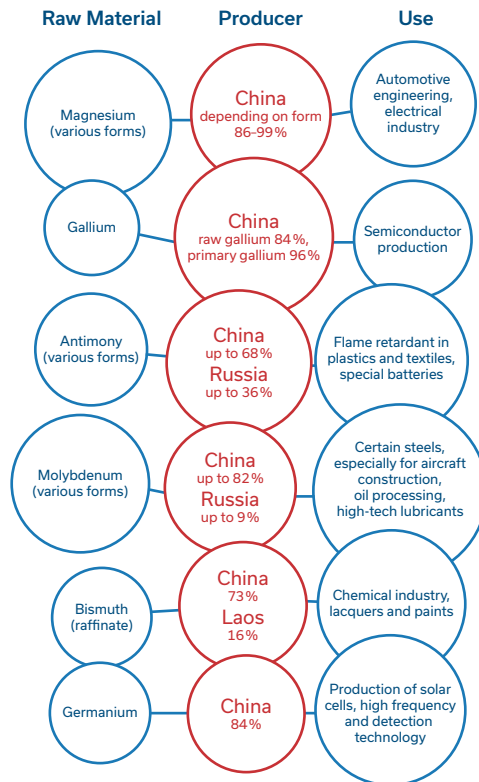
having been from Russia until now; in future they will come increasingly from other autocracies such as the Gulf states. But in the procurement of important industrial metals, there is an even greater concentration on a few supplier countries, especially China, as figure 1 shows.

Much of the concentration on China is not because the metals listed are themselves concentrated there. China as a country with a great surface area has access to many sources of raw materials, but its dominance in the raw materials extracted is due to the fact that China has succeeded in concentrating large swathes of the global processing capacities within its borders over the past 20 years. It did this with state support and aggressive export subsidies. This made raw materials in China so cheap that it was not profitable for other parts of the world to produce them themselves. This is particularly noticeable for magnesium: although it is one of the most common elements on earth, many magnesium products still come almost exclusively from China. Theoretically, China would not only be able to exploit its quasi-monopoly through high prices but could also use it for political manoeuvring. To date, China has rarely tried this with the EU. But even this analysis shows how closely advantages and disadvantages are connected: China's subsidies provided German industry with cheap raw materials in virtually inexhaustible quantities. The Communist Party has thus indirectly subsidised German industry for years with many billions of euros.

What Can Be Done?

How can Germany react to this situation? With regard to sales markets, incentives for diversification could be created by having the German Chambers of Commerce Abroad expand their quite successful market development programmes, while also making them less complicated and more focused on small and mid-sized companies. It would be a good idea to concentrate more on peripheral states, since there is sufficient experience in states where German companies are very active anyway, such as China and Vietnam, and thus additional consulting

Fig. 1: Origin and Use of Selected Raw Materials in German Industry



Source: BDI Federation of German Industries 2022: Analyse bestehender Abhängigkeiten und Handlungsempfehlungen, 27 May 2022, in: <https://bit.ly/3SFb6t1> [12 Oct 2022].

is not necessary. Such diversification need not be friendshoring, aiming at establishing new supplier relationships with democracies only. A “non-political” diversification, especially one at the expense of China, reduces the likelihood of dependency on individual authoritarian states.

Such a diversification strategy also includes economic partnerships and free trade agreements. Everything that facilitates market entry abroad leads to more trade. Partnerships with India, the Southeast Asian ASEAN states, and the South American Mercosur, as well as an ambitious trade policy towards Africa, should be at the top of the agenda. Any progress in free trade with the US would also be welcome. Such agreements would also help for imports, since

they make it easier for foreign exporters to do business in Germany. The German Chambers of Commerce Abroad should thus interpret their mandate more strongly in both directions.

But this solves very few of the raw material import dependence problems outlined above, since those problems are related to a concentration of production capacity among a few countries. In this context, the current problem with Russian gas appears solvable at least in the medium term since other suppliers can deliver enough gas (albeit not at the same price). However, for the above-mentioned raw materials from China, the situation is different. In the short term, the problem can be minimised with targeted stockpiling – with government support, if necessary. But in the longer term, Germany and the EU must contribute to creating new capacities outside of China. This does not necessarily mean that these capacities will be established within the borders of Europe. Countries like Chile and Argentina, as well as North African states are attractive as partners for the production of critical metals not only because of the availability of natural resources, but also of renewable energies. This is all based on state industrial policy and massive subsidies in these industries.

Even authoritarian regimes are interested in functioning trade and economic relationships.

To ensure that such highly problematic regulatory instruments are applied only when the market offers no other solutions in the long term, the first thing to invest in is a comprehensive screening of dependencies in the purchase of important raw materials. Such screening would provide objectively verifiable data that can be used to make transparent decisions about subsidies for individual industries.

A theoretical alternative for generating more domestic capacities in raw materials production would be to impose tariffs on raw materials

imports so that expensive local production becomes competitive again. In addition to potential Chinese counter-reactions, this has the disadvantage of making previously imported goods much more expensive and possibly scarcer. For the energy revolution, supplies from China will be indispensable in the medium term, even if the establishment of great capacities of raw materials for solar modules and batteries outside China were to begin today. So, it seems advisable to continue to purchase relatively cheap metals from China for the time being, while alternative capacities are being built up as quickly as possible.

However, establishing processing capacities for strategic metals does not solve the problem that ore deposits, which yield the aforementioned metals, are in some cases concentrated among a few countries. The Democratic Republic of the Congo, for example, has half of the global cobalt reserves; other important reserves are in Cuba and Russia. Kazakhstan controls almost half of the global supply of chromium, and half the supply of bismuth and tungsten is in China.⁵

The concentration among a few countries is a much smaller problem than the processing capabilities problem outlined above. But it is certainly the case that for many materials, authoritarian states are the main suppliers of many raw materials, though not for all. The only remedy here is good and, ideally, contractually fixed trade relations – especially with authoritarian states, since that is precisely where there is a great need for regulation. Ultimately, there is no way to avoid trading with unsavoury partners. The Comprehensive Agreement on Investment (CAI) between the EU and China, which has now been put on hold, was an attempt at agreeing on minimum standards with an authoritarian regime. There are good reasons why this agreement failed politically. Among them are the sanctions imposed in 2021 on members of the EU Parliament, and the objective of not further increasing the concentration of certain industries in China; a concentration that is already problematically high. But in essence, it is the right idea. Such agreements, even if undemocratic regimes

implement them only partially, place German companies operating in authoritarian states in a much stronger position, enabling them to contribute to Germany's supply security. After all, authoritarian regimes are interested in functioning trade and economic relationships, too. If they sign an agreement with the EU, their reputation as a business-friendly country alone will motivate them to act if the agreement is broken, since such violations would become public and greatly decrease the tendency of potential partners to trade with and invest in such states.

Summary

In the medium term, it will be quite possible in many cases to reduce undesirable linkages that are perceived as a dependency. But doing so is an expensive business for two reasons: first, it dispenses with the previous, cheap suppliers. Second, supplying the replacement domestically requires large investments. In times of high inflation, it is especially important to carefully consider which interdependencies with foreign countries are considered major risks, and where there is therefore willingness to pay a higher price to acquire raw materials.

It is also important to make this assessment based on good information, especially because many raw materials are located primarily in authoritarian states. What is more, Germany's prosperity depends on exports to countries all over the world. Generalised concepts such as friendshoring, where attempts are made to trade only with politically acceptable countries, are therefore certainly not a good idea. Placing such political conditions on trade relations is also difficult in theory. How are transparent decisions according to fixed categories to be made about what countries fulfil requirements of democracy, human rights, and sustainability? For these three categories alone, there are many indicators, all of which result in slightly different rankings. It can thus be difficult to draw a clear line between authoritarian states and democratic ones.

We will have to continue to engage in trade with non-democratic states. There will continue to

be raw materials for which there is little choice of supplier. It is good to diversify as broadly as possible and to establish domestic capacities where feasible and economically sensible. Work must also be done, especially with difficult partners, on formalising relations. This explicitly involves instruments that allow Germany and the EU to react robustly to measures used by other states to gain unfair competitive advantages. By proposing an instrument to counter economic coercion, the EU has already reacted to such measures.⁶ More important than coercive instruments, however, are screening instruments that clearly show where government intervention may be necessary – and, more important, where it is not. We should not abandon the German economy's successful collaborative model simply through fear of autocrats.

– translated from German –

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