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THE POLITICAL ECONOMY OF GEOECONOMIC POWER

Christopher Clayton
Matteo Maggiori
Jesse Schreger

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ABSTRACT

Great powers are increasingly using their economic and financial strength for geopolitical aims. This rise of "geoeconomics" has the potential to reshape the international trade and financial system. This paper examines the role of domestic political economy forces in determining a government's ability to project geoeconomic power abroad. We also discuss the role that persuading or coercing foreign governments plays in projecting geoeconomic power around the world.

Christopher Clayton
Yale School of Management
165 Whitney Avenue
P.O. Box 208200
New Haven, CT 06520-8200
and NBER
christopherdclayton@gmail.com

Matteo Maggiori
Stanford University
Graduate School of Business
655 Knight Way
Stanford, CA 94305
and NBER
maggiori@stanford.edu

Jesse Schreger
Columbia Business School
665 W 130th St
Kravis Hall, 551
New York, NY 10027
and NBER
jesse.schreger@columbia.edu

1 Introduction

The world has seen a stunning rise in the willingness of great powers to use their trade and financial relationships for geopolitical ends. This rise of "Geoeconomics" has the potential to reshape the international trade and financial system. Geoeconomic policies include not only sanctions but also the strategic use of export controls, efforts to reshape supply chains for security purposes, the provision of foreign aid to secure political alignment, and the encouragement or pressure on domestic and foreign firms to alter their business relationships. While the foundation of a nation's geoeconomic power is its economic strength, size and connections alone do not automatically translate into geoeconomic power. Instead, governments seeking to project geoeconomic power abroad need to be able to credibly co-opt or coerce their domestic firms and citizens, and perhaps critical foreign allies, to take part in this power projection. Achieving this involves navigating a range of political economy constraints at home, including legal restrictions, domestic political objectives, interest groups and other forces that limit a government's ability to exert its influence. An important question for geoeconomic power projection is how far a government can push its own firms or allies to act against their private interests in pursuit of the country's geopolitical goals.

2 A Sketch of Geoeconomic Power

We begin by very briefly presenting the core constraint countries face when projecting geoeconomic power. This is a reduced form of the general framework developed in Clayton et al. (2023). Geoeconomic power is the ability to induce a (foreign) entity to take an action that they would not otherwise take. The key constraint on the exertion of geoeconomic power is how much the coercing government ("hegemon") can ask a domestic firm, foreign firm, or foreign government ("targeted entity") to do in order to preserve its relationship with the hegemon, before it prefers to sever the relationship and not take the hegemon's demanded action.[1]

We conceptualize geoeconomic power projection as the hegemon asking a targeted entity to take an action that the hegemon desires. The targeted entity chooses an action $a \in \mathbb{R}^N$ which delivers utility $\Pi(a, \theta)$ to the targeted entity, where Π is increasing in θ. Here, θ captures the economic and political environment facing the targeted entity, above and beyond its action a. Suppose the hegemon wants the targeted entity to take the action a^h. Assuming the hegemon can influence θ, it could offer $\theta = \overline{\theta}$ if the entity complies and threaten $\theta = \underline{\theta} < \overline{\theta}$ if the entity refuses. This gives rise to a participation constraint for the target entity. The hegemon asks the targeted entity to take an action a^h to maximize the hegemon's welfare $W(a^h)$, subject to this participation constraint. Formally, the hegemon solves

[1] While we use the language of hegemon to refer to the government pursuing geoeconomics, other countries pursue similar policies at a smaller scale.

$$\max_{a^h} W(a^h) \text{ subject to} \tag{1}$$

$$\Pi(a^h, \overline{\theta}) \geq \sup_{a \in \mathbb{R}^N} \Pi(a, \underline{\theta}) \tag{2}$$

The hegemon's objective can include not just the economic well-being of its citizens but also its own geopolitical objectives. For instance, the United States may care about reducing China's ability to produce advanced semiconductors for military use above and beyond the effect such production has on American consumption. The actions a can cover a range of possible firm or government decisions. These actions could be something as straightforward as buying more American goods. However, it could also include more geopolitically aimed actions. For instance, the United States might ask a German bank to reduce its business with Iran (with a corresponding to the volume of financing it provides to Iran). If the bank complies, then its American subsidiaries may continue to access the Federal Reserve's emergency lending facilities (a high $\overline{\theta}$), while if it refuses it may face full exclusion from the dollar-based financial system (a low $\underline{\theta}$). Alternatively, China might demand a developing country government drop its recognition of Taiwan, with the threat $\underline{\theta}$ being a loss of access to Chinese intermediate inputs. In this case, Π can be thought of as encompassing the target government's preferences rather than a more narrow definition of economic profits.

3 The Political Economy of Geoeconomic Power

The core of geoeconomic power projection is the ability to widen the gap a targeted entity faces between acceding to the request of the hegemon ("inside option") and refusing it ("outside option"). In the context of Equation 2, there are two ways that a hegemon can widen this gap: making the inside option better with a higher $\overline{\theta}$ or making the outside option worse with a lower $\underline{\theta}$. Suppose, for example, the targeted entity is a firm. If the hegemon is able to increase that firm's profits conditional on compliance, modeled in Clayton et al. (2023) as solving commitment problems and increasing enforcement via joint threats, then that firm is more willing to voluntarily comply. Conversely, the hegemon can make the firm's outside option worse by threatening to cut the firm off from one or more inputs (the focus of Clayton et al. (2024)). Here, we discuss how political economy factors determine the ability of governments to offer carrots and raise the inside option $\overline{\theta}$ or sticks to make the outside option $\underline{\theta}$ worse.

3.1 Domestic Political Systems

We begin by considering how much a government can ask of its own domestic firms. One case in which we expect differences is when we contrast a mature democracy with a commitment to the rule of law to an entrenched autocracy without such a commitment. In an autocracy with weak legal protections or commitment to the rule of law, the government faces fewer restrictions in punishing domestic actors that refuse to go along with their demands (i.e., lowering $\underline{\theta}$). The government can threaten non-compliant firms with expropriation, regulatory pressure, and the loss of government contracts. It may also directly threaten the owners of the firm with investigations or worse. If the autocratic regime is powerful enough, one can think that it effectively does not face a participation constraint at all when making demands of its domestic firms: they simply have to comply (i.e., very low $\underline{\theta}$). In addition, an autocrat may find it easy to directly buy off domestic firms in exchange for their cooperation (high $\overline{\theta}$).

In contrast, a mature democratic government may face a host of legal and institutional constraints in pressuring its own firms. Firms cannot be arbitrarily "punished" by the government for refusing to comply, particularly if there is no legal basis for the request. A democratic government might be able to ask the firm to take some actions in the national interest via moral suasion, but there are limits to how much a government can ask a firm to do. Conversely, it is also challenging for mature democracies to reward firms for complying. Explicit bribes are illegal, and it is generally challenging to finely target other forms of rewards like government contracts. All else equal, these democratic constraints limit the government's ability to raise $\overline{\theta}$. Hybrid regimes and oligarchies, by contrast, may find it easier to have its friends secure compliance of targeted entities via indirect payments, effectively offering the regime a more immediate way to raise $\overline{\theta}$ than is available to mature democracies.

In terms of the participation constraint of Equation 2, this would be a reason to believe that in a mature democracy $\overline{\theta}$ is relatively close to $\underline{\theta}$, dramatically limiting what a government may be able to ask of its firms. Indeed, when the Biden Administration tightened export controls on its firms selling cutting-edge semiconductors to China, firms started lobbying the government to loosen them (NY Times). This contrasts with the instances of geoeconomic coercion undertaken by China and outlined in Reynolds and Goodman (2023). For example, after Chinese dissident Liu Xiaobo was awarded the Nobel Prize in 2010, China drastically cut salmon imports from Norway in retaliation by instituting new inspections and regulations.

The preceding discussion comparing the constraints facing autocracies and democracies assumes a static equilibrium in which an autocracy may face fewer constraints. However, in a dynamic setting the nature of the constraints may change. In particular, if an autocracy repeatedly takes arbitrary actions, it may have a weaker economy, directly lowering its geoeconomic power, or other countries may sever their relationships with the country anticipating future coercion. Indeed, one force that may strengthen the ability of democracies to project geoeconomic power is their dynamic ability to commit to international agreements, tying their hands in a way that ultimately amplifies their ability to coerce (Clayton et al. (2024)).

3.2 Credibility and State Control

A key reason for differences in geoeconomic power between governments is their differential ability and willingness to carry out threats. Implicit in our objective function for the coercing country (Equation 1) is that the government's payoff depends only on the action taken by the targeted entity (a^h) but is independent either of the reward $\overline{\theta}$ or the punishment $\underline{\theta}$. While integrating the cost of offering the reward into the hegemon's objective, $W(a^h, \overline{\theta})$, is straightforward, because the punishment $\underline{\theta}$ is never realized on-path, issues of credibility arise. Governments would like to threaten the most severe punishment, but targeted entities may doubt that the government will actually carry through on its threats, particularly as it may be relying on private actors such as its firms to actually take the costly actions needed to enforce a punishment, such as cutting off profitable sales (Padró i Miquel and Yared (2012)).

The most direct way that a government can slacken the participation constraint of a firm and potentially resolve this credibility issue is to control the firm directly by acquiring it. This is one crucial area in which different domestic political systems act to differentially foster or constrain the ability of a country to exert geoeconomic power. In this respect, the United States and China are at opposite extremes.[2]

Consider first the case of China. Chinese state-owned enterprises have been active in directly acquiring foreign firms, ports, rare earth mines, and other assets that the government deems strategic. Liu (2023) documents prominent cases of the Chinese government acquiring firms in strategic sectors for the purpose of technology transfer. In addition, China has been utilizing its state firms to directly acquire critical minerals for strategic industries including in rare earths and funding strategic ports through the Belt and Road Initiative.

The United States finds itself in the opposite situation. Despite widespread concern in policy circles that China has acquired a near monopoly on critical rare earth materials, the U.S. government has limited means to directly take control of these resources. While the International Development Finance Corporation appears to be increasingly used for geoeconomic purposes, the U.S. faces significant limits on its ability to take equity stakes and target its lending for foreign policy aims. Even when the American government can directly invest or lend, it is generally limited to taking a minority stake and therefore has more limited recourse on directing the actions of the foreign firm.

The trade-offs on state ownership are not as simple as democracies versus autocracies. Indeed, in 2008 France launched a sovereign wealth fund (SWF), the Strategic Investment Fund, to guard French companies from being acquired by foreign "predators."[3] Unlike the Middle East oil states with SWFs recycling their petrodollars, the French fund was specifically designed to outbid foreign firms in their attempted purchase of critical French firms. More recently, we have seen a range of new policies designed to prevent foreigners from acquiring domestic strategic firms, including in mature democracies (Bauerle Danzman and Meunier (2023)). However, attempts to acquire strategically

[2]This analysis builds on the earlier work of Frieden (1994) on the political economy of colonial control.
[3]Financial Times via Liu (2023).

important foreign assets appear far more limited, with China by far the most important player.

3.3 Distributional Considerations

From the national perspective, the decision of how much to force domestic firms to privately sacrifice in geoeconomic power projection involves assessing whether the distortion of private activity is more than compensated for by the aggregate gains. In practice, geoeconomic policies are likely to have significant distributional effects. For instance, when the United States first announced restrictions on Nvidia's ability to sell cutting-edge semiconductors to China, its share price fell significantly on announcement. The costs of the policy might have been borne disproportionately by the owners of the firm, whereas any benefits of slowing China's ability to use such frontier equipment for military purposes accrued to the broader US public. How a government perceives the political impacts of these costs is likely to vary significantly. In the context of targeted controls, a relatively small number of firms in the sanctioning country are likely to bear the cost of the policy, with the rest of the country getting hurt far less. Depending on the nature of the political coalition and other aspects of the political structure, the government may find it more or less feasible to ask for sacrifices from certain firms. Indeed, exemptions to these policies could also be used to benefit entities friendly to the government. In the context of the participation constraint, this would dictate what $\underline{\theta}$ firms could lobby for, above and beyond the government's technical and legal capabilities.

Distributional considerations not only affect the feasibility of imposing certain policies but also can influence the long-term sustainability of geoeconomic strategies. Governments that consistently impose heavy costs on influential domestic sectors may face backlash at the polls or in the legislature. Indeed, one potential cost of geoeconomic power projection is that the targeted country may choose to respond in a way designed to hurt particular constituencies, as seen in China's retaliatory agriculture tariffs. In addition, if geoeconomic power projection is more politically palatable than simple protectionism and industrial policy, countries may pursue policies for distributional reasons under the guise of economic security.

3.4 The International Political Economy of Geoeconomic Power

The final dimension we consider here is the ability to convince or coerce foreign governments to pressure their own firms on the hegemon's behalf. While the U.S. may not be directly able to generate a threat powerful enough to lead a foreign firm to drop a profitable business line, it may have levers to pull that lead the firm's own government to force the firm to do so. This power was on full display when the Biden Administration tightened export controls on semiconductor manufacturing sales to China. The American government wanted to halt the sale of advanced semiconductor manufacturing equipment to China, but the pivotal equipment itself was not actually produced in the U.S. Most important was the Extreme Ultraviolet (EUV) lithography equipment produced by the Dutch firm ASML (Miller (2022)). The U.S. pressured the Dutch government to in turn pressure ASML, ultimately leading the firm to stop sales to China. While the U.S. faced limits on the carrots (higher $\overline{\theta}$) or sticks (lower $\underline{\theta}$) it could use to target ASML directly, it instead applied significant pressure on the Dutch government to in turn restrict the ability of ASML to sell to China. It was reported that Secretary of State Mike Pompeo directly lobbied the Dutch government to block the sale of lithography equipment and shared classified intelligence reports with the Dutch Prime Minister (Reuters). Of course, the nature of implicit or explicit threats made by the U.S. government to support these requests is harder to ascertain. In 2020, the Dutch government reversed course on allowing ASML to sell EUV machinery to China and in January 2024 ASML announced that the licenses for the shipments of some of its advanced lithography equipment to China had "recently been partially revoked by the Dutch government" (CNBC). More recently, ASML was restricted by the Dutch government from servicing previously installed hardware. More generally, and as explored in detail in Clayton et al. (2024), much of the geoeconomic power of the U.S. comes from managing a coalition sufficiently large as to approach a near monopoly within a crucial good or service, including international finance. The U.S. and China differ significantly in the structure of their alliances and the willingness of third countries to join them. The sources of coalition strength, ranging from military ties, international trade relationships, and cultural and historical connections, are important determinants of a hegemon's ability to change the incentives of foreign firms to enhance its own geoeconomic power.

4 Conclusion

With geoeconomics taking an ever more important role in the international policy toolkit, there is a growing literature trying to understand the sources and best uses of geoeconomic power. There is still much that needs to be learned about the political underpinnings of geoeconomic power. This paper aims to discuss a number of these dimensions and to point out the urgent need to integrate them into formal models in order to understand the nature of power, minimize the downsides of its use, and navigate this new era of geoeconomic rivalry.

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