

# China Shock 2.0 and Europe's Economic-Security Gap: Europe Needs a Tool to Link Market Access to Local Production

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Nr. 218, ISSN 2195-7525  
Kiel Institute for the World Economy

# Overview/Überblick

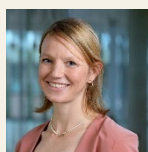
- **Europe faces “China Shock 2.0”.** China now competes directly with the euro area in close to 40 per cent of the sectors where Europe holds a comparative advantage. An undervalued exchange rate and heavy state support for priority industries drive large and growing Chinese surpluses. The pressure hits European firms across many sectors, both at home and in third markets.
- **The EU is preparing its answer.** Brussels is weighing faster trade defence, “Buy European” industrial policy and a diversification instrument for the few sectors where the EU depends too heavily on one supplier, for which a proposal is expected around the turn of the year. Germany and France accelerated these developments with a non-paper on 5 October. But the systematic and strategic response they demand runs into institutional constraints we tackle in this brief.
- **A hotchpotch of reactive measures does not a strategic trade and industrial policy make.** Europe needs to define its objectives – geopolitical, economic-security or linked to the green transition – before it chooses its instruments. Held against a strategic objective, such as building and holding a critical productive capability on European soil, the toolbox is ill-suited: almost none of it steers where production takes place.
- **Batteries show what this means.** Cells are a foundational input for drones and other autonomous systems, military ones included. Defence demand alone cannot finance a competitive cell industry. A mass market for electric vehicles (EVs) plausibly can. Localising EV production in Europe is hence a means to build a European battery industry, not an end in itself.
- **Yet Europe cannot trade market access for local production.** Access to the single market is its biggest bargaining chip. China built its car industry by making market access conditional on local production. The EU could not do the same, even if it wanted to: its trade remedies need evidence of a subsidy, of dumping or of an import surge.
- **Europe needs a purpose-built economic-security instrument.** The trade lever sits with the Union, national security with the member states. This split leaves Europe without a clear legal basis to act on a European security argument at the level of the single market. The instrument – a European counterpart to the logic of the US Section 232 – can start on existing Union competences but should rest, in the longer run, on a Union competence for economic security. This approach offers a blueprint for the forthcoming diversification instrument.

**Keywords:** China Shock 2.0, economic security, trade policy, market access, batteries, electric vehicles

- **Europa erlebt den „China-Schock 2.0“.** China konkurriert inzwischen in knapp 40 Prozent der Sektoren, in denen Europa einen komparativen Vorteil hat, direkt mit dem Euroraum. Ein unterbewerteter Wechselkurs und massive staatliche Förderung von Schlüsselindustrien sorgen für große und wachsende chinesische Überschüsse. Der Druck trifft europäische Unternehmen in vielen Branchen, im Binnenmarkt wie auf Drittmarkten.
- **Die EU bereitet ihre Antwort vor.** Brüssel erwägt schnellere Handelsschutzverfahren, eine „Buy European“-Industriepolitik und ein Diversifizierungsinstrument für die wenigen Sektoren, in denen die EU zu stark von einem Lieferanten abhängt. Ein Vorschlag dazu wird um den Jahreswechsel erwartet. Deutschland und Frankreich haben diese Entwicklung mit einem Non-Paper vom 5. Oktober beschleunigt. Doch die systematische und strategische Antwort, die sie fordern, stößt auf institutionelle Grenzen, die dieser Policy Brief behandelt.
- **Ein Sammelsurium reaktiver Maßnahmen ergibt keine strategische Handels- und Industriepolitik.** Europa muss seine Ziele – Geopolitik, wirtschaftliche Sicherheit oder grüne Transformation – festlegen, bevor es seine Instrumente wählt. Gemessen an einem strategischen Ziel, etwa dem Aufbau und Erhalt kritischer Produktionskapazitäten in Europa, ist der Werkzeugkasten ungeeignet: Fast keines der Instrumente beeinflusst, wo produziert wird.
- **Batterien zeigen, was das bedeutet.** Batteriezellen sind ein grundlegender Input für Drohnen und andere autonome Systeme, auch militärische. Die Verteidigungsnachfrage allein kann keine wettbewerbsfähige Zellindustrie finanzieren, ein Massenmarkt für Elektroautos dagegen wohl schon. Die Lokalisierung der E-Auto-Produktion in Europa ist daher ein Mittel zum Aufbau einer europäischen Batterieindustrie, kein Selbstzweck.
- **Doch Europa kann Marktzugang nicht gegen lokale Produktion tauschen.** Der Zugang zum Binnenmarkt ist sein größtes Druckmittel. China hat seine Autoindustrie aufgebaut, indem es Marktzugang an lokale Produktion knüpfte. Die EU könnte das nicht, selbst wenn sie wollte: Ihre Handelsschutzinstrumente setzen den Nachweis einer Subvention, von Dumping oder eines Importanstiegs voraus.
- **Europa braucht ein eigens geschaffenes Instrument für wirtschaftliche Sicherheit.** Der handelspolitische Hebel liegt bei der Union, die nationale Sicherheit bei den Mitgliedstaaten. Wegen dieser Trennung fehlt Europa eine klare Rechtsgrundlage, um auf Ebene des Binnenmarkts gestützt auf ein europäisches Sicherheitsargument zu handeln. Das Instrument – ein europäisches Gegenstück zur Logik der US-amerikanischen Section 232 – kann auf bestehenden Unionskompetenzen aufsetzen, sollte aber langfristig auf einer Unionskompetenz für wirtschaftliche Sicherheit beruhen. Dieser Ansatz bietet eine Blaupause für das geplante Diversifizierungsinstrument.

**Schlüsselwörter:** China-Schock 2.0, wirtschaftliche Sicherheit, Handelspolitik, Marktzugang, Batterien, Elektroautos

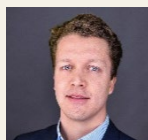
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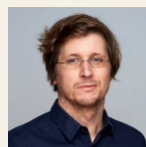
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# Introduction

China Shock 2.0 is a second wave of Chinese export competition, this time at the technological frontier rather than in low-wage manufacturing. China now competes directly with the euro area in close to 40 per cent of the sectors where Europe holds a comparative advantage, up from around 25 per cent in the early 2000s.<sup>1</sup> All of Europe is affected, but Germany is particularly exposed: its core industries – cars, machinery and chemicals – are losing exports to China while facing intensifying Chinese competition at home and in third markets.

Brussels, Paris and Berlin are discussing faster safeguards and provisional duties, and perhaps a US-style Section 301 instrument against currency undervaluation. The Franco-German non-paper of 5 October adds a country-neutral “second-strike” instrument, with the option to close off (parts of) the European market to deter retaliation in supply-chain warfare, but otherwise relies on more and faster trade defence. The most concrete vehicle to truly localise production is the Commission’s planned diversification instrument, whose scope is being narrowed to a small number of sectors where the EU depends heavily on a single dominant supplier.

The debate skips the question that must come first: what strategic objective is the new trade policy meant to serve? As trade defence, Europe’s toolbox is slow but largely sufficient. But if the objective is to secure critical production capabilities on European soil, those same tools are ill-suited to the task, because almost none of them steers the location of production.

## 1. Europe cannot use market access as a bargaining chip

China built its car industry by making access to its market conditional on local production and on joint ventures with domestic firms. A foreign manufacturer that builds locally brings process knowledge, suppliers and engineering capacity, and over time that knowledge diffuses into the domestic supply chain. Applying the same logic in Europe would mean treating access to the European market – one of the largest and richest on earth – as an asset Europe grants on terms of its own choosing.

Europe cannot do this. None of its trade instruments can be set or threatened at the border to bargain for the location of production. This is the main obstacle to a larger geoeconomic role for Europe.

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<sup>1</sup> S. Chowdhry, K. Erhardt and J. Hinz (2026), “Competing with China in Third Markets”, Kiel Policy Brief 213; C. Lagarde, address to the International Business Council of the World Economic Forum, August 2026.

## Why Europe cannot force localisation: the options all fall short

Europe does not lack trade instruments. However, each of them acts on the price, the volume or the border, and none on where capacity sits. We illustrate this with the instruments now discussed for electric vehicles (EVs), assuming that the strategic objective is to build and keep battery capacity in Europe.

**Countervailing and anti-dumping duties.** These are the instruments the EU has relied on so far: definitive countervailing duties on Chinese battery-electric vehicles entered into force in October 2024.<sup>2</sup> Such duties require evidence of a specific subsidy and of injury to producers of a narrowly defined “like product”, and are litigated for years. The resulting rates may be sensible on the instrument’s own terms, but they are awkward against a security objective: Tesla, exporting from Shanghai, pays 7.8 per cent, SAIC 35.3 per cent and Volkswagen’s China-built models 20.7 per cent. Hybrids were left out, although the same firms build them in the same subsidised plants, and Chinese exporters promptly switched to hybrids. A countervailing duty offsets a subsidy margin at the border. It does not reward production in Europe, and it does not build or keep a plant. Its rate tracks the foreign subsidy, not the value created here, and it lapses after five years unless renewed. Foreign firms may “jump the tariff” and assemble in Europe, but what moves is final assembly and not the cells or the know-how behind them.

**Safeguards.** These respond to an import surge rather than to an unfair practice, so the evidentiary bar is lower. But they hit allies as hard as rivals. They last four years, extendable once, and by design react only after the surge has hit. The variant now under discussion – quotas allocated by country, generous for Korea and Japan, tight for China – approximates a China-specific measure. But safeguards must apply to all WTO members alike. Quotas allocated on a long reference period can trim the recent surge, and partners in free trade agreements (FTAs) can arguably be exempted. Yet constrained exporters may claim compensation or rebalance unilaterally, as the EU itself did against the US steel measures in 2018. Such exemptions help little in a Union with some 80 FTAs, since broad exemptions invite re-routing of Chinese content.<sup>3</sup>

**Demand-side subsidy conditionality.** European governments spend more than €30bn a year subsidising company cars, mostly through tax breaks, and the bulk of these schemes attach no electric or European-content condition.<sup>4</sup> Rewarding only vehicles that are electric and EU-built, in the spirit of the US Inflation Reduction Act, needs no new money. The Commission’s proposed Industrial Accelerator Act goes in

<sup>2</sup> Commission Implementing Regulation (EU) 2024/2754 of 29 October 2024; duties come on top of the 10 per cent most-favoured-nation tariff on cars. Measures expire after five years unless an expiry review extends them (Art. 18 of Regulation (EU) 2016/1037).

<sup>3</sup> GATT Art. XIX and Art. XXIV; Agreement on Safeguards, Art. 2.2 (application irrespective of source), Art. 5.2 (quotas allocated on a previous representative period), Art. 7 and Art. 8 (rebalancing). For the EU’s own rebalancing against the US steel measures, see Commission Implementing Regulation (EU) 2018/886.

<sup>4</sup> Transport & Environment (2020), *Company cars: How European governments are subsidising pollution and climate change*: €32bn a year across the EU and the UK.

this direction: EVs bought or supported with public money would have to be assembled in the EU, with at least 70 per cent of the value of non-battery components of EU origin.<sup>5</sup> This is a real step. But subsidies cover only a fraction of a car's price, and they pay for the purchase of a vehicle rather than for the capacity to make one.

**Public procurement.** The International Procurement Instrument, the Foreign Subsidies Regulation and recent case law of the Court of Justice – bidders from countries without a procurement agreement with the EU have no right to equal treatment – allow a European preference. The Commission's proposed Public Procurement Act would extend it within the Union's international obligations.<sup>6</sup> Public car fleets, however, are a small part of the mass demand that anchors a battery industry. Defence is different. It buys at scale, and it is where a European localisation condition is easiest to justify and hardest to contest.

**Hard local-content and technical requirements.** This is the instrument that would onshore battery production directly, for instance by allowing the sale of a Chinese EV only if its powertrain, software and battery were made in the EU. It is also exactly what the rules prohibit. A hard local-content requirement breaches the national-treatment obligation of GATT Art. III and is expressly listed in the TRIMs Agreement.<sup>7</sup> Recast as a technical standard ("battery software verified in Europe"), it would likely also breach the Technical Barriers to Trade Agreement and the EU's own FTAs. A GDPR-style rule on connected-vehicle data offers more room, but it governs how data is handled, not where the cell is made.

**The Anti-Coercion Instrument (ACI).** In force since December 2023, the ACI needs an identified act of coercion and a qualified-majority Council determination.<sup>8</sup> It has never been used, not even against US pressure over Greenland or Chinese curbs on rare earths. It is a retaliation mechanism, not a way to exchange market access for local capacity.

**Sanctions and foreign-policy tariffs.** Sanctions under Art. 215 TFEU need unanimity. The 2025 tariffs on Russian and Belarusian fertilisers show a second route: the Union adopted them under the common commercial policy (Art. 207 TFEU), by qualified majority. But they are built to deny revenue to a hostile state, not to get a product made at home.<sup>9</sup>

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<sup>5</sup> European Commission, proposal for an Industrial Accelerator Act, March 2026, under negotiation between the co-legislators.

<sup>6</sup> Under the WTO Agreement on Government Procurement, to which China is not a party, market access is owed only on a reciprocal basis. Court of Justice, Case C-652/22, *Kolin*, 22 October 2024; European Commission, proposal for a Regulation on public contracts and concessions (Public Procurement Act), COM(2026) 590, 9 September 2026.

<sup>7</sup> WTO Agreement on Trade-Related Investment Measures, Art. 2 and Illustrative List; GATT Art. III:4. In 2025 a WTO panel found local-content conditions of the US Inflation Reduction Act inconsistent with these rules (*United States - Certain Tax Credits under the Inflation Reduction Act*, WT/DS623); the United States appealed into the void.

<sup>8</sup> Regulation (EU) 2023/2675 (Anti-Coercion Instrument), in force 27 December 2023.

<sup>9</sup> Art. 215 TFEU; Regulation (EU) 2025/1227 on tariffs on agricultural goods and fertilisers from Russia and Belarus, adopted under Art. 207 TFEU. The Commission's proposal, COM(2025) 34, pointed to the joint WTO declaration withdrawing most-favoured-nation treatment from Russia and to the EU's dependence on fertilisers from both countries.

## The trouble with the existing toolbox: a hotchpotch is not a strategy

The closer an instrument comes to a strategic objective, the worse it fits Europe's trade-policy architecture. Deployed more aggressively, the package can raise the landed cost of Chinese goods, but it still starts from what a foreign country has done and works backwards. Not one instrument can do what China did to Europe's carmakers three decades ago: make entry to the market conditional on building inside it.

This is by design. The GATT/WTO system was built by market economies on the assumption that no member would wield trade strategically against another. It constrains industrial policy and leaves discretion only where security is at stake. China's state capitalism has broken that assumption. The United States has largely abandoned WTO disciplines under Trump 2.0, and China is unwilling to adjust its model. Multi-lateral reform is out of reach.

A patchwork also has political-economy costs. A reactive toolbox directs protection to the industries under the strongest import pressure, which may be particularly poor targets. Sectors of the future rarely have the lobby that sectors of the past have. Each measure creates a constituency that resists its removal once the shock passes, so the distortions entrench. Member states value different sectors – Germany its car industry, the Nordics wind turbines – so a hundred measures produce a hundred national positions and pull the single market apart. And each measure invites retaliation, as China's denial of rare earths to European defence suppliers shows. The risk is a policy that maximises rent-seeking at home and confrontation abroad without building anything.

The alternative is to reverse the order of reasoning: decide what Europe is trying to secure, say so, and then choose – or build – the instrument that serves it. “Strategic” does not mean anti-China. It means using access to Europe's market for objectives Europe has deliberately chosen.

## 2. Where localisation makes strategic sense: batteries, and EVs as the route to scale

China's advance in global car markets has pushed EU policymakers to protect EV production in Europe. But protecting car-making simply because it is large invites rent-seeking. The strategic asset is the battery. Europe needs battery cells for its own security, and a mass EV market is the only plausible route to producing them at scale.

The battery cell is a general-purpose technology. The manufacturing base that supplies EVs also underpins grid storage and, increasingly, defence, which rests on

battery-powered autonomous systems, drones above all. In an age of autonomous warfare, cells are a foundational input, as ammunition and fuel were in an earlier era. A Europe unable to make cells at scale would enter a prolonged conflict dependent on an adversary's supply chain for the propulsion of its own autonomous forces. The objective is hence the capability to produce batteries at scale on European soil – held for security, not for the balance of trade.

Cell manufacturing is a scale industry. Between 1992 and 2016, lithium-ion cell prices fell by about 20 per cent with each doubling of the cumulative market.<sup>10</sup> Economic history points the same way. South Korea's Heavy and Chemical Industry Drive of the 1970s, an industrial policy motivated by national security after the US troop draw-down, supported targeted firms only temporarily. Yet it raised their productivity and sales for three decades, mainly through learning by doing.<sup>11</sup> The Korean tool was cheap credit in a developing economy, not a market-access condition, but the mechanism – temporary support, lasting capability – is the one at stake here. Defence procurement alone is far too small to drive such learning. A plant sized for military demand would stay sub-scale. The volume comes overwhelmingly from one mass civilian market: electric vehicles. Europe does not want EV production for its own sake. It wants the demand anchor that battery capability needs.

Two caveats matter. First, the cells that defence needs must be close enough to automotive cells for the civilian base to carry the military capability. US assessments suggest they are,<sup>12</sup> but Europe should be precise about the capability it wants to keep rather than subsidise a broad “battery industry” in the name of security. Second, China's deepest dominance lies upstream, in precursor and cathode-material chemistry. The sensible objective is to localise the higher-value and sensitive layers – cells, power electronics, software and integration – while accepting that some upstream chemistry will for a time come from China or from partners.

The same reasoning applies beyond batteries. Machine tools, robotics and power electronics share this structure: a critical capability, a fragile dependence and a market large enough to anchor domestic scale if policy is organised around the objective rather than the border. Semiconductors are the limiting case: strategic, but no fab is built anywhere without subsidy, so the sector is instructive as a warning rather than as a template.

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<sup>10</sup> M. S. Ziegler and J. E. Trancik (2021), “Re-examining rates of lithium-ion battery technology improvement and cost decline”, *Energy & Environmental Science* 14(4): 1635-1651.

<sup>11</sup> J. Choi and A. A. Levchenko (2025), “The Long-Term Effects of Industrial Policy”, *Journal of Monetary Economics* 152: 103779.

<sup>12</sup> Federal Consortium for Advanced Batteries (2021), *National Blueprint for Lithium Batteries 2021-2030*, US Department of Energy.

### 3. Europe's economic-security competence gap

Not every industry is strategic. But where Europe identifies a productive capability as necessary for its security, it should be able to use access to its market to retain it. Here it runs into an institutional problem: the trade lever and the security objective sit at different levels of government.

Trade is an exclusive Union competence, while under Art. 4(2) TEU national security “remains the sole responsibility of each Member State”.<sup>13</sup> Brussels can act against subsidies, dumping and import surges under powers it already holds. What it lacks is a legal basis to start from a European security judgment – that a given capability must exist on European soil – and act on it at the level of the single market. The member states may invoke security, but they cannot act at the common external border: in a customs union, a national restriction is simply defeated by re-routing through another member state.

China partly hides this gap, because the dependencies it creates usually come with subsidies and overcapacity that give Brussels an economic rationale. The United States exposes it. Dependence on US suppliers of advanced AI chips could be a serious supply-security risk without any dumping, subsidy or coercion, and none of Europe's trade instruments would apply. The diversification instrument will hit the same wall: it can act where a distortion gives Brussels a case, not where the dependency is on a partner.

**What an economic-security instrument should do.** The diversification instrument is the natural vehicle. Five design points follow:

1. **Ground it in existing competences now, and in a Union economic-security competence later.** The Union has more room than it uses. Under Art. 31 TFEU the Council sets the Common Customs Tariff by qualified majority, without the Parliament. A tariff that escalates from raw materials (lithium at zero) to finished batteries and EVs (say, 50 per cent) rewards final production in Europe. Notified to the WTO as a modification of the EU's schedule under GATT Art. XXVIII, it triggers negotiations and compensation, but it is WTO-legal. FTA partners would be exempt. The EU's new steel measure shows the route works: since October 2025 the Commission has negotiated quota allocations under Art. XXVIII with more than 20 partners.<sup>14</sup> Combined with the common commercial policy (Art. 207 TFEU), the internal-market power (Art. 114) and emergency economic measures (Art. 122), this tariff power carries the instrument wherever

<sup>13</sup> Art. 4(2) TEU; Art. 3(1)(e) and Art. 207 TFEU. Outside the Common Foreign and Security Policy (CFSP), EU law knows no concept of “EU security”. A CFSP framework for security-based tariffs is conceivable but politically unlikely; in an emergency, Art. 122 TFEU offers a route, as used for the open-ended immobilisation of the Russian central bank's assets.

<sup>14</sup> European Commission, *Questions and answers on implementing the EU's Steel Regulation: the tariff quota distribution for steel imports*, QANDA/26/1485, 30 June 2026. Alternatively, the tariff could be set under Art. 207(2) TFEU, with the Parliament involved.

a distortion or overconcentration gives the Union an economic rationale. In the longer run, the Union needs a competence for economic security, so that it can act on a European security judgment in its own right.

2. **Make it act on capacity, not only on the border.** Its distinguishing feature must be that it moves the location of production, through localisation conditions tied to market access and through origin-neutral rules that favour building in Europe. The carbon-footprint thresholds of the Batteries Regulation, and possibly an extension of the carbon border adjustment mechanism to batteries, are candidates. Their limit is that they reward clean production, not European production: a Chinese plant running on clean power would pass.
3. **Design it against capture, and make it work against partners too.** The failure modes are an anti-China programme with a security label and a queue for whichever sector lobbies hardest. The guard against this is to define the objective before the instrument is used, and to make the instrument usable against an ally as well as a rival. The United States is the test. Against China, where the issue is subsidised overcapacity, existing competences can justify the instrument. Against the United States, where the issue is supply security alone, only an economic-security competence will do. Conceptually, the instrument sits between the US Section 232 (security) and Section 301 (unfair practices), on a European legal basis.<sup>15</sup>
4. **Accept the WTO cost and manage the EU-law risk.** The instrument would likely face a WTO challenge and could be found inconsistent with WTO rules. Europe cannot count on the security exception of GATT Art. XXI, which panels read narrowly.<sup>16</sup> But WTO litigation runs for years and WTO law has no direct effect in EU courts, so the binding near-term constraint is EU legality. Careful drafting, with solutions-oriented EU lawyers involved from the start, can meet it.
5. **Build it fast and bridge the interim.** Institutional innovation need not take decades. After the Chinese takeover of the robot maker KUKA in 2016, the EU adopted its investment-screening regulation in under three years.<sup>17</sup> In the near term, open safeguard investigations in strategic sectors. In parallel, build the instrument and fold the interim measures into it, so that the ad hoc package does not harden into permanent policy by default.

<sup>15</sup> Section 232 of the US Trade Expansion Act of 1962; Section 301 of the US Trade Act of 1974.

<sup>16</sup> WTO panel report, *Russia – Measures Concerning Traffic in Transit* (WT/DS512/R, 2019); panel reports in *United States – Certain Measures on Steel and Aluminium Products* (WT/DS544 and related disputes, 2022), which found the US Section 232 tariffs were not “taken in time of war or other emergency in international relations”.

<sup>17</sup> Regulation (EU) 2019/452, adopted March 2019.

## 4. Conclusion: Europe needs an economic-security instrument

Europe's largest source of geoeconomic leverage is the asset it has been least willing, and least able, to use: access to its own market. China makes that access conditional on local production, the United States increasingly on security. Europe has tools that respond to subsidies, dumping, import surges and coercion, but they cannot answer a more basic question: what does Europe need to produce itself?

That question has to come first. A trade policy assembled from reactive measures will be shaped by the industries asking for protection. It may keep imports out. It does not build what Europe has decided it needs.

Europe hence needs the competence to act on a European judgment about which capabilities its security requires, and an economic-security instrument that can make entry to the European market conditional on production inside it. The leverage is there. What Europe lacks is the power to set conditions on it.

# Imprint

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DE 251899169

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