Weaponizing the International Economic System: Pitfalls and Opportunities

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1. Introduction

Economic exchange between countries has always involved commercial, political, and security risks. Those risks have been managed under the US-led rules-based multilateral order for those countries that signed up to the system. That system was forged in the dying stages of World War II in Bretton Woods and no country benefited from the resulting economic order more than the United States. Now the United States is the system's biggest disrupter. China's rise as an economic power and competitor to the United States and the US response has led to fragmentation of the current economic order (Quah, 2024). As a result, the globalisation that flourished as a result brought prosperity and peace is now under threat.

Great Power rivalry, or strategic competition, as well as outdated multilateral rules and uncertainty from global shocks and protectionism have led to an increase in the risks from economic exchange that threaten the benefits. The weaponization of economics has caused many to see economic interdependence as a vulnerability instead of a source of prosperity *and* security.

Efforts to decouple the United States and China, the world's largest economic powers and trading nations, have stalled in recognition of the costs of untangling the complex interdependence between them. Decoupling European energy dependence from Russia may be possible over time but the advanced industrialised economies are now attempting to de-risk their economic relationships with a Chinese economy that is deeply integrated into

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complex global production networks. A focus on de-risking without a functioning, open and rules-based economic system that mitigates many risks will leave decoupling, even at huge cost, as the most rational outcome.

This paper explains how economics has become weaponized and how it might be restored to make countries more secure and better off economically.

We distinguish two modalities of disruption to the globalized international economic system. First, is *protectionism*, or disruption that lowers economic efficiency in order to protect special interests but is otherwise unjustified. This is the kind of disruption that economic analysis seeks to resist and is why geopolitics, say, is dismissed as "bad economics".

Second, is *pragmatic pluralism*, or disruption to the efficient global allocation of resources that is derived from an acknowledgement of new priorities—resilience, national security, jobs—and seeks reallocation of resources towards such justifiable purposes. It might be that these new priorities were previously unrecognized, or that they bear externalities previously unacknowledged. The notion of resilience, e.g., figured significantly in no policy discussion until the COVID pandemic. But now it obviously does. Resilience-adjusted economic efficiency is simply a counterpart of risk-adjusted return in finance.

Another dimension to pragmatic pluralism might be jobs. These last potentially bear a positive externality over and above the economic value they add to GDP. The externality bears on political stability and social cohesion. If jobs help support political stability, then that would call for re-examining the old mantra "Protect the worker, not the job." In a world where the breakdown of social cohesion implies extreme populism and socioeconomic instability, jobs need to be protected too. A similar argument applies to national security.

A subset of pragmatic pluralism is what some economists call "precautionism", i.e., actions that might seem protectionist but actually draw on a need to be cautious on risks that will materialize in the future. Priorities that stem from pragmatic pluralism no longer fit a description of "bad economics".

If protectionism is the motivation for policies, our job is to explain why we should resist and challenge such developments. If, however, it is pragmatic pluralism (and thus including precautionism) that drives new policies, then our job is to help design those policies to be more effective.

This paper is organised as follows. In Section 2 we discuss macroeconomic outcomes driven by the dynamics of alternating priorities in economic performance and national security. Our discussion here is, in turn, historical and analytical. Section 2 will show how different historical episodes have placed higher priority, alternately, on economic performance and on national security. Unsurprisingly, these different episodes have seen varied macroeconomic outcomes as a result.

Of particular concern to us is how, under certain circumstances, economic policies are made subservient to national security, i.e., national security "weaponizes economics". Our analysis shows that when this happens inappropriately, it can lead to dynamics that self-defeatingly undermine national security goals.

In our reasoning, it is important to disentangle those situations when economics is inappropriately weaponized from those when economics is rightly disrupted in service of pragmatic pluralist goals (and not just to seek traditional economic efficiency). In this paper, as in Quah (2025), we do not take a traditional "guns vs butter" approach to the tradeoff between economic performance and national security. Indeed, in current policy discussions, when technologies are so-called "dual use", advancing security goals is exactly collinear with advancing economic performance.

Drawing on our analysis of historical episodes, Section 3 provides a formalization of these possibilities, different from that in Quah (2025).

In Section 4, we draw together the lessons from Sections 2 and 3, to argue for policies to evade Epic Fail or Prisoners Dilemma outcomes, as described also in Armstrong and Quah (2024).

2. Weaponising economics

National security concerns are resurgent not just in one or two countries but everywhere. Those anxieties draw from a list that includes items both new and old: the global climate crisis, green energy transition, global pandemic risks, the need for resilience, domestic unrest over inequality and fractured social cohesion, and, not least, Great Power rivalry. War in Europe and the Middle East are a major source of uncertainty and are also disrupting global commodities markets. Many items on the list make for sensible adjustment to an objective of pure economic efficiency, that is, they are “pragmatically pluralistic” objectives. Yet others, however, provide protectionist goals: those include rivalry that makes for containment of a competitor nation, for disengagement and sanctions to harm others, or for support of narrow special interest groups for their profit.

With national security taking priority, economic performance becomes not just a victim or target in policymaking. Instead, in what is known as economic statecraft (e.g., Blackwill and Harris, 2016), economic policies can also constitute the tools that states manipulate to try and achieve national security objectives. Farrell and Newman (2019) argue and demonstrate that interdependence itself is weaponisable, and thus its manipulation becomes part of economic statecraft.

The ideas that underpin this binary relationship are usefully made explicit. Often, economic competition is discussed as a contest with multiple winners; security competition, in contrast, conventionally adopts a zero-sum framing. Economic competition is when a nation attempts to get ahead by increasing its productivity: it invests in schools, encourages research and development, improves public infrastructure, and raises human capital by developing skills and training the nation's workforce. Such actions elevate the nation's economic performance at the same time they improve the situation for the whole world. Security competition, in contrast, is when one nation attempts to get ahead by keeping others down, encircling and containing its rivals, and keeping from them frontier technologies. In security competition, whether the nation ends up absolutely stronger or weaker is secondary: What matters is how the nation does relative to its opponents. In zero-sum security competition, a nation's gain is exactly its opponents' loss. On the other hand, in positive-sum economic competition, everyone gains.

Paradoxically, the literature on economic statecraft mostly treats economic exchange as zero-sum, or even negative-sum, with interdependence seen as a security risk and a vulnerability, given the perception that relative economic gains are more important than absolute gains (Powell 1991).

The recent economics literature has lagged that of international relations, security studies and political science in the study of the nexus of economics and national security. That is perhaps because the economic fundamentals of free trade largely have held a consensus among economists and could be pursued without consideration of geopolitics or security.

The creation of the GATT in the postwar era meant that trade and international economic policies were largely able to be pursued separately from the 'high politics' or 'high foreign policy' matters of national security and survival (Cooper, 1972a). Trade disputes across the Atlantic, with Japan and in the context of the Cold War meant there was an explicit recognition of the economics and political-security nexus by economists from an American perspective in the 1970s and 1980s (Cooper, 1972b; Dixit, 1987; Srinivasan, 1987). Negative externalities from growing economic interdependence with the existence of vulnerability and sensitivity to growing trade shares also expanded a literature that explored the interaction between trade, political security and conflict (Cooper, 1972b; Mansfield and Pollins, 2001), but that was largely in the domain of the international relations literature.

The new global economic and geopolitical circumstances that involve economic coercion and fragmentation of the global trading system in a globalised world have led to a number of studies examining the choices of Great Powers (Armstrong and Quah, 2023; Clayton et al. 2025) and constrained policy options for small open economies (Clayton et al. 2024a; Clayton et al. 2024b; Becko and O'Connor, 2025). The Clayton et al. (2024a) and Becko and O'Connor (2025) models have in common the constrained or limited actions by the non-hegemonic powers, or small open economies, as a starting point. They model 'economic security' transparently but narrow the range of policy instruments under consideration and muddle together different economic and security issues under the umbrella of over-dependence or concentration. The focus becomes the policy objective of reducing trade dependence or concentration.

In much of the recent literature, Third Nations are price takers individually and have little to no agency to change their external circumstances. That might appear to be the reality but assumes the rules-based multilateral trading system no longer functions and the global economic system is one of rule by might and power. Collective action is assumed too impractical with the Great Powers going their own way.

There is important work in measuring the exposure to geopolitical fragmentation to trade (Hakobyan et al. 2023), the costs to domestic firms of economic security policies like export controls (Crosignani et al. 2025) and that model the geoeconomic choices of countries (Clayton et al. 2024b), for example. They treat the world as given and how it appears to be but mostly from a Great Power perspective that assumes positive-sum economic exchange can no longer be pursued separately from geopolitics or security considerations. That is the world of the 1930s and assumes the post-war economic order no longer functions to allow the pursuit of economic exchange that results in high trade shares or concentrated markets. That is, trade once again follows the flag.

In this paper we are concerned with how Third Nations can restore economics in the global order. Zero-sum or negative-sum geopolitics and Great Power strategic competition need not mean zero-sum or negative-sum economic exchange. How can Third Nations create the circumstances where economic exchange can be positive-sum and avoid an epic fail prisoner's dilemma of interactions between countries being dominated by security risks? We posit that the pacifying effects of interdependence need not be lost and positive-sum economic exchange can contribute to mixed-game outcomes with political security so that less of the policy domains are seen in zero-sum terms.

This paper does not underestimate the importance of national security in macroeconomic policymaking. Indeed, this is why we consider national security as among the factors underlying pragmatic pluralism. It is important, however, to be able to clearly separate national security that arises from pragmatic pluralism or is simply disguised protectionism. . It is the role of security agencies to identify and protect nations from tail risk that poses an existential threat. It is when national security takes priority and dominates economic policymaking that policy options are narrowed towards corner solutions. That is because security or sovereignty often have an infinite price. No price is high enough to surrender any security or sovereignty. National security also often has no constraints or weak guardrails, so is subject to mission creep: there is no clear end for the 'high fence' that US national security advisor Jake Sullivan articulated for the US 'small yard' of 'critical' technology industries, since modern technology has many dual military–civilian uses. The technologies in question were previously seen as mutually beneficial positive-sum areas for improving productivity and innovation, for example, to combat climate change. Those are now behind a high fence with the risk that the small yard of zero-sum critical technologies will expand.

As economics becomes weaponized, the rational response is to restrict economic engagement. Export controls, tighter screening and restrictions on foreign investment and trade diversification gathers momentum with protectionism and a national security imperative driving de-risking or decoupling. Legitimate concerns around supply chain resilience cause a response that tries to friendshore and limit economic engagement to 'trusted' partners, making supply chains more vulnerable with fewer options and concentrating risk. When a rules-based economic system does not mitigate risks, firms and governments have to self-insure against those risks with costly 'hedging' strategies being labeled as de-risking. The costs are borne by societies as the security risks perceived by governments increase.

The domination of traditional security responses — unwinding economic interdependence, prioritising military deterrence as a means of preventing conflict, weaponising economic interdependence for coercive purposes and threatening military force to achieve political ends — risks global political and economic fragmentation, or much worse.

3. Economics and security as complements

Strategic competition leading to zero-sum economic competition also complicates the relationship between security and economics. The most obvious way where security and economic considerations oppose arises from the narrative where security concerns lead to trade sanctions and tariffs, import restrictions, export controls, and constraints on foreign investment. All these actions disrupt economic exchange and are costly. Therefore, from the perspective that free trade is optimal and deviations from it harm economic well-being, security concerns that set up obstacles automatically work to oppose economic objectives.

This distinction between economics and security, however, can be overplayed. As a matter of logic, economic objectives and security goals need not always be rivalrous, in that elevating one necessarily diminishes the other. Examples can be found, in both theory and history, where security and economic objectives work in tandem, so that advancing one also progresses the other. The model in Quah (2025) endogenizes this tradeoff. Historically, President Eisenhower's 1955 pivot towards international trade engagement in a calculated move to isolate the Soviet Union brought together a group of nations through trade that set that group against the anti-market ideology of communist Soviet Union. In this instance therefore, advancing US security interests came hand in hand with US participation in the beginnings of globalization.

The Eisenhower trade pivot differs from another better-known trade-security relation, namely that hypothesized in Capitalist Peace theory. The Eisenhower pivot uses economics to bind a group against an antagonist outside the group; the latter uses economics to bind a group together for peace within the group. Both, however, are examples where security concerns and economic objectives align in the same direction and are complements.

There are policy choices that make countries poorer and less secure and there are policies that contribute to security and prosperity. There are also policy strategies that can help manage risks to national security and at the same time contribute to prosperity, or that make countries more secure without affecting economic exchange.

In the extreme, economic exchange and national security can be framed as substitutes or complements. The most basic complementarity of economics and security starts with the need for a strong economy to finance a military and defence force. National security includes military security and protecting sovereignty: both are achieved more readily if a nation achieves economic strength. Economic exchange builds national wealth and power and is a source of economic and therefore military strength.

For centuries there has been a recognition that economic exchange between countries also has a peace dividend by increasing the costs of conflict. The French philosopher Montesquieu famously argued ‘peace is the natural effect of trade’ in 1748 because trade made countries reciprocally dependent (Montesquieu, 1748). Adam Smith qualified that with his argument in the Wealth of Nations that ‘commerce, which ought naturally to be, among nations, as among individuals, a bond of union and friendship, has become the most fertile source of discord and animosity’ (Smith, 1776). Karl Polanyi famously argued that the ‘long peace’ in Europe in the nineteenth century was enforced by High Finance, which would tolerate no expensive wars that would threaten the fiscal stability of states to which it loaned money and in which it conducted most of its profitable business (Polanyi, 1944; Flandreau and Flores, 2012).

Economic interdependence that makes conflict more costly acts as a constraint, but not a binding constraint. Angell (1909), widely misquoted as arguing war would not break out due to economic interdependence, in fact argued prior to World War I that the economic cost of war was so great that war was economically and socially irrational.

Economic engagement between countries can strengthen national security by reinforcing and habituating adherence to a rules-based order that creates a bigger and broader plurality of interests. Foreign investment creates foreign stakeholders in the health of an economy in which they are invested.

The European project has at its heart the belief that economic interdependence will avoid another destructive war in Europe. War has returned to the European continent but not in integrating Europe, the European Union. Russia’s strategic use of gas supplies against Europe is sometimes cited as a counterpoint to the argument that interdependence promotes political security. But Russia was not integrated into European supply chains and European energy dependence on Russia is qualitatively different from economic interdependence in the European Union or East Asia.

Economic interdependence, built on confidence in an open, rules-based multilateral system has brought East Asian nations economically, socially and politically closer. Political rivalries and unresolved history have been kept in check in Northeast and Southeast Asia by deepening economic integration built on an embrace of open economic policies. Economic interdependence among countries in East Asia creates strong incentives to maintain peace, stability and cordial political relations. The same cannot be said for neighbouring South Asia, as well as many other regions that lack economic interdependence.

Economic competition under accepted rules brings gains for all sides and is about improving competitiveness, productivity and welfare. It has a significant peace dividend.

In the main, however, current geopolitical rivalry encourages a temperature that feeds on opposition between security and economics, which Adam Smith warned of. It is difficult to see any win-win upside to a narrative of containing, decoupling from, or de-risking a geopolitical rival. A vocabulary of friend-shoring and of “restricting the benefits of exchange and investment to like-minded partners” does not present a message of voluntary, inclusive self-improvement, but instead set one side against the other. Geopolitical rhetoric has, thankfully, shifted away from an unhelpful and inappropriate “long twilight struggle between democracy and freedom on the one hand, and totalitarianism and tyranny on the other” of John F. Kennedy (1961). But there remains a great distance between current discourse and, in retrospect, the more hopeful ones from the Eisenhower pivot or even Nixon’s message of not letting the other side continue to live in angry isolation, “there to nurture its fantasies, cherish its hates, and threaten its neighbours” (Nixon, 1967).

The abuse of economic tools and economic leverage by China and the United States — the weaponization of economics — have significant negative spill-overs on the rest of the world and bring significant uncertainty to the multilateral trading system. Economic objectives and security concerns that can be complements are being turned into simplistic substitutes where one needs to be reduced to further the other. Deepened economic interdependence is seen as an economic and political security risk. East Asia is especially at risk of an epic-fail outcome because of the vagaries of political relations between nations that are kept in check with deep integration into the global economy within the framework of agreed rules and with complex economic interdependencies around regional supply chains (Armstrong, 2012).

Level playing field and the security value of multilateral rules

Risks from international economic exchange can be managed with strong domestic rules, regulations and institutions (de Brouwer, 2023). But without strong international rules, norms and institutions the policy options for individual nations are narrowed (Armstrong, 2023). Risks can be managed internationally under a multilateral system that reduces the number and capabilities of malign actors, including by shifting the risk onto actors with malign intent. That process is strengthened, not weakened, through international cooperation.

The multilateral trading system, built on the principle of equal treatment — the most-favoured nation principle — has kept the global economy open and acts to insure against economic shocks and aggression. The large global economy with alternative buyers and suppliers has protected countries against trade stoppages, whether politically motivated or from other shocks. The open system therefore helps protect against coercion while creating space and options, especially for smaller countries that would otherwise be most at risk.

The rule of law in the international economic system, as opposed to the rule by power, is a fundamental principle guiding the United Nations and international cooperation. International economic rules may not be equally enforced and independently adjudicated as they should be but until the United States turned to protectionism in the Trump presidency, the United States acted as the ultimate guarantor and enforcer of those rules. When the United States demurred from those rules in the past it at least respected their spirit.

The use or misuse of economic leverage as a tool for coercion by a country against another country for political purposes occurs when there is market power. Restricting imports or conducting an export embargo where there is a competitive market has little to no effect as alternative buyers or suppliers are easily found — competition crowds out strategic behavior. In monopolized markets, or where there is significant market power, the monopolist can extract rents. The same is true for a monopsony, or a market where the seller has significant market power. This is the idea that drives the optimal tariff theory — that a large importer can benefit from the imposition of a tariff that shifts the terms of trade at the expense of the exporter. Market power and economic leverage is deployed to maximize rents but can also be leveraged for political or geopolitical purposes. High trade shares and concentrated markets were managed under a rules-based trading system and the global economy could benefit from specialisation in comparative advantage and economies of scale. Policy-induced trade diversification reverses the gains from globalisation and forgoes the positive security externality.

Governments intervene in markets for commercial reasons or political purposes where there are asymmetries in dependence, or market power. The United States limited Japan's semiconductor industry in the 1980s to preserve US market power and economic rents and avoid competition. A very similar story is playing out with US sanctions targeting the advanced semiconductor industry in China. The key difference is that Japan was compliant, perhaps because of its security dependence on the United States, whereas China is investing in circumventing US sanctions and developing its own indigenous semiconductor supply chains.

Even when a country attempts economic coercion or uses economic leverage for geopolitical purposes with commodities where it has market power the results are not always as intended. For the targeted nation, there are often significant short term and adjustment costs. In the postwar period multilateral rules have by and large protected countries from the naked abuse of economic weapons. That was one of the key motivations of the postwar economic order, most importantly of the GATT (Hirschman, 1945).

The nature of market power in the international economy is largely to do with economies of scale, not from entry barriers with an open global economy. Market share and market power will erode when the (risk-adjusted) price increases and other suppliers enter the market or there is innovation towards substitutes. This is the case with China's dominant supply of rare earth metals where China had a near monopoly by producing 95 per cent of global rare earth supplies in 2010 despite only having an estimated one third of global reserves.

China's export restrictions of rare earth elements, critical for high tech manufacturing, to Japan, the world's largest customer, in response to an incident in the East China Sea around disputed territory caused China's global market share to plummet. China was supplying over 90 per cent of Japan's rare earth metals prior to the Chinese export restrictions but that share fell rapidly to around 50 percent within two years as other export sources came on stream. China was still a dominant supplier, but other sources became commercially viable. The short term shortage of rare earths, but more importantly uncertainty around security of supply, caused the price to increase. Japanese companies and the Japanese government invested in rare earth development elsewhere and industry has developed self-insurance policies such as stockpiling rare earth metals and investing R&D for substitutes. Part of the risk mitigation strategy of Japanese buyers of processed rare earth elements is to stockpile enough to last a possible future embargo.

Market power in an open international economy can only be sustained as long as that it is not abused or weaponised. Without multilateral rules that give confidence that nations are not able to abuse market power for geopolitical leverage, there will be a retreat from concentrated markets with diversified trade and de-risking. Concentrated markets need not imply risk and forgoing the benefits of specialisation and economies of scale will be costly.

The primary lesson of Australia's 2020 experience of Chinese export bans for political purposes was that the economic weapons China fired were blunted by the multilateral trading system. There were immediate costs to Australia from lost Chinese trade and the inability to immediately ship goods to alternative markets, but in the subsequent year a significant share of the affected Australian exports were redirected to alternative markets and export values substantially recovered (Productivity Commission, 2021).

China substituted import supplies from Australian competitors in markets affected by its trade restrictions, in some cases significantly from Australia's closest ally, the United States, under obligations of the Phase One trade agreement between China and the United States. The adjustment in both Australian and Chinese trade was not without cost to producers and consumers in each country — loss in value in Australian exports especially in the short term and more limited and higher priced products, especially coal, in China. But the options in open international markets guaranteed by the multilateral trading system considerably cushioned the costs of the adjustment to these Chinese policy interventions.

Damage to global confidence in trade and economic exchange with China and the global trading system more broadly is another element to assess in this episode. The longer-term reaction in markets to confidence-shaking policy interventions of this kind is an important object of economic policy and diplomacy. The US–China trade war has undoubtedly caused far bigger systemic damage to the global trade regime, but that inflicted by Chinese economic coercion against Australia is also not trivial. The long-term effects on China are not certain; they will depend on what credibility it can restore in future policy behavior, including through its response to the application and development of trade law.

There are several key lessons from this experience. One is that absent effective diplomatic engagement, Great Powers — under any trade regime — have the clout to inflict trade damage on smaller powers where direct international trade interdependence is not mutually strong (as it is, for example, in Australia's iron trade with China). The most important lesson from this experience, however, is that the multilateral trading system provides a crucial buffer against these policy shocks. This is a well-tested proposition in the analysis of agricultural trade shocks (Anderson, 2016), and its logic is universal. The multilateral system reduces the risks, even from egregious policy interventions, and lowers their economic and political cost. Flexible markets react and respond to shocks, companies innovate around them, and policy actions can be tested in international legal processes such as in the WTO.

Maintaining an open international economic system with the principle of equality — embedded in the most-favoured nation clause that creates a level playing field — has a security as well as economic rationale. Equal economic treatment under WTO rules underpins international rule of law in economics.

4. Restoring economics

The weaponization of economics and strategic competition between the Great Powers is turning economics and security into substitutes where one has to be given up to achieve the other, causing a dangerous trade-off and a negative feedback loop. To avoid this epic-fail equilibrium of a vicious cycle between prosperity and security which leads to narrowed policy choices towards corner solutions, preserving and reforming the multilateral system will require collective action to be mobilised around the shared interest of retaining a rules-based economic system.

This section describes the false choices Third Nations are faced with between their immediate economic and political security and the multilateral system, some priorities for preserving the established rules-based economic order and principles for its reform and strengthening. The global economic order does not need another world war to reinvent itself.

System preservation: the false economy of picking sides

Third Nations are having to navigate their economic, political and strategic choices with China and the United States increasingly applying pressure to choose between them. The Great Powers are using tariffs, sanctions and industrial policies to exert influence over other countries. The false dichotomies of China versus the United States or security versus prosperity are an anathema to a multilateral system where there is space for major powers to coexist and where economics and prosperity are complements, not substitutes.

The Great Powers are deploying policies that are inconsistent with the principles and established rules of the multilateral trading system. During the first Trump administration, the European Union and countries like Australia and Japan negotiated exemption with voluntary export restraints (VERs) or managed trade agreements with the United States to avoid Section 232 tariffs of the Trade Expansion Act of 1962 on steel and aluminium deployed in the name of national security. That is despite the fact governments agreed to prohibit the use of VERs as part of the Uruguay Round of the GATT, and managed trade is a retreat from free trade.

These policies are becoming more blatant as strategic rivalry intensifies. The United States introduced extraterritorial unilateral sanctions on China's advanced semiconductor industry, prohibiting companies from other countries, and especially those from allies Japan, South Korea and the Netherlands that are advanced equipment and input manufacturers, from doing business in China. There is no longer any pretence of not forcing Third Nations to choose sides.

Those are sticks but there are also carrots being used to pick sides at the expense of the other Great Power and in doing so erode the rules-based global economy.

Subsidies of the kind deployed by the United States with Inflation Reduction Act are discriminatory and forbidden under the GATT and WTO disciplines. US allies qualify for the subsidies under certain conditions, like having an existing free trade agreement with the United States, and the incentive is to negotiate access to the subsidies despite their conflict with international trade law. Those choices by Third Nations — some small and that may seem like economically and politically expedient choices — enable and validate the direction the United States is heading in and contribute to weakening the existing international economic order.

How then can Third Nations avoid the rational choice of accepting economic carrots in the form of subsidies that are a race to the bottom and erode the rules-based trading system? How can they avoid either capitulating or retaliating in the face of economic sticks (or coercion) from the Great Powers? What is at stake is a destabilising breakdown in the existing order, not a peaceful transition to a new economic order.

The first condition is for Third Nations to adhere to the established rules in the WTO and other regional and bilateral arrangements, regardless of what the Great Powers do. The Great Powers may be blatantly disregarding the rules and norms of the established system but have not walked away from it.

Second is to protect their interests in a multilateral trading system that keeps markets open and international economic engagement rules-based. The system has always had its flaws and is far from perfect but it has limited discrimination, promoted transparency, openness, fairness and predictability and constrained protectionism among diverse and sovereign nations. Two immediate threats to the existing system are that the rules are no longer enforceable in the WTO and the national security exception is being abused.

The dispute settlement system in the WTO is no longer functioning with the US veto of Appellate Body judges that dates back to the Trump presidency. The Appellate Body is a cornerstone of the WTO, itself the culmination of a decades-long process of building a rules-based international trading system. In its absence, the WTO is unable to meaningfully conclude trade disputes between its members, with many disputes effectively appealed 'into the void'.

Six months after the Appellate Body ceased to have enough judges to function, the European Union and Canada led the creation of the Multi-Party Interim Appeal Arbitration Arrangement (MPIA), a plurilateral framework which duplicates the Appellate Body, enabling members to resolve WTO disputes among themselves. Australia, New Zealand, Singapore and importantly China, were among the original signatories, with Japan joining in early 2023, almost four years later, expanding the grouping to 53 members.

Trade disputes have been resolved among MPIA members and are an expression of the interest in a rules-based system. Expansion of the MPIA membership will help insure against a complete collapse of the dispute settlement system even as the WTO membership works to reform and restore the system.

An anti-coercion instrument has been considered among some G7 members that would act as a deterrent by allowing collective retaliation to attempted economic coercion. Such a measure would substitute for the multilateral dispute settlement system and may further weaken, if not completely replace, the multilateral system, towards a system of clubs or blocs. The WTO's dispute settlement system takes time but is rule-based and universally applied, with the punitive measures acting as a deterrent against further transgressions. Reform of that system would protect against fragmentation of the trading system towards rule by power instead of rules.

WTO panel decisions that are unfavourable for non-MPIA members are appealed into the void, just as the United States did in December 2022. The steel and aluminium tariffs imposed by the Trump administration, deployed citing national security, were ruled in breach of US obligations under its GATT and WTO commitments. The Biden administration dismissed the decision and US Trade Representative Katherine Tai stated that the WTO "should not get into the business of second-guessing the national-security decisions that are made by sovereign governments". Russia and the United States argue that WTO security exceptions are 'self-judging' or 'non-justiciable' (Voon, 2023).

Article XXI of the GATT has always permitted nations to enforce limiting measures for legitimate national security interests. Yet, this allowance was never meant to be universal. There existed an understanding to avoid exceeding a boundary that would otherwise lead to the undermining of GATT's rules under the guise of national security.

The rules-based trading system is at risk if WTO members can deploy discriminatory tariffs, quotas or other trade restrictions with their own interpretation of national security without a functioning dispute settlement system. The MPIA is a temporary solution to part of that problem. Another will be to put bounds on what can be legitimately allowed to be considered under the national security exception. Third Nations have an incentive to codify what are legitimate national security interests and under what conditions Article XXI in the GATT can be invoked (Hoekman et al, 2023). Restoring the norm and credibly committing to those bounds for Article XXI through agreements can help preserve the rules-based trading system.

The WTO underpins the bilateral, regional and plurilateral arrangements and agreements that are built on top of it. A fracture in the confidence of the WTO will leave the global trading system with a patchwork of agreements with gaps in coverage of rules and members.

System reform

In a world where Great Power competition makes cooperation difficult and creates incentives towards epic-fail outcomes, the established rule-based system can be protected and reformed with Third Nation agency. Third Nations can act collectively around shared interests as they have with MPIA and other plurilateral and regional arrangements.

Reforming the multilateral trading system and updating its rules is occurring in groups of countries, sometimes among like-minded nations in plurilateral arrangements, and other times in regional arrangements driven by shared interests and geographic closeness . These are bottom-up processes that build on the existing system by creating new rules relevant for modern commerce. These will often be driven by political, not solely economic, interests and need not be inconsistent with rulemaking that strengthens multilateralism. The risk comes from arrangements that are driven primarily by security interests and that are designed to exclude nations.

Friendshoring and ideas of limiting trade to 'trusted partners' or like-minded countries make the world much smaller. It suggests a simplified, static view of the world with permanent friends and permanent enemies. The Biden administration may have viewed the world through a binary lens of autocracy versus democracy but the reality in East Asia and much of the world is one of countries in transition, many of whom are committed to the rule of law internationally, especially in trade, whatever their domestic political system. Friendshoring may be a compromise solution to forces of onshoring but fail in their economic and political rationale.

Arrangements that are open to new members will contribute to rulemaking that can expand the multilateral system. Two examples of arrangements that have succeeded in expanding membership are the original P4 between Brunei, Chile, New Zealand and Singapore that expanded to become the Trans-Pacific Partnership and the Digital Economy Partnership Agreement (DEPA) between Chile, New Zealand and Singapore that is designed to expand membership.

Flexibility in coverage and membership can help to further rulemaking. The Regional Comprehensive Economic Partnership among the ten Southeast Asian nations, Australia, China, Japan, New Zealand and South Korea is the other 'mega regional' agreement alongside the Trans-Pacific Partnership agreement, now called CPTPP after the United States dropped out. Both are open to new members with the United Kingdom having joined CPTPP and others, including China, formally applying for membership.

How those arrangements expand membership will determine how consequential they become in multilateral rulemaking. Although many bilateral and regional economic agreements have preferential clauses and theoretically detract from the principle of equal-treatment embodied in the MFN clause in the WTO, they are WTO-plus agreements that are designed as complements, not substitutes, to the multilateral trading body.

Arrangements like APEC have features of open regionalism that further economic cooperation and integration among members, without diverting trade from non-members. APEC has also been the forum for modes of cooperation that have worked among a diverse membership unable to agree to legally binding commitments among themselves. Those modes of cooperation like the pathfinder approach and concerted unilateralism are examined below.

Third Nations can utilise existing arrangements and expand membership and rules. To avoid fracture of the global economic system they need to remain open to Great Power engagement and membership. Exclusive arrangements with no chance for membership do not create incentives for reform or membership. A CPTPP that does not engage China in possible membership negotiations due to political reasons, for example, will not incentivise Chinese reforms or commitment to new rules and standards.

The groupings and frameworks created by Third nations can incentivise and accommodate Great Power cooperation that encourages the supply of global public goods, not G2 cooperation that risks damaging the interests of Third Nations. The G2 game is rational for the Great Power but not for the rest of the world. The US-China Phase One trade agreement in 2019 demonstrated that even when the Great Powers find compromise, they rarely consider the implications of their actions on other countries. That managed trade agreement diverted trade internationally and potentially weakened the multilateral system.

What is at stake in the provision of global public goods means there is significant incentive to cooperate between the major powers. Global public goods like avoiding catastrophic climate change and global stability from avoiding debt crises in developing countries are so important that they might mean China and the United States find common cause and build trust by working together. The Great Powers may not have as strong an interest as Third Nations in a global public of rule-based trade so will require more arrangements that wrap and enmesh the Great Powers in rules and markets. Competition in multilateral rule-making is a source of conflict between the Great Powers but can be shaped in the interest of Third Nations, the more the arrangements are open and inclusive.

Collective action in a multipolar world

The post-war economic order had an enforcer in the United States that is now its spoiler. US domestic challenges have resulted in a more inward-looking and disruptive United States. How might Third Nations cooperate and overcome the collective action problem in the face of the world's most powerful nation disrupting cooperative outcomes and engaging in strategic competition with the second most powerful nation and other Great Power, China?

A Stackelberg leadership model where a lead country moves first and then the follower firms move sequentially is no longer feasible (von Stackelberg, 1952). A Stackelberg equilibrium may have been possible in the post-war period when the lead nation had commitment power but that is no longer the case.

The GATT and later the WTO helped avoid a prisoner's dilemma outcome in international trade and other global forums helped to forge cooperative outcomes in other domains at various times, such as in macroeconomic policy coordination in the G20 in the immediate aftermath of the global financial crisis. These equilibriums no longer seem feasible and prisoner's dilemma outcomes appear more likely. Repeat games (with annual leaders' meetings), punishment for deviating (agreed rules with penalties, ranging from reputational loss to punitive measures) and creating the frameworks to incentivise collective action will be necessary. If the major powers are locked into strategic competition, collective leadership to create the frameworks for cooperation will be up to Third Nations.

Quah (2024) suggests seeking inadvertent cooperation. In a classic Prisoner's Dilemma scenario, mutual cooperation through binding agreements could theoretically shift outcomes toward collective gain. Yet in today's fragmented global order, trust in formal agreements is scarce. Instead of pursuing unattainable comprehensive binding commitments, the international community should focus on fostering cooperation through informal, self-interested alignment — a concept well understood in economics. Adam Smith famously illustrated this idea, noting that societal benefits often arise not from altruism but from individuals pursuing their own interests.

A modern example lies in the South China Sea disputes of the 2020s. Despite overlapping territorial claims — an inherently zero-sum conflict — Southeast Asian nations have avoided unchecked rivalry by establishing a voluntary Code of Conduct. This framework prioritizes stability without requiring full consensus, and efforts persist to engage China within this structure. Such incremental, interest-driven coordination demonstrates how even adversarial actors can achieve pragmatic cooperation without relying on rigid, enforceable agreements.

Inadvertent cooperation can be combined with a strategy of Third Nations nudging Great Powers out of a prisoners dilemma gridlock (Quah, 2024). Zero-sum conflicts, by definition, offer no room for compromise, making negotiation futile. Many disputes, however, mirror the Prisoner's Dilemma, where mutual cooperation yields optimal outcomes but self-interest drives parties toward suboptimal choices. To disrupt this cycle, strategic incentives—such as modest concessions or assurances—can be introduced. These need not be deployed in an ideal cooperative scenario, but their mere availability helps align interests, breaking gridlock and steering outcomes away from the default non-cooperative equilibrium. By creating mechanisms to reward collaboration or offset defection risks, even adversarial actors can shift the balance toward mutually beneficial resolutions.

The third idea suggested by Quah (2024) is to build systems around plurilateralism or pathfinder multilateralism. A fractured global economy rules out truly universal multilateral frameworks, but the ethos of collective problem-solving can endure through narrower arrangements in targeted domains. These "plurilateral" arrangements act as pioneering models when comprehensive cooperation is unattainable, preserving progress in the absence of fully functional multilateral institutions. Posen (2020) suggests principled plurilataralism that can be led by Japan that includes expansion of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) agreement, as the leading example.

A case in point is the WTO's Multi-Party Interim Appeal Arbitration Arrangement (MPIA). This stopgap mechanism allowed participating nations to resolve disputes among themselves, bypassing systemic gridlock. By focusing on incremental, achievable collaboration among willing partners, such initiatives sustain the spirit of multilateralism even as geopolitical fragmentation deepens. They demonstrate how flexible, subset-driven cooperation can fill voids left by broader institutional failures.

Coordinating inadvertent cooperation, nudging and plurilateral arrangements among Third Nations is difficult in a fragmented global system. The collective action problem where individual country interests do not align with the group interest will need to be overcome to avoid prisoner's dilemma outcomes. Having countries free ride on the efforts of others also poses problems that can disincentivise unilateral action towards inadvertent cooperation.

One possible solution to overcome both the collective action and the free rider problems is *concerted unilateral action* where states identify specific common objectives, but subsequently take steps to pursue those goals unilaterally and voluntarily. That mode of cooperation most known for its success in APEC was through non-binding and voluntary cooperation around the understanding that trade and investment liberalisation was beneficial for individual countries, and the benefits would be compounded if done in concert. Countries committed to a common cause and acted in their own self-interest, benefiting others (Garnaut and Drysdale, 1994; Soesastro, 1994). The organising goal was the 'Bogor Goals' agreed to at the APEC summit in 1994 in Bogor of free and open trade and investment by 2010 for industrialised economies and by 2020 for developing countries.

The Bogor Goals spurred concerted unilateral liberalisation in East Asia and the Pacific. That brought collective action in Asia among a very diverse group of countries with political differences and rivalry. Leadership was provided by the APEC process, an institutional structure in which the tasks of hegemonic leadership were collectively shared amongst the countries of the region.

The positive externalities of a country's actions are internalised to an extent with concerted unilateral action because the gains are compounded as other countries move in roughly the same direction over time, at their own pace. The Paris Climate Agreement is a form of concerted unilateral mitigation (Garnaut, 2015), helping to avoid a Prisoner's Dilemma outcome.

It is difficult for countries to reduce emissions alone or undertake trade liberalisation when markets are closing up but a group of countries with a critical mass agreeing to pursuing what's in their own interest, agreeing to do so collectively, but at their own pace, can help preserve and reform the economic system that they rely on.

Third Nations coming to agreement on the public good or common interest can help organise and motivate concerted unilateral action towards shared objectives. The energy transition imperative and the public good of open markets could help coordinate inadvertent cooperation, nudging and plurilateral arrangements with unilateral action in concert.

Getting agreement on rules for trade and commerce between groups of countries that alleviate or solve challenges between China and the United States can help make progress towards those public good goals.

Conclusion

The actions of the great powers threaten contagion and a race to the bottom in industrial subsidies, security-motivated protectionism, economic coercion and a weakening of the rules-based trading system. This trajectory, left unchecked, will cause fracture in the multilateral system, international economic disorder and adversely affect political, not just economic, security.

Third Nations acting collectively to strengthen the multilateral system, engaging where they can with the Great Powers. That helps to preserve policy space for Third Nations, politically and economically constrain the Great Powers, even by isolating them.

Domestic and multilateral frameworks are needed to reassert and elevate the economic imperative in the international economic order.

The language and framing of policies such as decoupling, de-risking, friendshoring and limiting cooperation to like-minded partners is an anathema to East Asia's success in managing relations between diverse countries with economic integration leading political cooperation. Although the language of decoupling has shifted to de-risking in the United States (and beyond), it is not yet clearly defined or codified and includes decoupling completely, to avoid any perceived security risk, instead of engagement with risk mitigation.

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