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Bolstering Europe's Economic Strategy vis-à-vis China

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The European Commission's 2019 *Strategic Outlook* deftly described China as a partner, a competitor and a systemic rival. This description holds today, but managing these different dimensions is proving increasingly difficult as China poses mounting challenges to core European values and interests. By putting pressure on European companies in response to Lithuania's opening of a Taiwan office, China undermines the integrity of the European single market and the common trade policy; by sanctioning parliamentarians, academics and research institutes over allegations of "misinformation", it deliberately opposes Europe's democratic principles and freedom of speech; and by proclaiming a "no limits" strategic partnership with Moscow and tacitly supporting Russia despite its war of aggression in Ukraine, it is making security policy choices at odds with those of the European Union (EU). Meanwhile, China's approach to global integration and its economic policy priorities increasingly focus on limiting its dependence on foreign suppliers and shielding its vulnerabilities, in a context of massive economic downward pressure.

These profound changes call for a re-assessment of the EU's strategy vis-à-vis China, along three main axes. The first involves traditional trade policy concerns, in response to the shift in China's approach to global integration and to the massive distortions created by its economic practices. Pushing to reform World Trade Organization's rules and to apply them fairly remains the best solution for the EU, but attempts to do this have proven frustrating so far. One way to improve the EU's leverage in this area is to maintain an active but selective use of trade defense instruments. Several measures have already been taken to develop an autonomous instruments toolbox: while negotiations about the anti-subsidies instrument should still be completed, we recommend focusing on the efficient and consistent use of these tools, which will require political leadership and the deployment of substantial means. In contrast, we do not recommend prioritizing a revival of the stalled effort to ratify the Comprehensive Agreement on Investment (CAI).

The second dimension relates to new issues that are taking increasing importance in bilateral economic relations: the defense of human rights is a legitimate objective whose complex implementation will require information-sharing and coordination to elaborate the necessary due diligence frameworks; a carbon-border adjustment mechanism, the enforcement of which should remain a priority, with special attention paid to the way Chinese policies are accounted for, while devoting the resources needed to build strong industrial positions in green technologies; and data regulations that incorporate approaches to personal data which do not block interoperability for industrial uses, conditional on reciprocity, security and privacy.

Third, the EU should put economic security and sovereignty at the core of its strategy vis-à-vis China. Beyond the necessary improvement of EU's capacity for monitoring, research and intelligence, doing this requires developing cost-efficient responses to both minimize vulnerabilities and consolidate or build strong positions in strategic sectors. Policies to accomplish this must be developed into an integrated approach, supported by a stronger institutional capacity.

In sum, European responses should not aim at cutting bilateral economic dependence with China, but rather at making the relationship more balanced and safer.

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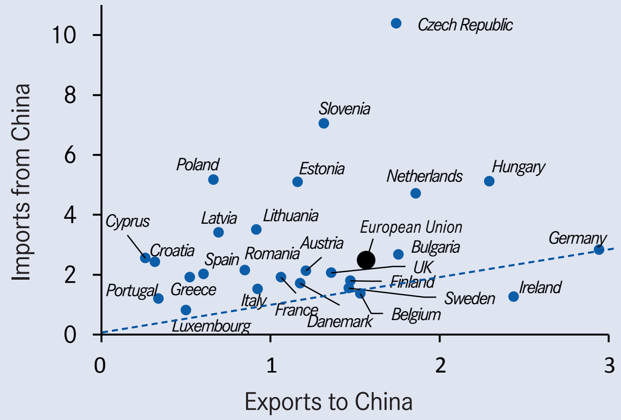
Introduction

When a political agreement was reached on a bilateral investment treaty between China and the EU, on 30 December 2020, it was hailed as a resounding diplomatic success, "an important landmark in our relationship with China and for our values-based trade agenda", in the words of the President of the European Commission. Less than three months later, however, China was announcing sanctions on 10 individuals and four entities in the EU, in response to EU sanctions on Chinese entities accused of human rights abuses in Xinjiang, thereby paralysing *de facto* the process of ratifying this agreement. This episode epitomises the difficulty to manage the relationship with a counterpart famously described in the 2019 *Strategic Outlook* as a "negotiating partner..., an economic competitor..., and a systemic rival".[1] As a matter of fact, China is a very peculiar counterpart for the EU, because it is simultaneously powerful, dynamic and different. Three years down the road, though, it is already time to take stock and think again about this strategy, because the situation has been changing quickly in the meantime, in several ways.

1. The intensity of trade and investment relations with China varies starkly across Member States

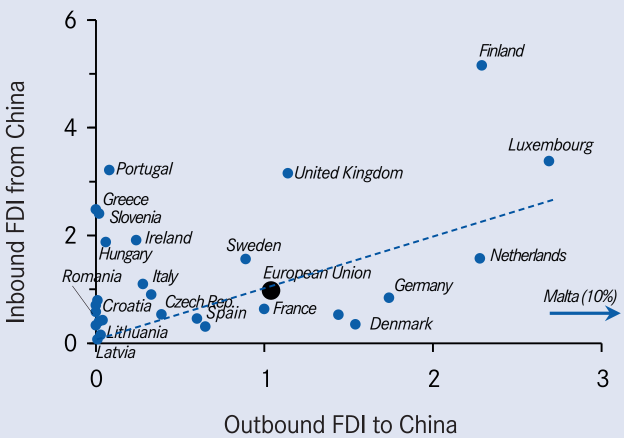
a. Trade (in % of GDP)



Note: The dashed line represents the Y = X axis (i.e. a situation where the imports from and exports to China are equivalent as a percentage of GDP).

Sources: Chelem-CEPII and Huotari M., S. Jean, K. Parra Ramirez and M. Péron (2022) : "Dissecting EU-China Economic Relations", *Focus du CAE*, no 086-2022, July.

b. Foreign direct investments (in % of GDP)



Note: Value of aggregate FDI transactions from and to China over the 2000-2020 period, as a percentage of GDP. The dashed line represents the Y = X axis.

Sources: Rhodium Group and MERICS Research. Details in Huotari M., S. Jean, K. Parra Ramirez and M. Péron (2022) : "Dissecting EU-China Economic Relations", *Focus du CAE*, no 086-2022, July.

EU-China economic relations in context

A close, imbalanced relationship

China is a leading economic partner of the EU, and the relations are deepening as the amount of imports from China went from €25 billions per month at the end of 2019, to more than €40 billions at the beginning of 2022. Economic relations with China matter for all Members, directly or through internal dependencies in the Union, *via* two main relations: trade in goods and foreign direct investments flows. While bilateral FDIs are uneven (Figure 1b), trade flows with China are substantial for all Members States (see Figure 1a, and Huotari *et al*., 2022 on indirect linkages). Still, the contrast is striking between countries like the Netherlands, Finland, Germany, Hungary, Malta or the Czech Republic, for which bilateral economic links are intense on most accounts, and others like Italy, Spain, Romania, Croatia, Latvia or Lithuania, where there are of far lesser significance. Against this background, France is in an intermediate situation, with in particular bilateral economic relations with China that are far lower than those of Germany, even though the difference in export intensities shrinks when indirect contents are accounted for.

While Chinese export specialization is getting closer the one of several EU countries, it differs in important ways. It includes a large share of products classified as high-tech, for instance in consumer electronics, and is very successful in key new products, such as electric vehicles (see *Focus* associated, Huotari *et al*., 2022). Another striking characteristic of these trade relations is their imbalance, which has even been growing worse, reflecting the enduring difficulty for the Chinese government to put in practice its stated willingness to rebalance its economy. These persisting imbalances are not sustainable, and growing competitive pressures in key industries are likely to create new frictions.

While Chinese FDI to the EU declined substantially compared to the peak in 2016 and 2017, it seems to have now stabilized,

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Original pieces of analysis underlying this *Note* are detailed in the associated *Focus*, Huotari M., S. Jean, K. Parra Ramirez and M. Péron (2022) : "Dissecting EU-China Economic Relations", *Focus du CAE*, no 086-2022, July.

[1] European Commission (2019): *EU-China. A Strategic Outlook*, EC and HR/VP Contribution to the European Council, March, p. 1.

at a level comparable to flows in the opposite direction. Greenfield investment was the most dynamic component, worth more than $2.5 billion yearly in 2020-2021, its highest level ever, and representing 30% of Chinese FDI in the EU. European FDI, mostly driven by German big multinationals, has also revived and reached record levels in 2021. Targeted and selective market openings, including in the financial and automotive sectors, continue to create new perceived opportunities for major European corporates.

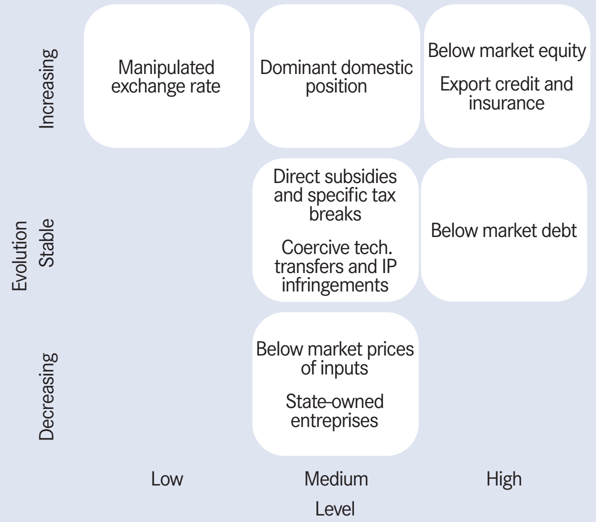
The shift in China's approach to global integration and economic policy priorities

Beijing's perspective on globalization and interdependence has shifted significantly, particularly since the escalation of tensions with Washington in 2018. It is very likely that the economic warfare waged by the "West" against Russia will heighten preexisting concerns among leaders in Beijing about their own dependencies and vulnerability and accelerate a shift towards greater autonomy. The policy shift towards the Dual Circulation Strategy (DCS) set out by President Xi Jinping in April 2020 already focused on managing China's interdependence with the world by re-emphasizing indigenous innovation and self-reliance. The DCS seeks to insulate China from external shocks by reducing dependence on external demand (exports to advanced economies) as a driver of economic growth by boosting domestic consumption, social policy expenditures and relations with developing economies. It doubles down on China's ambitious industrial policy plans, as expressed in the Made in China 2025 strategy, to position China as a global manufacturing powerhouse in high value-added products while seeking to ensure access to critical inputs, resources and technology by diversifying supply chains. New policies also aim at localizing R&D in China wherever feasible.

The US-China trade war sent China's self-reliance campaign into overdrive, especially given restrictions on US technology exports to some Chinese firms. The fact that foundational technologies remain largely imported or foreign-made has been increasingly considered unacceptable. Hundreds of billions of yuan have therefore been allocated to support innovation, using traditional state-aid mechanisms like financing on favorable terms or subsidies as well as newer tools like state-guided funds or technology-focused stock exchanges (see Figure 2).

Policymakers are rolling out a suite of securitization measures, including new rules to support the national security dimensions of economic relations. For example, national security reviews are now required for firms investing in areas defined as Critical Information Infrastructure (CII), a designation that has not been accurately defined. China also deploys less explicit tools that impact supply chains more broadly. There are unofficial

2. Chinese subsidies are moving toward more innovative forms



Reading: China uses the manipulation of exchange rate at a relatively low level, but increasingly since a few years.

Source: Chimits F. (2021): "Chasing the Ghost of Transatlantic Cooperation to Level the Playing Field With China: Time for Action", *MERICS China Monitor*, October. See for details, Huotari M., S. Jean, K. Parra Ramirez and M. Péron (2022) : "Dissecting EU-China Economic Relations", *Focus du CAE*, no 086-2022, July.

yet growing requests for "Autonomous and Controllable" (A&C) technology value chains, in order to make sure that production processes are not exposed to foreign sanctions or coercive measures. The implication is that in areas of critical technology, China aims either to develop indigenous production or to fully onshore foreign technology value chains. For foreign producers, this implies additional constraints on local production and creates additional market access barriers for the technologies concerned. European companies in China report that they are facing growing pressures, often forcing them to decouple their China operations from their global ones, with potential negative impacts on their activity.[2]

For European companies, the treatment varies widely across sectors. When they are able to offer technologies for which there is no good local substitute (semiconductors, software, upstream inputs in chemicals and machinery), they are welcome; where China feels it can already be self-reliant (ICT, telecommunications or digital services), in contrast, they face mounting obstacles, and often feel squeezed out of the market; in sectors deemed non-contentious (automotive, cosmetics), foreign producers are considered as useful to spur competition, and their treatment by the authorities is characterized by benign neglect.[3]

A recent study[4] confirms that China's R&D ecosystem is considered to be increasingly vibrant and that China-based

[2] See European Union Chamber of Commerce in China (2021): "European Business in China: Business confidence Survey 2021", *EUCCC Report*, June, and European Union Chamber of Commerce in China (2021): "European Business in China Position Paper", *EUCCC,* no 2021/2022, EUCCC, September.

[3] See EUCCC and MERICS (2022): *China's Innovation Ecosystem: Right for Many, but not for All*, Report based on a survey and in-depth semi-structured interviews with European corporates from the EUCCC R&D working Group, June.

[4] EUCCC and MERICS (2022) *op. cit*.

innovation activity is being increasingly integrated into companies' global efforts. At the same time, companies face increasing pressure to onshore higher value-added production and innovative activities, as a prerequisite to succeed in the Chinese marketplace. Such practices would clearly be at odds with the national treatment principle. Chinese efforts to localize innovation activities should be closely monitored to make sure that they respect this principle, and they should be vigorously opposed if they do not, because that would represent a significant threat to the vitality of the EU's innovation system.

Finding 1. China is increasingly focusing on self-reliance and securitization, which creates additional barriers and disadvantages for European companies in China, especially in sensitive sectors. It also results in a forceful localization pull for higher-value added production and innovation activities.

Dealing with traditional trade policy concerns

The traditional focus of EU trade policy lies in ensuring a level playing field, and many issues stand out in this respect in relations with China. First, despite the relatively low level of tariff duties in China, effective market access remains a serious concern, for both trade and investment, due to the way rules and regulations are applied in practice. Second, in contradiction to China's commitments, forced technology transfers remain widespread, even though in many cases they do not result from legal obligations. Third, industrial subsidies play a prominent role in allocating resources across firms and sectors in China, reaching a scale unparalleled anywhere else. Direct subsidies are not the main concern, as the modalities of state support and guidance are shifting rapidly towards a "financialization of state capitalism" and towards the targeted use of markets as multipliers of state support, as exemplified by the increasing recourse to below-market equity finance in high-tech sectors (Figure 2).

Finding 2. Competition in China is distorted by the lack of transparency and fairness in the way regulations are applied, and by persistent practices of forced technology transfers. Multifaceted government support of an unprecedented scale generates massive distortions.

Applying WTO rules and pushing for reform

In dealing with these traditional trade policy issues, favoring rules-based solutions is preferable for the EU from the point of view of both interests and values. Beyond the general case for multilateral trade agreements, this is coherent with the institutional nature of the EU, which is inherently organized around rules and has less political cohesiveness than a state, a significant handicap for power politics.[5] In addition, the confrontational approach followed under the Trump administration has little to show in terms of concrete results –or even as a consistent strategy.

In practice, efforts to obtain a suitable application of rules, while not fruitless, remain frustrating. An example is the difficulty to end forced technology transfers, despite years of complaints about the issue (including at the WTO in 2018, see Huotari *et al*., 2022). More recent cases show that enforcing their intellectual property rights in China remains challenging for EU companies.[6] Another example is the paralysis of the Appellate Body of the dispute settlement system; even though the creation of a Multi-Party Interim Appeal Arbitration Arrangement (MPIA) maintained the possibility of enforceable rulings among members, including China, it cannot play the same institutional role. More broadly, the frustration stems from the difficulty for this system to deal with opacity and informal obstacles which, while not specific to China, are especially important in its economy.

The domain in which this frustration is highest is probably industrial subsidies. The WTO Agreement on Subsidies and Countervailing Measures (SCM) defines disciplines in this respect, either by prohibiting those that are excessively distortive (because they are contingent on export outcomes or on the use of local products), or by making actionable those that are prejudicial to partner countries. In practice, though, this framework falls short of leveling the playing field, chiefly because its rules are excessively restrictive in their definition or too demanding in the proofs that they require.[7]

The EU has made concrete proposals about WTO reform in general, and issues related to subsidies in particular, and recently reaffirmed its willingness to work in this direction.[8] These efforts should be continued: as a number of the issues at stake are not bilateral in nature, only a multilateral institutional framework, with the associated peer pressure, can provide an efficient framework for rules-based dispute settlement. In this respect, though, prospects for substantial reform remain remote. A multilateral agreement is certainly out of reach in the near future, but even a plurilateral one

[5] For a detailed, insightful analysis of the way multilateralism remains helpful to deal with China, see Mavroidis P.C. and A. Sapir (2021): *China and the WTO. Why Multilateralism Still Matters*, Princeton University Press.

[6] See the case raised by the EU against China in February 2022 for restricting EU companies from going to a foreign court to protect and use their patents (WTO, DS611).

[7] It is also noteworthy that notifications requirements are not well met, notably by China, whose latest notifications were issued in 2019, for years 2017 and 2018, and were far from comprehensive –as noted in WTO Secretariat (2021): *Trade Policy Review: China*, Report, September.

[8] See European Commission (2018): *EU Concept Paper on WTO Reform*, September, and European Commission (2021a): *Trade Policy Review: An Open, Sustainable and Assertive Trade Policy*, February.

would require convergence on substance between the key players, for which there exists very limited ground, in particular because there are few incentives for China to accept new disciplines that might constrain its industrial policies.[9] Efforts to engage China on this issue, in coordination with like-minded countries, should be pursued notwithstanding, but they should be accompanied with active policies minimizing the cost of these subsidies for the EU, and improving its bargaining position by limiting the benefits that China can reap from practices that distort a level playing field.

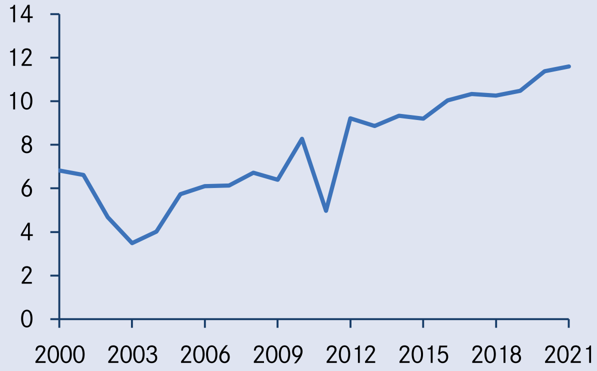
Trade defense instruments

Precisely, trade defense instruments (TDI) are designed to deal with concerns about unfair competition. The most commonly used by the EU is antidumping. Indeed, 91 measures were in force against Chinese imports at the end of 2020, representing about 70% of all EU antidumping measures.[10] Eight countervailing measures, meant to adjust to industrial subsidies, were also in force against Chinese imports at that date, plus one against Chinese subsidies granted to Chinese-owned companies based in Egypt and exporting from there to the EU.

Antidumping measures result in very sharp drops of import volumes, often in the range of 60 to 90%, and they were covering almost 11% of total imports in 2021, a share that increased significantly over the last decade (Figure 3). It is only slightly lower than the one for the United States (12% in 2019, according to Bown *et al*., 2020).[11] As such, this instrument very significantly influences bilateral trade with China. This is why the dispute launched by China at the WTO in December 2016 about the way it was treated in the EU's antidumping procedure was of particular significance: it was based upon the assertion that, following the expiry of the 15-year transition period, China should be considered a market economy and as such, treated as other trade partners in antidumping procedures. This dispute was abandoned by China in June 2019, validating *de facto* the EU reform of its antidumping methodology that makes it possible to continue applying the so-called "analog country method" when state interference significantly distorts the Chinese market.[12] In practice, antidumping thus remains the key trade defense instrument for the EU, because it is both powerful and less difficult to implement than others.

Nonetheless, this instrument is not up to the task of balancing the consequences of Chinese industrial subsidies, for several reasons. One is that the use of such trade defense instrument is by definition supposed to be exceptional, addressing situations of outright unfair competition. As a matter of fact, while the 2018 TDI reform opened the way for the Commission to launch investigations by itself ("*ex officio*"), in practice they remain launched as a result of industry complaints. And because they are complex and costly, they are concentrated in a few sectors, like metals or metal products and chemicals, which usually account for about two-thirds of all cases.[13] The risk is that such a concentration of cases would create rent-seeking behaviors in some sectors, where the combination of influence, skills and coordination capacity makes it possible and profitable, while not being practicable in other sectors where these conditions are not met, despite the reality of an unfairly subsidized competition. For these reasons, maximizing the use of antidumping procedures should not be considered an objective in itself.

3. Share of EU imports from China subject to an antidumping measure (in %)



Note: The share covered by each investigation is computed for the year before its initiation.

Source: Calculations by Kevin Lefebvre, CEPII, based on Eurostat and on Bown C.P., M. Cieszkowsky, A. Erbahar and J. Signoret (2020): "Temporary Trade Barriers Database", *World Bank*.

Recommendation 1. Reinforce cooperation between like-minded countries on subsidies in order to jointly engage China on this topic. Remain active but selective in the use of trade defense instruments.

The other limitation of trade defense instruments is that they can deal only with competition distortions in the

[9] The so-called "trilateral" dialogue with the United States and Japan had no visible outcome between January 2020 and its recent relaunch, suggesting that even coordination between countries which share similar views on many issues, is not easy.

[10] European Commission (2021b): "Commission Staff Working Document Accompanying the 39th Annual Report from the Commission to the European Parliament and the Council on the EU's Anti-Dumping, Anti-Subsidy and Safeguard activities and the Use of Trade Defence Instruments by Third Countries targeting the EU in 2020", *European Commission*, SWD(2021) 234 final.

[11] Bown *et al*. (2020) find a significantly lower coverage rate for the EU, mainly because they measure import shares during the year before implementation, while we are referring to the year before initiation.

[12] See Bellora C. and S. Jean (2016): "Granting Market Economy Status to China in the EU: An Economic Impact Assessment", *CEPII Policy Brief*, no 11.

[13] See European Court of Auditors (2020): "Trade Defence Instruments: System for Protecting EU Businesses from Dumped and Subsidised Imports Functions Well", *European Court of Auditors* Report, no 2020/17.

EU's market for goods: they are of no use in China or in third markets, and they do not cover services. Against this background, the EU has been focusing on two additional tools to seek a rebalancing of the trade and investment relationship with China: the CAI and a toolbox of autonomous instruments.

The bilateral investment agreement

For years, the CAI has been prioritized as a way to engage bilaterally China. As a matter of fact, the agreement does include significant commitments on the Chinese part regarding market access for investment in several sectors, the behavior of State-Owned Enterprises (SOEs), the transparency of subsidies, and forced technology transfers. Given the limited actual concessions made by the EU, this has been presented by the Commission as an agreement allowing a substantial rebalancing of bilateral economic relations. Its benefits may have been oversold, though, because of the uncertainty associated with the way the agreement will be effectively implemented, and because many apparent concessions were changes China was willing to make anyway.[14]

In any case, the agreement is now at a stalemate: reciprocal sanctions have halted for good the ratification process in the EU Parliament, and its completion in the near future seems very unlikely. The agreement in principle was thus announced while the political conditions for enforcing it were not met. This calls into question the general process as well as the prioritization of this agreement in order to rebalance the bilateral economic relationship. By hailing the concessions obtained from China as a rebalancing of the economic relationship, the narrative accompanying the agreement reveals its weakness: if the agreement were really asymmetrical, what was the incentive for China to enforce it? And if its enforcement is doubtful, what is its value for the EU? The political dimension of such agreements, frequently presented as partnerships, often stands out; this is not the case here, as the sanctions made obvious only a few months down the road. This is why, under the present circumstances, we do not consider that ratifying the CAI should be a priority.

Recommendation 2. Do not seek to complete CAI ratification until the political context improves significantly.

The autonomous instruments toolbox

Instead, the EU should not expect the rebalancing to come from Chinese concessions, but rather from its own initiatives to defend its interests and values. This logic has for a few years been underpinning the development of autonomous instruments that are wide-ranging and relevant, even though none of them is specific to China:[15]

- The appointment of a Chief Trade Enforcement Officer, meant to embody and accompany the focus on the implementation of trade agreements and commitments. Effective since July 2020, it is too early to judge its real impact;
- The enforcement regulation (2021/167) adapting the EU's practice in the application and enforcement of trade rules to a context where the WTO dispute settlement system is de facto paralyzed;
- The International Procurement Instrument, agreed in March 2022, seeks to rebalance conditions of access to government procurement markets with non-EU countries that did not make analogous commitments. Vis-à-vis China, such an instrument appears legitimate and necessary to ensure reciprocity, but its efficiency risks being blunted by the fact that Member States, not the Commission, will decide on possible exemptions. Centralized decision-making would be more efficient in terms of both independence and coherence;
- Foreign subsidies regulation: the Commission has circulated a proposal, which is being studied by the European Parliament (EP). This regulation is needed to counter the impact of foreign subsidies on the internal market through foreign investment or mergers and acquisitions.

While the regulation on foreign subsidies remains to be finalized, the focus should now lie on the consistent implementation of this variety of tools. This will be challenging and will presumably require devoting substantial resources to this task, following up on the rebalancing from negotiation toward implementation.

Recommendation 3. Finalize the foreign subsidies regulation and focus on the efficient implementation of the toolbox of autonomous instruments.

[14] See Godement F. (2021): *Wins and Losses in the EU-China Investment Agreement (CAI)*, Institut Montaigne, February.

[15] Leaving aside those related to economic sovereignty and security, like investment screening, anti-coercion instruments or export controls, dealt with below.

"New" issues

Increasingly, issues that do not belong to the traditional realm of trade and investment policies are playing an important role in the definition and management of the EU's economic policy vis-à-vis China. This is in particular the case of human rights, climate change and the regulation of the digital economy.

Human rights

The common trade policy is a component of the Union's external action, with the associated objectives, including the defense of human rights (Article 21 TEU). As a result, economic relations cannot be separated from questions such as ongoing massive human rights violations in China, the breaking of international commitments (Hong Kong, United Nations Convention on the Law of the Sea) and the strengthening of authoritarian party rule at home. Values questions explicitly feature in specific agreements and instruments.[16]

The most immediate challenge remains the suppression of Uyghurs in Xinjiang and, while the recent ratification by China of two International Labour Organization conventions on forced labor is positive in principle, only concrete progress will really matter here. This has motivated proposals to ban from the single market products made with forced labor, a step the United States already took in December 2021. Beyond the prohibition of knowingly buying products made with forced labor, which already existed in the United States, the key point of such legislations is to shift the burden of the proof to companies, with significant investigation and reporting requirements.

As a matter of fact, the direct exposure to exports from the Xinjiang region is comparatively limited for the EU. Global exports from the Xinjiang region climbed back to above EUR 15bn worth of goods in 2021 according to official statistics. Major export goods include electrical products, tomato paste, shoes and textiles –over 80% of those exports traditionally go to Central Asia. Less than 1% of Xinjiang exports are handled by foreign-invested enterprises, with that share declining significantly over past years. Indirect exposure through China-internal supply-chains adds significantly to the picture, however. According to human rights organizations, up to 20% of all cotton-based products, and up to 97% of all polysilicon-based solar panels around the world, are at high risk of being tainted with Uyghur forced labor. Given this complex background, the channels and exact scope of European entanglement with human rights violations in China will remain difficult to ascertain.

Some Member States, such as France and the Netherlands, have already adopted legislation to enhance accountability and have introduced mandatory due diligence frameworks. Other governments are currently considering similar actions, including Germany, Austria, Sweden, Finland and Denmark. At the European level, the European Parliament has proposed a legislative initiative in March 2021, and the Commission issued its proposal for a Directive on Corporate Sustainability Due Diligence on 23 February 2022.

Trade and investment measures can only be a component of the EU's policies, and their efficacy should not be overstated, given the complexity inherent in their enforcement and the extensive possibilities for circumvention. This calls for paying close attention to the coherence and suitability of regulations, which should require from enterprises means that are proportional to their capacities, in accordance with United Nations guiding principles and OECD guidelines, and they should account for the sector-specific context. As success in the use of such policies is difficult to define and evaluate, especially vis-à-vis China, implementation should leave ample room for adjustments further down the road.

Recommendation 4. In using trade and investment policies to deal with human rights violations, focus on coordination with like-minded countries, the proportionality of regulations, and the adjustability of actions.

Climate change

Fighting climate change effectively is a key common responsibility on which the EU and China should develop their partnership. The carbon border adjustment mechanism (CBAM) proposal published by the Commission in July 2021 is of central importance in this area. Its success will hinge on the capacity of the EU to make it not a source of trade conflicts, but an incentive for partners to accelerate their own transition.

The economic consequences of the proposal should be limited for China in the short run, but the mechanism could be far more consequential in the long run, especially considering the extension and intensification (in terms of price) of the process. Assuming that the relative price of carbon between China and the EU remains unchanged over time, Bellora and Fontagné (2022)[17] show how consequential the mechanism could be for bilateral trade: EU imports from China might fall by 5% for manufacturing products as a whole by 2040, and by 20% or more for metals, metal products and chemicals.

In practice, the specific way the CBAM takes into account Chinese policies is central to making a constructive reaction

[16] For instance, the CAI agreement was also meant to establish a more solid anchor for the enforcement of labor rights in China.

[17] Bellora C. and L. Fontagné (2022): "EU in Search of a WTO-Compatible Carbon Border Adjustment Mechanism", *CEPII Working Paper*, no 2022-01, March. Comments based upon detailed results provided by the authors.

from China possible. China has launched its national Emissions Trading System (ETS) in June 2021, but it is limited to the power sector (with a price fluctuating around $8 per ton so far) and relies upon technology-specific benchmarks and free allowances.[18] Accordingly, it is expected to play only a limited role in curbing Chinese emissions. Differences in policy control also imply that it does not lend itself to direct comparisons –let alone full linkage– with the EU system, which has a pre-determined absolute cap on emission quotas and is bound to get rid of free allowances. This does not mean that Chinese policies will not be ambitious, but they may take different forms, like constraints on coal-fired power capacity and possibly a carbon tax and other policy instruments.

While there is no direct equivalence between such policies and an ETS, the corresponding efforts need to be taken into account. To do so, the priority should be to engage in dialogue and cooperation about how to deal with comparability across policy schemes, while maintaining the momentum toward CBAM implementation. The WTO and/or the OECD could be well-suited to host such an initiative, which could take the form of the comparability forum proposed by Lamy *et al*. (2021, 2022).[19] Coordination around minimum prices, in order to form a club of countries cooperating on the transformation of industrial sectors and jointly applying a common adjustment mechanism, could also be considered.[20] However, given the urgency of fighting climate change, these initiatives should not delay the implementation of CBAM, which should remain the priority.

While every effort should be made to foster coordination on the climate, we do not think that linking it to cooperation in other areas would be a reliable way to move forward. Given the tensions already described and the difficulty in building trust, relying upon incentive-compatible, self-contained schemes seems safer.

Meanwhile, the technological and industrial dimension of the ecological transition is another challenge in which relations with China are likely to play an important role. Given its strong positions in many of the relevant raw materials, technologies and markets, along with the focus of its industrial policy on the corresponding sectors. Chinese advances represent a challenge for European competitors. This is a good thing in itself but raises concerns related to a level playing field, industrial subsidies and the entanglements of innovation systems. Given their strategic importance, these sectors deserve special attention and warrant ambitious policies to make sure the EU further develops strong positions in both applied research and industry.

Recommendation 5. In moving toward CBAM implementation, engage with China about the way to account for different climate policies in a plurilateral framework. In parallel, devote special efforts to build strong positions in research and industry in green technologies.

Digital economy

Digital policies to regulate and tax the transfer and use of information, data, software and technology will underpin the future of trade. As a major digital power, China will have considerable influence over global digital rule-setting, including in the WTO. China is already attempting to shape digital trade rules, for instance via the Regional Comprehensive Economic Partnership (RCEP). Patterns of policy making and Beijing's announcements point to a continued divergence from OECD baselines and EU interests:

- China remains one of the most restricted countries in digital trade across several dimensions, including fiscal restrictions and market access, establishment restrictions, restrictions on data and trading restrictions;
- China pursues different digital standards and fundamentally restrictive digital policies and is the world's leading practitioner of surveillance. Since the enactment of the Chinese Cybersecurity Law in 2017, foreign companies in China are forced to comply with a host of cyber-security rules, including intrusive information and communications technology (ICT) product certification and security review processes;
- There are few restraints on government interference in digital markets, for instance regarding censorship and cyberspace regulations;
- Companies face growing localization requirements, including for data hosting and cloud services, and a wide range of restrictions for cross-border flows and the transfer of data, including personal data and data considered relevant to national security, but also customs duties on electronic transmissions;
- China is a leading practitioner of mercantilist policies that shape digital trade and the context for global digital competition including via ICT industrial policies, the protection, nurturing and favoring of national champions, and public procurement constraints on technology choices.

While such restrictions also limit China's global competitiveness in the realm of digital services, its approach

[18] See for instance Tu K.J. (2021): "China's Long Quest for an Appropriate Carbon Pricing Regime" in Mathieu (ed.), *Can the Biggest Emitters Set Up a Climate Club? A Review of International Carbon Pricing Debates*, Études de l'IFRI.

[19] Lamy P., G. Pons and P. Leturcq (2021): "GT6. Vers un mécanisme d'ajustement carbone aux frontières", *Europe Jacques Delors Policy Paper*, July, and Lamy P., G. Pons, I. Garzon and L. Kauffmann (2022): "GT8. Aspects internes et internationaux du MACF de l'UE", *Europe Jacques Delors Policy Paper*, February.

[20] See e.g. Goldthau A. and S. Tagliapietra (2022): *How an Open Climate Club Can Generate Carbon Dividends for the Poor*, Euractiv Media Network, January.

is likely to have far-reaching implications for global digital rule-setting and bilateral relations.

The entanglement between Chinese digital platform providers and global markets, specifically services involving personal data, is likely to increase (as ongoing TikTok probes illustrate) but remains constrained. The outlook is different, however, for product- and manufacturing-related digital services for which access and competition in China are likely to be heavily contested, requiring new forms of reciprocity. A recent survey finds that more than half of the German companies surveyed expect that due to the regulatory differences in digitization, the Chinese market can hardly be served by exports any longer but increasingly only by producing in China.[21] Cybersecurity and data protection requirements and regulations have entered the list of top 5 business challenges for German and top 10 concerns for EU companies in China.

Recommendation 6. Use reciprocity conditions as a leverage to support EU companies in their efforts to maintain transferability of industrial and other data across Chinese borders, conditional to security and privacy.

Building a new economic sovereignty and security core

The EU's economic relations with China are not only marked by increasing politicization, they are also increasingly at risk of major disruptions –and the stakes would be disproportionately higher for the EU than they are in relation to Russia.[22] We do not think that cutting economic interdependence would be a suitable response to this situation: exchanges generate significant economic gains,[23] and despite asymmetries that can be exploited, they also create overlapping interests that could serve as the basis for durable and constructive relationships. However, the overall situation warrants putting economic sovereignty and security at the core of EU's China policy objectives, in order to minimize vulnerabilities, and to secure the means to act independently and to pursue fundamental goals. A safer interdependence, not decoupling, should be the aim.

While the EU is exposed to its externalities, it would not be well advised to copy China's approach to economic security. There is, however, a lot Europe can learn from like-minded partners in Asia: Japan, South Korea, Taiwan and Australia are all much more interlinked economically with China than the EU and its individual Member States, and their relations with China have been occasionally fraught with serious disputes, tensions and sanctions. They have generally shown remarkable resilience in dealing with these episodes and have taken concrete steps to adapt without giving up the benefits of their relations with China. Examples include the way Japan cut its dependence to China for rare earth supply, from 90% of its imports in 2008 to 58% in 2020, as a result of a proactive diversification strategy, after facing a *de facto* export ban on these materials in the 2010 bilateral dispute following a collision between ships near the Senkaku/Diaoyu islands;[24] or the way Australia's Treasury improved its "intelligence" and strategic assessment of China's capabilities, intents and vulnerabilities, including analyses that have underpinned the design of diversification strategies. South Korea and Taiwan are also remarkable in having built very strong positions that have made them indispensable in strategic sectors (including semiconductors), giving them strong leverage to cope with possible tensions.

Make interdependence with China safer

A sophisticated and dynamic assessment of European dependencies needs to be at the center of Europe's efforts to strengthen economic sovereignty and security vis-à-vis China. Several recent studies and reports pave the way for this.[25] The focus should be on strategic dependencies, defined by the European Commission as "dependencies that are considered of critical importance to the EU and its Member States' strategic interests such as security, safety, health and the green and digital transformation".[26] The critical importance of sectors has to be assessed qualitatively, based on their indispensability or their strategic interest, including the performance of critical infrastructure and of Europe's defense industrial and innovation base. Vulnerability, in contrast, needs to be evaluated at a detailed level, based on product-level trade statistics. The objective is to identify cases where supply relies upon a limited number of extra-EU sources, with limited possibilities of substitution or by a lack of alternative suppliers available in Europe or

[21] See Matthes J. (2021): "Wettbewerbsverzerrungen durch China. Akademische Evidenz und Ergebnisse einer Befragung deutscher Unternehmen", *IW-Report*, Nr. 11, Köln.

[22] In 2021, 22.3% of EU imports originated from China, compared to 7.7% from Russia. Meanwhile, 10.2% of EU exports went to China, against 4.1% to Russia.

[23] On gains for French consumers, see for instance Carluccio J., P. Gautier and S. Guilloux-Nefussi (2018): "Dissecting the Impact of Imports from Low-Wage Countries on French Consumer Prices", *Banque de France Working Paper*, no 672.

[24] See, e.g., "Japan's Global Rare Earths Quest Holds Lessons for the US and Europe", qz.com, 23 April 2021. Available at https://qz.com/1998773/japans-rare-earths-strategy-has-lessons-for-us-europe/

[25] See in particular Bonneau, C. and M. Nakaa (2020): "Vulnérabilité des approvisionnements français et européens", *Trésor-Eco*, no 274, whose methodology was used and extended in European Commission (2021c): "Strategic Dependencies and Capacities", *Commission Staff Working Document*, no SWD 352. See also Zenglein M.J. (2020): "Mapping and Recalibrating Europe's Economic Interdependence with China", *MERICS China Monitor*, November 18, and Jaravel X. and I. Méjean (2021): "A Data-Driven Resilience Strategy in a Globalized World", *Note du CAE*, no 64, April. For critical materials, different methodologies can be used, building specific information about the reserves and output available in this case (e.g., European Commission (2020a): *Critical Raw Materials Resilience: Charting a Path Towards Greater Security and Sustainability*, COM/2020/474, September. For more aggregate assessments, see also EC's Strategic Foresight Reports, issued yearly since 2020, and the associated resilience dashboards.

[26] EC (2021c), *op. cit*.

in the world market. Although their frequency varies widely depending on the method they employ, several analyses show that such dependencies are not uncommon,[27] including in particular items belonging to raw materials (in particular rare earths and certain metals), electronic components, chemical products and pharmaceutical ingredients. They also invariably conclude that the main partner with regards to which such strategic dependencies show up is China. An extreme (and important) case is rare earth elements, for which China provides 98% of the EU's supply.[28]

Dependence on the Chinese market also matters. China has already used access to its market as an instrument for sanctions or coercion, for instance recently against Australia and Lithuania, and against European firms taking measures in relation to forced labor in Xinjiang. Accordingly, being over-reliant on the Chinese market could be a source of vulnerability. And many large European firms do appear heavily exposed to China: while estimates vary, it appears clearly that a substantial share among them, probably on the order of one-third, derive more than 10% of their total revenue from China.[29] However, this general figure groups together all revenues, irrespective of the place of production. From a public policy perspective, in contrast, affiliates in China matter far less than European units, because they are less directly linked to employment and production in Europe. Focusing on exports to China thus provides another insightful measure of exposure to the Chinese market, and calculations based on French firm-level data show that the orders of magnitude are different in this case:[30] in 2019, exports to China represented more than 5% of output (on French territory) for only 1.7% of French manufacturing firms, and for 4.3% of large firms (see Table below and Huotari *et al*., 2022). In sum, exposure to the Chinese market is far larger when considering all EU companies' revenues in the Chinese market, including through local production, rather than only exports; while private investors are concerned with the former –and should be conscious of the extent of their exposure to geopolitical risks in China– public policies should focus mainly on the latter. Accordingly, the opportunity of providing government guarantees for private investments in China should also be reconsidered, taking into account the broader context of the bilateral relationship.

Yet another potential vulnerability is a clustering of corporate or sectoral dependence on China's market, which creates risks not only for companies. Such a situation also endangers long-term corporate and national competitiveness if higher value-added and innovation-intensive activities are systematically relocated. Dealing with such threats requires monitoring closely how European-Chinese R&D relations develop and how entanglement with the Chinese innovation system challenges Europe's long-term competitiveness.

Recommendation 7. Strengthen the EU's capacity for monitoring, research and intelligence on vulnerabilities, resilience and competitiveness challenges associated with the EU's economic and innovation entanglement with China.

Export dependence on China among French goods-producing firms, by group size (proportion of firms according to the share of exports to China in total sales reported in France, in %)

		Small-medium	Intermediate	Large	All
	No export	88.7	41.4	22.6	85.1
Exports to China as a share of total sales reported in France	< 5%	9.9	53.7	73.1	13.2
	5-20%	1.1	4.5	4.3	1.4
	> 20%	0.3	0.4	0.0	0.3
Exports to China as a share of total sales from France for the category		0.5	0.9	1.6	1.3
Share of the category in total sales reported in France		11.9	29.7	58.3	100.0

Scope: Goods-producing firms, except agriculture and extractive industries.

Source: Calculations based on confidential French Customs data (Statistiques du commerce extérieur de la Direction générale des Douanes et droits indirects) and Dispositif Esane (INSEE). See Huotari M., S. Jean, K. Parra Ramirez and M. Péron (2022) : "Dissecting EU-China Economic Relations", *Focus du CAE*, no 086-2022, July for details.

[27] The share of products concerned is assessed to be equal to 2.4% by Bonneau and Nakaa (2020, *op. cit*.), 2.7% by the EC (2021c, *op. cit*.), 11.8% by Zenglein (2020, *op. cit*.), and 6.4% by Jaravel and Méjean (2021, *op. cit*.).

[28] EC (2020a, *op. cit*.).

[29] Out of the 25 EU-listed companies studied in Zenglein (2020, *op. cit*.), 12 derived more than 10% of their total revenue from China in 2019. Focusing on the 25 most exposed to China, out of the 50 biggest firms by market capitalization in MSCI Europe, Dams T. and M. Xiaxue (2022): *Investors Beware: Europe's Top Firms are Highly Exposed to China*, Clingendael Report, April, find that China accounted for more than 10% of revenue for 17 of them.

[30] Another channel directly linking output in Europe to Chinese demand is sales to Chinese travellers, which are sizeable in particular for luxury goods.

European responses

Addressing these strategic dependencies requires pursuing two broad objectives: resilience –limiting vulnerabilities and strengthening the capacity to absorb shocks– and relevance –reinforcing the capacity to act and shape international outcomes, by setting rules, influencing partners and building strong competitive positions.

Several objectives should be pursued to improve resilience:

- *Use multilateral and like-minded fora to tackle violations of international agreements and coordinate with partners*. The EU has just launched a WTO case on Lithuania, and others like Australia have done so successfully in episodes involving coercion. The G7 format, the EU-US trade and technology council, and dialogues with Japan and Australia can serve to coordinate the interpretation of international rules and proposals for their evolution;
- *Secure access to critical raw materials*. Despite the four communications published by the European Commission on this topic since 2011, the situation remains worrying, especially in a context where the ecological transition will transform, and in many cases increase, reliance on specific raw materials. Putting into practice the proposed action plans should be considered a priority, including through a proactive diversification strategy;[31]
- *Secure critical supply chains*. Diversification and friend-shoring (and in some cases storage) should be considered first, because of their cost-efficiency. Public policies might contribute to provide accurate information and raise awareness among private actors. More targeted incentives for industries and companies to diversify their global supplies and markets away from China should be considered, but only for specific products of critical importance and high vulnerability;
- *Protect critical infrastructures and assets*. Resilience should also be considered at the level of infrastructures and emerging technology ecosystems, using robust and coherent methods, as developed for the "EU 5G toolbox";
- *Improve the supervision and control of economic flows*. Despite significant improvements, questions remain about the capacity of European authorities to monitor correctly the ultimate beneficiary owner when complex schemes are at stake, or when investments are below established thresholds. The EU has also recently upgraded and modernized its Export Control Regulation, which is likely to increase China-related cases. There is a need for debate on outbound investment screenings, including by considering examples established or debated in South Korea and Taiwan (and now the US);
- *Prevent unwanted transfers of intellectual property and technology*, through improved screening of technology transfers and of research cooperation with China in the EU. Coordination on cybersecurity vis-à-vis China should also be strengthened, in coordination with like-minded partners.

Enhancing relevance requires focusing on additional, more proactive objectives:

- *Develop and access new technologies by catalyzing and leveraging industrial ecosystems*. As radical innovation takes increasing importance, the ambition of China's industrial policies reinforces the need for public policies to boost fundamental research and early industrialization, create new markets where they are needed, and catalyze the development of new technology ecosystems. The New Industrial Strategy spelt out in 2020, which aims at improving the coherence between competition and industrial policies, promoting inter alia industrial alliances, is a welcome step to tackle these challenges. This does not come without concerns, though, and the debate on the revised rules on State Aid applied to the IPCEI[32] emphasizes the need to thoroughly monitor the use of such instruments, under a proper governance, making sure that they are effectively open to a wide membership and avoid being turned into a cover for a subsidies race between Member States;[33]
- *Consolidate strong positions*. Being a leader in important sectors gives leverage in case of political tension. Given the inertia of many technological domains, consolidating a strong position[34] may be in many cases a more cost-efficient strategy than remedying vulnerabilities;
- *Regulate and set standards globally*. While the EU has gained increasing influence over the past decades in influencing de jure and de facto standards worldwide,[35] the so-called "Brussels effect" cannot be taken for granted, especially at a time when China has laid out ambitious objectives of normative influence. The willingness to "strengthen the EU's regulatory impact" needs to be underpinned by real industrial and innovation capacity, effective coordination, and incentives for European manufacturers to invest in standardization. In addition, the EU should request effective access to Chinese standardization

[31] At the French level, the Varin Report, submitted to the French Government in early 2022as part of France2030 investment plan, also deals with this issue.

[32] "Smart and Selective Use of the IPCEI Instrument", Joint non-paper by the Czech Republic, Denmark, Finland, Ireland, Latvia, Lithuania, Poland, the Netherlands, Slovakia, Spain and Sweden, 28 April 2021.

[33] See also Poitiers N. and P. Weil (2022): "Opaque and ill-Defined: the problems with Europe's IPCEI Subsidy Framework", *BlogPost Bruegel*, January.

[34] In particular, the EU is China's main supplier by far in industrial machinery and equipment (Zenglein, 2020, *op. cit.*), and holds very strong positions in pharmaceuticals (Cotterlaz P., G. Gaulier, A. Sztulman and D. Ünal (2022): "Industrie pharmaceutique européenne: quand rentabilité rime avec vulnérabilité", *La Lettre du CEPII*, January).

[35] Bradford A. (2020): *The Brussels Effect: How the European Union Rules the World*, Oxford University Press.

institutions as a prerequisite for any form of bilateral standardization cooperation;

– *Pursue a competitive partnership strategy*. The EU is right to prioritize new international digital partnerships. The Global Gateways project will require a visible project pipeline, effective cross-silo coordination in Brussels, a better inclusion of Member States (via rotating Council presidency) and the private sector (advisory council).

Pursuing these objectives, not directly linked to immediate economic optimization, will almost by definition come with a cost. This is unavoidable, and the ambition of these responses will depend upon the means devoted, and upon their cost-efficiency.

Given the very wide scope of policy areas involved, and the need for a more coherent and efficient implementation, this background would warrant an institutional adaptation, in order to improve both information and decisions. Japanese, Dutch or Australian government initiatives to raise the level of attention and coordination across ministries on economic security issues point the way forward. Europe would benefit from an equivalent advisory, research/intelligence support system, that assesses specific vulnerabilities and associated resilience challenges. Beyond analysis and coordination, managing the EU's relation with China have become a *chefsache*, an issue for the political leaders to decide, as already emphasized in the 2019 *Strategic Outlook*. Accordingly, another useful step would be to put together the political leadership for external economic relations of the EU under the authority of an Executive Vice-President of the EC.

Recommendation 8. Develop integrated approach to economic security, and sovereignty challenges vis-à-vis China, based upon cost-efficient responses. Improve the institutional capacity to implement Europe's economic strategy vis-à-vis China, for instance by creating a position of Executive Vice-President of the European Commission, in charge of external economic relations.

Managing bilateral economic relations with China is becoming increasingly intertwined with wider strategic issues, related to the sovereignty and security of the EU. Such an adaptation will be challenging, and potentially costly in different respects. In dealing with this, the overarching priorities should be unity, solidarity and coherence, coping with the asymmetry in coordination between political and economic issues. These challenges should be considered in an integrated perspective of managing what should be a still deep interdependence with China.

conseil d'analyse économique

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