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Europe's response to the Sino-American rivalry

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Introduction

Back in 2019, there still was much speculation about whether Washington intended to "reform, leave, or dismantle the World Trade Organisation (WTO)?"[1] This uncertainty arose at a time when the US was blocking the appointment of new judges and effectively throwing a wrench into the smooth functioning of the WTO's Appellate Body. The answer has become clearer since.

The distortions of competition caused by Chinese state capitalism create systemic imbalances of such magnitude within the liberal market economy that the US has decided to circumvent some multilateral rules on national security grounds. Washington has adopted coercive measures and an industrial strategy echoing China's approach based on massive subsidies and domestic content requirements. In a game of tit-for-tat, Washington and Beijing keep exchanging one aggressive announcement after the other. **The race for technological leadership is accelerating alongside a reshuffling of globalisation that could equally result in the coexistence of rival blocs, or in an escalation of retaliatory measures and the fragmentation of global value chains.**

The rest of the world has little choice but to adapt to this global environment that is becoming increasingly marked by conflict. Some American initiatives that take

1 "The WTO in crisis: Can we do without multilateralism in the digital age?", Elvire Fabry, blogpost, Jacques Delors Institute, 9 December 2019.

aim at China also have an impact on third countries, such as the Inflation *Reduction Act* (IRA), a colossal state aid plan adopted by US lawmakers in August 2022. The IRA aims to spur the innovation and production of green technologies in the US in order to achieve the goal of carbon neutrality, while reducing dependence on Chinese technology and curbing the flow of critical US technologies to China to slow down its economy. Federal funding will likely end up exceeding the advertised price tag of $369 billion (€345 billion) planned over ten years, given that not all financing projects have ceilings. Many countries have raised concerns over the public aid package—concerns that are heightened by America's unlimited capacity for subsidies afforded by the US dollar. The IRA is strengthened by local content requirements that distort competition between US-based companies and those located elsewhere[2].

Europe must act to prevent European investment from being diverted to the United States, where the cost of energy is already much lower, without triggering a full-fledged subsidy race among EU Member States that would undermine the rules of fair competition upon which the Single Market is built.

The stakes, however, are much broader than just taking measures to respond to the IRA. Europe must ensure access to technologies that will deeply transform our economies and societies. These are highly promising growth sectors in which Europe would be mistaken not to position itself by developing its own capacities for innovation and production. **Crucially, access to these technologies will no longer be based on trust in an open global market, as it becomes increasingly difficult to navigate geopolitically-driven export restrictions.** Europe is taking active steps to reduce its strategic dependencies, especially on the import of goods whose production is highly concentrated in China. However, it must also prepare for a new risk of concentration of technological innovation and production, which could create new dependencies on the two countries leading this technological race.

This paper does not delve into the details of the IRA or the Green Deal Industrial Plan proposed by the European Commission on February 1, 2023[3]; instead, it evaluates the implications of the changing nature of globalisation to situate the European debate at the appropriate strategic level. The impact of Washington's priority given to national security (I) and the risk of an escalation of export restrictions (II) call for a calibrated European response that goes beyond the IRA (III).

To achieve greater strategic autonomy, the EU must adapt its internal market to the demands of this new era, by combining, on the one hand, a strategy to diversify supply and access external demand and, on the other hand, enhanced innovation and production through the "fair pooling" of capacities that benefits all Member States.

2 For the sale of electric vehicles, tax credits are only granted if 40% of the value of critical minerals (extracted or refined) used in the batteries and 50% of the battery components come from the United States or a country that has a free-trade agreement with the United States. These percentages will increase to 100% in 2029. If only one of the conditions is met, the tax credit is limited to $3,750 instead of $7,500. Any tax credit is conditional upon the vehicle being assembled in the United States and ensuring that the battery does not contain minerals or components from unreliable countries, such as China and Russia. However, an exception was granted by the United States in December 2022 for commercial electric vehicles, which do not have to meet these conditions to qualify for tax credits.

3 "A Green Deal Industrial Plan for the Net-Zero Age", European Commission, COM(2023) 62 final, 1 February 2023.

I . The changing nature of globalisation in the era of national security

"A LA CARTE" COMPLIANCE WITH MULTILATERAL RULES

It is premature to suggest that deglobalisation is underway given that global trade reached a record high of $32 trillion in 2022, which is not just due to a rebound following the Covid economic downturn[4]. Richard Baldwin's research[5] has shown that the gradual decline in the world's trade-to-GDP ratio over the past decade is primarily due to a cycle of falling prices for fuel and mining products, which account for a quarter of world trade in goods. But global flows of data and services continue to increase, and emerging countries, particularly in Southeast Asia, continue to actively pursue strategies to integrate into global value chains. The WTO has recently downgraded its growth forecasts for global trade in 2023, forecasting a mere 1% increase, down sharply from the previous estimate of 3.4%. The WTO anticipates weaker global demand due to uncertainties over the rebound of consumer spending in China and the ongoing **reshuffling of globalisation** resulting from the US-China technology decoupling, and the departures from multilateral rules triggered by *America First.*

The US was the first country to promote the rules established by the General Agreement on Tariffs and Trade (GATT) and the WTO. The country leveraged China's emergence as the "world's factory" to provide its middle class with access to low-cost imported goods. But unlike Europe, the US did not rely on welfare programs to cushion the impact of industrial transformation and help workers adjust to economic change. The social impact was severe and explains the Biden administration's objective to reorient US trade policy towards a 'trade for workers' approach that ultimately strengthens the country's industrial policy and benefits workers.

Moreover, China is no longer viewed as a reliable partner. Deng Xiaoping's successors were satisfied with the commitments made for China's entry into the WTO in 2001 but have not adhered to the spirit of economic liberalism underpinning the organisation. The development of state capitalism in China has taken precedence over the convergence towards a market economy model. Beijing has taken advantage of the non-discrimination principle that forms the foundation of the WTO and undermined its spirit through forced technology transfers and unlimited state aid to its public enterprises. During the 12th WTO Ministerial Conference in the spring of 2022, China reaffirmed its "unwavering" commitment to multilateralism, defending the *status quo* of a system that currently benefits China. Yet China is unwilling to negotiate more binding rules, such as better regulation of state-owned enterprises and state aid. China's weight in the global economy has significantly increased in recent years, with its economy tripling in size since 2008 and accounting for 18.9% of the world's GDP in 2022. The resulting distortion of competition has become a systemic issue, which cannot be sustained under a regulation of globalisation that is based on the principles of fair competition and a level playing field.

Not only does the concentration of the production of certain strategic goods in China pose a risk in the event of involuntary or coercive supply disruptions, but it also **caps the benefits that the US derives from its economic integration with China. Specifically, such benefits come to an end when the global economic leadership of the United States is challenged by China's rapid economic growth.** The benefits of the economic integration between the two powers are being re-evaluated through the lens of national security. As soon as China started gaining greater influence within

4 *Global trade update*, UNCTAD, December 2022.
5 "The peak globalisation myth", Richard Baldwin, 2022.

the system and the benefits of globalisation became less evident for the United States, the legitimacy of the current global economic system was called into question.

Washington is no longer willing to abide by certain multilateral rules that it perceives as hindering its ability to compete with China. From such perspective, the rules that are laid down are merely worth the benefits thereby derived. **Since the *status quo* of multilateral rules benefits China more than the United States, conformity to such rules has come to be determined by the latter *à la carte*, on a case-by-case basis.**

The US is taking a protectionist turn[6] by increasing measures that create distortions of competition between domestic and foreign companies to facilitate the relocation of production domestically. Congress has moved away from negotiating trade agreements that provide greater access to the American market, and instead adopted an aggressive industrial policy whereby in the name of national security there are no limits to the resulting distortions of competition.

Washington is now adopting the same discriminatory measures that Beijing has been implementing for years. As early as 2015, the Chinese Ministry of Industry and Information Technology imposed a requirement that state subsidies for the purchase of electric vehicles be contingent on the use of Chinese batteries. The policy allowed China to surpass Japan and South Korea, the global leaders at the time, and now to boast six of the world's top ten battery companies[7]. Fast forward to today and it's now Washington, through the IRA, that is adopting **domestic content criteria in breach of WTO rules**.

Washington's distancing from the WTO was further underlined by a strong statement from the spokesperson for the Office of the US Trade Representative, Adam Hodge, on December 9. He rejected the WTO Dispute Settlement Body's opinion that the steel and aluminium import tariffs imposed by Donald Trump were illegal, stating that it was not up to the WTO to evaluate a risk to US national security[8]. Referring this case to appeal on January 29, 2023, when the US has blocked the WTO Appellate Body by vetoing the appointment of new judges, betrays an instance of cynical formalism that undermines multilateralism. Especially since US Trade Representative Katherine Tai announced on January 18 in Davos that the US wants to "lead the thinking around what a new version of globalization might be – what a new economic world order might look like".

This is neither a wholesale repudiation of the WTO's rules nor a complete decoupling from the Chinese market. **Sino-American decoupling is sector-specific, focused on disruptive technologies** that extend beyond just green technologies and include artificial intelligence, supercomputers, biotech, and more. It does not affect the vast majority of low-tech consumer goods imported from China. In fact, American imports of Chinese products not subject to the 25% tariff increase imposed by Donald Trump in January 2019 have even increased by 50% over the past four years[9]. Furthermore, the US is not engaged in dismantling the WTO.

On January 12, 2023, Washington even announced that it would comply with Section 129 of the Uruguay Round Agreements Act regarding a dispute over Spanish

6 "US assertive protectionism" Elvire Fabry, *blogpost*, Jacques Delors Institute, 7 November 2022.
7 "'Made in China' electric vehicles could turn Sino-EU trade on its head", Gregor Sebastian and François Chimits, Mercator Institute for China Studies (MERICS), 30 May 2022.
8 ustr.gov "The United States will not cede decision-making over its essential security to WTO panels", December 2022.
9 "Four years into the trade war, are the US and China decoupling?", Chad P. Bown, PIIE, 20 October 2022.

olives[10]. However, by following China's lead in making national security the new standard for their economic policy, the US is opening Pandora's box. Decoupling may not be limited to military or dual-use technologies. **By making WTO rules optional, Washington is also weakening the entire framework of multilateral rules.**

The degree of economic interdependence that has been achieved globally does not shield any country from an escalation of retaliatory measures, and the risk of disruptions to globalisation, with no possibility of arbitration. As in the days of the GATT, before the creation of the WTO's Appellate Body, the major powers will have the most influence and "might will make right". Low-income and developing countries will be particularly vulnerable. However, **Europe will also be significantly exposed to a disruption of globalisation limiting external market access**. Unlike the US, the EU does not generate sufficient domestic growth to sustain its social safety nets, and Member States must maintain access to more distant markets.

REDUCING RISK THROUGH DIVERSIFICATION: A MORE URGENT AND COMPLEX STRATEGY.

Although the pandemic exposed the vulnerabilities associated with the excessive concentration of production of certain goods in specific countries, as well as the domino effect of a disruption in one link of a value chain on the entire chain, as of 2021, 60% of American and European companies operating in China still intended to invest more in the country[11].

With the war in Ukraine, supply diversification has become necessary. Sanctions targeting Russia[12], in tandem with the acceleration of Sino-American decoupling triggered by the alliance between Xi Jinping and Vladimir Putin as well as Beijing's economic support for Moscow, are pressuring companies to **move from the planning to the actual reorganisation of value chains**. The optimisation of profits from international trade must take into account the cost of securing supply, all the more as the Sino-American technological rivalry is expected to lead to more supply disruptions. At Davos in January 2023, the President of the European Commission, Ursula von der Leyen, made **"de-risking" a top priority for Europe**, emphasising that Europe should seek to de-risk rather than decouple from China.

European companies continue to benefit from globalisation. Now that the urgency is on reducing carbon emissions and strategic dependencies, policies are being implemented to reduce the negative externalities of value chain fragmentation and the risks of economic coercion hinging on economic interdependence. However, access to distant markets remains strategic to source critical raw materials or compensate for weak domestic demand. Efforts to increase the resilience of value chains since the beginning of the pandemic have in some cases led to the **extension of these chains**.

At this stage, there is no significant movement of companies reshoring production back to their home country. In 2022, most firms opted for more storage and diversification by pursuing "dual-sourcing" and "China + 1" strategies. Last spring, 55%

10 United States – Anti-dumping and countervailing duties on ripe olives from Spain, WT/DS577 (20 December 2021) (DS577).

11 "Business confidence survey", EUCCC, 2021 • "Foreign Corporates Investing in China Surged in 2021", Tianlei Huang and Nicholas R. Lardy, PIIE, 29 March 2022.

12 "Less than Nine Percent of Western Firms Have Divested from Russia", Simon Evenett and Niccolò Pisani, SSRN, 20 December 2022.

of companies surveyed by the European Bank for Reconstruction and Development (EBRD) increased their inventories, and 49% began diversifying their supply base[13].

However, this diversification is becoming both more urgent and more complicated as the **emphasis placed on a poorly defined criterion of national security is fuelling a race between Washington and Beijing to provide massive public subsidies and export restrictions, the scope of which is broadened by the principle of extraterritoriality.**

I NATIONAL SECURITY: A CRITERION WITHOUT ARBITRATION?

The Treaty on European Union stipulates that each Member State shall determine what constitutes national security and assess the evolution of risks (Article 4.2). It also provides that derogations on the grounds of national security cannot be based on criteria of economic competitiveness, but only to defend "public order and public security, and in accordance with the principle of proportionality.

The General Agreement on Tariffs and Trade (GATT) of 1947 provides for a security exception in Article XXI, which allows a member to protect its essential interests in the event of "war or other emergency in international relations," without specifying the meaning of "emergency." It wasn't until the opinion of the DS512 Panel (Ukraine vs. Russia) in April 2019 that the WTO Dispute Settlement Body claimed competence in assessing the risk and legitimacy of the applied exceptions. The report concluded that it is the responsibility of the Member itself to determine the "necessity" of the measures for the protection of its essential security interests (paragraphs 7.146 and 7.147). However, the report also emphasized that the obligation for a Member to interpret and apply Article XXI in good faith implies that WTO panels can scrutinize whether there is evidence of bad faith, and whether the contested measures were "not implausible"[14].

In Washington, this opinion was seen as another example of overreaching by "activist" judges. Specifically, the US contends that such jurisprudence is illegitimate because it is only the members of the WTO (the states) who can agree on new rules. The United States did not wait for the Biden administration to assert that its national security cannot be subject to any supranational institution. This had already been emphasised by the Trump administration in its annual reports on trade policy[15].

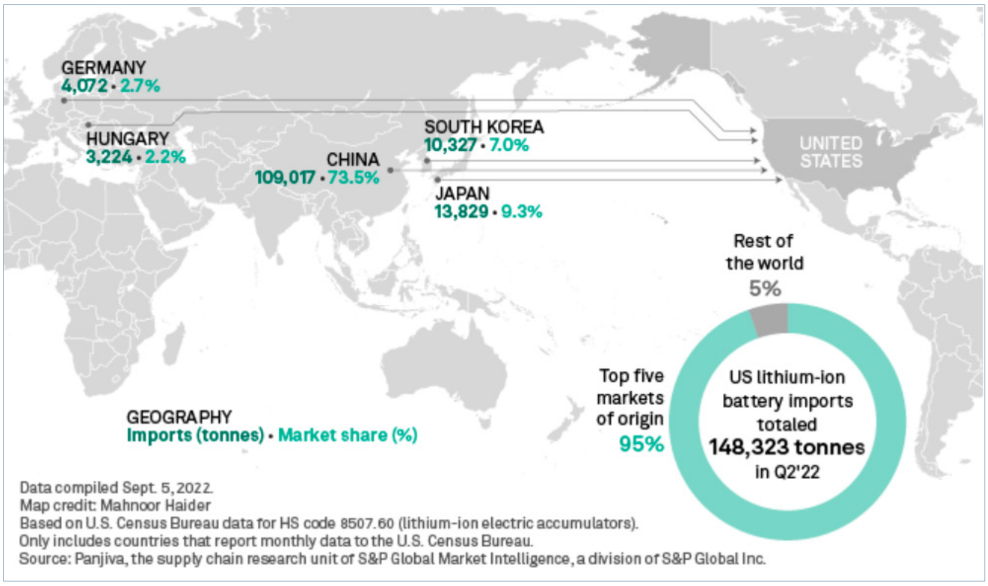
In addition, **economic security is a key pillar of national security for the United States. This includes both the transition to green technologies and the preservation of its technological leadership**. Washington believes that measures to guarantee national security cannot be restricted by multilateral rules.

13 Survey conducted between May and July 2022 covering 815 firms that both export and import across 15 economies in the EBRD regions. Business Unusual, EBRD Transition Report 2022-23, 22 November 2022, p. 63.

14 "Russia – Measures Concerning Traffic in Transit", Panel Report, DS512, WTO, 5 April 2019.

15 "2018 Trade Policy Agenda" and "2017 Annual Report of the President of the United States on the Trade Agreements Program".

MAP 1. US imports of lithium-ion batteries in Q2 2022



The argument of national security invoked to justify the measures taken in the IRA is thus threefold. First, it is vital to accelerate the green transition of the American economy. Second, it is important to secure the necessary supplies for this transition by reshoring production to the United States as much as possible, including the extraction and processing of strategic minerals. The production of batteries and their components, such as strategic minerals, is heavily concentrated in China, and in the light of Beijing's increasing use of economic coercion there are concerns about new restrictions on the export of these goods. In the second quarter of 2022, the US imported 73.9% of its lithium-ion batteries from China[16], which also represents 77% of global production capacity[17]. China also accounted for 38.7% of US imports of refined lithium in 2022.

Lastly, technological leadership is in itself a matter of national security since being on the cutting edge of disruptive technologies is key to ensuring economic competitiveness. China already leads the world in the production of solar panels and wind turbines, and its exports of electric vehicles have skyrocketed since 2021[18]. And given that China is ahead of the United States in certain areas of artificial intelligence and 5G communication (while also rapidly catching up in the field of supercomputers), **Washington is taking steps to boost American innovation while curbing China's progress by restricting its access to critical American technologies.** (Map 1.)

Without the possibility of international arbitration or even international dialogue on national security criteria, rising economic nationalism poses the risk of an uncontrolled escalation of economic coercion.

16 US Census Bureau, 2022.
17 "Visualizing China's Dominance in Battery Manufacturing (2022-2027)" (visualcapitalist.com)
18 "'Made in China' electric vehicles could turn Sino-EU trade on its head", Gregor Sebastian and François Chimits, 30 May 2022.

II . The escalation of retaliatory measures

I THE ACCELERATION OF TECHNOLOGICAL DECOUPLING BETWEEN THE UNITED STATES AND CHINA

Washington is ramping up discriminatory measures against China on the grounds of national security:

- Restrictions on the export of military-use technologies; export licensing requirements for any technology or software using American technology; end of preferential treatment for Hong Kong; expansion of the Entity List containing all foreign companies that cannot be suppplied; etc.;
- Restrictions on investments with enhanced monitoring by the Committee on Foreign Investment in the United States (CFIUS);
- Visa restrictions on Chinese students and researchers;
- Restrictions on Chinese imports: tariffs (section 23[19] on steel and aluminium and section 30[20] on a wide range of products); ban on imports coming from Xinjiang;
- Financial sanctions on Specially Designated Nationals (SDNs)[21].
- Securing information and communication infrastructure to prevent the use of technologies from unreliable countries, and bans on the use of certain applications (e.g. TikTok for all federal employees);
- Restrictions on the use of certain Chinese technologies, such as drones.

The pace of technological decoupling has accelerated significantly following a decision by the Bureau of Industry and Security (BIS) on October 7, 2022 (just a few days before the 20th Congress of the Chinese Communist Party) to cut off China's access to American technological know-how for the production of semiconductors. The ruling aims to prevent China from acquiring or developing advanced computer chips, supercomputers, or semiconductors[22]. The BIS decision prevents all US citizens and permanent residents of the United States from helping China acquire these technologies. Criminal penalties can include up to 20 years of imprisonment and up to $1 million in fines per violation, or both. The **extraterritorial scope** of this decision also extends to foreign companies that use American technologies to manufacture semiconductors, giving the US government the ability to intervene against third countries. To ensure national security, the United States adopted the Foreign Direct Product Rules (FDPR) in 1959, allowing the US to establish a list of American technologies and software that cannot be used by third countries to manufacture products destined for certain countries (including China at present).

The decision made on October 7 is particularly impactful because it is estimated that about 65% of worldwide exports directly or indirectly rely on semiconductor chips: semiconductor chips themselves, such as semiconductor devices and integrated electronic circuits (5%); products that rely on chips (29%); and products that don't contain chips but still need them to function (30%)[23].

The new restrictions are broad in scope. They go beyond military-use semiconductors. The Biden administration's pressure on Dutch company ASML (which generates 15% of its total revenues in China) and Japan to curtail their exports to China aimed to extend the export restrictions beyond military-use semiconductors, as the older

19 Trade Expansion Act, 1962.
20 Trade Act, 1974.
21 List of individuals, companies and organisations that pose a threat to national security.
22 "Commerce Implements New Export Controls on Advanced Computing and Semiconductor Manufacturing Items to the People's Republic of China (PRC)", Regulation 87 FR 62186, 7 October 2022.
23 Asian Economic Integration Report 2022, Asia Development Bank, February 2022, p. 22.

chip designs (10 to 15 years old) used for military purposes are already produced by China.

Details of the agreement reached on January 27, 2023 with the Netherlands and Japan have not been made public at this stage[24]. But according to statements made by US National Security Advisor Jake Sullivan last September, the objective is no longer to stay a few generations ahead, but to maintain "as large of a lead as possible" over China[25]. Instead of a cooperative approach to gain access to green technologies for combating climate change, Washington has opted for a strategy of fierce competition.

The creation on January 10, 2023 by the House of Representatives of a Select Committee "on the Strategic Competition Between the United States and the Chinese Communist Party (CCP)" could further accelerate and expand the decoupling process, also in terms of access to data. The committee has no legislative power but will make recommendations based on public hearings to address the CCP's evolving "economic, technological and security" policies and its ongoing "competition with the United States". In today's highly polarised US political climate, bipartisan support for anti-China policies has become the primary driver of economic reform.

The United States is also preparing to implement new rules concerning outward direct investment. While more complicated to implement than restrictions on semiconductor exports and control over individuals who contribute to China's technological development, these new investment controls targeting China could further accelerate the decoupling process. Particularly since the broad interpretation of national security tends to expand the scope of the sectors affected. While the US Treasury wants to limit the controls to the supercomputer and artificial intelligence sectors, Jake Sullivan is once again pushing for a wider perimeter that also includes biotechnologies and green energy.

But the risk of an escalation in retaliatory measures is increasing. To counteract US measures, China also equipped itself with a similar legislative arsenal, which may **create a deterrent effect but also risk triggering an escalation**[26].

Like the US, China drew up an Unreliable Entities List (UEL) in September 2020, which designates foreign entities that cannot benefit from Chinese technology exports. China also strengthened its export controls regime by adopting the Export Control Law (ECL) in October 2020 to safeguard "national security and other interests". In June 2021, China adopted its own extraterritoriality rules that offer considerable discretion in calibrating the response to the extraterritorial measures announced by third countries. And like the United States, China has been strengthening its regulations on the security and protection of critical information infrastructure since August 2021. Beijing is increasingly applying economic coercion towards foreign partners, including Japan, Australia, Canada, and Lithuania. Meanwhile, Washington is no longer limiting those targeting China.

The EU also amended its export controls regime in September 2021 by implementing Regulation (EU) 2021/821 on dual-use items. The regulation does not introduce

24 "Netherlands and Japan join US in restricting chip exports to China", Demetri Sevastopulo and Sam Fleming, Financial Times, 28 January 2023.

25 "Remarks by National Security Advisor Jake Sullivan at the Special Competitive Studies Project Global Emerging Technologies Summit", White House, 16 September 2022.

26 "Leveraging Trade Policy for the EU's Strategic Autonomy", Elvire Fabry, *Policy Brief*, FEPS, June 2022, p. 7

new controls but gives Member States more leeway to control dual-use technologies that can be used for both military and civilian purposes.

Newly bolstered offensive arsenals on both sides increase the risk of retaliatory measures and the potential escalation of export restrictions that may be improperly anticipated and handled.

THE ESCALATION OF EXPORT RESTRICTIONS

The control of exports through the application of taxes, quotas, and regulations, such as export licenses, has a long history[27]. These restrictions have been frequently used to secure a national supply of goods or to protect downstream processing industries from price increases caused by foreign demand.

When food and fertiliser prices surged after the 2007-2008 financial crisis (with inflation for these products peaking at 41% in May 2011) and food riots erupted around the world, many countries responded by imposing export restrictions. But restrictions can also have a negative impact on the competitiveness of exporters, as the decrease in income for an industry that sells below international prices may reduce its competitiveness in the medium term.

Export restrictions can also have a negative impact on global trade, such as in 2022 when a **domino effect of countries introducing export restrictions around the world to secure national supplies** or apply economic pressure could be observed. In June 2022, the SGEPT's Essential Goods Monitoring Initiative showed that trade policy measures related to medical goods, medical equipment and vaccines in response to the Covid pandemic were mostly restrictive[28]. In addition, "72 export curbs on food and fertiliser have been erected by 27 governments (the latter totals exclude Western and Japanese sanctions that affect food exports to Russia and Belarus)". During the first ten months of 2022, 166 measures restricting food and fertiliser exports were implemented worldwide, with 66.3% of these measures being taken by G20 countries[29]. A total of 46 nations were responsible for restrictions on food and fertiliser exports, including 13 G20 members.

Moreover, **limiting supply can lead to even greater disruptions in supply chains or create a coercive effect, especially when there is a high concentration of production, leaving few alternatives for sourcing.** When applied arbitrarily for geopolitical reasons, such limitations can become critical to securing the supply of raw materials and strategic goods. With its global monopoly on rare earth refining (98% share), an essential input for technologies needed for the green and digital transitions, such as solar panel wafers (97%), **China has a formidable weapon of retaliation against any country or company it wishes to target** (80% of US rare earth imports and 98% of European imports come from China). Restrictions on Chinese exports of rare earths in the 2000s had already caused a surge in global prices[30]. After consolidating its position as a global monopoly on rare earth refining in the early 2000s, China began to impose export restrictions in 2006, including strict export quotas in 2010.

27 The first export control levied by the United States dates back to 1775 when Congress outlawed the export of goods to Great Britain.
28 "It's not only food and fertiliser: trade curbs are rising for medical goods too", St Gallen Endowment for Prosperity through Trade (SGEPT), June 2022.
29 "G20 Responsible for over half of trade restrictions affecting food and fertiliser", *Essential Goods Initiative*, SGEPT, November 2022.
30 "China's Growing Conflict with the WTO: The Case of Export Restrictions on Rare Earth Resources", Brigid Gavin, *Intereconomics*, Vol.48, 4/2013, footnote 16.

BOX 1. WTO arbitration against Chinese export restrictions

The 2012 WTO Appellate Body (AB) Panel Opinion on a complaint filed in 2009 by the US, EU and Mexico concluded that Chinese export restrictions on nine raw materials (including bauxite, manganese, magnesium, coke and zinc) violated the commitments that China made upon joining the WTO. The Panel helped to provide a general clarification on the issue of export restrictions.

First, the report clarified the relationship between the GATT and China's WTO Accession Protocol. Although the general exception provided in Article XX of the GATT allows China to invoke the conservation of natural resources, it cannot deviate from its commitments that were negotiated under the accession protocol. However, China only retained the right to apply export duties on 84 products listed in an annex to the protocol. As the export restrictions did not concern products in the annex, China could not invoke Article XX. Furthermore, the restrictions had increased domestic consumption of these raw materials, which is incompatible with the conservation of natural resources argument.

Regarding Section IV of GATT invoked by China, which deals with economic development, **the AB clarified that there is no legitimate right to use trade restrictions for economic development purposes under GATT rules.** As for Article XI(2) of GATT, the Chinese restrictions were not "temporary", nor were they intended to remedy a "critical shortage".

Although the AB's ruling led China to suspend its export restrictions, a second complaint was filed by the US, the EU and Japan against the export restrictions on rare earths that had caused prices to soar. The AB's new opinion in 2014 found these restrictions to be non-compliant and forced China to lift them in 2015.

While the WTO arbitration process allowed for the lifting of these export restrictions, it also exposed the **limitations of achieving true compliance, as China continues to resist and push back against WTO norms**. China has taken advantage of gaps in the dispute settlement system, which require WTO members to comply with their obligations without guaranteeing recourse to countervailing measures that compensate for the economic harm caused by an illegal practice. As legal scholar Mark Wu has pointed out, the "reasonable period of time" granted to the defendant to comply without having to pay compensation to the aggrieved trading partners creates a "remedy gap" and therefore a "free pass" for temporary breaches[31].

China is taking advantage of this situation to pursue its industrial policy goals aimed at ensuring its position as a technological leader and economic power. **Beijing's loss of credibility resulting from late compliance is well worth the economic benefits it gains.** China has also realised that by not imposing any export restrictions on its strategic minerals, not only does Beijing bear the cost of negative externalities on the environment and public health, but it is limited to a position of low added value in the value chain. Meanwhile, other countries situated downstream in the supply chain get cheap access to essential inputs, which enables them to develop high-value technologies.

Export restrictions in sectors that are not covered by the foreign investment "negative list" have the potential to attract foreign expertise and capital to partner with

31 "China's Export Restrictions and the Limits of WTO Law". WU, M. (2017). World Trade Review, 16(4), pp 673-691.

Chinese companies in joint ventures. The clustering effect that is created helps to cement **China's leadership in the development of crucial technologies** and increases the dependence of other countries on high value-added Chinese exports[32]. **Export restrictions are being used to climb the ladder of global value chains** and secure China's dominant position, with all the geopolitical implications that would follow if China were to ultimately use this position in an offensive manner. All the more so as Beijing can afford to take the risk of affecting the competitiveness of its companies through these restrictions since they are state-owned enterprises[33].

Lack of reform at the WTO and the blockage of appointments to its Appellate Body have contributed to making it a dysfunctional system. China is now even more incentivised to take advantage of this situation, especially given that the United States is also choosing to disregard certain rules. As highlighted by WTO Director-General Ngozi Okonjo-Iweala at the 12th Ministerial Conference (MC12), the *status quo* is only a favourable scenario for some members, and these are the worst compliers. China's recent complaint to the WTO on December 15, 2022, against US export restrictions on semiconductors, shows that Beijing has good reason to preserve a system that is favourable to its interests, given that the instability created by an escalation of restrictions would limit the benefits that it derives from globalisation.

However, the implementation of China's new ECL law in 2020 increases the likelihood of further restrictions[34], as the scope of control extends beyond military, dual-use, or nuclear goods. The law covers a very broad range of technologies, services, and goods related to national security preservation, which since Xi Jinping's 2014 *Comprehensive National Security Outlook*[35], now comprises 16 security areas including political security, territorial security, military security, economic security, cultural security, societal security, scientific and technological security, cybersecurity, environmental security, resource security and nuclear security.

China did not immediately respond to the US decision made on October 7, 2022, which cut off its access to American semiconductor supply chains. Instead, Beijing opted to go down the legal route by filing a complaint with the WTO, and announcing a massive $143 billion plan to support domestic semiconductor production. However, as signalled by the announcement made in early 2023 on export controls on solar panel wafers, **Beijing seems willing to respond to American restrictions by deploying its own arsenal of export controls**[36]. Its goal is the same as that of Washington for semiconductors manufacturing: to preserve China's dominance in wafer manufacturing.

Beijing can also benefit from the **concentration of production in state-owned enterprises**, as seen in the rare earths sector. **China's mining landscape was restructured in early 2022 through a merger that reinforced state control** in order to maintain high export prices, improve productivity and ensure control of the sector for strategic purposes. At the same time, China's foreign investment negative list excluded access to rare earth mines. The new industrial conglomerate, *China Rare Earth Group Co. Ltd*, which combines three of the six major state-owned mining com-

32 *Ibid.*, p. 686.
33 *Ibid.*, abstract.
34 "Rare Earths Supply Is About To Get Much Tighter" *Yahoo Finance*, 5 May 2022.
35 Tai Ming Cheung, "Innovate to Dominate: The Rise of the Chinese Techno-Security State", Cornell University Press, 2022.
36 "China Mulls Protecting Solar Tech Dominance with Export Ban", Dan Murtaugh, Bloomberg, 26 January 2023. This would be in addition to other restrictions (laser radar technology, cell cloning technologies, CRISPR gene editing technology, synthetic biology technology, etc.). 关于《中国禁止出口限制出口技术目录》修订公开征求意见的通知 (mofcom.gov.cn) ; 中国反击！新增7项先进科技禁止/限制出口 合计达139项_新浪科技_新浪网 (sina.com.cn)

panies, now accounts for 62% of China's rare earths production[37]. As the holding company is none other than the state, controlling investments, planning, and inputs, the Chinese Communist Party can use this leverage for geopolitical purposes.

While China's share in global rare earths production has already fallen from 86% in 2014 to 58% in 2020, Beijing intends to defend its dominant position against the efforts of third countries to diversify and produce domestically. According to customs data, the average export price of rare earths has already jumped by 36% in November 2021 compared to the previous year[38].

Third countries will remain highly dependent over the course of the decade given that China has monopoly power over rare earths refining, with 90% of global capacity. Possible export restrictions provided by the ECL law could further limit the technological development capabilities of countries targeted for geopolitical reasons, especially given that the law, like that of the United States, has extraterritorial reach.

While the United States seeks to alter China's trajectory through means other than multilateral regulation, **the challenge for Europe goes beyond responding to the IRA, and lies in preparing for this new, more aggressive international context that may lead to new phenomena of production concentration and the development of new supply dependencies.**

III • Leveraging the Single Market to tackle a rise in unfair competition.

FRIENDSHORING: A REAL OPPORTUNITY?

In the absence of multilateral coordination to effectively regulate export restrictions and ensure the regulation of strategic supplies, much attention is to be paid to the coordination efforts of certain countries. Since April 2022, the US Treasury Secretary Janet Yellen has been calling for "friendshoring" (relocating supply chains to politically friendly and reliable countries) to promote economic integration among reliable partners who share the same values (democracy, individual freedoms, rule of law, protection of human rights, etc.). The first Summit for Democracy brought together 115 countries at the initiative of Joe Biden in December 2021. **For the United States, a truly successful decoupling strategy is contingent on friendshoring**, as it is imperative to avoid any risk of American technologies being re-exported to China by third countries. It is also important to agree on common standards for new technologies. The agreement signed on January 27 between Washington and Brussels to better coordinate on the use of artificial intelligence in the areas of climate change, natural disasters, healthcare, energy, and agriculture, is a step in this direction.

The primary focus is to secure the supply of strategic minerals by diversifying extraction and ensuring solidarity when it comes to procurement. This is the objective of the EU-US Trade and Technology Council Working Group on Export Controls, whose main result to date has been "[d]eeper information exchange on exports of critical U.S. and EU technology, with an initial focus on Russia and other potential sanctions evaders, coordination of U.S. and EU licensing policies, and cooperation

37 "China Merges Three Rare Earths State-Owned Entities to Increase Pricing Power and Efficiency", *China Briefing.*
38 *Ibid.*

with partners beyond the United States and the European Union"[39]. But the US also signed a Minerals Security Partnership (MSP) in June 2022 to strengthen critical mineral supply chains with major partners, including Australia, Canada, Finland, Japan, South Korea, Sweden, the United Kingdom, and the European Union. A few months earlier, the EU and Canada also signed a bilateral agreement on building secure critical mineral supply chains. In turn, Japan and Australia signed a similar agreement in October 2022.

Europe's strong criticism of the IRA is largely due to the fact that the law's provisions contradict the objectives of friendshoring, starting with the discrimination between the extraction and refining of raw materials in North America as opposed to those that are imported. The criticism is compounded by **Europe's heavy reliance on US military support for Ukraine and imports of US liquefied natural gas. This dependency limits Brussels' ability to impose retaliatory measures** that are comparable to those prompted by Donald Trump's aggressive tariff measures.

The coordination of export restrictions between the US and other countries (which provides additional reassurance for Washington) is made even more challenging as these measures can have a direct impact on the competitiveness of businesses[40]. As China and the United States each call for a new international order, the opposition of a group of autocracies to a group of democracies, built on the principle of friendshoring, creates significant uncertainty surrounding the choices of pragmatic countries that may be less inclined to align with one or the other group, remaining more focused on preserving access to both markets.

Furthermore, it remains to be seen how friendshoring could be limited to the technology sector without disrupting more broadly global supply chains. In the era of economic coercion, an orderly reorganisation of trade is far from obvious. **The shape that Sino-American decoupling takes suggests less a scenario of regulated coexistence between two blocs than an exacerbated rivalry that can spill over to less strategic dependencies.** The President of the EU Chamber of Commerce in China, Joerg Wuttke, speaks of a "tectonic shift" that could lead China to further cut off Western companies from access to its market[41].

THE HORIZON OF MULTILATERAL COOPERATION.

As proposed by the EU Chamber of Commerce in China in 2022[42], the risks of escalation in the Sino-American rivalry call for the development of a clear and proportionate regulatory framework for export controls, beginning with the following actions:

- Clarify the supervision and enforcement methods of governmental organs, and the rights and powers thereof, so as to facilitate direct dialogue and discussion between export control authorities and industry.
- Exempt commercial mass market products from export controls, focusing instead the export control system on items that have a direct and strategic bearing on China's national security.
- Implement a practical and user-friendly licensing system (featuring bulk and general licensing), and licensing exceptions for intra-company transfers.

39 "Fact Sheet : U.S.-EU Trade and Technology Council Establishes Economic and Technology Policies & Initiatives".
40 "The Limits of Friend-Shoring", E. Benson and E. Kapstein, CSIS, 1 February 2023.
41 "Trade turns chilly: Chip embargo symbolizes deeper US-China strains", Laurent Belsie, *The Christian Science Monitor*, 24 January 2023.
42 "European Business in China. Position Paper 2022/2023", EUCCC, September 2022, p. 104.

- Update the current dual-use control list with designations based on the nature of controlled items.
- Narrowly define the scope of "deemed exports" subject to licensing, and introduce reasonable export thresholds and exemption arrangements.
- Clarify the definition and management mechanism of "re-export".

However, despite the goal shared by Europe and emerging countries of a predictable market regulated by fair competition standards, there is little chance of reviving multilateral cooperation in the short term. **Washington and Beijing alternate offensive measures and temporary appeasement, which allows them to maintain control over the escalation of the coercive measures**, as seen during the meeting between Joe Biden and Xi Jinping on the sidelines of the G20 in Indonesia. However, the normative rivalry between the two powers as they compete to shape the new world order creates a significant obstacle to predicting a short-term de-escalation that would enable more effective multilateral cooperation.

The EU is committed to equipping itself with the necessary tools to assert its influence in an increasingly unconventional struggle, without resorting to non-discriminatory measures that contravene WTO rules. The EU thereby attempts to safeguard the possibility of a return to more effective multilateral cooperation in the medium term.

ADAPTING THE EUROPEAN STRATEGY BEYOND A RESPONSE TO THE IRA

Europe must adapt to the changing landscape of globalisation, which is exemplified by the IRA but also driven by the significant investments made by both the US and China in technological innovation, impacting the energy transition and the transformation of production methods.

Europe must avoid creating new dependencies by only relying on its niche positions in innovation and advanced technology production—especially as American and Chinese supply chains gradually become more intricate on the basis of arbitrary national security criteria. Focusing solely on specialisation in one segment of the chain, as preferred by Scandinavian industries, may become too limiting if access to other links in the chain becomes more conditional. In the medium-term, Europe cannot rely on gaining access to technological innovations that have been accelerated by the exceptional means deployed by the US and China. Europe must adopt a diversification strategy in sectors where it has the strongest dependencies coupled with a strategy to strengthen its own innovation and production capabilities for future technologies.

This requires, first and foremost, **a revision of competition rules between EU Member States to ensure the "fair pooling" of investment and production capacities.** Having a level playing field would be a more effective way to ensure that an amendment to EU state aid rules leads to equitable benefits for all Member States.

It is essential to prevent the rise of new imbalances between EU Member States and to foster convergence in the growth of European economies in order to maintain their cohesion. EU members states have economies which are more or less dependant on the internal market, or on their integration with global supply chains. Distortions of competition triggered by third countries affect them to different extents and can equally strengthen internal imbalances within the single market. As a result, the main focus of the *Green Deal Industrial Plan (GDIP)*, proposed by the European Commission on February 1, 2023, is to strengthen the internal market and prevent fragmentation.

A LEVER FOR INVESTMENT RATHER THAN A RACE FOR SUBSIDIES

To level the playing field with the US and China by investing heavily in disruptive technologies, the EU must first **adjust its competition policy framework to enable the pooling of national capacities.** Evaluating whether the GDIP proposal addresses this issue requires attention to both broad principles and details.

The primary objective is to simplify the regulations for the award of state aid to create a more attractive ecosystem for private investment, while ensuring fairness among all EU Member States. The establishment of a one-stop-shop in each member state would streamline and accelerate the administrative procedures for the award of state aid, whether in the form of subsidies or tax credits; the elimination of tenders for less mature technologies, the extension of project implementation deadlines, and the simplification of notifications for companies participating in important projects of common European interest[43] (IPCEI) could similarly contribute to the same goal.

Attention should then shift to developing multi-country projects (in line with the logic of IPCEI) and ensuring that the most vulnerable regions have access to state aid in order to balance competition and capacity sharing among Member States.

The lessons learned from initiatives taken in the digital arena, particularly the promotion of European standards for green technologies, can also prevent the formation of barriers between Member States.

These efforts to govern state aid, which also require a narrower focus to identify projects of strategic interest to achieve the net-zero carbon objective, aim to provide greater legitimacy to the proposed increase in state aid thresholds.

It should also be noted that **investments are not only aimed at the innovation stage but also at the production stage,** since the plan is part of a broader strategy to reduce strategic dependencies and enable the EU to establish a foothold in expanding markets.

This "regulated" simplification of state aid is nevertheless tied to the need for more European funding in order to ensure that smaller Member States, with less financial capacity, can contribute to the pooling of investment in green technological innovation. This would help to address the concern that countries such as Germany and France would benefit more from higher state aid ceilings. The EU plans to redirect its reserves of loans and subsidies towards developing green technologies, including through programs such as *REPowerEU*, the Recovery and Resilience Plan, the Brexit Adjustment Reserve, *InvestEU*, and the EU Innovation Fund. But then, the European Commission is also planning to propose a **European Sovereignty Fund**, which is set to be presented before the summer of 2023. The fund is intended to broaden the scope of European investment beyond green technologies to build up innovation and production capabilities across a wider range of technologies.

However, many details are still missing from the GDIP. The operational criteria for the **alignment mechanism** will be published soon in a separate communication[44]. The mechanism aims to unlock state aid that is comparable – and therefore proportionate – to what a third country could offer a European company to encourage

43 « Les projets importants d'intérêt commun européen. Une nouvelle forme de différenciation ? Analyse des enjeux pour le marché unique de l'Union européenne », Andreas Eisl, *Policy Paper n° 276*, April 2022.

44 "Leak : Commission details subsidy-matching scheme for green industry" *Jonathan Packroff* and *Théo Bourgery-Gonse*, Euractiv, 3 February 2023.

it to be based establish on its own territory. The Commission intends to mitigate the risk of a subsidy race by requiring solid evidence of a subsidy opportunity in a third country and capping European aid at 10% of eligible costs and €100 million per company per member state, though these limits may be adjusted. In addition, regional disparities would be taken into account to assist the less developed regions in Europe.

The specifics of the safeguards aimed at preventing the diversion of investments outside of the EU or relocation to another Member State will be crucial in convincing the most hesitant Members that the system is both effective and well-regulated.

Lastly, **the Green Industrial Plan places specific emphasis on workforce training as well as the conditions needed to open up the European market**. European countries that need access to strategic raw materials and are pursuing a diversification strategy to reduce their current strategic dependencies will also want to expand their export markets for the technologies they develop. **The EU's new range of autonomous trade defence instruments (such as foreign investment screening, control of foreign subsidies, reciprocity in public procurement, and anti-coercion measures) will be crucial to ensure fairer competition with third countries. The effectiveness of these instruments in limiting distortions of competition will depend, in particular, on the support demonstrated by the EU Member States for their active use.** This will allow to guarantee the opening up of the European market as well as greater access to the markets of third countries.

The protectionist turn taken by the US has made it more difficult for Washington to sign trade partnerships around the world. Washington's strategy of establishing forums for dialogue to agree on high common standards, particularly in the digital sector, and without offering its partners greater access to the US market, has thus far been largely ineffective. Former Treasury Secretary Henry Paulson's criticism of excessive decoupling associated with protectionism leads to a proposal that is similar to the European strategy: reduce dependence but remain open to the world[45].

• Conclusion

The intensified debate on the EU's reaction to the IRA from November 2022 to February 2023 suggests that Europeans have undergone a shift in their perspective on globalisation. The focus is now on reducing risks. It remains to be seen whether the EU's ambition to adapt to the changing global landscape will be hindered by concerns of competition among Member States, which may be greater than the fear of international competition, increasingly driven by the rivalry between the US and China.

The arbitrary use of the national security argument as the new standard in Chinese and American policies is alarming, as it may lead to an escalation of export restrictions and new risks of concentration in the production of disruptive technologies. This poses a significant risk for Europe, which may develop new strategic dependencies if it does not have the necessary investment means to deploy its own capacity for innovation and production. Europe depends to a greater extent on the stability and predictability of the rules-based trading system, making it more susceptible than the US to the damage caused by any violations or weakening of these rules. The strategic autonomy of the European Union therefore demands more than just niche strategies.

45 "America's China Policy Is Not Working. The Dangers of a Broad Decoupling", H. M. Paulson, *Foreign Affairs*, 26 January 2023.

The closer coordination of European public policies (particularly on competition, trade, and the internal market), which is reflected in the European Commission's proposal for a Green Industrial Plan, well exemplifies the new ambition to **make the internal market not only a space for fair competition, but also for the equitable pooling of capacities.**

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PREMIER MINISTRE
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