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EUROPEAN COMPANIES ARE FACING THE DECOUPLING OF CHINA AND THE UNITED STATES

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6.1 ■ The state of play

The trade and technology war between the US and China directly impacts European companies. LTheir value chains are exposed to the tremors created by export restrictions and other non-tariff barriers on both sides. The US *Bureau of Industry and Security*'s *Entity List*, which restricts exports to certain foreign companies, already includes 59 Chinese companies accused of supporting Beijing's military activities. It has prompted the Chinese side to introduce a similar list in September 2020, the *Unreliable Entity List*, and a new export control law that came into force in early December 2020. China has also just strengthened its regulations on the security and protection of critical information infrastructures, imposed data localisation requirements and urged Chinese companies to avoid using foreign technologies, particularly in the strategic priority sectors of the 14th Five Year Plan, notably infrastructure, to ensure 'more autonomous and controllable' value chains. Finally, in June 2021, China responded to US measures that have extraterritorial reach with its own extraterritoriality strategy, which could also target European companies.

As national security concerns take hold in economic policy, both sides are striving to reduce their mutual dependence on technological goods, even to the point of aiming for 'self-sufficiency' on the Chinese side. If Xi Jinping is exposed to the economic cost of a more significant closure of the Chinese market, which risks limiting productivity, the EU's growing dependence on intra-EU trade and the deficit in the European trade balance with China (181 billion euros in 2020) are becoming more problematic and require European companies to adapt.

European firms cannot give up access to one of its two most strategic markets for exports.[1] The Chinese middle class, which will likely double to 800 million hyperconnected consumers in 2030, represents an unparalleled market that European companies cannot do without. The European Chamber of Commerce in China (EUCCC) 2021 survey shows that sixty per cent of European companies in China plan to invest more in the Chinese market (up four per cent from the 2019 pre-Covid survey).[2] The gradual decoupling of the United States and China in the technology sector is nevertheless **calling into question the development models of compa-**

1. In 2019, 9% of European exports of goods, excluding intra-European trade, went to China and 18% to the US. By comparison, the US exported 6% of its goods to China and 16% to the EU the same year. IMF data, 2020.
2. *Business confidence survey 2021*, EUCCC.

nies, which are forced to segment their offerings and processes between China and the rest of the world.[3]

6.2 ▪ A costly adaptation for European companies

European technology companies, particularly in the information, communication, and financial services sectors, will have to make strategic choices about both the use of Chinese or American technologies and compliance with country-specific standards and norms. This is problematic for companies operating in both countries and the collection, storage, transfer, and use of data.

Companies are forced to adapt as best they can by offering one set of products for China and another for the rest of the world to avoid falling foul of Chinese and American legislation. The EUCCC mentions two adaptation strategies. Companies with a large share of global sales in China can set up a specific supply chain and R&D system for the local Chinese market in parallel with the system for the rest of the world: this is the **'dual system'** approach. Alternatively, they can adopt a **'flexible architecture'**, which consists of maintaining international operations with value chains that cover China and the rest of the world, locating in China only what is strictly necessary to comply with new Chinese legislation. **Both strategies have a negative impact on economies of scale and innovation**. The reorganisation of company structures leads not only to investment and job losses but also to higher costs.

In addition, European companies (especially in the automotive, consumer goods, consulting, and financial sectors) face competition from US companies that are also not intending to give up the Chinese market.

The Biden Administration is investing heavily in building domestic manufacturing capacity while compartmentalising its conflictual geopolitical posture with China and the engagement of US companies in the Chinese market. Denouncing China's policies on the international stage (Xinjiang, Hong Kong, Taiwan, and unfair trade practices) while sanctioning large Chinese companies, has not prevented successive administrations, from Donald Trump to Joe Biden, from being flexible when it comes to US investments and doing business in China. For example, ninety-five

3. Bilateral trade between the US and China is already down sharply from the 2017 baseline used for the Trump administration's Phase One deal, and two-way foreign direct investment is at a ten-year low. Understanding EU-China decoupling. Macro trends and industry impacts, China Center, US Chamber of Commerce, 2021, p. 11.

per cent of US companies operating in China that participated in the June 2021 *US-China Business Council* survey believe that they are likely to further increase their profits from operations in China compared to 2020 and pre-Covid historical levels.

At the same time, the European Parliament, which is a target of Beijing's sanctions, is struggling to accept the multifaceted strategy that the European Commission has championed since 2019, declaring China not only a 'systemic rival', but also a 'competitor' and 'partner', with whom European companies should continue to engage. In fact, strengthening economic ties with China offers better leverage for the EU to defend its values than an isolation scenario.

Furthermore, the limitation of travel reduces physical meetings with Chinese partners. This creates **an additional decoupling of 'perceptions' and 'reciprocal opinions'**, detrimental to the development of European business in China. The workforce on the ground in China is increasingly operating in isolation and no longer necessarily shares the vision of those in European headquarter. The health and economic situation also continues to be different on each side and influences the way of working.

Without the right levers to respond to the challenge of accelerating the decoupling between China and the United States at the technological and normative level, companies are calling for a European strategy that engages the weight of the EU-27 to establish fairer conditions of competition with their partners. They support the search for a European third way that would allow them to avoid being caught in the pincer movement of Sino-American rivalry.

This approach, described by the European Commission as 'open strategic autonomy', aims to **strengthen the resilience of the Single Market by reducing member states' strategic dependencies while ensuring that the European market is open** and that trading partners are called upon to do the same on the basis of a fair competition agenda.

The EU is defending this agenda first and foremost at the multilateral level by supporting a reform of the World Trade Organisation, which is nevertheless currently paralysed by US inertia. Indeed, the absence of the US from the negotiating table limits the pressure that could be brought on China to minimise the distortions to competition that its state-owned enterprises create. At the trilateral level, i.e., between the European Union, Japan, and the United States, it has become ever more pressing to move the joint initiative from the beginning of 2020 to regulate industrial subsidies forward. However, as the pandemic and the race for technological leadership are attracting more state aid everywhere, this has become a much more complex exercise.

At the unilateral level, through the establishment of a legal arsenal of autonomous defence instruments, the EU can still, in the short term, most actively defend European companies. In line with the mechanism for controlling foreign investment in strategic assets adopted in October 2020, the adoption of instruments for **controlling foreign subsidies**, e.g., the introduction of greater reciprocity in public procurement and an anti-coercion instrument, aim to provide the EU with an autonomous decision-making and reaction capacity. They are in support of the multilateral legal framework, even more so as the persistent blocking of the WTO Dispute Settlement Body requires a margin of strategic autonomy through unilateral measures that remain in line with international trade law.

Given the asymmetry in the openness of the two markets, their demographic weight, and economic growth, the EU cannot bank its entire strategy on reciprocity, which the Chinese government does not want. But the EU can also not cease to exert pressure to obtain greater reciprocity in market access conditions. Therefore, the EU would benefit from showing strong cohesion by rapidly adopting autonomous defence instruments. Moreover, although China's consumer spending was 5.6 trillion US dollars in 2019, consumer spending in the EU and the United States, amounting to 8.3 trillion and 14.4 trillion dollars, respectively, can still provide leverage for the West when it tries to obtain reciprocal market access. Indeed, this is even more the case if one considers the combined weight of all OECD members, which have a consumer market worth 32.3 trillion US dollars.

6.3 ▪ Recommendations

- The major European business federations agree that dialogue with China should be maintained at all costs, whether at the level of companies or the political level.

- The coordination of European players between major national federations and their European counterparts, as well as with European institutions, is essential to make the specific needs of businesses heard. This is true for both bilateral negotiations of the EU and discussions at the WTO, considering the diversity of interests that must be defended depending on the sector and the issues to be resolved, including the location of international value chains and data governance.

- Assessing the risk of exposure to territorial sanctions and being caught between the US and China is becoming so complex **that companies need to be assisted in the examination of their value chains. A single desk could be set up by the European Commission, similar to the implementation of trade agreements. This would help companies to assess the risks, costs, and benefits of decoupling value chains with either a 'dual system' model or a 'flexible architecture'.**

- Businesses support the **ratification of the** December 2020 **EU-China Comprehensive Investment Agreement (CAI)**, or even a re-engagement of negotiations to strengthen reciprocity. While CAI remains contingent on the lifting of reciprocal sanctions between the EU and China, it would allow for catching up on the investment terms obtained by the US in the Phase One agreement and, on some points, even go further. The freeze on ratification should not prevent Europeans from re-engaging in dialogue by taking advantage of the implementation of the autonomous defence instruments to negotiate more reciprocity.

  In particular, the agreement would allow European companies to participate in Chinese standardisation bodies, something that neither the Phase One deal nor the RCEP (signed between 15 Asian countries, including China) are helping to do. As the competition of regulatory models increases and China becomes more ambitious in promoting its standards, in particular for 5G technology and Artificial Intelligence, investing more resources to increase its influence in European and international standardisation bodies, it is essential that European companies can, in turn, gain access to Chinese bodies. Furthermore, beyond the mobilisation of companies within these standardisation bodies, according to their market shares and means, **Europeans would benefit from developing a more offensive joint strategy to promote European standards** in third countries (as China does along the Silk Road) and within international bodies.

- The use of the EU's autonomous defence instruments is the subject of much debate among member states as the trialogue negotiations between the Commission, the Council and the European Parliament begin in early 2022. Dependence on the Chinese market varies from one member state to another and between economic sectors. This diversity of interests is reflected in the heterogeneous positions that have been taken by the most important business federations.[4] They differ on the balance to be struck in the way these instruments operate, particularly between the need to preserve the attractiveness of the European market and avoiding to restrict market access for protectionist purposes, as well as the need to adopt instruments whose defensive nature is sufficiently credible to serve as a lever for opening up third-country markets. To defend a European third way between the United States and China, the calibration of these instruments is as necessary as the cohesion that the EU-27 will display in their use.

Under pressure from the German employers' organisation (BDI), the end of Angela Merkel's mandate was marked by a shift in Germany's position towards China, with **a rapprochement of German and French positions favouring** the autonomous defence agenda. **The consolidation of this dynamic with the new coalition on the other side of the Rhine** could be decisive in rallying the other member states, starting with the Netherlands and Sweden. The key is to develop a shared conception of an autonomous defence that aims to increase market access and will act as a guarantor against protectionist temptations or excessive dependence on China.

4. Partner and Systemic Competitor - How Do We Deal with China's State-Controlled Economy? BDI, January 2019. Italia, Europa e Cina: Analisi e proposte per un rinnovato modello di cooperazione, Confindustria, 12 April 2019. Confederation of Swedish Enterprise's Agenda: For Free and Sustainable Trade, Swedish Enterprise, September 2020. China and the United States - A challenge to companies, Ministry for Foreign Affairs of Finland, 14 June 2021. The EU and China - Addressing the systemic challenge, A comprehensive EU strategy to rebalance the relationship with China, BusinessEurope, January 2020.