

China and the role of Europe in a new world order

• Introduction

The EU-China relationship has deteriorated significantly. Given the likely direction of travel of China and of the world, it needs rebalancing in various directions in order to strengthen the EU's position while engaging China where cooperation seems both necessary and possible and avoiding its isolation. This will imply releveling the economic playing field, reducing critical EU dependencies, increasing its resilience and its strategic autonomy, augmenting its global clout, and building cooperation with China in topics or regions where our interests converge.

The Russian invasion of Ukraine marks a new low point in EU-China relations. The fact that the Chinese government has shared the anti-western narrative of the Russian aggressor has accentuated many of the long-standing economic and political tensions between the two blocs. It has forged a new sense of unity amongst Member States vis-à-vis China, prompted a number of Member States to rethink their economic dependencies on the authoritarian state and led Brussels to stress the systemic rivalry between the EU and China in even starker terms than before.

While it is now obvious that the diplomatic relations will remain on a downward spiral for the foreseeable future, it is much less clear how this new reality should translate into policy. With the remaining economic interdependencies and the need to cooperate with China as a world power on several issues from climate policy to health or food security, the EU will need to find new ways to juggle conflicting economic and political goals. France and Germany should, therefore, take the lead in formulating this new approach.

EUROPE IN THE
WORLD

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#china
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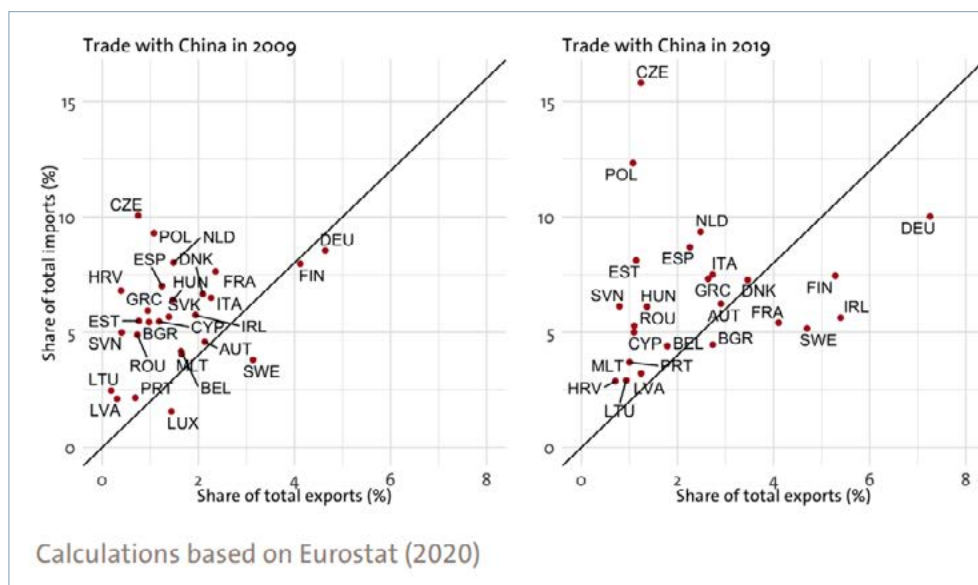
Most importantly, the two countries should push the EU to continue to level the playing field towards Chinese competitors, reduce its dependence in strategic sectors through trade policy but also through a politically and macroeconomically meaningful European industrial strategy. Moreover, the EU should leverage the geopolitical clout of its standard-setting powers and carve out a realistic agenda for an arm's length cooperation in those areas in which the two blocs still pursue common interests.

I • The Changing geo-economic ties between China and the EU

I STATE OF PLAY

Economic relations between China and the EU are at a complicated spot. For one, this has structural reasons. Recent years have seen a massive increase in trade ties. Between 2011 and 2021, European imports from China almost doubled (86%), while exports to China grew by about 76%. The EU has become China's largest trade partner and the Chinese market is the second largest destination for EU goods after the U.S. While this increase was by no means uniform across the EU and much more pronounced in Germany than in France (see fig.1),

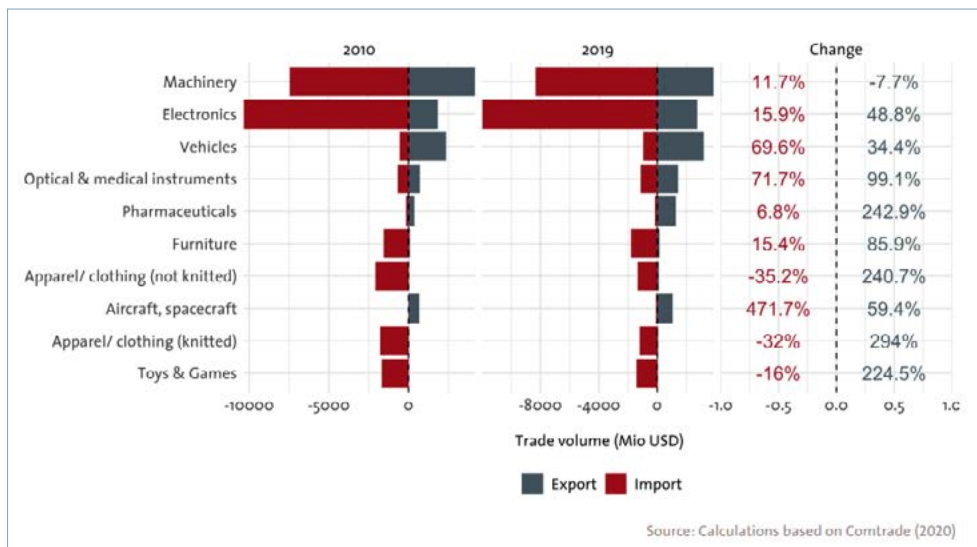
FIGURE 1. Increasing disparities among EU Member States in their trade relations with China



It has substantially heightened the economic stakes that many Member States have in a functioning economic relationship with the People's Republic. Given that the Chinese middle class is expected to reach 800 million consumers by 2030 it will also continue to be too big to be ignored by Western companies.

At the same time, China's state-led growth strategy has led to a massive climb up the value-chain. This has two consequences: **First, China has become a more integral part of European, French, and German production of goods and is increasingly replacing intra-European supply-chains.** Second, China's today produces many of the goods it used to import from the EU itself. Despite the massive increase in overall trade, European exports of manufacturing capital and machinery have fallen in the most recent decade (see fig. 2).

FIGURE 2. Distribution of EU-China trade flows by main sectors, 2010-2019



As a result, trade trends are increasingly unbalanced: Europe is becoming more and more dependent on China both as an export market and for key inputs such as telecommunication equipment, data processing machines and rare earths and metals. The EU is still exporting more value added than China, but the difference is shrinking rapidly, and China seems determined to wean itself off European imports in key sectors. The recent crises have accentuated this picture. **Between January and May 2022 German exports to China scored -6.3% and French exports -10.1%, while German imports of Chinese goods increased by 8.9% and French imports by 10.6%.**

These trends have long fed into European concerns that the EU economy has become too dependent on China, while China seems increasingly willing to emancipate itself from European inputs. Two recent developments are further fueling these concerns.

First, a perfect economic storm in China may turn the world's former bedrock for export demand into a source of economic insecurity. In addition to rising Omicron cases, never ending zero-COVID policy, congestion in major ports and disruptions in supply chains, other factors point to a more uncertain future, such as remaining insecurities in the Chinese financial and especially the real estate market, massive devaluation of the Yuan and a low inflation rate (2.1% as in May 2022) which signals very weak demand. In April 2022 retail sales was down by 11% YOY and national industrial production down by 3%, while a GDP growth limited to 4.8% during the first quarter of 2022 pulls the country away from the Chinese authorities' annual growth target of 5.5%. As a result, in April 2022, 23% of European companies operating in China were considering shifting current or planned investments in China to other markets. The number had doubled since February and was the highest percentage recorded in the past decade.¹

Second, the geo-politicization of trade and increasing weaponization of interdependence since COVID and especially since the outbreak of the war in Ukraine have further strengthened European reliance on China both for as an export market and as a provider of key inputs. On the one hand, this is driven by the broader concerns

¹ European Chamber of Commerce in China / Roland Berger (2022) 'Covid-19 and the War in Ukraine. The Impact on European business in China', European Flash Survey, April.

that both the pandemic and now the Russian aggression have sparked about concentrated dependencies, especially on geopolitically adverse actors. On the other hand, the specific concerns relating to the Chinese government are shaped by the Chinese politicization of key supplies during the pandemic and by recent spats over the CAI and Chinese trade bans to Lithuania to sanction Vilnius's decision to allow Taiwan to open a representative office under its own name.

In sum, the promising market has turned out to be a less reliant trade partner and more challenging systemic rival for the EU in recent years.

I LOOKING FORWARD

What do these trends mean for the future of the economic relations between the EU and China? First of all, it is important to note that current proclamations about the end of globalization are likely to be overblown. During the pandemic, long-distance trade grew more than short-distance trade, suggesting that regionalization is not always the best option to increase the resilience of supply chains and that remote sourcing may also be needed.² At the same time, the share of services in global trade continues to increase and we are only at the beginning of the trend towards transborder flows of data. A broad-based decrease in international trade flows is therefore highly unlikely.

However, there are several factors that point towards a possible fragmentation of globalization around regulatory blocks based on different interpretations of precaution and diverse risk management. Patterns. On the one hand, China seems to be willing to deepen its economic ties to Russia.

The Chinese government has made a number of proclamations in that direction and already increased the imports of Russian gas and oil. If Chinese would start to increase their exports to Russia to support its economy even more actively³, they could become subject to Western sanctions. Reciprocal retaliation would likely accelerate US-China decoupling⁴, lead to export restrictions of strategic technologies on both sides and add pressure on other partners to choose sides or to develop separate supply chains for the two markets. China could also extend economic coercion by restricting rare earths exports to the US as well as other targeted countries or reduce access to its market. The strengthening of transatlantic relations within the framework of the Trade and Technology Council, could make the EU's engagement with China even more complex.

What kind of trade-blocks could emerge in such a situation is a debated question among specialists. China will continue to foster further trade regionalization in Asia. But, as much as in Europe, Southeast Asian countries are increasingly worried by China growing regional economic influence and look for a diversification of their trade flows.⁵ We are thus likely to see a scenario in which especially smaller

2 Altman, S. A. and Bastian, C. R. (2022) 'Trade Regionalization: More Hype Than Reality?' Harvard Business Review, 31 May.

3 Since the invasion of Ukraine, Chinese exports to Russia have fallen from 38 percent compared with the second half of 2021. Chinese companies limit the risk to being exposed to sanctions. Yet China may continue to support Russia with increased imports from Russia (oil and gas), as suggests the rise of 12% of China's overall trade with Russia in March from a year earlier - outpacing the growth in China's total imports and exports. Chorzempa, M. (2022) "Export controls against Russia are working - with the help of China", PIIE, 27 June.

4 Lamy, P. and Köhler-Suzuki, N. (2022) 'Deglobalization Is Not Inevitable How the World Trade Organization Can Shore Up the Global Economic Order', *Foreign Affairs*, 9 June.

5 Seah, S. and alt (2021) 'The State of Southeast Asia' The State of Southeast Asia: 2021 Survey Report', ASEAN Studies Centre at ISEAS-Yusof Ishak Institute, 10 February, p21.

countries will attempt not to pick sides but try to navigate increasingly complicated global trade relations.

Overall, the future of EU-China relations will largely be shaped by the development of the Chinese regime. Most current analyses –amongst them for example the recent book by former Australian prime minister and China expert Kevin Rudd– do not expect a political regime change in China |8. To the difference of his predecessors, Xi has prioritized ideology over the economy, and unless dissent on this line surfaces at the top ranks of the Party, which is not impossible, no change can be expected in the foreseeable future. The EU thus has to prepare itself for complicated relations with a slowing down economic giant. This requires striking a delicate new balance between openness, autonomy, and sovereignty but also planning for worst-case geopolitical scenarios such as a Beijing aggression towards Taiwan which is not developed in this paper.

II • Rebalancing EU-China relations within the “PRC” triangle (partner, rival, competitor)

Despite the historical asymmetry of France and Germany’s respective approaches to China, recent trends led to a closer alignment between the two countries. With its strong industrial and market presence in China, Germany intended for long to preserve strong economic ties with its first trade partner. Faced with increasing Chinese trade distortions and legal uncertainty for outward investments to China, it has now moved closer to the level playing agenda advocated by France. The new government coalition is likely to prioritize this approach even further. At the same time, the important French maritime presence in the Asia-Pacific traditionally made it also more sensitive to the rise of China in the region. Yet, while the focus was already rather on the competitor than on the partner, the war is now amplifying the systemic rivalry on the defense of human rights and increasing the convergence of Germany and France on the principle that to remain open to cooperation the EU needs to strengthen its position.

This convergence now needs to be leveraged to develop a common European agenda that fits the new geo economic and geopolitical reality while remaining open to constructive engagement in areas where Sino-European interests still overlap. We see this agenda developing around six priorities.

I LEVEL THE PLAYING FIELD TO ENGAGE WITH CHINA IN INTERNATIONAL FORA.

Germany’s strong support to the level playing agenda advocated by France has allowed to quickly equip the EU with new trade autonomous defense tools. In addition to the recent agreement in the Council on reciprocity in public procurements (IPI), the carbon border adjustment mechanism (CBAM) and the foreign subsidies instrument, the more conflictive relation with China is speeding the debate on the anti-coercion instrument (ACI) which could prove to be even more decisive if it is well calibrated to shield against less traceable modes of economic coercion. By moving beyond responsive countermeasures to deal with the prospective damage coming from unfair competition, these tools aim at rebalancing bilateral relations. Now France and Germany will have to support an active use of these tools to increase the leverage of the EU in defending existing and new multilateral rules against China’s reinterpretation of the global order. Keeping China engaged in the WTO and other multilateral fora to avoid a more autarkic China to become more aggressive would however also call the EU to continue engaging the US on a reform of the WTO, a long shot in Washington.

But the use of these instruments will be determined by the ability of Member States to agree on the type of challenge posed by China, the role of the EU in the context of the US-China decoupling, and the level of dependence on China that Europeans are prepared to accept. Building this cohesive position requires first an active dialogue between and with German and French Businesses.

I REDUCE DEPENDENCIES IN KEY VALUE-CHAIN THROUGH DIVERSIFICATION

With the trend to the weaponization of interdependence, the reduction of critical dependencies becomes more pressing. For 137 imported items on which the European Commission has already identified that the EU has a strategic dependency, 52% of this dependency is on Chinese imports. The concentration of production makes the diversification of sourcing even more challenging as amongst the 520 products for which a single exporter accounts for more than half of world exports in 2018, 320 are from China.⁶

Surveys show that as soon as in 2021 businesses have backed up from nearshoring plans to boost inventory levels and dual sourcing. There is however a gap between the political rhetoric of reducing European strategic dependencies and the decisions of private companies to engage in diversification. Given the significant investment and operating costs of diversification of supply, the incentives of businesses are mixed and dual sourcing is prioritized for raw materials. Diversification of rare earths supply is particularly critical as China provides 85% of the world's processing capacity of rare earths.

Supporting their efforts to dual source would firstly call to develop more granular collective intelligence on strategic dependencies by tasking the European Commission to secure data sharing with private companies to complement customs' data. Diversification also requires market access. Advocating for the negotiation and ratification of new trade agreements is now a matter of security of supply. It requires political leaders to invest in a pragmatic and responsible discourse that makes these security issues more tangible to European public opinion. France could more actively build up on the implementation of trade autonomous defense tools—ending the era of the so-called “naïve open Europe”, a fashionable expression in Paris—to give a new push to the conclusion and ratification of strategic trade agreements focused notably on sourcing raw material. While the US has retreated from trade negotiations to focus on regulatory dialogue and cooperation, China is increasing its grip in South-east Asia, Africa, and Latin America with active bilateral and regional negotiations. The EU cannot limit itself to develop regional trade with the Balkans and Middle Eastern and North African countries. It also entails dealing with remote partners in Asia (India, ASEAN, Taiwan, ...) as well as in Africa and Latin America, assessing their reliability foremost on their respect of the rule of law.

I INCREASE EUROPEAN RESILIENCE THROUGH COMMON EU INDUSTRIAL STRATEGY THAT INCORPORATES GEOPOLITICAL AND MACROECONOMIC GOALS

To remain competitive and strengthen its resilience in key strategic sectors, the EU needs to get serious about its own industrial strategy. France and Germany have been at the forefront of pushing for more active industrial policies for some time now. This has already led to a number of important initiatives such as the extension of Important Projects of Common European Interests (IPCEIs) in areas such as microchips, batteries, cloud systems and hydrogen, the focus on strategic sectors in National Recovery and Resilience Plans (NRRPs) through NextGenEU and the

⁶ Jean, S., Reshef, A., Santoni, G. and Vicard, V., forthcoming, 'The Global Concentration of Exports: Monopolized Products in China'.

Commission's proposal on a European Chips Act to strengthen competitiveness and resilience in the area of semiconductors.

The experience of the war and the prolonged supply-chain issues will constitute a further push towards more public support to foster the competitiveness of strategically important industries. However, the agenda is met with increasing skepticism from a range of EU governments that fear that the current approach mostly favors deep-pocketed Member States and will distort competition in the Single Market. If the EU's industrial strategy is supposed to be more than a flash in the pan, France and Germany need to take these concerns seriously.

This requires, first and foremost, two things. First, EU industrial policy needs a much stronger economic governance framework. Getting industrial policy right remains complicated and comes with tangible risk of government failure. Many Member States and parts of the Commission therefore remain skeptical of a return to naïve dirigisme and picking European winners. Given that much of the governance of, for example, IPCEIs is decided ad hoc by the involved Member States, there is little guidance on criteria for selecting and sustaining funds to specific undertakings, and the inner workings of the project development remain largely opaque, these concerns are legitimate. To convince skeptics of a more assertive industrial strategy to face competition from China, France and Germany should therefore push to take the governance side much more seriously and develop common EU standards projects.

Second, common industrial policy requires common funding. The EU's current approach to industrial policy largely consists of relaxing state aid rules for specific projects to allow for more national spending. However, Member States differ widely in their capacity to provide such funding. The current strategy, thus, risks unfair competition, economic divergence and political conflict. To avoid this, a successful European industrial strategy therefore needs common financing instruments. In the short-term, this could include changing the funding structure of IPCEIs so that Member States jointly fund projects independent of their location. In the long run, the EU should beef up the resources available for upstream research, innovation and industrial policy projects at the EU level with new own resources, larger contributions to the EU budget or additional common borrowing.

I PROMOTE EU STANDARDS MORE ACTIVELY IN INTERNATIONAL ORGANIZATIONS AND WITH THIRD COUNTRIES

The EU is a normative power, but competition is becoming fiercer in the field of digital standards and the EU's ability to promote its own standards in this area will be crucial for its strategic autonomy. China, which still accounts for only 1.8% of international standards, has strong ambitions in this area, especially for 5G technology and artificial intelligence. It invests considerable resources to increase its influence in European and international standardization bodies, while also developing an offensive strategy to promote its standards along the Belt and Road initiative, which has unlimited geographical reach. The French and German companies should actively support the new *Standardization Strategy* presented by the European Commission on 22 February 2022, to adapt EU capacities to the resources invested by Beijing. European businesses would gain from developing a more offensive common strategy to promote European standards within international bodies and increase cooperation in this field with Asian, African, and Latin American countries, while ensuring better control of the conformity of their imports with these standards. This strategy rightly aims at strengthening coordination between EU Member States and like-minded partners. The funding of standardization projects announced in African and neighborhood countries should nevertheless be extended to remote areas such as Latin America and South-East Asia.

Germany and France could also advocate for the EU to join the CPTPP which will carry weight with common standards. This could be a powerful instrument to influence Chinese trade practices. The Russian invasion gives a fresh geopolitical dimension to the Transatlantic Trade and Technology Council (TTC) as well. The focus of each of the ten working groups is key for the EU's strategic autonomy. The two partners would notably gain from developing common digital standards that safeguard political rights. Above all, the TTC should already make it possible to coordinate the measures adopted on each side to address Chinese trade distortions, in line with the waiver that has already been negotiated in case of discrepancies between EU and US sanctions on Russia. The inclusiveness of the agreements delivered by this cooperation would also be decisive in promoting a rules-based world order and in keeping the US engaged in multilateral negotiations.

I ENGAGE CHINA MORE ON COMMON CHALLENGES WHERE COMPLEMENTARITY CAN BRING BENEFITS

The recent geopolitical developments have seriously limited the room for constructive cooperation between the EU and China.

Against this background, the EU should pragmatically reassess the best instruments and fora to find common ground. This, first and foremost, requires revisiting the EU's own goals. It is now clear that little progress can be made based on the 2019 EU-China Strategic Outlook and that the EU should downscale its priorities in order to have a more realistic shot at progress. Such priorities should be grounded in reciprocity and the *de facto* respect for agreed norms, principles, rules and procedures. Based on these standards, the EU should, for example, continue to cooperate with China on promoting a rule-based multilateral trading system, push for the achievements of the Sustainable Development Goals (SDGs), and look for new ways to reduce global health risks of digital fragmentation by engaging China in a conversation about the adequate balance between convergence (critical infrastructures or platforms market power regulation) and coexistence (data regimes or content regulation) among digital ecosystems.

On top of these areas, EU and China should build a stronger bilateral cooperation in two domains where they have major interests which other regions do not share to the same extent: climate change and decarbonation of energy and production systems and Africa's lack of infrastructure finance, be it in clean energy or in transport. Joint projects in these two sectors, which could be combined for hydropower for example, could go some way in alleviating the African concern about yielding too much influence to old or new colonizers.

I ADVANCE ON EU STRATEGIC AUTONOMY TO AVOID A WEST VERSUS REST WORLD

The war as well as the heightened competition with China underline the need for the EU to strengthen not just its economic but also its geopolitical capacity to act (see *EU 2050 Evian note*). Calls for more European sovereignty or open strategic autonomy have been around for some time. The war should obviously provide a major boost to this agenda. The big question is how the EU should position itself in an emerging global order that is now remade by open confrontations between the West on the one hand and Russia and, to some extent, China on the other. Two things are important from a European perspective. On the one hand, the EU will need to become a true security power that closely coordinates with NATO partners and above all the US. On the other hand, being forced into binary choices between the "West" and the "Rest" would hamper the strengthening of European strategic autonomy, weaken the engine of European integration and make the pursuit of a

genuinely European civilizational model⁷ (see *EU 2050 Evian note*) rapidly appear as vain. The EU therefore needs to be able to find its own posture vis a vis the “Rest” in establishing a pattern of relationships with developed or developing countries that would help them avoid being trapped in a binary choice between the US and China in the future. Importantly, this is not about equidistance but about the EU’s ability to strategically choose partnerships that best serve its interests and values.

The Russian invasion of the Ukraine also puts a spotlight on the limitations of this sovereignty in the current institutional context. The increase of EU military spending is hampered by a lack of coordination and common procurement, strong sanctions against Russia are continuously watered-down as a result of the veto-power of individual Member States and the goal of achieving independence from Russian energy exports raises concerns about EU coordination in energy policy and the lack of resources for strategic investments (see *EU 2050 Evian note*). Importantly, given the economic weight of the Chinese economy for many Member States, the issues surrounding finding a common position on Russia would only be aggravated in cases of confrontation with the People’s Republic.

• Conclusion

Mutual perceptions of Europe and China have deteriorated significantly. While increasing the EU’s economic capacity and engaging in a more level playing field with China, there is a need also to restore a calmer and more constructive climate aiming to establish a peaceful coexistence with the Chinese authoritarian regime. For that, people-to-people relations are most needed. China’s assumed persistent closure during the fall 2022 makes this more difficult. But to avoid having a more isolated China becoming more aggressive, Europeans need to enhance ways for mutual understanding. It needs to invest in China analysis and enhance knowledge on China among European decision makers as much as at the level of European populations •

7 Lamy, P., Maillard, S. and Pons, G., ‘EU in 2050: older, greener, larger, safer and more than ever indispensable’, Evian-Conference 2022.

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