RECONNECT CHINA

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Partner, competitor, or both? Thoughts on derisking in EU-China economic relations

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Executive summary:

The EU and its member states are gradually clarifying what the concept of derisking means for its economic relationship with China. Derisking is a useful concept to frame EU-China relations since there are risks in close ties to a powerful external actor with a state-led economy. However, in the current debate surrounding China, derisking could easily translate into an overly broad rejection of economic interactions with this country. We urge the EU to be pragmatic and realistic in determining where to derisk economic ties to China which in our view includes considering at which point risks have been sufficiently covered, and which interactions do not carry political or geopolitical risks. The EU should consider which kinds of trade and investment between the two sides should be limited for geopolitical reasons, but also which can be left open to corporate actors and even which ones are still worth actively supporting.

Policy recommendations:

-Establish where the *limits* of derisking lie; at what point do we consider ties to China derisked?

-Economic interactions with China could be conceived as falling in one of the following categories:

Red light: the EU should introduce measures discouraging or prohibiting cooperation initiatives;

Yellow light: the EU is indifferent and leaves interactions with China to sub-state actors;

Green light: the EU sees public benefits resulting from interactions with China and actively encourages linkages.

Introduction

Ever since the European Commission has described the People's Republic of China (PRC) as "simultaneously ... a cooperation partner, ... negotiating partner, ...an economic competitor […] and a systemic rival" (European Commission and HR/VP 2019), the EU has struggled with managing its ties to the world's second largest economy. It is clear that the earlier European consensus towards a broad-based and ever-expanding relationship with Beijing has been overturned. In March 2023, 'derisking' officially became one of the EU's main objectives in relations with China. This policy brief builds on two workshops held in Groningen in November 2023 and November 2024 which hosted a group of experts from think tanks, academia and the public sector as part of the project ReConnect China. Based on the contributions and discussions held there under the Chatham House rule, this policy brief will comment on the direction of the EU's China policy and offer some suggestions on derisking the EU's relation with China. We start from the proposition that derisking should not result in a rejection of economic ties to China. The collective EU can rely on its strengths to build a clear-eyed, interest-based relation with China that errs neither towards naivete nor towards an overly securitized view that sees only dangers in links to China.

A EU policy driven by caution, but not fear

Since the Covid-19 pandemic, there has been a great deal of discussion in Europe on the (perceived or real) economic dependence on China and the risks this entails. In some respects, this has been a recent round of recurring European nervousness about the growing clout of China in the world economy, similar to worries on incoming Chinese FDI in 2016-2017 or floods of Chinese manufactured goods in earlier years. Today, however, the debate on China in Europe is, more than in the past, colored by a perception of China as both a security threat and an ideological threat that seeks to undermine liberal democracy on a global scale. A notable statement in that regard was made by NATO Secretary General Mark Rutte in December 2024. Mr. Rutte grouped China together with Russia, North Korea and Iran as countries that "are hard at work" to "chip away at our freedom" and to "reshape the global order".[1] These themes were to some extent already emphasised by returning European Commission President Ursula von der Leyen, under whose presidency the Commission has taken on a distinctly more critical attitude to China. Ms. von der Leyen argued in 2023 that "the Chinese Communist Party's clear goal is a systemic change of the international order with China at its center", citing the Belt and Road Initiative as well as Chinese initiatives for new international institutions and its brokering of talks between Iran and Saudi Arabia, among other factors.[2]

Ms. von der Leyen has clearly positioned herself in favor of derisking and rejected the notion of the much more radical policy of decoupling. Derisking is a rather fluid concept. As highlighted in a report published by the European Think Tank Network on China (ETNC) in 2024 (Andersson & Lindberg 2024), interpretations of derisking vary widely between member states. In a climate where China is seen in sometimes starkly hostile terms as in Mr. Rutte's speech, there is a risk that Europe may eventually end up with a version of derisking that is indistinguishable from decoupling. Derisking is, in itself, a welcome idea when dealing with a powerful country with clearly stated intentions to become a central player in the world economy. However, the policies that shape derisking should not be informed by a misguided notion that Beijing seeks to fundamentally alter the global order. Beijing clearly opposes Western interpretations of civil and political rights, but when it comes to the ordering of the world economy, Chinese elites are substantially committed to preserving the transnational capitalist system in its current form (Taylor & Cheng 2022). It is also worth noting that the EU has already generated a significant policy output in the past years aimed at insulating our economy from Chinese and other external pressures. During the first von der Leyen presidency the Commission produced an investment screening framework in 2019, the Toolbox on 5G security in 2020, an investigation into trade dependencies in 2021 and the anti-coercion instrument in 2023, as well as the European Chips Act, among other initiatives. When the previous Commission President Juncker warned in 2017 that "we are not naïve free traders" working on derisking had just started; today, at least specifically with regard to China, we can start to think about when we have done enough.

China needs Europe too, and knows it...

The EU has good reason to maintain a workable relationship with China. China is Europe's largest source of imports as well as a major destination for European exports and outward Direct Investments (see below). In addition, China has furthered the development and commercialization of certain technologies needed to de-carbonize the economy to an extent that no other country has done. While this was of course done with significant state support, the result is nonetheless that China is a source of technologies that should be rolled out in European economies without delay to slow the existential danger of climate change. A substantial degree of cooperation with China remains necessary even in times of derisking.

China similarly sees an interest in maintaining a workable relationship with the European Union and its member states. During the 24th EU-China Summit held in Beijing in December 2023, Chinese

[1] See the full text of the speech at https://www.nato.int/cps/en/natohq/opinions_231348.htm.

[2] See the full text of this speech delivered at the Mercator Institute for China Studies here: https://ec.europa.eu/commission/presscorner/detail/en/speech_23_2063.

President Xi Jinping referred to the EU as "…a key partner in trade, a prioritized partner in technology cooperation, and a trustworthy partner in industrial and supply chain cooperation".[3] Chinese Foreign Minister Wang Yi similarly referred to Europe as a "key partner for China to realize its modernization" in his six-day tour through Europe in February of 2024.[4] These statements are not just diplomatic niceties. After decades of accumulated investments, European companies account for millions of jobs in China through both their own production facilities as well as outsourced production. Furthermore, many Chinese producers rely on specialized machinery from Europe, a dependency which will not disappear overnight (Zenglein 2020). And Chinese companies looking to internationalize "value the European market both as an important puzzle piece in their global business strategy and as an important investment destination".[5] In the business confidence survey of Chinese companies of the Chinese Chamber of Commerce in the EU of 2023, 94% of respondents indicated that the European market "will play an equal or bigger role in their global expansion in the next three years", and 83% of respondents plan to expand their presence in the EU.[6] The EU is all the more important now to China as both a major market and a source of technological know-how since relations with its other large developed partner, the US, have deteriorated significantly in recent years. Put simply, China has fewer options than it did ten years ago.

…BUT THE EU SHOULD UNDERSTAND THE LIMITS OF ITS INFLUENCE

In short, the Chinese side does attach value to its economic relationship with Europe. This should give the European Union some leverage to demand adjustments in this relationship to make it more compatible with European economic interests, instead of requiring an across-the-board decrease of economic ties to China. At this point, a caveat should be made. We do not mean to say here that because the Chinese government and corporate elites value their economic ties to Europe that this gives Europe the ability to change China. European states and the EU should abandon grandiose visions of infusing China with their worldview along the lines of the old *Wandel durch Handel* idea in Germany, or the idea of Europe as a 'normative power'. Ties to Europe, even extensive ties, are not going to change the views of the Chinese party-state on what it sees as core strategic interests like the status of Taiwan, much less the features of its political system. Even its relationship to Russia has remained in place to a degree that unnerves European backers of Ukraine (Bermingham 2024). But the EU should consider itself in a position to negotiate changes within its *economic* relationship with China such as more localization in Europe of production of Chinese green technologies, or more openness to European investors in China in non-strategic sectors while preserving the overall relationship.

A NOT-SO-ONE-SIDED RELATIONSHIP?

In recent years, the news on the EU's economic relationship with China has struck an almost uniformly negative note, from the EU perspective. First, there is the enduring and widening deficit in the EU's trade in goods with China. The trade deficit declined somewhat in 2023 compared to 2022, but it still stood at 291 billion Euros (European Commission 2024). Repeated complaints about this from European leaders, including at the EU-China summit in December 2023, seem to make little impression on their Chinese interlocutors. Second, and related, are the long-standing complaints from European businesses operating in China – as related by Commission President von der Leyen, *"…a lack of market access for European companies to the Chinese market, to preferential treatment of domestic Chinese companies and overcapacities in the Chinese production" (European Commission 2023).* To this was recently added the European apprehensions about Chinese electric vehicles (EVs), leading the European Commission to announce the imposition of countervailing duties of up to 35.3% on various brands of EVs produced in China.

[3] Quoted by Haley Wong, *South China Morning Post*, 7 December 2023.

[4] Quoted by Xinhua, 22 February 2024.

[5] China Chamber of Commerce to the EU & Roland Berger 2024: p. 2.

[6] Idem: p. 68, 69.

The Business Confidence Survey 2024 of the EU Chamber of Commerce in China (EUCC)[7] similarly paints a rather bleak picture about the business environment in China for European companies. More than two-thirds of the survey's respondents (68%) reported that doing business in China became more difficult in 2023 (EUCC Business Confidence Survey 2024: p. 19). Market access barriers remain as problematic as ever, with 58% percent of respondents having "missed business opportunities in Mainland China as a result of market access restrictions or regulatory barriers" (p. 24), the second highest number on record (after last year's survey). Perhaps most worrying for these companies, a record low of 15% is optimistic about their profitability in the coming two years, with 44% being pessimistic (p. 28). However, it is also noteworthy that many European companies still see opportunities in China. The survey also found that 69% of respondents reported being profitable in China (p. 15). Furthermore, 42% of respondents answered they were considering expanding their China operations in 2024, versus 35% answering they were not considering this (p. 5). 65% answered they were maintaining their current investments in China versus 21% stating they were considering shifting investments or have already shifted investments elsewhere. To be sure, many of these scores are worse than they were in previous years, so it is doubtlessly the case that China's attractiveness to European companies is decreasing. But the survey also shows that China remains an important destination for many European companies even after Covid lockdowns, an escalating US-China rivalry and a persistent economic slowdown. The optimistic times of the early 2000s and 2010s are unlikely to return, but a solid European business interest in China remains.

The European deficit in goods trade is, of course, consistently large and increasing since China's WTO-accession in 2001, with the exception of 2023. That said, focusing only on this leads to misunderstanding of other important aspects of the overall relationship. Political economists Lukas Linsi and Milan Babic present some important nuances in their recent paper on FDI flows between Europe and China. First, they point out that the European FDI position in China is much larger than vice versa. Moreover, this gap was growing rapidly up to 2021, the most recent year in their study, when it reached nearly 300 billion USD (Babic & Linsi 2024: Figure 3). As a result, China exports much more to Europe than it imports from Europe, but European companies in China generate much larger revenue streams than Chinese companies in Europe. Babic and Linsi's analysis of firm-level data further shows that the activities of Chinese multinational firms are much more concentrated in Europe than those of European multinational firms are in China, as the latter tend to have a more global presence. The authors conclude that "in relative terms, Chinese companies' fortunes are more closely tied to Europe than European companies' to China" (ibid: p. 15) In short, while trade in goods is skewed in favor of Chinese exporters, when it comes to investments Europe both generate more income and is less dependent on China than the other way around. This reinforces the point made above that dependency between the EU and China is, on the whole, mutual. With these points in mind, we will offer the following conceptual suggestions for the EU's relation with China.

TOWARDS A POLICY OF PRAGMATIC SELECTIVITY IN ECONOMIC TIES

Firstly, to the extent that it has not already, the EU should abandon attempts at normative diffusion aimed at nudging China towards a liberal economy. Unlike earlier Commission strategy papers, the 2019 strategy is thankfully devoid of grand, unrealistic policy aims like "supporting China's transition to an open society based upon the rule of law" found in earlier times (European Commission 2003a, p. 12). It is by now clear beyond doubt that Beijing will not adopt a liberal economic model in the foreseeable future. The state-led nature of China's economy should be taken as a given on all levels of the EU's interaction with China. In some sectors the heavy involvement of the Chinese state gives rise to legitimate concerns on the European side which will require protective policy measures to address. In a broader sense, Beijing's tools of state intervention put down some limits to integration between the two economies

[7] See European Union Chamber of Commerce in China (EUCC) & Roland Berger (2024).

that would be imprudent for Europe to cross. However, there are still significant areas of overlapping economic interest where cooperation is fruitful for both sides. European policymakers should not allow distrust of China to blind them to areas of shared interests that remain. Moreover, as the EU and China are both among the world's most significant powers, there is a value to world stability in the two sides maintaining workable relations that transcends economic gains.

Secondly, the point above requires further consideration of the concept of de-risking. Policy documents such as the European Commission's analysis on strategic dependencies (European Commission 2021) and the European Economic Security Strategy (2023) have shown where there is still work to be done for Europe in reducing dependency on China in critical areas. But the inverse question should also be considered: at what point do we consider our economy sufficiently de-risked? Are there areas or sectors of the economy that we do *not* consider strategic, and where companies can be left free to pursue commercial opportunities as they see fit? It is interesting to note, as the EU Chamber of Commerce does, that in China "sectors not deemed strategic by the Chinese Government—such as F&B or retail" (EUCC 2023, p. 33) do better in terms of market access to European companies than sectors Beijing deems strategic; perhaps the EU should do the same.

A more challenging question concerns pressure from Washington towards de-risking or decoupling: where are the limits to where Europe is willing to go along with American wishes when it comes to China? Is there a point where a European (economic or other) interest is deemed to outweigh an American demand to curtail ties to China? And if an American demand goes beyond this point, is the EU willing and able to protect European companies if Washington responds with coercive measures to being refused? Washington now considers China its main competitor (The White House 2022: 23) but Europe does not. For Europe, Russia is the main adversary, which means US and EU interests do not fully overlap. Going forward, it is advisable for the EU to consider to what extent its alliance with the US means it needs to follow Washington's policies with regards to China.

Given that China is highly unlikely to liberalize its economy, the EU will have to respond in kind to a certain degree. That is, there should be a stronger political oversight of economic ties to align them with the public interest in Europe. The EU has been getting used to a more active industrial policy for some years already, including in relation to its China-ties; measures such as the investment screening mechanism introduced in 2019 were unthinkable less than a decade earlier. This represents a welcome development in the EU's approach to China. There clearly are substantial gains in continuing economic ties to China, but there are also asymmetries and risks. There are asymmetries in that Beijing backs its companies with robust industrial policies that can put European companies at a disadvantage that they cannot overcome on their own. There are risks in that China is a powerful non-allied country that acts first and foremost on behalf of its own self-interest. This combination means that state guidance is needed on the European side to gain the benefits, mitigate the risks and cushion the asymmetries inherent in economic ties with China. The economic relation with China should not be for companies alone to manage.

We propose that the EU adopt a 'traffic light model' to manage its economic relationship with China going forward. This is a conceptualization of different parts of economic ties and whether they should be promoted (green light), discouraged (red light), or where the EU should consider itself basically indifferent from a public policy perspective, leaving relations to private companies (yellow light). In the green light category, we find areas of cooperation the EU should actively promote because there is a clear public interest in doing so. For instance, the EU could leverage China's current desire to attract more quality FDI by introducing a guiding framework for its FDI in China that emphasizes ethical business practices and sustainable production, and sectors related to green transition technologies. Accompanying this could be scientific cooperation initiatives to stimulate scientific cooperation in pure science (i.e. without direct commercial or strategic implications).

In the red light category, conversely, the EU should introduce measures discouraging or prohibiting cooperation initiatives. In this category we may find cooperation that may be in the short-term interest of sub-state parties like companies or universities, but where there is a clear long-term penalty to the European public interest. Under this would fall technological cooperation or trade with clear military benefits to China that may be turned against EU partners in Asia like Japan or the United States. Equally, this category could encompass sectors where China seeks to push European companies out of the market in the foreseeable future, as happened in the case of European solar panel producers. Discouraging private actors from cooperating here could happen in the form of tighter screening mechanisms or perhaps outright prohibitions by member states.

Lastly, there is the yellow light category, where the EU sees no public interest one way or the other. In that case, private commercial interests can take precedence; in other words, while the EU will not allocate resources promoting cooperation here, it can let companies seek out opportunities as they please. This could mirror the attitude of the Chinese government that does not see some sectors like retail as strategic (see above) and therefore puts less obstacles in the way of foreign companies.

What China can do to improve relations

On the other side of the ledger, China can also take actions to improve ties with the EU. There are, of course, a number of high-profile complaints on the EU side that have been irritants for a long time. The EU delegation stated its wish-list in the 24th EU-China Summit in December 2023. It includes: helping reduce the trade deficit, ensuring Russia does not circumvent European sanctions resulting from the war in Ukraine, and improving market access for European companies. The last point has been on the EU agenda for so long that satisfactory progress (to the EU) on this point hardly seems like a realistic expectation anymore; when the EU's China strategy of 2003 was published, the Commission already pointed to the "persistence of market access obstacles in China" as one of the causes of a bilateral trade deficit (European Commission 2003b). The failed Comprehensive Agreement on Investment (CAI) was meant to lessen some of the obstacles to EU market access. While this treaty is now almost certainly beyond rescue, the Chinese government might consider whether there are elements in it that they are willing to extend unilaterally, as a gesture to lessen old irritations on the European side. Beyond that, there are steps that Beijing could take in the area of people-to-people ties. The pandemic restrictions in China have resulted in a significant outflow of European expats from the country. The EU Chamber of Commerce found in their 2023 Business Confidence Survey that the outflow of foreign nationals negatively impacted European companies through, among other effects, a "reduced transfer of know-how and best practices" and "increased communication difficulties between HQs and China operations" (EUCC 2023, p. 16). But the effects of a diminished European presence in China go beyond practical difficulties for companies. Many Europeans who have lived and travelled in China have grown enamored with the country thanks to the dynamism of its cities, the hospitality of its people, and the richness of its culture and cuisine. These people can play an important role in "telling China's story well" back at home, in the words of President Xi Jinping.

As such, we welcome the resumption of the EU-China People-to-People Dialogue. We further believe China could implement the following measures to improve relations with Europe. We welcome the 15-day visa exemption, now expanded to 30 days, for entering China for nationals of most EU countries. This policy could be extended to the three EU countries that are not yet covered by it as of December 2024: Sweden, the Czech Republic, and Lithuania. In addition, policies attracting expats to China including tax exemptions for living costs and policies on education for family members could be simplified and implemented on a long-term basis rather than being renewed every three or four years, as this presently adds uncertainty on decisions to relocate to China.

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