

# China's grand industrial strategy and what it means for Europe

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In recent years, the EU has attempted to strike a delicate balance in its response to China's rise and the accompanying historic shift in the global balance of power. It has sought to construct a multifaceted strategy that encompasses the two continents' interdependencies, the undeniable ideological clash, and a principled response to human rights violations. In 2019, the European Commission labelled China a negotiating partner, an economic competitor and a systemic rival.<sup>1</sup>

The present moment may mark a turning point: in a little over three months, an agreement (in principle) on an investment treaty was followed by sanctions and counter-sanctions. All the while, geopolitical conflict ratchets up between China and the US. Beijing is also embarking on a new economic course that will reshape its global relationships. The locomotive of the past two decades' global growth is attempting to slow and rebalance its model, with serious implications for the rest of the world. Furthermore, it has mapped out a grand economic and industrial strategy that upends many of the assumptions that underpin the EU's approach.

This Policy Brief addresses the latter development: stepping back, how has China's grand industrial strategy evolved over the past decade? What new course is being mapped out in its 14<sup>th</sup> Five-Year Plan (5YP)? Drawing on a range of expert insight, it analyses the broad, geopolitical implications for the EU's economic relations with China. Even as the EU faces growing competition in technologically sophisticated sectors, Beijing's inward turn risks cutting off its access to the Chinese market and compensating for greater competition. The Chinese economic model is evolving to blur the line between the public and private further, potentially rendering current efforts to tackle unfair Chinese competition insufficient.

Finally, China's efforts to attract foreign technology mean it is courting foreign investment actively, even while it signals greater protectionism to products made elsewhere. This calls into question the traditional equating of investor protection with European economic interests.

## BACKGROUND

### *EU–China economic relations*

In 2020, China became the EU's largest trading partner for goods, finally surpassing the US.<sup>2</sup> This appears driven by COVID-19 disruptions, but even if it reverses, China's size means it is the likely long-term equilibrium. However, this pales in comparison to intra-EU trade, and the US is still our biggest trading partner when accounting for services. In 2019, China accounted for an average of 2.4% of EU member states' exports, compared to 67.0% of the EU Single Market and 5.7% of the US. Germany stands out for its relatively high dependence on Chinese trade, taking up 48.5% of total EU exports to China, or 7.2% of its own exports. Meanwhile, only around 5.0% of the EU's inbound investment is Chinese.<sup>3</sup>

Certain European sectors and companies are significantly reliant on the Chinese market, such as Volkswagen (21% of revenues) or semiconductor firms NXP (37%) and Infineon (27%). In a sample of 25 public European companies, an average of 11% of revenue came from China. However, the Chinese operations of European multinationals tend to be remarkably self-contained.<sup>4</sup> Volkswagen produces 95% of vehicles for the Chinese market locally and reinvested 90% of the profits generated back into China.<sup>5</sup>

In terms of specific dependencies, the EU's exposure to China appears contained to the less technologically sophisticated portions of the value chain. China is particularly dependent on EU machinery and machine tools. However, it has steadily climbed up the value chain and is increasingly challenging European companies in sophisticated sectors. Furthermore, the EU has become increasingly integrated into the Chinese value chain, even as the intra-EU value chain becomes *less* integrated. China's reliance on EU intermediate goods is also decreasing, while EU reliance on Chinese intermediate goods has continued to rise.<sup>6</sup>

Overall, Chinese trade has brought the EU a range of benefits, from a growing export market to access to cheaper inputs. However, this has been coupled with longstanding concern over forced technology transfers, the role of state subsidies, and SOEs distorting trade and fair competition. In certain sectors (e.g. steel, solar panels), European companies have borne the brunt of subsidised Chinese manufacturing.

### *Chinese economic and industrial policy*

From 1978 to the early 2000s, Chinese economic policy was relatively sector-agnostic. However, since 2006 and accelerating in the aftermath of the 2008 financial crisis, China began to develop an industrial policy that focuses on specific sectors, particularly emerging technologies. This 'techno-industrial policy' is driven by Chinese policymakers' theory that they must take advantage of a coming wave of general-purpose technologies that will transform the world's economic and geopolitical structure:

"A new round of global technological revolution, sectoral change and military change is accelerating, and scientific exploration is unfolding at every scale from the microscopic to the cosmological. A group of revolutionary new technologies that are intelligent, green and ubiquitous are reshaping the global competitive landscape and changing the relative strength of nations."<sup>7</sup>

To position itself at the forefront of the coming technological revolution, China enacted a range of overlapping strategies (e.g. the Strategic Emerging Industries programme, the infamous Made in China 2025). In 2016, these plans were weaved together in an "integrating vision, a kind of master plan"<sup>8</sup> – the Innovation-Driven Development Strategy (IDDS). It is accompanied by a range of incentives and new policy mechanisms, the most important of which are arguably 'industrial guidance funds'. Since 2014, these public investment funds have deployed between 6% to 11% GDP into new technologies. In the words of Chinese economy expert Barry Naughton, "Even if we confine our attention to the Industrial Guidance Funds, it is almost certain that the IDDS represents the greatest single commitment of government resources to an industrial policy objective in history."<sup>9</sup>

Chinese private companies are significant beneficiaries of these funds. China's new techno-industrial policy self-consciously seeks to meld market mechanisms with government guidance and investment. The guidance funds attempt to replicate US-style capital market activity across a range of funding types and instruments. Research indicates that state-owned investment firms have become a dominant force in Chinese capital markets.<sup>10</sup> In keeping with this melding of public guidance and private enterprise, there has been significant growth of Chinese Communist Party (CCP) committees in private companies.

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Analysts distinguish this new approach to economic governance from the SOE-dominated 'China, Inc.' model. The latter – a source of much consternation in trade policy circles – relied on SOEs' nebulous and privileged status and use of state banks to channel hidden subsidies. While SOEs have gained greater prominence and scale under President Xi, the new 'CCP, Inc.' or 'investor state' is a much more fluid ecosystem of regulation, political control, state capital flows and strategic direction-setting, with no clear demarcation between the public and private sector.<sup>11</sup>

The success of this new approach remains to be seen. China is still struggling in several of its target areas (e.g. semiconductor manufacturing), and tales of waste, fraud and contradictory policy incentives are rife. On the other hand, there have been several notable successes, such as in renewable energy, electric vehicles and semiconductor design.<sup>12</sup> Aggregate data bears that China's innovation capacity has been increasing steadily,<sup>13</sup> and so is its rise up the value chain.

## **STATE OF PLAY**

### *The Five-Year Plan*

In many ways, the latest 5YP represents a continuation of the techno-industrial policy turn. However, it also marks a shift to a more insular and security-focused strategy, with technological self-sufficiency and increased reliance on the domestic market at its heart. Analysts note a greater concern over the international environment, a melding of national security and economic policies, and Chinese policymakers' reassessment of their supply chain exposure and the benefits of interdependence.<sup>14</sup> In many ways, this mirrors European and American debates over decoupling and strategic autonomy.

As President Xi declared a year ago,

“The shock of the pandemic has revealed the hidden risks in our production and supply chains. In order to ensure our industrial security and national security, we must strive to build self-reliant, controllable, secure, and dependable production and supply chains [...] and comprehensively increase efforts to innovate and substitute (technology) imports.”<sup>15</sup>

As a result, China’s new economic strategy explicitly seeks to develop domestic supply chains. Critically, this includes encouraging foreign companies to set up local operations and become “magnet[s] for attracting global resources and factors.”<sup>16</sup> European firms in China are already feeling the impacts. Some are being actively courted by Chinese policymakers due to their ability to bring in new technology. Others are forced to turn to Chinese supply chains and firewall their China operations, particularly in sensitive areas like digital and telecommunications technology. Still others are being squeezed out of areas where China already has significant indigenous capabilities in favour of national firms.<sup>17</sup>

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### *Dual circulation*

A key concept in this new strategy is *dual circulation*, which distinguishes domestic (i.e. domestic market, domestic demand, domestic supply chains) and international circulations (i.e. international trade, external demand). Although their precise definitions are contested, the focus appears to be on improving domestic economic capacity and leveraging domestic demand to do so, in keeping with the self-sufficiency goals outlined above, while still being able to tap into external demand.

However, despite China’s longstanding demand imbalances – an extremely low share of consumption as a share of GDP, an equally high investment rate –, domestic circulation appears focused on supply-side reforms for now. This has implications for Europe since measures to rebalance domestic demand and increase Chinese households’ purchasing power would have likely meant increased wages, rebalancing the cost advantages of Chinese industry and producing a more level playing field. The focus on the supply side could signal moves to reorientate existing domestic demand towards domestic products, to the disadvantage of European exporters. The growth of regional trade initiatives (e.g. the Regional Comprehensive Economic Partnership) – the external circulation – can also be understood in this context:

“Such [trade talks] will help break the US conspiracy of excluding China and will lure foreign technology, industries, capital and talent to China”.<sup>18</sup>

## **PROSPECTS**

China’s new approach has three significant implications for the EU’s economic relations with China.

### **1. Tougher competition, greater protectionism**

The past decade has already given the world a taste of China’s growing competitiveness in technologically sophisticated sectors. While its model’s resource waste may be substantial, the huge investment in the sectors – combined with competition, market mechanisms and the benefits of a huge internal market – will undoubtedly yield new challenges for European companies in advanced sectors, particularly in third-country markets. In and of itself, greater competition and technological development should be welcomed. But if China’s protectionist tendencies bear fruit, particularly if combined with continued repression of Chinese consumption, Europe would lose out on the benefits of a growing Chinese market. Rather than offer the potential for greater economies of scale and profit in exchange for tougher competition, Europe could become exposed to deeply distorted, mercantilist competition and increasingly one-sided supply chain dependency.

### **2. Further blurring of the public/private sector distinction**

European policymakers have focused much of their concerns over fair competition on SOEs and subsidies. These remain active concerns. However, a system of strategic state direction, widespread public investment in private firms, and extensive public-private cooperation create a very different set of level-playing field challenges that will need to be addressed.

### **3. Divergence of European investors’ and exporters’ interests**

China has long sought to draw in foreign investors to help it develop domestic capacities, and indications are that it will continue to do so. However, if it is also consciously reducing imports and external supply chain dependencies, EU policy must draw a clear distinction between the interests of the European economy and of China-based multinationals that are headquartered in Europe.

The benefits of European investment abroad come from the spillovers back to Europe itself, such as bigger export markets, scale economies, technological innovation, and the development of more efficient supply chains. However, if these investments result in European multinationals setting up increasingly self-contained Chinese operations that cement China’s dominance in various value chains further, this may benefit their balance sheets but provide little benefits to the European real economy and European workers. It then becomes more debatable whether agreements like the EU–China

Comprehensive Agreement on Investment truly advance Europe's economic interests (even laying aside the debate over its enforceability, scope and political desirability in the face of recent Chinese sanctions).

*How should the EU adapt its China strategy?*

Should China continue down this path, in response, the EU should:

- continue to develop trade instruments to combat unfair competition at home and abroad, including through cooperation with allies and the reform of multilateral institutions;
- ensure that these instruments and institutions can respond to unfair competition from private companies benefiting from state capital investment, not just from SOEs;
- ensure that the extensive and often opaque government holdings in private firms are reflected in foreign direct investment and export controls;
- incorporate China's attempts to reconfigure supply chains into its own assessment of strategic dependencies, identifying areas that could become vulnerable;
- prioritise improving access to the Chinese market for goods and services produced in Europe (when it comes to European companies' investment in China, the European Commission must carefully analyse whether spillover benefits truly justify expending precious political and diplomatic capital);
- develop alternative sources of growth (e.g. growing markets in Asia, Africa), and boost demand and reduce barriers within the Single Market to offset greater Chinese protectionism; and
- ensure that its industrial policy efforts will enable European industry to match China's developments. A mapping exercise should be conducted to evaluate the EU's level of committed resources relative to China (and the US), covering both member state and EU-level support and controlling Chinese policy's inherent waste.

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China is actively developing a greater synthesis of economic, national security and geopolitical strategy, and the EU must adapt its own strategy to reflect that. A protectionist turn and growing one-sided dependencies will threaten Europe's long-term strategic autonomy and undercut any attempts to construct a balanced approach to EU–China relations. If the EU's multi-track strategy is to work, a concerted effort is required to preserve economic parity and balance between the two powers.

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