Three Scenarios for EU-China Relations

But one direction of travel?

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Summary

- Tensions between the EU and China have increased considerably since end-2020
- Sanctions have been imposed on both Chinese and EU officials, the ratification process of the CAI has been frozen, and the EU has taken a more confrontational stance, which China is trying to counter by playing ‘good cop, bad cop’
- That said, the EU is still by no means cutting China off, or even demonstrating it has a unified and coherent strategy vis-à-vis Beijing
- This report ponders three possible future scenarios for EU-China relations --tensions subside; a slow downhill grind; and a trade war-- and assesses the impact of the latter on each EU member
- We argue a continuation of the current slow downhill grind is most likely in the foreseeable future. This would mainly have an impact on investment (policy), but could somewhat lower foreign investment income while raising input and production costs for EU firms
- The key question is how long this ‘neutral’ scenario is sustainable for: there is considerable risk that at some point EU-China relations deteriorate much more sharply
- This would hurt trade and investment (income), raise input costs, and endanger the green transition for the entire EU. We show that the impact would likely be largest for Germany due to the importance of China for its exports and foreign investment income

Rising EU – China tensions

Tensions between the EU and China have increased considerably since they surprised the world at the end of last year by signing their Comprehensive Agreement on Investment (CAI) ‘in principle’. Immediately afterwards, however, the EU parliament passed a resolution condemning explicitly China’s treatment of the Uyghurs in Xinjiang along with China’s actions in Hong Kong. The EU then introduced token sanctions on some China individuals, which China responded to with sanctions on EU institutions and even members of the EU parliament. In May, ratification of the CAI was frozen on the European side until these sanctions are removed, which China says requires the EU removing its sanctions first.

Rhetoric has understandably continued to escalate. In mid-July, the EU joined the White House in condemning cyberattacks on Microsoft servers by China-based hackers, although the EU stopped short of pointing the finger to the Chinese government directly.

Furthermore, it appears EU members are converging on the view China should be treated more as a systemic rival engaging in unfair trading and foreign investment practices than a trade partner to be negotiated with. This trend had already been visible since the EU labelled China a partner, economic competitor and systemic rival, in March 2019, but has accelerated. US President Biden has also been making overtures to persuade, rather than force, the EU into cooperation with the

US against China and, to perhaps some degree, with success. Moreover, Beijing's crackdown on various areas of its private sector seen over the first half of 2021, culminating in late July's move against edu-tech, shook investor confidence in China, with even some China bulls starting to debate what was meant by the moves, and what the implications were for continued economic cooperation.

At the same time --in very European fashion-- there have been contrasting signals, in part because member states try to juggle their foreign relations, business interests, and their position vis-à-vis the EU.

In this report we will look more closely at these key issues and ponder three possible future scenarios for EU-China relations. Among them is a significant ramp-up of tensions that could culminate in economic measures and counter-measures being taken. We specifically consider which EU countries are most vulnerable to such a development: as we show, for some the answer harks back to their current stance on China.

Bye-bye China?

As noted, **the ratification process of the highly-touted CAI has been frozen.** Furthermore, several other initiatives have been proposed or agreed upon to make it more difficult for foreign (read: Chinese) firms to participate in public procurement bids and acquisitions without: (i) reciprocity in their home country (the International Procurement Instrument); or (ii) in case of distorting foreign state subsidies (Investment Screening Tool). Meanwhile, the currently-debated Corporate Due Diligence Act adopted by the European Parliament should make large EU companies accountable for abuses of human rights and the environment in their value chain. While not directly aimed at China, it would likely make it more difficult for EU companies to use certain Chinese inputs, such as cotton, rare earths, and solar panels from the Xinjiang region (which the US has already banned all imports from, for example).

As for international cooperation, **the EU and US have intensified talks and issued joint initiatives to improve cooperation and challenge China's rising economic importance**: Towards a renewed Transatlantic partnership; the EU-US Trade and Technology Council pledge; and a statement holding countries like China that support trade-distorting policies to account. Moreover, June's G7 meeting saw leaders push out a joint statement announcing intentions to counter China's Belt and Road Initiative (BRI) via a Build Back Better World ("B3W") green, democratic alternative. (Prompting China to denounce the statement and urge the G7 to respect facts, rather than slandering the country with false accusations.)

For its part, China has tried to lure the EU into the 'China camp' by playing the sympathy card, while also threatening the EU with sanctions. On 11 June, China adopted the Anti-Foreign Sanctions Law (AFSL), which allows China to take retaliatory measures against foreign countries, organizations, or persons deemed to have been involved in discriminatory and restrictive measures against Chinese organizations and residents. In fact, any relative or person with ties to those convicted can face charges under the AFSL[1]. Such legislation is now in the process of being extended to Hong Kong, where EU firms and banks have a substantial presence.

At the same time, China's rhetoric about the EU's troika view of Beijing as simultaneously "partner, economic competitor, and systemic rival" appears to perhaps be shifting, demanding a less ambiguous stance. (See box: '*CAI from the China Side*'.)

[1] Aside from the AFSL, the Hong Kong National Security Law adopted last year is also relevant for anyone, even when based in the EU; and so is the Chinese Data Security Law (which takes effect in September) vs EU laws on the same matter.

Not so fast

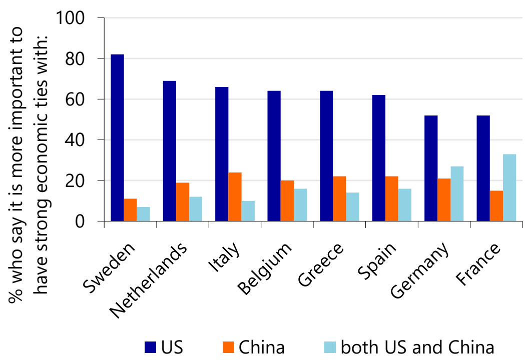
All that being said, **the EU is still by no means cutting China off or demonstrating a unified and coherent strategy vis-à-vis Beijing**[2]. It has failed to impose sanctions related to China's intervention in Hong Kong for example, because Hungary (with no real presence there) opposed them, and unanimity among the EU 27 is required[3]. Furthermore, the new policy tools mentioned above are still in the works, as they require approval from one or more EU bodies.

In late July, EU Foreign Policy chief Borrell announced that in September he will present a report, together with the European Commission, to the European Council, "*to see if it is necessary to review the current strategy*" on China ahead of the Council meeting in October. This is reportedly to be modelled on the 2019 document that referred to China simultaneously as a partner, an economic competitor, and a systemic rival. Crucially, however, Borrell also stated: *"Despite our different views over the Hong Kong or the Uyghur cases, what Trump called the economic decoupling with China is something beyond our intentions and is contrary to our interests."* Which seems to have already dictated what the final outcome can be.

Meanwhile, the EU still sees China as a partner to fight climate change. This is not only because it holds the view that the problem is addressed most effectively through cooperation --as past experience and extensive research have shown-- but also because it realises that it will need China's cooperation (certainly in the short-term) because the EU lacks control over inputs necessary for its projected green transition (see box *China's control of rare earths and other critical raw materials* below).

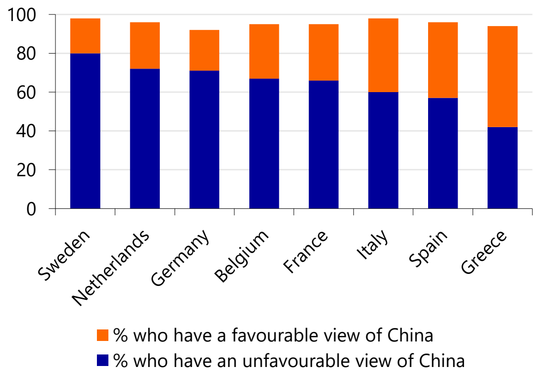
In terms of the EU's increasingly-difficult global power-balancing act, Brussels also continues to reiterate that it wants to work with the US when that suits the EU's goals, but that the goals of both parties --specifically regarding China-- are not completely aligned, and that there should be room for diverging actions.

Figure 1: A majority regard economic ties with the US more important than with China, but 1/3 argues China is equally or more important



Note: % respondents of PEW survey who say it is more important for their nation to have strong economic ties with the US/China. If ties with both are valued equally, this could mean equally important or equally unimportant.
Source: PEW Research (June, 2021), RaboResearch

Figure 2: Swedish public has most negative view of China, while in Greece more hold a favourable than unfavourable view



Note: % of respondents who have a favourable/ unfavourable view of China – PEW survey

Source: PEW Research (June, 2021), RaboResearch

[2] Recently Lithuania pushed to develop a common strategy towards China among the EU27, but so far the request for a summit has not been met.

[3] To prevent single Member States from upholding decisions on such and other foreign policy decisions, Von der Leyen, as well as multiple Member States, wants to move towards qualified majority voting on such matters. Yet not surprisingly, some recalcitrant and smaller Member States oppose changing the voting rules.

Divergence among Member States

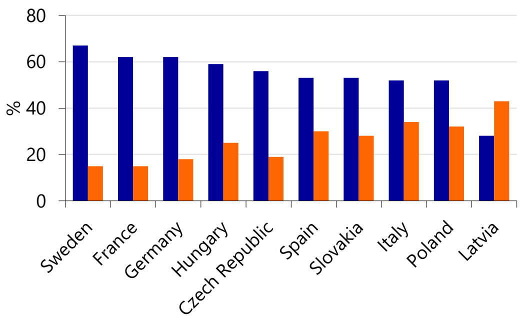
More generally, **there is divergence among Member States on how to deal with China**. Scepticism and awareness of certain threats stemming from the Asian giant have been growing almost everywhere over the past years (Clingendael, PEW research, and Palacky University Olomouc). By contrast, despite public opinion turning more negative, Hungarian PM Viktor Orbán in particular is presenting itself as China's friend in the west, while Germany's Chancellor Merkel doesn't want to harm the export potential of Germany's industrial base too much –despite the recently adopted supply-chain act– and is a strong advocate of *'Wandel durch Handel'*. (Which some critics suggest can imply change in the opposite direction!). Meanwhile, French President Macron wants the world to know that the EU --or better, France-- is a major power that by no means follows orders from Washington, D.C., and believes he/the EU/France can have an influence over China and so on the broader Asian region if Paris keeps Beijing as a partner.

Exemplary of the EU's internal struggle *and* that foreign policy action is not drafted by all 27 members have been on-line meetings between Merkel, Macron, and Xi[4]. In one, the former two expressed concerns over the G7 statement, while confirming the importance of EU-China ties and the need for partnership on issues such as climate change and fighting COVID - without the consent of other Member States. Xi in turn, expressed hope the "*European side can play a more positive role in global affairs,*" and "*demonstrate strategic independence.*" Specifically, China proposed not joining the US in an alliance countering China, as pledged, but to establish a 'Quadrilateral' relationship of France, Germany, China, and Africa. Foreign policy analysts underline that China fears an EU-US alliance, but --correctly?-- believes it can prevent this by playing up diverging interests of EU members in exactly this manner.

It remains to be seen whether when dealing with China the EU can credibly act as if it has "strategic autonomy" in the foreign policy field --without an army and with predominantly national sovereignty to the fore-- *and* respect its social standards and values, and not harm its economic prospects.

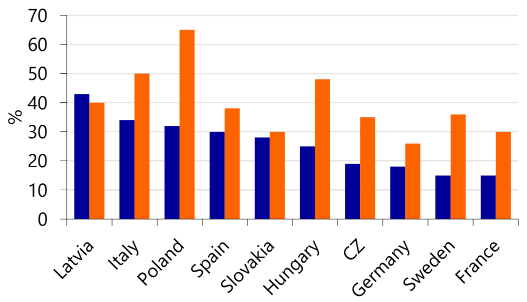
Regardless, the EU's long tradition of '*Wandel durch Handel*' will not be easily abandoned – because there is no concrete, risk-free geostrategic alternative on the table.

Figure 3: Sweden has the most negative feelings towards China, followed by France and Germany. In Latvia, positive feelings outweigh the negative



Note: Survey conducted in September and October 2020
Source: European public opinion on China in the age of COVID-19, Palacky University Olomouc, 2020; RaboResearch

Figure 4: In Poland, Hungary, and Sweden the US overwhelmingly arouses warmer feelings than China. In Latvia and Slovakia, it's balanced



Note: Survey conducted in September and October 2020
Source: European public opinion on China in the age of COVID-19, Palacky University Olomouc, 2020; RaboResearch

[4] According to a recent survey, about half of the Germans think Germany should align its China policy with the EU, compared to 20% who think Germany should shape an independent policy. Meanwhile, more than 1/3 of the French state that France should go it alone, while only less than 1/4 wants France to align its policy with the EU.

China's control of rare earths and other critical raw materials

One notable area of risk for the EU vis-à-vis China is the latter's control of key 'rare earth' elements (REE) required for most hi-tech and Green production. As part of its long-standing industrial policy, China dominates mining of such minerals, and as such could, if it chose, seriously disrupt EU (and global) supply chains as a result.

According to the European Commission, 86% of global rare earth processing is done in China and China provides 98% of the EU's supply of REE. Even though we only see this as a tail risk, from a geostrategic perspective it is a fat one, especially if EU-China relations deteriorate.

While REEs are not actually rare, their production can be highly polluting, making it questionable to what extent the EU could mine them, where possible, despite research on the matter in light of its trajectory to secure access to critical raw materials. Alternative supplies outside China are concentrated in Australia (6% global production) and the US (2%) – but even that has geostrategic implications given the EU desire for "strategic autonomy".

In addition to rare earths, the EU recognises that its planned Green Transition is also reliant on imports of cobalt and lithium. It has projected that for electric vehicle batteries and energy storage alone it would need 5 times as much cobalt and 18 times as much lithium by 2030 as is currently supplied to it; and by 2050, respectively, 15 and 60 times. While both China and the EU are largely absent cobalt and other critical raw materials[5], China holds a large share in global output of refined cobalt (over 60%) and also owns some 40% of global lithium production – although Chile is by far the largest supplier of lithium to the EU. This strategic problem will not disappear even if the EU recycles these materials to an extent not seen before.[6]

In addition, China has a huge head-start in developing access to mines it doesn't have within its borders via its Belt and Road Initiative (BRI), in terms of infrastructure, logistics, and resulting political clout. (While military bases, as in Djibouti, are a possible future source of negotiating strength.) One key example is supplies of cobalt from the Democratic Republic of Congo, which holds 60% of global cobalt mines, and is the source of 68% of all cobalt exported to the EU.

The EU has, via the G7, pledged to work alongside the US and other democracies to build a "B3W" (Build Back Better World) rival to China's BRI, even if its funding and planning are currently far behind the easier and cheaper rhetoric and marketing. While this might cement a supply chain for the EU of these much-needed goods, it would very obviously involve the EU working against perceived Chinese interests, which could hardly remain detached from the cooperation envisaged in the CAI, and in China's stated desire to work as "partners".

Indeed, China has already reached out to France and Germany to suggest a joint investment program with key African states to develop infrastructure and resource extraction. This would obviously run counter to the B3W pledge made at the G7, and in de facto terms tie the EU (via France and Germany at least) to the BRI – which would then likely force the US to react.

Of course, the EU could decline both the G7 and Chinese offers and forge its own path towards key resources. However, it would then be clashing with the US *and* China; and Russia; and Turkey. And it would be doing so without the military dimension each of these powers can bring to the table in what can be a highly unstable region. In short, both the EU's plans for a Green Transition and EU-China relations arguably run through Africa as much as they do through the Silk Road of Central Asia: which again places the EU at an immediate strategic junction.

[5] See Critical Raw Materials Resilience: Charting a Path towards greater Security and Sustainability, by the European Commission. It also shows the EU's current import reliance for cobalt is 86%, and for lithium and rare earths 100%.

[6] See the European Commission's raw materials scoreboard 2020/2021, page 73-75.

Friends, frenemies, or enemies?

Going forward, multiple scenarios regarding EU-China relations can play out, and we will discuss:

- An **optimistic** scenario – albeit with potentially serious side effects;
- A **'neutral'** scenario – or rather a continuation of the slow downhill grind; and
- A **pessimistic** scenario – where the remainder of the report will flesh out which EU countries would be most impacted.

While we believe the 'neutral' scenario is most likely, there is considerable risk that EU-China relations deteriorate much more sharply. There are also opportunities that could reverse recent trends, yet these would require tangible steps by China that doesn't seem very likely.

1) Tensions subside: But happy ending, or recipe for future troubles?

Source: Getty Images

In contrast to the US, who have placed a broad range of demands on China to change its trade and investment practices, and where President Biden and Congress are on the same page, the EU may well be satisfied with a more limited set of actions on the part of China. That would allow European Parliament to re-assess the CAI and restore EU-China relations to some extent. Speculatively, this could include:

- Lifting sanctions on European Parliament members;
- Committing to concrete actions to improve the human rights situation (with the CAI strengthened on the social agreements part); and
- Promising the EU to support its climate agenda and energy transition (i.e., Through the commitment to provide necessary inputs such as rare earths, and to work with the EU to avoid European carbon taxes on its industries).

Crucially, however, ***this scenario assumes the EU does not have to trade human rights or its concerns about China's economic practices for greening, because it is China which makes the required moves on both fronts***. Without that assumption, the first CAI 'side effect' would be the EU surrendering both its human rights/values *and* concerns over China's economic practices merely to gain access to raw materials (see box '*China's control of rare earths and other critical raw materials'* above) and to maintain current export market share.

The second side effect is that this could hit EU-US relations. Perhaps under the Biden-administration this would not lead to an immediate increase in tensions, and the EU would likely make the point that the CAI shares numerous similarities with the 'Phase 1 trade deal' the US government struck with China in early 2020. However, the US stance towards China is steadily hardening, even under Biden, the Phase 1 trade deal is already being questioned by the US

Treasury Secretary, and should 'Trumpist' forces resurface (first with a shift in power in Congress from Democrats to Republicans in the November 2022 elections, then at the November 2024 presidential elections), this would obviously raise the risk of major US-EU clash. (See box '*Global geopolitical implications*'.)

However, putting this important issue aside, assuming the CAI is approved following Chinese policy shifts, the EU *may* benefit from enhanced markets access in China, while the major benefit for China would be to have an agreement with one of the three major economic blocs in the world, and as such would be seen as a significant political success for it.

Under this scenario we would expect moderate positive benefits from continued cooperation, notably on topics where both --theoretically at least-- could be seen as sharing common interests, i.e. the energy transition, fighting climate change, and perhaps even taking steps towards a level playing field for large corporations.

However, this is an extremely optimistic scenario for several reasons:

1. It is very hard to see China lifting the sanctions on EU MPs –without reciprocity- and reforming in the ways the EU Parliament envisages to press ahead with the CAI;
2. We noted in a previous research note that the weakness on the EU side is it may lack the powers to enforce its demands as set out in the CAI, making it toothless;
3. In that same note, we have also explained that even if developments vis-à-vis China are good for EU *firms*, they are not necessarily so for the EU itself;
4. It is hard to see the US remaining happy if the EU and China move closer together at all; and
5. Economic cooperation could benefit both sides in the short term, but China would always have the upper hand over the EU regarding access to critical materials, where it is practically a given that frictions will rise at some point; and, over time, in regards to relative economic gravity.

In short, any deal struck now could be readdressed by China when the balance of power has shifted in its favour in the future. As such, the EU would also not abandon its efforts to become strategically autonomous and less dependent on China for strategic goods and inputs, while China would pursue its own path of decoupling/dual circulation and mercantilism as it sees fit.

Hence, **even if tensions were to subside in the short term, they would likely reappear eventually alongside some form of decoupling in certain areas/sectors.**

CAI from the China side

This report is written from the European perspective, but it is very important to recognize that China is not a passive actor vis-à-vis the EU. Indeed, when looking at the three scenarios that we describe --the EU and China moving much closer, the base case of the current status quo, and the two moving further apart-- Beijing has its own dynamic.

In its internal discussions, China is increasingly seen by foreign-policy Sinologists as dividing the world into three camps: the countries that agree with it; the countries that are seen as opposed to it; and those who are currently undecided. Crucially, Beijing emphasizes that efforts should be placed on this latter group in order to bring them into the first camp, rather than allowing them to drift into the 'anti-China' cluster. This would logically include the EU.

Against that backdrop, consider comments made by Chinese Foreign Minister Wang Yi to his Maltese counterpart on 23 July and in an official statement: *"The EU's triple positioning for China is mutually contradictory and cancels itself out. China and Europe are partners, not competitors. China and Europe have neither serious conflicts of interest, nor historical imbroglios."*

This can be seen as lobbying. Or it could be a possible warning for the EU that while it may prefer to prevaricate, Beijing is just as capable of forcing a binary "with us or against us" geostrategic choice on the bloc as the US was under former President Trump.

2) Status quo maintained: But a slow downhill grind

Source: Getty Images

The first, optimistic scenario ignores the *underlying reasons* why EU Parliament threw a spanner in the works by not signing off on the CAI. The sanctions on EP members may have been the direct trigger, but already at the end of 2020 it was clear that not all Member States were happy with the way Germany had pushed through the preliminary deal between the EU and China. Since then, European public opinion vis-à-vis China has further deteriorated, while the US has continued a pressure strategy on the country, as demonstrated by the series of actions since Biden took office. The most recent example of this is the warning by the US administration that US companies may face increased operational risks in Hong Kong – which China has ironically underlined both with its recent crackdown on its private sector, and with its plan to impose anti-sanctions legislation on the territory.

In this second 'neutral' scenario, the EU realises there is no way back towards partnership, but only a 'slow grind' forward towards a more confrontational stance of a systemic rival. After the major economic disruptions of the sovereign debt crisis and pandemic, the EU remains economically weakened; and against the backdrop of its ambition to implement a pro-growth and green investment agenda, the EU believes it cannot afford another major setback in international relations through a trade-war with either China or deteriorating relations with the US.

As such, the CAI is left to its own devices, although small bits and pieces may still find their way into legislation. In this scenario, the EU gradually becomes more hostile towards China, but without cutting ties entirely, as the EU acknowledges it also needs China as a key market for its exports, and for imports of critical raw materials.

In other words, the EU would follow a multi-faceted approach, trying to maintain trade ties with China and the US, as today. In this scenario, investment policy would be impacted the most. On balance, we will see a deterioration in the options for Chinese investment in the EU, with China reciprocating except where it believes it can leverage an EU firm's investment against its national government, and/or wishes to access key technology and capital.

For example, we could see stricter rules over corporate governance or due diligence making it harder for Chinese companies to invest or take over European companies, and for European companies to do business with Chinese suppliers.

The EU would also implement stricter rules or guidelines for the (public) procurement of goods, similar to the executive order signed by President Biden in February and updated in July. It would also put more pressure on European companies to review their supply-chain model and bring home more sensitive parts; diversify their suppliers; and/or reduce reliance on intermediate imports[7]. If necessary, the EU may even take action to forbid certain activities or subsidise them domestically to reduce the EU's external reliance. In the same line of reasoning we could imagine share caps or outright bans on foreign (Chinese) investment and take-overs in certain strategic sectors in the EU. The CAI already foresaw in such caps for certain sectors such as renewable energy.

Meanwhile, evidence suggests that China itself is partially decoupling, on its terms and at its own pace: if so, the EU can either accelerate the process or wait for China to act when it sees it as being strategically beneficial. In this scenario, we would expect China to gradually pursue a decoupling path vis-à-vis the EU; and China would not hesitate to put its Anti-Foreign Sanctions Laws into practice, but would stick to relative pinpricks to prevent escalation and hard decoupling – in line with its reaction to the EU's sanction related to treatment of the Uyghurs.

In this scenario, we could still see some positive growth-enhancing effects in the near-term in the EU (notably if supply chains move back to Europe), although the steady deterioration in EU-China relations may lead to heightened uncertainty, and this could also weigh on trade and foreign investment income at some point. The latter could also result from the continuation of the trend of gradually slowing FDI flows into China. Counterbalancing that, stricter regulation for foreign investment in the EU and production chain shifts could raise input and production costs for EU firms, while less Chinese involvement in public procurement procedures in the EU could perhaps raise the costs of some public tenders.

Regarding climate change, there would still be room for cooperation, as it is urgently needed on both sides. **There could be relatively less scope and willingness on the part of China than in scenario 1**, however, potentially leading to frictions arising faster/more often.

EU-China relations deteriorate sharply; trade-war breaks out

Source: Getty Images

The key question is whether the status quo/'neutral' scenario is actually tenable in the medium-term. Indeed, we should also not dismiss the possibility that we could hit a tipping point ahead more rapidly than many expect. For example, if China pushes sanctions under the flag of the AFSL too far; if China deems it is ready for larger-scale economic decoupling; or if it were to make a major geopolitical move, e.g., against Taiwan. These would likely all take us to the third, most painful 'trade war 'scenario.

[7] See also Updating the new Industrial Strategy for Europe .

Another potential risk event that could set off such an acceleration in decoupling would be changes in the European leadership. In September, Germans go to the polls. Whilst the role of the CDU in any future government is hard to ignore, it may have to concede some of its powers to its coalition partner(s). If that happens to be the Greens, we could expect more pressure on the German government to reduce its emphasis on exports and trade, and instead take a tougher stance on Russia and China. This would almost certainly trigger a Chinese response. Although the French position may initially serve as a counterbalance under President Macron to any shift in Germany, the elections taking place next year could either amplify or attenuate such forces: assume, for example, that France also gets a leadership that takes a more nationalistic approach with an aim of 'bringing the jobs back home'.

On top of the issues raised in this scenario, the EU would implement more stringent share caps and explicit bans on Chinese take-overs and investment into the EU. Cooperation on the green transition and climate front also runs against a wall. The Carbon Adjustment Mechanism (CBAM) plans by the EU would not form the basis of talks on carbon pricing (floors) in China but rather be challenged by them at the WTO. The latter would also raise subsidies for certain firms and introduce tariffs on EU exports in order to compensate for CBAM-induced costs.

Overall, the US-China trade war can arguably serve as a blueprint for this scenario. It would:

- Lead to a reduction in both exports and imports from both countries;
- See a reduction in FDI --both into the EU and China-- and in foreign income streams, with China blocking more inflows from European investments in China and/or EU earnings outflows from China, and pressurising activities of EU firms;
- Lead to a more general slowdown in investment due to increased uncertainty; and
- Perhaps see China block key exports like rare earths, which would severely hamper the EU's green transition and hence its climate fighting agenda (again, see box *China's control of rare earths and other critical raw materials* above).

Table 1: Qualitative impact assessment

Impact assessment	*Uncertainty*	*Trade flows*	*FDI flows*	*Green transition*
	Risk perception/ domestic investment	Tariffs	Flows and income	Cooperation to meet input needs
Relations thaw	↑	↑	↑	↕
'Neutral': slow grind	↓	↔/↓	↓	↓
China-EU trade war	↓↓	↓↓	↓↓	↓↓

Source: RaboResearch

Geopolitical implications

Alongside the issues listed until now, it is also important to have a 'bigger picture' view of the underlying geopolitical dynamic. US President Biden has continued former President Trump's policies, stating the world is at an inflection point between liberal democracy --which the EU exemplifies-- and authoritarianism, meaning China. While this 'battle' takes place on the economic field, it has political, technological, national security, and military dimensions. Biden, like Trump, has sworn not to allow China to become 'world number one' - a zero-sum equation.

Beijing rejects this view, but also says Western hegemony is over, offering a new model given "*China's modernisation has proven itself as a viable alternative to the Western system of governance*". This, and China's recent actions, prompt fear in some - and acceptance in others: as Singaporean statesman Lee Kuan Yew stated years ago, *"How could* [China] *not aspire to be number one in Asia, and in time the world?"* The question is, where does the EU sit on this issue?

After a bloody 20th century, the EU is reluctantly re-embracing the concept of "open strategic autonomy". It therefore needs to consider not just national election cycles, economic cycles in export-dependent Member States, a green transition *in which it controls no key material inputs or global supply chains*, but also the Grand Strategy of what it wants the 21st century to look like, and how to achieve that goal. Crucially, there are major conflicts between these objectives; more so as the US --which the EU relies on in the military and Eurodollar spheres-- takes a more confrontational stance against China. Indeed, let's consider the geopolitical consequences of the three scenarios painted previously:

If **EU-China relations thaw** one must assume: 1) China changes significantly, which would be a major win for the EU – but is *extremely* unlikely; or 2) the EU prioritises short-term economic goals over larger geo-strategic ones. The geopolitical consequences of 1 are minimal, because the US would be as happy as the EU. However, in 2 the consequences would be profound. While China would offer an olive branch, would the US maintain its defence umbrella, or move closer to the UK and Quad (India, Australia, Japan), taking financial linkages, trade, and supply chains with it over time? As the weaker partner relative to a rising China, option 2 also means the EU's prospects of shaping a 21st century world order to its liking would be greatly diminished.

The **'Slow Grind'** scenario is merely a holding pattern – and one dictated by the pace of change in the US and China rather than the EU. Recent legislative and foreign-policy changes in Washington DC and Beijing should make it abundantly clear such a strategy is not the basis for a sustainable Grand Strategy. The exception would be if the US and China were to agree that the EU is neutral territory, and irrelevant to the more important struggles in the Indo-Pacific, Africa, and Middle East. Yet it would then be illogical to assume the EU --without its own army and with high export dependence-- could successfully carve out an "autonomous" role for itself on tech/data, a green transition, and related supply chains.

In an **EU-China trade war** the geopolitical implications would be profound. The EU would join a giant bloc, the economic gravity of which would draw in other 'unaligned' economies. China would be forced to respond with either a major policy shift, as in option 1 of the first scenario; or use its economic gravity to create its own sphere of influence – which the EU would be outside of. This threatens a drop in EU exports and a bifurcated global economy, in a similar way the world was divided from 1933-1989, a very bitter experience for Europe (and others). As such, the upside risks of such an EU approach are obvious – a 21st century world it can thrive in: but so are the downside ones, and they appear more probable.

So what to do? The least risky geopolitical scenario is 'Slow Grind'. Yet this is also an implausible foundation for the EU to develop the Grand Strategy needed to meet its other policy goals – and one which could give under US or Chinese pressure at any time.

Dependency channels

In order to gauge EU countries' vulnerability to scenario three, EU-China decoupling, we look at bilateral trade and FDI flows. More specifically, we have built a Vulnerability Heat Map based on Member States' dependence on China for their exports, (intermediate) imports, so-called chokepoint products, tourism, inward direct investment by China, and income on investments in China.

Clearly exports (imports) could be hurt when China (the EU) decides to raise tariffs, or if the EU (China) blocks certain exports. Imports from China --and hence input costs for manufacturers in the EU-- could also be impacted if the Corporate Due Diligence Act is adopted and strongly enforced, and if the EU raises pressure on European companies to review their supply chain model and bring home sensitive parts, increase diversification of suppliers, and reduce reliance on intermediate imports.

Meanwhile, stricter regulation for foreign investment and procurement --or outright bans in a more extreme scenario-- in the EU would reduce foreign investment by China and likely raise procurement execution costs. Income flows into the EU stemming from investments in China could also be hurt if China decides to toughen regulation on foreign/EU investment, making foreign/EU investments more difficult. Another route via which China could harm EU firms (and their countries of origin) is by preventing them from channelling income earned in China to the EU or by pressurising their activities in China.

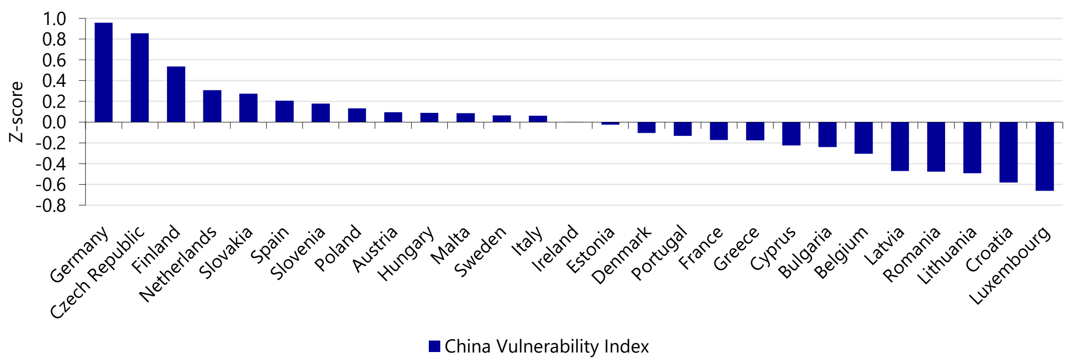
In the Appendix we explore all these indicators and rank countries' vulnerability per indicator, while Table 2 gives an overview of how vulnerable Member States' are in each of the different areas: in other words a Vulnerability Heat Map. We have also built a Vulnerability Index to combine all different elements, which we'll explore next.

China Vulnerability Index

We have standardized (using z-scores) most metrics that have passed in review, while preventing 'double accounting', e.g., by only incorporating one of the two export dependency measures. We have also corrected for the Dutch position as China's gateway to Europe (see appendix) - but it has not changed the ranking. After taking a simple average of these standardized scores we arrive at an overall ranking of EU countries' links to China (Figure 5).

At the top we find Germany, followed by the Czech Republic, and Finland, whereas Croatia and Luxembourg care near the bottom of the rankings. Germany's links to China are most visible: via exports and the income from its FDI – both undisputedly reasons why Berlin is keen not to antagonise China. Meanwhile, the Czech Republic relies more on China for imports of final goods and chips than most EU peers. Finally, Finland 'thanks' its high position to the relatively large share of Chinese inward FDI. Yet it is good to note that this results from specific transfers in 2019. To illustrate, if we average China's share in FDI over the five years to 2019, Finland drops to 13th place, while Sweden jumps from 12th to 4th, for example.

Figure 5: Germany most vulnerable to decoupling, closely followed by the Czech Republic



Source: RaboResearch calculations based on Macrobond, UN Comtrade, Trademap, WTTC, Eurostat

Importantly, the ranking and heat map do not cover the specific vulnerability China may expose via pressure on individual EU firms for which the Chinese market is key, even when their country score is not high (e.g., see Implications of the EU China investment deal (CAI), Figure 1). Moreover, we only look at direct trade flows, not value added or the final destinations for exports, or real origins of imports, which could differ. This could imply China's relevance to some countries' GDP is over- or under-estimated. Yet we nevertheless prefer to look at direct trade flows due to a lack of recent data on value added, final destinations and real origins: if matters turn for the worse, targeting direct trade flows with import tariffs and export bans would be easiest. Finally, it is worth noting that **the heat map does not incorporate second-order effects**, e.g., if German exports to China suffer, this will have a broader economic impact on its economy; and if economic growth in Germany slows, this will hit Germany's EU trading partners.

Table 2: Vulnerability Heat Map

	Export to China (% total export)	Export to China (% GDP)	Share Chinese tourists*GDP share tourism	Import from China (% world)	Import from China (% GDP)	Import intermediates China (% world)	Intermediate goods import China (% GDP)	Chips import (% total import)	Chips import China (% total chips import)	Inward FDI China (% total inward FDI)	FDI income in China (% total FDI income)
Austria	2.9	1.1	0.4	6.2	2.5	1.7	0.2	0.5	10.4		
Belgium	1.9	1.1	0.1	2.7	1.6	3.0	0.7	0.6	4.2	0.2	0.2
Bulgaria	2.8	1.3	0.0	4.5	2.5	3.6	0.5	0.7	0.8	0.3	0.0
Cyprus	2.3	0.1	0.1	5.0	1.8	6.6	0.3	0.0	0.8	0.5	
Czech Republic	1.2	1.0	0.2	15.8	11.3	2.4	0.4	1.7	19.4	0.4	0.0
Germany	7.3	2.8	0.1	10.0	3.2	3.9	0.3	1.4	8.5	0.5	12.9
Denmark	3.5	1.1	0.1	7.3	2.0	4.0	0.2	0.3	3.6	0.1	3.4
Spain	2.3	0.5	0.2	8.7	2.3	5.8	0.3	0.2	13.0	0.4	0.7
Estonia	1.3	0.6	0.1	8.1	4.8	3.6	0.5	1.5	4.6	0.1	0.0
Finland	5.3	1.4	0.2	7.5	2.0	2.8	0.1	1.1	9.5	4.8	-1.5
France	4.2	0.9	0.1	9.3	2.2	3.0	0.2	0.6	4.9	0.3	2.2
Greece	2.6	0.5	0.3	7.3	2.2	3.4	0.2	0.1	6.2	0.7	0.0
Croatia	0.7	0.2	0.4	2.9	1.3	1.5	0.2	0.1	2.4	0.3	
Hungary	1.4	1.0	0.2	6.1	4.4	2.2	0.3	2.9	4.2	0.0	0.0
Ireland	5.4	2.3	0.0	5.6	1.4	2.6	0.1	1.0	3.3	0.8	
Italy	2.7	0.7	0.3	7.5	1.8	5.1	0.3	0.3	4.2	0.2	3.1
Lithuania	0.9	0.6	0.0	2.9	1.9	2.5	0.3	0.3	4.2	0.0	0.5
Luxembourg	1.4	0.3	0.2	2.9	0.9	0.9	0.1	0.1	5.1	0.3	
Latvia	1.2	0.5	0.1	3.2	1.7	1.9	0.2	0.6	5.8	0.2	
Malta	1.0	0.3	0.0	3.7	2.0	3.1	0.2	4.6	3.6	0.1	
The Netherlands	2.5	1.6	0.0	9.4	5.3	4.0	0.4	2.6	5.4	0.6	1.5
Poland	1.1	0.5	0.0	12.3	5.1	4.6	0.5	0.9	10.9	0.2	0.3
Portugal	1.0	0.3	0.3	3.7	1.4	3.2	0.3	1.1	3.3	1.8	-0.6
Romania	1.1	0.3	0.0	5.3	2.0	2.6	0.2	1.5	1.0	0.1	0.0
Slovakia	2.1	1.8	0.1	6.4	5.5	1.8	0.3	0.6	11.8	0.0	3.3
Slovenia	0.8	0.5	0.2	6.1	4.3	4.3	0.8	0.2	15.1	0.0	0.0
Sweden	4.7	1.4	0.1	6.1	1.8	1.9	0.1	0.3	1.7	2.8	4.9

Source: RaboResearch calculations based on Macrobond, UN Comtrade, Trademap, WTTC, Eurostat

Conclusion

In short, tensions between China and the EU have been rising since the end of last year, when they signed the Comprehensive Agreement on Investment (CAI) in principle. The EU has taken a more confrontational stance, which China is trying to counter by both playing soft and hard ball.

Importantly, the EU is still by no means cutting China off, and lacks a unified and coherent strategy vis-à-vis Beijing. In part, this is because member states are trying to juggle their foreign relations, business interests, standards and values, and their position vis-à-vis the EU. Moreover, the EU still sees China as a partner to fight climate change, a partner it in fact cannot afford to lose in light of the raw materials needed to fulfil its planned green transition.

In terms of the EU's increasingly-difficult global power-balancing act, Brussels also continues to reiterate that it wants to work with the US when that suits the EU's goals, but that the goals of both parties --specifically regarding China-- are not completely aligned, and that there should be room for diverging actions. Clearly this position is not met with much enthusiasm in the US.

Going forward, we expect the EU to continue to try to maintain trade ties with China and the US, while striving to reach strategic autonomy, respect its social standards and value, and not harm its economic prospects. A continuation of this current 'slow downhill grind scenario' would mainly have an impact on investment (policy), but could somewhat lower foreign investment income, while raising input and production costs for EU firms.

The key question is for how long this 'neutral' scenario is sustainable: indeed there is considerable risk that at some point EU-China relations deteriorate much more sharply. If that would happen, this will hurt trade and investment (income), raise input costs for EU firms and public tender costs, and possibly endanger the green transition for the entire EU.

The impact would likely be largest for Germany due to the importance of China for its exports and foreign investment income – both undisputedly reasons why Berlin is keen not to antagonise China. At the same time, several Central and Eastern European Member States are relatively vulnerable to EU-China decoupling via their relatively large dependence on Chinese imports. This group of countries is generally also most at risk to suffer from second-order effects via their economic links with Germany.

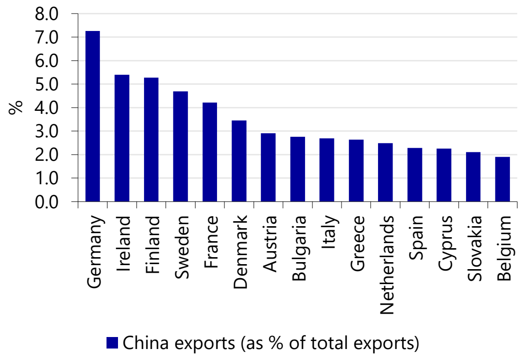
While this will only incentivise the EU to continue to stick to our assumed second scenario, of a slow downhill grind in relations, the underlying geopolitical dynamic --especially given the US stance, and EU dependence on and shared values with it-- still suggests that **while we see three possible paths ahead for EU-China relations, the greater probability is that in the longer term there is still likely to be only one direction of travel.**

Appendix 1: Dependency channels explored

Germany, the export king

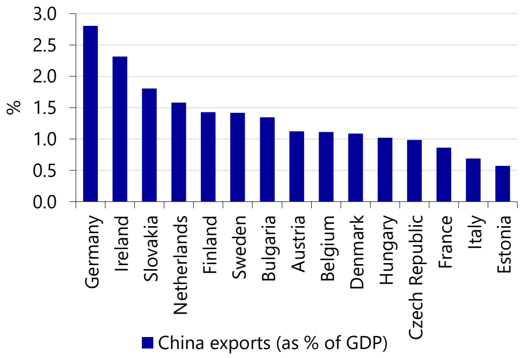
We measure China's importance for countries' exports by looking at their exports to China as a percentage of their total exports, and exports as a percentage of GDP. Figures 6 and 7 show that Germany and Ireland are most dependent on China in this respect, due to the combination of China's importance as an export destination and the share of exports in both countries' GDP. For Germany, China is a very important destination for its cars (and parts thereof), while Ireland mainly exports chips.

Figure 6: Germany most dependent on exports



Source: Macrobond, UN comtrade, RaboResearch

Figure 7: With exports making chunk of GDP

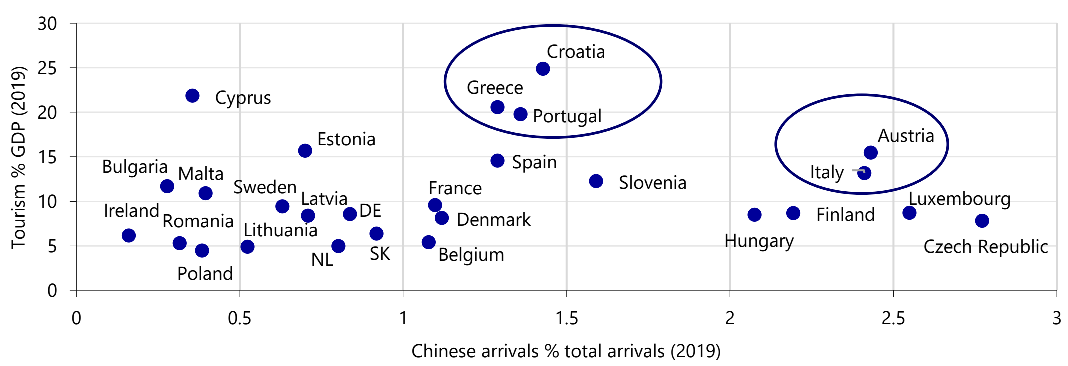


Source: Macrobond, UN comtrade, RaboResearch

Croatia, Austria, and Italy most vulnerable to halt of Chinese tourists

While goods trade between the EU and China is far more important than trade of services, we should also look at services trade and the importance of Chinese tourists for European economies. In a very extreme scenario, China could forbid its citizens to travel to the EU. The share of Chinese tourists in a country and the importance of tourism to the overall economy in Figure 8 show Chinese tourists make up a fairly small share of all tourists in EU countries, with at maximum around 2.5% in Czech Republic, Luxembourg, Italy and Austria. Out of these countries, tourism is most important to Austria and Italy, with tourism making up 15% and 13% of GDP, respectively (WTTC). In Croatia, Greece, and Portugal the share of Chinese tourists is half of that in the previously mentioned countries, but these economies are still relatively exposed due to the very large share of tourism in their GDP.

Figure 8: Chinese tourists most important for Austria, Italy, Croatia, Portugal and Greece

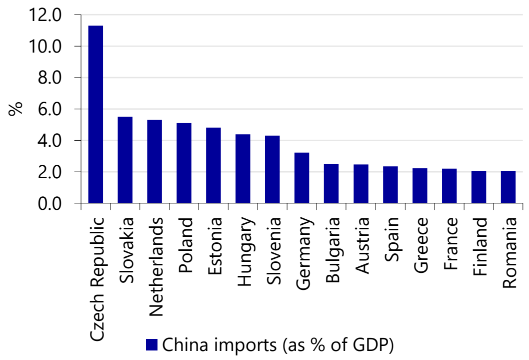


Source: Macrobond, WTTC, RaboResearch calculations

Central- and Eastern EU economies most reliant on Chinese imports

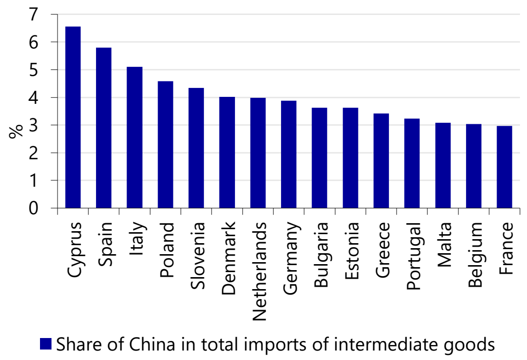
Turning to imports, we find the Czech Republic is most dependent on China for its imports, with these also making up for a substantial share of the country's GDP. As for most countries at the top of both lists, imports mainly concern products related to telephones and automatic data processing machines – although their share is much larger in Czech Republic than in most other countries. While the top of the import share list also includes the larger Western Eurozone Member States, Figure 9 suggests imports from China are most relevant to the GDP of Central and Eastern EU Member States. The Netherlands also scores high on both measures, but we must note that we should take into account it acts as a gateway to Europe for Chinese products. If we correct for products simply imported to re-export, without meaningful edits, only 5% of total imports comes from China (valued at 2% of GDP).

Figure 9: Chinese imports key for the Czechs



Source: Macrobond, UN comtrade, RaboResearch

Figure 10: Spain, Italy top intermediates list



Source: Macrobond, UN comtrade, RaboResearch

Apart from total imports, it can also be worthwhile to specifically look at intermediate imports. By means of the latter we can gauge how much the industry in EU countries depends on China for input components. As Figure 10 shows, Cyprus, Spain and Italy are the most dependent on China for such inputs. A drawback of this overview is that it only looks at the relative size of imported intermediates, not their importance. And if there is one thing the current shortage of semiconductors and containers has showed, it is that such "chokepoints" can be an equally (if not more) important impediment to trade and production. This overview, for example, probably underestimates several countries' dependence on semiconductors for their car manufacturing industry, and the ever growing demand for rare earths and other inputs needed for the green transition, such as cobalt and lithium.

Chokepoints: computer chips and green inputs

One way to gauge countries' vulnerability to disruptions in the supply of so-called chokepoints is to look at imports of computer chips as a % of total imports (Figure 11). It appears Malta, Hungary, and the Netherlands are most dependent on the import of "chokepoint" products, followed by Portugal and Germany, while the share of chokepoint imports is close to zero in Greece. Note, however, that the ratio for the Netherlands overstates the importance of chips to the Dutch economy, as it hosts relatively large numbers of distributors and brokers who import chips just to resell them to manufacturers all over Europe. Of course this adds to Dutch economic activity, but fairly little as compared to the value added generated by using chips to produce cars and parts for example. Unfortunately, it is impossible to correct the Dutch Figure for this feature due to data gaps.

With respect to dependence on China, it is also relevant to look at what share of chips countries import come from China, as the total figure clearly overestimates China's relevance in this field. On average less than 10% of chip imports in the EU comes from China, limiting their leverage in this area. It also only produces low-end chips --as they are still unable to produce high end ones--

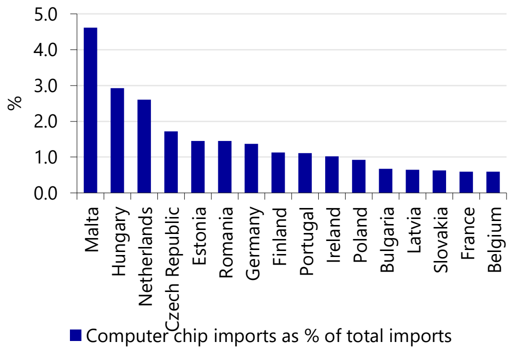
for which there are more alternatives available. Still, for some countries like the Czech Republic, Slovenia, and Spain, China is an important import partner on this front (Figure 12). And at this moment it would likely be difficult to find new import sources if China decides to try to leverage the dependence of certain Member States on chips, given that global demand largely outweighs supply.

Moreover, the data on direct flows don't necessarily show the real country of origin of the chips. For example, chips that are produced in China, refined in Malaysia and then exported to the EU (the Netherlands in this specific example), do not show up in the bilateral trade flow data between China and the EU (the Netherlands). Consequently, while the first ratio (total chip imports as a % of total imports) overestimates China's relevance, the second (chip imports from China as a % of total chip imports) seems to underestimate its importance in this respect. When relating it to EU countries' vulnerability to rising tensions between China and the EU, however, we would argue that direct flows of chips between China and EU Member States are a better indicator to look at then indirect flows – at least in the foreseeable future[8].

Meanwhile, the EU is looking to significantly scale-up/bring home the production of chips, to increase its 'strategic autonomy' and meet increasing demand, but it will likely take years before dependence on other countries will fall - if it happens at all. In the meantime, the EU is unlikely to implement barriers to imports on these kind of products from China --to try to harm China in a scenario of rising tensions-- if there are insufficient alternatives.

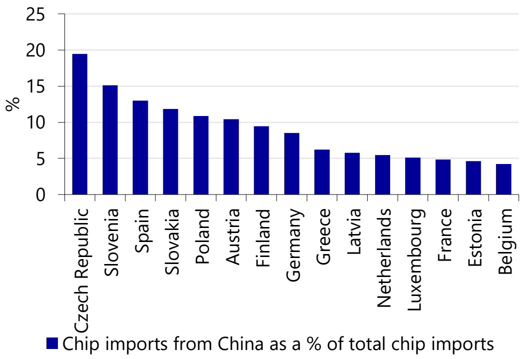
Looking further ahead, a risk for countries' dependence on these chokepoint imports is that the EU fails to sufficiently increase its own production and China's '10,000 SME' plan and 'Made in China' strategy, to replicate or co-opt Western tech, succeed. More specifically, if at some point they will be able to produce high end chips and/or tech to make high-end semiconductors, then they would be actually be able to block the tech and gain significant leverage.

Figure 11: Malta, Hungary and the Netherlands seem most dependent on chokepoint products



Source: World Bank WTTS database, RaboResearch

Figure 12: While Czech Republic, Slovenia and Spain rely most on China for computer chips



Source: Trademap.org, RaboResearch

Rare earths and other 'green' inputs

A field in which China actually does have significant leverage already is in the field of rare earths and other inputs needed for the Green transition. China has serious control of key 'rare earth' elements required for most hi-tech and green-tech production. It is hardly possible, though, to rank EU Member States based on their vulnerability in this respect. Widely available international trade data does not show the real origin of rare earths imports, and for many EU countries rare

[8] While in theory China could try to prevent its chips travelling to the EU via other countries, this seems impossible since it has no jurisdiction over other countries' trade decisions. It would imply blocking chips leaving China from the very start. From the EU's perspective it could implement rules of origin checks at the border, but as we explain this would only become a risk over the medium term and is very unlikely in the short term.

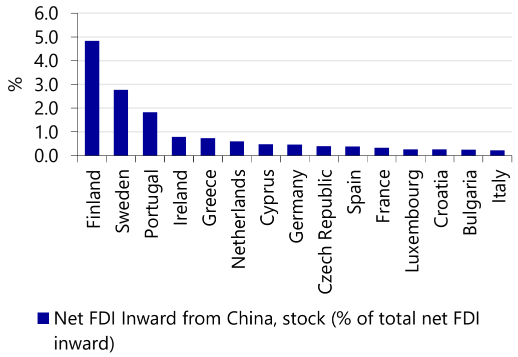
earths coming from China travel via Austria --according to UN Comtrade data-- making Austria a the main importing source for multiple EU Member States, even though 86% of global rare earth processing is done in China. In general, China holds leverage over the entire EU since according to the European Commission, 98% of rare earths used in the EU are currently sourced from there. It also has large control over multiple other critical raw materials, as mentioned in the box '*China's control of rare earths and other critical raw materials*'.

The importance of investment from and in China

The final two indicators we look at are Member States' linkages to China via Chinese investments in Member States and income earned on Member States' investments in China[9].

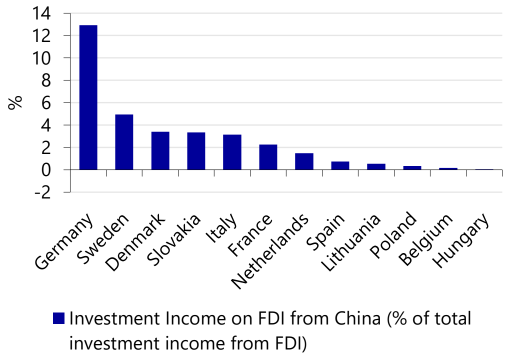
Finland stands out as the EU country that is most dependent on China for FDI, followed by Sweden, and Portugal (Figure 4). Almost 5% of all of Finland's foreign direct investment comes from China, mainly resulting from a few large M&A deals in 2019. In the years prior to 2019, China's share of net inward FDI in Finland was 0% of the total net. For Sweden, on the other hand, China's share has been rather stable in the years running to 2019, mainly because of Chinese investments into Sweden's car sector and R&D for electric vehicles and parts thereof. China's share in Portugal has also been stable for several years, where China's involvement is largely the result of the sale of state-owned assets in the aftermath of the Eurozone debt crisis. Overall, Figure 10 shows, however, that China's share in total inward FDI is limited. That said, when only looking at China's share in the total picture, we would ignore the fact that China has picked –or tried to at least- its investment destinations with care. It can still have a large influence in countries given its investments generally involve strategic sectors that fit its longer-term Made in China strategy, and/or infrastructure nodes, such as ports.

Figure 13: Finland, Sweden and Portugal rely the most on China for foreign investments (2019)



Note: Data is not available for AT, Greek data is from 2018
Source: Macrobond, Eurostat

Figure 14: Germany relies the most on China when it comes to income on foreign investments



Note: Data is not available for AT, HR, IE, LV, LU, MT,
Source: Macrobond, Eurostat

When looking at the investment income of EU Member States derived from investments made in China, Germany clearly stands out. As much as 13% of income earned on foreign direct investment comes from its investments there. This mainly results from the presence of its car manufacturers in China, to serve the Chinese market. For others, China's share drops to below 5%, although it could still be relevant to specific industries and companies. Swedish investors are mainly found in the car sector, and machinery and equipment. For Italian investment in China, the Chinese car sector is also among the largest recipients (both in production and sales), followed by manufacturers of basic metals and machinery equipment. Danish investments in China stand out

[9] There are two accounting possibilities as regards to foreign direct investment: the *asset/ liability principle* and the *directional principal*. We use the *directional principle* as recommended by Eurostat, the IMF and the OECD for this type of analysis, as it "provides a more realistic view of the intensity of the investor links between two economies".

in the sense that the financial services sector is the main destination, although metals and machinery are also important.

Value added, final destinations, real origins and second-order effects

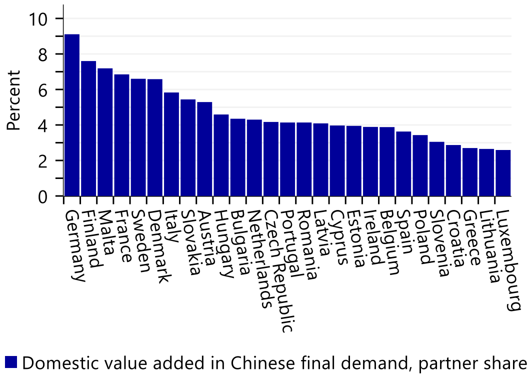
It is important to note that we have only looked at direct trade flows, not value added nor the final destinations of exports or effective origins of imports, which could differ. This could imply China's relevance to some countries' GDP is over- or under-estimated. For example, regarding exports, relevance could be over-estimated if a country's exports to China largely consist of re-exports with little domestic value added, while it could be under-estimated if a country is a large supplier of inputs to another country's industry, which processes these inputs in products that are exported to China.

For example, the car part that is produced in Hungary, Czech republic or Poland and exported to Germany, to be used in a car that is exported to China. If car exports to China are hit with tariffs this would obviously also have an impact on the important car sectors in the former three countries.

We nevertheless prefer to look at direct trade flows, due to a lack of recent data on value added and final destinations, and the lack of data on the exact travel route of an input/ product in general. Moreover, if matters turn for the worse, targeting direct trade flows with tariffs, quota's and export bans would be most straightforward.

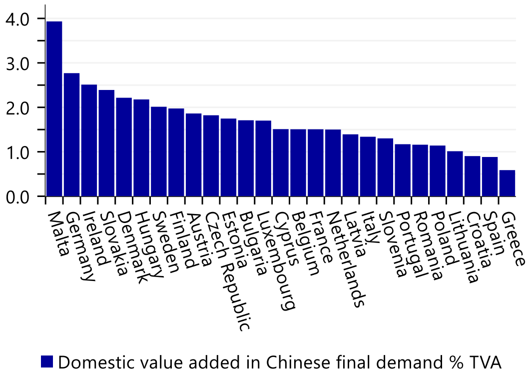
Finally, it is worth noting that the heat map does also not incorporate broader second-order effects. For example, if German exports to China suffer, this will have an impact on its economy beyond those specific exports. And if economic growth in Germany slows, this will hit trading partners for which Germany is an important export destination in general, i.e. also beyond a destination for inputs that ultimately end up in China. Clearly, the more countries suffer from rising tensions between China and the EU, the broader the second-order effects.

Figure 15: In domestic value added, Germany most dependent for its exports (2015)



Note: Domestic value added by reporting country in products that ultimately end up in China, as a % of domestic value added in total foreign final demand (world)
Source: Macrobond, OECD TiVA, RaboResearch calculation

Figure 16: In value added, China most important for Malta, Germany, and Ireland (2015)



Note: Domestic value added by reporting country in products that ultimately end up in China, as a % of total value added generated in the reporting country
Source: Macrobond, OECD TiVA, RaboResearch calculation

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A summary of the methodology can be found on our website