



European Union
Chamber of Commerce in China
中国欧盟商会



MERICS

Mercator Institute for China Studies

Decoupling

Severed Ties
and Patchwork
Globalisation



European Union Chamber of Commerce in China

www.europeanchamber.com.cn

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ABOUT THE EUROPEAN UNION CHAMBER OF COMMERCE IN CHINA

FOUNDED IN
2000
BY 51 MEMBER
COMPANIES

The European Union Chamber of Commerce in China (European Chamber) was founded in 2000 by 51 member companies that shared a goal of establishing a common voice for the various business sectors of the EU and European businesses operating in China. It is a member-driven, non-profit, fee-based organisation with a core structure of 34 working groups and fora representing European business in China.

34
WORKING
GROUPS AND
FORA

The European Chamber has more than 1,700 member companies in seven chapters operating in nine cities: Beijing, Nanjing, Shanghai, Shenyang, South China (Guangzhou and Shenzhen), Southwest China (Chengdu and Chongqing) and Tianjin. Each chapter is managed at the local level by local boards reporting directly to the Executive Committee.

MORE THAN
1,700
MEMBER
COMPANIES

The European Chamber is recognised by the European Commission and the Chinese authorities as the official voice of European business in China. It is also recognised as a foreign chamber of commerce by the Ministry of Civil Affairs. The European Chamber is part of the growing network of European Business Organisations (EBOs), which connects European business associations and chambers of commerce from more than 40 non-EU countries around the world.

Mission statement

As a member-based organisation, the European Chamber seeks several things:

- 1 Ensure greater market access and a level playing field for European companies operating in China.
- 2 Improve market conditions for all businesses in China.
- 3 Facilitate networking among members and stakeholders.
- 4 Provide specific, relevant information to its members on how to do business in China.
- 5 Update its members on economic trends and legislation in China.

Principles

- 1 We are an independent, non-profit organisation governed by our members.
- 2 We work for the benefit of European business as a whole.
- 3 We operate as a single, networked organisation across Mainland China.
- 4 We maintain close, constructive relations with the Chinese and European authorities, while retaining our independence.
- 5 We seek the broadest possible representation of European business in China within our membership: small, medium and large enterprises from all business sectors and European Member States, which operate throughout China.
- 6 We operate in accordance with Chinese laws and regulations.
- 7 We treat all of our members, business partners and employees with fairness and integrity.

OPERATING IN
9
CITIES



European Chamber
中国欧盟商会

About MERICS

Since its creation in 2013, MERICS has established itself as the go-to European think tank on China. With about 20 full-time research staff from different disciplines, MERICS is currently the largest European research institute focussing solely on contemporary China studies. Based in Berlin, MERICS plays an active role in informing European public debates on China and in providing senior decision-makers across Europe with in-depth China-related insights critical to their portfolios.

MERICS was founded by the Stiftung Mercator to strengthen knowledge and debate about China in Germany and Europe.

Independent research means MERICS experts will take a stand – one firmly grounded in liberal-minded and democratic values. In doing so, MERICS experts provide new perspectives on China and advice for shaping relations with it.

Executive Summary

The global COVID-19 pandemic turned 2020 into a year of uncertainty, individual suffering, economic disruption and heightened geopolitical tensions. While the roll-out of vaccinations has created something of a silver lining, the closing weeks of 2020 saw an acceleration of decoupling trends, pulling major economies further apart and disrupting commercial flows and other exchanges:

- The outgoing Trump Administration took another, maybe final, swipe at a major Chinese technology company: Semiconductor Manufacturing International Corporation (SMIC), China's most advanced semiconductor firm, was blacklisted by the United States (US), effectively making them a 'company *non grata*' for global investors.
- Disputes between China and Australia led to a ban on Australian coal imports that has resulted in rolling power outages across various parts of China.
- China released measures to expand its national security review process for foreign investment.

Even the news that the European Union (EU)-China Comprehensive Agreement on Investment (CAI) had been concluded at the political level was met with significant scepticism across Europe, with many expressing doubts over the possibility of arriving at a fairer, more reciprocal EU-China economic relationship.

Meanwhile, China-based automotive manufacturers have been getting a taste of what disruptions to critical inputs like semiconductors can result in. Pandemic-related fluctuations in supply and demand have led to a shortage of certain semiconductors required for electronic control units (ECUs), which collectively form the 'computer' of a vehicle.¹ As a result, manufacturers are shuttering much of their production until the shortage is corrected, which is expected to take up to nine months.²

To casual observers, such examples are part of a recent story that began in 2018, when the Trump Administration imposed the first round of tariffs on Chinese imports to the US. In reality, however, decoupling is a much longer-term trend that stretches back to the earliest days of China's opening up and reform. Through market access and other barriers, China has long managed its interdependence with the world economy in a highly strategic and limited manner: selective coupling where it needed foreign technology or competition—such as in high-speed rail and the financial sector respectively—and remaining uncoupled in sectors reserved for China's, often state-owned, national champions.

For more than 15 years, China's leaders have also advanced extensive industrial policies in an attempt to develop self-reliance in critical technologies and seek dominance in high-value-added industries. The now infamous China Manufacturing 2025 (CM2025) initiative, which aims to substitute global competitors in ten strategic technologies, was just the most visible expression of a deeply engrained and extensive support system that protects China's rising stars.

It is this blend of China's conditional coupling, a vast state-aid apparatus and protectionism extended to national champions, and Beijing's new-found self-confidence in its non-convergence with Organisation for Economic Co-operation and Development (OECD) norms and principles that is driving the current 'crisis of interdependence' with China. The Trump Administration may have provided the spark, but the powder keg China had created was bound to ignite eventually.

1 Zhang, Fanny, *China auto industry recovery faces challenges from Europe chip shortage*, ICIS, 9th December 2020, viewed 22nd December 2020, <<https://www.icis.com/explore/resources/news/2020/12/09/10584052/china-auto-industry-recovery-faces-challenges-from-europe-chip-shortage>>

2 *Semiconductor bottlenecks hit auto sector, VW, suppliers warn*, *Automotive News*, 4th December 2020, viewed 22nd December 2020, <<https://www.autonews.com/china/semiconductor-bottlenecks-hit-auto-sector-vw-suppliers-warn>>



The future of globalisation with China is at stake

Things are now at a turning point. A Biden Administration will likely be less caustic and create fewer disruptions within the global economic order. But the massive shift in public opinion towards China, as well as a growing bipartisan consensus in Washington to consider China a strategic competitor on a divergent trajectory, means things are unlikely to result in 'globalisation renewed'.

Unfortunately, China's response to this 'crisis of interdependence' seems to be a redoubling of its drive to build self-reliance, and European companies in China report that this drive is different and more radical than in the past. As the December 2020 Central Economic Work Conference summaries noted, China's top two priorities for 2021 are: 1) to build scientific and technological strength, with a call for a "new type of whole-of-nation system";³ and 2) developing greater autonomy and control in industrial supply-chains. Any further market opening and deeper 'coupling' with China will therefore be conditional upon whether doing so supports these two goals.

The current impact of decoupling on European companies

Navigating the current and potential effects of this rapidly evolving reality is both complicated and distressing for European companies, particularly as they seek to expand their contribution and exposure to China's post-COVID growth story. China's long-standing non-coupling, combined with the growing chorus of countries committing to, or flirting with, active decoupling measures, is making this endeavour more complicated in a number of ways. This report identifies nine interrelated 'layers' of decoupling organised under four main categories that are impacting businesses to varying degrees:

- **Macro decoupling** – political and financial;
- **Trade decoupling** – supply chains and critical inputs;
- **Innovation decoupling** – research and development (R&D), and standards; and
- **Digital decoupling** – data governance, network equipment and telecommunications services.

Underpinning the analysis of this study are European Chamber members' reported experiences, expectations and impacts of decoupling trends. This information was gathered through a general survey, as well as several layer-specific surveys and scores of in-depth interviews. Following these exchanges, the concerns identified by members were categorised into three levels of urgency:

1. Some of the most visible aspects of the decoupling story are only of **moderate concern**. The political dimension of global decoupling was identified as a dangerous catalyst for decoupling across the different layers but considered mostly manageable, apart from the growing impacts of human rights concerns on business in China. While deepening financial decoupling could lead to highly specific impacts for certain companies, the 'nuclear' options of direct confrontation or cutting China off from the US dollar (USD)-backed financial system were universally considered unlikely by companies interviewed for this report. Companies were generally resilient enough to endure most aspects of trade decoupling with only limited wounds being suffered, with multinational companies (MNCs) having adapted comparatively better than small and medium-sized enterprises (SMEs).
2. Members recognised two emerging areas of divergence and decoupling that are of **rapidly growing concern**: standards and data. In non-contentious areas like machinery and chemicals, China's standards are largely aligned with international ones. But in the areas that China has either labelled as strategic or in areas where its digital champions are world leaders, divergence in standards is ongoing. Meanwhile, the EU and China look likely to mutually decouple on the data front, with their different data-governance systems pushing an agenda of extensive data localisation requirements and erecting barriers to cross-border data transfer.

³ *The Central Economic Work Conference was held in Beijing, Xi Jinping and Li Keqiang delivered important speeches, Xinhua, 18th December 2020, viewed 21st December 2020, <http://www.xinhuanet.com/politics/leaders/2020-12/18/c_1126879325.htm>*

3. Access to certain critical inputs is **already a major concern** for anyone with operations or even just supply chains in China. While most of the discussion about the ‘tech war’ has been limited to critical inputs like semiconductors, the effects of the conflict are actually far more pervasive. In order to calculate decoupling risks, companies need to urgently audit their own operations, as well as the operations of those up- and downstream of them, to identify critical bottlenecks that could be potentially targeted by either the US or China for strategic purposes. Digital decoupling is also having a sharp impact on companies, with telecommunications and network equipment manufacturers feeling increasingly squeezed out of the market. Most worryingly, information and communication technology (ICT) companies, and a growing number of firms across all industries, are unable to integrate their digital solutions in China, in large part due to market access barriers to the provision of both basic and value-added telecommunications services.

The present and future tech quagmire: preventing digital dilemmas, tech autarky and a weaponisation of interdependence

Taken in isolation, decoupling dynamics within each layer are causing at least some suffering to European companies, but when these layers intersect the pain becomes excruciating.

The picture painted by European Chamber members of the growing divergence in technology ecosystems can best be described as a quagmire. High-tech commercial flows are being ‘securitised’ at a growing pace. Direct market access barriers, like negative lists and national security measures, are increasingly joined by indirect ones, like national standards or licensing requirements, to prevent developing technology ecosystems in the US and China from overlapping.

Whether it’s the US’ Clean Network proposal or measures by Chinese authorities aimed at creating “autonomous and controllable” technology, it is all part of the same slippery slope: the technologies that are defining the future, and which are increasingly integrated into every sector of the economy, are being divided between two of the world’s three largest economies, each of which has a growing firewall separating itself from the other.

The US is moving towards a world in which Chinese technology should be purged from supply chains servicing Americans, while China is creating state-sponsored national champions to dominate a self-reliant ecosystem of indigenous technology integrated across its entire market.

The responses: uncharted, precarious and costly

As global supply chains are multi-tiered and heavily reliant upon a combination of leading technology from both the US and China, European companies that would like to integrate the best from both markets fear being forced to choose one of two strategies:

1. **Dual systems:** One supply chain and R&D system to exclusively serve China and one to provide for the rest of the world. For digital systems in China, this would necessitate either building an entire digital stack for the local market, or partnering with / outsourcing to Chinese providers.
2. **Flexible architecture:** Everything that can be supplied in a ‘neutral’ manner in either market is developed and built for both systems, with other parts being developed separately for each market with the capability of being ‘swapped out’.

The costs of either option are considerable. Every step taken down the path of decoupling inflicts further damage on innovation, efficiency, cost-saving and economies of scale. Some companies, especially those for whom China represents a small share of global sales, admitted that, if left unchecked, decoupling could so imperil their economies of scale that they would be forced out of China altogether. Others, especially those with a higher proportion of global sales in China, would have to reorganise their company structures. In either case, this translates into lost investment



and jobs, as well as higher costs and fewer choices for end-consumers.

As the world moves towards increasing techno-nationalism, the possibility of complete digital disintegration requires sober analysis as well as a responsible counter-vision for global integration.

For governments, this is about managing the intersection of partly incompatible economic models and conflicting geo-economic strategies in a way that prevents further disruption of globalisation with China:

- Get to grips with the costs and implications of how your own and other governments' actions shape decoupling trends, and work to find exit ramps, especially in areas where actions from one player intersect with and magnify those of another.
- Invest in pluri- and multilateral frameworks to regulate diverging digital worlds, and new and emerging technologies, with a special emphasis on maximising interoperability and connectivity across jurisdictions.
- Ensure that restrictions on foreign technology and investment in certain value chains is proportionate to the degree of security and privacy risks, and refrain from imposing restrictions on entire technology value-chains when only specific links generate risks.

In the meantime, **European companies** should buckle down, and prepare for the worst:

- Develop a corporate taskforce at headquarters (HQ), with designated counterparts in critical markets to jointly track emerging developments and share information to create a global strategy to mitigate decoupling effects.
- Map out the current and potential measures that would impact your company, both directly and indirectly (through suppliers/customers) across different jurisdictions, and prepare strategies to address all potential scenarios.
- Include in corporate strategy development the costs/benefits of the 'dual systems' and 'flexible architecture' strategies for managing the technology quagmire.

This is about more than just reactive and minor adjustments to temporary and erratic decoupling measures deployed by the Trump Administration or navigating China's landscape of strategically-managed interdependence. It is about the joint responsibility of business and governments to make patchwork globalisation work for their citizens.

Exhibit 1: Three possible states of globalisation and what they would mean from a macro, trade, digital and innovation perspective

		Globalisation renewed	Patchwork globalisation		Globalisation disrupted
Geo-economic strategies		Liberal integrationist, principled multilateralism	Open strategic autonomy; plurilateral and like-minded clubs	Self-sufficient 'dual circulation' and nationalism	Winning and prevailing; 'my country first' (or alone)
MACRO	Politics	Rules-based alignment; financial stability	Systemic competition; financial uncertainty	Permanent politicisation; financial disintegration	Conflict; financial disruption
	Finance				
TRADE	Supply chains	Integration and reciprocity	Fairness and leverage in strategic competition; diversification and resilience	Securitisation of commercial flows; reliance, dominance and control	Weaponising interdependence; reshoring and nationalising
	Critical inputs				
DIGITAL	Data governance	Deep connectivity	Digital distance	Digital disintegration	Digital dilemmas; data exploitation and bifurcation of technology stacks
	Network equipment				
	Telecommunications services				
INNOVATION	Standards and IP	Techno-globalism	Industrial policy renewal	Techno-nationalism	Technological autarky
	R&D				
Decoupling status		'Trusted open relationship'	'Marriage of convenience'		'Moving (staying) out' and acrimony

Key Takeaways

Macro Decoupling

Political

- The politicisation of business and geopolitical tensions are making the Chinese business environment increasingly difficult for foreign companies to navigate, and act as catalysts for decoupling in other areas.
- The current impacts on European companies in China include increasing risks due to a souring of public opinion in home markets towards China, a drop in business sentiment and uncertainty for operations due to the securitisation of business flows.
- The European business community in China is worried about the increased risk associated with ‘political reciprocity’ dynamics, and the potential for more unpredictable tit-for-tat exchanges of economic restrictions resulting from political/diplomatic tensions.

Financial

- In an effort to further reform its own financial system, China is actively working to integrate into the global financial system by establishing new investment channels into its capital markets and new opportunities for foreign financial institutions and investors.
- As long as China lacks a fully convertible capital account and an internationalised *renminbi* (RMB), its reliance on the USD remains its ‘Achilles heel’. Efforts to internationalise both its currency and financial markets are likely to accelerate, but liberalisation is needed to do so.
- Any broad restrictions on access to the USD would amount to a ‘nuclear option’ that would bring considerable economic damage to the US and the rest of the world. Only a massive escalation of political tensions seems likely to trigger it, as happened with Russia and Iran.

Trade Decoupling

Supply chains

- Supply chains were already changing considerably in China before either the COVID-19 pandemic or the trade war, with low-cost production moving elsewhere and most European companies expanding locally and further onshoring their supply chains.
- The trade war and pandemic were disruptive and expensive, but European MNCs proved resilient and made shifts in supply chains to outright avoid many tariffs and maintain operations in China during its COVID-19 recovery.
- Many European companies report a desire to further invest in China and onshore supply chains for the local market to avoid potential future disruptions, though enthusiasm varies by sector based on how welcome they feel in the market.

Critical inputs

- Targeted restrictions on the sale and export of critical goods—such as semiconductors, related manufacturing equipment, software or even rare earths—have become a more pressing concern for companies operating in China and globally.
- European companies have so far felt a limited direct impact due to export controls, but exposure is considerable for most. Pandemic-related shortages have shown how damaging lost or limited access can be, giving companies a taste of what the future may hold.
- Even companies with little to no risk may still be hit if their suppliers/customers can no longer source components or equipment from abroad. China’s new export controls increase risks as well, as locally-developed goods and solutions could be blocked from export.



Innovation Decoupling

R&D

- Although China is an increasingly attractive R&D destination, a number of issues—some long-standing and intensified by decoupling trends, others that have recently emerged as a result—constitute barriers to European companies' R&D activities.
- In Europe, government stakeholders are re-considering their engagement with China on innovation cooperation, and the EU is working on tools to prevent unfair practices within its internal market.
- As a consequence, European businesses will encounter increased difficulties when developing both their global and China R&D strategies.

Standards

- While access to standardisation bodies in China has improved considerably in recent years, European companies—particularly in key sectors—still face informal barriers that prevent them from effectively engaging in standards-setting in China.
- These access issues become all the more relevant when considering China's use of standardisation as a tool to advance its industrial and geopolitical agenda both at home and abroad.
- As a result, European companies may see their competitive edge being dulled and their market share reduced, while these standards-setting trends could also lead to distortion, or even fragmentation, of the global standardisation system.

Digital Decoupling

Data governance

- Data governance regimes in China and the EU already significantly restrict the transfer of data across the borders of these jurisdictions, creating significant compliance risks for companies.
- European companies anticipate that further restrictions on privacy and national security grounds will come into force soon, due in part to new legislation and judicial decisions in the EU, and further measures in China.
- As a result, it will be difficult and risky to exploit the potential of data pools across the EU's and China's jurisdictional boundaries, even as the importance of data as a tool for innovation and efficiency-building grows.

Network equipment

- US efforts to decouple from Chinese telecommunications and network equipment, and the scrutinisation of any China-originated links found in network value chains under its Clean Network programme are impacting European companies and their offerings in the US market.
- China's rapidly expanding barriers to foreign telecommunications and network equipment value chains via requirements for "autonomous and controllable" technology is pushing European players out of the market or into niche roles.
- In combination, these dynamics are inadvertently forcing companies to consider firewalling their China and US network operations from one another, with their China operations relying more and more on local solutions and US ones being stripped of China-sourced inputs.

Telecommunications services

- China's long-standing barriers to foreign telecommunications services and digital solutions has surged, especially with regard to the digital technology at the centre of the fourth industrial revolution, which includes value-added telecommunications services (VATS) like cloud and data centres.
- To offer their digital solutions, which increasingly come from traditional industries outside of ICT/ telecommunications, European companies are forced into joint ventures (JVs) with Chinese counterparts.
- As a result, European companies often have to integrate their products with locally-sourced digital solutions to serve local customers, which can result in the provision of suboptimal offerings that are not globally interoperable.

Chapter One

The Drivers of Decoupling

1





Chapter 1: The Drivers of Decoupling

Decoupling dynamics are being driven by myriad factors. Many countries around the world are reviewing their levels of dependence on certain economies either as a result of shifting geopolitical allegiances or to mitigate supply-chain risks, such as those created by the global COVID-19 pandemic. However, at the root of decoupling are fundamental changes in how the world's two largest economies—China and the US—now see themselves in relation to each other and the rest of the world.

These changes were summarised by Rhodium Group's Dan Rosen as follows:

“China: No longer maintains ambiguity about the nature of the Chinese system and whether it will converge with OECD norms: it emphasises the differentness and says it won't.

The US: Now defines China as a strategic competitor, not a transitional nation converging with our norms, and sees economic dynamics as core to this competition: engagement is now a *verb*—sometimes the right action—not a noun describing policy.”⁴

In addition, changes in how the EU is operating as a global partner, but particularly in its relationship with China, are having an increasing influence on decoupling dynamics. The changes can be summarised as follows:

The EU: Now defines China differently across various areas – a partner in addressing common challenges, an economic competitor and a systemic rival. Engagement with China must yield results, without which the growing EU toolkit for mitigating external distortions will come into play.⁵

China

China's broad and enduring efforts to develop self-reliance and manage its economic interdependence with others are key drivers of global decoupling.

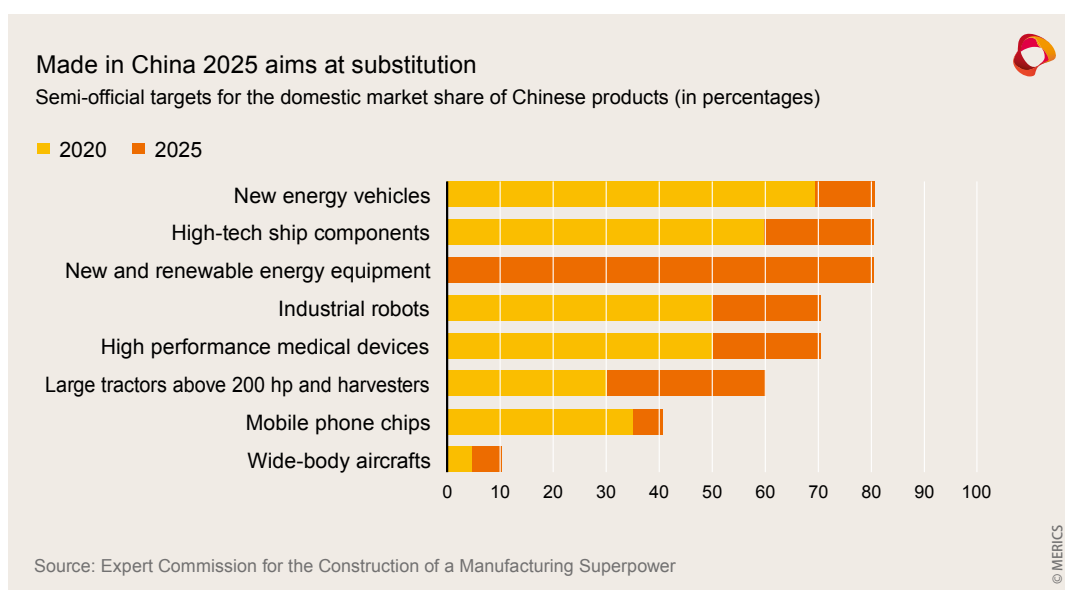
Self-reliance in the current China context is not a push for a return to complete economic independence. Instead, it is a desire for a kind of managed integration that enhances China's development progress, while building national champions and mitigating the risks associated with a full merging with the global economy. Over the years, China's leaders have used two main tools to achieve this end: its market access regime and industrial policy.

Since foreign investment first started flowing into China at the beginning of the reform and opening-up period, China has vacillated in its approach to regulating market access in an attempt to manage interdependence while advancing economic development. Its market has steadily opened up, but much of the opening has taken place in non-critical areas, or has been conditional, for example through JV requirements that have kept foreign players as minority stakeholders or by requiring technology transfers that have empowered Chinese companies.

The framework for managing market access has changed over time. First, tightly controlled reviews and approvals for individual investments eventually moved towards an investment catalogue (positive list) of sectors in which foreign investment is permitted. Then the investment catalogue gave way to the current negative lists, which restrict or

4 Rosen, Daniel H., *A Post-Engagement US-China Relationship?*, Rhodium Group, 19th January 2018, viewed 22nd December 2020, <<https://rhg.com/research/post-engagement-us-china-relationship/>>

5 This generally reflects the European Commission's views from March 2019; *EU-China – A strategic outlook*, European Commission, 12th March 2019, viewed 22nd December 2020, <<https://ec.europa.eu/commission/sites/beta-political/files/communication-eu-china-a-strategic-outlook.pdf>>



prohibit foreign investment in certain industries leaving the rest open to foreign participation, at least on paper.⁶

With the imminent release of the 14th Five-year Plan, the enduring legacy of industrial policy in China is clear to see. Its reliance on industrial policy had accelerated with the 2015 promulgation of CM2025.⁷ This initiative identifies ten strategic industries in which China's leaders set domestic and international market share targets, and makes multiple references to "indigenous innovation" and "self-reliance". As outlined in the European Chamber's report *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces*, a wide range of support for domestic companies is provided by the government under the initiative, including: compelled technology transfers from foreign companies; protection from foreign competition; subsidies; government-backed investment funds; local government support; and technology-seeking investments abroad.⁸

Used jointly, market access regimes and industrial policy have proved valuable in advancing China's self-reliance. For example, high-speed rail technology in China developed quickly due to extensive state support combined with mandates for foreign technology transfers as a condition for market access.⁹ Once China's high-speed rail companies were confident enough, market access was tightened, though not through direct means such as a change to the legal regime governing foreign investment. Instead, the high-speed rail sector was subjected to one of a plethora of indirect barriers that have long-plagued China's business environment. In this case, handpicked, state-owned national champions benefitted from an unfair procurement system, which quickly gave them complete market share and the ensuing economies of scale that drove down their costs considerably.

China's self-reliance campaign—combined with market access barriers, an unlevel playing field, a lack of reciprocity and the increasingly strong role given to state-owned enterprises (SOEs) at the expense of the private sector—has played a central role in creating tensions with its trade and investment partners. Once the Trump Administration took power and fired the first shots of the US-China trade and technology wars, these tensions formed a powder keg.

The beginning of the trade and technology wars gave China a feeling that its self-reliance drive had been retrospectively

6 *Special Management Measures for Foreign Investment Access (Negative List) (2020)*, National Development and Reform Commission (NDRC), 23rd June 2020, viewed 8th July 2020, <<https://www.ndrc.gov.cn/xxgk/zcfb/fzggwl/202006/P020200624549035288187.pdf>>

7 *Notice of the State Council Issuing of "China Manufacturing 2025"*, The State Council, 8th May 2015, viewed 22nd December 2020, <http://www.gov.cn/zhengce/content/2015-05/19/content_9784.htm>

8 *China Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces*, European Union Chamber of Commerce in China, 7th March 2017, <<http://www.europeanchamber.com.cn/en/press-releases/2532>>

9 *Shimbun, Sankei, Japan's Transfer of Bullet Train Technology A Mistake. China, Of Course, Has Copied It, Japan Forward*, 18th August 2017, viewed 22nd December 2020, <<https://japan-forward.com/japans-transfer-of-bullet-train-technology-a-mistake-china-of-course-has-copied-it/>>



justified; as US measures grew in intensity, the more entrenched this sense of vindication became. Importantly, it seems that this self-reliance plan has not only been validated at the political level, which had widely bought into it early on. European Chamber members interviewed for this report noted that, unlike previous schemes, even the private sector and Chinese society at large were getting on board. Essentially, it has gone from an all-of-government goal to an all-of-economy and even an all-of-society one. This was explicitly called for in the mid-December 2020 Central Economic Work Conference readout, which listed eight key tasks, the first of which was strengthening national scientific and technological forces through a “new type of whole-of-nation system.”¹⁰

This came on the heels of a November 2020 article written by President Xi Jinping in *Qiushi*, the Party’s theory journal, which goes well beyond the notion of just achieving self-reliance in entire value chains:

“First, [we will] expand the market, consolidate and enhance the international leading position of advantageous industries, forge some ‘assassin’s mace’ technologies,¹¹ continue to enhance the advantages of the entire industry chain in high-speed rail, power equipment, new energy, communication equipment and other fields, improve industrial quality, tighten the dependence of the international industrial chain on my country, and form a powerful countermeasure and deterrence for foreign parties to artificially cut off supply.

...Second [we will] make up for shortcomings, that is, to build an independent, controllable, safe and reliable domestic production and supply system in areas and nodes related to national security, which can be self-circulating at critical moments to ensure the normal operation of the economy under extreme conditions.”¹²

Significantly, this is all to take place in the broader context of China’s efforts to further integrate into global markets in other areas: the right kind of foreign investment can enhance the development of China’s companies while they compete for market share in third markets. In this regard, self-reliance in China very much encourages companies to ‘go out’, especially through its Belt and Road Initiative.¹³ China’s dual-circulation model, introduced in 2020, fits well with this vision, as integration with other markets is just as much a strategy of resilience as developing the domestic market so that it can endure if decoupling with any market(s) takes place.¹⁴

To pursue both long-standing and new goals China has rolled out a wide range of additional tools. It has responded to US tariffs in a tit-for-tat manner, but has also bolstered its own arsenal of economic tools. China’s *Unreliable Entities List* seems set to match the US’ *Entities List* with its ability to punish specific companies, while export control rules have been reinforced to give Chinese authorities the ability to prevent even technology exports.¹⁵ Meanwhile, the surge in the use of the term “autonomous and controllable” suggests that the stability and national security implications of China’s technology ecosystem is a top priority, and that perhaps foreign providers in certain areas may not be reliable partners in the long-term.¹⁶

China’s self-reliance drive seems largely set in stone as of now, and companies should anticipate that this will continue to evolve. Even in the final days of drafting this report, the situation developed further when new investment

10 *The Central Economic Work Conference was held in Beijing, Xi Jinping and Li Keqiang delivered important speeches, Xinhua*, 18th December 2020, viewed 21st December 2020, <http://www.xinhuanet.com/politics/leaders/2020-12/18/c_1126879325.htm>

11 ‘Assassin’s mace’ is most commonly translated as a tool that can be quickly brought into play, and which can turn the tide of a losing situation – similar to ‘trump card’ or ‘ace up your sleeve’.

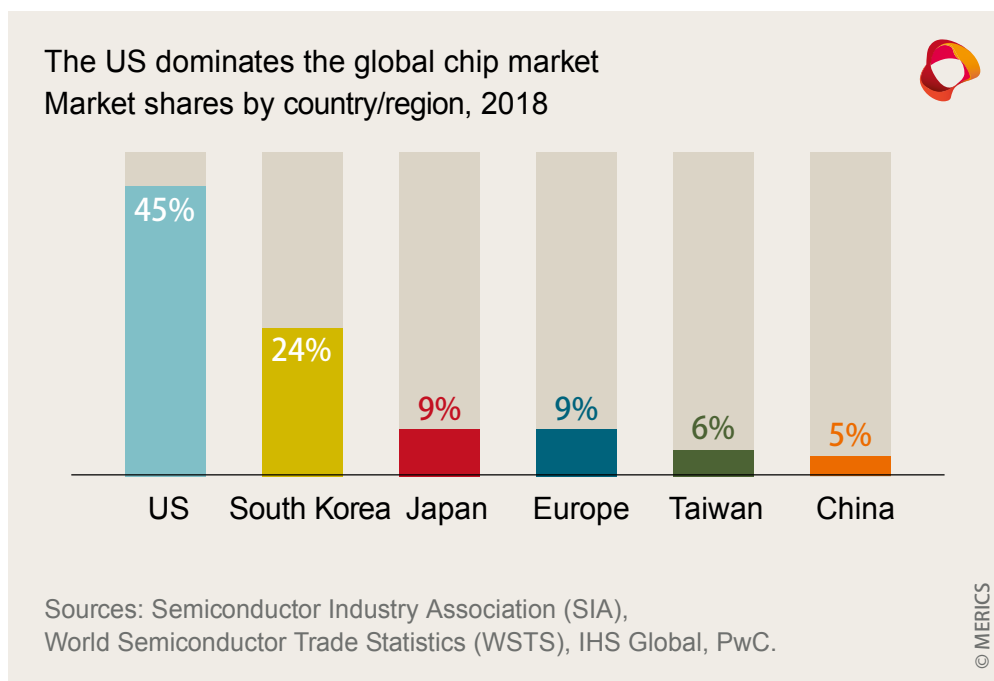
12 President Xi Jinping, *Industrial and supply chains cannot be dropped at critical moments, Qiushi*, 3rd November 2020, viewed 9th December 2020, <http://www.qstheory.cn/zhuanku/2020-11/03/c_1126690768.htm>

13 *The Road Less Travelled: European Involvement in China’s Belt and Road Initiative*, The European Union Chamber of Commerce in China, 16th January 2020, <<https://www.europeanchamber.com.cn/en/press-releases/3110>>

14 China’s “dual circulation” strategy means relying less on foreigners, *The Economist*, 7th November 2020, viewed 22nd December 2020, <<https://www.economist.com/china/2020/11/07/chinas-dual-circulation-strategy-means-relying-less-on-foreigners>>

15 *Fourth update to the Unreliable Entities List rules*, The Ministry of Commerce, 19th September 2020, viewed 22nd December 2020, <<http://www.mofcom.gov.cn/article/bfwzl/202009/20200903002593.shtml>>

16 Yuan, Yang, *US tech backlash forces China to be more self-sufficient, Financial Times*, 15th January 2020, viewed 22nd December 2020, <<https://www.ft.com/content/c6993200-1ff3-11ea-b8a1-584213ee7b2b>>



screening tools were put in place on the grounds of 'national security' in late December 2020.¹⁷

The United States

The US was a central player in the development of the globalised economy in the post-war years, serving as a chief founder of the General Agreement on Tariffs and Trade, the precursor to the World Trade Organization (WTO). As such, it was unsurprising that once China began its reform and opening up agenda under Deng Xiaoping, US political and business leaders alike quickly worked to build bilateral ties. This culminated with China's eventual WTO accession with the support of the Clinton Administration.

Less than two decades later, in something of an about-face, the US began instigating measures that have added considerably to the decoupling dynamics that had first surfaced in the late 2010s. After a short-lived attempt to make some sort of deal, the Trump Administration began deploying a number of tools to try and bring China to heel. The trade war began with tariffs on a handful of goods from China before escalating into a tit-for-tat exchange that eventually covered essentially all goods traded between the two countries.

At the same time, the world caught a first glimpse of the technology war when the US threatened to cut off Chinese telecommunications giant ZTE, including from the US semiconductor industry on which China's technology and telecommunications giants have come to depend. The technology war was eventually extended to Huawei when, on 15th September 2020, the company lost access to all suppliers of the chips needed to power its products.¹⁸ This was achieved through the *Entities List* for US suppliers and the application of the *de minimis* rule, which allows US regulators to cut off overseas supplies to blacklisted firms, or cut off any company supplying blacklisted firms, if a certain threshold—usually 25 per cent—of a product's value is derived from American sources.¹⁹

¹⁷ *National Security Review Measures for Foreign Investment*, NDRC, 19th December 2020, viewed 21st December 2020, <<https://www.ndrc.gov.cn/xxgk/zcxfb/fzggwl/202012/P020201219582032130362.pdf>>

¹⁸ *Addition of Huawei Non-US Affiliates to the Entity List, the Removal of Temporary General Licence, and Amendments to General Prohibition Three (Foreign-Produced Direct Product Rule)*, Bureau of Industry and Security, Commerce Department, 20th August 2020, viewed 22nd December 2020, <<https://www.bis.doc.gov/index.php/documents/regulations-docs/federal-register-notices/federal-register-2020/2588-2020-18213-huawei/file>>

¹⁹ *De minimis Rules and Guidelines 734.4 and Supplement No. 2 to part 734 of the EAR (as modified on 5 November 2019)*, Bureau of Industry and Security, Commerce, 5th November 2019, viewed 22nd December 2020, <<https://www.bis.doc.gov/index.php/documents/pdfs/1382-de-minimis-guidance/file>>



The technology war was escalated further with bans being placed on a range of Chinese network suppliers. Restrictions on Huawei and ZTE in the US 5G rollout were joined by actions launched against the applications TikTok and WeChat to restrict their use in the US, though both are challenging these rules through the US judiciary.²⁰ Measures to curb the use of Chinese technology within US borders culminated in the Clean Network initiative announced by US Secretary of State Mike Pompeo.²¹ The Initiative's goal is to remove anything and everything sourced from China in US telecommunications and network systems. The Clean Network initiative also aims to draw in allies and 'like-minded' countries, and persuade them to impose similar bans on Chinese suppliers. The US has since blacklisted dozens of Chinese companies, including chip manufacturer SMIC and drone manufacturer DJI Technology Co.²²

It is significant that it is not just China the US has recently squared up to. The Trump Administration's 'America First' ethos has driven it into conflicts with a number of other countries. Canada and Mexico were made to suffer until they agreed to some significant changes to the North America Free Trade Agreement (NAFTA),²³ and salvos were also fired at the EU,²⁴ Japan²⁵ and South Korea.²⁶ The Trump Administration happily pursued unilateral and bilateral resolutions to the issues it perceived as threats to its interests, and made a habit of largely foregoing or even attacking multilateral institutions like the United Nations (UN) and the World Health Organization (WHO).^{27&28} The WTO, in particular, has been badly damaged, with its arbitration tribunal now devoid of judges to rule on cases as a result of the US refusing to give its approval on new appointees.²⁹

Another key driver of US decoupling dynamics that cannot be overlooked is that they are a reaction to the challenge posed by China. After more than a century of unopposed global leadership, the US can now feel China breathing down its neck. China is setting itself up to dominate in science and technology, with a significant push in areas like industrial automation, artificial intelligence (AI) and the Internet of Things (IoT); is increasing its global influence through its presence in multilateral institutions and its Belt and Road Initiative (BRI); and has been adding considerably to its military strength.

While the US' position is likely to shift at least somewhat under a Biden Administration, companies will still need to factor into their strategies that the current situation with respect to decoupling will continue to develop and may even deteriorate: US decoupling efforts could continue apace; Biden and his team could opt to recalibrate tactics but maintain Trump's strategic goals; or the US could successfully form a broader coalition of like-minded countries. In any case, things will not return to the 2016 norm.

Europe

At the heart of the European project is the desire to pursue the greatest possible degree of economic 'coupling' and a global outlook that is characterised by openness and integration. This is reflected not only in specific treaty obligations such as a principled openness for international capital flows and high barriers for reciprocity demands, but also in the

20 Commerce Department Prohibits WeChat and TikTok Transactions to Protect the National Security of the United States, Commerce Department, 18th September 2020, viewed 22nd December 2020, <<https://www.commerce.gov/news/press-releases/2020/09/commerce-department-prohibits-wechat-and-tiktok-transactions-protect>>

21 The Clean Network, State Department, viewed 22nd December 2020, <<https://www.state.gov/the-clean-network/>>

22 U.S. blacklists dozens of Chinese firms including SMIC, DJI, CNBC, 18th December 2020, viewed 22nd December 2020, <<https://www.cnbc.com/2020/12/18/us-adds-chinese-drone-company-dji-to-economic-blacklist.html>>

23 Ljunggren, David & Esposito, Anthony, Negotiators fail to reach NAFTA deal, Trump launches new attack, Reuters, 11th May 2018, viewed 22nd December 2020, <[24 Schreuer, Milan, E.U. Pledges to Fight Back on Trump Tariffs as Trade War Looms, The New York Times, 7th March 2018, viewed 22nd December 2020, <<https://www.nytimes.com/2018/03/07/business/trump-tariffs-eu-trade.html>>](https://www.reuters.com/article/us-trade-nafta/negotiators-fail-to-reach-nafta-deal-trump-launches-new-attack-idUSKBN1C1P5></p>
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25 Kihara, Leika & Kaneko, Kaori, Deadline looming, Japan struggles to elude Trump tariff threat, Reuters, 10th September 2019, viewed 22nd December 2020, <[26 Song, Jung-a & White, Edward, South Korea urges Trump to drop threatened car tariffs, The Financial Times, 13th May 2019, viewed 22nd December 2020, <<https://www.ft.com/content/6b4d2bb0-72ea-11e9-bf5c-6eeb837566c5>>](https://www.reuters.com/article/us-usa-japan-trade-analysis/deadline-looming-japan-struggles-to-elude-trump-tariff-threat-idUSKCN1VU2IN></p>
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27 Gramer, Robbie, & Lynch, Colum, Trump Stealthily Seeks to Choke Off Funding to U.N. Programs, Foreign Policy, 2nd October 2018, viewed 22nd December 2020, <<https://foreignpolicy.com/2018/10/02/trump-stealthily-seeks-to-choke-off-funding-to-un-programs/>>

28 Huang, Pien, Trump Sets Date To End WHO Membership Over Its Handling Of Virus, NPR, 7th July 2020, viewed 22nd December 2020, <<https://www.npr.org/sections/goatsandsoda/2020/07/07/888186158/trump-sets-date-to-end-who-membership-over-its-handling-of-virus>>

29 Johnson, Keith, How Trump May Finally Kill the WTO, Foreign Policy, 9th December 2019, viewed 22nd December 2020, <<https://foreignpolicy.com/2019/12/09/trump-may-kill-wto-finally-appellate-body-world-trade-organization/>>

continuous deepening of economic ties between China and EU Member States.

In contrast to what has become almost consensus in Washington DC over the past two years, there is still a strong feeling within Europe that decoupling from China should *not* be the way forward. However, Europe's decision-makers, and public, have grown increasingly concerned about the risks and vulnerabilities associated with both a possible 'overdependence' on China and the global decoupling dynamics driven by China's and the US' actions.

So far, there are very few concrete official European measures that seek to more actively manage interdependence for strategic purposes or even engineer a conscious 'partial decoupling' from China. However, three developments in the past few months contain the seeds of a more strategic perspective.

First, with the introduction of a European framework for investment screening,³⁰ the so-called 5G toolbox³¹ and an upgrading of the EU export control regime,³² European authorities are introducing a greater degree of scrutiny of commercial interactions in some narrowly-defined areas related to core national security, public order, dual-use technology and critical (digital) infrastructure. Chinese officials have been quick to depict these changes as protectionist measures or driven by the EU's unity with US interests. The changes are, however, to a very large extent rooted in autonomous European deliberations and remain well within the realm of fundamentally liberal OECD norms. The framework operates with transparently-defined, generally country-agnostic principles. It also remains far less restrictive and intrusive compared to the scrutiny exercised by Chinese authorities, for instance on foreign direct investment (FDI), particularly in what are considered 'sensitive' industries. That being said, what are mostly nationally-decided and -implemented measures do have an impact and potentially also limit Chinese business opportunities in narrowly-defined realms.

Second, catalysed by the COVID-19-induced disruption of global supply chains, there is a growing debate about vulnerabilities associated with a perceived 'overdependence' on China with regard to imports of certain critical products. This often blends with more structural concerns related to the future of European competitiveness in light of deepening corporate and sectoral dependencies on the Chinese market.

In practice, these debates are likely to have only limited impact on actual business conduct for the foreseeable future. Political calls for more diversification, such as in the recent German Indo-Pacific guidelines,³³ remain at a rhetorical level. European companies are, overall, doubling down on the growth opportunities and innovation potential of the Chinese market, not least as China rebounds faster from the COVID-19 crisis compared to the rest of the world. Politically, there will likely be some targeted European measures to increase resilience for very specific inputs and goods (such as rare earths or personal protective equipment). The overarching, if somewhat contested, economic policy framework remains to develop Europe's 'open strategic autonomy' in combination with a more assertive enforcement of European trade policy instruments.

Third, with the European Commission's plans to issue a new strategy in March 2021, a revival of European industrial policy has the potential to reshape patterns of economic interdependence, also with China. With new policies and rekindled tools (such as the Projects of Common European Interests),³⁴ more R&D and financial/tax support, European companies are likely to adjust marginally to this new incentive landscape in strategic industries; for instance, to develop European battery, hydrogen or cloud technology. While seeking to compete with China's capacity

³⁰ *EU foreign investment screening mechanism becomes fully operational*, European Commission, 9th October 2020, viewed 22nd December 2020, <<https://trade.ec.europa.eu/doclib/press/index.cfm?id=2187>>

³¹ *Secure 5G networks: Questions and Answers on the EU toolbox*, European Commission, 29th January 2020, viewed 22nd December 2020, <https://ec.europa.eu/commission/presscorner/detail/en/QANDA_20_127>

³² *Commission welcomes agreement on the modernisation of EU export controls*, European Commission, 9th November 2020, viewed 22nd December 2020, <<https://trade.ec.europa.eu/doclib/press/index.cfm?id=2209>>

³³ *"Germany-Europe-Asia: shaping the 21st century together": The German Government adopts policy guidelines on the Indo-Pacific region*, Federal Foreign Office of Germany, 1st September 2020, viewed 22nd December 2020, <<https://www.auswaertiges-amt.de/en/aussenpolitik/regionaleschwerpunkte/asien/german-government-policy-guidelines-indo-pacific/2380510>>

³⁴ *Projects of Common Interest*, European Commission, viewed 22nd December 2020, <https://ec.europa.eu/energy/topics/infrastructure/projects-common-interest_en>



to leverage state support, European industrial policy is, however, likely to remain fundamentally different, limited in scope and tools, and more horizontal and company-driven.

Going forward, several trends in EU thinking and policymaking on China are likely to impact the depth of economic integration between the two blocs, either through related shifts in public opinion or actual policy and regulatory changes. EU efforts to address distortions from China—through procurement reciprocity (its International Procurement Instrument),³⁵ competition policy tools and the application of trade defence instruments for third markets—could create further barriers for China's economic linkages with Europe. The EU's increasingly assertive stance on digital issues, including data privacy and data protection, is already resulting in greater scrutiny of China's digital giants operating and servicing in Europe. Furthermore, debates about human rights issues in supply chains, both at the national and EU level, will increase, further complicating doing business in China. Finally, a greater focus on environmental standards in EU trade policy, including the possibility of future carbon border adjustment, could create a whole new layer of managed interdependence with far-reaching implications, including for European businesses in China.

Decoupling beyond the EU-China-US triangle

Decoupling dynamics are playing out on a global level, which are not just reactions to the disruption caused by COVID-19. The global rethinking of the appropriate depth of doing business with China is rooted in more fundamental concerns. Greater scrutiny of Chinese investment is, for instance, a truly global phenomenon, with regulatory changes in most Group of Seven (G7) countries, many OECD economies and beyond, including India.

In East Asia, Japan and Taiwan have for a long time taken a much more strategic approach to managing interdependence with China than Europe historically has. This is because their different security environment, combined with the fact that they are comparatively more deeply intertwined with China than Europe is, provides them with a clearer view on economic security and geostrategic vulnerabilities. Japan, for instance, has a more integrated approach to investment screening, and export and R&D controls. There was also barely a question as to whether Japan would operate with a Chinese supplier for its domestic 5G networks. Taiwan, too, has years of experience in carefully managing cross-channel ties in the semiconductors industry and restricting some types of commercial interactions with Mainland China in that realm.

Other economies in the region, like Australia and India, are also at the forefront of proactive 'diversification policies', ranging from long-standing trade policy efforts to more dedicated measures. None of these policies or related measures are necessarily about decoupling or all-out de-Sinicisation, but rather attempts largely to avoid overdependence. Taiwan engineered its New Southbound Policy in 2016,³⁶ and complemented it in 2018 with a three-year reshoring plan, with incentives including land supply, labour, power, tax and loan subsidies. Australia's Department of Foreign Affairs and Trade conceived of its India 2035 strategy in 2018, also with a view to diversifying its economic relationships beyond China.³⁷

In response to the COVID-19 crisis, or as a result of growing Chinese assertiveness and related conflicts, such measures are now being pursued with a greater sense of urgency. Japan introduced a diversification fund as part of its stimulus package in April 2020;³⁸ the Indian Government retaliated 'asymmetrically' to developments in the border conflict with China by blocking more than 200 Chinese apps from Indian app stores;³⁹ and Australia is currently being urged to join a collective approach to respond to the unprecedented amount of economic pressure being exerted by China.⁴⁰

35 *International Procurement Instrument*, European Commission, March 2019, viewed 22nd December 2020, <https://trade.ec.europa.eu/doclib/docs/2019/march/tradoc_157728.pdf>

36 Marston, Hunter & Bush, Richard C., *Taiwan's engagement with Southeast Asia is making progress under the New Southbound Policy*, Brookings, 30th July 2018, viewed 22nd December 2020, <<https://www.brookings.edu/opinions/taiwans-engagement-with-southeast-asia-is-making-progress-under-the-new-southbound-policy/>>

37 *An India Economic Strategy to 2035*, Department of Foreign Affairs and Trade of Australia, 2018, viewed 22nd December 2020, <<https://www.dfat.gov.au/geo/india/ies/introduction.html>>

38 Reynolds, Isabel & Urabe, Emi, *Japan to Fund Firms to Shift Production Out of China*, Bloomberg, 8th April 2020, viewed 22nd December 2020, <<https://www.bloomberg.com/news/articles/2020-04-08/japan-to-fund-firms-to-shift-production-out-of-china>>

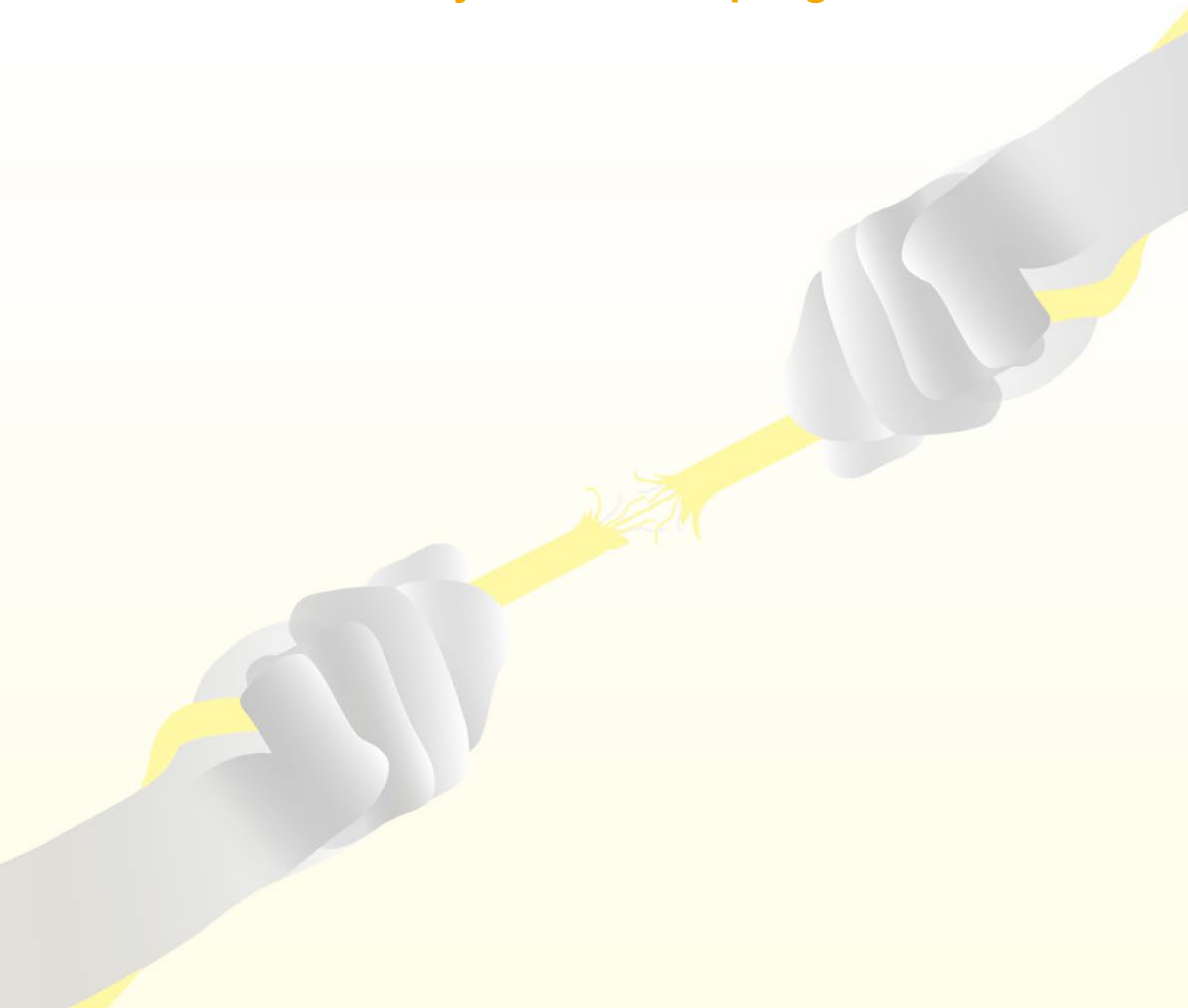
39 Yasir, Sameer & Kumar, Hari, *India Bans 118 Chinese Apps as Indian Soldier Is Killed on Disputed Border*, *The New York Times*, 2nd September 2020, viewed 22nd December 2020, <<https://www.nytimes.com/2020/09/02/world/asia/india-bans-china-apps.html>>

40 Greber, Jacob, *Australia's China pain becomes the talk of Washington*, *Financial Review*, 26th November 2020, viewed 22nd December 2020, <<https://www.afr.com/world/north-america/australia-s-china-pain-becomes-the-talk-of-washington-20201124-p56hav>>

Chapter Two

The Layers of Decoupling

2





Chapter 2: The Layers of Decoupling

In October 2020, the European Chamber surveyed its members to gain a better understanding of their perspectives on decoupling and related issues. A general survey was conducted, with 120 members responding, along with several surveys on specific issues that were only taken by related European Chamber working groups:

- Financial decoupling (Banking and Securities Working Group – 13 respondents)
- Data governance decoupling (Cybersecurity Working Group – 17 respondents)
- Critical inputs decoupling (Automotive; Auto Components; Petrochemicals, Chemical and Refining; and Information and Communications Technology working groups – 16 respondents)
- Standards decoupling (Standards and Conformity Assessment Working Group – 30 respondents)

Results from the four specific surveys are used throughout the various ‘layers’ of decoupling in the coming pages, while the general survey is primarily discussed here.

Awareness, exposure and preparation

Respondents reported a decent level of awareness of decoupling. A mere four per cent felt that they were not exposed to decoupling at all, with the vast majority predicting low to moderate exposure. The level of planning lagged slightly behind the level of exposure, indicating that more can be done to prepare for the potential impacts of decoupling.

	Level of awareness	Level of exposure	Level of planning/ preparation
High	52%	11%	11%
Moderate	31%	48%	37%
Low	14%	37%	40%
None	3%	4%	12%

Source: European Chamber survey on decoupling conducted in September 2020

However, responses to questions later in the survey indicate a perception of higher exposure across the different layers of decoupling, as well as an increased likelihood of experiencing significant negative impacts. This could very well reflect the fact that as respondents were faced with more questions and the potential scope of decoupling was gradually revealed, they recognised that they were subject to a higher level of exposure than the initial question had led them to think. This was replicated in the dozens of interviews with member companies, many of whom later acknowledged that they had not considered critical issues, or that they had only examined their own company’s level of exposure without considering that of their partners up- and downstream.

Current vs expected impacts

Although half of respondents are already facing some kind of negative impact, things look likely to worsen considerably. That being said, one in 10 respondents expect some positive impact, perhaps viewing themselves as reliable alternatives to other foreign (especially American) competitors.

	Current impacts	Expected impacts
Highly negative	5%	20%
Somewhat negative	46%	52%
No impact	36%	9%
Somewhat positive	5%	9%
Highly positive	0	1%
Don’t know	8%	8%

Source: European Chamber survey on decoupling conducted in September 2020

Comparative challenges

Respondents were asked to list nine different challenges in order of the most to least significant. Lower average numbers indicate that they are higher level challenges:

Decoupling remains mainly a potential/future concern for most, meaning it may be less prioritised than the challenges included in this list, which are longstanding and already impactful. However, as the rest of the findings demonstrate, decoupling has the potential to cause serious harm to many European Chamber member companies. The level of awareness of decoupling is self-reportedly high, as is the level of exposure, but the level of preparedness remains

low. Companies would do well to remedy that imbalance while decoupling remains low on the list of priority challenges, rather than after it has risen in significance.

Comparative impacts of each layer

The European Chamber and MERICS had initially identified eight main 'layers' of decoupling to analyse. These layers were used for the survey, but after subsequent interviews with companies, industry experts, government and thought leaders, changes were made. The digital/telecommunications layer was subsequently divided into two – network equipment and telecommunications services. The standards layer was also divided in two – standards and R&D. Finally, the self-sufficiency layer was removed due to it being a horizontal issue that spanned all other layers.

Average rating – rated from 1–9, with 1 being the most challenging and 9 being the least
3.73 – Global economic slowdown
3.99 – COVID impact
4.02 – Chinese economic slowdown
4.46 – Competition with Chinese POEs
4.75 – Competition with Chinese SOEs
4.79 – Ambiguous rules and regulations
4.90 – Market access issues
5.14 – Rising labour costs
5.20 – Decoupling

Source: European Chamber survey on decoupling conducted in September 2020

	All negative (significant negative)	No impact	All positive
Digital/telecoms ⁴¹	85% (34%)	12%	0
Data Governance	76% (24%)	16%	4%
Financial	70% (23%)	23%	1%
Supply Chains	68% (23%)	23%	6%
Standards ⁴²	68% (15%)	22%	5%
Self-sufficiency	64% (15%)	26%	6%
Political	59% (12%)	34%	0
Critical Inputs	49% (15%)	42%	3%

Source: European Chamber survey on decoupling conducted in September 2020

The layers most commonly selected as having a negative impact tended to be those with the most horizontal reach – everyone is affected by digital/telecommunications issues while not as many will face an issue with critical inputs. That being said, the potential damage from these various challenges could differ considerably. An automotive manufacturer losing access to semiconductors from the US or batteries from South Korea or Japan could face much harsher consequences than a bank might if they are no longer allowed to transfer their employee data out of China.

How to read this chapter

Each of the nine layers of decoupling are explored in close detail to determine the current situation, the level of exposure of European companies, expectations and likely scenarios, and implications and recommendations for both European companies and governments. While readers are encouraged to get to grips with all nine layers, there is a summary at the start of each that provides the headline findings. These layers are written in a largely 'siloes' fashion, meaning that there is limited overlap between them. For the bigger picture and how these layers intersect, please follow up with Chapter Three on page 73.

The layers are categorised as follows:

- Macro Decoupling: Political and financial
- Trade Decoupling: Supply chains and critical inputs
- Innovation Decoupling: R&D and standards
- Digital Decoupling: Data governance, network equipment and telecommunications services

⁴¹ Originally planned to cover all digital/ telecommunications issues in a single layer, after subsequent interviews were conducted it became clear that a separation was needed between network equipment and telecommunications services.

⁴² After subsequent interviews, it became apparent that a broader section on innovation was needed, which was separated into standards and R&D.



Macro Decoupling: Political and financial

Before looking at the impact of decoupling on specific industries and horizontal issues, the following sections offer more of a macro perspective, with two stand-out findings.

First, negative public opinion both in China and Europe, resulting from geopolitical tensions and uncertainty regarding the increased securitisation of commercial flows and potential new sanctions, are impacting both the operations and overall business sentiment of European companies in China.

Second, China's maturing economy and increased opening is resulting in it gradually integrating further into the global financial system. However, reliance on the USD and the US financial system makes the Chinese economy, and therefore all companies operating in it, vulnerable should US-China relations deteriorate further.

Political

Summary

The politicisation of business and geopolitical tensions are making the operating environment in China increasingly difficult for European companies to navigate. These factors not only create uncertainty but also act as catalysts for decoupling trends in different areas of the global economy.

Companies are concerned that conflicts or competition over values and systems could potentially have a growing influence on their business operations in the future. Achieving a minimal level of political trust among the EU, China and the US is therefore going to become more important but also harder to achieve.

The current impacts of the politicisation of business on European companies in China include growing negative public opinion in Europe on China in general, a drop in business sentiment and uncertainty for business operations following regulatory changes, as well as greater scrutiny of businesses based on national security or human rights considerations, which is resulting in increased pressure for some companies to justify their China operations.

The main concern is that a business environment that is increasingly shaped by politics of alliances, 'political reciprocity' and loyalty tests will result in unpredictable tit-for-tat exchanges of economic restrictions.

General outlook

In the European Chamber's *Business Confidence Survey 2020* (BCS 2020), 43 per cent of respondents stated that China's business environment had become more political over the previous year,⁴³ with almost half of those saying that external political pressure was being exerted by the Chinese Government and media. Respondents also reported feeling pressure from both the European Commission and their home governments.⁴⁴

Political issues that currently influence the business operations of European companies in China can be divided into two main categories: those related to developments happening within China's borders and those related to geopolitical tensions.

Issues related to developments happening in Greater China (politicisation of business)

The potential direct and indirect impacts that developments in China can have on business operations—including the

43 *European Business in China Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 10th June 2020, <https://www.eurochamber.com.cn/en/publications-archive/774/European_Business_in_China_Business_Confidence_Survey_2020>

44 Ibid.

protests in Hong Kong and the subsequent introduction of the National Security Law, allegations of forced labour in Xinjiang and the Chinese Communist Party's (CCP's) increased presence in business—are of concern to international companies.

These issues create a business environment that put international companies at increased risk of being needlessly caught in a political crossfire. There is a growing list of cases in which Chinese authorities have pressured businesses, both domestic and foreign, to toe the party line.⁴⁵ For example, following the Hong Kong protests, Cathay Pacific was compelled to suspend staff that appeared to have displayed support for the pro-democracy movement.⁴⁶ A further example was the retaliation against the entire National Basketball Association (NBA), after one person in charge of an NBA franchise expressed personal support for the Hong Kong protests.⁴⁷

External coercion by companies' home countries—applied by either government, the public, human rights groups, or a combination of the three—is also playing a part. For example, there is now increased pressure for companies in China to either withdraw from Xinjiang or at least carry out extensive audits of their supply chains.⁴⁸ This presents a difficult situation – some had originally invested in Xinjiang only at the request of Chinese authorities in order for them to receive approval for larger investment projects elsewhere in China. External scrutiny of this issue and the situation in Hong Kong is expected to increase in the future.

Foreign companies operating in China are also deeply concerned by repeated efforts by Chinese leaders to increase the role of the CCP in companies' decision-making processes. While the Company Law mandates the establishment of Party Organisations (also known as Party Cells) within all companies if they employ three or more Party members that want it, in September 2020, the General Office of the Central Committee of the CCP published guidelines outlining the need for closer alignment between the Party and private business.⁴⁹

Issues related to geopolitical tensions

Geopolitical tensions between China and the rest of the world are increasing. Exacerbated by the actions of 'wolf warrior' diplomats during the COVID-19 pandemic,⁵⁰ 2020 saw China involved in many public disagreements with countries including Australia,⁵¹ the Czech Republic,⁵² India⁵³ and Sweden.⁵⁴ Diplomatic disagreements between China and a company's home-country government create uncertainty and can complicate business operations for the firm.

Growing geopolitical and security tensions have seen a trend emerge across different global jurisdictions to expand the definition of what constitutes a threat to national security. The fact that European and Chinese authorities do not recognise each other as trusted security partners, and are not aligned for instance on human rights, arms controls or a wider set of OECD principles, makes companies from both jurisdictions vulnerable. The introduction or tightening of existing measures related to export controls and 'unreliable entity' lists, as well as supply-chain and investment scrutiny in China and Europe, will see more commercial flows being securitised, while putting ever greater pressure on companies' compliance teams.

45 Lohse-Friedrich, Kerstin, *China's Public Diplomacy: International companies face increasing reputational risks*, MERICS, 5th June 2019, viewed 24th November 2020, <<https://merics.org/en/report/chinas-public-diplomacy>>

46 *Hong Kong: China bans Cathay Pacific staff seen to support protests*, BBC, 9th August 2019, viewed 24th November 2020, <<https://www.bbc.com/news/world-asia-china-49296387>>

47 Kludt, Tom, *The losses are substantial: the NBA's trouble with China, four months on*, *The Guardian*, 24th February 2020, viewed 24th November 2020 <<https://www.theguardian.com/sport/2020/feb/24/china-nba-hong-kong-protests-financial-costs-update>>

48 Reinhard Buetikofer: *'We are learning to avoid being enchanted by 'win-win' rhetoric'*, MERICS, 10th September 2020, viewed 24th November 2020, <<https://merics.org/en/interview/reinhard-butikofer-we-are-learning-avoid-being-enchanted-win-win-rhetoric>>

49 *European Chamber stance on united front work in China's private sector*, European Union Chamber of Commerce in China, 12th October 2020, viewed 24th November 2020, <http://european-chamber.com.cn/en/press-releases/3291/european_chamber_stance_on_united_front_work_in_china_s_private_sector>

50 Hille, Kathrin, *Wolf warrior diplomats reveal China's ambitions*, *FT.com*, 12th May 2020, viewed 24th November 2020, <<https://www.ft.com/content/7d500105-4349-4721-b4f5-179de6a58f08>>

51 McGregor, Richard, *China sends a message with Australian crackdown*, *FT.com*, 25th November 2020, viewed 29th November 2020 <<https://www.ft.com/content/9ed5f582-423d-41c4-ba23-0441f7dee165?sharetype=blocked>>

52 Hu, Yuwei, *Czech reaffirms One-China principle in positive move to save ties soured by Senate leader's Taiwan trip*, *Globaltimes.cn*, 5th October 2020, viewed 3rd December 2020, <<https://www.globaltimes.cn/content/1202727.shtml>>

53 *India-China dispute: the border row explained in 400 words*, *BBC.com*, 10th September 2020, viewed 3rd December 2020, <<https://www.bbc.com/news/world-asia-53062484>>

54 Hutt, David, *Sweden-China ties grow ever icier over Hong Kong and coronavirus*, *Nikkei Asia*, 11th June 2020, viewed 3rd December 2020, <<https://asia.nikkei.com/Politics/International-relations/Sweden-China-ties-grow-ever-icier-over-Hong-Kong-and-coronavirus>>



Significant geopolitical shifts, including the potential flashpoints on China's periphery, also have the potential to be hugely disruptive to business operations. Developments in Australia-China relations should serve as a wake-up call to foreign companies in China (if they did not remember previous cases of Norway, South Korea and Japan, that is)^{55,56&57} that economic coercion—the use of economic levers such as trade tariffs / bans for political or strategic purposes—is a key tool at the Chinese Government's disposal.⁵⁸

Current Impacts

Impact of the politicisation of business

All European companies in China are affected by any deterioration of EU-China bilateral relations, the securitisation of commercial flows and the regulatory changes (sanctions or barriers to trade and investment in the name of national security concerns) that limit opportunities for commercial exchanges in both jurisdictions. The perception of (attempts to exercise) greater Party control over businesses' operations, also in foreign enterprises, makes it harder for business executives to justify future investments if they are unable to guarantee that operational decisions will continue to be completely autonomous.

The allegations of human rights violations in Xinjiang have already resulted in actions from both the US and the EU. The Uyghur Human Rights Policy Act introduced by the US,⁵⁹ and the potential introduction of legislation on human rights in supply chains in the EU, are likely to put the burden of proof on companies to provide conclusive evidence that there are no human rights violations taking place anywhere along their supply chains in order to avoid the risk of economic, legal and reputational consequences.⁶⁰ This is complicated by the fact that there is currently a lack of clear guidance on what evidence companies need to provide in order to be excluded from sanctions related to human rights concerns.

European Chamber members that have operations in Xinjiang have stated that the evolving regulatory regime in the US and EU has resulted in a significant increase in compliance costs. Risks of indirect linkages to the situation in the province, related either to the potential for 'forced labour' to have occurred at some point in the supply chain or to doing business with Chinese companies implicated in security or surveillance measures, complicate the picture further for companies that are not actually present in the region themselves.

Meanwhile, the introduction of the National Security Law in Hong Kong and the subsequent US sanctions on specific Hong Kong-based individuals have not had a significant impact on business operations of Mainland China-based European companies. However, the introduction of the law has seen European politicians' views on China become more negative.⁶¹

Impact of geopolitical tensions

US-China tensions have played a key role in China's hardening tone towards the West in general, and vice versa. China's more assertive diplomacy has led to increased negative public opinion in other countries towards China. In democratic European countries, this can result in direct reputational risks for companies that operate in China, and is

55 Walsh, Michael, *Norway once felt China's wrath – what can Australia learn from them?*, *ABC.net.au*, 4th September 2020, viewed 3rd December 2020, <<https://www.abc.net.au/news/2020-09-04/norway-once-felt-chinas-wrath-what-can-australia-learn-from-them/12621056>>

56 Hanson, Fergus, et al, *How China uses trade as a lever for coercive diplomacy*, *Maritime Executive*, 31st August 2020, viewed 3rd December 2020, <<https://www.maritime-executive.com/editorials/report-how-china-uses-trade-as-a-lever-for-coercive-diplomacy>>

57 Xiong, Gloria, *Beijing increasingly relies on economic coercion to reach its diplomatic goals*, *The Washington Post*, 23rd July 2020, viewed 16th December 2020, <<https://www.washingtonpost.com/politics/2020/07/23/beijing-increasingly-relies-economic-coercion-reach-its-diplomatic-goals/>>

58 McGregor, Richard, *China sends a message with Australian crackdown*, *FT.com*, 25th November 2020, viewed 29th November 2020 <<https://www.ft.com/content/9ed5f582-423d-41c4-ba23-0441f7dee165?sharetype=blocked>>

59 Byrd, Haley, *Senate approves Uyghur human rights bill*, *CNN*, 14th May 2020, viewed 8th December 2020, <<https://edition.cnn.com/2020/05/13/politics/uyghur-bill-senate-china/index.html>>

60 Fox, Benjamin, *New human rights laws in 2021, promises EU justice chief*, *Euractiv.com*, 30th April 2020, viewed 24th November 2020, <<https://www.euractiv.com/section/global-europe/news/new-human-rights-laws-in-2021-promises-eu-justice-chief/>>; *Statement by the President*, *The White House*, 17th June 2020, viewed 24th November 2020, <<https://www.whitehouse.gov/briefings-statements/statement-by-the-president-41/>>

61 Elmer, Keegan, *Chinas leaders 'arrogant and aggressive' over Hong Kong security law*, *EU politician says*, *SCMP.com*, 27th May 2020, viewed 10th December 2020, <<https://www.scmp.com/news/china/diplomacy/article/3086361/chinas-leaders-arrogant-and-aggressive-over-hong-kong-security>>

increasing pressure on politicians to take a 'tougher' stance on China. According to a recent Pew Research Center study, views on China within European societies have become increasingly unfavourable in recent years.⁶² This can have knock-on effects in broader areas of EU-China interest; for example, the CAI will now face more scrutiny in the European Parliament, now that negotiations have been concluded at the political level.

Level of exposure of European companies

For European companies in China, the level of exposure to either US-China tensions, views from the US and the EU on human rights in supply chains or views regarding the situation in Hong Kong can be described as follows:

- **US-China tensions:** European companies that still conduct trade directly between the US and China, or have a large presence in both markets, are vulnerable to changes in the US-China relationship. However, most European companies have, in recent years, managed to mitigate the impact of the US-China trade war by adapting their supply chains and strategies to avoid doing business across the US-China 'border', thereby reducing their exposure.⁶³
- **Legislation related to human rights in supply chains:** The potential impact (on EU companies in China) of US and EU legislation aimed at addressing alleged human rights violations in supply chains largely depends on a company's level of exposure to Xinjiang. For most European companies in China that do not have actual operations there, the exposure is extremely low. However, companies also need to be cognisant of the fact that there may be some risk depending on who they currently do business with. The level of exposure is high for those European companies that either have factories or production sites in Xinjiang, or supply chains that run through the province. They are currently most exposed to potential reputational damage and the implications of new US or EU sanction regimes.
- **Hong Kong situation:** Exposure to this issue for European companies that only operate in Mainland China is limited. However, if the company has its regional HQ in Hong Kong, it is more vulnerable to external pressure from the EU or the US.

All companies operating in China are potentially vulnerable to pressure to allow the Party to take a more proactive role in their operations. Two main factors determine the level of exposure:

- **Size of the company:** In general, the smaller the company, the less likely it is that the CCP will have a large influence on its business operations. This is mainly because smaller companies will probably have fewer potential CCP members (maybe even less than the three required to establish a Party cell).
- **Joint venture partnership:** European companies that hold a minority position in a JV are potentially more exposed to increased pressure to allow the Party into decision-making processes as they have less say in the partnership.⁶⁴

Exposure to impacts resulting from negative public opinion depends on several factors:

- **Home country:** If a country has political tensions with China, the Chinese public and government tend to scrutinise its businesses more. The greater the tensions, the more exposure a company has to negative messaging on Chinese social media, for example.⁶⁵
- **Location in China and external communication:** The location of operations in China can act as a red flag for Western audiences, as the Western media and public increasingly see a moral obligation for European companies

62 Silver, Laura, et al, *Unfavourable Views of China Reach Historic Highs in Many Countries*, Pew Research Center, 6th October 2020, viewed 24th November 2020, <<https://www.pewresearch.org/global/2020/10/06/unfavorable-views-of-china-reach-historic-highs-in-many-countries/>>

63 *European Chamber survey on the US-China trade war finds more companies making changes to adapt to the indefinite nature of the tensions*, European Union Chamber of Commerce in China, 10th October 2019, viewed 10th December 2020, <https://www.eurochamber.com.cn/en/press-releases/3063/european_chamber_survey_on_the_us_china_trade_war_finds_more_companies_making_difficult_strategic_changes_to_adapt_to_the_indefinite_nature_of_the_tensions>

64 Martina, Michael, *In China, the Party's push for influence inside foreign firms stirs fears*, Reuters, 24th August 2017, viewed 9th December 2020, <<https://www.reuters.com/article/us-china-congress-companies-idUSKCN1B40JU>>

65 Bland, Ben, et al, *China wields power with boycott diplomacy*, Financial Times, 4th May 2017, viewed 9th December 2020, <<https://www.ft.com/content/c7a2f668-2f4b-11e7-9555-23ef563ecf9a>>



to take a stance on developments on the ground.⁶⁶ For Chinese audiences the ‘right’ external communication through all traditional media and social media platforms, including company websites, is important.⁶⁷ For example, a company or organisation listing Taiwan or Hong Kong on its website in a way that could be interpreted as the regions being separate from Chinese territory is often enough to cause a public backlash in China.⁶⁸

- **Customer base:** The level of exposure can also be determined by whether a company is B2B or B2C. Consumers are a more volatile group of customers than businesses as, by definition, they are the stakeholders that form public opinion. Fashion companies that operate and sell in China, for example, can be highly exposed to shifts in public opinion, and face the risk of their brands being boycotted as a result of negative publicity.⁶⁹ B2B companies, like those in energy or chemicals, face less exposure as decisions made at the corporate level are less influenced by public opinion, comparatively speaking.

Expectations and likely scenarios

Human rights and supply chains

Companies can expect to face increased pressure from the European public and home governments until they can prove that their supply chains are not in any way ‘entangled’ with alleged human rights violations.

The call for supply chains to be moved out of Xinjiang is expected to continue. For producers of consumer goods, such as in the textile industry, the situation is particularly sensitive. It is plausible that certain brands could be boycotted regardless of whether the company is compliant with regulations or not. Companies may need to consider leaving production sites or suppliers in Xinjiang as a result of increased external pressure, in order to be completely sure that they are not implicated in any way. This pressure is even now being felt in the fashion industry,⁷⁰ with some brands having already announced that they will no longer source products from Xinjiang-based suppliers.⁷¹ The overall situation has put foreign companies between a rock and a hard place: if they stay, they risk facing a reputational backlash at home; if they leave, they risk damaging their position in the Chinese market.

Market access restrictions

The threat of economic coercion remains a concern for companies. Chinese authorities are already threatening to restrict market access for companies or products originating from Europe following geopolitical tensions as a result of decisions made regarding Huawei’s access to 5G public procurement in the region.⁷² It is highly unlikely that Europe will manage to completely stave off (threats of) economic coercion, such as the type that followed the recent diplomatic tensions between Australia and China.

Additionally, the risk that a company’s future access to the Chinese market may become conditional upon the political behaviour of its home country, as well as upon the behaviour of its employees, is likely to remain. China could, for example, exploit the vague definition of the phrase ‘national security’ in its new Export Control Law in order to take action against another country. For instance, measures could be taken towards regions that, in China’s eyes, abuse export controls and threaten its national security and interests, all without having to provide a detailed explanation as to what such a threat would entail.⁷³

66 Leali, Giorgio, *Unions and NGOs call on big brands to stop using Xinjiang forced labour*, *Politico*, 23rd July 2020, viewed 9th December 2020, <<https://www.politico.eu/article/unions-and-ngos-call-on-big-brands-to-stop-using-xinjiang-forced-labor/>>

67 *UBS economist reinstated after China ‘pig’ comments*, *BBC.com*, 1st October 2019, viewed 9th December 2020, <<https://www.bbc.com/news/business-49898296>>

68 Magramo, Kathleen, *Dior apologises after Taiwan excluded from map of China, sparking latest online backlash*, *South China Morning Post*, 17th October 2019, viewed 9th December 2020, <<https://www.scmp.com/economy/china-economy/article/3033331/dior-apologises-after-taiwan-excluded-map-china-sparking>>

69 Afanasieva, Dasha, *Fashion can bear the costs of virtue cotton*, *Reuters*, 27th August 2020, viewed 9th December 2020, <<https://www.reuters.com/article/us-britain-cotton-china-breakingviews-idUSKBN25L18Z>>

70 Milne, Amber, *Brands urged to stop sourcing from China’s Xinjiang over forced labour fears*, *Reuters*, 23rd July 2020, viewed 9th December, <<https://www.reuters.com/article/us-global-garment-china-xinjiang-trfn-idUSKCN24O0DR>>

71 Wilen, Anton, *H&M Says It’s Not Working With Any Garment Factories In Xinjiang*, *Bloomberg*, 9th September 2020, viewed 16th December 2020, <<https://www.bloomberg.com/news/articles/2020-09-09/h-m-says-it-s-not-working-with-any-garment-factories-in-xinjiang>>

72 Lin, Liza, et al, *China may retaliate against Nokia and Ericsson if EU countries move to ban Huawei*, *Wall Street Journal*, 20th July 2020, viewed, 3rd December 2020, <<https://www.wsj.com/articles/china-may-retaliate-against-nokia-and-ericsson-if-eu-countries-move-to-ban-huawei-11595250557>>

73 *China passes new law restricting sensitive exports*, *Associated Press*, 18th October 2020, viewed 24th November 2020, <<https://apnews.com/article/technology-beijing-global-trade-china-national-security-396e42dbf147c9b55863fb90099303cb>>

Implications and recommendations for European companies

It will become more and more important for companies to invest in due diligence and compliance teams in order to navigate potential issues in supply chains. External auditors that are trusted in Europe and the US might need to be employed to satisfy European stakeholders that audits are carried out transparently.

If tensions progress, there will be further deterioration in public opinion on China in Europe, which in turn will result in higher levels of scrutiny of companies invested in China. The push by the CCP to become more involved in the business operations of companies needs to be monitored as well. For companies that are headquartered in Europe, their business leaders in China should actively explain to HQ the business reality on the ground to bridge the knowledge gap and develop a fully-aligned China strategy.

- Begin thorough due diligence of your company's operations and those of your suppliers, and identify trusted third-party auditors to carry this out.
- Review all external communications, including those on corporate websites, to ensure both compliance with local regulations and that messaging is not likely to provoke a public backlash.
- Engage actively with stakeholders in Europe to explain the nuances and intricacies of doing business in China, and align with your HQ on the company's China strategy.

Implications and recommendations for governments

EU

The EU should be united in its approach to external political pressure and assist European companies in mitigating geopolitical tensions and crisis situations. Additionally, EU business is experiencing uncertainty due to the increasing securitisation of commercial flows through increased efforts to screen investment and the introduction of export control laws.

Following changes in legislation regarding supply chains and political pressure from European civil society, companies in China may struggle to provide the level of proof that is required for them to demonstrate that their supply chains are 'clean'.

- Support the development of an 'EU solidarity mechanism' to coordinate member states if EU actors/companies face political pressure.
- Run scenarios for geopolitical disruption/crises as joint exercises with business.
- Align with like-minded partners and establish common (multilateral) standards regarding investment screening and export controls to avoid being singled out for negative comment.
- Provide guidance so that companies are clear on the requirements from a compliance standpoint when new legislation is being implemented.
- Engage more with European business leaders in China to understand the challenges of doing business in China.

China

European businesses are committed to China as an investment destination and want to add value to the Chinese economy. However, public support in Europe is becoming more important for companies to be able to increase investments and grow business operations in China. Deepening EU-China dialogue and cooperation will be particularly important moving forward.

Companies added to the development of the economy of Xinjiang when they moved operations there many years ago. However, with Xinjiang now an increasingly politically sensitive topic in Europe, its companies will be less likely



to invest there due to growing external pressure to demonstrate to their home-country governments and the public at large that they are operating 'cleanly'.

- Engage more with stakeholders in the EU, like the European Parliament, multinational companies and industry associations, in order to stimulate honest dialogue and find constructive solutions to existing problems.
- Do not pressure companies to increase investments in Xinjiang, or introduce punitive measures for any company that chooses to withdraw investment from the province.
- Work with companies to facilitate trusted, third-party audits of their operations and supply chains.

Financial

Summary

China is currently accelerating reforms of its financial system in an effort to improve the efficiency of capital allocation. So far, this process has entailed a cautious opening up of its financial services sector to attract more foreign portfolio investment, thereby increasing China's integration into the global financial system. The Chinese market remains attractive for international financial institutions, and the opening that has taken place has created some new opportunities, like Goldman Sachs' acquisition of full ownership of its Mainland China securities business.⁷⁴

As a result of only being allowed into the Chinese market at a late stage, European financial players currently have a relatively small market share and play niche roles, meaning their exposure to decoupling is low. However, with China's integration into the global financial system still ongoing, this has the potential to change.

Currently, although Chinese companies may be increasingly cut off from capital markets through emerging delisting efforts in the US, the resulting diminished access to international capital will have a limited impact. China's government is already taking steps to secure access to international capital for its companies by strengthening domestic alternatives (most notably Hong Kong) and reducing dependency on international financial centres, especially in the US.

Among other reasons, these developments have added greater urgency to long-standing plans to internationalise the RMB, as without this taking place China would be extremely vulnerable if its access to the USD were to be restricted. Yet, without giving up control of the RMB, by relaxing currency controls for outbound flows or by free-floating it, full liberalisation is unlikely to happen.

Growing political tensions are expected to result in targeted sanctions on access to the USD and hence access to the US financial system. But these will mostly be limited to very specific companies or individuals connected to a certain area of dispute. However, some companies interviewed for this report have expressed concerns that the US could cut off all of China, or even just Hong Kong, from the USD by weaponising the currency and preventing financial institutions from offering their USD clearing services to Greater China-based clients through increased sanctions.⁷⁵ Given the USD's dominance in international trade, subjecting Chinese companies to more stringent US regulation could severely undermine international payment corridors that are part of the Society for Worldwide Interbank Financial Telecommunication (SWIFT) network.

Significant sanctions are unlikely, but not unprecedented. US and EU sanctions on places like Russia and Iran show that a major disruption of the geopolitical status quo can result in political and security matters taking precedence over economic considerations. But trade volume and related cross-border transactions between the world's largest

⁷⁴ Murdoch, Scott, *Goldman Sachs shifts to full ownership of China securities joint venture*, Reuters, 8th December 2020, viewed 14th December 2020, <<https://www.reuters.com/article/us-goldman-sachs-china-idUSKBN28I0F0>>

⁷⁵ "Clearing is the procedure by which financial trades settle – that is, the correct and timely transfer of funds to the seller and securities to the buyer.": Chen, James, *Clearing*, Investopedia, 9th April 2019, viewed 10th December 2020, <<https://www.investopedia.com/terms/c/clearing.asp>>

economic blocs are considerably higher than when the Russia and Iran sanctions were imposed. The implications of this ‘nuclear option’ would therefore send shockwaves throughout the global economy, affecting Chinese and foreign companies alike.

General outlook

Current and potential developments with regard to financial decoupling generally break down into issues related to either financial market integration or currencies.

Financial market integration

China’s state-led financial system, strictly controlled capital flows and the large role assigned to state-owned banks⁷⁶ reflect its preference for a managed economy. As such, foreign-owned financial service providers’ access to China’s financial system has remained extremely limited – they held less than two per cent market share in 2020, according to European Chamber members interviewed for this report. However, in recent years, China’s financial regulators have been turning to foreign competition in an attempt to improve the practices of domestic players, with 2018 seeing steps taken to dismantle some direct market access barriers.

- **Outlook for European financial institutions:** European Chamber members report that Chinese regulators have been increasing their efforts to open the market to foreign enterprises, for example by removing foreign ownership caps for financial institutions under the *Foreign Investment Negative List*.⁷⁷ While the market share of foreign companies will remain small, China’s huge domestic market still provides attractive opportunities. This can be seen in, for example, the increase in foreign ownership shares in financial services companies, including asset management and insurers.⁷⁸ However, due to its slow opening, China’s financial services industry will remain dominated by SOEs and Chinese private companies, with European financial service providers only able to play niche albeit—according to Chamber members—profitable roles. However, there are other aspects of decoupling that could make the position of foreign financial institutions in the Chinese market less viable, as discussed in the Digital Decoupling section of this report on page 57.
- **Outlook for portfolio investments:** Due to its impressive post-COVID-19 economic growth projections, higher yields and the strong initial public offering (IPO) market, paired with new investment channels, China was bound to attract more capital inflows. However, when combined with tight capital controls and the enormous corporate debt pile, these investments in Chinese securities become both lucrative and risky. The addition of Chinese stocks and bonds to major global stock indices (or sub-indices) like the MSCI and FTSE Russell will automatically increase the investment exposure of major European funds to the Chinese market.⁷⁹ But despite growing concerns about capital controls and the challenges associated with the repatriation of capital, foreign investors’ exposure will only gradually increase. The recent defaults on Chinese bonds are a sign that the Chinese market is maturing; however, there is a long way to go before China breaks completely with the implicit guarantees it has historically used to shield its companies.⁸⁰ Until these concerns are addressed, investments will most likely remain concentrated in relatively safe securities (e.g., those with high ratings).
- **Outlook for Chinese companies’ access to US capital:** In 2020, a number of Chinese companies delisted from American stock exchanges following the announcement from acting US Treasury Secretary Steven Mnuchin that companies from foreign countries have to comply with US accounting standards or else be delisted by the

76 Zenglein, Max & Karmfelt, Maximilian, *China’s caution about loosening cross-border capital flows*, MERICS, 19th June 2020, viewed 26th November 2020, <<https://merics.org/en/report/chinas-caution-about-loosening-cross-border-capital-flows>>

77 *European Chamber Banking and Securities Working Group Position Paper*, European Union Chamber of Commerce in China, 10th September 2020, <http://european-chamber.com/en/publications-archive/859/Banking_and_Securities_Working_Group_Position_Paper_2020_2021>

78 *China’s Finance World Opens Up to Foreigners*, Sort of, Bloomberg, 23rd January 2020, viewed 26th November 2020, <<https://www.bloomberg.com/news/articles/2020-01-22/china-s-finance-world-opens-up-to-foreigners-sort-of-quicktake>>

79 Ibid.

80 *China edges towards greater financial discipline*, Financial Times, 30th November 2020, viewed 2nd December 2020, <<https://www.ft.com/content/2b6442aa-3b17-458e-b038-98e4f0c59ac4>>



end of 2021.⁸¹ The bill was recently passed, but had not been signed into law at the time of writing.⁸² While not specifically targeting Chinese companies, it represents a *de facto* ban on Chinese companies from being listed on an American stock exchange, since the Chinese authorities will not allow Chinese auditors to be inspected by the US Public Companies Accounting Oversight Board.⁸³ This will boost China's long-standing efforts to encourage its companies to list on the Chinese Mainland or in Hong Kong instead of overseas.⁸⁴

Currency Access

China's strong position in international merchandise trade means that the country is highly dependent on unrestricted access to the USD. To address this reliance, China's regulators have aimed to internationalise the RMB for years, with limited success.

- **Outlook for the USD:** Regardless of the Chinese Government's desire to reduce reliance on the USD, it will remain the most important currency for cross-border transactions for the foreseeable future.
- **Outlook for the RMB:** Despite the size of China's economy and the RMB being upgraded to an international reserve currency by the International Monetary Fund in 2015, the share of RMB payments in cross-border transactions was just 1.66 per cent in October 2020.⁸⁵ China's exchange rate regime has undergone a gradual transition since 2005, but remains under the strict control of Chinese regulators. This means the currency is not fully convertible, limiting its attractiveness in international transactions. The strict controls stem from the government's desire to closely manage economic development while limiting any risk of rapid capital outflows.⁸⁶ As a result, the limited international acceptance of the RMB for settlement of cross-border transactions means that companies still prefer to use USD even when exporting goods from China to the Asia Pacific region. Even China's flagship BRI projects are primarily being funded in USD.⁸⁷ In order to stimulate the use of the RMB in cross-border payments, and to prepare for potential additional US sanctions that would limit access to the US financial system, in July 2020, the Bank of China recommended that companies in Greater China use the RMB-based Cross-border Interbank Payment System (CIPS) for processing international payments instead of the SWIFT network.⁸⁸ This advice seems somewhat misguided given that CIPS is a clearing and settlement services system for cross-border RMB payments and trade, while SWIFT provides a secure and standardised messaging network for communication on financial transactions in multiple currencies; the two co-exist and complement each other, instead of competing.⁸⁹ China's desire to increase the use of the RMB in international payments does not depend so much on the system that is used, but more on the development of a viable alternative to the USD. At this moment, the RMB does not present such an alternative.

Impact on, and exposure of, European companies

Looking at the status quo, the impact of decoupling on European financial service providers or investors is currently not significant. European financial service providers in China are expected to gain more access to the Chinese market

81 Wu, Zheyu, *Expert: Washington's threat to delist Chinese firms may give competitive boost to non-US exchanges*, CGTN.com, 11th August 2020, viewed 26th August 2020, <[https://news.cgtn.com/news/2020-08-11/U-S-threat-to-delist-Chinese-firms-may-boost-non-U-S-exchanges-SScamD4uMo/index.html#:~:text=U.S.%20Treasury%20Secretary%20Steven%20Mnuchin,Commission%20\(SEC\)%20last%20week](https://news.cgtn.com/news/2020-08-11/U-S-threat-to-delist-Chinese-firms-may-boost-non-U-S-exchanges-SScamD4uMo/index.html#:~:text=U.S.%20Treasury%20Secretary%20Steven%20Mnuchin,Commission%20(SEC)%20last%20week)>

82 *US passes bill that could delist Chinese companies from stock markets*, DW.com, 3rd December 2020, viewed 4th December 2020, <<https://www.dw.com/en/us-passes-bill-that-could-delist-chinese-companies-from-stock-markets/a-55805624>>

83 Patterson, Stewart, *US-China economic decoupling: how far have we come and how far could decoupling go*, Hinrich Foundation, September 2020, viewed 26th November 2020, <https://www.hinrichfoundation.com/media/qnjbsdob/hinrich-foundation_how-far-would-us-china-decoupling-go_stewart-paterson_septemeber-2020_final.pdf>

84 Cheng, Evelyn, *Chinese companies are leading the global IPO rush amid a 'flight from uncertainty'*, CNBC, 27th October 2020, viewed 29th November 2020, <<https://www.cnbc.com/2020/10/27/chinese-companies-are-leading-the-global-ipo-rush-amid-a-flight-from-uncertainty.html>>

85 *RMB tracker November 2020*, SWIFT, 19th November 2020, viewed 4th December 2020, <<https://www.swift.com/our-solutions/compliance-and-shared-services/business-intelligence/remnmbi/rmb-tracker/rmb-tracker-document-centre>>

86 Zenglein, Max & Karmfelt, Maximilian, *China's caution about loosening cross-border capital flows*, MERICS, 19th June 2020, viewed 26th November 2020, <<https://merics.org/en/report/chinas-caution-about-loosening-cross-border-capital-flows>>; Lockett, Hudson, *Renminbi's rise stokes expectations Beijing will move to cool rally*, Financial Times, 21st October 2020, viewed 26th November 2020, <<https://www.ft.com/content/97dff9cd-a8b3-45d1-b6e8-8d98450dc37e>>

87 Smith, Colby, *The Belt and Road's dollar problem*, Financial Times, 18th December 2018, viewed 26th November 2020, <<https://ftalphaville.ft.com/2018/12/18/1545130791000/The-Belt-and-Road-s-dollar-problem/>>

88 *Chinese banks urged to switch away from SWIFT as US sanctions loom*, Reuters, 29th July 2020, viewed 26th November 2020, <<https://www.reuters.com/article/us-china-banks-usa-sanctions/chinese-banks-urged-to-switch-away-from-swift-as-u-s-sanctions-loom-idUSKCN24U0SN>>

89 *China's onshore yuan clearing and settlement system CIPS*, Reuters, 30th July 2020, viewed 26th November 2020, <<https://www.reuters.com/article/china-banks-clearing-idUSL3N2F115E>>

in the coming years. Nevertheless, the opening will still primarily be of benefit to niche players.

The tight capital controls in China and lack of an internationalised currency are still inconvenient and a source of concern for the European business community in cases where they would like to increase the use of the RMB in cross-border transactions. Nevertheless, in many ways, European companies in China have grown accustomed to this norm and are less likely to be exposed to related risks.

Expectations and likely scenarios

Further US (and potential EU) financial sanctions will be targeted

Securitisation of economic issues continues to become more prevalent in the US. In November 2019, the US banned on national security grounds American investment in companies that had links to China's military.⁹⁰ In addition, pressure from Washington has resulted in US retirement funds halting investment in Chinese stocks, in an effort to limit exposure to the China market.⁹¹ This trend is expected to continue. However, due to the interdependence between the two economies, the stakes of substantial additional measures to restrict China's access to the US capital market are high. It is therefore expected that any further sanctions will be targeted at specific individuals and companies.

Recently, the European Council adopted a regulation concerning potential restrictive measures against serious human rights violations and abuses.⁹² While not mentioning specific countries or regions, the regulation gives the Council the possibility to freeze and restrict access to funds and economic resources for "natural or legal persons, entities or bodies responsible for, providing support to or otherwise involved in serious human rights violations or abuses, as well as those associated with the natural and legal persons, entities and bodies covered".⁹³ This could be used to target individuals or bodies with operations in Xinjiang, if the EU determines that human rights abuses are taking place there.

European companies remain on the sidelines

There might be some disruption of business for investors and banks resulting from the current complex political environment and existing and potential new US sanctions. However, absent of a major escalation, such as increased US sanctions or other financial restrictions that would potentially complicate prospective business opportunities, the impact should be quite limited. Simply put, there is not much to be lost in the first place for European financial institutions in China. Nevertheless, the likely increase in compliance requirements for European financial institutions will be a further drag on their China business.

Acceleration of China's efforts to integrate into the international financial system

While China's ongoing reforms of its financial system and its desire to reduce dependency on the USD are not related to current tensions with the US *per se*, decoupling is likely to accelerate both actions. This could result in the opening of new RMB-payment corridors and potentially a cautious loosening of capital controls. Although capital controls are a key element for the Chinese Government to manage its economy and are unlikely to be completely abandoned any time soon, increased financial sanctions could see this happening faster than would have otherwise been the case.

Full internationalisation of the RMB will remain unlikely as long as China's regulators maintain their current restrictions. Broad financial sector reforms would be needed to create incentives for companies outside of China

⁹⁰ *China's finance world opens up to foreigners, sort of, Bloomberg*, 23rd January 2020, viewed 26th November 2020, <<https://www.bloomberg.com/news/articles/2020-01-22/china-s-finance-world-opens-up-to-foreigners-sort-of-quicktake>>

⁹¹ Cho, Yusho, *US pension fund freeze on investment chills China stock outlook, Nikkei Asia*, 15th May 2020, viewed 26th November 2020, <<https://asia.nikkei.com/Business/Markets/US-pension-fund-freeze-on-investment-chills-China-stock-outlook>>

⁹² *Council Regulation 2020/1998 of 7 December 2020 concerning restrictive measures against serious human rights violations and abuses*, European Council, 2020, viewed 7th December 2020, <<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.LI.2020.410.01.0001.01.ENG&toc=OJ%3AL%3A2020%3A410%3ATOC>>

⁹³ *Ibid.*



to use it, in addition to a relaxation of capital controls and allowing more convertibility of the RMB.⁹⁴ According to European Chamber members interviewed for this report, there is a limited possibility that the RMB will be widely used in international payments within the next five to ten years.

Escalation not likely, but not unprecedented

US attempts to cut off China's access to the USD would likely be limited in scope. Experts interviewed for this report suggest that the US could in theory institute restrictions on its own banks to cease all transactions in USD with Chinese institutions and companies. However, doing so would not completely cut China off from the USD – the global reserve currency is plentiful and omnipresent. Yet, if this appropriately-named 'nuclear option' were to be dropped, it would essentially destroy the ability for USD transactions to proceed between China and the rest of the world, and could in fact disrupt *any* USD-based settlement, spreading economic fallout globally.

A major political event of global proportions related to China could spark outrage in the US and the EU, resulting in significant sanctions. Although it would necessitate a highly unlikely break from the status quo to take place, it would not be unprecedented. The US and even the EU have adopted far-reaching sanction regimes that have also impacted their own economies in two different instances in the last two decades: following Iran's nuclear proliferation activities and following Russia's annexation of the Crimean Peninsula.⁹⁵

EU sanctions against Iran (nuclear proliferation) and Russia (annexation of Crimea)

Iran: Restrictions on trade in several goods, measures in the transportation sector, individual travel restrictions and asset freezes, and restrictions in the financial sector (such as freezing the assets of several Iranian banks).⁹⁶

Russia: Limited access for certain Russian banks and companies to the EU primary and secondary capital markets.⁹⁷ Russia and Ukraine have been hit hard by the sanctions, with Ukraine entering a recession in 2015, and Russia suffering huge economic losses.⁹⁸

Implications and recommendations for European companies

Companies will need to be able to navigate sudden changes in policy and the possible introduction of sanctions. While not expected, if imposed, substantial financial sanctions can still be implemented overnight. European financial institutions in China need to continuously develop their due diligence efforts when deciding whether to enter into a partnership with, or provide financing to, a Chinese company.

As a variety of issues (see the Political section on page 20) come to a head, companies will need to increase their environmental, social and corporate governance (ESG) monitoring to account for political risk.

- Put contingency plans in place to shift cash balances to places other than Hong Kong, for example, Singapore or somewhere in Europe.
- Increase compliance and due diligence efforts in order to anticipate changes to legislation and increased political risk.

94 Lai, Edwin, June 2015, *Renminbi internationalisation: the prospects of china's yuan as the next global currency*, HKUST IEMS Thought Leadership Briefs, No. 9, Hong Kong University of Science and Technology, viewed 26th November 2020, <<https://iems.ust.hk/publications/thought-leadership-briefs/renminbi-internationalization-the-prospects-of-chinas-yuan-as-the-next-global-currency>>

95 Ibid.

96 *EU restrictive measures against Iran*, European Council, 9th April 2019, viewed 26th November 2020, <<https://www.consilium.europa.eu/en/policies/sanctions/iran/>>

97 *EU restrictive measures in response to the crisis in Ukraine*, European Council, 5th October 2020, viewed 26th November 2020, <<https://www.consilium.europa.eu/en/policies/sanctions/ukraine-crisis/#>>

98 Havlik, Peter, *EU-Russia sanctions exchange has had important economic and political consequences*, Vienna Institute for International Economic Studies, 20th February 2019, viewed 26th November 2020, <<https://wiiw.ac.at/eu-russia-sanctions-exchange-has-had-important-economic-and-political-consequences-n-365.html>>

Implications and recommendations for governments

EU

Overall, trade and investment relations between the EU and China are important. However, there remain many investment barriers in China, especially for financial service providers. The EU should continue to work towards achieving a level playing field so that European financial companies can enjoy the same rights in China as Chinese companies enjoy in Europe.

In light of US-China tensions, governments play a high-risk game should they intervene politically in the financial services industry: the interdependency of the markets makes such a move ill-advised if significant economic fallout is to be avoided.

- Conclude and enforce a meaningful CAI.

China

Further integration of China into the global financial system is important for global growth and development. For European business, China remains an important trade and investment destination. However, if companies want to engage in projects outside of China, the RMB often does not provide a good alternative to the USD in cross-border payments.

- Further integrate into the international financial system.
- Develop a clear pathway and timelines for fully internationalising the RMB and liberalising the capital account.



Trade Decoupling: Supply chains and critical inputs

The COVID-19 pandemic has provided a preview of the kind of instability that can come from supply chain disruptions and losing access to critical inputs, albeit caused by a non-political development. When China first went into lockdown in early 2020, so too did the suppliers of the 70 per cent of imported active pharmaceutical ingredients (APIs) that are essential to India's pharmaceutical industry, which produces much of the world's generic drugs.⁹⁹ Near the end of 2020, European automotive manufacturers noted that chip manufacturers in Europe and the US, which were operating limited production due to the pandemic, were struggling to produce enough top-end inputs to service automobile production in China where demand had recovered.¹⁰⁰ While neither of these examples can compare to the kinds of difficulties a company would face if suddenly and completely cut off from its critical inputs through government actions, they still showcase how disruptive losing even partial access can be.

Trade in recent years has also been hampered by politically-driven efforts, most intensely between the US and China. The US response to China's enduring market access restrictions was to apply tariffs and export control measures meant to divest supply chains out of China and undercut Chinese technological development, to which China responded with its own corresponding tariffs and the strengthening of its own export control framework. The following two sections look at the impacts of these moves.

The supply chains section looks at the general impacts of the trade war, but also takes into account natural market developments and disruptions like the COVID-19 pandemic.

The critical inputs section focusses on the technologies and components crucial to operations for which alternative sources cannot be easily found. While many products will require some inputs that are produced only by a single producer, this section looks mainly at semiconductors, software and rare earth metals.

Supply chains

Summary

Supply chains in and out of China have continued to shift over recent years due to long-standing market-driven forces. The general trend is unsurprising, with goods that demand cheap labour—traditionally made by Chinese companies—now being divested out of China to other markets. Meanwhile, European companies that are chiefly 'in China, for China' have largely worked to onshore and localise their supply chains.

Politically-driven efforts aiming to push companies to divest from China emerged in 2018 with the US-China trade war. As the tit-for-tat increases in tariff rates and the value of goods affected rose, European companies in China found themselves taking hits from both sides. The unexpected emergence of the COVID-19 pandemic magnified the instability of global supply chains, severely disrupting many and forcing companies to rethink supply chain strategies. At least for some European companies in China, these disruptions have been largely manageable despite the pain inflicted. In response to the trade war, most MNCs were able to adjust supply chains at an acceptable cost and weathered the storm of the pandemic well.¹⁰¹ However, SMEs were disproportionately impacted by both crises, as they are more reliant on cross-border suppliers and have fewer resources to manage challenges of this magnitude.

99 Chatterjee, Patralekha, *Indian pharma threatened by COVID-19 shutdown*, *The Lancet*, 29th February 2020, viewed 9th December 2020, <[https://www.thelancet.com/journals/lancet/article/PIIS0140-6736\(20\)30459-1/fulltext](https://www.thelancet.com/journals/lancet/article/PIIS0140-6736(20)30459-1/fulltext)>

100 Sun, Yilei, Goh, Brenda, & Jan Schwartz, *Chip shortages could slow automotive production, VW and suppliers say*, *Reuters*, 4th December 2020, viewed 9th December 2020, <<https://www.reuters.com/article/volkswagen-china-production/chip-shortages-could-slow-automotive-production-vw-and-suppliers-say-idUKKBN28E11N>>

101 *European Business in China Position Paper 2020/2021*, European Union Chamber of Commerce in China, 10th September 2020, p. 9, <<https://www.eurochamber.com.cn/en/publications-position-paper>>

European companies are generally looking to maximise onshoring to secure their supplies. From a global perspective, companies are considering further bolstering the resilience of their supply chains intended for other markets. However, exactly how these shifts will proceed is unknown, with many companies having already stretched their resources managing the pandemic and the resulting economic upheaval. Furthermore, there remains the potential—however unlikely—for the 25 per cent tariff placed on most goods moved between the US and China at the peak of the conflict to be increased, and for more fronts on the trade war to be opened.

How does your company expect supply chain decoupling (e.g., trade tariffs, onshoring/offshoring of supply chains) to impact your business?	
Significant negative impact	23%
Somewhat negative impact	45%
No impact	23%
Somewhat or significant positive impact	6%
Don't know	3%

Source: European Chamber survey on decoupling conducted in September 2020

General outlook

Market-driven supply chain shifts

European companies largely remain 'in China, for China'; they have spent the last decade building up their supply chains inside the market and aim to continue this strategy.¹⁰² This keeps costs and administrative challenges low, while also taking advantage of China's world-class industrial clusters and high-quality talent. Many of the MNCs interviewed for this report noted that their supplies for the Chinese market are up to 80 to 90 per cent onshored already. This allowed them to fare relatively well when the COVID-19 pandemic emerged.

European SMEs in China are more likely to rely on suppliers and customers overseas. They are also more likely to be a local supplier to just a single customer in China, making them joined at the hip to the successes and struggles of their partner. The pandemic has thus hit them harder than their MNC counterparts, especially as the now rolling lockdowns in Europe and North America have repeatedly affected supplies and customer demand.¹⁰³

Politically-driven decoupling

Initiated in 2018, the US-China trade war became the most explicit expression of political will to force economic decoupling. As the number of affected goods and the rate at which they were tariffed rose, European companies initially expressed deep concern. However, as the reality of the conflict settled in, businesses were often able to adapt so as to dodge the tariffs altogether, or at least mitigate their impact. In many ways, the conflict demonstrated the limitations of the Trump Administration's strategy to apply bilateral tariffs in a global economy.

However, this is not a story unique to the US-China relationship. The COVID-19 pandemic has led political leaders around the world to raise concerns about possible reliance on China for critical medical equipment and pharmaceuticals.¹⁰⁴ Meanwhile, the Japanese Government established a USD 2.35 billion fund to help finance

¹⁰² Houtari, Mikko, Weidenfeld, Jan, and Wessling, Claudia, (Eds) *Towards a "principles first approach" in Europe's China policy*, MERICS, September 2020, p.44, viewed 15th December 2020, <https://merics.org/sites/default/files/2020-09/200910_MPOC_EU-China_final_0.pdf>

¹⁰³ *COVID-19 severely impacting business: trade associations call for proportionate measures to get real economy back on track*, The European Union Chamber of Commerce in China, 27th February 2020, viewed 15th December 2020, <http://www.europeanchamber.com.cn/en/press-releases/3161/covid_19_severely_impacting_business_trade_associations_call_for_proportionate_measures_to_get_real_economy_back_on_track>

¹⁰⁴ Burger, Ludwig, *Europe's scramble for face masks prompts longer term rethink*, Reuters, 16th April 2020, viewed 15th December 2020, <<https://www.reuters.com/article/us-health-coronavirus-europe-masks/europes-scramble-for-face-masks-prompts-longer-term-rethink-idUSKCN21Y131>>



Japanese companies to move capacity out of China, not only into Japan but to nearby markets as well.¹⁰⁵ India has also started discussing how to address what it views as a reliance on China as a source for APIs that feed into India's massive pharmaceutical industry.¹⁰⁶ This situation has the potential to become far more complex, and even the possibility of a joint Japan, India and Australia strategy has emerged with their talks on a trilateral 'Supply Chain Resilience Initiative' that aims to reduce dependency on China.¹⁰⁷

Current impacts

Market-driven supply chain shifts

The long-standing onshoring strategy of most European companies operating in China paid off when the COVID-19 pandemic struck.¹⁰⁸ While highly localised supply chains made China operations more susceptible to the devastation of the lockdown in February and March 2020, they also allowed things to largely get back online as China came out of that initial wave. When European companies began to take their operations into lockdown in the EU and the US, they found critically-needed revenue streams coming from China.

Companies have since been forced to consider the position of the small share of their supply chains that they maintain in the EU or the US. Several European automotive manufacturers, for example, keep the production of certain high-tech components restricted to these markets. This is due either to quality issues, concerns about intellectual property (IP) leakage, or both. When the pandemic spread beyond China's borders, the supply chains of European automotive manufacturers went down worldwide. The bulk of their supply chains came back online when China returned to work; however, as lockdowns in the EU and the US had taken down the flow of essential components, original equipment manufacturers in China found their operations hamstrung due to the fact they were missing some crucial parts. As one interviewee quipped, "who is going to buy a car without an engine, or a gearbox, or the controls that run the brakes?" While these companies were eventually able to get special lockdown exemptions for these specific inputs to maintain their only major source of revenue at the time (which came from China), they are now looking at how to mitigate future potential disruptions.

Politically-driven decoupling

The 'in China, for China' localisation strategy proved useful once the US-China trade war began, even in areas where companies were negatively impacted. Many reported that they used their global positions to service the US or China in lieu of previous links that crossed the 'border'. This obviously was not ideal as companies' previous supply chains had been optimised for efficiency. But while costs increased, the additional expense was not nearly as damaging as paying the 25 per cent tariffs.

One chemical company that supplies a wide range of furniture producers provides a good example. Its customers that produce for global brands were able to shift around their supply chains to offset the high number of US-bound exports. One manufacturer had operations in Japan that were mainly for supplying the Japan/South Korea/Taiwan markets, while its China-based factories focussed heavily on exports to the US. The manufacturer simply had its Japan-based production export finished goods to the US and its China operations supply the Japan/South Korea/Taiwan markets. However, smaller producers in China found themselves seriously hit by the tariffs, and either switched focus to the local or non-US markets, or looked at investment into unaffected countries.

In cases where companies were directly impacted by the tariffs on either side of the Pacific, it was due to two main

105 Japan sets aside JPY 243.5 billion to help firms shift production out of China, *The Japan Times*, 9th April 2020, viewed 15th December 2020, <<https://www.japantimes.co.jp/news/2020/04/09/business/japan-sets-aside-%C2%A5243-5-billion-help-firms-shift-production-china/>>

106 Thacker, Teena, *India must manufacture more APIs locally, depend less on China: Experts*, *The Economic Times*, 18th June 2020, viewed 15th December 2020, <<https://economictimes.indiatimes.com/industry/healthcare/biotech/pharmaceuticals/india-must-manufacture-more-apis-locally-depend-less-on-china-experts/articleshow/76436167.cms?from=mdr>>

107 Samanta, Pranab Dhal, *India-Japan-Australia supply chain in the works to counter China*, *The Economic Times*, 19th August 2020, viewed 15th December 2020, <<https://economictimes.indiatimes.com/news/economy/foreign-trade/india-japan-australia-supply-chain-in-the-works-to-counter-china/articleshow/77624852.cms>>

108 Zhang, Zoey, *EU Businesses in China Look to Mitigate Trade War Impact: EuCham 2019 Survey*, *China Briefing*, 23rd October 2019, viewed 15th December 2020, <<https://www.china-briefing.com/news/eu-businesses-china-look-mitigate-trade-war-impact-eucham-2019-survey/>>

factors: their location in the supply chain and the elasticity of the affected product (see Table 1).¹⁰⁹

Table 1: A matter of elasticity

	Highly elastic goods	Non-elastic goods
Upstream position	Bad – customers can change to a supplier in an unaffected market, or pressure you to cut into margins to maintain market share.	Good – customers cannot change suppliers as there are no alternatives, so you can maintain your price and the customer must accept the additional tariff costs.
Downstream position	Good – you can switch to an alternative supplier or leverage your position to pressure your current supplier to cut into their margins to mitigate tariff costs and maintain market share.	Bad – you cannot change suppliers as there are no alternatives, and must accept the additional tariff costs.

Medical device producers demonstrate this dynamic quite clearly. High-volume devices like syringes, pacemakers or thermometers are produced globally in such abundance that a variety of suppliers across diverse sources exist for each input. A company assembling them in China could therefore find alternatives to a regular supplier from the US, meaning that the US-based supplier must either give up those sales or drop prices to compensate for the tariffs. On the other hand, low-volume medical devices, like magnetic resonance imaging (MRI) machines, often rely on highly specific inputs for which alternatives cannot easily be found. A company assembling MRI machines in China would therefore be more likely to have to accept tariff costs if importing inputs from the US.

However, this scenario has the potential to change over time. Companies caught in the ‘wrong’ position, which are forced to accept or offset the cost of tariffs to maintain market share, may be willing to put up with this situation for a limited period, but are unlikely to do so in the long-run.

Level of exposure of European companies

Market-driven supply chain shifts

Having already heavily onshored, the bulk of supply chains for European companies’ China operations are not directly at risk, and interviewed companies did not indicate any major shift in their China strategy. However, companies that purchase from or sell to Chinese companies that rely on cheap labour are more exposed to partners that are steadily shifting operations overseas. Several chemical and refining companies, as well as machinery producers, said their global strategy included increasing investment into India and Southeast Asia to court Chinese companies moving there. That being said, this is not happening at the expense of European investment in China, where the same companies indicated no plans to divest. Several companies expressed enthusiasm for the recently finalised Regional Comprehensive Economic Partnership (RCEP), which they believe could ease many bottlenecks through the creation of a regional cross-border supply chain.

Politically-driven decoupling

European SMEs remain the hardest hit by disruptions like the trade war, as they often produce highly-specialised goods that require specific inputs that may not be possible to source elsewhere, or at least not without accepting higher costs, lower quality and/or reduced compatibility.¹¹⁰ European MNCs, on the other hand, see far less direct exposure from the measures taken so far. The degree of exposure will also depend heavily on the elasticity of the supplies in questions, as well as the position of the company in the supply chain.

¹⁰⁹ The higher the elasticity of a product, the more alternative sources it has. Low or non-elastic products have fewer, or perhaps only one, alternative source.

¹¹⁰ *Futility of applying bilateral tariffs in a global economy increasingly apparent, as large firms side-step intended impact and small firms endure steady beating*, The European Union Chamber of Commerce in China, 9th December 2019, viewed 15th December 2020, <[https://static.europeanchamber.com.cn/upload/medianews/attachments/European_Chamber_September_Trade_War_Survey\[27\].pdf](https://static.europeanchamber.com.cn/upload/medianews/attachments/European_Chamber_September_Trade_War_Survey[27].pdf)>



Nevertheless, all companies should keep in mind that, while the risk looks lower under a Biden Administration, there are far more tools that could potentially be brought to bear in a continued trade conflict. First, tariffs have no upper limit, and the 25 per cent rates imposed bilaterally could in theory be raised so high as to essentially smother trade of specific goods. Second, quotas, export controls, embargos, abuse of customs procedures, consumer boycotts and state direction to companies to cease buying/selling certain goods are all potential risks moving forward.

Furthermore, European companies should look beyond just the US-China relationship. While generally limited to certain goods, political/diplomatic conflict between China and other countries has often resulted in the weaponisation of trade. Japan,¹¹¹ South Korea,¹¹² Norway,¹¹³ the Philippines,¹¹⁴ Canada¹¹⁵ and Australia¹¹⁶ have all experienced this to one degree or another. While European companies were not as exposed in these cases as they have been under the US-China trade war, they still serve as reminders that disruptions can take place anywhere.

Expectations and likely scenarios

Market-driven supply chain shifts

As China continues to climb the value chain, it stands to reason that low-cost manufacturing will continue to leave the market for developing economies – essentially following the same model of the four Asian Tigers.¹¹⁷ European companies can expect that supply chains that have been largely complete within China will see links that rely on cheap labour moving into nearby markets like South and Southeast Asia. The success or failure of the EU-China CAI would also have a significant impact on supply chain strategies. A finalised deal could lead to even further onshoring as a result of boosted investor confidence, especially if the issue of forced technology transfers is dealt with and the playing field is levelled to allow foreign companies to compete fairly with China's national champions.

Politically-driven decoupling

Although President-elect Biden has been clear in his opposition to broadly-applied tariffs, it looks likely he will maintain them, at least in the short term, while he attempts to build a more coherent China strategy with allies in Europe and Asia.^{118&119} However, European companies in China should expect that a Biden Administration will remain overall 'tough on China'.¹²⁰ In lieu of moderate tariffs on all imports, more surgical applications of a range of trade tools are possible. Additionally, as the US secures more allies in this conflict, companies may feel more than just bilateral disruptions moving forward, though likely only in the areas where consensus could be found among the relevant players.¹²¹

While China may not be able apply the same kind of technological chokehold that the US can on exports like semiconductors and other critical inputs, it does have the power to retaliate asymmetrically through its strong position in supply chains of a wide range of industrial and consumer goods. China's leadership has hinted at this with its

111 Bradsher, Keith, *Amid Tension, China Blocks Vital Exports to Japan*, *The New York Times*, 22nd September 2010, viewed 15th December 2020, <<https://www.nytimes.com/2010/09/23/business/global/23rare.html>>

112 Chang, Gordon G., *China Trying to Crush South Korea's Economy*, *Forbes*, 5th March 2017, viewed 15th December 2020, <<https://www.forbes.com/sites/gordonchang/2017/03/05/china-trying-to-crush-south-koreas-economy/?sh=ae49511349c1>>

113 Gibbs, Walter, and Fouche, Gwladys, *China steps up retaliation against Norway for Nobel*, *Reuters*, 12th October 2010, viewed 14th December 2020, <<https://www.reuters.com/article/us-nobel-peace-china/china-steps-up-retaliation-against-norway-for-nobel-idUSTRE6971XY20101012>>

114 West, Keshia, *Banana crisis blamed on Philippines-China dispute*, *Australia Network News*, 29th June 2012, viewed 15th December 2020, <<https://www.abc.net.au/news/2012-06-29/an-banana-exporters-caught-in-philippines-china-dispute/4100422>>

115 Blair, Jennifer, *The Year that Was: China punishes Prairie farmers*, *Alberta Farmer Express*, 6th January 2020, viewed 15th December 2020, <<https://www.albertafarmexpress.ca/news/the-year-that-was-china-punishes-prairie-farmers/>>

116 *China Turns to Lobsters, Wine and Coal to 'Punish' Australia*, *Bloomberg*, 3rd November 2020, viewed 15th December 2020, <<https://www.bloomberg.com/news/articles/2020-11-03/china-turns-to-lobsters-wine-and-coal-to-punish-australia>>

117 The economies of Hong Kong, Singapore, South Korea and Taiwan, all of which underwent rapid industrialisation from the 1960s to the 1990s, maintaining high GDP growth rates.

118 Lawder, David & Hunnicutt, Trevor, *Pulled in many directions, Biden may keep Trump's China tariffs in place*, *Reuters*, 8th September 2020, viewed 15th December 2020, <<https://www.reuters.com/article/us-usa-election-biden-trade-analysis/pulled-in-many-directions-biden-may-keep-trumps-china-tariffs-in-place-idUSKBN25Z1VH>>

119 *Biden Offers Transatlantic Embrace to EU's Already Open Arms*, *Bloomberg*, 2nd December 2020, viewed 3rd December 2020, <<https://www.bloomberg.com/news/articles/2020-12-02/biden-tells-nyt-he-won-t-quickly-remove-china-phase-one-tariffs>>

120 Cheng, Evelyn, *US-China trade tensions won't be going away under Biden's administration*, *Bloomberg*, 9th November 2020, viewed 16th December 2020, <<https://www.cnbc.com/2020/11/09/us-china-trade-tensions-wont-be-going-away-under-bidens-administration.html>>

121 Spetalnick, Matt & Hunnicutt, Trevor, *Exclusive: Biden, if elected, would consult allies on future of US tariffs on China – advisers*, *Reuters*, 29th October 2020, viewed 15th December 2020, <<https://www.reuters.com/article/usa-election-biden-china-exclusive/exclusive-biden-if-elected-would-consult-allies-on-future-of-u-s-tariffs-on-china-advisers-idUSKBN27E09F>>

express goal of not just developing self-reliance, but also striving to take dominant positions in critical sectors for possible leverage.¹²² China has already shown a willingness to leverage market access as a diplomatic tool, and with new export control regimes, as well as extralegal means like giving orders to its national champions and SOEs,¹²³ it is not difficult to see how it could also leverage its export position.¹²⁴

Implications and recommendations for European companies

As a natural development, European companies should expect some of their suppliers and customers to move out of China as its economy grows.¹²⁵ Monitoring such shifts and preparing for their logistical and administrative ramifications is advised. European companies will also want to examine the resilience of their supply chains to better manage future disruptions like those felt during the pandemic.

European companies should increase scrutiny of their own supply chains to evaluate the potential risks of a wide range of trade measures in addition to tariffs. While US-China trade ties should be the main focus, companies would be wise to also look elsewhere. For example, while developments like the RCEP are likely to facilitate natural shifts of supply chains to Southeast Asia, companies should keep abreast of the growing risk of political and diplomatic tensions between China and the countries signed onto the RCEP, most of which have either historical or ongoing conflicts.

- Strengthen supply chain monitoring up- and downstream both to identify suppliers and customers relocating to markets with lower labour costs, and to avoid further US-China trade war disruptions.
- Prepare for possible changes to logistics, including having to import/export parts or goods more frequently due to supply chain shifts out of China.
- Evaluate exposure to further trade-war-related measures like higher tariffs, import and export quotas and other restrictions, with a focus on finding flexibility in supply chains to manage potential escalation.

Implications and recommendations for governments

As supply chains for goods produced with low-cost labour gradually shift to other countries, China needs to prepare to lose some of the links in its industrial clusters that both Chinese and foreign companies find so attractive and have come to rely on. Compensating for this loss will require a streamlining of customs procedures to allow for these goods to be imported into China in the most efficient way possible.

The US and China should better evaluate the impacts of the tariffs so far applied in the trade war. The total volume of trade between the two economies did not change significantly, and, if anything, increased.¹²⁶ In the meantime, the heaviest costs were paid by SMEs on both sides of the Pacific, including the many non-Chinese/American companies doing business in each market.

China

- Facilitate the natural moving of low-cost, labour-intensive production out of China and redouble customs reform efforts.

122 President Xi Jinping: *Industrial and supply chains cannot be dropped at critical moments*, *Qiushi*, 3rd November 2020, viewed 9th December 2020, <http://www.qstheory.cn/zhuanku/2020-11/03/c_1126690768.htm>

123 *China orders state traders to stop buying American farm goods, threatening phase one trade deal*, *South China Morning Post*, 1st June 2020, 15th December 2020, <<https://www.scmp.com/economy/china-economy/article/3087021/china-orders-state-traders-stop-buying-american-farm-goods>>

124 See the Critical Inputs section on page 38

125 Ghosh, Prince, *The Exodus Of Chinese Manufacturing: Shutting Down 'The World's Factory'*, *Forbes*, 18th September 2020, viewed 15th December 2020, <<https://www.forbes.com/sites/princeghosh/2020/09/18/the-exodus-of-chinese-manufacturing-shutting-down-the-worlds-factory/?sh=3f21e252c2f2>>

126 Disis, Jill, *Trump promised to win the trade war with China. He failed*, *CNN*, 25th October, 2020, viewed 22nd December, 2020, <<https://edition.cnn.com/2020/10/24/economy/us-china-trade-war-intl-hnk/index.html>>



Multilaterally

- Recognise the futility of bilateral tariffs in a globalised economy, the costs of which are chiefly borne by SMEs and end-customers.

Critical inputs

Summary

Most reporting and discussions on US-China decoupling, particularly so-called technology decoupling, cite the semiconductor industry as a key battleground. The product of highly globalised and specialised value chains, semiconductors encapsulate the importance of critical inputs and the degree of disruption that decoupling can have on businesses around the world.

Not only are semiconductors themselves essential components across various industries, but their production process also relies on the availability of critical materials, manufacturing equipment and design software.¹²⁷ With few countries and companies in possession of the expertise to produce advanced chips, disruptions to their supply have become 'choke points' for companies, and countries more broadly. US attempts to exploit China's semiconductor choke points and Beijing's use of aggressive industrial policy to replace foreign semiconductors and equipment with domestically-produced alternatives are the beginnings of a potential decoupling of critical input supply chains that could leave European companies stranded in the middle.

Many companies, especially in the technology and manufacturing sectors, depend heavily on the steady supply of materials, components and equipment that are so specialised or advanced that there are few, if any, alternative suppliers. In addition to semiconductors, these critical inputs can also include software and raw materials such as rare earths, as well as dual-use goods that have both civilian and military applications. Even small disruptions to critical input supplies can disrupt entire operations or industries when alternative supplies are too costly, low-quality, incompatible, or not available in the first place. With the future trajectory of the US-China trade conflict up in the air, European companies with operations in China must make some tough choices to manage risks – not only within their own company, but also with suppliers and customers up- and downstream.

General outlook

The potential decoupling of critical input supply chains has gained attention in the context of the US-China trade and technology conflict but is by no means an entirely new phenomenon. A decade ago, China famously leveraged its global dominance in the production of critical rare earths—raw materials needed in a variety of high-tech sectors—to exert political pressure by restricting exports to countries that were then heavily dependent on Chinese supplies (see Case Study). While these tactics have not caused countries such as Japan to decouple entirely from Chinese rare earth supplies, they have resulted in a significant rethink across Japan, the US, the EU and other countries regarding the global flow of these critical goods.¹²⁸

Case Study: Japan-China rare earths dispute (2010)

In September 2010, a major diplomatic dispute between China and Japan over a maritime incident in the contested Senkaku/Diaoyu Islands led to Beijing's sudden suspension of rare earth exports to Japan.¹²⁹ Though denied by

¹²⁷ Kleinhans, Jan-Peter, and Baisakova, Nurzat, *The Global Semiconductor Value Chain: A Technology Primer for Policy Makers*, Stiftung Neue Verantwortung, 6th October 2020, viewed 20th November 2020, <<https://www.stiftung-nv.de/de/publikation/global-semiconductor-value-chain-technology-primer-policy-makers>>

¹²⁸ For example, the EU Commission in September 2020 launched the new European Raw Materials Alliance to reduce Europe's raw materials' dependency on third countries such as China (which supplies 98 per cent of the EU's rare earths). *EIT RawMaterials will manage newly launched European Raw Materials Alliance (ERMA)*, EIT RawMaterials, 29th September 2020, viewed 25th November 2020, <<https://eitrawmaterials.eu/wp-content/uploads/2020/09/EIT-RawMaterials-will-manage-ERMA-Press-Release.pdf>>

¹²⁹ Yamaguchi, Mari, *China rare earth exports to Japan still halted*, *Bloomberg Businessweek*, 21st October 2010, viewed 28th November 2020, <<https://web.archive.org/web/20110909131412/http://www.businessweek.com/ap/financialnews/D9J02PF01.htm>>

the Chinese Government, which claimed that any suspensions were due to the private actions of various rare earth companies or part of long-term environmental protection measures, Japanese companies insisted the export embargo was real.¹³⁰ The incident demonstrated China's ability to weaponise its domination in the production of critical inputs to exert political pressure. However, it also offers lessons on the costs of decoupling and paths for reducing vulnerabilities to Chinese export bans. Over the following decade, Japanese companies invested heavily in finding ways to slash rare earth metals consumption, locate alternative suppliers and increase rare earth recycling.¹³¹ China's dominance in rare earths—while still significant—is now diminished relative to 2010.¹³² Diversification, stockpiling and cutting demand can clearly minimise the impacts of future rare earth embargoes, but come at considerable costs and logistical challenges that demand years of effort to overcome.

Targeted restrictions on the sale and export of critical goods have become a more pressing reality for companies operating in China and globally. The US has taken a series of measures to stop or limit the sale of 'emerging' and 'foundational' technologies to China (see Table 2). Semiconductors, chip-making equipment and related design software have been a particular focus, with the US Commerce Department introducing targeted export controls to limit access to advanced US chips, or the equipment needed to manufacture them, for companies such as Huawei.¹³³ One underlying focus of the US is preventing the export to China of dual-use technologies or technologies that could be used to commit human rights abuses – an aim that the EU is also increasingly building mechanisms to address.^{134&135}

For its part, China has a series of extralegal tactics for imposing *de facto* export bans, such as allegedly giving orders to SOEs to halt exports, as many have suggested was done in the aforementioned case of rare earth exports to Japan. The US-China trade deal is based on the very same premise – that the Chinese Government will direct its SOEs to purchase US goods such as soybeans.¹³⁶ Beijing recently demonstrated its ability to tighten the screws on economies it has disagreements with when it reportedly informally instructed its companies to stop buying a range of Australian goods, before blocking imports altogether.¹³⁷ China has also formally expanded its toolbox for targeted export and import controls, with a particular view to directly retaliating against US (or EU) export controls and entity listings. Beijing now has the possibility to ban rare earth exports through a comprehensive Export Control Law that came into force on 1st December 2020, and has also formalised its own version of an entity list as forms of retaliation.¹³⁸

Furthermore, China's leaders were explicit during the October 2020 Plenum of the CPC Central Committee when they not only called for boosting self-reliance in critical technologies, but also highlighted the need to gain a dominant position in future technologies – the goal being to employ technological deterrence against other countries such that if they cut China off from a key technology, China cuts them off from another important technology.¹³⁹ The point was

130 Ting, Ming Hwa, & Seaman, John, *Rare Earths: Future Elements of Conflict in Asia?*, *Asian Studies Review*, June 2013, viewed 28th November 2020, <https://www.researchgate.net/publication/262857817_Rare_Earths_Future_Elements_of_Conflict_in_Asia?>; Gholz, Eugene, *Rare Earth Elements and National Security*, Council on Foreign Relations, October 2014, viewed 28th November 2020, <https://cdn.cfr.org/sites/default/files/pdf/2014/10/Energy%20Report_Gholz.pdf>

131 Shida, Tomio, *History offers lessons in escaping China's rare-earth dominance*, *Nikkei Asia*, 25th June 2019, viewed 28th November 2020, <<https://asia.nikkei.com/Economy/Trade-war/History-offers-lessons-in-escaping-China-s-rare-earth-dominance2>>

132 Haenle, Paul, & Kennedy, Scott, *What Exactly Is the Story with China's Rare Earths?*, *ChinaFile*, 31st May 2019, viewed 28th November 2020, <<https://www.chinafile.com/conversation/what-exactly-story-chinas-rare-earths>>

133 *Department of Commerce Announces the Addition of Huawei Technologies Co. Ltd. to the Entity List*, US Department of Commerce, 2019, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2019/05/department-commerce-announces-addition-huawei-technologies-co-ltd>>

134 Donnan, Shawn, & Leonard, Jenny, *U.S. Blacklists Eight Chinese Tech Companies on Rights Violations*, *Bloomberg*, 8th October, 2019, viewed 22nd December, 2020, <<https://www.bloomberg.com/news/articles/2019-10-07/u-s-blacklists-eight-chinese-companies-including-hikvision-k1gvpq77>>

135 *Dual use goods: Parliament and EU ministers agree on new EU export rules*, European Parliament, 2020, viewed 25th November 2020, <<https://www.europarl.europa.eu/news/en/press-room/20201105IPR90915/dual-use-goods-parliament-and-eu-ministers-agree-on-new-eu-export-rule>>

136 Bown, Chad P., & Lovely, Mary E., *Trump's phase one deal relies on China's state-owned enterprises*, *PIIE*, 3rd March 2020, viewed 9th December 2020, <<https://www.piie.com/blogs/trade-and-investment-policy-watch/trumps-phase-one-deal-relies-chinas-state-owned-enterprises>>

137 Tan, Su-Lin, *China-Australia relations: import ban on Australian copper, sugar expected after blocks on lobster, timber, barley*, *South China Morning Post*, 2nd November 2020, viewed 7th December 2020, <<https://www.scmp.com/economy/china-economy/article/3108056/china-australia-relations-import-ban-australian-copper-sugar>>

138 Wu, Yuehe, *United States, don't underestimate China's ability to strike back*, *People's Daily*, 31st May 2019, viewed 25th November 2020, <<http://en.people.cn/n3/2019/0531/c202936-9583292.html>>; *China's first entity list may target foreign entities blocking Chinese firms' supplies: experts*, *Global Times*, 19th September 2020, viewed 25th November 2020, <<https://www.globaltimes.cn/content/1201374.shtml>>; *China's export control laws to be used to break US 'long-arm' jurisdiction: analyst*, *Global Times*, 18th October 2020, viewed 25th November 2020, <<https://www.globaltimes.cn/content/1203798.shtml>>

139 *Proposals for the Formulation of the 14th Five-Year Plan (2021–2025) for National Economic and Social Development and the Long-Range Objectives Through the Year 2035*, State Council, 2020, viewed 25th November 2020, <http://www.gov.cn/zhengce/2020-11/03/content_5556991.htm>



Table 2: A tale of three export regimes

US	China	EU
<p>Export Administration regulations: The Commerce Department has identified a list of ‘emerging’ and ‘foundational’ technologies essential to national security for which it recommends more stringent export controls should be used.¹⁴⁰ Exports to China are key targets.</p> <p>Entity List: The Commerce Department in 2019 banned US exports to Huawei and its affiliates.¹⁴¹ The list has also been used to sanction several Chinese entities and individuals implicated in alleged human rights violations in Xinjiang¹⁴² and the building of military islands in the South China Sea.¹⁴³</p> <p>Foreign Direct Product Rule: New rule amendments introduced in 2020 require any companies supplying Huawei with goods that are the direct product of US software or technology or produced using US equipment to comply with US export regulations.¹⁴⁴ This includes European companies that use US components.</p> <p>Other: The Defense Department in 2020 restricted US exports to Chinese companies with links to the military, including Semiconductor Manufacturing International Corporation (SMIC).¹⁴⁵</p>	<p>Export Control Law: Passed in October 2020, this law regulates the export of items including dual-use goods as well as military and nuclear products, while enabling targeted export embargoes in the name of safeguarding China’s “national security and interests”.¹⁴⁶ Government officials and state media have repeatedly mentioned the possibility of export bans on rare earths.¹⁴⁷ The Ministry of Commerce (MOFCOM) also expanded its catalogue of technologies subject to export controls to include new items such as certain types of AI technology.¹⁴⁸</p> <p>Unreliable Entities List: Gives China the ability to impose trade or investment restrictions, fines and other punishments on companies deemed a danger to China’s national security or found to take discriminatory measures against Chinese entities or individuals.¹⁴⁹</p>	<p>Export controls: In November 2020, the European Parliament agreed on updated rules on the sale and export of technologies that can be employed for cyber-surveillance, requiring EU companies to obtain a government licence before selling such products abroad.¹⁵⁰</p>

140 *Review of Controls for Certain Emerging Technologies*, Federal Register, 19th November 2018, viewed 25th November 2020, <<https://www.federalregister.gov/documents/2018/11/19/2018-25221/review-of-controls-for-certain-emerging-technologies>>; *Identification and Review of Controls for Certain Foundational Technologies*, Federal Register, 2020, viewed 25th November 2020, <<https://www.federalregister.gov/documents/2020/08/27/2020-18910/identification-and-review-of-controls-for-certain-foundational-technologies>>

141 *Department of Commerce Announces the Addition of Huawei Technologies Co. Ltd. to the Entity List*, U.S. Department of Commerce, 15th May 2019, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2019/05/department-commerce-announces-addition-huawei-technologies-co-ltd>>; *Department of Commerce Adds Dozens of New Huawei Affiliates to the Entity List and Maintains Narrow Exemptions through the Temporary General License*, US Department of Commerce, 19th August 2019, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2019/08/department-commerce-adds-dozens-new-huawei-affiliates-entity-list-and>>; *Commerce Department Further Restricts Huawei Access to US Technology and Adds Another 38 Affiliates to the Entity List*, US Department of Commerce, 17th August 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/08/commerce-department-further-restricts-huawei-access-us-technology-and>>

142 *Addition of Certain Entities to the Entity List*, Federal Register, 10th September 2019, viewed 25th November 2020, <<https://www.federalregister.gov/documents/2019/10/09/2019-22210/addition-of-certain-entities-to-the-entity-list>>; *Commerce Department to Add Nine Chinese Entities Related to Human Rights Abuses in the Xinjiang Uighur Autonomous Region to the Entity List*, US Department of Commerce, 22nd May 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/05/commerce-department-add-nine-chinese-entities-related-human-rights>>; *Addition of Entities to the Entity List*, Revision of Certain Entries on the Entity List, Federal Register, 5th June 2020, viewed 25th November 2020, <<https://www.federalregister.gov/documents/2020/06/05/2020-10869/addition-of-entities-to-the-entity-list-revision-of-certain-entries-on-the-entity-list>>; *Commerce Department Adds Eleven Chinese Entities Implicated in Human Rights Abuses in Xinjiang to the Entity List*, U.S. Department of Commerce, 20th July 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/07/commerce-department-adds-eleven-chinese-entities-implicated-human>>

143 *Commerce Department Adds 24 Chinese Companies to the Entity List for Helping Build Military Islands in the South China Sea*, US Department of Commerce, 26th August 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/08/commerce-department-adds-24-chinese-companies-entity-list-helping-build>>

144 *Commerce Addresses Huawei’s Efforts to Undermine Entity List, Restricts Products Designed and Produced with US Technologies*, US Department of Commerce, 15th May 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/05/commerce-addresses-huaweis-efforts-undermine-entity-list-restricts>>; *Commerce Department Further Restricts Huawei Access to US Technology and Adds Another 38 Affiliates to the Entity List*, US Department of Commerce, 17th August 2020, viewed 25th November 2020, <<https://www.commerce.gov/news/press-releases/2020/08/commerce-department-further-restricts-huawei-access-us-technology-and>>

145 *DOD Releases List of Additional Companies, In Accordance With Section 1237 of FY19 NDAA*, US Department of Defense, 3rd December 2020, viewed 4th December 2020, <<https://www.defense.gov/Newsroom/Releases/Release/Article/2434513/dod-releases-list-of-additional-companies-in-accordance-with-section-1237-of-fy/>>

146 *Export Control Law of the People’s Republic of China*, NPC, 2020, viewed 25th November 2020, <<http://www.npc.gov.cn/npc/c30834/202010/cf4e0455f6424a38b5aefc8001712c43.shtml>>

147 *China’s export control laws to be used to break US ‘long-arm’ jurisdiction: analyst*, *Global Times*, 18th October 2020, viewed 25th November 2020, <<https://www.globaltimes.cn/content/1203798.shtml>>

spelled out most explicitly in a piece by President Xi in the party theory journal *Qiushi*, in which he called for efforts to, “forge some ‘assassins mace’¹⁵¹ technologies to tighten the dependence of international industrial supply chains on our country to form a powerful countermeasure and deterrence for foreign parties attempting to artificially cut off supply.”¹⁵²

While these measures have not amounted to large-scale decoupling so far, they open a path for policy decisions that could drastically disrupt critical value chains. Companies are already being forced to reassess their business strategies in preparation. Huawei and other Chinese technology companies have been turning to alternative suppliers for chips and other critical inputs restricted by US export controls, replacing foreign inputs with domestic alternatives where possible.¹⁵³ China’s leadership has doubled down on government support for the domestic production of high-end chips and other advanced technologies, which of course predate (and to some extent caused) the trade conflict with the US.¹⁵⁴ European companies that sell advanced technologies to Chinese entities are also caught in the middle, with the US’ tightened *Foreign Direct Product Rule* subjecting some of them to US export restrictions.¹⁵⁵

Current impacts

With full-blown decoupling in the space of critical inputs still limited, many European companies’ access to them has not yet been affected directly.

The EU’s newly-revised export control framework focusses specifically on dual-use technologies with human rights implications and, as such, has a relatively narrow scope. Meanwhile, the most stringent and expansive US export controls affect only sales to Huawei and—to a lesser extent—other Chinese technology companies such as SMIC and Hikvision, a manufacturer of video surveillance equipment for civilian and military purposes. Furthermore, most European chip manufacturers have been unaffected by Huawei’s blacklisting due to their products incorporating less than the 25 per cent threshold of US-origin content specified by the *de minimis* rule of the US Export Administration Regulations. In the short term, European companies may have even been able to benefit from Chinese companies’ intensifying efforts to de-Americanise their supply chains, which is seeing them turn to European alternatives in areas where domestic companies are not able to produce sufficiently advanced products.

However, around half of respondents to the general survey conducted to support this report expect critical input decoupling to have a somewhat or significant negative impact on their business going forward. Many companies are concerned that broader decoupling could result in the limited or total loss of critical inputs for their operations in China. Most respondents to this report’s survey specifically on decoupling in critical inputs say that while they would be able to source local substitutes for critical manufacturing components or equipment in China, they would have to compromise on quality, cost and/or compatibility.

The potential disruptions that could emerge from these issues would result in a deterioration of current business sentiment. Further tightening of US export controls, through decisions such as the lowering of the *de minimis* threshold, would increase the number of European companies that have to comply with US restrictions of exports

148 *Announcement on Adjusting the Catalogue of Technologies Prohibited or Restricted by China from Export*, MOFCOM, 28th August 2020, viewed 25th November 2020, <<http://www.mofcom.gov.cn/article/b/xxfb/202008/20200802996641.shtml>>

149 *Provisions on the Unreliable Entity List*, MOFCOM, 2020, viewed 25th November 2020, <<http://www.mofcom.gov.cn/article/b/c/202009/20200903002593.shtml>>

150 *Dual-use goods: Parliament and EU ministers agree on new EU export rules*, European Parliament, 9th November 2020, viewed 25th November 2020, <<https://www.europarl.europa.eu/news/en/press-room/20201105IPR90915/dual-use-goods-parliament-and-eu-ministers-agree-on-new-eu-export-rule>>

151 杀手锏 - literally the killing strike of a mace, but metaphorically it means something held back to strike with at the right moment. Often translated as ‘ace in the hole’ or ‘trump card’.

152 President Xi Jinping, *Industrial and supply chains cannot be dropped at critical moments*, *Qiushi*, 3rd November 2020, viewed 9th December 2020, <http://www.qstheory.cn/zhuanku/2020-11/03/c_1126690768.htm>

153 Fitch, Asa, and Strumpf, Dan, *Huawei Manages to Make Smartphones Without American Chips*, *The Wall Street Journal*, 1st December 2019, viewed 26th November 2020, <<https://www.wsj.com/articles/huawei-manages-to-make-smartphones-without-american-chips-11575196201>>

154 *Notification on Issuing Several Policies to Promote the High-Quality Development of the Integrated Circuit Industry and Software Industry in the New Era*, State Council, 2020, viewed 26th November 2020, <http://www.gov.cn/zhengce/content/2020-08/04/content_5532370.htm>

155 Whitten, Reid, Maberry, J. Scott, and Agada, Enumale, *Hua-Wait a Minute: Entity Designation Affects Non-US Manufacturers’ Exports to China Tech Giant*, *Global Trade Law Blog*, 21st May 2019, viewed 25th November 2020, <<https://www.globaltradelawblog.com/2019/05/21/entity-designation-exports/>>



to Chinese entities.¹⁵⁶ Even when European firms are not under the purview of American export regulations, they may still face pressure from Washington to suspend exports to China. Leading Dutch semiconductor equipment manufacturer ASML, for example, famously halted the sale of advanced lithography machinery to China after US officials persuaded the Dutch Government not to renew ASML's licence.¹⁵⁷

When it comes to China's toolbox, while authorities may so far have been hesitant to use the *Unreliable Entities List*, it hangs above the heads and impacts the business strategies of European companies in China, especially those in the ICT industry. Most companies that have been singled out for inclusion so far are American, including Qualcomm, Apple and FedEx, but European companies such as Nokia, Ericsson and HSBC have also been called out as potential targets for retaliation over disputes related to Huawei.¹⁵⁸ More broadly, in the long-term, European companies will be affected by Chinese companies' efforts to indigenise their technology supplies and reduce their reliance on any foreign supplies.

Level of exposure of European companies

European companies' dependence on imports of critical inputs for their China operations is varied, and for many fairly limited. Thanks to high supply chain localisation rates, most European companies only import a small fraction of their supplies needed for their Chinese operations from abroad. The vast majority of respondents to the survey on critical inputs said they import only 15 per cent or less by value of their manufacturing components and equipment for their operations in China (see Survey results below). However, 27 per cent of survey respondents say that their products rely on US-produced semiconductors and/or software for which there are no alternatives, while 20 per cent say the same applies to their manufacturing equipment.

What share (by value) of manufacturing components does your company import for operations in China?	
None	6.67% of respondents
1–5%	33.33% of respondents
6–15%	33.33% of respondents
16–25%	6.67% of respondents
26–50%	6.67% of respondents
51–75%	6.67% of respondents
more than 76%	6.67% of respondents
What share (by value) of manufacturing equipment does your company import for operations in China?	
None	20% of respondents
1–5%	20% of respondents
6–15%	20% of respondents
16–25%	6.67% of respondents
26–50%	6.67% of respondents
51–75%	13.33% of respondents
more than 76%	13.33% of respondents

Source: European Chamber survey on critical inputs decoupling conducted in September 2020.

¹⁵⁶ US officials including Robert Lighthizer have said the Trump Administration is considering lowering the *de minimis* threshold, which means that European companies with products that contain minimal US-origin components may need to apply for licences to continue exporting to Huawei. See for example: *Testimony of Ambassador Robert E. Lighthizer*, Senate Committee on Finance, 17th June 2020, viewed 25th November 2020, <<https://www.finance.senate.gov/imo/media/doc/17JUN2020LIGHTHIZERSTMNT1.pdf>>

¹⁵⁷ Alper, Alexandra, Sterling, Toby, and Nellis, Stephen, *Trump administration pressed Dutch hard to cancel China chip-equipment sale: sources*, Reuters, 6th January 2020, viewed 25th November 2020, <<https://www.reuters.com/article/us-asml-holding-usa-china-insight-idUSKBN1Z50HN>>

¹⁵⁸ Lin, Liza, Woo, Stu, & Wei, Lingling, *China May Retaliate Against Nokia and Ericsson If EU Countries Move to Ban Huawei*, *The Wall Street Journal*, 20th July 2020, viewed 25th November 2020, <<https://www.wsj.com/articles/china-may-retaliate-against-nokia-and-ericsson-if-eu-countries-move-to-ban-huawei-11595250557>>; Shen, Weiduo, & Chen, Qingqing, *Update: HSBC could face dead end for conspiring with US against Huawei*, *Global Times*, 24th July 2020, viewed 25th November 2020, <<https://www.globaltimes.cn/content/1195542.shtml>>

Despite these numbers painting a picture of relatively low reliance on imported critical inputs, European companies' potential level of exposure is still high. It can take just one small component, piece of equipment or software that can no longer be sourced to disrupt a company's entire China operations – with potential ramifications for their global business. Though for most companies this is a far-off, worst-case scenario that is unlikely to transpire, the uncertainties about whether decoupling trends will intensify still cause many to worry.

Companies in high-technology sectors are particularly at risk, given that they are more likely to rely on being able to source advanced components or equipment that only a few companies in the world sell. Companies reliant on semiconductors or related equipment would be most directly exposed should the US go ahead with tightening its export regulations, such as the *de minimis* threshold. One interviewed company that produces cutting-edge industrial tools highlighted the crucial importance of a US-made processor to its business operations in China, explaining that an inability to source this input would effectively shutter their operations in China since there are no alternatives.

Software and digital solutions have the potential to be another critical input bottleneck. US and Chinese technologies dominate in most areas, though European providers are highly competitive in industrial solutions. As a result, the growing possibility of a technology showdown between the US and China is deeply concerning for European companies, which anticipate being caught in the crossfire. The main concern is that the US will attempt to purge Chinese involvement in any part of the American technology ecosystem. As such, in interviews for this report, European companies in sectors as varied as automotive, machinery and chemicals noted that they expect to have to create firewalls between their US and China operations and supply chains. Meanwhile, China's own market access regime in the digital realm makes it increasingly difficult to bring in a fully-integrated global technology stack. Companies also anticipate that they will need to localise their digital systems in China.

In addition, while some companies may not see any immediate risks to their own critical inputs, disruptions may affect them indirectly if their first-, second- or even third-tier suppliers can no longer source components or equipment from abroad. Concerns also arise when looking downstream: if a company's customer loses access to critical inputs, the company could face a drop in demand for products or components from that customer as a result.¹⁵⁹ The vast majority of interviewed member companies have audited their own supplies to assess risks related to critical inputs, but had not yet considered doing so with their upstream or even downstream partners, though they universally went on to say that this would be a priority consideration moving forward.

Beyond their China operations, there are additional risks to European companies as a result of Beijing's efforts to decouple in critical inputs. Some European companies are concerned that, in the future, expanded Chinese export controls may prevent them from exporting components or software researched and developed in China.

Expectations and likely scenarios

An expansion of export controls on advanced technologies and other critical inputs across the US, China and the EU would likely have far-reaching implications for global value chains. European companies—especially those operating in China—would face even more compliance hurdles, as they have to simultaneously navigate stringent EU, US and Chinese export regulations that affect their ability to import and export parts and products to and from China.

Export control frameworks are likely to remain in place or even be expanded in all three blocs, while increasing their extraterritorial reach. The EU's landmark decision in November 2020 to revise its regulations could result in more European discussions on the need to control the export of sensitive technologies to China.

At the time of writing, it remains unclear exactly how the incoming Biden Administration plans to proceed with US

¹⁵⁹ See the example of European automotive manufacturers that faced such issues during the COVID-19 outbreak in the Supply chain section on page 36.



export controls *vis-à-vis* China – a major determining factor for the future trajectory of decoupling in this area. However, there has been much talk of President-elect Biden pursuing closer transatlantic cooperation, which could pave the way for a multilateral approach to controlling the export of advanced technologies to China.¹⁶⁰ Export controls on, for example, semiconductor manufacturing equipment or facial recognition technology, that are coordinated among European countries such as the Netherlands and Asian markets such as Japan, South Korea and Taiwan (all US allies), are likely to prove more effective than previous unilateral actions.

As previously mentioned, one potential scenario of export control tightening could see the US adjusting the *de minimis* rule, lowering the current 25 per cent threshold of US-origin content by value below which foreign-made products are exempt from the Foreign Direct Product rule. Reducing or removing this threshold would force European companies that produce semiconductors or related equipment to choose between removing US content from their supply chains or halting any supplies to Huawei and other blacklisted Chinese companies. In an alternative scenario, the US administration may decide to alter its foreign direct product requirements so that they apply to a broader list of Chinese entities and continue adding technology companies to its Entity List.

Having expanded and strengthened its retaliatory toolbox over the past few years, Beijing is now more able and likely to exploit European choke points, such as the bloc's dependence on rare earths, and employ asymmetric retaliatory responses should the EU target China with expanded export controls or apply more concerted pressure over human rights issues.

Implications and recommendations for European companies

Managing the supply of critical inputs in China will become more complicated as companies try to anticipate and avoid potential future disruptions. Companies will face difficult decisions regarding onshoring or relocating supply chains and/or diversifying critical input sources. Some companies may be pressured to onshore into China or completely sever ties with the US to avoid compliance issues. The more reliant companies are on potentially-affected critical inputs, the more pressing strategic decisions on localising supplies in China, building up Chinese alternatives or moving production out of China become. De-Americanising supply chains and consolidating 'in China, for China' strategies may limit political-risk exposure while preserving market access. However, such decisions naturally carry significant logistical and financial implications, with cost increases that may be unmanageable, especially for SMEs. In the short term, companies can stockpile critical inputs that cannot quickly or sufficiently be replaced. However, stockpiling is only a (costly) short-term mitigation measure that can—at best—act as a buffer and buy time.

- Conduct detailed supply chain reviews and risk assessments to measure the impact of potential export control expansions on your supply of critical inputs and prepare accordingly.
- Expand the scope of your due diligence efforts to determine the level of exposure of your suppliers and customers, and assess what disruptions to their supplies would mean for your operations.
- Review your global and Chinese R&D strategies and come up with contingency plans in the event of tightening Chinese export controls.

Implications and recommendations for governments

The aforementioned decoupling trends will cause massive uncertainty for governments in Europe, China, the US and elsewhere. While government actions related to critical inputs have predominantly stemmed from national security concerns, there is a risk that an overblown perception of those risks could lead to increasingly aggressive decoupling policies. There is a real danger of a race to the bottom being fuelled by unilateral tit-for-tat retaliations. The resulting separation of value chains could have a damaging effect on the innovation capabilities of European companies, as well as the global value chains of advanced technologies more broadly.

¹⁶⁰ Biden Offers Transatlantic Embrace to EU's Already Open Arms, Bloomberg, 2nd December 2020, viewed 9th December 2020 <<https://www.bloomberg.com/news/articles/2020-12-02/biden-tells-nyt-he-won-t-quickly-remove-china-phase-one-tariffs>>

EU

There is clear need for the EU to review and continue updating its mechanisms to deal with its priorities, such as ensuring European technologies are not used for human rights violations and mitigating the distortions caused by China's continuation of aggressive industrial policy. However, the EU must also carefully consider the damaging effects export controls can have on European businesses and Europe's own innovation capabilities. In areas where these concerns are legitimate and pressing, policy actions should be measured, proportionate and targeted, and take into consideration the broader context, including the preservation of strong global technology value chains.

- Adopt a systematic and measured approach to reviewing European supply chains for critical inputs and the impact of various export control frameworks.

China

A continuing tit-for-tat downward spiral of retaliations would ultimately do severe harm to China's own innovation capabilities, given that China's reliance on foreign technologies and know-how remains pronounced. To prevent full-scale decoupling, China should address Europe's and the US' concerns that are driving decoupling-type policies in critical inputs.

- Refrain from using an export control framework or other tools to threaten or unilaterally sanction individual European countries, companies or entities.
- Clarify the impact of the newly-passed Export Control Law for European companies, especially for their R&D operations.
- Proceed with meaningful market opening and SOE reforms, and create a truly level playing field for foreign companies.



Innovation Decoupling: Research and development (R&D), and standards

This section looks at the impact of decoupling on the innovation capabilities of European businesses, with a focus on R&D and technical standardisation.

Both R&D and standards-setting are highly collaborative activities that rely heavily on, and are strengthened by, cooperation between various stakeholders. As such, any attempts by government stakeholders to decouple in these areas would have considerable negative consequences. While this seems to be generally acknowledged by the EU and China, a number of long-standing and emerging trends in both R&D and in standardisation concern the European business community in China, and could force members to re-evaluate their overall innovation strategies both at the global level and in China.

R&D

Summary

China's recent emergence as one of the most innovative countries in the world makes it an appealing R&D destination for European companies. At the same time, there are a number of issues that have the potential to diminish the attractiveness of the country for both businesses and researchers. These include:

- fears over IP protection;
- restricted access to funding and research resources;
- a divergence of data management regimes between the EU and China;
- limitations on researcher mobility;
- policies that promote "autonomous and controllable" technology; and
- export controls.

In the EU, scandals related to espionage and Chinese influence activities in its universities and research institutions have also put European institutional, academic and business actors on the alert to varying degrees.

While radical decoupling measures, such as moving all R&D activities out of China, are not envisioned by many of the European Chamber members interviewed for this section, if left unaddressed, the aforementioned issues will see companies having to make difficult decisions about their global and China R&D strategies.¹⁶¹ Government discussions both within the EU and at the bilateral level are likely to shape the future of EU-China engagement in R&D and innovation, the outcomes of which will affect both European and Chinese companies.

General outlook

China has recently emerged as one of the most innovative markets in the world thanks to a combination of highly creative individuals and market-driven enterprises, as well as through a wide array of policies to incentivise innovation and improve the IP protection environment.¹⁶² These changes have been widely acknowledged by European businesses in China.¹⁶³ A clear indicator of the importance European companies attach to China as an R&D

¹⁶¹ This section has drawn on interviews with European Chamber member companies in the energy, automotive, ICT, industrial manufacturing, pharmaceutical, aerospace, medical devices and infrastructure industries.

¹⁶² According to the World Intellectual Property's 2020 Global Innovation Index, China currently is ranked as the 14th most innovative economy in the world. *Global Innovation Index 2020*, WIPO, 2020, viewed 18th November 2020, <https://www.wipo.int/edocs/pubdocs/en/wipo_pub_gii_2020/cn.pdf>

¹⁶³ According to the European Chamber's *Business Confidence Survey 2020: Navigating in the Dark* (BCS 2020), 40 per cent of respondents perceive China's R&D environment as more favourable than the worldwide average, and 69 per cent consider Chinese companies to be equally or more innovative than European counterparts. *BCS 2020*, European Union Chamber of Commerce in China, June 2020, <<http://www.europeanchamber.com.cn/en/publications-business-confidence-survey>>

destination is the fact that most of those interviewed for this section have some form of R&D activity in the country, ranging from localisation of global products or tailored solutions for the market to advanced R&D for global products.

However, mobility of talent and IP infringements, unequal access to funding and instances of forced technology transfer, along with concerns over China's use of R&D activities to realise its self-sufficiency ambitions by absorbing foreign technologies, remain major concerns for European businesses in China. Increasingly restrictive internet access, data management rules that diverge from those in the EU, export control and academic freedom regimes, along with potential *de facto* market access considerations such as the "autonomous and controllable" policies, have also added to the concerns of European companies when it comes to their R&D activities in China.^{164,165&166} These have been exacerbated by reports of espionage, Chinese influence activities in academia and unequal access to R&D programmes, which have prompted a number of discussions, as well as actions to tackle these issues, at the EU level.^{167,168&169}

Current impacts

While the US-China trade tensions have had limited impact on the mobility aspect of the R&D activities of the European businesses in China interviewed for this report, a few that rely on US researchers, particularly in fields like pharmaceuticals or agrochemicals, have been negatively affected by restrictions on researcher mobility. Some of these companies have also reported experiencing increased difficulties when it comes to sending their Chinese researchers to the US. However, it is important to note that making an accurate assessment of the impact of these restrictions is difficult at present, as the mobility disruptions caused by COVID-19 have been the top concern of European businesses throughout 2020. According to a survey by EURAXESS China, as of August 2020, 60 per cent of European researchers who had left China at the beginning of the year had not been able to return due to COVID-19-related travel restrictions. In another survey carried out by the European Chamber's Shanghai Chapter in August 2020, 29 per cent of respondents reported having experienced a negative impact on their R&D activities due to the travel restrictions imposed.^{170&171}

Most companies interviewed for this report have not reported considerable changes to their cooperation initiatives with Chinese partners so far. While in a few cases new cooperation initiatives with partners deemed sensitive, such as Huawei, have been halted, existing collaborations remain, although companies' HQs are increasingly scrutinising R&D cooperation with Chinese partners.

Long-standing issues like IP protection and access to data/knowledge resources (within and outside of China), as well as projects and R&D funding remain of significant concern for European businesses. Despite a marked improvement in China's IP environment, according to the European Chamber's BCS 2020, 37 per cent of respondents identified IP issues as being "unfavourable" or "very unfavourable" to China's R&D environment. This is one of the main reasons why 26 per cent of surveyed companies reported being unwilling to bring new technology to China. There is also the

164 "Autonomous and controllable" (also referred to as "secure and controllable") is a concept put forward by the Chinese leadership in several recent laws and regulations whereby the government would have broad discretion on deciding how it protects information networks, devices and data deemed critical to national and economic security. This concept is closely linked to the development and use of Chinese indigenous products and technologies instead of foreign ones.

165 Key recent policies include the updated list of technologies restricted for export and the Export Control Law. *Announcement on Adjusting and Issuing the Catalogue of China's Export Prohibited and Restricted Technologies*, State Council, 28th August 2020, viewed 28th November 2020, <http://www.gov.cn/zhengce/zhengceku/2020-08/29/content_5538299.htm>; *The full text of the Export Control Law of the People's Republic of China*, MOFCOM, 17th October 2020, viewed 28th November 2020, <<http://www.mofcom.gov.cn/article/zwgk/zcfb/202010/20201003008925.shtml>>

166 According to the European Chamber's BCS 2020, half of the respondents evaluated access to internet services negatively with regard to R&D activities in China. *BCS 2020*, European Union Chamber of Commerce in China, June 2020, <<http://www.eurochamber.com.cn/en/publications-business-confidence-survey>>

167 Rettman, Andrew, *China suspected of bio-espionage in 'heart of EU'*, *EUobserver*, 6th May 2020, viewed 18th November 2020 <<https://euobserver.com/science/148244>>

168 *China: Government Threats to Academic Freedom Abroad*, Human Rights Watch, 21st March 2019, viewed 18th November 2020, <<https://www.hrw.org/news/2019/03/21/china-government-threats-academic-freedom-abroad>>

169 As of March 2019, there had been 367 Chinese participations in 169 Horizon 2020 grants. *China and Horizon 2020 (Infographic)*, European Commission, March 2019, viewed 26th November 2020, <https://ec.europa.eu/research/iscp/pdf/infographics/ec_rtd_eu-china-info_042019_en.pdf#view=fit&pagemode=none>

170 *Quarterly Newsletter/Issue 3 2020*, EURAXESS China, August 2020, viewed 28th November 2020, <https://cdn4.euraxess.org/sites/default/files/2020_euraxess_china_3_quarter-v2.pdf>

171 *European Business in China Position Paper*, European Union Chamber of Commerce in China, September 2020, <<https://www.eurochamber.com.cn/en/publications-position-paper>>



not inconsiderable issue of forced technology transfers to take into account. While, according to the BCS 2020, 16 per cent of members reported having felt compelled to transfer technology to maintain market access, in strategic industries like medical devices, aerospace and aviation, and environment, this number rose to close to a third of respondents.¹⁷²

These IP-related concerns look set to increase when taking into account China's updated export control regime, which would provide supervisory bodies wide discretion when it comes to requiring technical information on the products being exported, but which would also broaden the range of what would constitute a technological export – potentially including forms of IP like patents.¹⁷³ These export-control-regime-related issues are already having a negative impact on industries like aerospace, with companies effectively putting on hold their plans to expand R&D activities in China due to their concerns. Other companies in the ICT and automotive sectors have also signalled their unease when it comes to the negative impacts they might experience in the future due to these restrictions.

China's "autonomous and controllable" policies are also having an impact on European businesses' R&D operations. Companies in the ICT sector in particular have mentioned that in the future they might be forced to either move or increase R&D activities in China in order to comply with these policies and not lose market share.¹⁷⁴

Data management rules in China are also a major factor in companies' plans for their R&D activities. While China's sheer size makes it an attractive data pool too big to ignore, this data loses value when companies encounter barriers to dynamic and effective cross-border data transfer processes.

Data and IP constraints to R&D – the case of pharmaceuticals

In a number of separate interviews conducted for this report, European pharmaceutical companies mentioned the attractiveness of China's market as a general R&D destination, partly because of its large data pool. However, constraints on cross-border data flows are very concerning for an industry that relies heavily on global data exchanges in areas like clinical trials for the efficiency and effectiveness of the healthcare solutions they develop. These constraints are particularly stringent for pharmaceutical companies since, aside from general laws and regulations on cross-border data flows, the *Human Genetic Resources Administrative Regulations* and the Draft Biosecurity Law further restrict the collection and transfer of human genetic resources (including their data) in China by foreign companies.¹⁷⁵ In addition, these restrictions create potential IP-related concerns, as the only avenue available to foreign institutions that want to utilise human genetic resources is through joint research projects with Chinese partners (which must have access to all the data and information related to these projects).¹⁷⁶

As a result, these potential limitations on data flows create concerns among European pharmaceutical companies that a fragmentation scenario may arise in which their operations in China would only be able to develop R&D for the Chinese market. IP issues also remain a key barrier—and a potential disincentive—for foreign companies in this sector when it comes to conducting R&D in China.

EU-China innovation cooperation is being viewed more cautiously by the European side due to the aforementioned recent reports of influence activities and espionage. This has prompted both member states and the EU to initiate

172 *Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 2020, <<http://www.europeanchamber.com.cn/en/publications-business-confidence-survey>>

173 *China: Technology export control and beyond*, Allen & Overy, 11th September 2020, viewed 28th November 2020, <<https://www.allenoverly.com/en-gb/global/news-and-insights/publications/china-technology-export-control-and-beyond#:~:text=China%3A%20Technology%20export%20control%20and%20beyond%2011%20September,from%20Export%20%28the%20Catalogue%29%20on%2028%20August%202020>>

174 The use of products developed in China constitutes an important aspect of the "autonomous and controllable" concept.

175 Cui, Can, *China to Criminalise Human Genetic Resources Violations*, MOFO Life Sciences, 22nd July 2020, viewed 28th November 2020, <<https://lifesciences.mofo.com/topics/China-to-Criminalize-Human-Genetic-Resources-Violations.html>>

176 *New human genetic resources regulations in China*, Hogan Lovells, July 2019, viewed 28th November 2020, <https://f.datasrvr.com/fr/1/319/56529/New_human_genetic_resources_regulations_in_China_-_July_8_2019.pdf>

discussions on how to combat interference in R&D within its internal market, but also how the approach to EU-China cooperation should be refined. Significant actions taken so far include the drafting of a concept note on tackling foreign interference in higher education and research institutions; the inclusion in the *White Paper on Foreign Subsidies* of a chapter dedicated to the participation of subsidised players in EU R&D initiatives; the re-thinking of the implementation of specific Horizon Europe arrangements (for example, Article 18.5) for Chinese participation; and the release of an IP Action Plan that looks to create a global level-playing field by tackling unfair practices such as industrial espionage.^{177,178,179,180&181} Additionally, the EU and China are currently in the process of negotiating an EU-China Joint Roadmap for Future Science, Technology and Innovation Cooperation, the final result of which will influence European companies engaging or looking to engage in projects with Chinese partners under the umbrella of Horizon Europe.

Level of exposure of European companies

The majority of issues already outlined in this section are likely to have a horizontal impact across industries, with levels of exposure varying depending on exactly which sector a company is in and the makeup of their personnel. For instance, in terms of talent mobility, companies heavily relying on researchers from the US have a higher degree of exposure. Likewise, intellectual property rights (IPR)-intensive industries may be more exposed to the current shortcomings of China's IP system, and businesses in sectors like ICT, automotive or aerospace—which can potentially develop technologies or IP subject to export control—are also more vulnerable to the updated export control regimes in the US, China and potentially Europe.¹⁸² The ICT sector is also particularly vulnerable to the ramifications of China's "autonomous and controllable" policies.

It is also important to note that, in general, the level of exposure of European companies will vary depending on their global R&D strategy and on the nature of their R&D activities in China (for instance, whether it is for localisation or for global products, or deals with technologies deemed 'sensitive'). In particular, for 'sensitive' technologies—for example, those for dual use or that could be used in situations linked to human rights abuses—it is likely that companies will face restrictions on various fronts.¹⁸³

Expectations and likely scenarios

The Chinese Government is expected to continue investing heavily in strengthening its R&D ecosystem, be it through talent attraction policies, funding, subsidies or other initiatives. Thanks to these efforts, coupled with the size of both its market and data pool, and its increasingly competitive and innovative domestic companies, as well as the generally dynamic environment for innovation, China will likely remain an attractive R&D destination for foreign businesses. At the same time, it is unlikely that the government will backtrack on policies and initiatives such as export controls for technology, data management restrictions or the push for "autonomous and controllable" technology, which have been in practice damaging to China's goal of becoming a global R&D leader. Lingering concerns over talent mobility

¹⁷⁷ *Concept note on tackling foreign interference in higher education institutions and research organisations (draft)*, European Commission, 20th February 2020, viewed 28th November 2020, <<https://s3.eu-central-1.amazonaws.com/euobs-media/3ef6dc3d60ee27a2df16f62d47e93fdc.pdf#:~:text=CONCEPT%20NOTE%20ON%20TACKLING%20FOREIGN%20INTERFERENCE%20IN%20HIGHER,Organisations%20%28RTOs%29%2C%20research%20funding%20organisations%2C%20industry%20and%20related>>

¹⁷⁸ *White Paper on Foreign Subsidies*, European Commission, viewed 18th November 2020, <<https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12452-White-Paper-on-Foreign-Subsidies/public-consultation>>

¹⁷⁹ Horizon Europe is the EU's seven-year research and innovation programme, running from 2021 to 2027 with a proposed budget of EUR 100 billion. Horizon Europe succeeds the EU's previous programme, Horizon 2020. *Horizon Europe*, European Commission, viewed 28th November, <https://ec.europa.eu/info/horizon-europe_en>

¹⁸⁰ Kelly, Eanna, *EU expands powers to block Chinese and US companies from Horizon Europe*, *Science Business*, 1st October 2020, viewed 18th November 2020, <<https://sciencebusiness.net/framework-programmes/news/eu-expands-powers-block-chinese-and-us-companies-horizon-europe>>

¹⁸¹ *Commission adopts Action Plan on Intellectual Property to strengthen EU's economic resilience and recovery*, European Commission, 25th November 2020, viewed 28th November 2020, <https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2187>

¹⁸² IPR-intensive industries are defined as those having an above-average ownership of IPR per employee, compared with other *IPR-using industries*. IPR-intensive exporting industries from the EU are particularly relevant for this study. *IPR-intensive industries and economic performance in the European Union*, European Patent Office and European Union Intellectual Property Office, September 2019, viewed 28th November 2020, <https://euipo.europa.eu/tunnel-web/secure/webdav/guest/document_library/observatory/documents/IPContributionStudy/IPR-intensive_industries_and_economic_in_EU_WEB_IPR_intensive_Report_2019.pdf>

¹⁸³ In addition to regulations rolled out in China and the US, the EU is also in the process of rolling out new export control rules. *Dual use goods: Parliament and EU ministers agree on new EU export rules*, European Parliament, 5th November 2020, viewed 28th November 2020, <<https://www.europarl.europa.eu/news/en/press-room/20201105IPR90915/dual-use-goods-parliament-and-eu-ministers-agree-on-new-eu-export-rules>>



and IP issues will no doubt remain.

It also is unlikely that, in the short- to medium-term, reservations in Europe about R&D activities in China and Chinese influence activities in the bloc are going to change. As previously noted, this is already affecting policy considerations within the EU and in the HQs of European companies. There will be continued scrutiny of European stakeholders' participation in R&D activities in China and Chinese stakeholders' participation in R&D activities in Europe.

Implications and risk management for European companies

The main conundrum European businesses will have to face will be balancing the attractiveness of the Chinese market as an R&D destination—especially in areas where China offers them incentives to engage in R&D activities—and the need to develop certain R&D activities to either maintain/increase their market share or even to gain market access, against the risks associated with Chinese restrictions on exports and data flows, as well as considerations regarding involuntary IP transfers. Companies will need to work out how to effectively respond to the increasing scrutiny from their HQs and potentially governments (especially when it comes to cooperation on sensitive technologies). They will also almost certainly have to decide what kind of R&D they can afford to develop in China, where to locate their IP in order to circumvent potential export controls or other restrictions, as well as with whom they can cooperate and which talent they can deploy.¹⁸⁴

- Develop an overall R&D strategy—both at the global and China level—that balances the opportunities associated with increasing R&D investment in China and the current and expected risks of such engagement.

Implications and risk management for governments

EU

In order for the EU to prevent its traditionally open R&D ecosystem from being taken advantage of, policymakers are right to look into developing measures against risks stemming from distortive practices; the lack of reciprocity in access to R&D programmes; IP theft; and influence activities. At the same time, in order to strike the right balance between tackling these risks and preserving legitimate opportunities, European governments should enter into discussions with other key stakeholders, like research institutions and businesses, and where appropriate incorporate their views into the overall strategy. Initiatives to protect the European innovation environment from unfair practices should also not preclude the EU and member-state governments from continuing cooperation on innovation and R&D with third countries—including China—as long as appropriate frameworks that guarantee reciprocity and establish clear standards when it comes to issues like data-sharing or IP protection are put in place.

Ensuring that the European innovation ecosystem is top-notch is also key, not only because this will be essential for boosting European competitiveness in the global arena, but also because it can provide international companies with viable alternative R&D destinations. Achieving such an ambition will require investment and funding, as well as deeper integration between the different national ecosystems and enhanced synergies at the European level.

- Continue to work towards positioning Europe as a global innovation leader.
- Ensure that necessary steps are taken to develop a balanced overall innovation strategy that remains open, while at the same time countering unfair practices from third-country players.
- Ensure that a solid cooperation scheme is in place when it comes to innovation and R&D cooperation with China and other countries, which guarantees reciprocity and prevents unfair practices.

184 Cohen, Mark, and Rogers, Philip, *A techno-globalist approach to intellectual property and supply chain disruption*, Hinrich Foundation, October 2020, viewed 28th November 2020, <https://www.hinrichfoundation.com/media/mbfc5j2j/a-techno-globalist-approach_hinrich-foundation_october-2020.pdf>

China

The Chinese Government would be well advised to look closely at the conflict between its push for global R&D leadership and the policies it is currently pursuing that will hamper these efforts. Additionally, if it is to regain the full trust of European business, academic and institutional stakeholders, it will need to reassess its activities abroad. Failure to do so could lead to a situation where Europe is pushed to further scrutinise, and even partially curtail, foreign access to Horizon Europe, one of the largest research and innovation programmes in the world.

- Take substantial steps to restore the trust of European stakeholders with regard to China's R&D activities both in China and in the EU, which will entail:
 - improving long-standing issues like IP, access to information and other resources, and talent mobility; and
 - ensuring that commitments made with the EU are enshrined in solid and enforceable cooperation guidelines.
- Address the conflict between China's ambitions as a global R&D leader and the policies that undermine these ambitions – particularly from the perspective of European businesses and governments.

Standards

Summary

Standardisation is a key driver of innovation, and an essential tool to facilitate trade and interoperability. A discipline traditionally considered highly technical, standardisation has become increasingly politicised in recent years. This politicisation, partly linked to the US-China trade tensions but also to issues like China's own strategic agenda and the global technology race, has led to concerns that the global standardisation system could become fragmented, resulting in disruptions to trade and innovation.

China is pushing to expand its influence in global standardisation activities in key sectors, both by promoting its own domestic standards internationally and through increased participation in international standards-setting.¹⁸⁵ At first glance, this may indicate further convergence and integration rather than decoupling. However, evidence shows that the rate of adoption of international standards in China has actually slowed down in the past few years.¹⁸⁶ This, combined with long-standing issues such as a general lack of foreign access to standardisation activities in China, could impact European businesses' ability to shape the standards they will have to abide by, both domestically and, potentially, internationally, which would make them less competitive.

The Chinese Government has also looked to promote Chinese standards in third countries through its BRI.¹⁸⁷ While China's progress in this endeavour is not yet clear, if successful it could lead to a loss of market share for European businesses in third countries. It could also result in an increased economic and technological dependence of these third countries on China and, in a worst-case scenario, contribute to the fragmentation of the global standardisation system.

General outlook

It is important to understand that the Chinese and European standardisation systems are very different. The European system is hierarchical, based on a public-private partnership, highly harmonised with international standards, open

185 De la Bruyere, Emily, & Picarsic, Nathan, *China's next plan to dominate international tech standards*, *TechCrunch*, 11th April 2020, viewed 28th October 2020, <<https://techcrunch.com/2020/04/11/chinas-next-plan-to-dominate-international-tech-standards/>>

186 *The EU and China – Addressing the Systemic Challenge*, BusinessEurope, January 2020, viewed 28th November 2020, <https://www.buseurope.eu/sites/buseurope/files/media/reports_and_studies/the_eu_and_china_full_february_2020_version_for_screen.pdf>

187 Examples of this are the SAC's Action Plan to Connect One Belt, One Road Through Standardisation (2015-2017) (http://www.gov.cn/xinwen/2015-10/22/content_2952067.htm), and the Standard Unicom Joint Construction of One Belt, One Road (2018-2020) <http://www.sac.gov.cn/ztydyj/bzhyw/201801/t20180119_341413.htm>



and transparent; the Chinese system is mostly driven by the state, with relatively low levels of harmonisation with international standards, and is not completely open and transparent.¹⁸⁸ For quite some time, the Chinese Government has been incorporating standardisation into its toolbox for advancing Chinese industrial policy—particularly with regard to innovation and high technology in key sectors, as can be seen in its CM2025 initiative, for example—and geostrategic interests both at home and abroad.

In terms of access to overall standardisation activities in China, there is a general consensus among European companies that the situation has improved considerably in recent years. At the same time, while instances of explicit exclusion of foreign businesses from these activities have been reduced, and are now isolated to areas like cryptography, rail, food contact materials and financial services, the current picture of access to standardisation activities is more nuanced: while 62.5 per cent of the 30 European companies surveyed for this section report improved access to standardisation activities in China, only 24 per cent enjoy full access. The top three issues preventing companies from full participation are unclear access procedures (62 per cent), unavailability of information (38 per cent) and the inability to obtain full voting rights in standardisation bodies (34 per cent). An example of the latter is foreign automotive manufacturers' inability to obtain voting rights in the China Automotive Technology and Research Centre, a key institution that works closely with the Ministry of Industry and Information Technology (MIIT) on standardisation for the automotive industry. However, these are long-standing issues that do not seem to be directly linked to decoupling concerns. In fact, US-China trade tensions do not seem to have precipitated retaliatory moves from Chinese standardisation bodies to block US or other foreign companies from participating in standards-setting, despite the fact that a number of attempts were made in the US to either exclude Chinese companies from standardisation bodies or to prevent US companies from cooperating with Huawei on standards-setting.¹⁸⁹

Although there has been a government push in the past few years for China to adopt more international standards, data shows that the adoption rate has actually slowed down, and the percentage of national standards that are identical to international standards remains extremely low.¹⁹⁰ The implications of this become increasingly significant in the context of China's plan to position itself as a leading developer of standards in industries it has identified as strategic. In areas such as ICT, cell and gene therapies, smart manufacturing and new energy vehicles (NEVs), an increase in domestic standardisation activities has been observed by European Chamber member companies. These trends reflect China's standards-related strategic goals set out in documents like CM2025 and the more recent China Standards 2035.^{191&192}

China is attempting to position itself as a leader in international standardisation by increasing both its presence and output in bodies like the International Standardisation Organisation (ISO) and the International Electrotechnical Commission (IEC), and by joining key sector-specific organisations like the International Council for Harmonisation of

188 According to the CEN-CENELEC latest Global Outreach report, as of May 2020, 77 per cent of the CENELEC catalogue was identical to or based on ISO deliverables (for CEN it was 33 per cent), whereas only one third of all the Chinese standards had been adopted from international standards – and even fewer were identical. Sources: *CEN-CENELEC Global Outreach Report*, CEN-CENELEC, May 2020, viewed 28th November 2020, <<https://www.cenelec.eu/intcoop/Pages/default.aspx>>; *China in International Standards Setting – USCBC Recommendations for Constructive Participation*, US-China Business Council, February 2020, viewed 18th November 2020; <<https://www.uschina.org/reports/china-international-standards-setting>>

189 Beattie, Alan, *Technology: how the US, EU and China compete to set industry standards*, *Financial Times*, 25th July 2019, viewed 28th November 2020, <<https://www.ft.com/content/0c91b884-92bb-11e9-aea1-2b1d33ac3271>>; *Commerce Clears Way for U.S. Companies to More Fully Engage in Tech Standards-Development Bodies*, US Department of Commerce, 15th June 2020, viewed 28th November 2020, <<https://www.commerce.gov/news/press-releases/2020/06/commerce-clears-way-us-companies-more-fully-engage-tech-standards>>

190 Kamenski, Jack, *Standards Setting in China – Challenges and Best Practices*, US-China Business Council, February 2020, viewed 28th November 2020; <https://www.uschina.org/sites/default/files/standards_setting_in_china_challenges_and_best_practices.pdf>

191 *The State Council issued 'China Manufacturing 2025'*, State Council, 19th May 2015, viewed 28th November 2020, <http://www.gov.cn/xinwen/2015-05/19/content_2864538.htm>

192 *'China Standard 2035' project closing meeting and 'National Standardisation Development Strategy Research' project kick-off meeting held in Beijing*, SAMR, 15th January 2020, viewed 28th November 2020, <http://www.samr.gov.cn/xw/zj/202001/120200115_310519.html>

Technical Requirements for Pharmaceuticals for Human Use.^{193&194} Additionally, since the inception of the BRI, China has made a point of promoting Chinese standardisation in project-recipient countries through policy guidance, mutual recognition and other agreements (92 agreements with 52 countries signed up as of September 2019), translation of standards into English (570 as of 2019, and most related to infrastructure) and the promotion of Chinese domestic standards in BRI projects.¹⁹⁵

Current impact

Limited access to Chinese standardisation activities is particularly problematic for European companies in sectors where China is pushing for the development of indigenous standards, as foreign companies may end up being prevented from participating in the early—and likely crucial—drafting stages of domestic standards for key industries that could eventually become international standards.

Divergent standards in areas like precision medicine or cybersecurity also remain a source of unease for European companies and create barriers to their operations. An example of this can be seen with financial services companies being informally encouraged to use domestic products with Chinese standards in the public procurement of critical information infrastructure (CII).¹⁹⁶ These and other informal requirements related to China's “autonomous and controllable” policies *de facto* exclude foreign companies not using these divergent domestic standards from participating in these bids.¹⁹⁷

China's increased participation in international standardisation bodies is not necessarily viewed in a negative light by European businesses, as they believe these organisations are transparent, collaborative and have clear procedures. Of more concern—particularly for companies involved in infrastructure or energy—is the promotion of Chinese standards along the BRI, particularly in projects that are mostly Chinese-financed. If a project-recipient country accepts the use of Chinese standards, the immediate effect will be a drastic reduction in the chances for foreign companies to participate in such projects. This is not the only potential risk derived from the linkage between domestic standardisation and the BRI, as explained in the coming sections.

Level of exposure of European companies

Companies in relatively non-contentious and traditional sectors, such as home appliances, may well continue to gain increased access to standardisation activities in China. They may also continue to observe an increase in harmonisation with, or even adoption of, international standards. However, the lack of access to domestic standardisation activities for European companies in strategic areas will remain a barrier to their China operations.¹⁹⁸ This could also have a spill-over effect if domestic Chinese standards are converted into international standards.

Additionally, China's mid-term standardisation strategy, China Standards 2035, sets out a vision for a system based

193 *ICH Assembly, Montreal, Canada, May/June 2017*, ICH, 17th June 2017, viewed 26th November 2020, <<https://www.ich.org/pressrelease/ich-assembly-montreal-canada-mayjune-2017>>

194 Currently China has 64 secretariats in the ISO and 11 in the IEC, and in 2019 it obtained a chair and two vice-chairs in the 3rd Generation Partnership Project (3GPP). In the case of ISO, from 2011 to 2018, China's share of secretariats grew from five per cent to 8.21 per cent. Over the same period, its share in working group secretariats rose from two per cent to 6.58 per cent. Sources: SAC *China*, ISO, viewed 18th November 2020, <<https://www.iso.org/member/1635.html>>; *China IEC full member*, IEC, viewed 18th November 2020, <https://www.iec.ch/dyn/www/f?p=103:34:4934401698192:::FSP_ORG_ID,FSP_LANG_ID:1003,25>; *3GPP Elects Plenary Leadership for the next 2 years*, 3GPP, 21st March 2019, viewed 18th November 2020, <https://www.3gpp.org/news-events/2023-2019_elections>; Rühlig, Tim, *Technical standardisation, China and the future international order – A European perspective*, Heinrich Böll Stiftung, February 2020, viewed 28th November 2020, <<https://www.ui.se/globalassets/ui.se-eng/publications/other-publications/technical-standardisation-china-and-the-future-international-order.pdf>>

195 Li, Lei, *Belt and Road industrial standards to be introduced: official*, *China Daily*, 11th September 2019, viewed 18th November 2020; <<https://www.chinadaily.com.cn/ai/201909/11/WS5d78ee06a310cf3e3556b120.html>>

196 ‘Autonomous and controllable’ (also referred to as ‘secure and controllable’) is a concept put forward by the Chinese leadership in several recent laws and regulations whereby the government would have broad discretion on deciding how it protects information networks, devices and data deemed critical to national and economic security. This concept is closely linked to the development and use of Chinese indigenous products and technologies instead of foreign ones.

197 Sacks, Samm, Li, Manyi Kathy, *How Chinese Cybersecurity Standards Impact Doing Business In China*, Center for Strategic and International Studies, 2nd August 2018, viewed 28th November 2020, <https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/180802_Chinese_Cybersecurity.pdf>

198 These domestic standardisation activities include both standards developed under the state umbrella, such as national, sector-specific and local standards, and standards developed under so-called market-led processes, like association and enterprise standards.



on state-driven mandatory national standards and market-driven association standards.¹⁹⁹ While several European Chamber members interviewed for this report indicated that a simplification of the Chinese standardisation system—along with the idea of an increased role for market-driven standards—could have positive effects, many also expressed reservations about the associations standards system. In its current form, this system is highly complex, sometimes non-transparent and non-inclusive, ever-growing in both the number of standards (some of them duplicative) and associations, and not purely market-driven.²⁰⁰ The latter issue—combined with the high number of associations—is of considerable concern, even for larger European companies, as it adds a layer of unpredictability to resource allocation strategies for standardisation.

The evidence so far indicates that efforts to promote domestic Chinese standards along the BRI have had mixed results.²⁰¹ That does not necessarily mean, however, that China is going to stop doing so, which can potentially increase the exposure of European companies from certain sectors that are doing business in third countries and that want to become involved in BRI projects.

Expectations and likely scenarios

With direct access barriers to participation in standardisation activities in China having already been mostly eliminated in non-controversial or non-strategic sectors, what remains are informal hurdles to participation, and a few direct barriers, in highly sensitive sectors like cybersecurity. The former has proven to be, and will likely remain, more difficult to identify and address. For the latter, even if access is granted, a situation where foreign businesses experience informal barriers to participation in standards-setting could ensue.

Blueprints like China Standards 2035 seem to indicate that China will continue to push for the development of homegrown standards in strategic sectors while adopting—at least partially—international standards for more traditional industries. This will probably be complemented by a continuation of China's push to increase its influence in international standardisation bodies. The development of a simplified, two-pronged standardisation system consisting only of national and association standards remains a possibility, though it is yet to be seen if relevant Chinese Government bodies could reach consensus on whether to proceed with such a reform.

Finally, when it comes to standardisation along the BRI, there is currently insufficient evidence that China has been successful in promoting domestic standards in project-recipient countries.²⁰² However, the signing of mutual recognition agreements with third countries leaves the door open for a potential push from China to create long-term economic and technological dependencies from them, thus increasing the market share for Chinese companies to the detriment of European businesses.

Implications and recommendations for European companies

Given China's dynamic innovation ecosystem and its ambitious standardisation strategy, being at the table is an essential first step for European companies to address potential issues related to market access, competitiveness and localisation costs. According to the European Chamber's BCS 2020, only a third of respondents were involved in standardisation activities,²⁰³ and several of the companies interviewed for this report mentioned that they participated more as observers rather than actively in standards-setting. European businesses should take into account the increasing relevance of China as a standardisation power when assessing their current and future involvement in

199 Rühlig, Tim, *Technical standardisation, China and the future international order – A European perspective*, Heinrich Böll Stiftung, February 2020, viewed 28th November 2020, <<https://www.ui.se/globalassets/ui.se-eng/publications/other-publications/technical-standardisation-china-and-the-future-international-order.pdf>>

200 As of 18th November 2020, 3,978 associations and 19,368 association standards had been registered in the national information platform for association standards, <<http://www.ttbz.org.cn/>>

201 Rühlig, Tim, *Technical standardisation, China and the future international order – A European perspective*, Heinrich Böll Stiftung, February 2020, viewed 28th November 2020, <<https://www.ui.se/globalassets/ui.se-eng/publications/other-publications/technical-standardisation-china-and-the-future-international-order.pdf>>

202 For the purpose of this report, 'BRI countries' refers to countries that have signed a BRI-related MOU with China.

203 *Business Confidence Survey 2020: Navigating in the Dark*, European Union Chamber of Commerce in China, 2020, viewed 18th November 2020, <<http://www.europeanchamber.com.cn/en/publications-business-confidence-survey>>

standardisation activities in the country, particularly in sectors where China is pushing for domestic standards-setting.

A second step would be to advocate for access both to standards-setting activities and to standardisation financing provided by the government. In the case of informal barriers, companies should advocate to ensure the implementation of transparency and openness in regulations supervising the activities of standardisation bodies. In third countries, European businesses should continue to advocate for the use of international standards.

- Develop a clear strategy for engagement in standardisation activities in China.
- Continue to advocate for more access to China's standardisation activities, working together with EU institutions and the European Chamber.
- Promote the use of international standards in third countries.

Implications and recommendations for governments

EU

Taking into consideration China's multiple efforts to utilise standardisation as a tool to achieve its geopolitical and industrial ambitions—in some cases through potentially distortive practices like extensive subsidisation for companies to develop and internationalise standards—Europe should consider unilateral, bilateral and multilateral actions.²⁰⁴ First, in terms of the competitiveness of European standardisation in the global arena, the EU and its member states need to ensure that the environment of its internal market is conducive to innovation and technological development. Additionally, the EU should look into embracing a more strategic approach to standards-setting.

With China, the EU should ensure that the implementation of relevant clauses enshrined in the CAI related to access to standardisation activities are closely monitored. It is also important that the EU continues to engage with China in standardisation through dialogues that set clear and measurable goals for cooperation.

The EU should seek cooperation with like-minded international partners on standardisation to counter risks of the global system becoming fragmented; develop dialogues on best practices with third countries in the process of building up their own standardisation systems; and promote the use of international standards with third countries through bilateral agreements, regional fora and EU-led initiatives like the Connectivity Strategy between Europe and Asia.

- Improve the EU's innovation/industrial ecosystem and the efficiency of its standardisation mechanisms.
- Continue to be active in the international standardisation arena, both through European and member states' standardisation bodies.
- Ensure policymakers have a clear, comprehensive and fact-based understanding of China's standardisation activities and strategy, both domestically and along the BRI.
- Tackle barriers to standardisation through various engagement channels with China.
- Cooperate with third countries (including China) on various aspects of standards-setting, both bilaterally as well as through initiatives like the EU Connectivity Strategy.

China

From the Chinese perspective, the need for efficient and effective standardisation systems as a basis for global competitiveness also stands. Ultimately, this can only be achieved with valuable input from *all* stakeholders. Efficiency must also be a key part of China's vision for its standardisation system, especially when looking at implementing major reforms, such as those outlined in China Standards 2035. Finally, it is key that China acknowledges the benefits

²⁰⁴ *Enterprise formulates and revises standards, and the government subsidises! List of standardisation subsidy policies in various regions*, CVC, 27th April 2020, viewed 28th November 2020, <http://www.cvc.org.cn/news/181_10089.html>



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of a global standardisation system and continues to work towards further integrating into rather than breaking away from it.

- Continue to open the standardisation system to foreign participation.
- Ensure that the various initiatives on standardisation reform—current and future—focus on creating an inclusive, transparent and efficient system, and work towards increased integration with the international standards system.

Digital Decoupling: Data governance, network equipment and telecommunications services

The following sections look at the trend referred to as ‘digital decoupling’, across three distinct but intertwined layers: data governance, networks and telecommunications services. Broadly speaking, in this report digital decoupling can be understood as the formation of multiple and mutually-divergent regulatory regimes, which are already presenting considerable barriers to companies’ ability to transfer data across borders and develop globally-integrated digital solutions.

It is important to understand that China’s burgeoning digital market has never been seamlessly integrated into the global economy, despite growing talk of a ‘balkanisation’ of the digital world and related technologies being driven by escalating geopolitical tensions. In fact, European companies in China have long faced considerable market access barriers, including a range of government-imposed restrictions.

Two main dimensions to data governance decoupling stand out.

First, decoupling of data management regimes in China, the EU and elsewhere is a major concern for surveyed European Chamber members, as this is a horizontal issue affecting companies across all industries. Government regulations in this domain, originating from both China and the EU, have already caused disruptions to cross-border data flows, as different jurisdictions impose sweeping data localisation requirements due to a combination of privacy, national security and economic concerns.

Second, growing securitisation of internet infrastructure and ICT supply chains is pressuring companies to rethink their global strategies. Caught between China’s drive for greater technological self-reliance and its need to assert control over all aspects of its digital environment, and the US’ aim to purge Chinese technology from a broad range of systems, European companies are being increasingly scrutinised in both markets, and few expect things to improve any time soon.

Data governance

Summary

The growing importance of data as a tool for companies to drive innovation and refine efficiencies in every part of the economy is difficult to overstate. However, although unrestricted access to data would be a boon to economic development, commercial use must take into account that individuals have privacy rights and governments have legitimate interests in managing the collection, processing and transfer of data. While this does not apply to the bulk of industrial and commercial data, there are sensitive data and personal information that could present legitimate concerns to national security and individual privacy respectively.

Data is a driving force across all sectors: energy companies gather and process data to maximise efficient distribution; banks use data to map out shifts in trends for depositors and loan recipients; financial institutions utilise data to refine algorithms to better manage investments; and automotive manufacturers collect data to more precisely measure vehicle performance and determine recommended maintenance routines.

While China’s data governance regime remains a work-in-progress, it is showing signs of significant divergence from the EU model, even as it converges with the EU’s in certain respects. Meanwhile, the EU’s own data governance framework is continuing to evolve, both through legislative and regulatory changes, such as the proposed Data



Governance Act and several related measures, but also judicial decisions like the Schrems II judgement.^{205,206&207} The different approaches to managing data collection, processing and flows in China, the EU and elsewhere are potentially leading towards *de facto* decoupling, and have already produced disruptions in cross-border data transfers. Incompatible governance regimes with variant definitions of ‘data’, especially in how personal data is made distinct from industrial/commercial data, are impeding cross-border transfers. This makes it difficult for companies to exploit this important resource, the value of which is maximised by building large pools of data drawn from sources all around the world.

Companies are bracing themselves for data governance requirements to tighten further in the EU and China, and are adopting highly conservative compliance practices in anticipation. This section will look at both how the data regulation regimes of the EU and China interact, as well as how they operate in isolation, but it is also important to note that similar issues of incompatibility between data governance regimes exist across many different jurisdictions.

How do the different definitions/interpretations of ‘data’ in different markets (i.e., China, the EU and the US?) impact your business operations?	
Significant negative impact	47%
Somewhat negative impact	35%
No impact	6%
Somewhat positive impact	12%
Significant positive impact	0%

Source: European Chamber survey on data governance decoupling conducted in September 2020

General outlook

Companies across a wide range of industries expect that broad decoupling in terms of data governance will challenge their operations. Three quarters of respondents to the general survey expect to experience a negative impact, with 30 per cent anticipating the impact to be significant.

The challenges driving this sentiment primarily stem from still unclear definitions under China’s evolving regulatory regime of ‘important data’, ‘personal information’ and ‘sensitive personal information’. This generates issues so significant that of the surveyed members from the Chamber’s Cybersecurity Working Group, all but two identified differentiating standard industrial and business data from ‘important data’ and ‘personal information’ as a significant challenge. Two thirds indicated that they constantly face major compliance risks as a result of uncertainty over how Chinese law applies to particular types of data. As a result, many companies already adopt a highly conservative approach to cross-border data transfer out of China in order to maintain compliance – a decision not only limited to personal data, but often industrial/commercial data as well.

The problems arising from these differing understandings are then exacerbated by the goals of various state actors. For example, the EU has a strong regime for protecting individual privacy and personal data through its GDPR framework, but has historically had a relatively relaxed approach to the flow of industrial and commercial data, both in and out of the bloc.²⁰⁸ There is, however, some uncertainty over whether this will continue to be the case, given the political imperatives to assert greater regulatory control over data generated within the EU, and the pressures from

205 *Data Governance Act*, European Commission, 25th November 2020, viewed 14th December 2020, <<https://ec.europa.eu/digital-single-market/en/news/data-governance-act>>

206 Espinoza, Javier, *EU vs. Big Tech: Brussels’ bid to weaken the digital gatekeepers*, *Financial Times*, 8th December 2020, viewed 14th December 2020, <<https://www.ft.com/content/4e08efbb-dd96-4bea-8260-01502aaf1bd7>>

207 *The CJEU judgment in the Schrems II case*, European Parliament, September 2020, viewed 14th December 2020, <[https://www.europarl.europa.eu/RegData/etudes/ATAG/2020/652073/EPRS_ATA\(2020\)652073_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/ATAG/2020/652073/EPRS_ATA(2020)652073_EN.pdf)>

208 *General Data Protection Regulation*, *Official Journal of the European Union*, 27th April 2016, viewed 20th October 2020, <<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0679&from=EN>>

the ‘Schrems II’ judicial decision towards data localisation in practice.²⁰⁹

At the other end of the spectrum is China’s still incomplete framework of the Cybersecurity Law, the Data Security Law (Draft) and the Personal Information Protection Law (Draft), along with subordinate regulations and guidelines that are not legally binding but likely in practice to be employed or referred to by Chinese authorities in execution of administrative decisions and supervisory activities.^{210&211} The level of access to data on networks in China, including the networks of foreign enterprises, that is apparently intended to be given to Chinese authorities through laws and regulations raises questions over whether a wide range of data transfers to China or Chinese actors will be compatible with EU data governance laws.²¹²

In addition, various restrictions and burdens repeatedly provided in different laws, regulations and standards, or publicised drafts, without clarification of the relationship and application of them, have raised European companies’ concerns over the efforts, cost and feasibility of fully complying with those legal requirements. Although there are some indications that negative feedback from foreign companies on draft laws and regulations has led to some reconsideration of intrusive measures by Chinese authorities, many provisions remain unpublished or in draft form, leaving European companies uncertain of what is to come.

The lack of clear definitions of key terms and mandatory processes under the Chinese regime has left European companies with the distinct impression that the aim is to create a system in which a sizeable chunk of data is treated like a strategic resource that must be carefully kept within China’s borders. Furthermore, the Chinese authorities’ concern with ‘information security’ in the broader sense means that they place a high priority on maintaining access to, and control of, data within China’s borders.

Current impacts

Companies tend to centralise their data processing, preferably in their global HQs, meaning that Chinese firms would aim to bring their data collected through operations in the EU back to China while European companies would aim to do the same in the other direction. However, when looking at the EU and China in isolation, it appears that European companies in China face significant regulatory disadvantages compared to their Chinese competition with operations in the EU.

For example, if a Chinese and a European company have operations in each market, both companies might collect appropriately anonymised user data to better determine trends in consumer demand across markets. The more users whose data can be harvested and combined for analysis, the more insightful the conclusions that can be drawn.

Presently, Chinese companies can typically transfer the data they collect in Europe back to China, which means, in terms of consumer data, they have a potential data pool of more than 1.8 billion users across both markets to combine and analyse. For the time being, Chinese firms are relatively free to transfer processed data out of the EU under default contractual provisions (‘standard contractual clauses’ (SCCs)). However, this situation is already changing as a result of the trend in judicial decisions in Europe regarding data management and GDPR compliance, as well as a growing appetite among European policymakers to tighten oversight on foreign companies’ data collection and transfer, especially Chinese and American ones. For example, in Schrems II, the European Court of Justice made

209 *Frequently Asked Questions on the judgment of the Court of Justice of the European Union in Case C-311/18 – Data Protection Commissioner vs Facebook Ireland Ltd and Maximilian Schrems*, European Data Protection Board, 23rd July 2020, viewed 14th December 2020, <https://edpb.europa.eu/sites/edpb/files/files/file/1/20200724_edpb_faqonjeuc31118_en.pdf>206 Espinoza, Javier, *EU vs. Big Tech: Brussels’ bid to weaken the digital gatekeepers*, *Financial Times*, 8th December 2020, viewed 14th December 2020, <<https://www.ft.com/content/4e08efbb-dd96-4bea-8260-01502aaf1bd7>>

210 *Cybersecurity Law*, National People’s Congress (NPC), 7th November 2016, viewed 20th October 2020, <http://www.gov.cn/xinwen/2016-11/07/content_5129723.htm>

211 The draft *Data Security Law* and draft *Personal Information Protection Law* have been removed from official websites as of 19th November 2020 for further review and consideration of input from its corresponding call for comments. The NPC has posted information about the most recent drafts in the following link: <http://www.npc.gov.cn/flcaw/more.html>

212 One such example is the *Regulations on Internet Security Supervision and Inspection issued by the Ministry of Public Security*, which include sections like Clause 15, which allows the Public Security Bureau to enter a place of business and inspect and copy data “related to cybersecurity”, <http://www.gov.cn/gongbao/content/2018/content_5343745.htm>



clear that SCCs will not be presumed adequate, and that the obligation lies with data controllers or processors to verify whether the laws and practices of the recipient country provide a level of data protection essentially equivalent to that guaranteed within the European Economic Area.²¹³

Meanwhile, European firms have comparatively more barriers to overcome in order to transfer the data they collect in China back to their European HQs. If a company is unable to transfer that data back, it will be limited to two separate pools of potential users—1.4 billion in China and 450 million in the EU—that cannot be combined to generate more useful information. Although data markets in both jurisdictions are underdeveloped and fragmented, China’s jurisdictional and political unity compared to the EU’s imposes fewer barriers to developing such markets. This further amplifies China’s potential scale advantage in data pools.

Has your company already postponed or abandoned, or is thinking about postponing or abandoning, certain projects, new products or services due to the implementation of restrictive personal information regulations in China?

We are thinking about postponing/abandoning them	34%
We have already postponed/abandoned them	19%
None of the above	44%

Source: European Chamber survey on data governance decoupling conducted in September 2020

Level of exposure of European companies

European companies are heavily exposed in this situation, in no small part because of how globalised their operations already are. For example, companies that aim to roll out globally-integrated digital solutions would lose the benefits of access to globally-scaled data. Interviewed industrial and commercial software firms, as well as companies in a variety of industries that are creating interconnected digital solutions, forecast that various markets will continue down the path of extensive data localisation requirements and broad restrictions on data transfers. If that happens, they anticipate that they will need to adopt ‘island’ strategies in which solutions are highly localised and disconnected from one another. Such an approach would diminish efficiency and economies of scale while also driving down the companies’ value proposition in the eyes of their customers.

The degree to which companies will be affected depends on their ideal uses of the data they collect. Several interviewed companies reported that they are not negatively affected by the data transfer requirements because their data-use goals would not be better achieved by transferring data back to Europe. For example, some companies mainly harvest local user data to refine their product localisation, such as user preferences for car paint colours, as one automobile company reported, or to identify malfunctions or inefficiencies in certain China-based equipment or infrastructure, such as the location and usage of electric vehicle charging stations, as stated by a European energy company. Meanwhile, firms involved in renewable energy development noted that, while their local data pool still yielded useful results, it would be ideal to aggregate the data collected in China and the EU, for example in wind energy production, to better identify efficiencies based on diverse conditions.

Company size and strategy can also determine exposure levels. Interviewed automotive companies suggested that European manufacturers have largely fallen into one of two camps for developing autonomous driving systems. One, largely made up of players with a relatively small market share in China, aims to create global systems that can then be localised to suit regional conditions; the other, generally large-volume producers, has created autonomous driving systems largely from the ground up in major markets like China. In this case, the former is more exposed to data

213 Recommendations 01/2020 on measures that supplement transfer tools to ensure compliance with the EU level of protection of personal data, Data Protection Board, 11th November 2020, viewed 14th December 2020, <https://edpb.europa.eu/our-work-tools/public-consultations-art-704/2020/recommendations-012020-measures-supplement-transfer_en>

decoupling than the latter, which may well be able to endure even in relative isolation. This is because autonomous driving systems rely on training algorithms that use generated data points to ‘teach’ the system which decisions should be made under specific conditions. The larger the pool of data points for these algorithms to learn from, the higher the development speed and quality.

Expectations and likely scenarios

Even if the status quo of the various data governance regimes remains unchanged in the coming years, the negative impact felt by European companies will grow. Few companies are not either already collecting some kind of data, be it commercial, industrial, personal or all of the above, or exploring how to begin doing so. As data collection becomes both broader (from more sources) and deeper (from more detailed collection), a company’s competitiveness will be enhanced or diminished relative to the size of their and their competitors’ data pools, which are in turn impacted by the inward and outward flows of data permitted by the authorities governing the origin of said data. While unlikely to be the decisive factor, as all the data in the world cannot make up for inferior quality, data pools will play an increasingly important role moving forward.

In general, European companies do not have a positive outlook on how the situation is likely to develop. With regard to the future of China’s data management framework, a mere 19 per cent said they were somewhat optimistic, while 69 per cent were either somewhat or highly pessimistic. At the same time, interviewed companies and experts are similarly unsure of which direction the EU’s data governance model may be moving in.

The EU and China already seem to be going down the route of expanded data regulation. In Europe, various member-state regulators have begun tightening data management rules, especially for transfer abroad.²¹⁴ On the horizon are the Schrems II ruling by the European Court of Justice and the EU Commission’s proposal for a Data Governance Act,²¹⁵ and the announced Digital Services Act and upcoming Digital Markets Act.^{216,217&218} These will see the introduction of rules that will have an impact on companies, including through restrictions on transfers of commercially-sensitive data to foreign countries where protections are deemed not equivalent to European law. Similar developments are afoot in China with the 2020 promulgations of the draft Data Security Law and the Personal Information Protection Law.

Meanwhile, the discussion about the trustworthiness of Chinese companies’ control of user data is already alive and well in the US with the ongoing debates about TikTok and WeChat.^{219&220} European companies listed in the US may also face tougher regulations from the authorities. For example, if the 2019 National Security and Personal Data Protection Act were to be enacted by the US Congress in the form originally tabled, it would potentially forbid US-listed companies from transferring any data from the US into China.²²¹

The European Chamber does not expect data governance to become a sudden and explosive front of decoupling. Instead, if left unchecked, the situation is more likely to steadily expand in a tit-for-tat manner, through some sort

214 Manancourt, Vincent, *The demise of Privacy Shield may be the end of US-Europe data transfers*, *Politico*, 3rd August 2020, 14th December 2020, <<https://www.politico.eu/article/privacy-shield-is-dead-long-live-data-localization/>>

215 *Proposal for a Regulation on European data governance (Data Governance Act)*, European Commission, 25th November 2020, viewed 14th December 2020, <<https://ec.europa.eu/digital-single-market/en/news/proposal-regulation-european-data-governance-data-governance-act>>

216 *The Digital Services Act package*, European Commission, 22nd June 2020, viewed 14th December 2020, <<https://ec.europa.eu/digital-single-market/en/digital-services-act-package>>

217 *Watch: Von der Leyen gives glimpse of what EU’s Digital Services Act will look like*, *Euronews*, 2nd December 2020, viewed 14th December 2020, <<https://www.euronews.com/2020/12/02/eu-commission-president-von-der-leyen-outlines-vision-for-eu-digital-market>>

218 *The Digital Services Act Package*, The European Commission, 16th December 2020, viewed 22nd December 2020, <<https://ec.europa.eu/digital-single-market/en/digital-services-act-package>>

219 *Executive Order on Addressing the Threat Posed by TikTok*, The White House, 6th August 2020, viewed 20th October 2020, <<https://www.whitehouse.gov/presidential-actions/executive-order-addressing-threat-posed-tiktok/>>

220 *Executive Order on Addressing the Threat Posed by WeChat*, The White House, 6th August 2020, viewed 20th October 2020, <<https://www.whitehouse.gov/presidential-actions/executive-order-addressing-threat-posed-wechat/>>

221 S.2889 – *National Security and Personal Data Protection Act of 2019*, The 116th Congress of the United States of America, 18th November 2019, viewed 22nd December 2020, <<https://www.congress.gov/bills/116/congress/2019/senate/bills/2889/text?q=%7B%22search%22%3A%5B%22National+Security+and+Personal+Data%22%5D%7D&r=1&s=2>>



of reciprocity review mechanisms, or via the expansion of regulatory controls. Rather than waiting for this potential to become reality, policymakers should explore ways to align the basics of data management regimes of various markets enough to minimise friction.

Implications and recommendations for European companies

European companies will have to make difficult decisions regarding their data collection and processing in order to remain competitive. An admittedly oversimplified spectrum of choices would have at one end full data localisation, both for storage and analysis/use, in 'island solutions' to avoid transfer compliance concerns altogether; and at the other end would be capacity building in legal and compliance operations to try and maximise the amount of data that could be compliantly transferred. The pros and cons along the spectrum would vary based on factors like company size, intended uses of collected data and the scale of resources that could be allocated to compliance or localisation.

- Evaluate the cost-benefit spread of extensive compliance and legal resources to manage what data flows are possible in comparison to a fully localised data 'island solution' in China.

Implications and recommendations for governments

EU

European companies and member-state governments would benefit from a better understanding of the inconsistencies between the EU's regulatory regime for data and that of China's, so that European actors can make informed decisions about data exchanges and so that a common understanding at the EU level can be developed.

European actors also need to consider whether those arguing for data localisation requirements within the EU are serving European interests in the long term. US and Chinese technology powerhouses were built on the foundation of their highly-integrated data markets. As the EU data market remains relatively diffuse, heavy localisation requirements could produce negative effects without resulting in the rise of European technology champions. Data localisation requirements are also likely to be seen by those outside of Europe as inconsistent with European advocacy for a 'free, open and global Internet', and may undermine the EU's capacity to portray itself as a viable third way in data governance between the US and China.

- Issue guidance to member states and businesses outlining the similarities and differences between the EU's and China's data management frameworks.
- Establish an EU-wide risk mitigation approach to data security with regard to cross-border transfer with economic partners.
- Re-evaluate the direction in which the EU's data management regime is headed, and ensure that data protection measures are applied in a manner that is proportionate to legitimate national security and privacy risks.

China

As China continues to develop its data management framework, the country's leaders have an opportunity to course-correct. China, which in its recent Global Data Security Initiative announcement touted an 'objective' and 'law-based' approach to transnational data exchanges, needs to give foreign actors more confidence that its evolving data management regime is governed in practice by a level of transparency and predictability adequate to protect foreign interests. Unilaterally, China could increase efforts to address the many long-standing concerns of the business community.

- Re-evaluate the direction in which China's data management regime is headed, and ensure that data protection measures are applied in a manner that is proportionate to legitimate national security and privacy risks.

- Deliver on requests from the business community for specific and detailed definitions of data categories and clear procedures for data processing for cross-border transfer.
- Harmonise the varying data management regimes across different jurisdictions in China such that measures are uniform.

The EU and China

Governments eager to embark on data governance decoupling should be aware of the consequences this would have on development and innovation. Beyond the obvious economic advantages of free data flows, many other government objectives can be aided by maximising the potential pools of data that companies can use. Data is intrinsically tied to improvements in energy efficiency, better controlling emissions, improving product safety, boosting the value of pharmaceuticals and medical devices, and providing fine-tuned financing for SMEs, among others.

- Balance public demands for data protection with the need for certain data uses and transfer to drive improvements in areas of public concern.

Multilaterally

Engagement between the EU and China, and other partners, can yield fruit. Working bilaterally and even multilaterally to determine how to align regimes can further bring out the greatest potential of global data sets while also protecting legitimate personal information and security risks.

- Work with key economic partners to determine a basic common framework for data management with aligned definitions of data types and basic guidance on standard procedures for companies to process/anonymise certain data to allow for compliant transfer.

Network equipment

Summary

Telecommunications and digital issues are at the forefront of the escalating geopolitical confrontation between China and the US, with European companies taking collateral damage. The increasingly global trend of governments asserting greater sovereign control over the Internet and digital connectivity is leading to active decoupling in areas where companies were, until recently, able to strengthen ties across borders. The debate around next-generation telecommunication networks is the most prevalent example of what the future may hold in this domain:

- Explicit declarations have been made by the US that go far beyond just banning Chinese vendors from 5G networks, as seen most prominently in its Clean Network programme.²²²
- Diverse approaches have been taken by EU Member States towards Chinese 5G equipment suppliers.
- Implicit policies have been enforced through vaguely phrased regulations—as witnessed in China’s broad use of the category ‘critical information infrastructure’—and the recommendation by Chinese authorities that domestic entities adopt “autonomous and controllable” technology, including but not limited to network products and services apart from just 5G.²²³

A full examination of the legitimacy of the securitisation of these issues is beyond the scope of this report. However, it seems that the 5G dispute is only the tip of the iceberg. While legitimate security concerns are entirely rational in today’s world, European companies are concerned about the broader, long-term trend of telecommunications and

²²² Fidler, David P., *The Clean Network Program: Digital Age Echoes of the “Long Telegram”*, The Council on Foreign Relations, 5th October 2020, viewed 22nd December 2020, <<https://www.cfr.org/blog/clean-network-program-digital-age-echoes-long-telegram>>

²²³ Jing, Meng, *China’s cybersecurity laws may be used to block US tech firms on national security grounds, says expert, SCMP*, 24th May 2019, viewed 22nd December 2020, <<https://www.scmp.com/tech/policy/article/3011655/chinas-cybersecurity-laws-may-be-used-block-us-tech-firms-national>>



digital issues becoming increasingly securitised, and trustworthiness being associated with the origin of ICT products and services.

General outlook

There have recently been considerable efforts on the part of various governments to actively disentangle their telecommunications and digital sectors, with China looking to decouple from the EU and the US, and vice versa. The 5G dispute is the most obvious manifestation of this trend. However, many of the considerations and criteria applied in ‘securing’ this crucial technology that so many technological breakthroughs will rely on are potentially applicable to other areas as well.

The Trump Administration’s Clean Network programme explicitly calls for removing Chinese companies and equipment from six areas of networks connecting the US and its diplomatic facilities abroad: carrier, store, apps, cloud, cable and path.²²⁴ This effort is extraterritorial in its ambition, with Secretary of State Mike Pompeo expressing his expectation that the US’ allies would join the initiative.

In parallel with this, President Donald Trump issued executive orders to ban Chinese social media apps TikTok and WeChat on national security grounds, although both bans are being challenged in court and the situation remains in flux at time of writing.²²⁵ Meanwhile, India has banned over 200 Chinese apps following an escalation of security tensions between the two countries.^{226&227}

China’s government has laid out two broad categories meant to securitise the digital arena as it proceeds with the implementation of the 2017 Cybersecurity Law.^{228&229}

The first category, CII, focusses on the specific hardware, software and services directly involved in the transmission of information in specific infrastructure, which includes but is not limited to 5G. The aim is to heavily restrict and regulate which companies can be involved in network development via inputs, construction, use and servicing—essentially the whole value chain—through a review process. For example, the *Cybersecurity Review Measures* for CII operators, issued in April 2020, fall short of providing a clear definition of CII.²³⁰ They outline rules for a national security review assessment that all “network products and services” procured by CII operators need to pass. Vague definitions and the emphasis on “supply chain security” (including “the risk of supply disruptions due to political, diplomatic and trade factors”) suggest potential discrimination against foreign companies.

Interviewed European Chamber members reported that broad definitions of CII result in the relevant authorities across all levels of government applying a conservative decision-making process when sourcing relevant goods and services.

The second, the use of the term “autonomous and controllable”, has surged in recent years, particularly in 2020, with

224 The Clean Network programme claims to be aimed at protecting sensitive information of US companies and citizens from unwanted intrusions of “malign actors, such as the Chinese Communist Party.” Essentially it is centred on the notion of trustworthiness as the main criterion for assessing the security of telecommunications networks and services. As such, Chinese telecommunication carriers, Chinese apps, app stores managed by Chinese smartphones makers, Chinese cloud providers, and suppliers of 5G network equipment (involved in network traffic, or ‘path’) and undersea cable infrastructure are deemed security threats. *The Clean Network*, US Department of State, 2020, viewed 8th December 2020, <<https://www.state.gov/the-clean-network/#:~:text=The%20Clean%20Network%20program%20is,as%20the%20Chinese%20Communist%20Party>>

225 *Trump’s WeChat, TikTok bans will go through, White House aide says*, *South China Morning Post*, 22nd November 2020, viewed 14th December 2020, <<https://www.scmp.com/news/china/diplomacy/article/3110895/trumps-wechat-tiktok-bans-will-go-through-white-house-aide>>

226 Singh, Manish, *India bans 43 more Chinese apps over cybersecurity concerns*, *TechCrunch*, 24th November 2020, viewed 14th December 2020, <<https://techcrunch.com/2020/11/24/india-bans-another-43-chinese-apps/>>

227 China itself has a history of censoring foreign websites and online products. Foreign apps face considerable barriers, as regulators have broad discretionary power in determining which content endangers national security. See, for example, the *Provisions on the Management of Mobile Internet Application Information Services*, Cybersecurity Administration of China (CAC), 28th June 2016, viewed 14th December 2020, <http://www.cac.gov.cn/2016-06/28/c_1119122192.htm>

228 *Cybersecurity Law, NPC*, 7th November 2016, viewed 19th May 2020, <http://www.gov.cn/xinwen/2016-11/07/content_5129723.htm>

229 McCarthy, Simone, *China’s new cybersecurity rules could hit foreign service providers*, *South China Morning Post*, 28th April 2020, viewed 14th December, 2020, <<https://www.scmp.com/news/china/politics/article/3081908/chinas-new-cybersecurity-rules-could-hit-foreign-service>>

230 *Cybersecurity Review Measures*, CAC, 27th April 2020, viewed 14th December 2020, <http://www.cac.gov.cn/2020-04/27/c_1589535450769077.htm>

the European Chamber's ICT and Cybersecurity working groups noting that the term is increasingly common in official documents, and is more and more often a topic of discussion with current and potential partners.²³¹ Officially the term is intended to have a positive meaning, as it emphasises high levels of security through the prevention of backdoors and other information technology (IT) security threats.²³² But in reality, "autonomous and controllable" carries a deeply negative connotation, intended or otherwise, that foreign technology is inherently less secure.

China's Cybersecurity and Data Security Laws are signalling to Chinese companies that they should favour "autonomous and controllable" technologies. At the same time, implementation measures for the Cybersecurity Law remain unclear. What impact do these risks have on market access and bidding access for European vendors?		
	Market access	Bidding access
Significant negative impact	44%	57%
Slight negative impact	50%	19%
No impact	6%	19%
Slight or significant positive impact	0	0

Source: European Chamber survey on data governance decoupling conducted in September 2020

For their part, the EU and its member states are taking an increasingly securitised perspective on telecommunications and digital technology. The Von der Leyen Commission has embraced the notion of digital sovereignty, and various member states are adopting more critical views about which companies can build and operate networks within their borders. More and more member states are imposing tough restrictions on Chinese 5G equipment vendors, often by raising specific standards so that little room is left for them. That being said, 5G network security currently remains a topic of debate rather than a foregone conclusion.²³³ In addition to 5G, the ongoing effort to create a European 'sovereign' cloud infrastructure, Gaia-X,²³⁴ to avoid reliance on American and Chinese solutions testifies to the blurring of lines between digital, industrial policy and security considerations.

Current impacts

Although the US Clean Network programme is yet to fully materialise, and how such a plan would proceed under a Biden presidency remains unclear, there has already been an impact on business sentiment. European Chamber members widely report that their global operations would be dramatically hit if they are ultimately expected to remove all Chinese hardware and software from their networks. After all, many Chinese providers are industry leaders across the network value chain, and many European companies have happily integrated Chinese technology into their offerings. As an illustration of the potential compliance difficulties, one interviewed company noted that when they were scrutinised by US authorities they were even asked about the nationality and physical location of those that had coded a specific programme.

231 For the purpose of this report, 自主可控 is translated as "autonomous and controllable", but is a catch-all for the wide range of comparable and interchangeable terms used throughout China, such as: 'secure/trustworthy/reliable/indigenous'. The term is frequently used at all levels of government communications, including as high as the State Council <http://www.gov.cn/xinwen/2019-07/17/content_5410689.htm> and by President Xi Jinping, <<http://cpc.people.com.cn/n1/2016/10/10/c64094-28763907.html>>

232 Paradoxically, China's cyber defences are actually relatively underdeveloped in no small part because of the extent of information that is required to be controlled by government actors, which inherently comes with the trade-off of less secure systems. Austin, Greg, *How Good Are China's Cyber Defenses?*, *The Diplomat*, 11th July 2018, viewed 14th December 2020, <<https://thediplomat.com/2018/07/how-good-are-chinas-cyber-defenses/>>; Weber, Valentin, *How China's Control of Information is a Cyber Weakness*, *Lawfare*, 12th November 2020, viewed 14th December 2020, <<https://www.lawfareblog.com/how-chinas-control-information-cyber-weakness>>

233 In January 2020, EU Member States and the Commission adopted a toolbox of risk-mitigating measures for 5G networks, which includes clear language about the risks posed by equipment vendors that may be subject to influence by a non-EU government and lack the ability to push back through democratic checks and balances. See *Cybersecurity of 5G networks – EU toolbox of risk mitigating measures*, European Commission, 29th January 2020, viewed 15th December 2020, <<https://ec.europa.eu/digital-single-market/en/news/cybersecurity-5g-networks-eu-toolbox-risk-mitigating-measures>>; Several member states, from France to Sweden, have taken decisive measures to limit the role of Huawei in the rollout of their 5G networks on security grounds, with some also signing joint declarations with the US Government to restrict Chinese vendors, see Cerulus, Laurens, *Huawei challenges legality of 5G bans in Poland, Romania*, *Politico*, 2nd November 2020, viewed 15th December 2020, <<https://www.politico.eu/article/huawei-hints-at-legal-action-against-5g-bans-in-poland-romania/>>; At the same time, implementation of the toolbox is up to national authorities, and the implementation progress report, issued in July, observed that progress was urgently needed to mitigate the risk of dependency on high-risk suppliers. See *Report on Member States' progress in implementing the EU Toolbox on 5G Cybersecurity*, European Commission, 24th July 2020, viewed 15th December 2020, <<https://ec.europa.eu/digital-single-market/en/news/report-member-states-progress-implementing-eu-toolbox-5g-cybersecurity>>

234 Stolton, Samuel, *Gaia X group signs corporation papers in bid for EU digital sovereignty*, *Euractiv*, 16th September 2020, viewed 15th December 2020, <<https://www.euractiv.com/section/digital/news/gaia-x-group-signs-corporation-papers-in-bid-for-eu-digital-sovereignty/>>



China's CII and “autonomous and controllable” approach has had a much sharper impact on European companies. Not a single surveyed company viewed it as positive, with nearly all expecting a negative impact on market access, and four out of five anticipating the same for bidding access. However, several interviewed companies anticipate some short-term benefits in areas where the priority is to get rid of US technology for which replacements, including European, could be found.

However, those same companies stated that they do not expect this advantage to last: once indigenous alternatives become good enough, they believe that they too will be replaced under the same justification. Domestic substitution is a long-standing concern for European companies in China. Whether due to industrial policy—such as CM2025—meant to advance Chinese national champions’ dominance in emerging sectors at the expense of fair competition, or as a result of the ongoing narrative that China must be ready to ‘go it alone’—as evidenced by a plethora of explicit statements by Chinese leaders—the European business community cannot afford to ignore the writing on the wall. Even occasional policies have been promulgated that explicitly state this intent, such as the 3-5-2 Directive, which orders the removal of foreign computers and software from government offices. It lays out a plan to replace 30 per cent by 2020, 50 per cent more by 2021 and the remaining 20 per cent by 2022.²³⁵

In fact, current geopolitical tensions around digital connectivity and restrictions imposed on Chinese ICT firms abroad are emboldening the Chinese Government to double-down on its push for self-reliance. For example, intensified efforts to develop a homegrown open-source software ecosystem show the extent to which Beijing is bracing for prolonged decoupling.²³⁶ Meanwhile, the possibility of government retaliation against foreign business in response to restrictions on Chinese ICT and internet companies adds to the prevailing climate of uncertainty, even though words may not always be followed by concrete actions.²³⁷ The inclusion of certain digital and emerging technologies in China’s new Export Control Law (see the Critical Inputs section on page 40), and a reciprocity clause introducing export controls in relation to data activities in the draft Data Security Law (see the Data governance section on page 57) opens up new avenues for Beijing to retaliate against restrictions on Chinese technology abroad, potentially creating further headaches for European companies.

Level of exposure of European companies

Potential exposure to the US Clean Network programme is generally low in the short-term. However, some of the first countries to implement their own measures against Chinese 5G companies and quietly push for varying levels of diversification are major economies on China’s doorstep, like Japan and Australia. Moving forward, it is not difficult to see how a Biden Administration could get buy-in from at least some other like-minded Pacific allies if it wished to pursue this strategy.

At the same time, the potential for further erosion of EU-China relations, driven by enduring promise fatigue and profound political divergences, could intersect with a more geopolitically- and digitally-confident European Commission and an increasingly assertive EU, resulting in the emergence of a broad coalition to counter China in the digital domain.²³⁸ Whatever opinions may be held about this possibility, it is a consideration that companies should take into account when determining their exposure to potential disruptions.

Within the China market, concerns about the non-transparent use of categories such as CII and “autonomous and

235 Yuan, Yang, & Nian, Liu, *Beijing orders state offices to replace foreign PCs and software*, *Financial Times*, 9th December, 2019, viewed 14th December, 2020, <<https://www.ft.com/content/b55fc6ee-1787-11ea-8d73-6303645ac406>>

236 Borak, Masha, *China pins its hopes on Gitee as an open source alternative to Microsoft's Github amid US tech tensions*, *South China Morning Post*, 28th August 2020, viewed 15th December 2020, <<https://www.scmp.com/abacus/tech/article/3099107/china-pins-its-hopes-gitee-open-source-alternative-microsofts-github>>

237 Bennhold, Katrin, & Ewing, Jack, *In Huawei Battle, China Threatens Germany Where It Hurts: Automakers*, *The New York Times*, 16th January, 2020, viewed 15th December, 2020, <<https://www.nytimes.com/2020/01/16/world/europe/huawei-germany-china-5g-automakers.html>>

238 The European Commission has recently proposed a new transatlantic agenda for cooperation, which devotes considerable space to tech and digital governance among like-minded democracies, including on “digital supply chain security”. See *Joint Communication to the European Parliament, the European Council and the Council: A new EU-US agenda for global change*, European Commission, 2nd December 2020, viewed 15th December 2020, <https://ec.europa.eu/info/sites/info/files/joint-communication-eu-us-agenda_en.pdf>

controllable” by public authorities are significant and growing, in line with increasingly prevalent self-reliance rhetoric. Member companies report being more heavily scrutinised due to their status as a foreign company, not just in public/government procurement, but also in private business deals. Explicit calls for China to develop comprehensive self-sufficiency in key areas and secure dominant positions in global supply chains aggravate European companies’ concerns, with Chinese companies feeling under more pressure to forego foreign partners for local ones.²³⁹

Whether intended or not, the combination of these policies and rhetoric is painting a target on the back of European companies involved in supplying, building and servicing networks.

Expectations and likely scenarios

Though not yet equivalent to each other, the securitisation and political economy thinking underlying the US’ Clean Network programme, China’s CII/“autonomous and controllable”/self-sufficiency push and certain aspects of Europe’s digital sovereignty ambitions all have the potential to feed on one another, resulting in a downward spiral. Unless those involved can identify and agree on an exit ramp that leads to a more sustainable approach, companies should expect things to tighten up further and factor this into their future strategies.

The European business community in China expects the government to continue pushing the “autonomous and controllable” guidelines – Beijing was doing so prior to the US-China economic conflict, and now likely feels vindicated. Companies should plan for even more politicised regulations and unofficial government guidance to Chinese firms to further scrutinise foreign players.

The potential for China’s authorities to further clarify and rein in the scope of CII and the permissible roles that foreign companies can play should not be discounted either. Clarification in China’s 14th Five-year Plan and explanations of the exact scope of its self-sufficiency strategy, set to be released in early 2021, would be useful to Chinese companies. It could alleviate their concerns that the government is asking them to shift away from foreign suppliers, or that their foreign partners will be deemed security risks in the future.

Implications and recommendations for European companies

European companies are likely to face increased scrutiny from China’s government in public procurement related to anything network-related, and may encounter it from local business partners as well. Enhancing government affairs work to seek clarity on current and upcoming rules and regulations can help mitigate risk. Relevant company departments can also enhance communication and coordination to better manage government and client relations and assuage the concerns of all stakeholders. While not a foregone conclusion, companies that devise robust contingency plans for a future in which their global operations may become splintered across various ‘islands’ could gain a foothold over their competitors.

- Strengthen corporate political risk assessment capacity and prepare for considerable regulatory pressure in US and Chinese markets from government and business partners alike, especially for companies whose digital products and services rely on supply chains in the US and China.

Implications and recommendations for governments

EU

Leaders in the EU and its member states would be well advised to weigh the broader impacts that could result from a race to the bottom on securitisation. Ensuring that regulations are measured, and that standards are objective and

²³⁹ President Xi Jinping, *Industrial and supply chains cannot be dropped at critical moments*, *Qiushi*, 3rd November 2020, viewed 9th December 2020, <http://www.qstheory.cn/zhuanku/2020-11/03/c_1126690768.htm>



proportionate to the actual risk of the many diverse parts of a network and its uses, can ensure that the right balance is struck.

- Encourage a Biden Administration to reconsider the Trump Administration's Clean Network programme and prioritise robust and objective multilateral standards and rules for data security, platform regulation and digital connectivity, with plurilateral ones as a serious alternative.
- Ensure input and buy-in from the European technology industry and other stakeholders in the implementation of the EU's Digital Strategy.
- Anticipate and brace for China's politically-motivated retaliation for restrictions on Chinese technology in the EU, and build mechanisms to support European companies affected.

China

China's government could mitigate concerns by explicitly defining what should be a narrow range of CII. Furthermore, messaging from top leadership that clarifies the scope of "autonomous and controllable" would help assure European companies in relevant sectors, while giving them support in their conversations with business partners that might otherwise view them as politically risky.

- Recognise that the party-state's interference with the private technology industry undermines Chinese companies' operations abroad and creates a cycle of mistrust that damages much-needed technological ties with other countries, including in Europe.
- Clarify definitions such as "autonomous and controllable" and reassure European companies that regulators responsible for cybersecurity reviews (such as the Classified Cybersecurity Protection Scheme and cybersecurity reviews for CII operators) will not discriminate against them.

Telecommunications services

Summary

While the infamous Great Firewall continues to leave China's market half-isolated from the rest of the world, less widely-known barriers to the full global integration of its digital economy have created an ever-widening gap between foreign companies' digital solutions and their customers in China.

Most commonly, this is experienced through difficulties in obtaining the necessary licence for the delivery of VATS, including but not limited to virtual private network (VPN) services, cloud services and internet content provider (ICP) services. Companies are left with a choice between either leaving key digital services out of their offerings in China, or entering into a JV with a local company, which is far from ideal. However, interviewed companies noted that the ability to bring preferred digital services into the Chinese market are limited in other ways that fall outside of the scope of VATS licensing requirements.

A certain amount of localisation is expected in any market, as integrating into local systems already in use by consumers is normal. However, European companies are essentially being compelled to fully integrate into a distinct ecosystem developed by their Chinese counterparts in order to remain competitive. Part of this is due to market forces – China's digital leaders are often favoured by local customers, so foreign firms would be wise to partner with them in certain areas. However, the uneven playing field created by regulators means that integration is necessitated even in situations where foreign solutions would be preferred.

General outlook

European companies are eager to be part of China's digital market, the world's second largest.²⁴⁰ Chinese consumers are already highly tech-savvy, and the resulting competitive edge of China's digital services and applications (for example, in e-commerce, mobile payments and the sharing economy) makes a presence in the market essential for global competition, as emerging local trends can quickly become international. The market is also doubling down on digitalisation through investment in new infrastructure to lay the foundations for the industrial internet, the IoT, digital services and emerging technologies related to advanced manufacturing.^{241&242} These developments are also increasingly going abroad, both as Chinese companies follow market forces into nearby regions, and along the Digital Silk Road, part of China's BRI.²⁴³

European companies want to be a part of China's digitalisation story and are keen to both bring their own offerings and integrate with Chinese partners where they see value. However, the playing field in the digital arena in China is largely set up to prevent foreign participation on an equal footing. The market remains only partially open, and the conditions for entry are very demanding even when options seemingly exist.²⁴⁴

One striking example is the requirements for VATS licences, which are necessary if a company wishes to provide services like internet protocol VPNs for telecommunications companies, or Platform as a Service (PaaS) and Software as a Service solutions. As outlined in the *Foreign Investment Negative List*, foreign companies in industries other than ICT are being forced to form 50:50 JVs to operate their online services in China,²⁴⁵ which is not the preferred setup for many of them. In fact, interviewed members reported that being forced into such partnerships too often leads to failure.

While pilot programmes in Shanghai, Beijing and Hainan meant to test opening in some of these areas could lead to progress, European Chamber members report that the overall application process for an operating licence is not transparent.^{246,247&248}

Inadvertently protected by such a regime, China's fierce digital champions have taken a dominant market position. It is quickly becoming clear that foreign companies incorporating digital solutions into their offerings need to do so in partnership with China's national champions. This is sometimes welcomed, with many interviewed companies reporting that they are keen to work with industry leaders like Tencent, Alibaba and Huawei, among others, but this is not always the case.

240 Zhang, Longmei, & Chen, Sally, *China's Digital Economy: Opportunities and Risks*, IMF, 17th January 2019, viewed 14th December 2020, <<https://www.imf.org/en/Publications/WPI/Issues/2019/01/17/Chinas-Digital-Economy-Opportunities-and-Risks-46459>>

241 Meinhardt, Caroline, *China bets on 'new infrastructure' to pull the economy out of post-Covid doldrums*, MERICS, 4th June 2020, viewed 14th December 2020, <<https://merics.org/en/analysis/china-bets-new-infrastructure-pull-economy-out-post-covid-doldrums>>

242 Savić, Bob, *China's New Digital Industrial Transformation*, *The Diplomat*, 19th June, 2020, viewed 14th December 2020, <<https://thediplomat.com/2020/06/chinas-new-digital-industrial-transformation/>>

243 Triolo, Paul, Allison, Kevin, & Brown, Clarise, *The Digital Silk Road: Expanding China's digital footprint*, Eurasia Group, 29th April 2020, viewed 14th December, 2020, <<https://www.eurasiagroup.net/live-post/digital-silk-road-expanding-china-digital-footprint>>

244 Meltzer, Joshua, *China's digital services trade and data governance: How should the United States respond?*, *Brookings*, October 2020, viewed 14th December 2020, <<https://www.brookings.edu/articles/chinas-digital-services-trade-and-data-governance-how-should-the-united-states-respond/>>

245 *Special Management Measures for Foreign Investment Access (Negative List) (2020)*, NDRC, 23rd June 2020, viewed 8th July 2020, <<https://www.ndrc.gov.cn/xxgk/zc/bf/fzggwl/202006/P020200624549035288187.pdf>>

246 *Reply of The State Council on the Comprehensive Pilot Work Plan for Promoting the Expansion and Opening Up of Beijing's Service Industry*, MOFCOM, 22nd February 2019, viewed 28th April 2020, <http://english.mofcom.gov.cn/article/zt_cv/lanmua/201902/20190202838335.shtml>

247 *Notification on the Preparation for the Relevant VATS Pilot Opening in FTZs*, MIIT, 18th May 2020, viewed 14th December 2020, <https://www.miit.gov.cn/jgsj/txs/zcbz/hwstz/art/2020/art_9de6764f2f934731ae28b40e4a90110a.html>

248 *State Council's Release on the General Construction Plan for the Hainan Free Trade Port*, State Council, 1st June 2020, viewed 8th June 2020, <http://www.gov.cn/zhengce/2020-06/01/content_5516608.htm>



How does your company expect digital/internet decoupling (e.g., restrictions on digital goods and services, the Great Firewall, restrictions on value-added telecommunications services) to impact your business?

Significant negative impact	34%
Somewhat negative impact	51%
No impact	12%
Somewhat/significant positive impact	0
Don't know	3%

Source: European Chamber survey on data governance decoupling conducted in September 2020

This set-up is increasingly frustrating for European companies at a time when even the most traditional sectors need to adopt digital technologies to improve productivity and stay competitive. On the verge of the Fourth Industrial Revolution and the advent of the IoT, digital technologies will form the backbone of entire economies, making any discriminatory regulations and market access imbalances in the digital economy extremely consequential. China's state-direction and support measures to develop a globally competitive industrial internet and IoT platforms also play into these concerns.²⁴⁹

Current impacts

If a European company chooses to drop certain digital solutions from their service offerings in China, it will not only lose market share, but also deprive consumers of potential value. If it opts to partner with a Chinese firm, it faces the prospect of being joined at the hip to an inadequate partner it must reach consensus with; in cases where the only suitable choice is to partner with a competitor, conflicts of interest within the JV can undermine operations. Several interviewed members noted that they preferred to partner with a local company that is not involved in digital services, but which could obtain the needed licence. Doing so, they explained, means that they can operate the JV without much interference (though also without any added value) provided the 'silent partner' continues to receive dividends.

Either situation means that European providers are not competing on a level playing field with local players. More significantly, European companies are likely to lose a key competitive advantage: they cannot provide globally-integrated solutions, as they must form partnerships and localise these services in a way that risks loss of interoperability. Companies in industries as diverse as automotive, banking, shipping, chemicals and ICT noted that the restrictions on cloud services are particularly damaging, as one of the chief values of cloud solutions is integration of and access to information beyond specific geographies.

VATS Licensing Examples

Cloud Services	Big Data Centres
A sub-category of B11-Internet Data Centre services, they can be deemed a combination of the Internet as a Service and PaaS models of cloud services. International cloud service providers cannot overcome the insurmountable licensing, technical cooperation and data localisation requirements. Previously the preserve of the technology industry, this problem is rapidly spreading to other industries.	All companies must rely on Chinese-owned big-data centres. Foreign big-data centres' business opportunities are limited to supporting Chinese companies, usually with certain technology or know-how. This stands in contrast to the business environment in the EU, which is also contemplating increased data-localisation requirements for all companies, but still allows non-EU companies to build and operate their own data centres as long as they are GDPR-compliant.
Online stores	Online insurance

249 Arcesati, Rebecca, et. al. *China's digital platform economy: Assessing developments towards Industry 4.0*, MERICS, 29th May 2020, viewed 14th December 2020, <<https://merics.org/en/report/chinas-digital-platform-economy-assessing-developments-towards-industry-40>>

European companies seeking to expand their online sales activities in China through their own e-stores need to obtain a 'B21-Online Data Processing and Transaction Processing Services' licence, which is 100 per cent open for operating e-commerce (i.e., a standalone service/platform like Taobao or Amazon) but only 50 per cent or less for other services. In this case, a brick-and-mortar retailer wishing to open its own e-store without relying on Chinese platforms needs to form a JV with a local company.

Despite recent market opening in the insurance sector, which now allows for wholly-foreign-owned providers to be established, insurance companies must create a JV with a local company with the right type of ICP licence to offer digital insurance products and services. This is an area where European providers are eager to compete for market share, yet they must do so at a disadvantage to their local competitors.

Level of exposure of European companies

European companies in China are already highly exposed to the challenges of obtaining VATS licences. While the level of exposure is unlikely to change if the regulatory status quo is maintained, the impact of lost opportunities will grow commensurate with the development and integration of digital services across the entire economy.

At the same time, companies are also exposed to a variety of additional risks varying from service to service. Having to partner with a local cloud provider at least provides the option of choosing from a range of both private and state-owned companies, with many of the private companies being market leaders. However, having to source VPN services for secure connections within a corporate network means having to choose between a handful of providers sub-contracted by China's three state-owned telecommunications providers, which members report provide unsatisfactory solutions at exorbitant prices.

Expectations and likely scenarios

The limited opening up of China's VATS licensing regime—specifically the pilot programmes in Beijing, Shanghai and Hainan—will, in principle, now allow foreign companies greater access. However, the details on the pilots so far released publicly or discussed with the European Chamber are extremely limited. For example, while China in May and June 2020 reiterated its intention to open up VATS services to foreign-invested enterprises in its free-trade zones, at the time of writing nothing had materialised.^{250&251} The most explicit change came in February 2019, when it was announced that foreign participation in B14-internet access services would be allowed in Beijing.²⁵² However, to the best of the European Chamber's knowledge, none of the foreign telecommunications companies that have attempted to obtain the relevant licence have been able to even find the necessary application forms. Until otherwise demonstrated, companies and foreign governments should operate under the assumption that meaningful opening in this area will not proceed.

As digital goods and services remain largely beyond the scope of the WTO—though WTO negotiations on trade-related aspects of e-commerce show that progress in this area may be forthcoming—bilateral agreements may be the best option for now.²⁵³ The EU-China CAI presents an important opportunity to build clear bilateral rules in these areas and ensure holistic market access so that digital solutions can compete and cooperate on market principles. This should apply regardless of whether the solutions are considered 'Chinese' or 'European' in origin, or where the solutions are physically developed. This is especially important as developments like the IoT will have such a broad impact across the entire economy. However, interviewed European Chamber members are currently pessimistic about gaining meaningful access to China's VATS market any time soon.

250 Notification on the Preparation for the Relevant VATS Pilot Opening in FTZs, MIIT, 9th May 2020, viewed 1st June 2020, <<http://www.miit.gov.cn/newweb/n1146285/n1146352/n3054355/n3057674/n3057693/n3057695/c7915545/content.html>>; *European Business in China Position Paper 2020/2021*, The European Union Chamber of Commerce in China, 10th September 2020, p. 323, <<http://www.europeanchamber.com.cn/en/publications-position-paper>>

251 State Council's Release on the General Construction Plan for the Hainan Free Trade Port, State Council, 1st June 2020, viewed 8th June 2020, <http://www.gov.cn/zhengce/2020-06/01/content_5516608.htm>

252 Reply of The State Council on the Comprehensive Pilot Work Plan for Promoting the Expansion and Opening Up of Beijing's Service Industry, State Council, 22nd February 2019, viewed 28th April 2020, <http://www.gov.cn/zhengce/content/2019-02/22/content_5367708.htm>

253 Negotiations on e-commerce continue, eyeing a consolidated text by the end of the year, WTO, 23rd October 2020, viewed 14th December 2020, <https://www.wto.org/english/news_e/news20_e/ecom_26oct20_e.htm#:~:text=WTO%20negotiations%20on%20trade%2Drelated,the%20participation%20of%2076%20members.&text=Participating%20members%20seek%20to%20achieve,many%20WTO%20members%20as%20possible>



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China's industrial policy and self-reliance efforts are aimed at building a digital ecosystem that can stand on its own if necessary, and which can be competitive globally. European companies should anticipate a growing need to integrate into this local ecosystem if they are to remain competitive in the eyes of their customers.

Implications and recommendations for European companies

Companies will need to fully consider the short-, medium- and long-term realities presented by China's seeming unwillingness to allow European digital solutions to compete fairly in its market and adjust accordingly. The opportunities lost by staying completely out of the market in these fast-developing service segments must be weighed against JV requirements, which come with the inherent operational risks of dealing with potentially unreliable partners and the prospect of technology/know-how leakage.

- Weigh the pros and cons of partnering with local providers to bring desired digital services into the China market.
- Evaluate the risk/reward balance of the types of partners available, putting non-industry players with low risk of technology leakage but that offer little on one side, and digital service providers with higher risk of technology leakage but with much more to offer on the other.

Implications and recommendations for governments

EU

European governments should recognise the significant challenges faced by European companies in this area. Action should be taken within the framework of the CAI to push for market access and enforcement mechanisms to ensure a level-playing field. Concerns about how this imbalance, if uncorrected, could impact competition in the long run should also be taken into account when formulating competition policy and the EU's approach to overall engagement and competition with China.

- Demand the inclusion of holistic market access provisions in the EU-China CAI.
- Take into consideration the value of business opportunities lost due to VATS licensing requirements in China in sectors apart from ICT/telecommunications when determining EU negotiation priorities.
- Use every possible format, such as the newly established High-level Digital Dialogue, to advocate the reform of VATS licensing requirements and the opening up of China's digital economy.

China

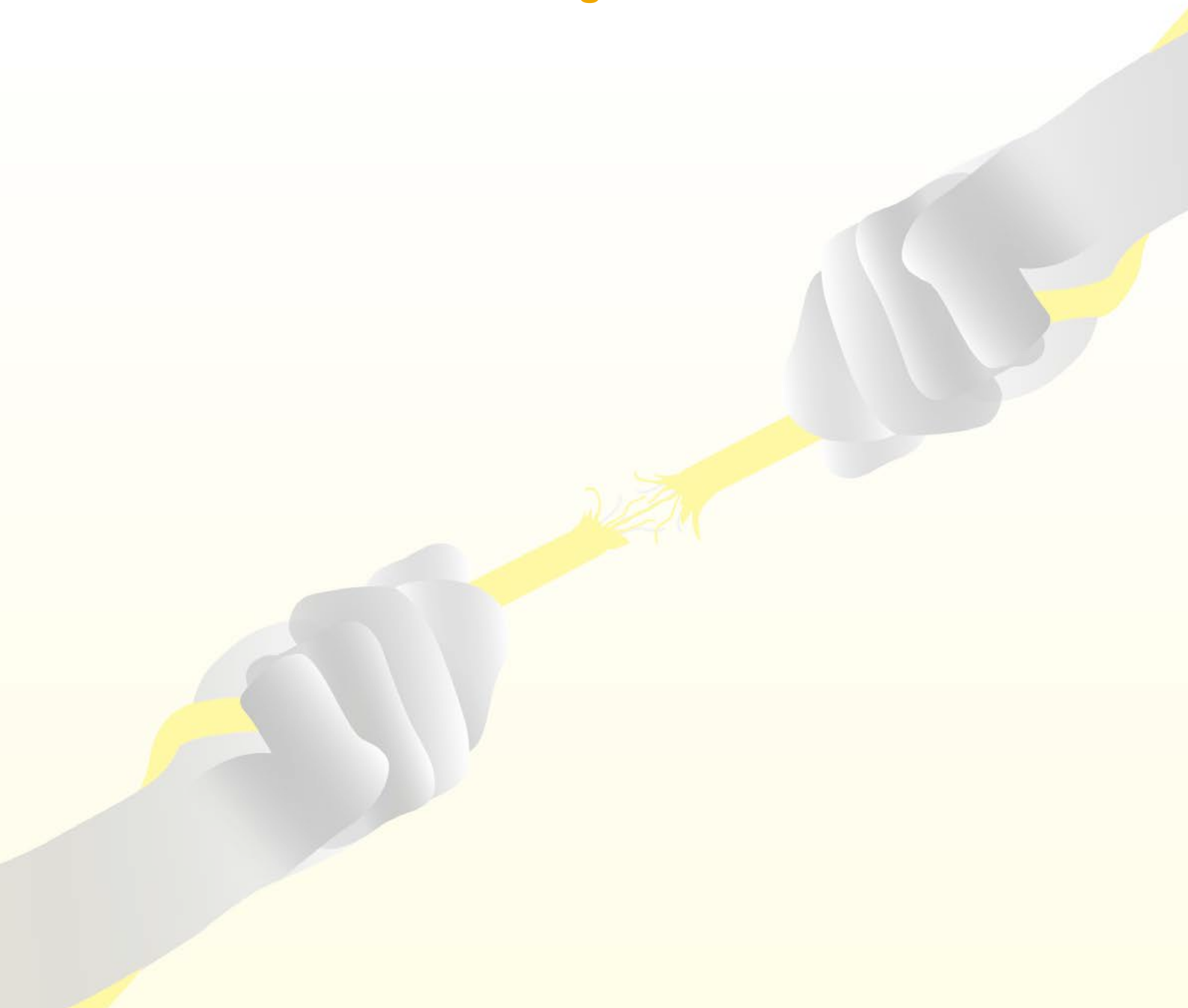
The Chinese Government would be well advised to weigh the considerable loss of value caused by imposing such barriers and conditions. Maintaining the status quo not only deprives China's consumers and companies from access to cutting-edge services, but also denies the competition that can inspire Chinese players to improve their own value proposition.

- Reform the market access regime to allow VATS to be provided by foreign enterprises.
- Reconsider the need for VATS licences in the first place.
- Include market access offerings for VATS in the EU-China CAI that address both direct and indirect barriers, including for non-ICT/telecommunications companies.

Chapter Three

The Big Picture

3





Chapter 3: The Big Picture

Decoupling dynamics in each of the nine layers covered in the previous chapter are capable of inflicting varying levels of damage on European companies on their own. However, when these layers intersect the effects are multiplied. The pain is most keenly felt in the areas where China's self-reliance campaign collides with the US' and other actors' efforts to engineer economic decoupling – most clearly in all things digital.

While the US' position is likely to shift at least somewhat under a Biden Administration, it would be unwise for companies to not factor into their strategies that the current situation could deteriorate further in different ways:

- US decoupling efforts could continue apace.
- Biden and his team may recalibrate tactics but maintain Trump's strategic goals.
- The next US administration might even accelerate decoupling efforts and draw in a broader coalition of like-minded countries.

China is contributing just as much to the uncertainty and challenges European companies see on the horizon. The long-standing, but recently accelerated, push for self-reliance shows no signs of letting up, and there is likely little that could be done by the EU, the US or others to persuade China's leaders towards an exit ramp. After all, the self-reliance campaign predates the first shots of the trade and technology war.

Different industries, different stories

While each European company faces a different scenario, they can generally be sorted into three broad classes within the context of China's push for self-reliance:

- *Business Class: includes companies that are being encouraged by Chinese state-planners to deepen their positions in China*

As a result of decoupling, some European companies in a variety of industries generally feel more welcome in the Chinese market. The best seats are increasingly reserved for those in industries that will play a critical role in China's self-reliance efforts. This includes any company that can bring the kind of technology capable of breaking technological bottlenecks, such as semiconductors and software. This category also includes upstream inputs like chemicals and machinery, both of which are essential to facilitating China's climb up the value chain and towards its goal of becoming self-reliant in critical inputs technologies.

- *Economy Class: includes companies that are in non-contentious sectors of the economy*

Most sectors open to foreign investment operate under a state of benign neglect. Companies are allowed in, and may even be encouraged to enter, but are not in priority industries. The automotive sector serves as a good example. China is keen to introduce foreign competition in the NEV, and commercial and passenger vehicles, sectors to help spur its own automotive manufacturers in that area, hence the plan to remove JV requirements in 2018, 2020 and 2022 respectively.²⁵⁴ The automotive sector, and NEVs in particular, has been a key pillar of Chinese industrial policy for a decade.

However, being important does not necessarily equate to being essential. First, China has its own automotive manufacturers it could rely on if complete decoupling somehow proceeded in the automotive sector. Second,

254 Lee, Amanda & Ren, Daniel, *China lays out plan for opening auto industry, clearing the way for Tesla's wholly owned plant*, *South China Morning Post*, 17th April 2018, viewed 21st December 2020, <<https://www.scmp.com/tech/enterprises/article/2142150/tesla-pole-position-china-pledges-remove-all-foreign-auto-ownership>>

automobiles are at the end of value chains, rather than in an upstream position that could undermine a wider range of sectors. If China lost access to foreign automotive technology, this would not disable its ICT or electronics sectors, as would happen if it lost access to foreign semiconductor-related technology or software. As such, there is less pressure to pull in foreign investment in this sector but also little need to oust foreign producers.

- *Cargo Hold: includes companies at risk of being squeezed out of the market*

The ‘cargo hold’ is home to sectors where European investment has been encouraged in the past, but where companies now feel increasingly squeezed out of the market, or forced into limited roles. This is most clear in ICT/telecommunications.²⁵⁵ Interviewed European Chamber members operating within this broad sector, as well as business leaders in other sectors that rise and fall based on the quality of ICT/telecommunications providers, noted that this situation is driven by two main factors. First, China’s CII requirements and “autonomous and controllable” guidelines put the national security of China’s networks as the most important consideration. Second, the survival and success of China’s digital champions, especially those ‘under attack’ like Huawei and ZTE, are national priorities.

The European business community in China has long noted that there is favouritism for indigenous companies in public procurement in order to help national champions build scale and secure revenue. It is also no secret that European telecommunications equipment companies have experienced a precipitous drop in market share in China during the transition to 5G networks. *Technode* reported that EU Ambassador to China Nicolas Chapuis raised this issue in a December 2020 speech delivered at a telecommunications event in Guangzhou. The ambassador stated that Chinese telecommunications operators “massively privilege their national suppliers”. He went on to note that, “The bottom line is a freefall of European market share in the telecoms infrastructure sector, standing today at less than 11 per cent, while their market share in other countries stands at more than 30 per cent.”²⁵⁶

Companies in the ‘cargo hold’ face insurmountable restrictions in the most essential emerging digital services. Foreign providers are often pushed into JVs by licensing requirements, preventing them from competing fairly with their Chinese counterparts, which can deftly navigate the quickly changing ecosystem without the inconvenience of being attached to an unwanted partner. Competing with China’s internet and technology champions would be hugely challenging under any circumstances, but the prevailing conditions limit European providers to playing only niche roles.²⁵⁷

Layer upon layer

Companies in the three different classes outlined above experience and anticipate the layers of decoupling in varying ways.

Concerns over political decoupling are similar among all companies, but with some distinctions. In general, European companies in any sector are likely to face political pressure from the EU and the US if they have a presence in regions like Xinjiang and Hong Kong, and all face the prospect of further pressure to provide space for the CCP to ‘guide’ business decisions.²⁵⁸ All companies are also in agreement that further political decoupling will act as an accelerant to the other layers of decoupling discussed in this report.

Meanwhile, diplomatic and geopolitical frictions are increasing concerns about retaliation against European

²⁵⁵ For more details, please refer to the network equipment and telecommunications services sections on pages 65 and 70 respectively.

²⁵⁶ Sheng, Wei, *EU diplomat says that China favours domestic 5G suppliers*, *technode*, 1st December 2020, viewed 21st December 2020, <<https://technode.com/2020/12/01/exclusive-eu-diplomat-says-china-favors-domestic-5g-suppliers/>>

²⁵⁷ Please refer to the Digital decoupling section of this report on page 57.

²⁵⁸ Please refer to the Macro decoupling section of this report on page 20.



companies in China. So far, China has restricted itself mainly to trade rather than investment as the avenue for punitive measures. However, China's state media have said that it would be "almost impossible" for China to avoid retaliating against what it characterised as "bullying" of Chinese technology companies.²⁵⁹ However, companies in 'business class' and popular consumer brands in 'economy class' are less likely to be targeted than those stuck in the 'cargo hold'.

The level of concern over financial decoupling is pretty much the same in all three classes. Interviewed companies across all sectors believe that any future financial sanctions imposed by the US would be targeted and quite limited; that delisting of Chinese firms in the US will be destabilising, but there are plenty of alternative capital markets and sufficient access to the USD outside of the US; and that the 'nuclear option' of the US severing China's access to the USD would be economic suicide and therefore is extremely unlikely.²⁶⁰

European companies across all three classes reported that they had managed to deal with both the economically- and politically-driven factors that have propelled supply chain decoupling. It is important to note, however, that MNCs had a relatively easier time of it than SMEs. Disruptions due to the COVID-19 pandemic and the trade war pushed companies in 'business class' and 'economy class' to further onshore their supply chains, which for most were already largely in China to begin with. Meanwhile, most companies in the 'cargo hold' have limited cross-border supply chains, either because they have little need for supply chains (think digital services), chiefly import complete or nearly-complete equipment, or are already using China-made equipment.

However, companies in all three classes suffered at least some pain, as even minor adjustments disrupted supply chains that had already been optimised for efficiency. Companies faced higher exposure depending on the number of components in their products and the volume of their production in China. For example, a chemicals company that produces, among other things, common polymers said it requires fewer inputs and its volume is vast, which made localisation of suppliers easier. Automotive manufacturers, on the other hand, reported higher exposure due to the sheer variety of components required for production. The level of exposure was higher still in cases where an individual company's production volume in China was low, as certain components could not be localised without losing much-needed economies of scale.²⁶¹

The gathering storms

The rapid development of data management systems in the EU and China is universally an area of growing concern for companies in all classes, as this is one of the only areas where decoupling is happening as much from the EU side as from China's. As things continue to tighten, the ability to transfer data across the EU-China virtual 'border' will diminish greatly. European companies now anticipate having to work from two separate pools of data, rather than from an ideal single aggregated one.

China's increasingly integrated national data market allows Chinese companies to easily collect and make use of data from a potential pool of 1.4 billion users, as well as much of the world's industrial data. The EU, on the other hand, has a highly fragmented data market across various jurisdictions. This presents a long-term competitive disadvantage for European companies as the importance of data as a tool to refine efficiencies and develop new goods, services and digital instruments grows.

While data will be an important factor in all industries moving forward, companies confined to the 'cargo hold' will likely face the greatest challenges, as all things digital will inherently be central to business development (just look at the importance of the role that data plays for digital giants like Google and Tencent). However, much of

259 Ma, Jihua, *Sweden should stop bullying Chinese tech with 'security' guise*, *Global Times*, 3rd November 2020, viewed 21st December 2020, <<https://www.globaltimes.cn/content/1205611.shtml?>>

260 Please refer to the Macro decoupling section of this report on page 20.

261 Please refer to the Trade decoupling section of this report on page 32.

the industry automation taking place related to industries occupying ‘economy’ and ‘business’ classes would also benefit tremendously from a large data pool to refine the processes and systems that will underpin Fourth Industrial Revolution developments like AI, robotics and the IoT. Autonomous cars are a central example, as the algorithms underlying self-driving systems rely on access to large pools of similar data points to ‘train’ the AI to recognise a vehicle’s surroundings and adjust accordingly.

The level of either alignment or divergence between Chinese and international standards varies across the three classes. Most companies in ‘business class’ are in traditional, non-contentious sectors in which there is little to no deviation. This is especially so in commodities like chemicals or in areas like industrial machinery, where European producers are on the cutting edge, and Chinese customers require that quality.

Divergence is mainly found in areas where China either wants to be a global leader or already is. China’s NEV standards, for example, differ quite a lot from most international standards but, more importantly, they tend to change from year to year in an industry that is accustomed to planning on a five-year horizon. In areas where China is a leader—such as in the telecommunications, digital and internet fields—it is pursuing a coordinated strategy of developing domestic technical standards, which are then pushed by various actors in international standards-setting bodies. If those standards are high-quality and fair, this is not an issue. However, companies in the ‘cargo hold’ noted that many of these standards are written to afford a competitive advantage to Chinese firms.²⁶²

The technology ecosystem quagmire

The intersection of decoupling in critical inputs, network equipment, telecommunications services and R&D has created a highly complex downward spiral that is already in motion. Fundamentally, it is a story of how critical input decoupling from the US, and telecommunications equipment and services decoupling from China, is forcing companies to consider how to service both markets in the future. This dynamic is even pushing the companies that are currently welcomed in China to consider ‘island solutions’.²⁶³

The tech decoupling toolbox

European Chamber member companies from the industrial software, automotive, network/digital equipment and telecommunications/digital services sectors were interviewed about technology decoupling. The findings presented here illustrate the extent of both the current and future challenges of decoupling.

The US is driving technology decoupling through two main mechanisms: export controls on critical inputs to certain Chinese companies and market access restrictions on Chinese technology in the US. This aim has been made explicit in its Clean Network initiative.²⁶⁴ Although it is not yet clear to what extent these tools will carry over into the Biden Administration, they nevertheless present considerable challenges. While they have so far only been used to target a handful of Chinese technology champions, their use sets a precedent that is already impacting European companies’ sentiment.

The more export control mechanisms are strengthened and used, the less certain European companies are that the innovation they do in either market can be offered globally, potentially demolishing returns on investment. These tools are already pushing European digital/network equipment and services providers out of China and pulling everyone else into China’s digital ecosystem, while preventing companies trying to bring what they develop in China into the US market.

US restrictions on access to critical inputs like semiconductors and software are also of considerable concern for many European Chamber members. European companies across all industries have a reputation for high-quality goods

²⁶² Please refer to the Innovation decoupling section of this report on page 46.

²⁶³ An ‘island solution’ is one that is designed to work in a limited geographical jurisdiction and is isolated from the rest of the world.

²⁶⁴ *The Clean Network*, US Department of State, 2020, viewed 21st December 2020, <<https://www.state.gov/the-clean-network/>>



Category	Sub-Categories	Category	Sub-Categories
Biotechnology	<ul style="list-style-type: none"> • Nanobiology • Synthetic biology • Genomic and genetic engineering • Neurotechnology 	Logistics technology	<ul style="list-style-type: none"> • Mobile electric power • Modeling and simulation • Total asset visibility • Distribution-based Logistics Systems
Artificial intelligence (AI) and machine learning technology	<ul style="list-style-type: none"> • Neural networks and deep learning • Evolution and genetic computation • Reinforcement learning • Computer vision • Expert systems • Speech and audio processing • Natural language processing • Planning • Audio and video manipulation technologies • AI cloud technologies • AI chipsets 	Additive manufacturing	<ul style="list-style-type: none"> • 3D printing
Position, navigation, and timing (PNT) technology	-	Robotics	<ul style="list-style-type: none"> • Micro-drone and micro-robotic systems • Swarming technology • Self-assembling robots • Molecular robotics • Robot compliers • Smart Dust
Microprocessor technology	<ul style="list-style-type: none"> • Systems-on-chip (SoC) • Stacked memory on chip 	Brain-computer interfaces	<ul style="list-style-type: none"> • Neural-controlled interfaces • Mind-machine interfaces • Direct neural interfaces • Brain-machine interfaces
Advanced computing technology	Memory-centric logic	Brain-computer interfaces	<ul style="list-style-type: none"> • Neural-controlled interfaces • Mind-machine interfaces • Direct neural interfaces • Brain-machine interfaces
Data analytics technology	<ul style="list-style-type: none"> • Visualisation • Automated analysis algorithms • Context-aware computing 	Hypersonics	<ul style="list-style-type: none"> • Flight control algorithms • Propulsion technologies • Thermal protection systems • Specialised
Quantum information and sensing technology	<ul style="list-style-type: none"> • Quantum computing • Quantum encryption • Quantum sensing 	Advanced materials	<ul style="list-style-type: none"> • Adaptive camouflage • Functional textiles • Biomaterials
		Advanced materials	<ul style="list-style-type: none"> • Faceprint and voiceprint technologies

and services, which can only be produced if they have access to the best inputs from around the world. Many of them remain reliant on US companies for upstream technologies in the semiconductor supply chain, and some European Chamber members noted that the technology they rely on is so specialised it cannot be replaced.²⁶⁵ Most European companies interviewed for this report had already reviewed their own level of exposure in this respect. While many of them import critical inputs, they felt it unlikely that they would completely lose access to them, expecting that instead controls would be used to target individual Chinese companies, rather than to apply broad export restrictions.

However, most had only done limited auditing of their supply chains, either up- or downstream, to gauge their level of exposure. Interviewed automotive manufacturers were the most likely to have done so, and they reported extensive exposure in terms of both imported critical components and manufacturing equipment:

- Even just one supplier losing access to a particular component could have a significant ripple effect, as—if alternatives cannot be quickly procured—any vehicle using that part would be incomplete.
- If China completely lost access to US semiconductors alone, the impact would likewise be catastrophic.
- If other global suppliers were pressured to cut China off through the US' *de minimis* rules being tightened, this would be a fatal blow to European automotive manufacturers in China.

In late 2020, the severe impacts of limited access to semiconductors became apparent in the automotive sector. Disruptions stemming in part from COVID-related production challenges and in part because of stockpiling efforts by various Chinese companies have led to a critical shortage of semiconductors needed for ECUs and microcontroller units.²⁶⁶ As these form the 'computer' of a vehicle, they are essential components without which a car cannot function. Both foreign and domestic automotive manufacturers in China are now forced to prioritise which models and production lines get these, leading most to continue production of higher-margin vehicles while shuttering the rest of their operations until the shortage is corrected. Suppliers are rushing to expand semiconductor production capacity, but report that it will take six to nine months to catch up with demand.²⁶⁷ These are the results of an accidental shortage, leaving many manufacturers increasingly aware of just how catastrophic an intentional cutting off of supplies would be.

For its part, China is already well down the road towards overbearing securitisation of high technology sectors. For example, its rules for CII protection, and the corresponding cybersecurity review measures, are broad in scope and lacking specificity. This creates difficulty and uncertainty for European telecommunications companies that want to participate in the provision, installation and servicing of hardware.²⁶⁸

However, CII is just one layer of the securitisation of China's digital ecosystem. Members also report increasingly being asked if their technology is "autonomous and controllable". Whatever the intended meaning, "autonomous and controllable" has come to imply that foreign companies are viewed as less reliable. Several European Chamber members indicated that when the phrase first came into use, they benefitted from additional sales, as governments and companies read between the lines that US providers were in the crosshairs, so a European alternative would be more stable. It did not take long for that attitude to change, and members across a wide range of sectors now report scrutiny from government, suppliers and customers alike.

European companies reported that their efforts to obtain documentation certifying their technology as "autonomous and controllable" have encountered red tape of an altogether different breed. A dozen ministries are needed to give approval, and even if everything runs smoothly, getting certified for a single product can take nine to 12 months, an eternity in the fast-moving digital arena.

²⁶⁵ Please refer to the Trade decoupling section of this report on page 32.

²⁶⁶ Zhang, Fanny, *China auto industry recovery faces challenges from Europe chip shortage*, ICIS, 9th December 2020, viewed 22nd December 2020, <<https://www.icis.com/explore/resources/news/2020/12/09/10584052/china-auto-industry-recovery-faces-challenges-from-europe-chip-shortage>>

²⁶⁷ *Semiconductor bottlenecks hit auto sector, VW, suppliers warn*, *Automotive News*, 4th December 2020, viewed 22nd December 2020, <<https://www.autonews.com/china/semiconductor-bottlenecks-hit-auto-sector-vw-suppliers-warn>>

²⁶⁸ Please refer to the Digital decoupling section of this report on page 57.



Another issue is China's mandating of JVs for foreign companies looking to offer VATS. A licence is necessary for VATS, the requirements for which forces European companies to partner up with local companies. Some European Chamber members have chosen to look outside the digital sphere for partners to avoid any potential interference from them. Others have considered joining up with competitors that may be more involved, for better or worse, but which also increase the risk of technology leakage. The alternative option is to simply outsource digital solutions to a local provider, integrating into the local ecosystem rather than attempting to contribute to it.

How the tech decoupling toolbox impacts companies

Tools wielded by the US are undercutting much of the value that European companies see in China, especially with regard to using China as an innovation centre for global markets.

Industrial software producers have invested heavily in China in no small part because of the local talent pool, which one interviewed member praised as "where skill meets will", and because productivity and innovation are abundant. Producers are keen to develop new solutions in China's fast-paced market and then integrate them into their global systems. However, if the US were to scrutinise every line of code in an effort to eliminate anything written in China, companies would have to separately develop dual programmes to service the two markets. This would result in a loss of the global interconnectivity that makes European software so valued in the first place.

European automotive manufacturers have for years integrated the best global digital solutions into their products, which in some areas means using Chinese developers. Chinese companies that are global leaders in automotive technology related to 5G, AI, radar and light detection and ranging (LIDAR), are highly attractive partners. However, whether or not their technology would be allowed in the US or other countries in the future is currently an open question. If prevented from partnering with these Chinese companies for cars produced in China for export, the losses for car manufacturers would be considerable. They would essentially be forced to create dual systems, one of which would have to have no 'trace of China'. This would be an exceptionally complex and expensive task, as the digital systems in modern vehicles are multi-layered and derived from a multitude of sources.

European companies involved in **telecommunications and related equipment** report the same. Happy to surround themselves with local talent, competitors and partners, they are already noting difficulties in taking the solutions developed in the Chinese market to the US.

Meanwhile, China's own tools are restricting foreign companies from bringing their digital solutions into the market and even driving some companies out.

The highly restrictive CII and "autonomous and controllable" requirements have left European companies scrambling. Several **telecommunications companies** and one **industrial software provider** reported in interviews that they were seeking high-profile business deals with major private firms, SOEs and even government contracts, all so they could use these as evidence that they would not be a liability to other potential business partners.

At the same time, China's "autonomous and controllable" requirements are being embraced in sectors outside of telecommunications, all to the benefit of local providers. This has a multiplier effect in the context of China's already highly-protected digital ecosystem, which is shielded by VATS restrictions.

European **automotive manufacturers** report needing licences for navigation services as well as cloud services, which they have yet to receive, forcing them to partner with local Chinese providers. This situation is frustrating as they cannot bring their preferred provider, while creating a broader issue with regard to integration into the globally-linked systems common across the entire industry.

Similar concerns exist for **telecommunications equipment makers** and **servicers**. Companies involved in 5G rollout are not merely aiming to be a part of the supplier pool, they are also eager to upsell through a variety of services

and digital solutions. Being able to bring cloud, VPN and data-related services is central for companies that want to provide offerings associated with the IoT or AI. If they cannot provide these services, they quickly become irrelevant to much of the market.

These market access restrictions have left the digital ecosystem largely up for grabs for China's own digital champions. With Chinese consumers increasingly integrating into the more localised technology ecosystem, foreign companies are pressurised to do the same in order to enhance interoperability with the rest of a consumer's technology stack.

European automotive manufacturers are being forced to consider how they can best integrate into this tight ecosystem while boosting their value in the eyes of Chinese customers. As such, they are preparing for scenarios in which they could switch to open-source operating systems (O/Ss) to minimise exposure to US restrictions. However, they also anticipate that both government pressure and consumer demand will steer them towards integrating their local systems with Huawei's Harmony O/S, which would mean that locally-developed solutions and even entire platforms could potentially face intense scrutiny or even barriers when taken to other markets.

Strategic outlooks

To navigate this technology ecosystem quagmire, European companies across the board are considering how to adapt their digital and supply chain strategies, both locally and globally. This broadly breaks down into two potential approaches:

1. **Dual systems:** One supply chain and R&D system to exclusively serve China and one to provide for the rest of the world. For digital systems in China, this would necessitate either building an entire digital stack for the local market, or partnering with/outsourcing to Chinese providers.
2. **Flexible architecture:** Everything that can be supplied in a 'neutral' manner in either market is developed and built for both systems, with other parts being developed separately for each market with the capability of being 'swapped out'.

Committing to dual systems would be almost prohibitively expensive while dragging down economies of scale for both production efficiency and innovation. That being said, this may be a more viable option for companies with relatively limited inputs and R&D investments that are spread across high volume products.

The flexible architecture model seems promising to some European Chamber members, though they admitted that it is potentially a highly fragile solution. Much would depend on the amount of exposed components and equipment, as well as the volume of production; as the amount increases, and/or production volume lowers, employing flexible architecture presents more challenges.

The trade-off to mitigate tech decoupling impacts: dual systems or flexible architecture?

The option of **dual systems** is more feasible in the **chemicals industry**. Many European chemical producers in China reported already having sizeable investments in which they repeatedly produce high-volume goods for years at a time. While they still need cutting-edge equipment run by complex digital systems, leaving the potential for exposure, the high cost of localisation could be spread out over a much larger amount of production, making this option easier to bear.

The **automotive sector** is more suited to the **dual architecture** model, as any vehicle has hundreds of components, a growing share of which are at least somehow digitised. If automotive manufacturers are forced to develop two separate systems, those that produce high volumes would be able to spread the costs of doing so over the higher volume, but this would still put them at a competitive disadvantage. Meanwhile, low-volume



producers simply may not be able to do the same and convince their Chinese customers to accept the resulting price increase per vehicle.

However, the success of the flexible architecture model is also heavily contingent upon the stability of EU-China-US relations. For example, if China and the US and/or the EU continue to impose new measures that drive technology decoupling, the viability of this model breaks down quickly, as every additional piece of technology that has to be localised could mean a reworking of the whole value chain. On the other hand, if decoupling is limited to only certain areas, and governments find ways to jointly manage and limit their restrictions in a way that is more predictable, companies may be able to plan accordingly. For example, if automotive manufacturers know that *just* the autonomous driving system needs to be separated, they can invest in full localisation of this specific technology without having to split the entire technology stack. However, with modern automobiles containing dozens of ECU components, sometimes more than 100, the level of exposure remains extremely high.

Meanwhile, for many industries, these two broad strategies may not be feasible at all.

For example, members of the European Chamber's Banking and Securities Working Group who had been encouraged by China's recent market opening are now being eased out the door again by the technology ecosystem localisation requirements. Already globally integrated, European banks have highly centralised IT systems to handle the digital demands of modern banking. Their often-small positions in the market, combined with the very limited room they have for meaningful expansion, puts many European banks in a potentially untenable position. They are already under incredible pressure to onshore their data systems to avoid running afoul of China's data management regime. Now they are being pushed to develop fully localised IT systems, both in terms of equipment and services (outsourcing the digital aspects of a bank's operations is not feasible due to the massive risks involved).

The European banks with the largest footprint may be able to justify the extensive costs of doing so, considering the amount of business they process in China. However, smaller banks are already indicating that the costs of building an entire secondary system exclusively for China are too high relative to the small amount of business they manage, meaning they may well have to leave the market for good.

The costs of decoupling

As companies lean more heavily into the digitalisation of every aspect of business, their potential exposure to the expanding technology war will grow commensurately, and so too will the costs.

First, there are the material costs. Companies opting to develop dual systems will need to invest extraordinary sums of capital. They would need to create separate R&D operations to develop and integrate solutions that are compatible with the local technology ecosystem. They would then need to create the supply chains in which all components that utilise sensitive technologies would also have to be compatible with the relevant ecosystem.

Automotive manufacturers reported that the dual system model would effectively double R&D costs in certain areas, while also decreasing the value of their offerings as they would no longer be utilising the best globally-available options. Interviewed companies also noted that this would necessitate more extensive localisation of supply chains. While many automotive components would fall outside of these concerns—such as mufflers, exhaust systems or door handles—the most critical are increasingly likely to touch on the digital and technology ecosystems in question. The supply chains for those components would therefore need to undergo extensive shifts to maintain the digital firewall between the ecosystems, which would entail enormous costs.

Second, the immaterial costs of the technology war will be extensive. Innovation that drives efficiency gains, as well

as new goods and services, will take a significant hit. This is not only due to the cost of running dual R&D systems (every euro spent to localise into one or the other market is one less euro spent developing new technology at the global level) but also due to the growing isolation of data pools, which diminishes the ability of companies to build efficiencies and find new solutions.

*In a fully-open global technology ecosystem, European **automotive manufacturers** would be free to integrate into their products the best technologies that jointly form the basis for autonomous driving. Manufacturers would also be able to develop an autonomous driving system that draws from their R&D operations around the world, and a common data pool could be created that is made up of data points collected by vehicle prototypes from R&D centres in Asia, Europe and North America. Instead, interviewed automotive manufacturers anticipate that the evolving localisation needs will make this impossible, seriously slowing down the pace of evolution of autonomous driving technology, while also making it more expensive to develop and roll out.*

Finally, the impacts on economies of scale are likely to be immense. Affected value chains that rely on global scale to manage costs will essentially be split in two. A company with only 10 per cent of their global sales being made in China may decide that the costs to localise relevant products are simply not worth it, or that they would result in end costs that are too high for customers to accept. Either way, they would be driven out of China, resulting in lost opportunities, as well as a 10 per cent loss to their global economies of scale, meaning higher costs and potentially lost jobs.

Meanwhile, a company with a high share of their global sales, say, 50 per cent, being made in China may determine that localisation costs are feasible, though still very costly. Such companies tend to already have more heavily onshored supply chains in the first place, so the number of affected inputs may be lower. However, most European companies centralise the production of their most advanced inputs in their home markets. The centralised economies of scale for those inputs would therefore be split in two. That could translate to higher end prices and even lost jobs as companies consolidate their offerings to maximise what remaining scale they have. For example, automotive manufacturers may decide to offer fewer models in an effort to streamline production and minimise the variety of affected inputs, shutting down entire production lines, which in turn would negatively impact upstream suppliers that fed into those models.

Conclusions

Political, financial and supply-chain/trade-war decoupling dynamics remain concerning but, in many ways, governments have already tapped the brakes and shown at least some interest in managing these aspects to prevent them from spiralling out of control. While each of these areas still has the potential for escalation, there seems to be some recognition that going much further down any of these paths would be as painful for the initiator as for the target.

Emerging issues like the impact of highly conservative data management systems in the EU and China, as well as the growing divergences in international standards development, appear to be proceeding unchecked. Importantly, the government actors in these areas do not even seem to be on the same page about what is happening and what the effects will be.

Finally, the global technology ecosystem has already deteriorated to the point where some companies are seriously looking into which of the unappealing options available to them is the least damaging. Others are beginning to wake up to the fact that the date for exiting China may be approaching.

All areas of decoupling have to be addressed by all governments. There is no returning to a period in which globalisation is renewed to some pre-Trump ideal, because such a time never really existed – China was not coupled with the rest of the world economy in many areas, and its self-reliance drive that is providing a backdrop to the current state of affairs had already been well in place for more than four years.



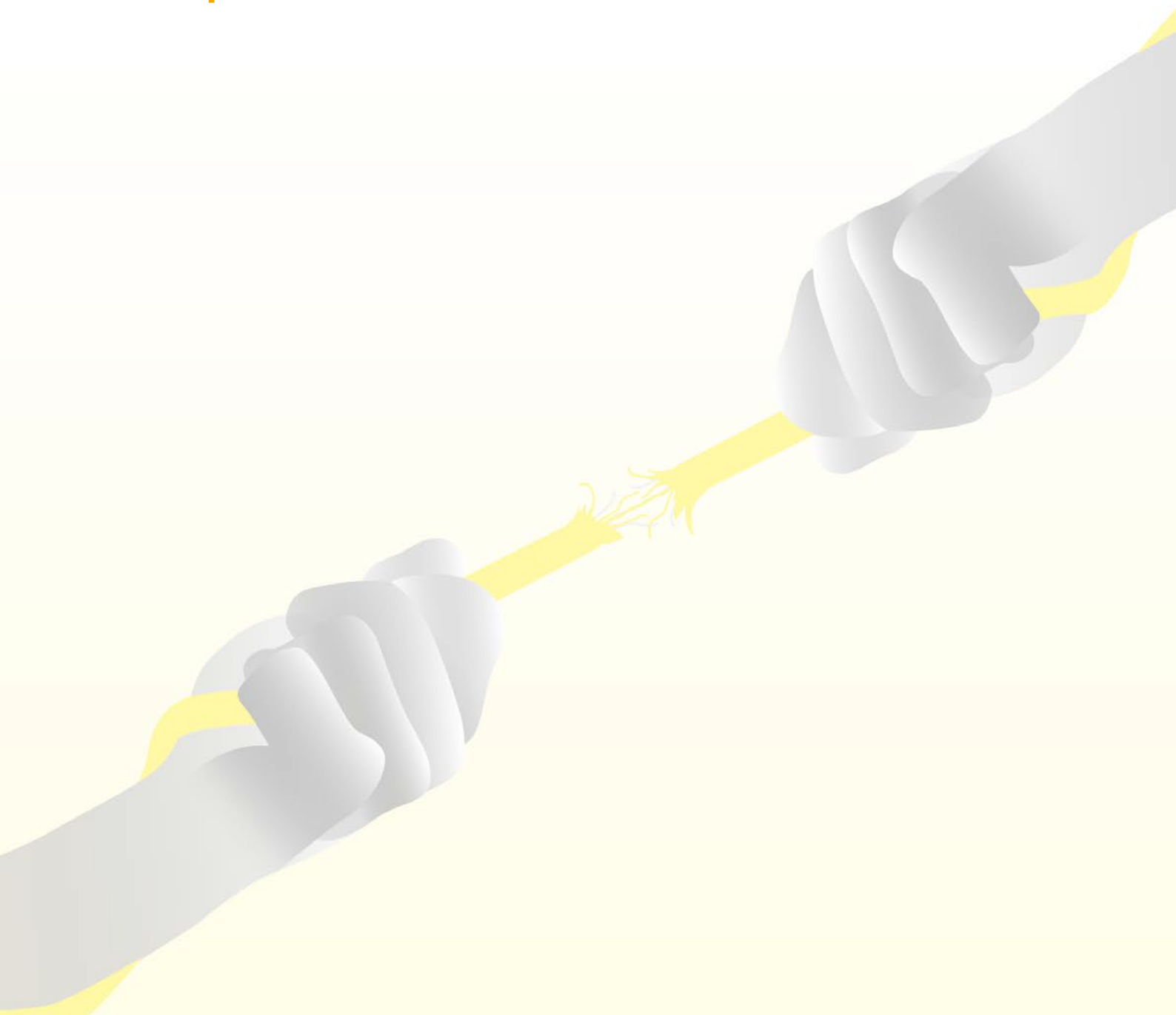
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European companies in China are concerned that, if governments cannot reach a level of understanding and put in place a universally-accepted framework to manage risk, entire industries will become completely impenetrable due to intensive restrictions imposed in the name of national security or self-reliance. The unthinkable result would be the crippling of global value chains, economies of scale and innovation systems.

Chapter Four

Implications and Recommendations

4





Chapter 4: Implications and Recommendations

1) Decoupling trends and possible remedies extend far beyond developments in US-China relations. Catalysed by political and strategic divergence, decoupling trends are likely to worsen in the future, despite a potential improvement in US-China relations in the coming months and a generally positive outlook for EU-China economic relations.

Recommendations for European companies

European companies are concerned about various decoupling-related issues. However, many interviewed business leaders had a limited 'line of sight', with a worryingly small share of them looking at the situation from a broader perspective. It is also highly concerning that there is often a lack of alignment, and even a considerable variation in the level of concern and understanding of issues, among those working for the same company.

- Develop a corporate taskforce at HQ with designated counterparts in critical markets that jointly track emerging developments and share information to create a global strategy to mitigate decoupling effects.
- Project multiple scenarios—ranging from significant improvements being made to the situation escalating beyond your control—and their implications for your company, with the status quo as the baseline.
- Strengthen corporate government and public affairs departments' capacity to monitor and engage with governments globally in order to help mitigate the impacts of decoupling.
- Take into account not only the nine layers of decoupling outlined in this report, but also the horizontal implications and potential impacts of intersecting issues.
- Participate more in joint government advocacy across markets through chambers of commerce, industry associations and standards-setting bodies, among others, to address and mitigate the effects of decoupling.

Recommendations for governments

EU-China economic relations are increasingly overshadowed by distrust, politicisation, geopolitics and systemic rivalry. There are already signs that this situation is locked in a steady, downward spiral with little political capital left over to pull it back. Many international actors, including the EU, India and Japan, are adjusting their geo-economic strategies to prepare for a less integrated world—or 'patchwork globalisation'—in response to structural market developments, global shocks and technological advancements. While growing pressure to align with either China or the US across the different layers of decoupling remains at the core of global decoupling tendencies, a purely bilateral perspective is not sufficient to grasp the full extent of the situation.

All sides

- Take proactive measures to defuse tensions, moving beyond tit-for-tat responses and blame games.
- Invest in action-orientated dialogue, measures to deepen interdependence, multilateral solutions and new frameworks to better manage emerging trade, technology and security tensions.
- Maintain or expand societal interactions and facilitate the free flow of people, talent and knowledge.

EU

- Continue to speak out against irrational all-out decoupling, and proactively support maintaining or deepening societal and business linkages in uncritical sectors.
- Invest more in greater policy coordination across member states and devise integrated strategic responses based on principled, open strategic autonomy that remains truly committed to global integration, including with China.
- Invest more in partnerships with like-minded governments, including in the UK, Japan, South Korea, India, Taiwan,

Australia, New Zealand and Canada, to devise aligned responses for navigating global decoupling tendencies.

- Learn from East Asian partners like Japan on how to manage interdependence with China by compartmentalising economic and political/strategic issues where possible.
- Consider mechanisms at the EU level that fulfil the functions of an economic security council, and display solidarity when faced with economic coercion.

China

- Recognise the legitimate concerns of international counterparts on the future of globalisation in relation to China.
- Clarify the extent of 'self-reliance' strategies to address governments across the world that consider China's new approach to globalisation ('dual circulation') to be a key factor shaping global decoupling tendencies.
- Recognise and respond positively to the substantial deterioration in global sentiment *vis-à-vis* China and the corresponding decrease in political trust, as well as other diplomatic tensions, that act as catalysts for further decoupling.
- Implement a truly level playing field and offer market reciprocity to the greatest extent possible to anchor global and EU relations.
- Successfully conclude the CAI with measurable implementation milestones, and continue to engage in global climate cooperation.

2) Decoupling trends across different layers are not fully synchronised but are interconnected and reinforce each other. Possible aggregate impacts are still underestimated and costs not well established.

Recommendations for European companies

Companies should map out and consider the possible introduction of new and strengthened measures that will drive decoupling. The range of possible instruments are considerable, and include technology-related market access barriers, entity lists, export controls (including for IP), and trade-related mechanisms like tariffs, quotas and bans. Companies also need to develop a deep understanding of the potential impacts and their corresponding costs. This should include both material costs, like higher production costs or lost revenue and market share, and immaterial ones, like a loss of innovation capacity and competitiveness, as well as diminished interoperability across jurisdictions.

- Map out the possible measures that would impact your company, both directly and indirectly (through suppliers/customers) across different jurisdictions, and prepare strategies to address all potential scenarios.
- Communicate internally across different geographies and departments to better understand the holistic impact of the intersection of decoupling trends on your global operations.
- Assess the current costs and consider corresponding mitigation strategies, including for possible future scenarios.
- Communicate the severity of current and potential costs to stakeholders to broaden their understanding of the ramifications of decoupling measures.
- Work with chambers of commerce and industry associations to better determine and communicate the broader costs of decoupling to government stakeholders.

Recommendations for governments

Decoupling measures instigated by authorities across the world and the strategic restructuring of industrial/technology ecosystems will create a business environment that is increasingly difficult to navigate for all companies, regardless of origin. The net result of decoupling in the name of 'national security' could also present a far greater threat to the stability and security of all countries, and result in substantial aggregate welfare losses, imply lower knowledge spillovers and slow down development.



All sides

- Maximise transparency, avoid discrimination and maintain procedural standards and regulatory precision when developing and implementing new measures that could potentially drive further decoupling.
- Counter-balance efforts to mitigate distortions and legitimate risks stemming from decoupling with clear communication and back-stops to inhibit the growth of nationalism and xenophobia.
- Develop nuanced strategies for strengthening supply chains that do not slide into trade protectionism.
- Invest in institutions and mechanisms that measure the economic impact of decoupling scenarios.

EU

- Coordinate with industry on foresight and risk-mapping related to China-decoupling developments.
- Adopt a systematic and pan-European approach to reviewing supply chain risks for critical inputs and the impact of various export control frameworks.
- Clarify defensive tools and their implications for foreign companies.
- Mandate serious impact evaluations and cost-benefit analyses for relevant EU public policy measures that have decoupling effects.
- Work closely with member states, the US and East Asian countries to reduce the risk of decoupling layers intersecting.

China

- Narrow the areas in which self-reliance is aimed for.
- Refrain from using an export control framework or other tools to threaten or unilaterally sanction individual countries and companies.
- Clarify the impact of China's new Export Control Law and the recent NDRC / MOFCOM rules on foreign investment reviews for European companies (especially those with R&D in China).

3) At its core, decoupling is really a contest being fought over the economy of the future.

Recommendations for European companies

Companies need to evaluate the short- and long-term ramifications of the technology war. The ongoing pulling apart of technology and digital ecosystems is already forcing difficult considerations, and the situation is set to worsen. If current technological bottlenecks, like semiconductors and critical software, were to close completely, this would present enormous challenges that companies need to prepare for.

- Begin a corporate-wide evaluation of the whole supply chain to determine the current and future level of exposure to potential loss of access to critical inputs.
- Start an internal audit of all networked and digital technologies used in corporate operations, data management, and production equipment and components to identify the level of exposure to further localisation requirements across different markets.
- Develop a cost/benefit analysis of adopting a 'flexible architecture' model that can be localised for different markets versus a 'dual system' model that completely separates production for the China market from production bound for the rest of the world.

Recommendations for governments

As technology continues down the path towards connectivity between any and all devices, risks to security and privacy grow. Governments are responding to this challenge with unchecked securitisation of technology. The

hyper-conservative approach taken by China, and increasingly the US and even the EU, is set to create a world of technologically walled-off systems, which will devastate economies of scale and drag on innovation. Where legitimate concerns exist, restrictions should be imposed proportionate to those risks – no more and no less.

All sides

- Create a common international framework that classifies the degree of national security risk that new or emerging technologies pose to certain value chains, and that then applies commensurate restrictions on foreign companies' involvement in those areas while ensuring market access where risk can be effectively managed or is non-existent in the first place.
- Work to align data governance models to best ensure privacy and security while allowing for non-sensitive industrial data and sufficiently anonymised and aggregated personal data to be transferred across borders.
- Advance a more proactive agenda to align on standards-setting in new and emerging technologies, with a bare minimum goal of ensuring interoperability across systems.

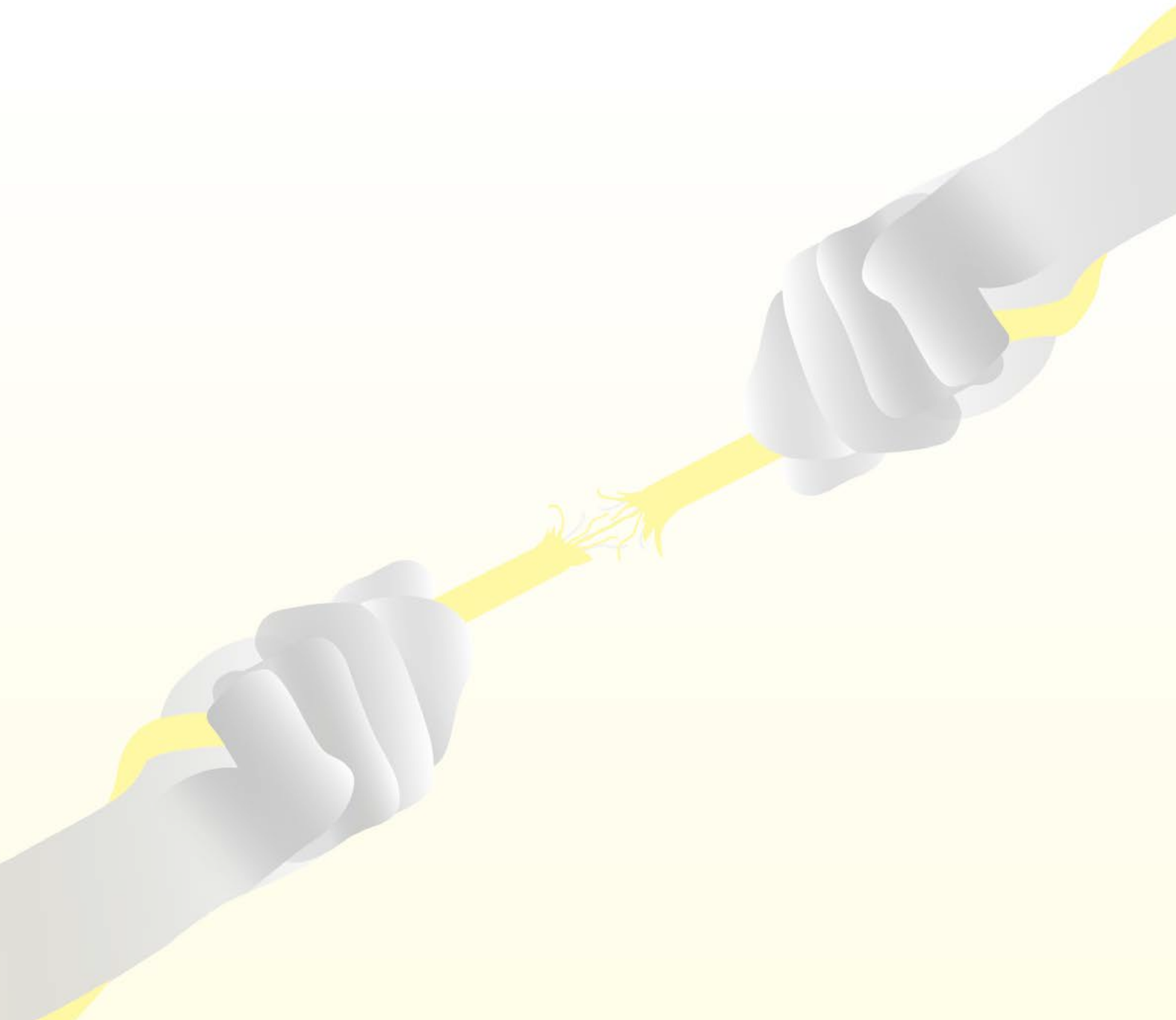
EU

- Prepare for several scenarios including disruption, bifurcation and severely limited integration of key technology ecosystems in the semiconductors industry, as well as within wider technology ecosystems related to 5G and the IoT.
- Strengthen Europe's innovation/industrial ecosystem including by ensuring input and buy-in from the European technology industry in the implementation of the EU's Digital Strategy.
- Push for greater reciprocity and fairness in innovation and R&D cooperation with China, including when determining Chinese companies' participation in the Digital Single Market and by using formats such as the High-Level Digital Dialogue, to incentivise China to reform its VATS licensing requirements and fully open up the digital economy.
- Brace for retaliation due to restrictions being placed on Chinese technology in the EU and build appropriate mechanisms to support European companies affected.
- Launch plurilateral negotiations among like-minded democracies on robust standards and rules for data security, platform regulation and digital connectivity.

China

- Recognise that the party-state's interference in the private technology industry undermines Chinese companies' operations abroad and creates a cycle of mistrust that damages much-needed technological ties, including those with Europe.
- Clarify definitions such as "autonomous and controllable" and reassure European companies that regulators responsible for cybersecurity reviews (such as the Multi-level Protection Scheme and cybersecurity reviews for CII operators) will not discriminate against them.
- Clarify the implications of the Export Control Law and Cybersecurity Law on know-how created in China by foreign companies.
- Issue guidance on China's cybersecurity review mechanism and provide companies with explicit requirements for approval.
- Improve long-standing issues related to IP, access to information and resources, and people mobility.

Abbreviations



Abbreviations

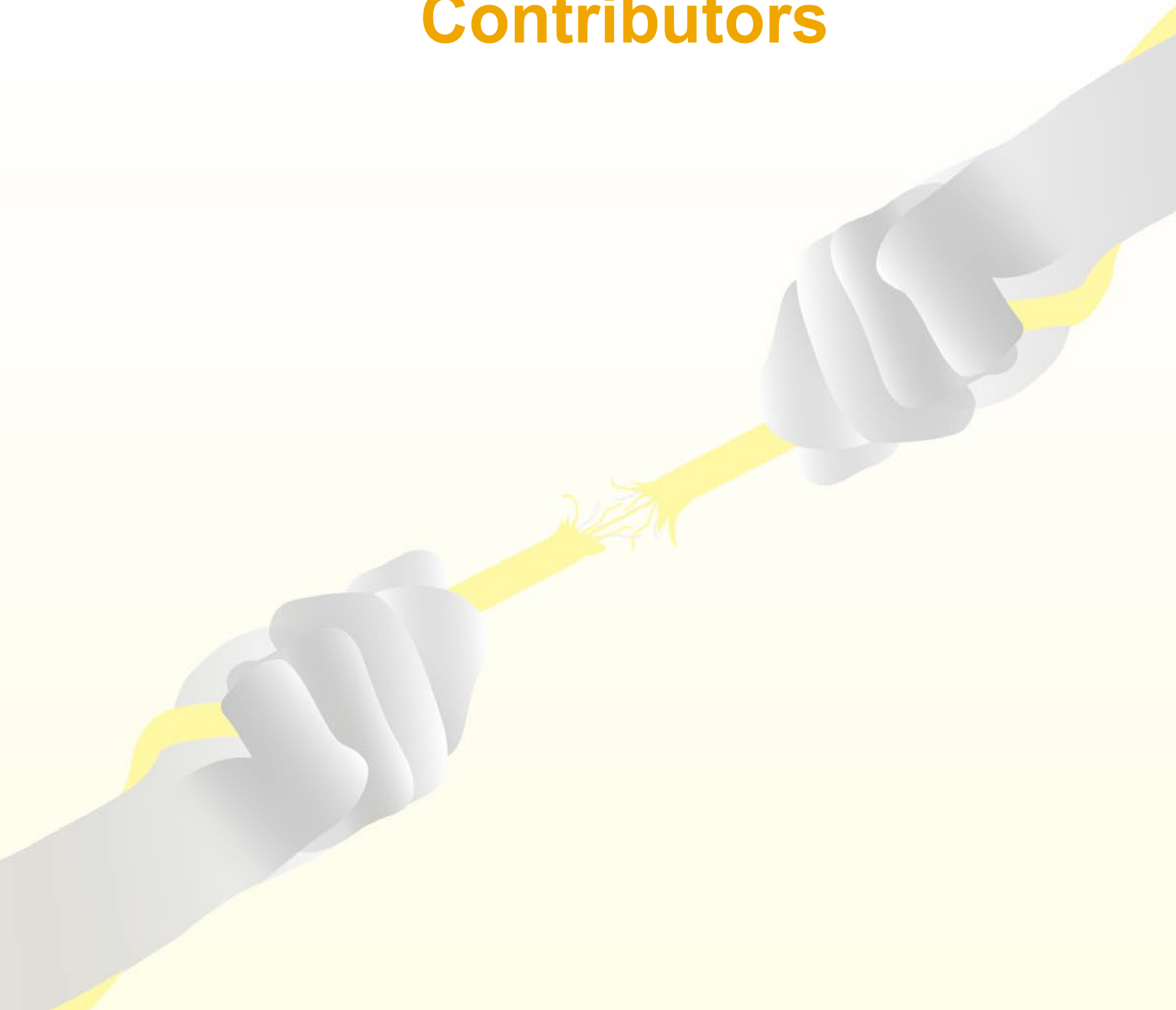
5G	Fifth Generation Technology
AI	Artificial Intelligence
API	Active Pharmaceutical Ingredient
BCS	Business Confidence Survey
BRI	Belt and Road Initiative
CAI	Comprehensive Agreement on Investment
CCP	Chinese Communist Party
CII	Critical Information Infrastructure
CIPS	Cross-Border Interbank Payment System
CM2025	China Manufacturing 2025
COVID-19	Coronavirus Disease 2019
ECU	Electronic Control Unit
ESG	Environmental, Social and Corporate Governance
EU	European Union
G7	Group of Seven
GDPR	General Data Protection Regulation
HQ	Headquarters
ICP	Internet Content Provider
ICT	Information and Communication Technology
IEC	International Electrotechnical Commission
IoT	Internet of Things
IP	Intellectual Property
IPO	Initial Public Offering
IPR	Intellectual Property Rights
ISO	International Standardisation Organisation
IT	Information Technology
JV	Joint Venture
LIDAR	Light Detection and Ranging
MIIT	Ministry of Industry and Information Technology
MNC	Multinational Company
MOFCOM	Ministry of Commerce
MRI	Magnetic Resonance Imaging
NAFTA	North America Free Trade Agreement
NBA	National Basketball Association
NEV	New Energy Vehicle
NDRC	National Development and Reform Commission
OECD	Organization for Economic Co-operation and Development
O/S	Operating System
PaaS	Platform as a Service
RCEP	Regional Comprehensive Economic Partnership
RMB	Renminbi
R&D	Research and Development
SCC	Standard Contractual Clause
SME	Small and Medium-sized Enterprise



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SMIC	Semiconductor Manufacturing International Corporation
SOE	State-owned Enterprise
SWIFT	Society for Worldwide Interbank Financial Telecommunication
UN	United Nations
US	United States
USD	United States Dollar
VATS	Value-added Telecommunications Services
VPN	Virtual Private Network
WHO	World Health Organization
WTO	World Trade Organization

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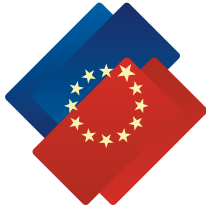
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