



MANAGING ECONOMIC COOPERATION AND COMPETITION WITH CHINA

Towards a More Integrated European
Trade Policy Approach

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KEY FINDINGS

- China will be a comprehensive, confident but internally conflicted trade actor that continues to deviate from WTO norms and pushes the boundaries of “traditional trade policy.” Beijing pursues an integrated trade policy approach and shows growing ambition in rule- and standard-setting. It is doubling down on regional and South-South trade partnerships and seeking to conquer new trade domains.
- China’s trade policy will prove challenging for Europe, given the persistent and distinct features of its domestic economic governance, coupled with internal and external pressures. Under President Xi Jinping, economic and trade policy is likely to be characterised by neo-mercantilist techno-nationalism and non-convergence with OECD countries.
- The EU has long sought to manage China-related concerns through negotiation, and multilateral or bilateral cooperative means, within reasonable timeframes. In an ideal scenario, the EU could call on a reformed WTO rulebook, jointly developed with China, and Beijing would quickly accede to existing WTO-associated plurilateral agreements. A strong EU-China bilateral investment agreement would lead to greater market opening, a more level playing field, transparency and effective disciplining of SOE behaviour. However, the EU’s ongoing efforts in these areas have yielded limited progress. More concerted measures will be necessary to push current negotiations forward.
- Europe needs to devise better-integrated trade policy to engage China, which is a trade actor that leverages and mixes traditional and non-traditional trade policy areas. An integrated EU trade policy needs to draw on trade-adjacent policy areas with the aim of **(1)** countering China’s distorted competition environment, and its consequences **(2)** pursuing competitive and sustainable connectivity **(3)** building leverage as a means to enforce “digital reciprocity” and data protection **(4)** securing equal access to China’s innovation system while ensuring the protection of IP and critical technologies in research cooperation.
- To successfully manage economic cooperation and competition with China, the EU institutions and member states should neither mimic China’s approach to integrated trade policy, nor give up their own liberal DNA. They should focus on **(1)** pursuing a set of targeted, issue-area specific policy priorities that respond to China’s trade profile while integrating the EU’s own approaches to the cross-cutting policy domains of standard setting, supply chain security and environmental and trade policies; **(2)** strengthening intra-European coordination and **(3)** capitalizing even more actively on the benefits of cooperating with OECD partners.

1. Introduction

Nearly two decades after China acceded to the World Trade Organization (WTO), its compliance record and alignment of economic policies and trading practices with existing WTO rules remains contested. With the exception of the decision to join the Information Technology Agreement (ITA) taken under President Xi Jinping, there are few signs that Beijing intends to conform to existing or emerging regulatory regimes linked to the WTO, nor to engage in meaningful reforms of the international trading system. Doing so would counter and constrain key features of China's state-led economy. The European Union (EU) has made laudable attempts to 'comprehensively overhaul the WTO by 2022'¹. However, Europe must anticipate a future in which the WTO and other international frameworks only govern some aspects of its trade relationship with China.

As this analysis sets out, China will be a comprehensive, confident, but conflicted trade actor, which continues to deviate from WTO norms, while pushing the boundaries of traditional trade policy. This creates both opportunities and challenges for Europe. To manage them, the new Commission should live up to its 'digital, green and geopolitical' agenda in the realm of trade and, together with the EU member states, embrace an integrated trade policy approach vis-à-vis China that is comprehensive and confident, and is guided by the need to promote European competitiveness in global trade.

China will be a comprehensive, confident, but conflicted trade actor

An integrated EU trade policy requires **(1)** in-depth awareness of China's approach to trade policy and the factors driving it, **(2)** EU-wide cohesion on the trade policy approach pursued towards China across different dimensions, **(3)** institutional capacity for EU internal coordination on relevant trade policy, **(4)** sufficient depth of policy proposals to implement a more integrated trade policy approach, and **(5)** greater coordination of EU trade policy with Organisation for Economic Co-operation and Development (OECD) partners' trade policies. While the EU already scores well on some of these criteria, improvements are needed in the most consequential areas of economic cooperation and competition with China. This analysis will highlight such areas and provide concrete recommendations for a more integrated EU trade policy.

2. Europe will find China a comprehensive, confident, but conflicted global trade actor in the next decade

MAIN FINDINGS

- Beijing's external economic policies ultimately serve the goal of preserving regime stability. There is little reason to expect a relaxation of the state-centred approach to trade policy in the next decade.
- China pursues an integrated approach to trade policy and positions itself strategically in adjacent policy fields like competition, connectivity, digitalisation, innovation and research. The EU can expect more strategic attempts to invest in its high-tech industries.
- Slowing economic growth, increasing corporate debt and weak productivity put China's competitiveness in question. Despite ambitions to achieve technological self-sufficiency, Beijing may be compelled to create more access for foreign businesses and capital.
- China's government has expanded state interventionism and pre-empted competition in strategically important areas. EU member states cannot rely on being able to benefit from a prosperous China on the long term.

MERICS research suggests that three core characteristics will define China's development as a global trade actor over the next five to 10 years, namely **(1)** comprehensiveness, **(2)** confidence, and **(3)** conflictedness. China can be expected to put a premium on increasing its ability to define the rules and standards underpinning existing and future areas of trade. China will also seek to expand its trading footprint across different geographies and newly emerging physical and (to a lesser extent) digital goods and services trade domains. Yet it will mostly resist the intensifying external pressures to implement deep structural economic reforms.

2.1 COMPREHENSIVE: CHINA'S TRADE POLICY FOLLOWS AN INTEGRATED APPROACH, WITH AMBITIONS TO SHAPE INTERNATIONAL RULES AND STANDARDS

Beijing's external economic policies are an extension of its domestic industrial policy approach, and ultimately serve regime stability for the Chinese Communist Party (CCP) and its inter-dependent state security system. China's trade policymaking trajectory is driven by its goals of ambitious modernisation, self-strengthening and 'rejuvenation'. China is serious about these goals. It is more strategic than any other big trading nation in how it leverages and mixes measures across various traditional and non-traditional trade policy areas to achieve them.

Beijing pursues an integrated approach to trade policy, which draws on levers from adjacent policy fields to maximise China's strategic positioning in global value chains. It seeks to ensure China's trade dominance in new geographies and new types of markets, and to shift asymmetric interdependence in China's favour. As part of this approach, China's trade policies are integrated with policy making in four wider policy fields, namely:

Beijing's external economic policies ultimately serve regime stability for the CCP

- **Competition policy:** China's competition environment at home is designed to achieve trade policy purposes, including by promoting 'better, stronger and bigger' state-owned enterprises (SOE) able to excel in global markets. China's approach to competition is consciously geared towards concentration and size, seen in Beijing as a way to avoid 'unhealthy' or 'unnecessary' competition, though European competitors see it as promoting an uneven and unfair playing field.
- **Connectivity policy:** China exports its domestic industrial and development policy approach by shaping 'coordinated credit spaces' abroad. In these spaces, China's SOEs and state banks foster trade-generating connectivity based on costly physical infrastructure projects with regional and inter-continental reach.
- **Digital policy:** Beijing recognised the strategic dimension of digital development earlier than the EU and its member states. It has promoted its vast digital ecosystems protected by market access and cyber-security restrictions that effectively shut out foreign competition. Today, China's digital market makes Beijing a formidable competitor in regulating the future global digital trade environment.
- **Innovation and research policy:** European policy making circles still under-estimate the degree to which China's research and innovation environment is developing in sync with top-down industrial and trade policy goals. Although the link to trade policy may seem distant, from Beijing's perspective measures geared at localising R&D, international research collaboration, and a top-down IP and standardisation system are essential for active 'value chain management' and to shape future patterns of trade and global inter-dependence.

Beijing's embedded and integrated trade policy goals are pursued with close attention to shaping global norms and rules that suit China's domestic priorities and preferences. Beijing still signs up to established global frameworks, such as the ITA, when it suits China's industrial upgrade strategy. Beijing also frequently engages in defensive moves to protect China's state-led economic governance approach from being weakened by international economic governance regimes.

Beijing's embedded and integrated trade policy goals are pursued with close attention to shaping global norms

Hence, China has promoted 'South-South alignment' as a way to preserve its special and differentiated treatment as a WTO member. It has also created an increasingly wide net of comparatively shallow bilateral and plurilateral trade agreements. Lately, China has put a particular emphasis on negotiating the Regional Comprehensive Economic Partnership (RCEP) among 16 Asian countries, which is expected to come into force in 2020 (though its credibility suffered a blow when India pulled out of negotiations in November 2019). While the rules and norms underlying China's 16 existing trade agreements with 24 countries and regions vary significantly, they tend to focus on liberalisation of trade in goods. In contrast, trade in services is often neglected, and less attention is paid to progressive environmental, labour, and other 'behind-the-border' regulations. It remains to be seen whether more progressive FTA features, such as China negotiated with Switzerland as an advanced trading partner, will be a model for the seven ongoing FTA negotiations China is conducting with third countries.

Beijing deploys China-centred informal networks as vehicles for rule-making and standard-setting efforts that often lack predictability, coherence and transparency. For example, Beijing uses the Belt and Road Initiative (BRI) platform to create new arrangements for legal cooperation; these range from trade facilitation, tax, procurement and investment rules,

to alternative structures for international arbitration and dispute settlement. Underscoring the rule-making and standard-setting role envisaged for the BRI, Chinese experts have even suggested that the BRI could become an equivalent – and possibly alternative – to the OECD².

One particularly important priority for China's trade policy is to set the rules and technological standards underpinning new trade domains. Beijing is keen, for instance, to shape the rules governing e-commerce to foster a more efficient policy and business environment for cross-border trade. In developing standards for emerging technologies – such as AI, quantum computing, genomics, new telecommunications equipment, or space mechanics – Beijing is opting for a more forward-leaning approach ('China Standards 2035') and leadership role in international standard-setting bodies such as the International Telecommunication Union (ITU)³. The aim is to internationalise China's domestic industrial standards, and to shape the underpinnings of the future trading landscape. A MERICS study on China's digital policies, for example, illustrates the impact of China's strategic international engagement in global standardisation bodies and of the resources put behind becoming a global leader in technologies, such as 5G or the Internet of Things (IoT). Hence, Chinese companies already hold more than 30 percent of standard-essential patents for 5G technologies, and China's proposal for an IoT Reference Architecture was approved as ISO/IEC 30141 by the joint ISO/IEC technical committee in 2018 in what was portrayed in China as a major victory for national R&D.

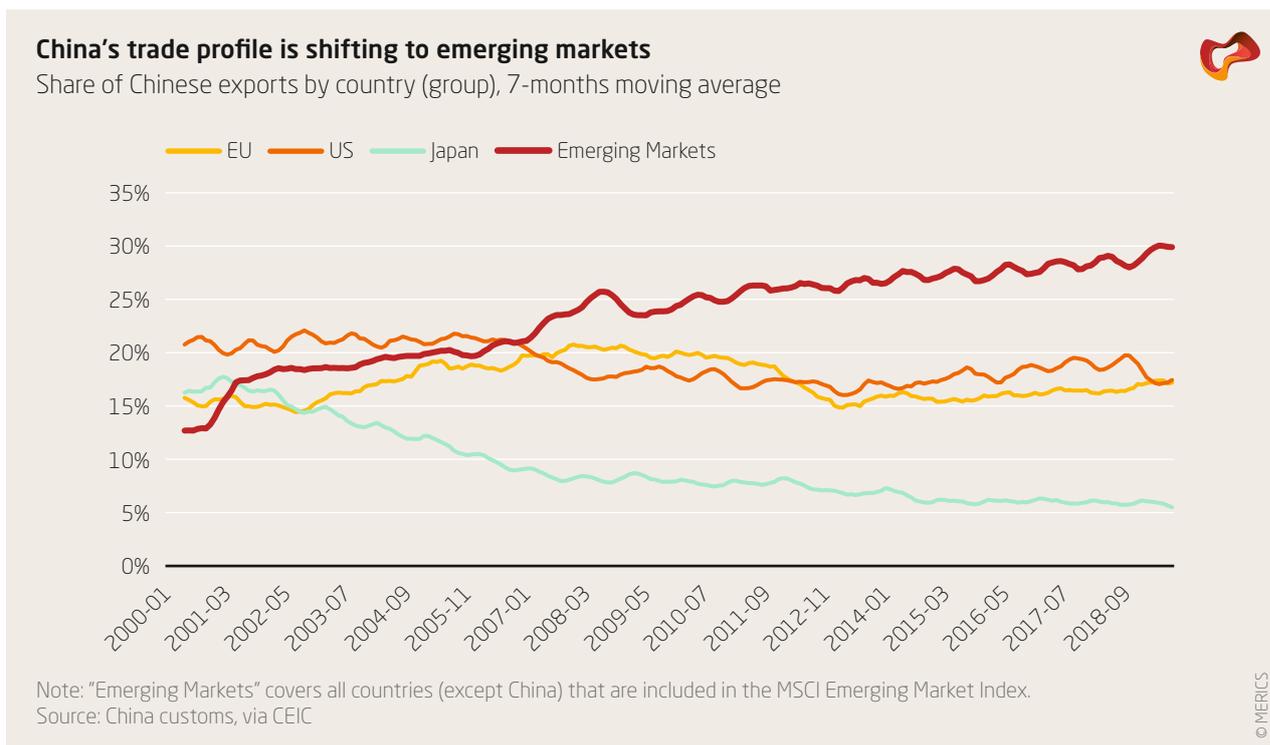
China aims to shape the underpinnings of the future trading landscape

2.2 CONFIDENT: CHINA WILL DOUBLE-DOWN ON REGIONAL AND SOUTH-SOUTH TRADE PARTNERSHIPS WHILE CONQUERING NEW TRADE DOMAINS

China's trade policy is grounded in the idea that its economy is relatively well insulated against systemic shocks from global markets as it has the biggest consumer market in the world. This sentiment is reinforced by the diversity of China's economy, which combines both manual labour and knowledge- and technology-driven modes of production. This multifaceted division of labour caters efficiently to global demand. Beijing readily projects confidence over its future trade role, as it is becoming ever more central to regional production networks within Asia, and further expanding its reach with a growing web of trade, investment and 'industrial capacity cooperation' agreements.

Beijing also shows confidence in its globalizing corporates, which often benefit from protectionism, vertical integration and subsidies at home combined with global China-centred production and transport networks. Most major Chinese companies (except Huawei and Lenovo) generate more than 75 percent of their revenues domestically. At the same time, the international presence of Chinese medium-high-tech industrial goods has reached unprecedented heights, in sectors such as machinery, motor vehicles and transport equipment, as well as in high-tech industrial products, specifically electronics. Chinese production accounts for about 35 percent of global manufacturing output. Chinese companies can be expected to step up the transfer of manufacturing and industrial production capacity to emerging economies, where they reap the benefits of China-centred global logistics networks.

Chinese corporates are capturing more of global value-added trade while sharpening their profile as global vendors of choice and expanding their sourcing footprint throughout Asia and into African and Latin American markets.



China will seize opportunities arising from the digitalisation of production and trade. The country is already in the global vanguard of e-commerce, with roughly 40 percent of global market shares, easily outstripping the combined market shares of France, Germany, Japan, the United Kingdom, and the United States. As MERICS research on China's digital policies has shown, Chinese e-commerce businesses are encouraged to further cut transaction and logistics costs by applying cutting-edge technologies, e.g. big data, AI, cloud computing, and blockchain.

The Digital Silk Road (DSR), the government's initiative to promote China-centred digital trade corridors and supply chains, to export its cyber and data governance norms, and to set global tech standards, has strong digital trade facilitation components. Since 2013, Chinese entities have invested over 10 billion USD in e-commerce and mobile payment deals worldwide. IoT devices are likely to be widely deployed along the BRI to expedite customs processing, and AI applications are increasingly being used to fully-automate China-owned ports. The digitisation of trade may well boost China's exports of physical goods, but China will face challenges in trading digital goods and services. Unless China's government reforms its restrictive approach to data governance, encapsulated in extensive censorship and 'The Great Firewall', it will be hard to bolster China's cross-border data flows, which currently amount to only about 20 percent of US data flows and are smaller than those of medium-sized EU economies.

2.3 CONFLICTED: INTERNAL AND EXTERNAL PRESSURES WILL CONTINUE TO CONFRONT EUROPE WITH CHALLENGES FROM CHINESE TRADE POLICY

China's leadership is likely to face significant constraints in delivering an attractive trade and investment environment, despite its confidence in pursuing ambitious trade policy

goals in many countries and new digital domains. Economic growth is slowing down while corporate debt increases and weak productivity puts China's overall competitiveness in question. Rapid population aging poses an additional challenge to the sustainability of the Chinese economy: By 2050, more than one third of the Chinese population will be above the age of 60, according to the China National Committee on Aging⁴. In a clear recognition of the associated challenges, Beijing may well be compelled to gradually create more access for foreign competition and capital in selected industries, as it finds itself faced with mounting economic tensions with the U.S. and some pressure from Europe, too. European businesses are therefore likely to find new opportunities in the coming years, as investment negative lists will shrink and market access in growth industries becoming more rewarding.

Exhibit 2

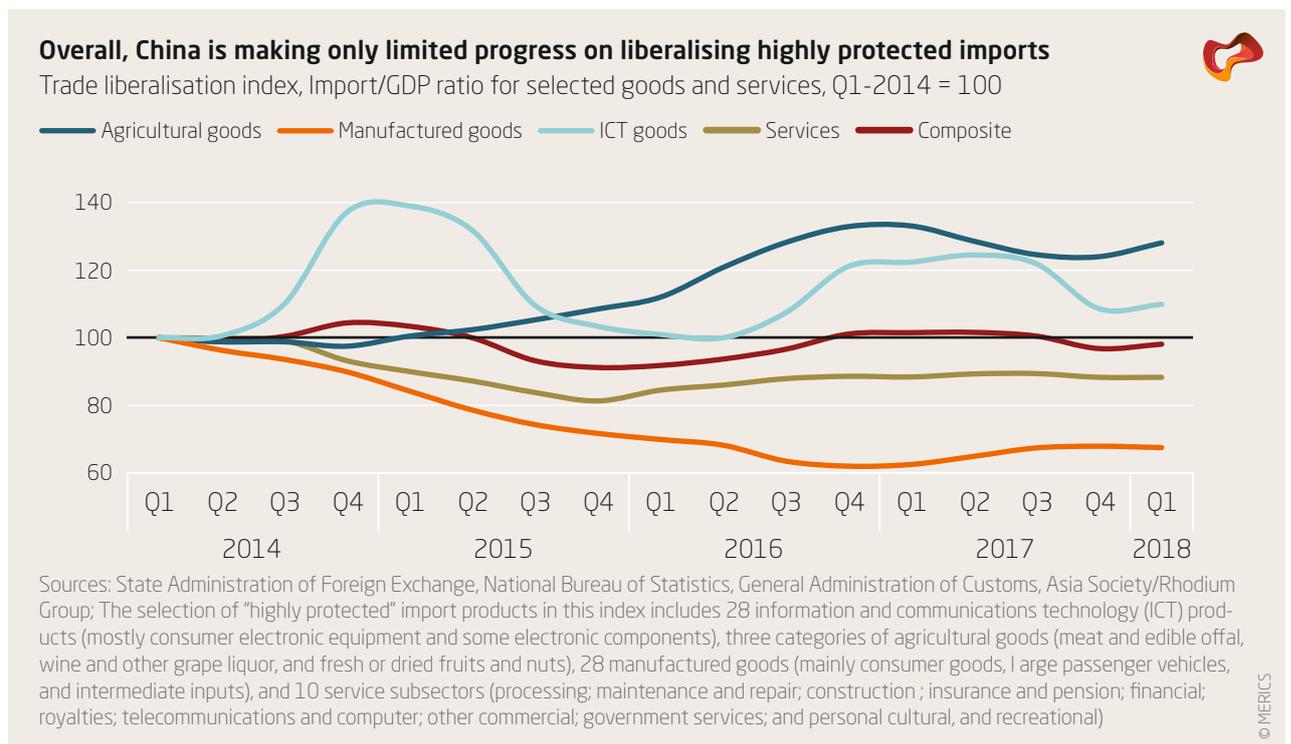
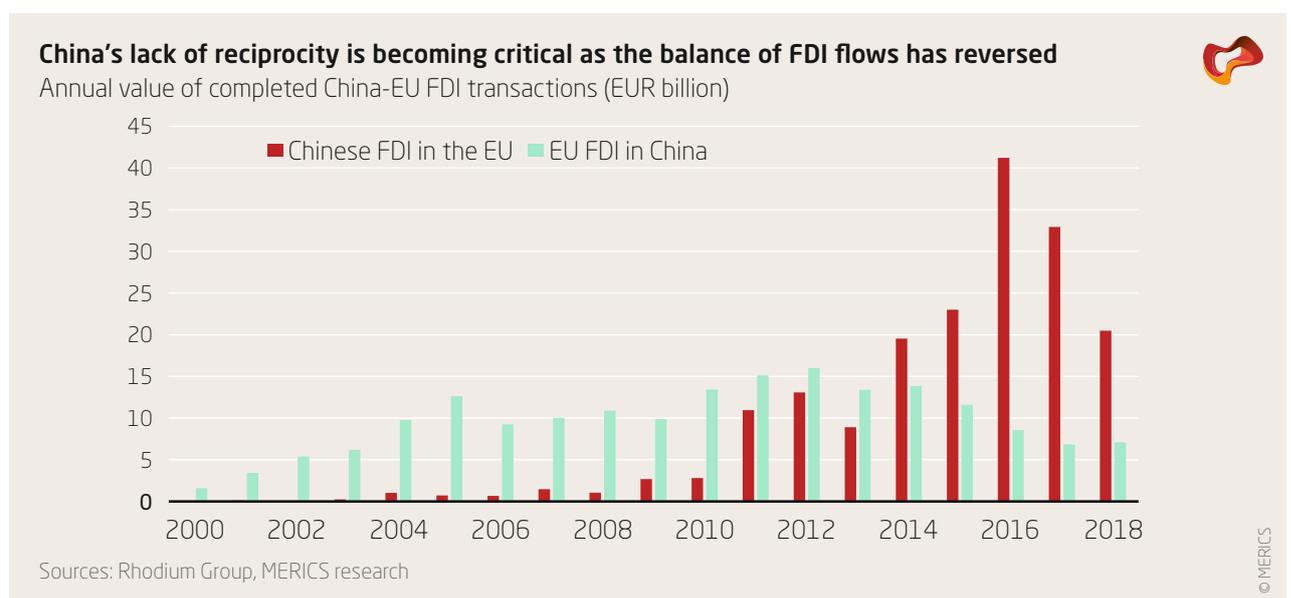


Exhibit 3



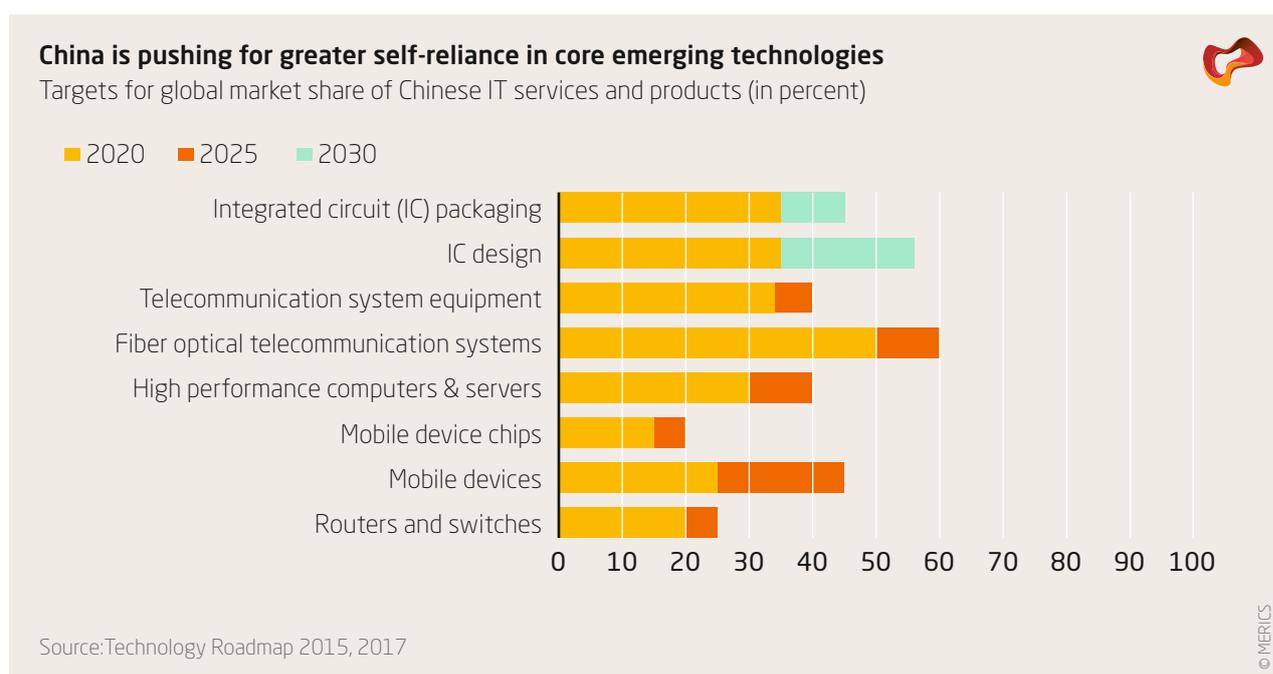
However, the overall picture that will present itself to European businesses operating in China will be one of fundamental uncertainty and also growing challenges. Under President Xi Jinping, economic and trade policy is likely to be characterised first and foremost by neo-mercantilist techno-nationalism and by non-convergence with the policies of OECD countries. This is the picture that emerges from in-depth MERICS research on China’s industrial policy ecosystem and the broader political dynamics⁵. Economic policy-making in China today puts a high premium on crisis management, central party leadership and control, upgrading of the state sector, doubling-down on indigenous (or autonomous) innovation and continued attempts to localise high-tech value chains.

President Xi’s heavy-handed structural reform program of China’s governance system is of critical importance to understanding China’s trade policy. Launched in 2018⁶, it ushered in more intrusive forms of party-state control over enterprises, including a stronger role for CCP cells in companies, and behavioural scores for corporates and their individual employees through the social credit system. The CCP’s tighter grip could have far-reaching implications for corporate realities on the ground. Some measures are also questionable from the perspective of global trade and investment rules.

US-China economic competition will accelerate China’s existing drive for technological self-sufficiency and may well deliver medium- to long-term successes. At present, there is economic pain from the changing geopolitics of trade and a looming domestic economic crisis. The introduction of stricter US export controls throughout 2019 has spurred China’s efforts to reduce dependency on key foreign technology. European players can expect to see an escalation of China’s strategic attempts to invest in European high-tech industries, including moves to facilitate or force technology transfer.

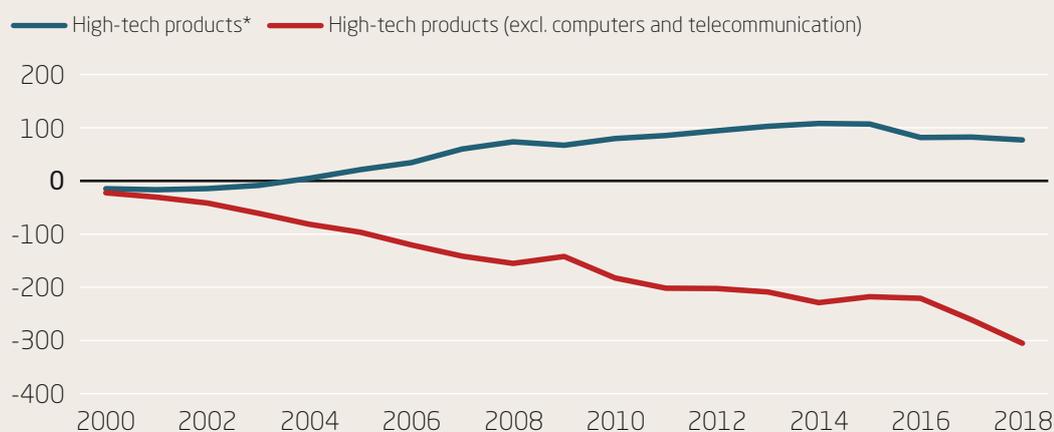
China will make significant strides towards bolstering the autonomy of its indigenous innovation capacity. In 2018, China spent nearly 2.2 percent of GDP or around USD 300 billion on R&D, surpassing the EU level of 2.1 percent. China aims to substantially increase R&D spending in the coming years. In 2019, it also expedited the introduction of its own export control regime for sensitive technologies, potentially adding to a global spiral of protectionist trade measures.

Exhibit 4



China has not yet managed to decrease its dependence on core high-tech imports

China's high-tech trade balance (USD billion)



*According to NBS definition: Biotech, life science, opto-electronics, electronics, computer and telecoms, chips, aerospace

Source: National Bureau of Statistics of China (NBS)

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The path of China's domestic economic reforms gives little reason to expect any relaxation of the state-centred approach to trade policy, unfair competition or protectionism in the next decade. Piecemeal improvements should not distract from the fact that overall economic reform in China has been regressing. In the past two years in particular, several high-profile European companies have benefited from selective and tactical market opening in sectors such as finance, automotive, and pharmaceuticals. Beijing has also engaged in targeted tariff reductions and introduced new IP regulations. However, key indicators of the dominant state-centred trend are uneven distribution of credit, over-investment in government-priority sectors, the ubiquitous nature of non-tariff barriers (including in government procurement), the application of standards and the introduction of the new corporate social credit system.

China's government seems to have turned its back to earlier approaches to economic reform and global economic integration. There has been selective opening of Chinese industries to foreign exports and competition. However, SOE reform and implementation of state-led development and industrial policies provide a much better measure of China's overall convergence with OECD practices as a trade actor. Using this yardstick, the state sector has since 2013 once again become by far the biggest recipient of loans and credits, though the private sector is generating roughly 60 percent of GDP, 70 percent of technological innovation and 80 percent of urban employment. Far-reaching SOE reforms will remain undesirable for the CCP, as the Chinese economy is on a slowdown trajectory. Beijing has come to appreciate SOEs once again as a necessary 'safety net' not only for citizens but also for China's economic model and CCP durability more broadly. Market forces are relegated to the background or deployed strategically, despite programmatic reform announcements in 2013⁷. Aspiring to be a 'global manufacturing' and 'science and technology innovation superpower' by 2049, China's leaders have again opted for a major expansion of state interventionism and prefer to pre-empt competition in areas of strategic priority. The medium- to long-term success of this approach is hard to predict, but EU member states would be ill advised to bet on the prospect of an economically healthy and successful China whose long-term prosperity benefits the EU as well.

3. The EU must raise its game to navigate the most consequential aspects of China's integrated trade policy approach

MAIN FINDINGS

- The EU's efforts to develop multilateral agreements with China on critical issues like competition policy and investment have seen only limited progress. EU actors need to evaluate alternative policy tools that are independent of China's goodwill.
- Medium-to-long term risks of doing business with China are growing. Government-induced market distortions will continue to harm EU producers and consumers.
- Since the launch of the Belt and Road Initiative China has come to dominate the global connectivity policy space. Europe risks losing ground and needs to focus on promoting sustainable connectivity and better competing with China in third markets.
- Digital policy is a strategic domain for Beijing's global trade policy. The EU must secure 'digital reciprocity' with China's often subsidised digital giants and raise its game to promote a balance between the free flow of data and the protection of privacy.
- Research and innovation cooperation have moved to the forefront of EU engagement with China. Potential and actual risks stemming from China's exploitation of Europe's innovation ecosystem and openness need to be carefully considered.

European policy responses to China's comprehensive, assertive and conflicted trade policy can fall into three main categories, namely: **(1)** accepting likely damages (if the cost to remedy is higher), **(2)** negotiating with China with the aim of removing the sources of damages, and **(3)** trying to offset damages through promotional or defensive measures implemented in the EU.

The ideal scenario sees the EU managing China-related concerns through negotiation and multilateral or bilateral cooperative means – the second option – within reasonable timeframes. The EU would turn to a reformed WTO rulebook jointly developed with China and Beijing would quickly accede to existing WTO-associated pluri-lateral agreements, such as the Government Procurement Agreement (GPA). The EU and China would develop new multilateral agreements on critical issues, including competition policy and investment, building on work in G20 and OECD frameworks. Bilaterally, the EU's successful export of its own rules via dialogues on competition and state aid would support Chinese convergence in both areas. Most important, a strong EU-China bilateral investment agreement would lead to more market opening, a more level playing field, transparency and effective disciplining of SOE behaviour.

In reality, the EU's ongoing efforts in these areas have yielded limited progress and forceful, concerted steps would be necessary to affect the trajectory of current negotiations, given recent trends in Chinese policy-making and economic indicators. In this context, EU member states and institutions need to evaluate second-best policy tools whose successful implementation does not depend directly on Chinese cooperation. The EU needs to continue reappraising its trade policy and to take a more integrated and holistic approach in order to manage economic cooperation and competition with China successfully. This means developing more integrated European responses in areas that China is leveraging for trade policy purposes; these include China's favourably structured domestic competitive environment; the pursuit of transnational connectivity and targeted digital policies as well as research and innovation policies.

3.1 EUROPEAN TRADE POLICY NEEDS TO WITHSTAND PERSISTENT, GOVERNMENT-INDUCED MARKET DISTORTIONS IN CHINA'S COMPETITION ENVIRONMENT

China's trade policy emanates from a competition environment that challenges European businesses operating there and that has significant spillover effects in third markets. Key features of China's state-guided environment include asymmetric market access conditions, distorted financing costs for Chinese companies, coordinated strategic behaviour – and sometimes collusion – among Chinese producers and pervasive interventions on input and operational costs that confer price advantages⁸.

Persistent government-induced market distortions that produce an uneven playing field represent confident decisions by China's current leaders and are not just symptoms of an incomplete transition. Since 2015, the CCP has escalated policy approaches that promote selected Chinese industries and companies. The trajectory is exemplified by the Made in China 2025 strategy (MIC25) and associated plans that promote continual renewal and adaptation of industrial policy practices^{9 10}. China's leaders have lowered the public rhetoric surrounding MIC25, but its implementation continues at full speed. MIC25-related outward-facing trade and investment practices have gained momentum since 2017. The MIC25 strategy increasingly blurs boundaries between state and private commercial activities. It combines a consolidation and strengthening of a group of central SOEs in traditional high-tech sectors with measures to co-opt, steer and leverage private enterprises for leapfrogging in sectors relevant to the fourth industrial revolution (smart, digital and emerging technologies). By the end of 2018, China's government had issued a total of 445 authoritative documents detailing MIC25 implementation measures. Local governments are busy translating the national vision into local directives with ambitious, constantly evolving, sector-specific targets, e.g. for domestic and global market shares. As a forthcoming MERICS study on China's platform economy shows, Beijing also envisages the expansion of the digital platform economy into the manufacturing sector as a critical means to build internationally competitive industrial internet platforms that serve China's modernisation goals¹¹.

MIC25 increasingly blurs boundaries between state and private commercial activities

Beijing's ongoing updating of its interventionist industrial and trade policy toolbox¹² remains controversial, as seen in internal policy debates. Reformist policymakers and some leading economists have voiced concerns about the current statist trajectory, given the inefficiencies and global pushback. They have suggested that private enterprises should be raised to a more equal footing with SOEs ('competitive neutrality'). Such ideas are, however, deeply contested in China, and decisive steps to level the competitive playing field have yet to materialise. The long drawn-out timetable for SOE reforms and the forceful remarks by China's Vice Premier and top trade negotiator Liu He made in November 2019, after the CCP Fourth

Plenum, about Beijing's plans to make the state economy 'stronger, better and bigger' signal little intention to weaken the state's grip on the economy¹³. It seems unlikely the current leadership would dramatically change course on the central role of the state in all areas of the economy, absent a major economic shock or crisis.

For European companies, this skewed competitive environment has shifted the balance of opportunities and challenges. China's forceful approach to modernising industry and nurturing innovation is creating plentiful opportunities for European suppliers and technology partners. It also makes advanced research and innovation partnerships more attractive, as China is itself becoming a source of innovation that is hosting technological development in key industries¹⁴.

Meanwhile, medium- to long-term risks for Europe are growing. Even under the unlikely, best scenario of a renewed emphasis on structural reform and government-induced market distortions would continue to harm EU producers and consumers. Direct and indirect channels for the transmission of these market distortions include market access barriers, unequal procurement practices, crowding out and substitution effects, dumping, subsidised production and investments also in third markets, among others. Given China's current policy trajectory, it is likely that these spillovers will increase until they eventually challenge Europe's innovation capacity and endanger the long-term viability of its economic model.

Medium- to long-term risks for Europe are growing

EUROPEAN PRIORITIES

Europe will need a multi-track approach to tackle the 'unfair competition' challenge with China from a trade policy perspective. In the last two years, EU leaders have been successful in defending openness without seeing all aspects of business relations with China through a national security lens. They have done so by devising some critical policy changes e.g. a fundamental revision of the EU's anti-dumping regulations and the setting-up of an investment screening framework. The pursuit of a generally liberal approach, that avoids replicating China's statist, market-distorting policies, should remain the mainstay of EU policy action. However, there is a growing consensus that, faced with unfair Chinese competition, bolder steps are needed to develop the external dimension of European competitiveness further.

In this regard, EU trade policy could serve to achieve two interlinked priorities: (1) the promotion of 'competitive neutrality' in China and (2) the development of new instruments to tackle the global spill overs from government-driven market distortions. Vis-à-vis China, EU actors should put greater emphasis on engaging those scattered groups of Chinese economic reformists around the OECD framework on competitive neutrality. A renewed clamp-down on liberal forces and recent policy trends in China provide reasons for doubt, but it remains a distant possibility that forging a 'WTO accession-like' domestic-international reform coalition on 'competitive neutrality' could have an impact on China's reform trajectory.

As China moves to the heart of the global economy, the EU and its OECD partners must deal with the consequences of government-induced market distortions more systematically. Avoiding a costly 'subsidies war' requires bold steps at home and a plurilateral approach. Different rules should apply if a state is impacting commercial activities in a non-market-driven manner (in areas not recognised by the OECD as relevant for public services or other legitimate interests). State ownership or influence should be taken into consideration, and not just on a case-by-case basis. What is needed in competition policy is a rethinking of theories of harm around foreign government action and market power – it should cover

presuming non-market, government-driven behaviour by certain types of countries to be harmful. Any action taken by the EU in this area will benefit if like-minded partners come together to devise international arrangements and rules that will help to manage systemic competition in the decades ahead.

SCORING EUROPE'S APPROACH SO FAR

Awareness of the challenges presented by China's competition environment has grown substantially in European policymaking circles in recent years, partly because of the US-China trade war. The issue of 'competitive neutrality' in China should receive more attention following the publication of a new European Chamber of Commerce in China (EUCCC) report on this issue in fall 2019, and with SOE disciplines being an essential component of the 'Comprehensive Agreement on Investment' under negotiation between the EU and China. The EU Commission has already resolved to address the distorting effects of foreign state ownership and financing and to review gaps in EU law that prevent European policymakers from acting¹⁵. This has, however, not lead to any concrete results so far, except for new guidance on procurement directives. It is likely that policy proposals such as the International Procurement Instrument, or even merger control relaxations, will gain traction.

Exhibit 6

	Level of EU awareness of China-specific challenges	EU-wide cohesion on policy approach towards China	Institutional capacity for EU internal coordination	Depth of EU policy proposals that promote integrated approach	Level of EU coordination with OECD partners
In China: Promoting competitive neutrality	Yellow	Red	Red	Yellow	Yellow
Beyond China: Tackling unfair competition spill-overs	Green	Yellow	Red	Yellow	Red

Note: Red = low, yellow = medium, green = high. This scoring represents a preliminary assessment by the MERICS research team. It incorporates findings from previous MERICS research and feedback from expert interviews conducted for this project from July to September 2019.

Failure to meet deadlines agreed at the EU-China Summit in April 2019 would force the EU to shift gears and pursue a more assertive agenda. For now, EU leaders stand behind the latest EU-China strategic outlook which aims yet again to test whether bilateral talks and promoting 'first-best solutions,' – such as WTO reform and increased market access – are still possible. Dealing with the structural impediments in China's competition environment and their international implications will require much greater internal coordination, developing stronger channels of influence within China and building leverage with partners.

3.2 EUROPE MUST ASSERT ITS OWN RULES AND STANDARDS WHEN FACING CHINA'S INTEGRATED TRADE, CREDIT AND INDUSTRIAL POLICY-DRIVEN CONNECTIVITY PLANS

In only six years since the launch of the Belt and Road Initiative (BRI) – Beijing's policy supporting China-centred trade and infrastructure networks worldwide – China has come to dominate the global connectivity policy space. The BRI links Beijing's comprehensive trade policy agenda with outward-looking industrial policy goals and geopolitical ambition. MERICS data suggests that since the launch of the BRI in 2013, China has spent more than EUR 80 billion on BRI-related projects, excluding projects still under construction or in the planning phase. It is clear that the BRI is about much more than just securing China's trade routes and energy supplies and exporting industrial overcapacity: It has broad policy implications for Europe related to competition, sustainability and (digital) governance.

China dominates the global connectivity policy space

In third markets, particularly in Asia and Africa, Beijing is rapidly expanding China-centred 'coordinated credit spaces,' combining the massive lending capacity of its policy banks with strategic export financing (e.g. tying financing to procurement from China and delivery of natural resources, and putting commercial and political motives, like the recognition of the 'One China policy', before humanitarian or environmental concerns in financing development) all the while supporting the global expansion of Chinese SOEs. China is already the world's largest provider of medium-to-long-term (MLT) export credits, with Sinosure and China EXIM credits totalling approximately EUR 35 billion in 2018 or about one-third of all global MLT export credit.

Chinese lenders, exporters, and construction companies benefit from an unfair advantage over their European competitors as they are not bound by conventions such as the OECD's arrangement on officially supported export credits or Paris Club donor rules, two groups that China has been reluctant to join despite the volume of China's export credit activity. BRI-related Memoranda of Understanding between China and Western countries have so far by and large failed to open projects to foreign competition or influence Chinese firms to adopt international best practices and OECD guidelines. In addition to creating an unlevel playing field for OECD companies in third markets, China's financing puts at risk the multilateral official finance system, which is key for ensuring sustainability of infrastructure projects. The lack of transparency in China's export credit system and the unclear distinction between China's development aid and export credits makes it harder to understand the scale of the challenge.

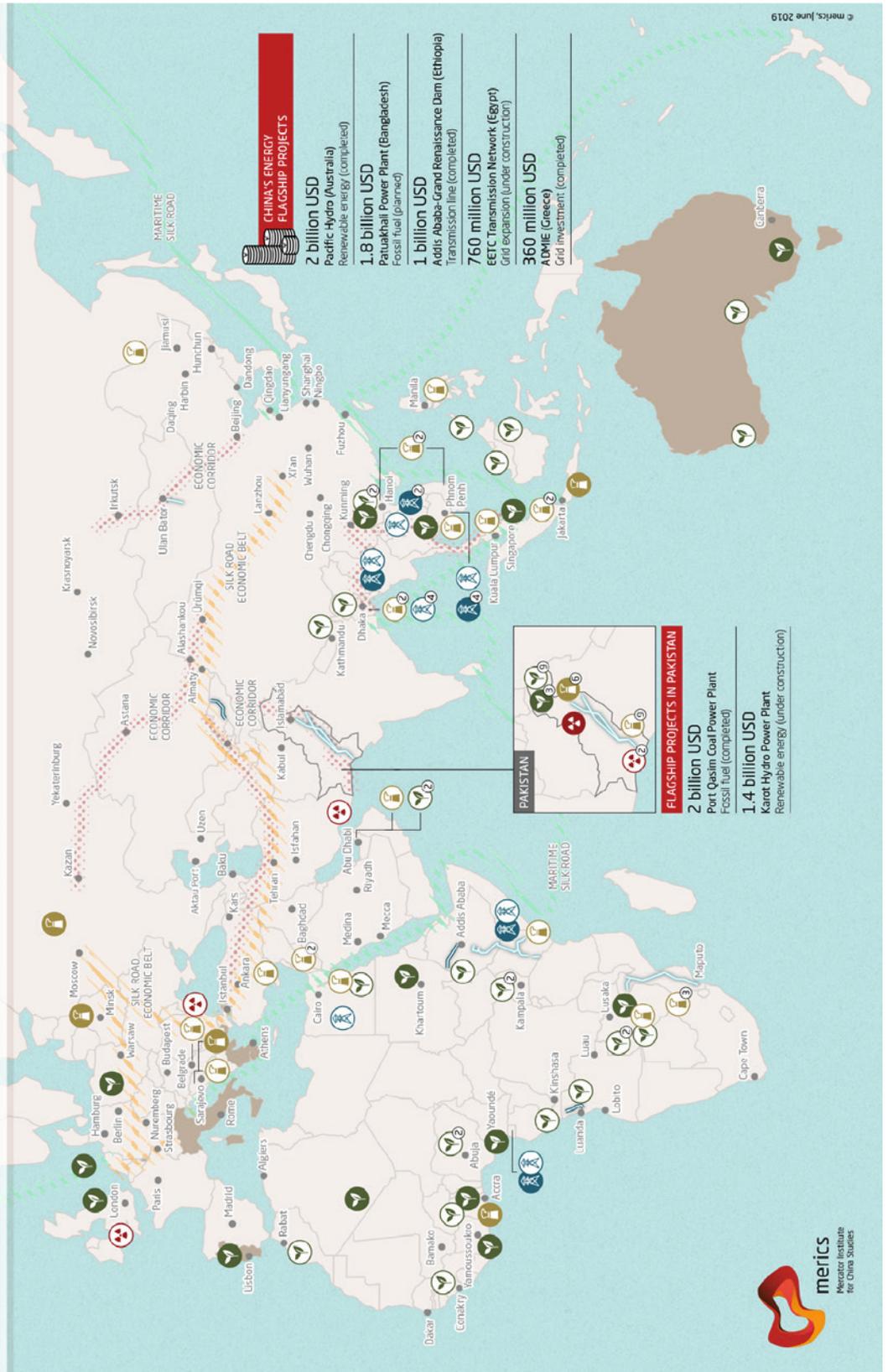
Powering the Belt and Road Initiative

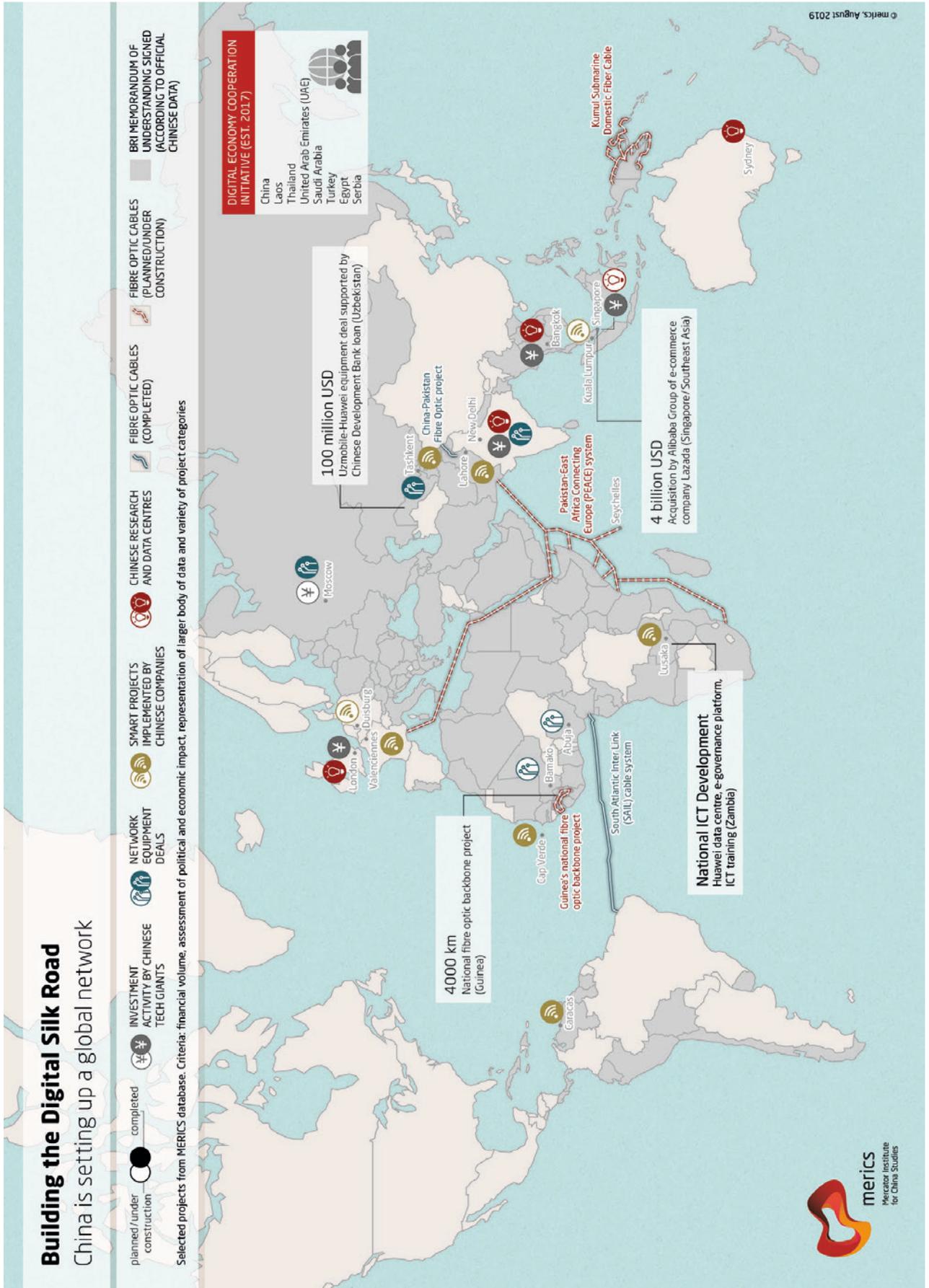
China builds and invests in power plants and grid infrastructure worldwide

planned/under construction completed no. of projects: > 1
Project value: > 100 million USD

FOSSIL-FUEL POWER PLANTS* RENEWABLE ENERGY POWER PLANTS** NUCLEAR POWER PLANTS GRID EXTENSION / DISTRIBUTION NETWORK EXPANSION TRANSMISSION LINE (PLANNED/UNDER CONSTRUCTION) TRANSMISSION LINE (COMPLETED) INVESTMENT IN GRID OPERATORS (COMPLETED)

*at least: 350 MW
 **at least: 200 MW





The digital component of BRI – the Digital Silk Road (DSR) – reveals how China orchestrates and bundles different elements of trade, connectivity, digital and competition policy in a way that challenges the norms and rules underpinning EU trade policy. MERICS analyses of the DSR show that, on the one hand, China’s activities contribute strongly to supplying Internet access in developing and emerging economies. On the other, generous state subsidies mean companies like ZTE and Huawei can offer ICT infrastructure equipment up to 40 percent cheaper than Western suppliers playing by market rules. This creates massive competitive challenges for European companies. Equally serious is that China fosters digital integration on its own terms and uses the DSR to promote its own technological standards. It is also mounting a normative challenge to EU regulations and norms that support Internet freedoms, data privacy, and multi-stakeholder cyber-governance.

A closer look at China’s construction of ‘traditional’ hard connectivity infrastructure – such as roads, ports, and rail links – shows that Beijing is far from prioritizing sustainability. European climate policy goals would be furthered by Beijing’s financing of sustainable energy infrastructure. However, MERICS research shows that China is not leading a ‘green’ revolution along the BRI: it is financing far more coal-fired power plants than renewable ones.

The BRI will continue to be driven by China’s state-led development and trade policy approach, prioritising Beijing’s commercial and political goals, and limiting space for meaningful EU cooperation. At the same time, ongoing internal policy considerations in Beijing point to potential opportunities for dialogue and cooperation. In April 2019, Beijing agreed to conduct a joint study on sustainable rail-based corridors under the EU-China Connectivity Platform. Beijing has also tried to address criticism of the BRI’s poor fiscal and environmental standards and aloofness from local needs. China’s Ministry of Finance developed a ‘Debt Sustainability Framework’ for BRI-participant countries. It is a non-mandatory policy tool that provides advice for conducting sustainability studies. Beijing also established the China International Development Cooperation Agency (CIDCA) to improve transparency and efficiency. Although both these initiatives are currently inadequate entry points for promoting greater Chinese alignment with Western connectivity-related policies, they may present the EU with new possibilities for future engagement.

EUROPEAN PRIORITIES

Europe risks losing ground to Chinese norms and market shares in Eurasia and beyond as China’s leadership actively deploys the BRI to promote China-centred economic integration and governance. The EU has taken a few positive steps to compete with China’s connectivity plans, and discussions on how to limit spillover effects of China’s unfair practices into the single market are ongoing. However, for the time being, the EU’s connectivity activities are in hold mode, as the EU can only start to draw on resources for the implementation of the September 2018 Eurasia connectivity strategy from the next Multiannual Financial Framework (2021-2027) onwards. At the same time, there is a risk that the EU’s connectivity efforts will not catch up fast enough with the new geopolitical approach of the Commission, rendering them a mostly apolitical, technical exercise that will struggle to compete with the bigger narrative the BRI umbrella offers.

EU member states should help the EU institutions design and pursue ambitious interim measures that will help the EU become a more relevant player in connectivity, especially in areas of strategic interest to Europe. This means focussing on two key priorities: promoting sustainable connectivity and better competing with China in third markets. The EU’s new cooperation framework with Japan within the EU-Japan Partnership on Sustainable

Europe risks losing ground to Chinese norms in Eurasia and beyond

Connectivity and Quality Infrastructure could be a role model initiative in this respect. EU member states could team up more proactively with other OECD countries to compete with China's BRI-led integrated trade, credit and industrial policy approach in third markets. The EU should also strengthen its institutional capacity to turn European banks into effective financiers of development, and communicate the productive role of Brussels, EU member states and European policy banks in creating sustainable infrastructure in the EU's neighbourhood on competitive terms.

SCORING EUROPE'S APPROACH SO FAR

The EU has started to give more attention to the connectivity space, first and foremost by issuing its own Connectivity Strategy¹⁶. Initiatives have included organizing a sizeable EU-Asia connectivity conference in September 2019 to identify next steps and potential synergies with like-minded and OECD partners such as Japan. So far, however, the EU has taken few concrete steps to foster 'competitive connectivity' in line with European standards and priorities, despite cautious attempts to extend EU infrastructure plans such as the transport-focused TEN-T to the EU's wider neighbourhood.

Exhibit 9

	Level of EU awareness of China-specific challenges	EU-wide cohesion on policy approach towards China	Institutional capacity for EU internal coordination	Depth of policy proposals that promote integrated approach	Level of coordination with OECD partners
Promoting sustainable connectivity	Green	Red	Yellow	Yellow	Yellow
Competing on connectivity in third markets	Green	Yellow	Red	Yellow	Red

European actors wanting to promote sustainable and competitive connectivity vis-à-vis China need to expand their focus to address challenges stemming from China's practices not only in the EU internal market, but also in third markets. This could be done by leveraging existing frameworks and instruments, stepping up conditional support for local partners in strategically vital third countries, and forging new partnerships, within Europe and beyond. Europe is well positioned within the OECD to improve the investment environment in BRI countries using existing regional initiatives in Central and South East Asia. It could be helpful to step-up engagement with China within the OECD export credit working group (IWG), or even issuing a formal invitation to China to join the OECD arrangement. More importantly, the EU should partner with like-minded countries in this framework, to leverage their joint standard-setting power and move towards common global standards and transparency regarding export credits.

At the same time, EU member states and the EU institutions need to support Europe's development banks in developing a strategic vision for engaging with Chinese policy and developments banks and initiatives in a clear-eyed manner that serve European interests. Greater EIB involvement and support from the EBRD for financing infrastructure projects outside the EU's immediate neighbourhood, including in cooperation with Chinese counterparts, should always be complemented by a strategic narrative promoting the 'European approach to connectivity'.

Europe should also leverage trade policy instruments to increase incentives and support for selected local governments in regions of direct geopolitical significance to the EU (including the Western Balkans). To this end, the EU should draw up a concrete action plan to increase outreach, funding and training to support local capacity in project evaluation and design and to accelerate the availability of funds for connectivity projects, prioritizing conditional on transparent procurement processes and sustainability. Resources could be drawn from a coalition of EU and like-minded partners like Japan, the US, and other OECD and Paris Club nations who share an interest in sustainable connectivity and a level playing field in the procurement market of countries involved in BRI. In this respect, the EU should engage constructively with the Blue Dot Network initiative of the U.S., Australia and Japan.

If Chinese unfair competition in third markets persists, the EU could consider undertaking a few more offensive measures on different fronts, such as blocking China's access to EU funds for infrastructure projects in third markets and scaling down the provision of EU ODA to China (in line with the Strategic Outlook's appreciation that China can no longer be considered a developing country). Chinese subsidies in third markets as well as non-restricted export credits and guarantees should be scrutinised and systematically targeted as potential violations of WTO rules.

3.3 EUROPE SHOULD NOT CONCEDE FIRST-MOVER ADVANTAGE TO CHINA IN REGULATING DIGITAL TRADE, E-COMMERCE, AND CROSS-BORDER DATA FLOWS

Digital policy is a strategic domain for Beijing as it seeks to position itself as a key shaper of the global trade environment. While officially welcoming WTO e-commerce discussions on technical issues, Beijing uses the sheer size of its market to promote protectionist data governance standards and restrict digital trade in line with national security and industrial policy priorities. Coupled with China's commercial power in the digital sphere, its protectionism paves the way for the global expansion of Chinese e-commerce giants who are increasingly writing the industry rules.

China remains the most restricted country in digital trade¹⁷. Foreign companies in China are forced to comply with a host of cyber-security rules, including intrusive ICT product certification and security review processes where they risk being asked to disclose source codes. These measures – along with mercantilist policies towards trade in digital goods and services, ICT, public procurement, IPR, competition policy, intermediary liability, taxation and subsidies, content access and standardisation – show that, with a view to its domestic market, Beijing is stepping up the 'digital decoupling' strategy it has pursued for a long time. While such strategy may prove unsustainable for China's economy in the long term, so far, ICT companies like Huawei, ZTE and Internet firms like Alibaba and Tencent have been able to capitalise on protectionism at home and increase their global market shares, including in Europe.

Beijing is stepping up its 'digital decoupling' strategy

Europe cares most about data protection

Data protection regimes in comparative perspective



	EU	US	China
Protection of personal data	✓	✓	✓
Constitutional clause on privacy	✓	✓	✓
Availability of judicial mechanism for constitutional protection	✓	✓	✗
Uniform legislation on data protection	✓	✗	✗
Specific data protection authority	✓	✗	✗
Extensive definition of personal information	✓	✗	✓

Source: Shi-Kupfer, Kristin and Chen, George (2018). "Deutsch-Chinesische Plattform Innovation, Policy Briefs 2017 der deutschen Expertengruppe". January 3. http://www.plattform-innovation.de/_media/PolicyBriefs_der_deutschen_Expertengruppe_2017.pdf. Accessed: September 20, 2018

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Beijing is also forcefully shaping its domestic data regime in ways that have international implications for privacy and global data transfers. Although China's regulators looked at the GDPR as a model when drafting the Standard for personal data protection, they opted only to regulate the collection, retention, use and transfer of personal information by companies¹⁸. While Beijing doesn't always succeed in compelling companies to turn over their data, the regulatory regime is designed in order facilitate the Chinese government's access to any kind of user data, as control over information and the Internet is deemed vital for national security and regime survival.. As regards data flows, China's 2017 Cybersecurity Law mandates the storage of personal and 'important data' – broadly defined as affecting national security and public interest – within mainland China, a provision that may soon affect any 'network operator' should some draft implementing measures also be adopted.

Commercial power in their closed home market enables China's firms to increasingly set the rules of global e-commerce, from industry standards and customs processes to consumer protection and the harmonisation of taxation. A case in point is the endorsement of Alibaba's Electronic World Trade Platform (eWTP) – a multi-stakeholder initiative for public-private collaboration aimed at incubating e-commerce rules and facilitating SMEs trading across borders – by G20 leaders in 2016. A European hub of the eWTP was recently opened in Belgium. These private-sector initiatives go hand in hand with the Digital Silk Road, therefore the implications for digital trade could be significant. MERICS research has found that Chinese companies are spearheading the application of blockchain to cross-border trade and logistics and already lead in international blockchain standardisation.

Beijing's proactive rulemaking and the initiative of its private companies confront Europe with opportunities and risks. Chinese firms could become Europe's partners in reducing barriers to cross-border e-commerce and making digital trade more inclusive worldwide. However, China's leadership will not compromise on rules they deem vital for national security and technological catch-up. As a result, any plurilateral agreement involving China is highly unlikely to produce internationally binding rules beyond narrow, technical aspects. Chinese representatives have stated their preference for WTO digital trade negotiations to 'stick to e-commerce.' The goal is to avoid meaningful discussions of data flows, privacy, market access, reciprocity, and tariff reduction.

Beijing's digital protectionism clashes with European interests in many areas. The unchecked transfer of European individual and company data to Chinese authorities – where an algorithmic surveillance state is taking shape – is poised to increase as Chinese digital platforms penetrate the European market. Outside of Europe, some countries are already emulating China's authoritarian approach to data management and cyber governance. Lastly, digital trade restrictions create a discriminatory environment and raise costs for foreign businesses in China, with potential spillovers into the European as well as into third markets.

Some countries are already emulating China's authoritarian approach to cyber governance

EUROPEAN PRIORITIES

Digital trade and cross-border data flows constitute the backbone of global growth and innovation. By 2020, the data economy could amount to four percent of the EU's GDP. In this context, the EU pursues a rules- and rights-based digital trade agenda, aiming to develop ambitious sets of norms well beyond those covering technical issues. It is promoting GDPR as a global privacy standard, while ensuring that data can travel freely across borders. Several EU proposals for WTO negotiations on digital trade and the digital economy directly challenge China's desired rulebook. These include prohibiting mandatory source code inspections, addressing forced data localisation, improving market access through an expanded ITA agreement, and curbing anti-competitive practices like cross-subsidisation and non-transparent technical standards.

The EU should focus on two core priorities. First, EU member states must jointly create the necessary leverage to secure 'digital reciprocity' vis-à-vis China and establish a level playing field with China's often subsidised digital giants. Second, in response to China's data governance rulebook and its global spread, Europe must raise its game to promote a balance between the free flow of data and the protection of privacy through both trade relations and intensified monitoring of Chinese companies' activities.

An effective policy trajectory for Europe must start from a completed Digital Single Market (DSM) and support system for Europe's digital industries and critical supply chains. It would also require more decisive positioning of the EU as a regulator in the digital economy and a bastion against the encroachment of digital protectionism. At the same time, cautious engagement with China could be pursued where interests align, such as on electronic trade and customs facilitation, consumer protection, SME empowerment and e-commerce for development.

SCORING EUROPE'S APPROACH SO FAR

The EU is well positioned to promote and enforce its data privacy standards through the GDPR's extraterritorial reach, and necessary first steps have been taken on regulating e-commerce and cross border data flows. The economic partnership agreement (EPA) and adequacy agreement with Japan, the trade agreement with Canada and the horizontal provisions on cross-border data flows and privacy protection in trade and investment agreements are important attempts to deploy and integrate Europe's commercial and regulatory powers more vigorously. The DSM work on reducing barriers to intra-EU e-commerce and protecting consumers has progressed, and Internet companies' competition and data violations are being more closely scrutinised and sanctioned.

Exhibit 11

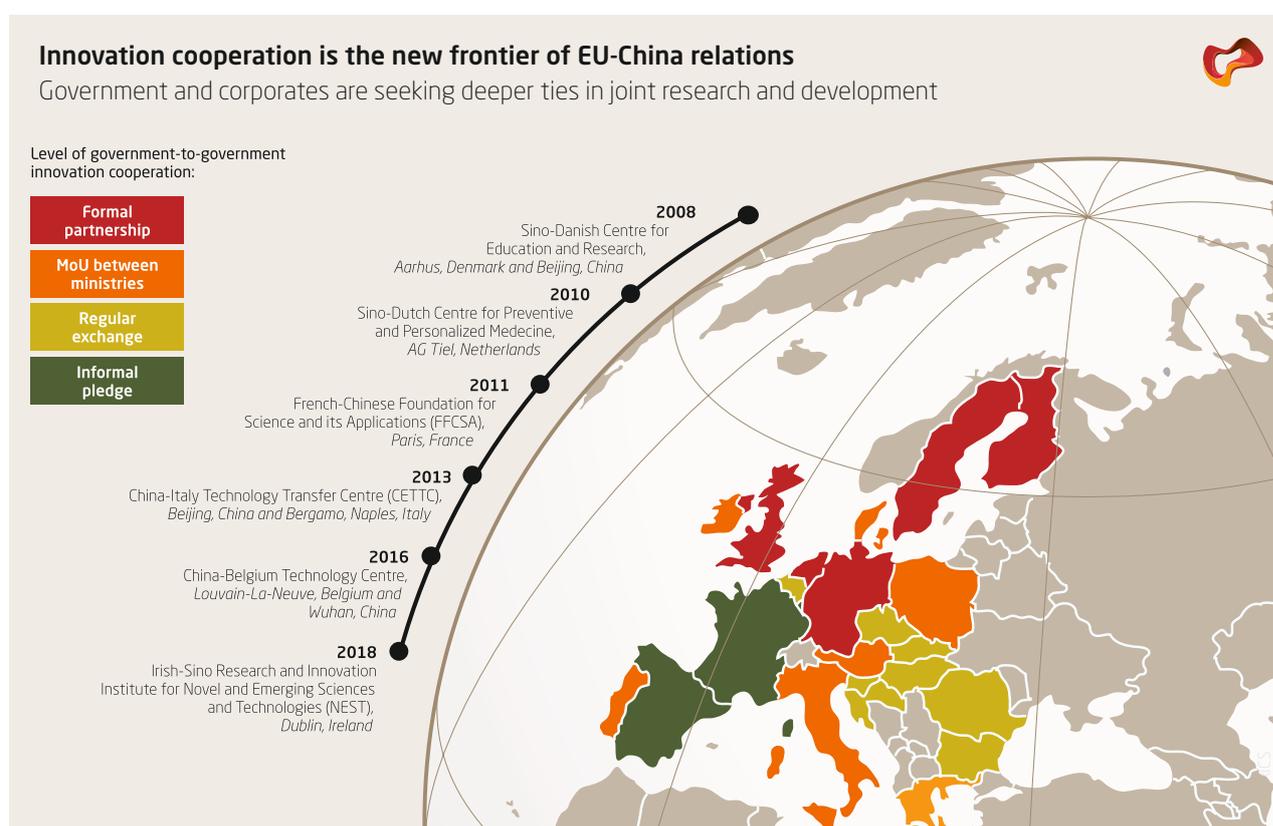
	Level of EU awareness of China-specific challenges	EU-wide cohesion on policy approach towards China	Institutional capacity for EU internal coordination	Depth of policy proposals that promote integrated approach	Level of coordination with OECD partners
Reciprocity in digital markets	Green	Red	Yellow	Red	Red
Protecting data privacy and free data flows	Yellow	Yellow	Green	Green	Yellow

Despite these achievements, much remains to be done to confront China on privacy and digital trade distortions. While taxation, competition and privacy policy violations of American companies have attracted much attention from EU regulators, Chinese digital giants are quietly gaining a foothold in Europe through data centres, cloud systems, e-payment platforms, and software solutions for intelligent vehicles and factories. The EU should monitor these activities. It should also adopt a comprehensive European Digital Trade Strategy to promote fair and reciprocal digital trade relations and confront data protectionism. A forward-looking strategy would also see the EU become more active in joining forces with like-minded partners and more assertively use existing as well as new instruments to tackle China-induced distortions, linking trade policy with other domains such as antitrust and public procurement.

3.4 EUROPEAN PUBLIC AND PRIVATE SECTOR ACTORS MUST PURSUE A MORE STRATEGIC APPROACH TO LINKING RESEARCH AND INNOVATION COOPERATION WITH CHINA WITH EUROPEAN TRADE POLICY

For Beijing, international research and innovation (R&I) collaboration is an increasingly central element of its integrated trade policy as well as a tool for achieving scientific, technological and even military leadership on a global scale, with ‘Chinese higher education and research more strongly embedded in national top-down strategies for economic, scientific, and innovation excellence’¹⁹. The attraction of foreign corporate and academic research into China and a multi-faceted, strategic approach to technology transfer are geared towards upgrading Chinese industry and shaping future patterns of trade (inter-) dependence. In line with the MIC25 plan, research and innovation centres focused on emerging technologies are widely spread across the country. China now outspends the entire EU on R&D and only trails the US in the number of academic articles published. The country has already made substantial achievements in disruptive research, as demonstrated by the launch of the world’s first quantum satellite in 2016 – built with the contribution of European expertise – and controversial gene-editing breakthroughs.

Exhibit 12



Research and innovation cooperation have moved to the forefront of European engagement with China, as the country advances rapidly in applied research linked to emerging technologies, such as AI, and slowly but steadily makes progress in progress in basic science. EU governments, corporates and universities have stepped up joint R&I projects with Chinese partners. Nine member states have signed cooperation agreements since the establishment of the EU-China High-Level Innovation Cooperation Dialogue in 2012. MERICS research shows that European corporate R&D activities, too, are rapidly shifting to China.



Selected innovation partnership agreements and R&D investments in China by major European corporates since mid-2018*

Company	Country	Sector	Type, location
Nestlé	Switzerland	Food and beverage	R&D centre, Beijing; System Technology Hub, Shenzhen
Roche	Switzerland	Pharmaceutics	Innovation Centre, Shanghai
Renault	France	Automotive, AI	Joint Alliance Innovation Lab Shanghai (AIL-SH) with Nissan and Mitsubishi, focused on autonomous and e-vehicles
Sanofi	France	Pharmaceutics	Global R&D Operations Hub for digitalisation and big data, Chengdu
Unilever	Netherlands, UK	Consumer goods	Joint R&D centre with Tmall (Alibaba) focused on personal care products, Shanghai
Airbus	European	Aviation, AI	Airbus China Innovation Centre, Shenzhen
Bosch	Germany	Automotive, AI	Bosch Digital Cabin R&D Centre focused on intelligent traffic and connectivity, Shanghai
Daimler	Germany	Automotive	R&D centre, Beijing
BASF	Germany	Chemicals	Expansion of Innovation Campus, Shanghai
BMW	Germany	Automotive	BMW China R&D Centre, Beijing
SAP	Germany	Software	Partnership with Alibaba for enterprise cloud solutions
Volkswagen	Germany	Automotive	R&D centre with Anhui Jianghuai for developing e-batteries, Anhui Province
Merck	Germany	Biotech	Expansion of Chinese R&D facilities for pharmaceutical and life-science research, Guangzhou, Shanghai, Nantong
Audi (Volkswagen)	Germany	Automotive, AI	R&D centre focused on autonomous vehicles, Wuxi
Carrefour	France	Retail	Opening of 'smart supermarket' in partnership with Tencent, Shanghai
Siemens	Germany	Industrial Software, AI	First AI lab outside Germany, Beijing; R&D centre for digitalisation, Chengdu
Lufthansa	Germany	Aviation	Lufthansa Innovation Hub (LIH)'s new location focused on travel and mobility tech, Shenzhen
Continental	Germany	Automotive components	R&D centre, Chongqing
Engie	France	Energy	ENGIE Lab China focused energy efficiency in buildings and cities, Shanghai
StreetScooter (Deutsche Post)	Germany	E-mobility	MoU with Chery for EV joint venture, including R&D centre to develop smart mobility solutions for logistics industry

* Source: MERICS research based on publicly available information on company websites and media reports. Only the top 50 European companies listed on the Fortune Global 500 (excluding oil and gas, mining, insurance and financial services) were considered.

This is particularly true for emerging industries, whose global value chains are currently emanating from China. Chinese actors also increasingly sponsor science parks and startups in the EU, gaining first-hand access to European know-how.

The openness of Europe's R&I ecosystem in terms of talent mobility, opportunities for non-EU investors, and funding for scientists has yet to be matched by corresponding openness on the Chinese side. Furthermore, the participation of Chinese researchers and corporates in Horizon 2020 programs has been geared towards the strategic absorption

of European technology and know-how in contested policy areas such as 5G or biotech research. In some cases, the partnerships resulted in Chinese researchers securing most of the new patents generated. In addition to benefitting from Europe's open attitude towards R&I collaboration, China's government has developed a laser-like approach to attracting and retaining both overseas Chinese and foreign talents whose research can contribute to China's hi-tech advances. Finally, undercover PLA researchers have been sent to multiple countries, including in the EU, to acquire foreign dual-use technology²⁰.

R&I cooperation with China, if regulated, can be immensely beneficial to Europe's innovation ecosystem and to its competitiveness, especially as China continuously grows its own indigenous talent base and know-how in emerging technologies. However, potential and actual risks stemming from China's exploitation of Europe's innovation ecosystem and openness need to be carefully considered, including within the framework of Europe's trade policy.

China's party-state has proven its capacity to steer and co-opt private tech firms and academic research for national economic, strategic and defence-related goals. Deep links between China's civilian universities and military and security agencies are a noteworthy example²¹. Government subsidies often enable Chinese companies to move faster than their European competitors, potentially hampering the latter's innovation potential. Furthermore, China's plans for industrial upgrading and indigenous innovation and its corresponding, targeted international R&I partnerships may result in losses of European IP and an erosion of Europe's competitiveness. They also advance China's military and domestic tech surveillance systems, casting normative and geostrategic doubts on the virtues of EU R&I collaboration with China.

EUROPEAN PRIORITIES

For the present, the EU's main priority is to step-up scrutiny of the protection of IP and critical technologies in R&I cooperation with China. This task will require EU actors to be more sober-minded and strategic in designing cooperation arrangements with Chinese partners. Naiveté is currently still particularly dominant in the academic world where a lot of the critical basic research takes place. EU public and private sector actors must also be more selective in funding cooperation projects with China in areas in which it already excels (e.g. 5G, AI, blockchain, quantum, etc.) or in areas that are closed to European companies in China. EU actors also must gain a much deeper understanding of how projects might inadvertently contribute to China's military advances or tech surveillance projects.

China can no longer be regarded as a developing country, as it was in 1998 when the Science and Technology Cooperation Agreement was signed. Its increasing status as an innovation powerhouse means the EU must go beyond a defensive posture and embrace proactive policies too. Hence, another EU priority should be to work with China on a securing a level playing field and reciprocal access to science, technology and innovation resources and open access to publications and research results. The EU must therefore pursue an approach to R&I cooperation that is explicitly linked with trade policy, agreeing on joint EU priorities for R&I with China and infusing those vigorously in EU-China debates on WTO reform, CAI negotiations, and EU buy-in into BRI projects.

The EU's approach to R&I cooperation must be linked with trade policy

SCORING EUROPE'S APPROACH SO FAR

The EU and many EU member states have well-established R&I cooperation frameworks with China. The European Commission's March 2019 'strategic outlook' document referred to the need for a more ambitious 'Horizon Europe' programme to 'include clear rules on exploitation of results and allow for effective reciprocal access to research and development funding'²³. It signalled awareness of the continued need for equal access to each other's research and innovation ecosystems, which was already reflected in the EU-China Joint Roadmap on Ensuring Reciprocal Access to Respective Research and Innovation Funding. Despite the progress made, the European side continues to lament lack of transparency around China's R&D tenders.

Recently, some Higher Education Institutions have been taking positive steps towards better-regulated R&I cooperation with China. On the corporate side, too, EUCC and European businesses in China closely monitor IP protection and tech transfer issues for foreign companies in the Chinese market. Europe still lacks, however, any broader framework for exchange and potential policy alignment on the matter, particularly with a view to trade policy.

Overall, Europe has been crippled by a piecemeal approach to managing the opportunities and challenges that stem from cooperating on research and innovation with China. It has been difficult to define a meaningful policy agenda that can gain traction among relevant stakeholders in companies and higher education because the policies in this area are distributed across different departments in the European Commission, and member states sometimes 'compete' with each other by pursuing divergent paths with China. As a result, there is only limited awareness among European research institutions, and even among corporates, of the risks of cooperation with Chinese partners. These include potential entanglements with the state-security components of the party-state and the Chinese military, and loss of long-term competitiveness.

Exhibit 14

	Level of EU awareness of China-specific challenges	EU-wide cohesion on policy approach towards China	Institutional capacity for EU internal coordination	Depth of policy proposals that promote integrated approach	Level of coordination with OECD partners
Equal access to research and innovation ecosystem	Yellow	Red	Yellow	Red	Red
Protection of IP and critical technologies	Green	Yellow	Red	Yellow	Yellow

Europe will need to strike a balance between maintaining an environment that is as open as possible and the overly narrow approach of imposing restrictions on collaboration only in those areas that acutely threaten EU countries' national security. Given China's policies towards strategic tech transfer and top-down civil-military integration (CMI), it makes sense to pursue greater alignment between research collaboration guidelines, measures to ensure supply chain security, an upgraded export control regime, and the screening of investment flows.

4. Outlook: Europe needs a better integrated trade policy for effective competition with China

Next year, 2020, will be a decisive year for the EU and China and their relationship, as both sides adjust their trade policies. The CCP's leadership is projecting unprecedented external confidence while operating in crisis-mode internally. The CCP faces massive headwinds from China's unfinished structural economic transition, a geopolitical backlash and an unfavourable global trade environment. Meanwhile, the EU has once again set out to test China's willingness to engage in cooperative 'first-best' solutions. These include joint WTO reform attempts and increased market access for European companies in China, albeit with much clearer – and more ambitious – timelines than before. The EU has also devised an action plan of internal homework as well as connectivity plans to build up European external competitiveness. Bringing about meaningful change in the trajectory of EU-China economic relations, concrete steps towards a bilateral investment treaty and greater Chinese compliance with existing global economic governance rules will have to emerge before September 2020 when leaders are due to meet at the EU-27-China summit in Leipzig.

The EU needs to pursue a more integrated trade policy approach

Europe cannot afford to build future China policy on hopes that convergence will be deeper or faster: the EU needs to prepare for less benign contingencies. Faced with China's integrated trade policy and rule-making ambitions, it is essential the EU pursues a more integrated trade policy approach that promotes unity, reciprocity and European competitiveness. The EU must build its policy approach on a clear-eyed assessment of China's future trajectory as a trade actor, as set out in this analysis. It should therefore draw on EU policy-making fields adjacent to traditional trade policy to generate the necessary policy synergies and leverage. In doing so, the EU institutions and member states should neither mimic China's approach to integrated trade policy, nor give up their own liberal DNA. They should focus on **(1)** pursuing a set of targeted, issue-area specific policy priorities that respond to China's trade profile while integrating the EU's own approaches to the cross-cutting policy domains of standard setting, supply chain security and trade promotion; **(2)** strengthening intra-European coordination and **(3)** capitalizing even more actively on the benefits of cooperating with OECD partners.

On government-induced market distortions, EU institutions and member states should:

- Make the concept of ‘competitive neutrality’ a standing agenda item in conversations with the Chinese administration in order to promote economic reform. This may include engaging more liberal actors in the Chinese system, working with provincial governments and others supportive of a more level playing field for private and foreign enterprises.
- Launch a debate among like-minded OECD members on theories of harm around foreign government action and market power, with the presumption that non-market, government-driven behaviour is harmful.

On competitive connectivity, EU institutions and member states should:

- Link bilateral trade and investment negotiations to China joining the OECD Arrangement on Officially Supported Export Credits.
- Push back against China’s unfair trade practices in third markets, by promoting global standards and transparency for export credits, possibly launching investigations into China’s potential violations of relevant global rules, or by blocking China’s access to EU funds for infrastructure projects in third markets.
- Contribute to connectivity project capacity-building in third countries of geostrategic and geo-economic importance to the EU (e.g. those in the Western Balkans and European Neighbourhood Policy countries), strengthening local infrastructure project evaluation and design capacities.
- Make infrastructure funding more easily available to third countries in exchange for adopting rules on transparent procurement processes and sustainability.
- Invest in the EIB’s and EBRD’s ability to pursue politically savvy infrastructure-related funding in third countries and to cooperate with Chinese partners in a clear-eyed manner where sensible.

On digital trade and cross-border data flows, EU institutions and member states should:

- Develop a clear, comprehensive and integrated European Digital Trade Strategy to ensure the EU is a rule maker in the digital economy.
- Reconsider the use of TDIs against Chinese ICT subsidies, with the launch of an anti-subsidy investigation into mobile telecom networks equipment providers from China as a first step.
- Make access to the Digital Single Market conditional on specific regulatory requirements and commitments on the Chinese side, including adopting a strong EU International Procurement Instrument (IPI) to tackle some of the reciprocity issues in digital trade with China and doubling down on existing regulatory compliance regimes (GDPR, accounting, etc.) when Chinese ICT companies want to do business in Europe.
- Step up scrutiny of Chinese tech firm’s data collection and data transfer practices in Europe, acknowledging that the level of personal data protection currently available in China renders the country ineligible for an adequacy decision based on article 45 of Regulation (EU) 2016/679.

On research and innovation collaboration, EU institutions and member states should:

- Produce a joint EU mapping and assessment of risks of R&I cooperation with Chinese institutions in different sectors and industries and raise awareness among European stakeholders particularly affected.
- Develop reciprocity rules with a view to Chinese access to EU research funds, with the aim of European R&D centres gaining access to Chinese research funding and maintaining the possibility of reaping the economic benefits of their research.
- Clarify and update the interpretations of the EU export control regime, banning the export of certain dual-use technologies where they may be used to violate human rights (e.g. cyber surveillance tech) or for unethical and/or defence-related research projects (e.g. biotech).
- Prioritise European entities for research funding for creating technologies at the heart of sensitive areas.

In addition to these targeted policy priorities, EU institutions and member states also need to tackle policy issues that cut across traditional boundaries of policy making in Europe and that will determine Europe's long-term external competitiveness vis-à-vis China, namely:

- Invest more aggressively in standard-setting efforts, with European companies being encouraged to think even more strategically about the commercial value of translating innovation into standard setting.
- Conduct a wide-ranging assessment of European supply chain dependencies, to produce a clear indication of what might be critical and non-critical dependencies, and a plan to monitor and mitigate those that are critical.
- Combine trade policies with environmental goals ('border adjustment'), taking into account China's weight and critical role for both policy areas, including through its new emission trading policies.

A well-integrated EU trade policy towards China will demand substantial efforts to balance intra-European interests on China policy, to bolster the EU's institutional capacities and to introduce new mechanisms to coordinate and monitor China policy across multiple policy domains. To align European forces on the agenda items specified above means taking account of the diverging 'China-affectedness' of member states. The EU and major member states will also have to consider the commercial interests of smaller member states; for instance, by providing alternatives to Chinese financing and investing more in trade promotion efforts.

To improve China policy coordination, several member states have recently enhanced their national level internal capacities. At the European level, co-ordination requires more than the current reliance on informal ad-hoc strategy groups (as recently established in the Commission General Secretariat). The more frequent "Strategic Outlook" implementation tracking by EU Permanent Representative represents a critical step towards coordinating the EU's internal positioning more effectively. The EU could, however, benefit from a more structured and high-level 'EU-China economic futures' task force that supports the work of the Council and the Commission. Alternatively, a dedicated China point-person (Special Envoy) or 'China Policy Leading Small Group'²⁴ with senior representatives from the institutions could be established. EU member states themselves might want to contemplate linking up national parliamentarians and officers with coordinating functions in relevant ministries to generate better understanding and integration on China policy.

OECD partners offer a substantial, under-utilised opportunity for collaboration to generate a better-integrated EU trade policy approach vis-à-vis China, to seek alignment and create leverage towards China on competition, connectivity, digital and research and innovation policies. Engaging like-minded partners in developing an integrated EU trade policy that can compete with China's comprehensive, confident, and conflicted trade policies will be vital if the EU wants to make managing economic cooperation and competition with China a success in the years ahead.

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