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The coming decoupling from China

Consequences for the EU's economic security strategy

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Summary

- A growing number of security-motivated barriers to trade and investment have begun to chip away at the hard-won openness of international markets. There are already signs that fewer investments are flowing between geopolitical rivals, and the fractures in the US-China trading relationship have widened since 2018.
- For many advanced economies, a decoupling from China appears imminent in key sectors. In the European Union, this gradual separation is driven by a swathe of initiatives pursued under Brussels' "de-risking" policy, such as investment screening, export controls and industrial policies designed to bolster domestic production. If fully implemented, these instruments will detach the Chinese economy from specific areas of the Single Market that the EU deems sensitive, notably critical infrastructure, cutting-edge semiconductors, specific raw materials and equipment needed for the green transition.
- The security-motivated barriers between rivals are yet to be balanced by a corresponding opening up among allies. Although democracies are exploring ways to cooperate, their strategies increasingly favour domestic firms, while new trade barriers risk complicating exchanges with partners and non-aligned countries. Barring a renewed commitment to free trade by large, advanced economies, the net effect of the economic security dynamic is likely to be a significantly less open global economy.
- In the economic security space, the EU should consider abandoning its country-agnostic approach in the name of free trade. Concentrating on China would allow Brussels to limit the scope of many initiatives, reduce their cost and administrative burden, and minimize the risk of protectionism. This would signal to third parties that their exchanges with Europe are not at risk of being caught up in the EU's economic security machinery.
- The United States' leadership in the economic security sphere is being undermined by America's protectionist tendencies and what many states view as an overly restrictive policy on China. In this context, the EU can represent a distinct approach where any barriers towards China come with a promise of a corresponding opening up to partners and non-aligned countries.

“Economic security” enters global markets

Despite the war in Ukraine, global trade in goods grew by 2.7 percent in 2022. This was well above the most pessimistic projections published by the World Trade Organization (WTO) in the wake of Russia’s invasion.[1] According to one estimate, trade in goods had recovered to pre-pandemic levels by mid-2022.[2] Similarly, global foreign direct investment (FDI) increased to $1.58 trillion in 2021, up 64 percent on 2020, and remained at comparatively stable levels into 2022.[3] Although the WTO estimates that trade will grow only by 1.7 percent in 2023, due to a looming recession, the organization projects a return to growth of 3.2 percent in 2024 as the global economy recovers.[4] In sum, globalization seems surprisingly robust under the circumstances.

Beneath this rosy surface, however, a worldwide struggle for “economic security” is chipping away at the hard-won openness of the global economy. To protect themselves from supply disruptions, technology transfers and espionage, governments in North America, Europe and East Asia have introduced investment screening mechanisms, export controls, procurement restrictions, supply chain resilience initiatives and more.[5] Between 2020 and 2022, at least 53 initiatives were launched globally to either introduce or expand investment screening mechanisms.[6] Most of these security-motivated barriers to trade seek to address risks emerging from exposure to China. Meanwhile, sanctions have become more common and extensive. The unprecedented western restrictions on exchanges with Russia are the most consequential example, but since late 2022 the United States has also announced a steady stream of export controls and sanctions listings against Chinese entities, effectively shutting them out of global markets.[7] Taken together, we are witnessing a growing number of restrictions on trade between adversaries.

This trend towards economic closure is closely related to the deteriorating security situation in the world. As geopolitical tensions rise, it is natural that some states become more anxious that rivals could exploit economic vulnerabilities to try to spy on or coerce them. Similarly, potential adversaries may start to worry about how their exports of advanced products could contribute to the other side’s economic and military potential. It is therefore understandable that as trust has broken down between China, on the one hand, and the United States and other G7 members, on the other, more restrictions have followed. Close allies, by contrast, do not have to worry about these “security externalities” to the same extent.[8] In friendly relationships, there are typically fewer expectations that economic exchanges will be exploited by the counterpart, and the growth of the other’s military capability is not seen as a threat. In theory, this should pave the way for more open economic relationships between allies. In a geopolitically divided world, we might therefore expect more trade to “follow the flag”; that is, we should see fewer exchanges between adversaries and at least the potential for more exchanges between partners.

Headed towards decoupling?

There are already early signs of a geopolitical fragmentation of the global economy. According to an extensive study by the International Monetary Fund (IMF), FDI is increasingly flowing between geopolitically aligned countries rather than countries that are geographically close, especially in strategic sectors such as semiconductors, telecommunications, critical minerals and green technology. In particular, the amount of FDI in key industries in China shrank by half between the start of the US-China trade war in 2018 and 2022.

The trend is clearest in the Chinese semiconductor industry, where by 2022 investment was only about one-third of the level in 2018, following US restrictions on the sector. In the same period, investment in the chip industries of Europe, the United States and other parts of Asia increased significantly.[9]

The costs associated with rising investment barriers along geopolitical fault lines are expected to be high. The IMF estimates that if the world splinters into a China-led bloc and a US-led bloc, global output would be reduced by about one percent after five years and approximately two percent in the long term. These losses would be unevenly distributed, and emerging markets and developing economies would suffer disproportionately. Costs are projected to be highest for low-income countries associated with the China-dominated bloc, as they would forego access to investments and technology from many advanced economies. However, losses for the US-led bloc would also be significant as members with strong linkages to China, such as Japan, South Korea and Germany, would incur important losses. Interestingly, the IMF's calculations suggests that Europe would be the least vulnerable of all regions to a geopolitical fragmentation, although the costs would still be substantial.[10]

Signs of decoupling are less obvious when it comes to trade flows. The value of US-China trade, for example, hit a record high in 2022. However, a recent study by the Peterson Institute for International Economics showed that US exports to China have fallen behind other countries since 2018, including of cars, aircraft, semiconductors and services.[11] As Chinese firms have shifted some of their purchases away from the United States, US businesses have also reduced their imports from China, instead turning to countries such as Vietnam, Thailand and India. According to one estimate, China will soon account for less than half of US imports from low-cost countries in Asia.[12] While there are multiple signs of a decoupling in US-China trade, exchanges between the EU and China appear relatively stable, even if there are concerns in the EU about a widening trade deficit.[13]

Friend-shoring fractures

Decoupling is often used to describe an absolute (and undesirable) endpoint where economic ties with China have been severed completely. However, decoupling also signifies a gradual or sudden *process* of separation from existing connections with China. If we accept that decoupling is a process rather than an end-state, then it becomes clear that almost all economic security policies imply decoupling.

The decoupling effect of some policies is more obvious than others. Sanctions, export controls and investment restrictions create direct legal barriers to economic exchange with China, with the intention of stopping specific flows of goods and capital. Industrial policies, meanwhile, take longer to come to fruition. For instance, the EU's Net-Zero Industry Act stipulates that, over time, the EU should be able to meet 40 percent of its demand for clean technology. The Critical Raw Materials Act sets similar goals for the extraction and processing of strategic raw materials. Such policies are sometimes referred to as "re-shoring", a process of bringing back supply chains from previously "offshore" destinations. These efforts imply, and are partly aimed at, decoupling from China.

"Friend-shoring", by contrast, is intended to transfer dependencies on China to trusted allies. The United States has launched several such initiatives since US Secretary of the Treasury Janet Yellen used the term in a speech in June 2022.[14] Washington has initiated the "Chip 4 Alliance" with Japan, South Korea and Taiwan to create a "democratic semiconductor supply chain", and the "Minerals Security Partnership", which includes countries such as Canada, France, Germany, Sweden, Japan and South Korea. Friend-shoring is sometimes presented as a more free-trade friendly alternative to re-shoring. However, like re-shoring, moving supply chains to an exclusive group of trusted allies necessarily means that specific segments of exchange with China will be discontinued. Friend-shoring therefore also implies, and is partly aimed at, decoupling.

The coming decoupling

Most economic security policies are new, and we are yet to witness their full decoupling effect. EU instruments such as the Critical Raw Materials Act, the Chips Act and the Anti-Coercion Instrument are either not yet operational or have only been so for a short period of time. In China, meanwhile, concerns about vulnerabilities and efforts to increase self-reliance go back several decades.[15] Yet like western governments, the Chinese leadership has recently accelerated its pursuit of economic security through an Export Control Law, an Anti-Foreign Sanctions Law and its Administrative Measures for Enterprise Outbound Investments.[16] It will only be possible to evaluate the free trade consequences of these initiatives in the years ahead.

One reason to expect further decoupling concerns expectations. For businesses, the proliferation of sanctions, export controls and investment screening raises red flags. Even if they are not directly affected, they must consider that future measures might have an impact on their exchanges with China. This already seems to have had a chilling effect on some markets. An IMF analysis recently noted that firms are increasingly discussing "re-shoring" and "friend-shoring". Since the US-China trade war in 2018, mention of these terms in the earnings calls of multinational corporations have increased at least six-fold.[17] In another recent survey, 66 percent of companies predicted that decoupling between the West and China would increase.[18] At this point, it is possible that the biggest decoupling effect no longer flows from the restrictions themselves, but from expectations that further restrictions might follow. For example, the extensive semiconductor export controls against China introduced by the United States in October 2022 only target highly advanced semiconductors but the entire global industry appears to be going through a reconfiguration to avoid the risks associated with the Chinese market.

Taken together, a further decoupling from China appears likely. What is concerning from a free trade perspective is that this security-motivated closure between rivals has thus far not been balanced by a corresponding effort to increase openness between allies. While most economic security initiatives include an ambition for friend-shoring, they also contain elements of re-shoring and industrial policy. For instance, both the US CHIPS and Science Act and the Inflation Reduction Act favour domestic production over foreign companies from allied countries.

The EU seems to have reinvigorated its efforts to conclude free trade agreements with countries such as Indonesia, India and Australia, as well as Mercosur. However, the EU has been trying to open up new markets for decades, and there are few reasons to believe that the process of signing trade deals will accelerate in any ground-breaking way in the years ahead.[19] Crucially, trade agreements require compromise from both the EU and its counterparts. To introduce economic security legislation, by contrast, there is no necessity to reach an agreement with a counterpart. Countries have the power to close their markets singlehandedly with reference to extraordinary geopolitical circumstances (although the process in the EU is slowed by the need to reach agreement among member states). Thus, even if many countries still have an ambition to further open up exchanges with their partners, this process is likely to be slower than the trend towards economic closure.

The cost of the EU's country-agnosticism

On 20 June, the European Commission launched its first-ever strategy on economic security. The instruments that make up the core of the strategy, such as the Foreign Direct Investment Screening Regulation and the Critical Raw Materials Act, are intended to reduce the risks emerging from economic exposure to China. In keeping with EU practice, however, there is no mention of China in the document.[20] In most contexts, this "country-agnostic" approach is a healthy reflex for a bureaucracy committed to free trade and multilateralism. Non-discrimination is a core principle of the international trading system and has helped to promote open markets for decades. In strategic policy formulation, however, clinging to unspecific, country-agnostic language has serious drawbacks.

Fact box: The EU's economic security strategy

The European Commission's economic security strategy calls for a "bolder and faster" use of existing policy instruments and the introduction of new mechanisms where necessary to protect Europe against a variety of risks. Together, these tools are set to create a system that will **promote** the EU's economic base, competitiveness and growth, **protect** against economic security risks and **partner** with like-minded countries in pursuit of these goals.

The strategy's guiding principles are proportionality and precision. Measures will be **proportional** in the sense of being commensurate with the level of risk that they seek to address and limited to avoid negative spillover effects. They will also be **precise**, by defining exactly which goods, sectors or core industries are concerned.

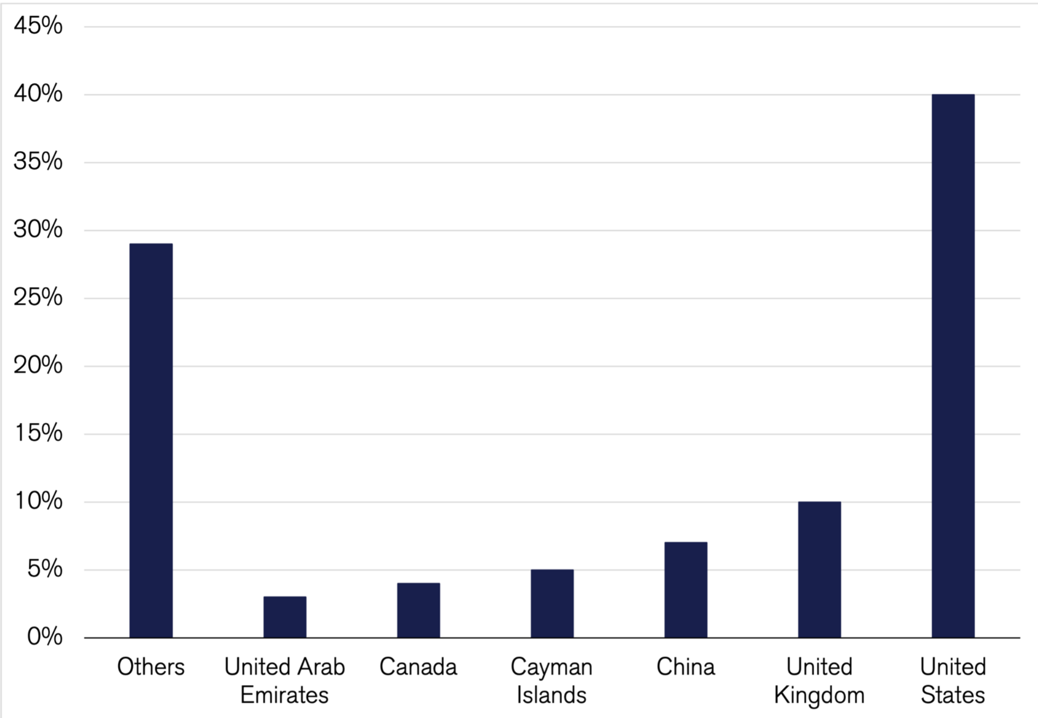
The strategy defines four types of risks faced by the EU:

- Risks to the resilience of supply chains, including energy security;
- Risks to the physical security and cybersecurity of critical infrastructure;
- Risks related to technology security and technology leakage;
- The risk of weaponization of economic dependencies or economic coercion.

The instruments for addressing these risks include: the Critical Raw Materials Act, the European Chips Act, the Net-Zero Industry Act, export controls, the Single Market Emergency Instrument, the Anti-coercion Instrument, the Foreign Direct Investment Screening Regulation, the Toolkit on Tackling Foreign R&I Interference, the 5G Toolbox and the Global Gateway.

A commitment to country-agnosticism means casting a wide net rather than being precise. In the name of fairness, EU institutions and member states will need to sift through investments from and trade deals with Europe's trusted partners, even if this was never the intention. For example, of the 414 investments flagged to the European Commission in 2021 as part of the EU's investment screening mechanism, only 7 percent originated in China. In 40 percent of cases, the United States was the origin of the ultimate investor, while 10 percent came from the United Kingdom (see Figure 1). This is not to say that investments from allies never merit investigation, but the distribution of notified cases suggests that the system lacks strategic focus. Moreover, universal policies not only create additional administrative burdens, but can also end up being used for unintended purposes. The detailed legal knowledge needed to analyse the EU's new instruments opens the door for specialized vested interests to have a disproportionately large influence on how the tools are used. Brussels is home to a vast lobbying industry, and the possibility cannot be excluded that these instruments will be hijacked for protectionist purposes.

Figure 1. Investments notified by member states to the Commission in 2021, by origin of ultimate investor.[21]



The biggest downside of strict country-agnosticism is the signal it sends to third parties. As instruments lack focus, even allies and partners must consider the possibility that their exchanges with the EU might be caught up in Brussels' economic security machinery. The impetus will be even stronger in non-aligned countries such as Saudi Arabia, Brazil or South Africa, which cannot rely on pre-existing mutual trust to dispel security concerns. As businesses take note of the additional hurdles associated with the Single Market, a chilling effect on both trade and investment could follow. Furthermore, Europe's policies could serve as inspiration for middle and smaller powers in world politics. With global markets on the verge of geopolitical fragmentation, the EU's position is important. As the world's largest trading bloc, its approach to economic security will have an impact on what other countries view as legitimate actions. Brussels must therefore think about the type of norms that it would like to see governing the global economic security space. From a free trade perspective, focused restrictions motivated by extraordinary geopolitical circumstances seem preferable to universal policies that could affect partners.

A recurring argument against a country-focused policy is that although China is the main problem today, this could change over time. The Anti-coercion Instrument, for example, was initially targeted at the United States but later developed in response to China's punitive measures against Lithuania in 2021.[22] Indeed, the EU's tools need to be kept sufficiently flexible to redirect their focus if needed. Clearly, foundational legal texts should not name countries. Yet this does not prevent the EU from spelling out the specific challenges that its instruments seek to address in a policy document like the economic security strategy. On the contrary, it is precisely what the text should have been used for. Being clear about the fact that most economic security risks concern China would not only foster precision but, by ruling out the use of some instruments against partners or allies, could also make international coordination easier, including with the United States.

Another concern is that naming China would be overly confrontational and set Brussels on a collision course with Beijing. This possibility needs to be taken seriously. China is certain to respond negatively to being designated a security risk, which might indeed limit cooperation over the short term. Yet to some degree, acknowledging China-specific risks is merely a recognition of the realities inherent in a "systemic rivalry", a label used by the EU to describe parts of the relationship in 2019.[23] Over the long term, strategic clarity may even bring some stability to EU-China relations. When the EU imposes sanctions against or directly criticizes China, Beijing often seems to react with surprise and outrage, as if the EU and China were close partners. In 2021, when the EU sanctioned Chinese entities involved in human rights abuses in Xinjiang, Beijing responded with restrictions on a long list of European individuals and organizations, including a central decision-making organ of the EU, the Political and Security Committee. The Chinese response was widely interpreted in Europe as an overreaction. It led to the freezing of negotiations on a Comprehensive Agreement on Investment (CAI), a seemingly undesirable outcome for both parties. It is not inconceivable that clarifying the EU's view of the relationship could help temper such erratic dynamics.

De-risking with the United States

"De-risking" is at the centre of Brussels' approach to China. Commission president Ursula von der Leyen first used the term in a speech in March, when she explained that the EU does not want to "cut" economic, societal, political or scientific ties. Instead, she called for a recalibration in "some areas where trade and investment poses risks to our economic and national security".[24] Although the Commission seems to use "de-risking" synonymously with "reducing risk", the term has traditionally had a different meaning. In the context of sanctions, it refers to "financial institutions terminating or restricting business relationships indiscriminately with broad categories of customers rather than analysing and managing the specific risks associated with those customers".[25] In other words, the Commission seems to have chosen a word that expresses precisely the scenario that the EU has been trying to avoid – a sweeping decoupling that goes beyond national governments' intentions.

It is therefore understandable that the United States was quick to adopt the EU's de-risking theme in a speech by National Security Advisor Jake Sullivan in April.[26] Washington has sought to persuade European governments to adopt a stricter policy towards China, and the administration of US President Joe Biden may have seen this as an opportunity to shape the development of the concept and EU policy. In any case, the fact that Washington sees the phrase as sufficiently sweeping to include all its economic security policies should raise warning flags among EU member states that champion a more open relationship with China.

In February, Biden declared that "Buy American has been the law of the land since 1933. But for too long, past administrations have found ways to get around it. Not anymore".[27] Such protectionism weighs heavily on US foreign policy. In Asia, the United States is trying to enlist partners in its ambitious China policy, but the Biden administration's inability to offer increased trade openness is undermining this effort. For instance, the US Indo-Pacific Economic Framework (IPEF) does not include tariff cuts and provides no significant access to the US market. With no new incentives, there are fewer reasons for partners to transfer supply chains from China or to help counter its influence.[28] It has been more than 14 years since the United States entered a bilateral free trade agreement.[29]

The US and the EU do not see eye to eye when it comes to economic security. This has also been true historically. During the Cold war, the United States and Western Europe coordinated their controls on exports to the Soviet bloc through the Coordinating Committee on Multilateral Export Controls (COCOM). However, there was recurring friction in COCOM between the United States, which wanted stringent controls on trade with Eastern Europe, and Western Europe, which sought to preserve a more open relationship.[30] Today, too, the EU's commitment to free trade is stronger than that of the United States and, insofar as Brussels does not see China as an immediate security challenge, the dynamic of the Cold war seems likely to repeat itself.

Many states view US policy as protectionist and excessively restrictive towards China. In this context, the EU can represent a fundamentally distinctive approach, whereby any security-motivated tightening towards China comes with a promise of a corresponding opening up to partners. With a precise and China-focused economic security strategy, the EU could simultaneously retain its role as a champion of free trade, hedge against risks and draw non-aligned countries closer. For this to be successful, however, Brussels must be willing to compromise on some of its recent policies that resemble those of the United States. Importantly, re-shoring elements and industrial policies should be revamped as inclusive initiatives open to most third countries other than China. This would serve as a counterweight to the growing web of security restrictions and could help preserve a level playing field among partners.

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