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Europe's Pushback on China



POLICY PAPER JUNE 2020

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*There is no desire more natural
than the desire for knowledge*

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INTRODUCTION

EU-China relations are in 2020 almost as much a test of the EU's resilience as is its economic response to the coronavirus pandemic. In June 2020, the European Union looks increasingly likely to succeed in setting up defensive economic policies, but to fail the test of EU-China relations as a means to make China change its policies. Facing the failure so far of talks aiming at policy changes from China, it has just used a direct virtual meeting with Xi Jinping and prime minister Li Keqiang to point out a long list of divergences. While maintaining that its relations with China are important to resolve global issues, it has put China on notice to translate its words into deeds.

There are good reasons for this.

2020 had not only been designated officially as an EU-China year, but it also coincided with Germany's and Chancellor Merkel's semester presidency in the second half of the year. After 29 rounds of negotiation over 8 years for a bilateral investment agreement (BIA), Mrs. Merkel upped the stake by deciding that a second 2020 EU-China summit be held in Leipzig in mid-September, with all 27 member states participating. It was dubbed a "leaders' meeting" out of deference for the customary summit run by the EU institutions. The expectation was that talks for the BIA would be wound up by that time. **Ever since June 2018 and an EU-China summit in Brussels, Europeans have been pressing the Chinese government to stop delaying or stalling talks, and to come up with actual agreements.**

Germany alone weighed 42.76% of EU exports to China and 18.29% of imports in 2019¹, regardless of the 5,000 German firms operating directly in China. This position has not come without concessions: according to Chinese sources, Germany is also Europe's largest source of technology transfers to China, with 25,166 technologies transferred to China, for a total value of contracts worth \$86.27 billion as of September 2019². **This deep economic interaction gives Berlin a prevailing influence on the EU's China policy, even if EU institutions and rules require much effort to create unity.** No other member state holds more than 10% of European exports to China. None has the footprint of German firms in China. Of course, this position of strength within Europe comes with relatively greater vulnerability to Chinese government actions.

1 Source: Eurostat. https://ec.europa.eu/eurostat/statistics-explained/index.php/Extra-EU_trade_in_goods#Main_EU_partners. EU exports to China in 2019: €225,2 billion; EU Import from China: €419,8 billion. Germany exports to China in 2019: €96,3 billion; Germany import from China: €76,8 billion.

2 Mei Zhaorong, "Review of Sino-German relations in 2019: Coexistence of cooperation and contradictions (2019中德关系回顾: 合作与矛盾并存)", Beijing Review, December 26, 2019, http://www.beijingreview.com.cn/shishi/201912/t20191226_800188474.html

2020 is also a year when several European policy initiatives will have a significant impact on relations with China. While the European Commission has issued precise guidelines on critical security issues for the coming 5G networks, each member state faces a decision over the telecom companies' choices of European (Ericsson or Nokia) or Chinese (chiefly, Huawei) suppliers, with other potential suppliers such as Samsung in a distant background. **The extraordinary global fight put up by Huawei and, more importantly, by China's government places companies and countries in a quandary.** Strong advice and diplomatic pressure are also coming in the other direction from the United States. One should not hide the fact that these future telecom networks, given their reach over much of human activity, are a critical security issue in its own right for Europeans.

The EU's new investment screening regulation – largely non-binding for member states but with a potentially strong nudging impact – is scheduled to be operational in October 2020. **In addition to this defensive instrument, there is concern over the vulnerability of ailing companies as a result of the pandemic.** Bloomberg reported in April a spike in Chinese requests for M&A proposals in Europe, mainly by Chinese SoEs³. Fosun International, a Chinese conglomerate and investment company, notes in its annual report its wish to "leverage its worldwide resources to identify more opportunities in this crisis"⁴. The European Union and some member states are creating new guidelines or temporary rules on financial take-over by non-EU actors:

- ▶ The European Commission published on March 25 a Guidance to the Member States concerning Foreign Direct Investment (FDI) and free movement of capital from third countries, asking member states "to be vigilant and use all tools available at Union and national level to avoid that the current crisis leads to a loss of critical assets and technology"⁵;
- ▶ Italy has issued a new Law Decree (Liquidity Law Decree) in April to extend the "Golden Power" and safeguard liquidity for Italian companies in distress⁶;

- ▶ Germany has extended in May the list of security-relevant businesses that will be subject to FDI screening⁷;
- ▶ France announced the inclusion of biotechnologies in the "critical technologies list" and the lowering of the threshold for non-EU investors that fall within the investment screening regime, from the initial 25% to 10% as a temporary measure resulting from the consequences of the COVID-19 lockdowns.

This is to avoid a repeat of the fire sale of company assets by indebted member states that happened during the 2011 euro crisis. The days of China cherry-picking Europe for convenient bits for knowledge transfer may be ending.

The EU has also adopted in 2019 a new public procurement strategy. It enables the EU that have neither signed up to the WTO's International Procurement Agreement (IPA) nor concluded a bilateral treaty with the EU. In the EU's next programs for science cooperation, the new multiannual program starting in January 2021 is supposed to accept partners, according to a new legal draft, "if they contribute to the budget, demonstrate a good capacity in science and technology, uphold democratic institutions and an open market economy, and commit to fair intellectual property protection"⁸.

Furthermore, on June 17, the European Commission adopted a White Paper "to address the distortions created by foreign subsidies" in the Single Market. It is currently open for public consultation until September 23 and yet to be approved by member states⁹. The White Paper is first and foremost an extension of the anti-subsidy rules that already apply to intra-EU investors, and like previous changes to anti-dumping rules, it is redacted in a non-discriminatory fashion. Chinese officials have immediately sensed the risks and have reminded the EU that its measures have to comply with WTO principles, and that "the EU needs to avoid sending negative signals to the outside world"¹⁰. The Mission also notes that China "strictly observes the WTO transparency principle on subsidies by making regular notification of the revision, adjustment and implementation of the relevant laws, regulations and measures". **The reality is that WTO rules**

7 "Protection for the health system", Federal Government of Germany, May 2020, 2020, <https://www.bundesregierung.de/breg-en/service/aussenwirtschaftsverordnung-1754400>

8 Florin Zubascu, "EU Science Ministers Want Reciprocity in International R&D Cooperation", Science Business, March 3, 2020, <https://sciencebusiness.net/framework-programmes/news/eu-science-ministers-want-reciprocity-international-rd-cooperation>

9 "The White Paper on Levelling the Playing Field as Regards Foreign Subsidies", European Commission, June 17, 2020, https://ec.europa.eu/competition/international/overview/foreign_subsidies_white_paper.pdf

10 "Spokesperson of Chinese Mission to the EU Speaks on a Question Concerning EU White Paper on Foreign Subsidies", Mission of the People's Republic of China to the European Union, June 18, 2020, <http://www.chinamission.be/eng/fyrjh/t1789662.htm>

3 "China's Corporates Are Gearing Up in Europe for M&A Bargains", Bloomberg, April 20, 2020, <https://www.bloomberg.com/news/articles/2020-04-07/china-s-corporates-are-gearing-up-in-europe-for-m-a-bargains>

4 "Announcement of Final Results for the Year Ended 31 December 2019", Fosun International Limited, March 31, 2020, https://ir.fosun.com/system/files-encrypted/nasdaq_kms/news/2020/03/31/17-46-50/2019%20Annual%20Results%20Ann_EN_2020.03.31%20final.pdf

5 "Coordinated Economic Response to the COVID-19 Outbreak", European Commission, March 13, 2020, https://ec.europa.eu/info/sites/info/files/communication-coordinated-economic-response-covid19-march-2020_en.pdf

6 "Decree-Law 8 April 2020, n. 23", Official Gazette of the Italian Republic, April 4, 2020, <https://www.gazzettaufficiale.it/eli/id/2020/06/06/20A03082/sg>.

come very short on the issue of state subsidies, which is precisely one of the main topics up for reform. In addition, the European External Action Service has extended to China in 2019 the coverage of a regular letter on disinformation. Created in 2015 to counter disinformation aimed at Central and Eastern Europe, the bulletin now identifies fake news and other social media onslaughts emanating from China.

In short, in addition to the 2020 Agenda of EU-China partnership that was agreed upon years ago but hardly acted on, there is now a list of unilateral moves by the European Union which must be either implemented, or have yet to be approved by member states, and which largely concern China in practice. Actual (as opposed to formal) compliance by member states is not a given. For instance, Hungary's Viktor Orbán has been able to disguise a Chinese investment into a fast Budapest-Belgrade railway with shell Hungarian companies that borrow from Chinese lenders; using special government powers created by Hungary for the Covid-19 emergency, Orbán's government has classified the terms for the loans as "secret" for ten years¹¹. This contrasts with the publication of Hungary's National Security Strategy in April 2020. That Strategy notes that economic cooperation must also take into account "the exposure risks arising from China's investment in critical infrastructure, its emergence as a potential supplier of state-of-the-art information and communication technology and, in general, its regional influence."¹² But Hungary is not alone: when the German government runs late on its decisions regarding 5G while German telecom companies pick Huawei as their main supplier for reasons of continuity and convenience, it undermines the credibility of this year's 5G security guidelines from the EU.

Indeed, the EU's 5G guidelines, and investment screening, leave much to member state decisions. But these are known structural limits to EU competences. Several DGs - Trade, Digital, Justice, Internal Market, Competition and the European External Action Service (EEAS) - have done an unprecedented job in setting up these defenses.

¹¹ "Hungary Classifies Budapest-Belgrade Chinese Rail Project," Reuters, May 19, 2020, <https://www.reuters.com/article/hungary-china-railway-law/hungary-classifies-budapest-belgrade-chinese-rail-project-idUSL8N2D14V2>

¹² "Official journal of Hungary No. 81", Government of Hungary, April 21, 2020., <https://magyarkozlony.hu/hivatalos-lapok/2NGUpJ514oAaRpmHiGFq5e98d4798d150/dokumentumok/6c9e9f4be48fd1bc620655a7f249f81681f8ba67/letoltes>

2020, A MISSED YEAR?

And yet this is not resulting in any visible change by China, nor is it likely to happen in the coming months. A virtual EU-China summit was arranged at the last minute on June 22, replacing what should have been a lengthier visit to Beijing in early July. **There simply hasn't been enough contact over the months of Covid-19 confinement, and no tangible sign of China's goodwill has emerged, other than very vague proclamations.**

In a landmark press conference held on June 22, Ursula von Der Leyen and Charles Michel, the EU co-presidents, have publicly aired disagreements with China over a very broad range of issues: Hong Kong, human rights, cybersecurity, in addition to requesting again a level-playing field for a fair and reciprocal access to the Chinese market. On WTO reform, climate change and debt forgiveness to countries hard-hit by Covid, they are also pointing out the need for action by China. On cybersecurity attacks, the Commission president did not hesitate to say that "their origin is known to us", and on disinformation, that "facts and figures" had been presented to China's leaders. Asked what the consequence of no deal on an investment agreement by the end of the year, she also explained this would put in question the EU-China Agenda for Cooperation.

How an EU that prefers cooperation and compromise to conflict and hard postures came to this stand needs to be explained.

The Leipzig summit envisioned by Angela Merkel was to be the opportunity to reach a comprehensive agreement on investment - which encapsulates most of Europe's economic demands of China. The format was criticized from the start, including by Mrs. Merkel's coalition partner and by its opposition in Germany. A group of German experts has argued to the Chancellor that it was unrealistic to hope for Chinese concessions matching European goodwill. **While China attaches much importance to formal statements, it would only concede to Europe left-overs from the China-US Phase One agreement.** A meeting with the 27 member states present risked to end with a show of disunity, or with only formal statements.

The Leipzig meeting with China is now delayed *sine die*. To much surprise, this is reportedly at the request of China – which on the contrary had insisted in previous months on holding the event. The tail of the pandemic provides a perfect excuse, of

course. **But the reality is that China is once more stalling top-level talks with Europe, much as it has repeatedly delayed a visit to Japan by Xi Jinping.** Thus, the postponement follows ever repeated Chinese assurances, since the beginning of the year, to hold negotiations in earnest. A call between Valdis Dombrovskis, Executive Vice-president of the European Commission, and Liu He, Vice-premier and chief negotiator with the United States, was interpreted as a sign that Liu He would now turn his attention to Europe¹³. The conclusion in January of the Phase One trade agreement with the United States had seemed to allow time for just that. But EU insiders know that in fact, no substantial progress has been made since the beginning of the year. Even on May 30, China's Ambassador to Brussels was suggesting the EU and China "meet halfway" for a compromise, when in reality China hasn't started to move on that road¹⁴. It was German government figures and EU officials who, off the record, suggested the Leipzig meeting might be cancelled if there was no progress in the bilateral investment talks. Instead, China moved first.

Nor has China come forward on other issues that could create a bridge between Europe and China, particularly on maintaining multilateralism. There has been no progress at all in reform talks about the World Trade Organization (WTO). Climate talks, delayed at the level of the UN due to the pandemic, also show no significant progress between China and the EU. **China's CO2 emissions have plateaued from 2015 to 2017¹⁵, after the Paris Agreement was concluded in 2015.** But even so, China will not improve on its commitment made five years ago. At the May meeting of the National People's Congress (NPC), prime minister Li Keqiang cited "clean coal" first in the energy portion of his speech, making clear what had already shown in available figures: coal's share of China's energy consumption is again on the way up, first as a result of the US-China trade conflict, and now because of the need to cut costs after the economic downturn created by the pandemic. China is also the world's largest exporter of thermal plants, while the EU has committed to ending all such exports.

The pandemic itself has added to the list of outstanding issues: most EU countries have had their hands tied in the very short run by the urgent need to procure personal protective equipment (PPEs) from China, which alone has the ability to mass produce them quickly (see Table 1). **But the pandemic has also created public resentment at China's initial handling of the crisis and obfuscation of human to human**

13 Stuart Lau, "China moves to keep EU investment talks on track", South China Morning Post, April 18, 2020, <https://www.scmp.com/news/china/diplomacy/article/3080563/china-moves-keep-eu-investment-talks-track>

14 Keegan Elmer, "China Asks EU to Remain Flexible on Negotiations for Joint Investment Deal", South China Morning Post, May 30, 2020, <https://www.scmp.com/news/china/diplomacy/article/3086831/china-asks-eu-remain-flexible-negotiations-joint-investment>

15 Éric Chaney, "Dividende carbone: une carte à jouer pour l'Europe", Institut Montaigne, June 2020, <https://www.institutmontaigne.org/ressources/pdfs/publications/dividende-carbone-une-carte-jouer-pour-leurope-note.pdf>

contagion with the World Health Organization (WHO). China is now rewriting step by step these episodes, with official denials of any mishandling, even at the provincial level. A recently published White Paper by China's State Council Information Office is intended "to keep a record of China's efforts in its own fight against the virus, to share its experience with the rest of the world, and to clarify its ideas on the global battle"¹⁶. This posture raises heavy doubts about Beijing's willingness to cooperate later in a WHO led investigation on international responses to the pandemic. It also raises questions regarding whether China, as promised by Foreign minister Wang Yi, will participate in joint efforts by the international science community to identify the source of the virus¹⁷.

On human rights concerns, the massive digital surveillance and internment of Uyghurs in Xinjiang (supposedly for "vocational training") over the past two years has added a new and frightening dimension to the existing divergences between the EU and China. A convergence between China and Europe on the need to implement the 2015 Iran nuclear agreement has perhaps been the only positive item on a long list of issues. On all issues of international governance, sustainable development or global health, the European Union faces a quandary: these should indeed be topics of cooperation, perhaps balancing the economic competition and the systemic rivalry which are on the increase. In reality, the only area of agreement is a common but vague commitment to multilateralism and multilateral institutions. That agreement does not extend to the reform of these institutions, beyond declarations in principle from China. It takes at least two to act on a multilateralist agenda...

16 "Fighting COVID-19: China in Action", China's State Council Information Office, June 7, 2020, http://www.xinhuanet.com/english/2020-06/07/c_139120424.htm

17 "State Councilor and Foreign Minister Wang Yi Meets the Press", Ministry of Foreign Affairs of the People's Republic of China, May 25, 2020, https://www.fmprc.gov.cn/mfa_eng/wjbxw/t1782369.shtml

Table 1: China's Production of Key Medical Supplies (As of April 30)

	Category	Product / Unit	Daily production capacity	Daily production	Multiple of the daily production in the early stage of the epidemic (late January)
1	Personal protective equipment	Medical protective suit (million suits)	1.89	0.8	90.6
2	Disinfectant products	Hand sanitizer (tonne)	409	308	2.6
		84 antiseptic solution (1,000 packs)	366	117	1.6
3	Medical equipment	Automatic infrared temperature measuring device (1,000 sets)	10.7	3.4	23.3
4	Test materials	Virus testing reagent (million kits)	10.2	7.6	58

Source: *Fighting COVID-19: China in Action*, China's State Council Information Office, June 7, 2020, http://www.xinhuanet.com/english/2020-06/07/c_139120424.htm

CHINA'S POST-COVID INTERNATIONAL POSTURE: FAST FORWARD

Some European leaders, and many economic stakeholders, may often wish to remain out of another picture, which is the hardening and broadening scope of China's international push on its periphery and beyond. **Facing China, hard power in the Asia-Pacific is exercised by the United States and its regional allies, with only an occasional show of European (largely French) presence in maritime East Asia.** Yet the increasingly assertive and even aggressive posture of China since the onset of the coronavirus crisis has implications for all. The announced imposition of a transposed national security law into Hong Kong's legal system, along with the official stationing of China's security organs in the Special Administrative Region (SAR), signal the end of the cat-and-mouse game played between Hong Kong's overlord and a population that has remained, ever since 1997, staunchly attached to democratic and autonomous institutions. This has consequences also for Taiwan. In response to the popular vote for a second term to president Tsai Ing-wen – termed as an independentist by Beijing in spite of her moderation compared to her party's traditional positions, China has increased its pressure on the island, through declarations, naval and aerial maneuvers. With India, long-simmering border disputes in the Himalaya turn into a show of force by China at an unprecedented level since 1962: with India as is the case with Hong Kong, China seeks first to establish facts on the ground, and then uses these facts as the baseline for any talks. In the South China Sea, there are again rumors of the coming declaration of an Air Defense Identification Zone (ADIZ), such as exists in the East China Sea since 2013.

To this set of issues, one should add the increasingly raucous and occasionally threatening tone of China's bilateral diplomacy with several European member states (Sweden, France, Czechia) – the EU as such being entirely spared so far on this front. However, it is not spared outright censorship, as happened in May 2020 with an anniversary opinion piece from European ambassadors to Beijing that was published with a cut by China's official press¹⁸.

Periodically, partners wishing to engage, or to re-engage China draw up a list of issues on which they expect China to converge on the basis of its own interests:

¹⁸ Carly Walsh and Simon Cullen, "The EU Has Admitted It Let China Censor an Op-Ed by the Bloc's Ambassadors", CNN, May 8, 2020, <https://edition.cnn.com/2020/05/08/china/eu-china-coronavirus-oped-censored-intl/index.html>

indeed, climate change, now vaccines and in general the preservation of a multilateral system. This effort is particularly led by Europeans. Indeed, the March 2019 Commission communication on China described the relationship as both a case of systemic rivalry and economic competition, but also a partnership of cooperation¹⁹.

For Europeans, the list has also included urban planning and sustainable or “circular” development, while nuclear non-proliferation often figures at the top of American wish lists for engagement. China, which got the best out of long negotiations to enter the WTO in 2001, has a long-standing practice on how to meet these expectations: playing off one interlocutor against the other and, less oddly than it seems, dealing with the hardest partner since China's responses are based on a calculation of respective strengths; finally, signing off on statements which may sound like commitments but have no legal value and include no mechanism for verification. Such was the case for the 15 articles of China's memorandum on acceding to the WTO, and also for the COP 21 Paris agreement, with only a vague agreement for reviewing implementation after a few years. From past experiences, the United States has insisted on including verification and legal opt out clauses in the January 2020 Phase One trade agreement. **The EU is making similar moves, but these remain political statements agreed with China rather than legally binding commitments.** In March 2019, in the face of undelivered promises, the Commission's strategic document cited ten action points to be fulfilled within one year. A recent audit estimates that of the four points largely relying on China, only two have been partially achieved. According to this audit, for the remaining six, the EU has only met its full target on one point concerning the 5G guidelines²⁰. This is in fact a harsh judgement on the EU. It is going full steam ahead with other action points which it can implement on its own, regardless of China's moves. What instead strikes an observer is the lack of commitment from China to the action points where it is needed.

In fact, the only issue on which Chinese negotiators are forthcoming, at least in principle, is Agenda 2025, the next set of broad objectives with China. This has become a fixture of the “comprehensive strategic partnership” that was sought from 2003. The last such agenda, created in 2013, expires in 2020, and the follow-up is now sought. In 2013, much was made of the fact that “peace and security” became the first pillar of cooperation. **Multilateralism, denuclearization, cybersecurity were among the objectives for cooperation – but these have remained entirely unfulfilled. China's preference for a long-term declaratory horizon may be based, once more, on gaining time and avoiding binding commitments.**

¹⁹ “EU-China - A Strategic Outlook”, European Commission, March 12, 2019, <https://ec.europa.eu/commission/sites/beta-political/files/communication-eu-china-a-strategic-outlook.pdf>

²⁰ Fabrice Pothier and David Fernandez, “EU-China Living up to the Ten Actions?”, Rasmussen Global, May 7, 2020, <https://rasmussenglobal.com/media/china-eu-living-up-to-the-ten-actions>

THE LONG SHADOW OF THE US

In fact, China's attitude towards Europe cannot be deciphered unless one factors in the all-important relationship with the United States. The US now bases its China policies on a strategic competition. It has engaged a harsh trade conflict with China, and is setting up a series of technology denials. **Given that the transatlantic alliance is a mainstay of Europe's foreign and security policy, this turnaround has implications for Europe itself.** The US also outweighs Europe in the eyes of Beijing. This is not because the US has brought greater benefits to China, or because China's trade and investment relationship with the US is larger. EU and US trade and investment in China are of similar magnitude, with perhaps more sourcing from China by US firms and more local market share for Europeans. Rather, the difference is negative: it rests on the actual dependencies of China vis-à-vis the United States, and the damage that America can inflict on China. In practice, the Chinese currency is part of the dollar zone, and the impossibility by China to manage its own currency is also reflected in extensive capital controls and high domestic interest rates. Technological dependence remains very strong – especially for digital and IT industries. The threat of technology denial (now effective through the case of Huawei and a number of other key Chinese companies), of decoupling from Chinese producers or subcontractors, and the possibility of financial sanctions of which the US has a long experience over Hong Kong are a unique combination.

It is striking for example, that China has taken no retaliation against American companies after the escalating measures against Huawei. American platforms had always been discriminated against in China, largely for reasons related to internet content control. But neither Apple nor other American IT companies have experienced any reprisals. On the other hand, China's Ambassador to the UK has threatened the UK over the Huawei issue, by suspending Chinese participation in the UK's nuclear plants, and in railway infrastructure: even these threats seem outlandish, since these projects were also in the interest of the Chinese companies. With Germany, reprisals against the German car makers in China have been hinted. The differences of treatment reflect the appreciation by China's leaders of relative strength in these cases. To this, one should add the hard power competition: after everything has been said about the rise of the Chinese military, the Pentagon and the US military presence on China's periphery remain the most tangible obstacle to China's further rise as a global military power. Finally, the US federal government, even under present circumstances, has powers that the European Commission can only dream of.

It follows that China's first stop in any important negotiation is Washington. The second stop may be for countries likely to support China on the international scene. Depending on the issue, it may range from a small set of quasi-pariah nations to a much larger league of authoritarian and/or sovereignist states, especially at the United Nations. Europe, with its balance between cooperation and acknowledgment of systemic rivalry, its taste for nuance and proportional responses, its institutional limitations, its internal divisions, a military focus on immediate Eastern border or nearby regions in crisis, has appeared far less likely to inflict damage on China. In the dry words of a key Chinese analyst, Europe "is powerless in spite of its intentions (有心无力)"²¹. In several member states, one witnesses a pitched opinion battle between the US and Chinese ambassadors. It is the case in Denmark regarding Chinese influence in Greenland, and in Poland over the responsibility for the pandemic. Another Chinese expert, attached to the Ministry of Foreign Affairs, talks about the EU's lack of credibility in the international capital market and the EU's incapability, in comparison with the US, to attract capital: the EU, he says, has to "snatch food from the jaws of a tiger (虎口夺食)"²². Protestations to "strategic autonomy" notwithstanding, Europeans must scale a high wall to regain leverage in negotiations.

The above is not altogether new. Deng Xiaoping dubbed Europe (and Japan) a nether-nether "second world". It was, in other words, a potential sphere of influence and often just a stop on the road to and from Washington (or Moscow at the time). Xi Jinping's belief in relations based on strength was formed long before Donald Trump appeared on the scene. America's turn away from engagement to meeting head on at all levels the competition from China has only deepened the gap between the US and the EU. Whatever Chinese analysts may say of an American decline, respect for Washington's capacity to make decisions runs stronger than any urge for concessions in order to "win over" Europe. In this context, 2019-2020 has brought new parameters to China's strategic calculus on how to deal with Europe: a new and untested Commission that was difficult to assemble, a messy Brexit process, an end of tenure coming for Angela Merkel, a social crisis in France, and finally a pandemic that has been even more damaging in Europe than was the case in China. The European leaders are therefore in a quandary. It is publicly difficult, except in some CEE member states where America remains the essential security provider and illiberal leaders are also a trend, to side too openly with the current US administration. Washington merely seeks compliance on some choke points regarding China, but does not lend itself to overall coordination with Europe. European leaders may have thought that if Donald Trump is

re-elected, China would finally find some interest in a deal with Europe on core trade and investment issues, to counter the risk of a US-led decoupling. And if Joe Biden wins, these same Europeans may hope for a return of transatlantic coordination and a policy towards China that requires less from Europeans.

This line of reasoning seemed to be that of Angela Merkel, who previously basked in praise from Barack Obama, and who has been repeatedly belittled by Donald Trump. Leaving behind a deal with China could be her legacy, and it coincides with the fear that many of Germany's companies have of losing the China market. France is unlikely to contradict this. In the Franco-German duet, it has just obtained a major step forward from Germany on post-Covid European debt policies. The French exports to China are almost five times weaker than Germany's on the China market, although some French companies do have large local stakes. France's current low public profile on China – whether it is human rights, Hong Kong, Covid and WHO – and the official silence on 5G issues are compatible with Chancellor Merkel's outlook on China.

21 Viviana Zhu, "China Trends: EU-China: A Fairly Smooth Road Ahead", Institut Montaigne, June 3, 2020, <https://www.institutmontaigne.org/en/blog/china-trends-5-eu-china-fairly-smooth-road-ahead>

22 Cui Hongjian, "The EU Recovery Fund is a big gamble on the future (欧盟复苏基金是对未来的一场豪赌)", China Institute of International Studies, June 1, 2020, http://www.ciis.org.cn/chinese/2020-06/01/content_41170160.html

IV

THE EU-CHINA PROCESS: STALLED OR SLIDING BACK

Evidence for these skeptical opinions from Beijing on Europe is backed by a review of the EU-China process in 2020. The turn of events has of course been aggravated by the pandemic. Neither the high-level economic dialogue nor the human rights dialogue have been held so far. The EU-China summit has taken place virtually, and earlier rather than later, over the course of a single day on June 22. It was preceded by a hastily convened strategic dialogue between HR/VP Josep Borrell and FM Wang Yi on June 9. A 30th round of talks towards the BIA (called the Comprehensive Agreement on Investment by the EU side, which has insisted on its structural reach, and a Bilateral Investment Treaty, or BIT, by China which sees it as a limited investment pact) will likely take place in late June – but in reality the issue has receded towards the end of the year, and perhaps even further. After Germany, it is Portugal and Prime minister António Costa who will hold the presidency in January-June 2021, and his country has been a key target for infrastructure and banking take-overs - this suggests that China may have an interest to delay the negotiation until the Portuguese EU presidency.

And in spite of a complete lack of concessions to the EU negotiators up to June 2020, Beijing has a window of opportunity after the US election. **By delaying the Leipzig meeting and with only a short virtual summit in June, it is able to keep its powder dry until the American presidential election, which will be a defining event.** A leading Chinese expert of European affairs suggests Beijing can choose on the key issue of subsidies and state enterprises. “It is not a simple economic decision, but involves political considerations (...) It will be a political decision whether it will be a compromise deal or a comprehensive but tough one”²³. Re-elected for a second term, Donald Trump could enjoy two years of free hand, which could cause serious damage to China’s bargaining power as the events of his first term have shown. Neither is it good for overall transatlantic relations – public outbursts often seem to outweigh security cooperation across the Atlantic, even when the latter is actually on the increase. Joe Biden has deeper connections with America’s pro-engagement camp, in spite of his campaign stand on China policies.

²³ Cui Hongjian cited by Wendy Wu, “China’s State-Owned Firms Remain Barrier to EU Investment Deal”, South China Morning Post, June 7, 2020, https://www.scmp.com/news/china/diplomacy/article/3087847/chinas-state-owned-firms-remain-barrier-eu-investment-deal?utm_source=copy_link&utm_medium=share_widget&utm_campaign=3087847

Many EU member states are either internally divided between security circles and economic stakeholders, or fall in one of the following two categories: those having commercial interests in the Chinese market (largely, Northern Europe), and those expecting investment from China (Southern Europe, if not a partly disillusioned Central and Eastern Europe).

Overlooking perhaps how much today’s China gauges strength, the EU’s High Representative for Foreign Affairs and Security Policy (HR/VP), Josep Borrell, had explained earlier at a press conference that “for China, to be presented as a systemic rival, is something that looks a little bit controversial. We have to explain what we mean by that”. Sounding apologetic was already backtracking, especially when one has just rejoiced that the strategic dialogue with a Chinese minister lasted three hours: yet it seemed difficult to cite outcomes from this. It was also surprising to hear in June 2020 the statement that (the Chinese) “do not have military ambitions and they do not want to use force”²⁴. This was said less than ten days after China announced a 6.6 % increase for defense – the only rising expenditure in the central 2020 budget -, and at the very moment of a major stand-off on the Sino-Indian border, while intrusions by Chinese warplanes were taking place inside Taiwan’s Air Defense Zone (ADIZ). **If one rationalizes the HR/VP’s judgements, they were based on two factors: one is a sober view of the limits to Europe’s hard power, that coincides with China’s own assessment. The other is a fear of divisions within the member states that could arise over a strong strategic statement.**

Hesitations indeed appeared in the declarations coming from member states regarding China’s recent aggressive moves. Most European countries have had only the most tepid and cautious expression about China’s new encroachment into Hong Kong. Sweden – facing a long uphill fight to reclaim a kidnapped and jailed citizen – was the only member state to advocate sanctions of any kind. To the EU’s credit, the HR/VP had made a statement early on, regretting that the Chinese move did not conform to “its international commitments, nor with the Hong Kong basic law”²⁵. Finally, the G-7 ministers of Foreign affairs issued a joint statement on China’s decision to implement a National Security Law in Hong Kong: “We strongly urge the government of China to reconsider this decision”²⁶. The EU Parliament has overwhelmingly voted a resolution considering a recourse to the International Court of Justice (ICJ) against China’s move.

²⁴ “EU-China Strategic Dialogue: Remarks by High Representative/Vice-President Josep Borrell at the Press Conference”, European External Action Service, June 9, 2020, https://eeas.europa.eu/headquarters/headquarters-homepage/80639/eu-china-strategic-dialogue-remarks-high-representativevice-president-josep-borrell-press_en

²⁵ “United Nations Security Council: Opening remarks by High Representative/Vice-President Josep Borrell”, European Union External Action, Service, May 28, 2020, https://eeas.europa.eu/track/click/31224/30389_en

²⁶ Stuart Lau, “Group of Seven countries urge China to reconsider Hong Kong national security law”, South China Morning Post, June 18, 2020, <https://www.scmp.com/news/china/article/3089494/group-seven-countries-urge-china-reconsider-hong-kong-national-security>

The Commission President also confirmed on June 22 that the cases of the Swedish citizen - and two Canadian detainees had been brought directly to Xi Jinping.

Europe may have preferred a course of less ambition and less risk that implied to focus on economic dialogue with China, while taking some defensive measures, and to be as non-committal as it could, if not neutral, on strategic issues. By not “choosing” between Washington and Beijing, it would be biding its time and hoping that it can bargain with both.

Such a course of action would not have been made possible by China - because it concedes nothing in form. Reportedly, Foreign minister Wang Yi has pushed very strongly on June 9 for Europe to give up the expression of a “systemic rivalry”. What some European leaders may have failed to see is that by stalling, Beijing loses in fact nothing in terms of bargaining power: it has always wanted much less change from Europe than the EU would wish from China. **This is the story of the last few years, when Europe hesitated on a retreat from engagement with Beijing, while Washington's sledgehammer approach once more got all of the attention – and the Phase One trade deal.** For both sides, the European Union has been a secondary consideration, because it wields insufficient leverage in spite of its huge economic size.

Europe's indecisiveness was understandable. **The European Union, which has an in-built preference for negotiation and compromise, seeks China's cooperation on global issues.** In the HR/VP's words, “our relationship with China does not fit into a single category – I am sorry for the people who would like to have a simple scheme”²⁷. But what if China is not forthcoming, even on the issues of climate change and the pandemic? In the words of the president of the European Parliament's group on relations with China, “it would be folly to assume that you can be systemic rivals on Monday and then go back to partnering for the rest of the week as if you were not”²⁸. This might have worked in the 1980s and even 1990s, at a time of a rising but reform-minded China. It does not apply to a power-hungry regime. “After 70 years, we are rich and strong”, said Xi Jinping recently.

27 “European Parliament: Remarks by the HR/VP Josep Borrell on the Foreign policy consequences of the COVID-19 crisis, on the PRC national security law for Hong Kong and on the possible Israeli annexation in the West Bank”, European External Action Service, June 18, 2020, https://eeas.europa.eu/headquarters/headquarters-homepage/81104/european-parliament-remarks-hrvp-josep-borrell-foreign-policy-consequences-covid-19-crisis-prc_en
28 Reinhard Bütikofer, “You Can't Be Systemic Rivals on Monday and Then Go Back to Partnering for the Rest of the Week” - Tai Conversations”, The American Interest, May 28, 2020, <https://www.the-american-interest.com/2020/05/28/you-cant-be-systemic-rivals-on-monday-and-then-go-back-to-partnering-for-the-rest-of-the-week/>

But this is only part of the picture. We may speculate that the postponement of the Leipzig meeting has acted as a jolt on Angela Merkel and EU's leaders. After all, the recent years have seen a clear progress in EU unity and coordination when it comes to defensive issues – trade, inward investment and critical technology. That unity is increasingly coming to technology export controls and to issues that fall in a more offensive category, such as public market access in China and other aspects of any structural reform of the Chinese political and economic system.

It is therefore a dynamic posture that has been chosen at the June 22 summit with China's leaders, in order to push back on China's rigid and stalling negotiation strategy.

Maintaining this posture will certainly be a challenge. Many member states – either because they are weak and uninterested in the China market, or on the contrary because they fear trouble for their companies in that market - are not ready to pay the price for a strong negotiating stand in front of China's obstinacy and leverage. Simultaneously, Donald Trump's future trade decisions remain uncertain. Therefore, the prospect of coordination with Washington is highly uncertain, as there is no assurance that an isolationist administration will not later turn against European economic interests. The HR/VP has declared on June 15 after a talk with US State Secretary Mike Pompeo that “for us, it's important to stay together with the US in order to share concerns and look for common ground to defend our values and our interest”²⁹.

Europe's change in posture is significant. Still, decoupling from the Chinese economy rattles countries with companies that remain strong in China and Hong Kong. As has always been the case, Chinese diplomats will work hard to separate nominal European statements on values and politics from economic interests, marginalizing the first and emphasizing the second. This is just what happened over the last June 9 EU-China strategic dialogue, when a Chinese MOFA statement cited the HR/VP as saying that the EU “seeks to have dialogue and cooperation with China on the basis of mutual respect, not rivalry or confrontation”³⁰. This was evidently an attempt to see whether the EU might be prepared to abandon the stronger side of its communication regarding China. To its credit, the EU called out this distortion via the press. But other Chinese press dispatches, more in line with

29 “Video conference of Foreign Affairs Ministers: Remarks by High Representative/Vice-President Josep Borrell at the press conference”, European Union External Action, Service, June 15, https://eeas.europa.eu/headquarters/headquarters-homepage/80898/video-conference-foreign-affairs-ministers-remarks-high-representativevice-president-josep_en

30 Stuart Lau, “EU Says Chinese State Media Distorted Remarks in Diplomatic Meeting”, South China Morning Post, June 11, 2020, <https://www.scmp.com/news/china/diplomacy/article/3088505/eu-calls-out-chinese-state-media-distorting-officials-remarks>

their usual practices, merely omitted the word “rivalry” from their account. On the eve of the annual summit, China’s Ambassador to the EU Zhang Ming repeats that “we should not see each other as strategic rivals”.

Which side can win in a waiting game? Beyond the uncertainty over the American election, two factors seem most relevant. One is simply how the bilateral economic relationship will be affected by externalities, such as the impact of the COVID-19 lockdowns and the US-China relationship. The other is the larger risk, beyond the bilateral relationship – and to both, since Europe is also a very big trading bloc – of either voluntary decoupling and remaking of value chains, or of a *de facto* retreat from globalization.

THE 2020 TRADE AND ECONOMIC PICTURE

It is too early to predict how an exceptional year will run its course for the European and Chinese economies. For the first time, the Chinese government has not released a growth target for 2020 at the annual NPC meeting in May. Since Europe’s Covid-19 crisis peaked two months after China’s, quarterly comparisons are imperfect. China’s lockdowns appear to have been much more rigorous than those implemented in Europe. But as China and Europe emerge from roughly two months of confinement and partial economic shut-down, it is worthwhile to check, even summarily, their respective health and dynamic.

The results are surprising – even in view of a very different casualty count (officially 4,645 deaths in China against more than 188,350 in Europe including the UK)³¹.

China’s seasonally adjusted GDP did plunge by 9.8% in the first quarter of 2020, against -3.3% for the Euro-27³². By contrast, Germany’ GDP is now set for a 10% + decline in Q2 2020, and France’s for a 20% fall. Among diverse forecasts, the IMF sees an annual 7,1% decrease for the EU, and a 1,2% growth for China³³. Many major bank economists had initially remained more bullish on China, but the consensus shifted somewhat, due to what was called a “second shock” for China: the impact of a lesser demand from the outside world, starting with the two major EU and US markets. It is also pessimism that induced, for the first time in decades, strong capital outflows and a current account deficit in the first quarter of 2020. A controlled 2.78 % slip of the RMB to the USD has occurred – in May, it is - 0.37 % to the euro relative to the average exchange rate in 2019³⁴.

Judging from numbers for China’s foreign trade in April and May 2020, the “second shock”, or a diminished demand from the outside world, isn’t happening all that much.

³¹ As of June 15, 2020, according to WHO’s daily situation report -147

³² “GDP and Spending - Quarterly GDP - OECD Data”, OECD, <https://data.oecd.org/gdp/quarterly-gdp.htm>

³³ “Real GDP Growth - Annual Percent Change - IMF Data Mapper”, International Monetary Fund, https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/EU/EURO/EUQ

³⁴ Source: ExchangeRates.org.uk

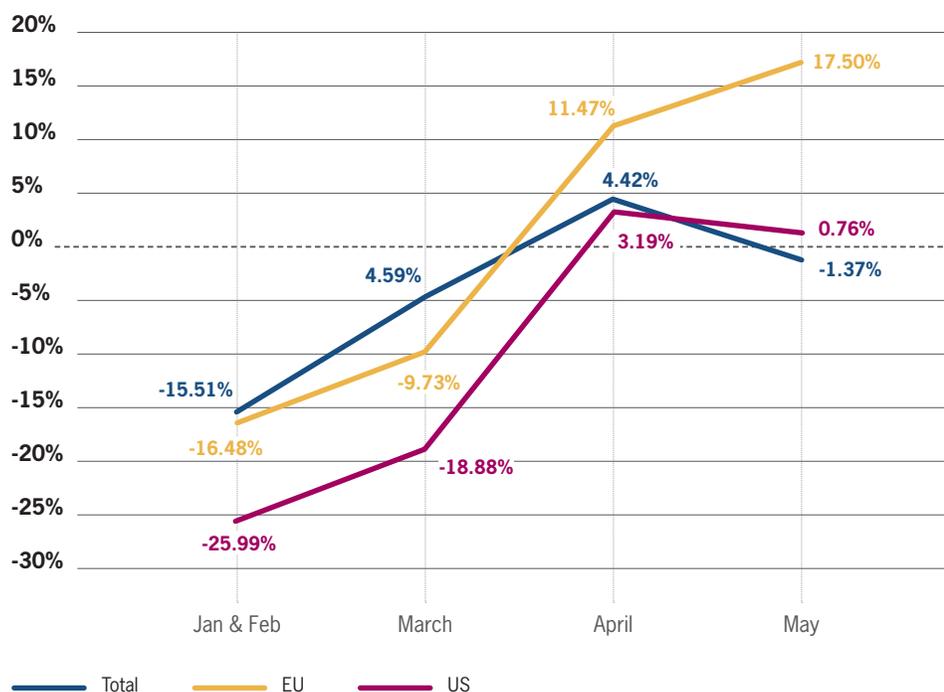
Monthly Average Exchange Rate of May 2020: 1 CNY = 0.140778 USD; 1 CNY = 0.12882 EUR

Yearly Average Currency Exchange Rate of 2019: 1 CNY = 0.1448 USD; 1 CNY = 0.1293 EUR

External demand appears to become again a key component of China's growth, and the country's trade surplus, at \$62 billion in May, is again record-breaking.

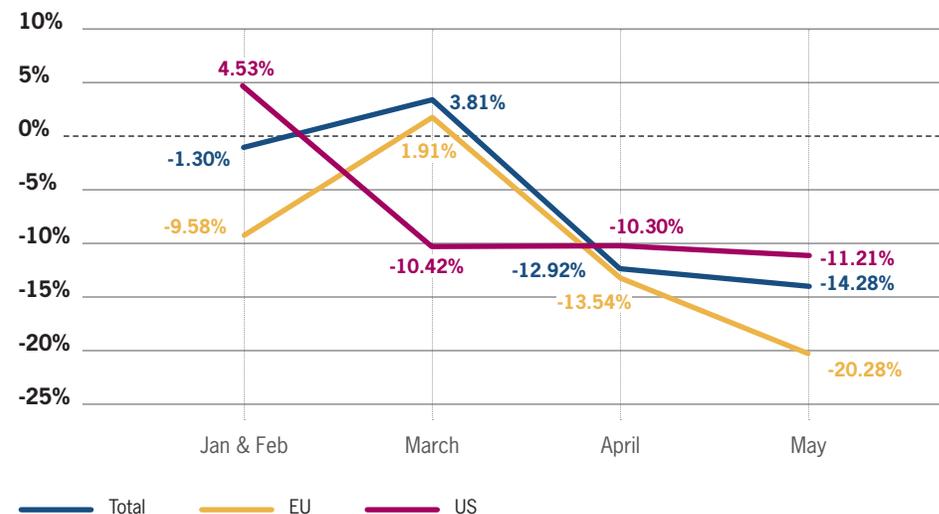
This is of course also a function of a large dip in Chinese imports: part of it is due to much lower prices for energy and raw material inputs, on which China had already stocked up in March, but imports from the EU (excluding the UK and in euro) are also at a record low: -13.54% YoY in April, -20.28% in May. Year on year exports to the EU (also excluding the UK) are at a record high in the same months (11.47% in April and 17.50% in May). These trade trends with Europe are not replicated with the United States – after an even deeper downturn in Chinese imports in the first quarter, both YoY import and export curves are less steep.

Graph 1: China's Total Export Value YoY 2020 Jan-May (in EUR - Exchange Rate Applied)



Source: Statistics - GACC - China Customs
Original data provided in RMB, exchange rate of respective month applied (InforEuro)

Graph 2: China's Total Import Value YoY 2020 Jan-May (in EUR - Exchange Rate Applied)



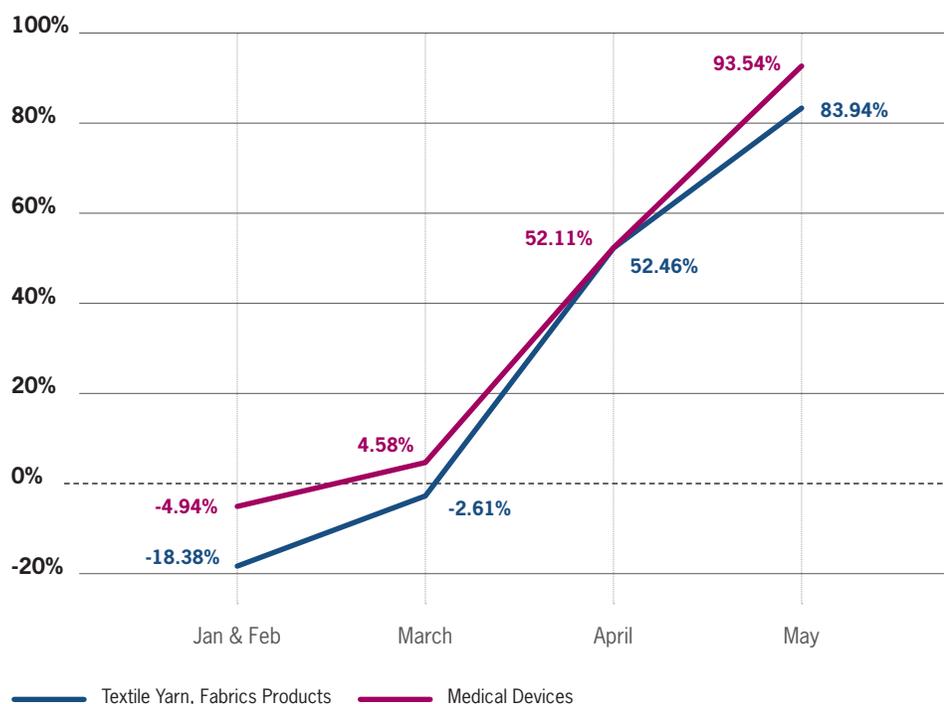
Source: Statistics - GACC - China Customs
Original data provided in RMB, exchange rate of respective month applied (InforEuro)

Overall, there is a huge spike in medical exports related to the pandemic – a short term outcome of China's “mask diplomacy” seizing the opportunity of the world's dependence to secure a major source of trade profit. From January 24 to February 24, China had imported 2,02 billion masks³⁵. But from March to May, it exported 70.6 billion of these³⁶. **Some idea of how profitable this has been can be gleaned from the rare available data for some European purchases:** Sweden purchased 19 million facemasks for €50 million (€2.63 each); LVMH (France) ordered 10 million masks for €5 million (€0.5 each); Italy signed a €13 million contract for 8 million masks (likely N97 level, €1.63 each). It is useful to remember that before the Covid crisis, a fair retail price for FFP2 masks was deemed to be around €0.35. In Taiwan, the government has now guaranteed a retail supply price for surgical masks equivalent to €0.15 for its citizens. According to China Customs Statistics, China's export value in euros of textile yarn and fabric products (which includes masks) dropped by 18.38%

35 “China's foreign trade in the first two months (解读前2个月我国外贸)”, General Administration of Customs, P.R.China, 07 March, 2020, <http://www.customs.gov.cn/customs/xwfb34/302425/2879133/index.html>
36 “Fighting COVID-19: China in Action”, China's State Council Information Office, June 7, 2020, http://www.xinhuanet.com/english/2020-06/07/c_139120424.htm

YoY in January and February, but increased by 52.46% YoY April and by 93.53% YoY in May (respectively €13.12 billion and €18.95 billion). A similar trend is observed in the export of medical devices.

Graph 3: China's Export Value of Textile Yarn, Fabrics Products, and Medical Devices YoY 2020 Jan-May (in EUR - Exchange Rate Applied)



Source: Statistics - GACC - China Customs
Original data provided in RMB, exchange rate of respective month applied (InforEuro)

But this is only part of the story. **What also appears in a trade breakdown by category is that China – as other East Asian suppliers – has enjoyed a surge in digital and telecom exports, while its more traditional industry sectors – apparel, footwear, furniture – still suffer.** This suggests a dual picture: indeed, low end manufacturing and employment, as well as retail sales, are not yet back to pre-Covid levels. This also explains, along with lower energy purchases from abroad,

the low level of import. But high end manufacturing and exports have more than recovered. This unexpected trend is currently coupled with “an extra-friendly attitude” of national and local officials to foreign companies, particularly American but also German³⁷. Its aim is of course to guard against the risk of disruption in China's supply chains, following the widespread talk of moving away from reliance on China.

Given the time lag between China and Europe for the pandemic, it is too early to make a comparison between China's rally and Europe's ability to recover, including its external trends. Nonetheless, one may note that in April 2020, German exports declined YoY by 31,1%, and even more towards France (-48,3%) and Italy (-40,1%). By comparison, over the same period, according to China Customs Statistics, Chinese export value in euros increased by 5,38% YoY to France, and fell by 2,63% YoY to Italy³⁸. It is hard to ascertain at what point in time these exports are tabulated, and there may well be some temporary disruptions in the logistical chain. A tentative conclusion could still be that European industry may be about to face a tsunami from its Chinese competitors – or more broadly by Made in China products. The structure of sales from China – with IT products in the front row as well as innovative consumer products such as batteries –, the still in force US custom additional duties which deflect exports from the US to Europe, and a lower renminbi all point in the same direction.

In one other aspect, China's economic recovery is very different from Europe's fiscal and lending efforts. The EU and member states' public efforts are huge, and they involve a break with the 3% – budget deficit ceiling, an escalation of debt purchases by the European Central Bank, a political step towards common borrowing aimed at financing the direct damage from the pandemic in hard-hit member states. The effort is said to top 2 trillion euros, a figure that is matched by the Federal Reserve Bank's own efforts in the United States. Unemployment compensation, in particular, has risen to unprecedented levels, in what is an effective countercyclical policy.

By contrast, China's budgetary and lending efforts are far from reaching the same macro-economic scale, and far less significant this time than during the 2008 global financial crisis. There are good reasons for this: local public finances, real estate and shadow banking, and even in the last period consumers, are already heavily leveraged. A frequent estimate is a total indebtedness of 250-300% of GDP. In today's bubble economy with global interest rates hovering around zero and huge monetary creation, China's situation may not seem unique: but it is, because this

³⁷ Dan Wang, “A Charm Offensive For Supply Chains”, Gavekal, June 5, 2020, <https://research.gavekal.com/gavekal-dragonomics>

³⁸ Original data provided in RMB, exchange rate of respective month applied (InforEuro)
In RMB value, exports to France increased by 9,2% YoY, and by 0,9% YoY to Italy.

level of debts is reached with heavy capital controls to prevent outflow, and interest rates that are only tolerable if growth rates outstrip these. **China hasn't made the transition to an open capital account, and would find it difficult to manage its financial system with a current account deficit and a currency anchored on the USD.** Its efforts to restart the economy are therefore unlike the West's: the central budget deficit will only expand from 2,8% to 3,6% of GDP; special infrastructure projects are resuming their growth after a slow year in 2019, adding a further 1,6% of stimulus to GDP; special treasury bonds add another 0,4%; there are small lending rates cuts from historically high levels (between 5 and 6% for real estate, for example). "Helicopter money" – or cash subsidies for the newly unemployed, has been discussed and rejected. SOEs have been prevailed on to keep paying salaries – but that is not the case of other employers, and unemployment compensation remains minimal.

The government's announced plans for most additional expenses target above all technology, innovation, digital industry and energy: they are in line with previous ambitions such as the Industry 2025 plan. China is fiscally and monetarily more conservative than the West in its plans for recovery. It is more focused on industrial transformation than on sustaining ailing industries. It is also far less generous to the unemployed - which also explains the speed with which the Chinese have gone back to work after a complete lockdown. Light industries with small firms producing low-end consumer goods for export are particularly hit in South China. It is also estimated that out of China's huge migrant labor force (said to include as many as 290 million workers in 2019³⁹), some 50 million may have stayed in their places of origin and not returned to places of work. The government now stresses anti-poverty programs – which essentially concerns underdeveloped rural areas.

In sum, **where Europe expects to take years to absorb the financial cost of its countercyclical policies, China is betting on a strong recovery to heal the social wounds, and continuing its state-led technological drive.**

39 "2019 Report of Surveys on Migrant Workers (2019年农民工监测调查报告)", National Bureau of Statistics, April 30, 2020, http://www.stats.gov.cn/tjsj/zxfb/202004/t20200430_1742724.html

THE EU QUEST FOR STRATEGIC AUTONOMY AND THE ISSUE OF DECOUPLING

The issue of *de facto* deglobalization or voluntary decoupling from China is of course seen as a paramount risk by its leadership. Even when Xi Jinping addresses the issue of the World Health Organization, he mentions the preservation of global supply chains as the first prerequisite of "stability". From the United States to Japan, new rules or subsidies are put in place to encourage companies to move away their production from China. There is also an increasing number of restrictions on technology exports being put in place, with semiconductors at the center of US action.

Europe sees a wave of arguments for either diversification of suppliers, or relocation. There is some ambiguity between the two themes, and sometimes between reshoring at home in each member state, within European borders or in Europe's periphery. The scarcity of medical supplies during the Covid-19 pandemic was of course a shock that echoed in public opinion. It has extended to the previously little known fact that active ingredients and generic drugs are mostly made in China, or subsidiarily in India. This has given a boost to the advocates of a national or European industrial policy: it means different things whether one considers France (manufacturing is 10% of GDP) or the United States (11%), Germany (20%) or even the Czech Republic (23%), or of course China (29%)⁴⁰. The economies that have kept a strong manufacturing basis (or which, like the Czech Republic, have not developed a service economy) are more tied to existing value chains, and therefore more careful about promoting changes.

Reshoring, whether in Europe or on a national basis, is an extension of the defensive policies that Europe is putting in place. These are currently expanding, as shown by the anti-dumping levies now decided against Chinese producers based in Egypt's export zones, which receive both Chinese and Egyptian state subsidies: it is the first time that the EU assesses anti-dumping charges in a third country, and it should serve as a warning to the use of Belt & Road projects to swamp European markets. But reshoring also implies a much more complex calculation of the costs and logistics involved.

40 "The Ministry of Commerce Holds Online Press Conference on Responding to the Epidemic and Stabilizing Foreign Investment", The Ministry of Commerce of the People's Republic of China, April 4, 2020, <http://english.mofcom.gov.cn/article/newsrelease/press/202004/20200402953246.shtml>

The former mayor of Chongqing, Huang Qifan, who has overseen both in Shanghai and Chongqing the arrival of multinational corporations (MNCs) and their direct investments, points out some of the difficulties in the implementation of “the political rhetoric of Western countries”⁴¹. China’s clusters of industries with their suppliers, the quality of the infrastructures, the educational level of the manufacturing labor force, the flexibility of industry responses to demand, will remain very hard to match: again, the example of the incredibly fast ramping up of medical supplies during the Covid-19 crisis is a prime example - yet it is what China’s subcontractors have always been able to deliver in other sectors, from digital components to the fashion industry.

The prime argument for reshoring should therefore remain the security of supply rather than a systematic effort to cut China out of global supply chains.

In some cases, both policies may intersect: as Huang Qifan recognizes, very long global supply chains have an increased vulnerability to man-made or natural disasters, from armed conflict to pandemics. A military escalation over the Taiwan issue, for example, would have devastating effects on the global supply chain, hurting both China and its trade partners. The continuing trend in China to shift to industrial self-sufficiency is worrying not only because it means that decoupling may in fact occur at China’s initiative, but also because it could facilitate China’s economic resilience in a protracted conflict.

Neither the security considerations nor the issue of economic opportunity should be ignored. **At a moment when China initiates at the same time violent skirmishes with India in the Himalayas and aggressive maneuvers in the South China Sea and close to Taiwan, the risks from a military conflict cannot be completely ignored by Europeans.** Diversification of sourcing, and a careful look at critical industries and components, are a minimal requirement. This can also serve as a warning to China’s leaders that policies seeking to indigenize China’s industrial production, and failure to grant reciprocal access, do result in decoupling initiatives by China’s partners, and not only by the United States.

But leveraging diversification and decoupling to obtain better reciprocity from China is not the main issue. **China is now working hard to separate Western firms from their governments, by delivering ad hoc gifts to select companies, working to address daily complaints against administrative excesses, and helping foreign companies to resume production quickly after the Covid-19 lockdown.** China’s Ministry of Commerce is in the lead for many of these initiatives since April 2020⁴².

41 “Global Supply Chain amid the COVID-19 Pandemic Shock”, China Finance 40 Forum, May 28, 2020, <http://new.cf40.org.cn/uploads/2020064hqf.pdf>

42 “The Ministry of Commerce Holds Online Press Conference on Responding to the Epidemic and Stabilizing Foreign Investment”, The Ministry of Commerce of the People’s Republic of China, April 4, 2020, <http://english.mofcom.gov.cn/article/newsrelease/press/202004/20200402953246.shtml>

Local officials are instructed to be responsive to requests⁴³. Shanghai is going several steps further, introducing measures to expedite cross-border investment, acquisition of subsidiaries, creating “single stop windows”, streamlining the protection of intellectual property rights, ensuring “fair participation in government procurement”⁴⁴. In addition, Hainan is set to become a high level free trade port by 2050, with measures aiming to encourage foreign investments⁴⁵. The released document also outlines the plan to formulate a “negative list” for trade in services by the end of this year, creating a possible competition for Hong Kong.

This would seem to be a dream program for any negotiation with the EU on a basis of reciprocity. It is not, for two reasons: these are unilateral, local and easily rescindable decisions. And they are taken in the context of new risks of FDI moving away from China, either because of the US-China trade conflict, or as a result of the pandemic. China in fact fears more the first than the second - it sees itself as better placed regarding the pandemic than Western economies. More structural and legal concessions would in fact come only if the situation of China’s economy, and particularly its exports and incoming FDI, deteriorate more. In political terms, the leverage that the US will eventually have over its own firms and critical foreign suppliers matters more than European responses. The first are offensive, the second are for the time being only defensive. For example, the US Commerce Department’s decision to prevent TSMC, the Taiwanese chipmaker, from supplying Huawei with its components matters in terms of relative strength. In the other direction, the decisions by several countries – France in 2018, Sweden in 2020 – to let Chinese companies buy some semiconductor firms - does not strengthen the EU’s negotiating hand.

In the long term, **policies to diversify critical supply chains away from China make sense, as would reshoring in Europe for some manufacturing. But they are unachievable in the short term, except in select cases with clear priorities, and with an acceptance of the costs involved, whether in diversification or reshoring.** Long supply chains are a security or environmental issue, not an economic one: it costs far more to ship containers across the Mediterranean than from Chinese to many European ports. The sectoral and societal choices made by EU countries matter as much as the relative advantage of other producers in deciding this.

43 A list of provincial and city initiatives towards foreign firms is found at “Promote the return to work and production! Local industrial and information systems in action (推进复工复产! 各地工信系统在行动)”, March 20, 2020, https://mp.weixin.qq.com/s/DvISvrYP8PeOZttrsDYj_A

44 “Notice of Shanghai Municipal People’s Government on Issuing Several Measures of This Municipality to Implement the Recommendations of the State Council on Further Improving the Use of Foreign Investment”, Shanghai Municipal People’s Government, April 13, 2020, <http://www.shanghai.gov.cn/shanghai/n46669/n46675/n48049/n48051/u26ai64688.html>

45 “60 Measures in Hainan’s Planned Free Trade Port Policy”, Caixin, June 2, 2020, <https://www.caixinglobal.com/2020-06-02/60-policies-about-hainans-planned-free-trade-port-101561993.html>

VII

THE EU-CHINA BALANCE SHEET

“It was the best of times, it was the worst of times” (Charles Dickens): a judgement in two parts is the only way to evaluate the European Union’s achievements over China issues in 2020.

There has been a degree of continuity, thoroughness and acceleration on a wide range of responses to the challenges that China raises. The near unanimous approval of the March 2019 Strategic Outlook on China has indeed been a milestone. **Since China attaches great importance to the declarative policies of its partners, it is no surprise that it seeks to overturn the conclusions of this communication.** In the past, from one summit to another and through successive China policy papers, EU statements had greatly wavered, either as a result of China’s persistent diplomacy or simply because institutional memory from one Commission to another was weak.

It is precisely persistence, together with leverage, that is the yardstick by which China judges its partners. The EU is now acquiring defensive leverage with a host of new policies - which happen to be compatible with WTO rules: for example, China’s legal challenge of the decision to deny market economy status (MES) (in practice, to include China in a category where special anti-dumping methods apply) has now stopped.

The success in setting up hands-on defensive policies applies to those policies over which the EU has control with respect to China. One could always wish that some of these - such as investment screening or 5G security guidelines - be more binding for member states, but the guiding rather than mandatory approach is in part a function of the treaties, in part a prerequisite from many member states. This cannot be resolved by the Commission. The outgoing Commission had set deadlines for completion of these new rules or guidelines, and they are mostly met - on 5G, for instance, responses from member states are due by June 30, and implementation of investment screening looks set to start in October 2020. Contrary to popular - or populist - opinion, EU staff is a scarce resource. The Commission itself employs 32,000 people⁴⁶, while the city of Paris employs 51,000. Both on the question of EU competences and human resources, it is the member states which have the answers to many inadequacies of function or performance.

⁴⁶ “EU administration - staff, languages and location”, European Union, https://europa.eu/european-union/about-eu/figures/administration_en

These achievements are not matched by the negotiating stance and tactics of the EU. Ultimately, this was due to a lack of strategic clarity on several issues. One is whether China’s leadership can separate economics from politics on two fronts: that of a systemic reform of China’s political economy - while it is governed by a Party-state led again by a strongman; and that of a readiness to make concessions to Europe, an important economic partner but a weak political power. The strategy is further confused by misunderstandings with the United States, to China’s delight. **Both sides of the Atlantic should realize that if divided, they have very little chances to obtain more than transactional and fleeting results from China. That is even more true of Europe, whose negative leverage, if now on the increase, hardly matches what the current US administration has now put in practice.**

Repeatedly, China frustrates European engagement. That was the case for the 2018 EU-China summit, when China refused even a joint declaration on climate which had been long in preparation, and which would have signified a degree of multilateral convergence and a criticism of the US: precisely, China gave priority to its direct relation with Washington. It is happening again with the deferral of the September Leipzig “leaders’ meeting” that would have taken place two months before the US presidential election. **At this point, Beijing hits the pause button and prefers to watch what the result will be, keeping its powder dry rather than granting any concession to Europe that it might need to match or extend later with the United States.**

It is likely a depressing view for Europeans to realize that by themselves, they have no power to influence China’s political agenda and many policies, including in relation with Europe. The EU, and the member states which have a large economic footprint in China, would wish a return to engagement and its positive fruits - sparking a new round of deep and liberalizing reforms in China, reversing the tide in Beijing towards a controlled developmental and technology state. Time is lost in endless cycles of negotiating rounds: it would often be more accurate to describe these as talks spelling out diverging views, without resolution.

Instead, prioritizing unity - including a common language among the EU’s presidency, commissioners and delegates abroad - and seeking convergences with China’s other partners - remain the more sensible course on the external front. Inside Europe, the pursuit of a defensive agenda is the only answer to the combination of rigidity and advances in China’s rise. It is exactly this course of action that has been the basis of a “frank and intense” virtual summit of June 22 with China’s leaders. To its credit, the EU presidency has cleared the ambiguity and indecision of the previous year in dealing directly with China. Europe’s economic weight in China’s calculations should be very large. That it isn’t so was due to the European reluctance to use it as leverage.

POLICY CONCLUSIONS

China just hit the pause button with Europe, postponing a meeting with the EU and 27 member states that Mrs. Merkel was planning for September 2020, without a new date. Instead, China will likely watch the result of the November US election. Why grant to Europe concessions that would need to be matched to or extended with the United States?

The EU's leaders have woken up to this reality, and above all to the fact that relations with the People's Republic of China are a constant test of strength. Beyond satisfaction at transatlantic division, rallying Europe is not a primary Chinese concern. It is they, not us, who see the world through the lens of a systemic struggle between democracies on the wane and the power of a self-correcting party-state. There is no such thing as a democratic ally. Instead, China's leaders will exploit the eventual chaos inside the democratic camp to obtain compliance with a long list of interests and goals.

Europe expects to take years to absorb the financial cost of countering the great pandemic recession. Instead, China is betting on a strong recovery to heal the social damage. All it needs is open markets that will help to finance its state-led technological drive. And that is what is currently happening. Digital and medical exports boost China's trade recovery, while China absorbs much less imports from the rest of the world. Decoupling is not an invention of the West, it is China's long-term plan for its development, moving towards national technologies and capital. Certainly, Beijing is also aware of the risk of investment flight from China. It speaks directly to foreign companies, with sweetheart deals and a sudden attention to their complaints. But for all the talk, investment from the European Union into China actually increased last year.

Who can blame Chinese leaders for thinking the relationship with Europe is fine as it is? It is now up to Europeans to make their own interests and values China-proof. Should convergence and cooperation from Beijing come back on some issues, it would be welcome. But Europe should not rely on this hope. The "frank and intense" talk by Europeans at the June 22 virtual EU-China summit is a new start.

Accepting this sober reality leads to the following policy recommendations:

► **Abandon your illusions.**

If there was one headline recommendation to make for European policy-makers, it would be: abandon your illusions. The days of engagement, of China's gradual acceptance of a number of systemic changes belong to a time when China was

coming from behind, economically weak and in conflict avoidance mode. It is strong today, in part because the Party-state mobilizes available resources to its own ends. Systemic rivalry is how the CCP sees the world under Xi Jinping. China's foreign policy is conducted on a basis of relative strength and with calculated risks increasingly being taken. Europe may think it is far away, but in an actual conflict, Europe is vulnerable because we depend on global integration, supply chains and rules.

► **Ready for China's undelivered promises in the short term.**

In the short term, Europeans should be ready to face the absence of results in their entreaties to China. Climate and environmental issues or current medical and vaccine concerns should bring us together in an ideal world. They do not. China still conducts a carbon-based energy policy with "clean" coal as the key. It does not want any prying into its own system's failures in facing the pandemic: the limit of its cooperation is China's own borders. Our other objectives for cooperation - multilateralism, denuclearization, cybersecurity - remain entirely unfulfilled with the exception of support for the 2015 Iran nuclear deal. China's preference for a long-term declaratory horizon is based, once more, on gaining time and avoiding legally binding commitments. "No change" is the preferred option in Beijing.

► **Diversify strategic supplies, assess the priorities and costs of reshoring at home**

In the long term, policies to diversify critical supply chains away from China make sense for Europe, as does reshoring for some manufacturing. But it costs far more to ship containers across the Mediterranean than from Chinese ports to European shores. Ensuring the security of critical supplies and technology has a cost – think, for example, of the price of drugs for health systems. We can perhaps bear the expense in this critical sector. But extending the scope of reshoring requires either large productivity gains, or a reduction in labor costs, or protectionism at the expense of our standard of living.

► **Europe gains no traction with China if it speaks with a weak voice.**

When China takes new risks, Europe's mixed language and balanced statements simply fail to make the grade, and are very often misread, voluntarily or involuntarily, by China's leaders. Their cynicism about values usually makes them disregard this portion of any statement, or to treat it as a lack of respect. The language of cooperation is easily twisted to fulfill compliance with China's goals and ideology.

► Move whenever possible towards binding rules for member states.

Investment screening, a halt to predatory take-overs, an EU instrument to sanction state subsidies to non-EU companies or using third country bases for dumping, a unified approach to telecom and digital network security are all commendable. Europeans should accept that these policies must become more binding towards member states. Europe is only as strong as its weakest link, given our goals of integrating even more deeply the continent. Similarly, these ambitious defensive moves require more resources and staff : as is the case with innovation or industrial policies, there is a need for coordinated resources at the European level.

► Turn to democracies without aiming for identical views.

Europe needs to stop focusing on trying to convince China, and turn much more to democracies instead. In a world that is shaken by resurgent nationalism, by internal challenges to the democratic process, it is important for Europeans to choose the least aversive partners, without aiming for identical views. Pure and perfect multilateralism does not work if one is its only practitioner. In the end, rising above those differences makes more sense than trying to cooperate with an authoritarian giant.

A league of democracies is an idealist concept, given the differences in interests and values within their range. Our most natural partners – the United States, Japan and other East Asian states, India, the Latin American nations, and many African states, are far from sharing the entire compact of European values, which have provided an unprecedented safety net to almost all individuals. Yet claiming equidistance between them and China or other autocracies only serves to fragment and accelerate the crisis of democracy, and to help the advocates of authoritarianism. Calling out China is useful. An imperfect, incomplete or contested democracy is still safer in terms of commitments and international law than a system which subordinates policy to one party rule, and respect for international law to its own interests of the moment.

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THERE IS NO DESIRE MORE NATURAL THAN THE DESIRE FOR KNOWLEDGE

Europe's Pushback on China

EU-China relations are in 2020 almost as much a test of the EU's resilience as is its economic response to the coronavirus pandemic. Facing the failure so far of talks aiming at policy changes from China, the European Union has just used a direct virtual meeting with Xi Jinping and Prime minister Li Keqiang on June 22 to point out their many divergences. This "frank and intense" talk by Europeans is a new start.

The EU's leaders have realized how much relations with China are a constant test of strength. China's first stop in any important negotiation is Washington. This applies to strategic and economic issues. But even on global governance - maintaining multilateralism, reforming WTO or WHO, countering climate change, there has been no practical convergence between China and Europe.

Europeans have a huge stake in a more balanced relationship. Failing this, they need to make their own interests and values China-proof. Signs of convergence and cooperation from Beijing would be welcome. But Europe should work on its strength regardless of China's moves. From these observations, this policy paper moves on to six recommendations.

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