The EU's concept of de-risking hovers around economic diversification rather than national security

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06 December 2023

Introduction

The EU has long been a convinced supporter of open markets and the global trading system, so it seems hard to believe that it introduced the concept of de-risking from China even before the US administration did. To better understand how we got here, there is a need to contextualise the situation of the EU and its relations with China.

The EU saw China's entry into the WTO as an opportunity to enlarge the global trading system while continuing to liberalise trade and investment. It was one of the tools within the more general Western engagement policy with China. On the economic front, engagement included companies in China but the scope was smaller than originally expected. Foreign direct investment in manufacturing was welcome only in those sectors that China decided to open and, in most cases, in exchange for technological transfer. Many sectors, especially in services, remained closed and state-owned enterprises were not privatised or subsidies eliminated. In essence, China never became a market economy and continued to use industrial policy to move up the ladder, while accumulating large trade surpluses, through repressed consumption and limiting market access to foreign competition.

This situation did not get any better since President Xi came to power in 2013. On the contrary, Chinese companies acquired enough size to compete abroad, helped by large acquisitions overseas but without yet opening their own market. The result of an increasingly unfavourable situation, from the EU perspective, led to a Copernican turn in its position towards China in March 2019. While recognising that cooperation was needed in certain areas- especially climate - competition but also systemic rivalry were introduced as key traits of EU-China relations.

Since 2019, two major shocks have led to the worsening of EU-China relations. The first was COVID-19, with China perceived as uncooperative, but also the realisation of the enormous dependence that Europe had developed on China for critically necessary products during a pandemic. The second was Russia's invasion of Ukraine and China's support for Russia, against the EU's interests, which came as a surprise to many.

Both the pandemic and the invasion of Ukraine brought Europe to the full realisation of the need to develop strategic autonomy and economic security, which included reducing critical dependencies on China, especially when economic and national security are at stake. The EU's second awakening on strategic dependences, namely on Russian gas, only accelerated the EU's search for a policy solution to such a situation. Still, by doing so, a new critical dependence – and again on China – became crystal clear, namely the sheer share of renewables imported into the EU from China.

Key issues

Pinpointing the exact launch date of 'de-risking from China' as a conceptual framework is tricky as it evolved gradually, fuelled by multiple factors over time. Many argue that China started its path to de-risking before the West did as a way to reduce dependencies from the West, mostly on the technological side. In fact, the concepts of self-reliance but also that of dual circulation are sometimes considered euphemisms for de-risking.

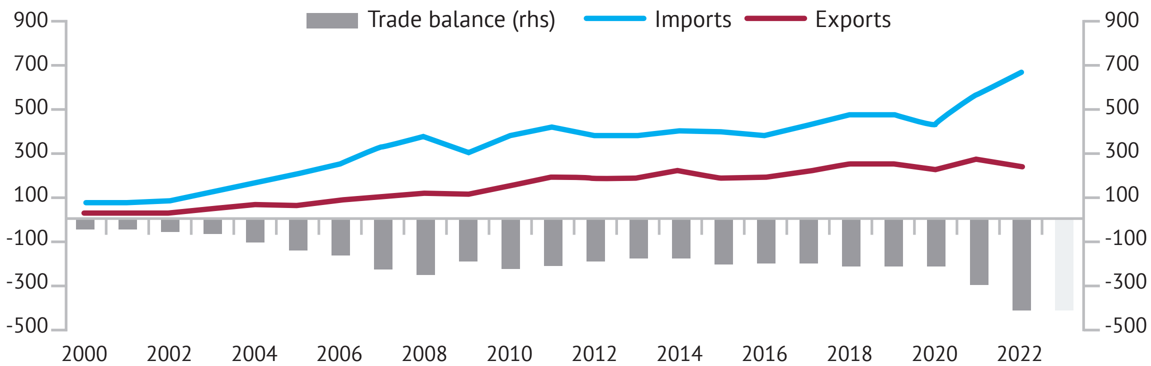
From the Western side, the Trump-led trade war against China brought to light the concept of de-coupling, especially on the technological front, but it proved to be unachievable, and certainly undesirable, because of the massive interdependences of the American and Chinese economies. The so-called Phase I deal signed right before the COVID-19 pandemic, was meant to be the first phase of normalisation of US-China relations, based on the premise that China would redress the large bilateral trade surplus with the US. The COVID-19 pandemic amplified supply chain disruptions, highlighting risks associated with concentrated production in China, which also meant that, contrary to what many analysts thought at the time, the Biden administration, which came to power in 2021, continued to limit the US dependences on China by keeping the import tariffs imposed by Trump but also adding more constraints to tech transfer, in particular of export controls on high-end semiconductor components, a tightening of inbound investment screening and many others.

This relentless push from the US to control its dependence on China was accompanied by an increasingly difficult situation in the EU as regards China. Since COVID-19, the EU has started to move to import much larger amounts of goods from China without the country reciprocating, which has led to a large trade deficit. By the end of 2023, the EU's trade deficit with China had reached €400 billion. This process paved the way for the EU's Commission President von der Leyen's first public speech in March 2023, before her official trip to China, in which she introduced the concept of de-risking, while making it very clear that it is different from decoupling.[1] This marked a significant turning point, bringing the concept into mainstream discourse. In subsequent months, major economies like the US and Japan quickly adopted the 'de-risking' language, reflecting a broader shift in strategy towards mitigating dependence on China while maintaining a certain level of engagement.

It is important to note that von der Leyen's concept of de-risking was never intended to be a synonym for decoupling. She explicitly argued against doing so. Her definition of de-risking, which has now entered the European Commission's toolbox for economic security, is linked to diversifying from excessive dependence on goods/components that are considered strategic. The idea of national security is clearly much less present in the European concept of de-risking than in the US one, introduced by Jack Sullivan announced in his speech at Brookings in April 2023.[2] One of the key issues hovering around national security is the risk of an invasion, or a military conflict, in Taiwan, which is pushed much more by the US concept of de-risking than in the European one.

More specifically, the EU's approach to de-risking, has been operationalised by a number of targets to reduce critical dependences and vulnerabilities in new legislation, such as the Critical Raw Material Act and the Net-Zero Industry Act, which set out targets to improve access to critical raw materials and to manufacture a minimum stock of clean teach. Yet, China's dominance in key strategic sectors and products is so overwhelming that such targets will be very hard to achieve. In fact, despite all the buzz, Europe's dependence on China has grown rather than decreased. The dependency on rare earths is 98%, antibiotics 79% and 90% of our solar panels come from China.[3]

EU TRADE BALANCE WITH CHINA (USDbn)

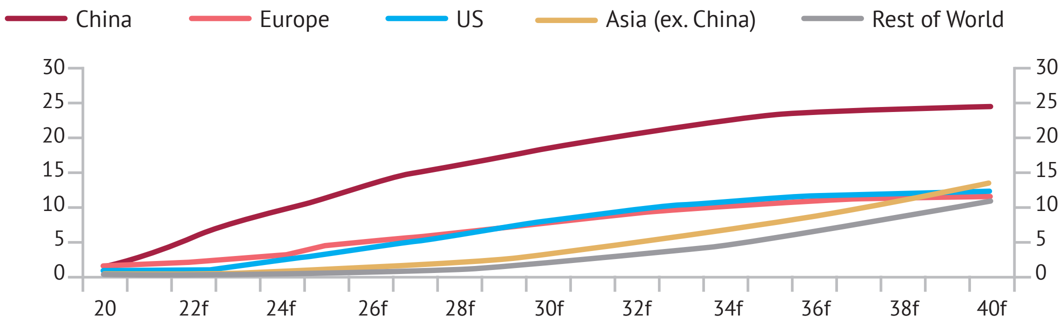


Note: 2023 trade balance based on linear projection of the first 7 months. Source: Natixis, Comtrade

Main challenges and opportunities

The question to ask ourselves is why de-risking is not happening if the risks of excessive dependence have been clearly identified. The answer boils down to private/individual interests versus social interests. Companies have an interest in continuing to source from China and/or have access to the Chinese economy, the world's second-largest market. Many companies continue to localise their production in China and to transfer technology for the sake of the market, downplaying the risk of an abrupt decoupling related to a national security shock (whether a military conflict in the Taiwan Strait or any other). Beyond abrupt decoupling, other risks relate to China's ability to leverage strategic dependences by retaliating. Since China introduced the 'Export Control Law' in 2020, it has passed legislation to impose export restrictions on products containing key technologies or key raw materials. China has already demonstrated this power by introducing export controls on gallium and germanium, which are essential materials for the production of green tech, as a response to the trilateral agreement between the US, Japan and the Netherlands to introduce export bans on high-end semiconductors. The fact that the US has enough reserves of gallium and germanium while the EU does not, show how difficult the situation is for the EU when implementing de-risking measures. On the social cost of excessive dependence on China (as exemplified during the pandemic), we cannot forget that the reliance on China's green tech for our decarbonisation is reducing the costs of this endeavour, as solar panels or electric vehicles imported from China are cheaper.

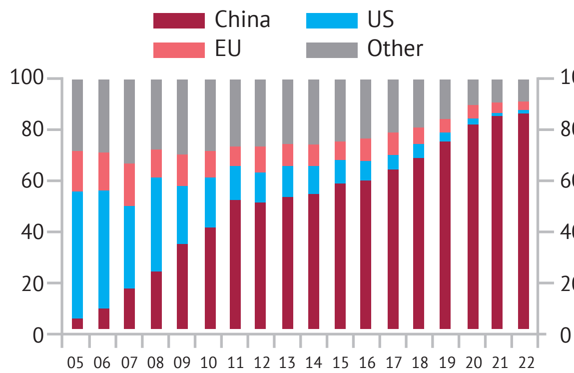
GLOBAL ELECTRIC VEHICLE SALES BY REGION (MILLION UNITS)



N.B. Included both BEV and PHEV. Source: Natixis, MarkLines, BNEF

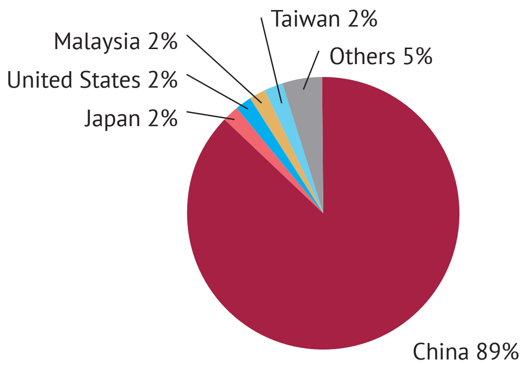
In other words, even at the aggregate level – and forgetting for a moment companies' interest, there is a trade-off between costs and security. How societies decide between the two might not be straight forward, making it hard to move fast on the de-risking strategy. This is even more complicated if we consider that security, in the EU context, is mostly a national prerogative. EU member states have different relations from China, with some having benefitted more than others. The case of Hungary's outright refusal of the EU de-risking strategy contrasts with Lithuania having suffered direct retaliation from China and having to rely on the EU for protection.[4]

SHARE IN SOLAR PANELS ALL COMPONENTS MANUFACTURING (%)



Source: Natixis, BNEF

EXTRA-EU IMPORTS OF SOLAR PANELS, 2021 (%)

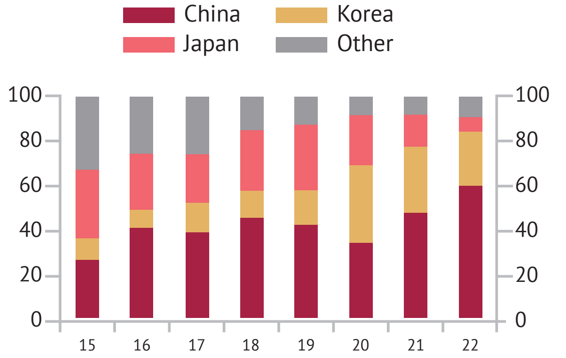


Source: Natixis, Eurostat (Comext DS-645593)

In order to align corporate and social interests, but also reach a consensus among different positions by member states, there should be fewer sticks and more carrots. In other words, while important, defensive measures cannot be the only ones on which the EU can rely. Offensive measures are needed, which act as carrots. The most obvious one is the possibility to bringing back business to European companies for sectors dominated by China.

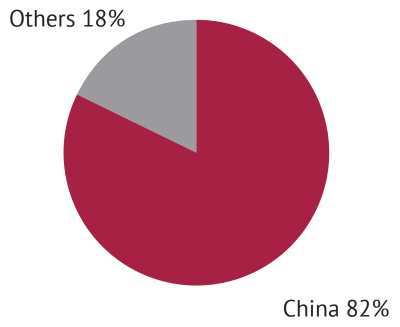
The problem with this idea is that we could end on the slippery road of reshoring and massive subsidisation of European production of green tech or any other product with critical dependences on China. This solution is neither efficient (EU costs are too high in many cases) nor feasible (since China still has chokepoints, we cannot avoid such as the control of critical raw materials).

MARKET SHARE OF LITHIUM-ION BATTERY FOR ELECTRIC VEHICLES BY COUNTRY (%)



N.B. Included top 10 players for each year.
Source: Natixis, SNE Research

EXTRA-EU IMPORTS OF LITHIUM ION BATTERIES, 2021 (%)



Source: Eurostat

The solution must come from a combination of reshoring to build some critical stocks but, most importantly, forging partnerships with other countries with lower costs and economies of scale to create complementary ecosystems to the now China-centric supply chain of a large number of goods, including green tech. Building a supplementary value chain should not be read as an action directed to contain China but rather to increase diversification of supply to avoid potential chokepoints and other risks related to relying on a single point of entry to critical goods. The opportunity, though, lies in the fact that so many other economies are in the same situation as the EU, including the US but also many emerging economies, whose energy transition depends on China. This means that coordinated action should be possible, making the costs of de-risking smaller. So far, the US reaction has been of providing the incentives to reshore production into the US but penalising Chinese entities trying to benefit from such subsidies. This solution is too costly for the rest of the world, in term of the side of subsidies needed, and possibly also for the US down the road. A green tech partnership where more countries are involved for the provision and refining of critical materials, but also manufacturing, seems much more sustainable over time. This proposal is explored further in a policy brief by Alicia García Herrero, Heather Grabbe, and Axel Källenius written in 2023.[5]

Recommendations and conclusions

The European Commission should continue with its goal of de-risking from the Chinese economy, understood as reducing its critical dependences but also ensuring economic security. This means increasing the diversification of sourcing whenever possible and working for a solution whenever not immediately possible. It also implies having contingency plans in the event of a major geopolitical event, whether in the Taiwan Strait or elsewhere.Still, the EU's de-risking approach, as opposed to the US one, needs to focus on diversification and enhancing the resilience of the EU's supply chain. This cannot be obtained by reshoring production only, for a number of reasons. Firstly, the costs are huge; secondly, China has created many chokepoints in the supply chain which the EU, alone, cannot mitigate. For this reason, relying on a network of incentive-aligned partners is the solution going forward. It goes without saying that creating such a partnership is easier said than done and will require leadership.

This is all the more so since an alliance of developed countries will not be enough to shape an effective and resilient partnership. Emerging and developing countries with enough critical raw materials but also the economies of scale to produce green tech will be needed. Beyond green tech, the model of creating a partnership with incentive-aligned countries which have different comparative advantages can be applied to other cases of excessive reliance on a single country. Pandemic-related protective gear and pharmaceuticals are another good example. The hardest risk to find protection from is surely the geopolitical one, especially in the case of a potential conflict in the Taiwan Strait but, even in this case, a partnership which agrees to pool stocks of semiconductors and other critical goods whose supply could be affected could be envisaged. A country-level solution, even an EU-level solution, will always be less efficient and more costly than one in a larger partnership.

1 European Commission (2023), "Speech by President von der Leyen at the European Parliament plenary on the conclusions of the European Council Meeting of 23-24 March 2023", Brussels.

2 The White House (2023), "Remarks by National Security Advisor Jake Sullivan on renewing American economic leadership at the Brookings Institution".

3 European Commission (2021), "Updating the 2020 Industrial Strategy: towards a stronger Single Market for Europe's recovery", Brussels.

4 Garcia Herrero, Alicia, (2023), "China-EU roller-coaster relations: Where do we stand and what to do? U.S.-China Economic And Security Review Commission", [US Congress hearing on "Europe, the United States, and Relations with China: Convergence or Divergence?].

5 García-Herrero, Alicia., Heather Grabbe and Axel Kaellenius, (2023), "De-risking and Decarbonising: A green tech partnership to reduce reliance on China", Bruegel.