Testimony before the US-China Economic and Security Review Commission Hearing on "Europe, the United States, and Relations with China: Convergence or Divergence?"
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1. The Deterioration of EU-China Relations in Three Phases

Europe's relationship with China has been worsening for more than half a decade, mirroring the decline in relations between Washington and Beijing. This deterioration can be broken down into three phases.

In the first phase, from roughly 2015-2018, European concerns about China revolved primarily around issues of economic competitiveness and market access. European companies began complaining about rising state intervention in the Chinese economy under President Xi Jinping, including preferential treatment for state-owned enterprises (SOE) and an insistence that Communist Party cadres play a more important role in corporate affairs. The launch of the Made in China 2025 initiative, which identified a set of industries in which China sought to become a dominant global player, was seen as a threat to established European manufacturers. And acquisitions of European firms by Chinese competitors multiplied, stoking concerns about the transfer of key technologies and a loss of control over critical infrastructure. The 2016 acquisition of German robotics maker Kuka was an important inflection point in the European debate, triggering a push at the national and European level to put in place tighter investment screening rules.

In a second phase, between 2019 and 2021, European concerns about China began to extend beyond economic issues to encompass a broader set of worries tied to human rights, disinformation, strategic dependencies and coercion. In March 2019, the European Union published a strategy document that described China as a partner, economic competitor and systemic rival and set out a roadmap for developing a set of defensive EU instruments aimed primarily, if not explicitly, at China. This represented a significant shift in Europe's language and policy approach to Beijing.[1] China's crackdown in Hong Kong, its repression of Uyghurs in Xinjiang and its handling of the COVID-19 outbreak, including the spread of disinformation about the origins of the virus and the exploitation of mask supplies for political ends, all contributed to a sharp deterioration of China's image in Europe starting in 2020. By the end of that year, over 70 percent of surveyed respondents in Germany, France, the United Kingdom, Italy and the Netherlands had negative views of China.[2] This was exacerbated in 2021 by China's sanctioning of European lawmakers, academics and think thanks in response to targeted EU human rights sanctions tied to Xinjiang, and an economic

[1] EU-China: A Strategic Outlook, European Commission and HR/VP contribution to the European Council, 12 March 2019, https://commission.europa.eu/system/files/2019-03/communication-eu-china-a-strategic-outlook.pdf

[2] Laura Silver, Christine Huang and Laura Clancy, Pew Research Center, 29 June 2022 https://www.pewresearch.org/global/2022/06/29/negative-views-of-china-tied-to-critical-views-of-its-policies-on-human-rights/

coercion campaign against Lithuania following the Baltic country's embrace of closer ties with Taiwan. The sanctions stand-off has relegated the EU-China Comprehensive Agreement on Investment (CAI), a deal clinched at former German Chancellor Angela Merkel's urging in the weeks before the Biden administration took office, to the deep freeze.[3]

Europe entered a third phase following Russia's invasion of Ukraine in February 2022. The "no limits" partnership sealed between Xi Jinping and Vladimir Putin in the weeks before the war began and China's subsequent refusal to condemn Russia's aggression, has cemented the view of China in parts of Europe as a geopolitical threat. Importantly, it has also increased awareness, both in governments and corporate boardrooms, of the risks of a conflict over Taiwan. This has triggered an intense debate in major capitals about reducing economic dependencies on China. While a far-reaching economic decoupling is seen as both undesirable and unrealistic, diversification and resilience have become the new buzzwords in Europe.

In a reflection of the new mood, European Commission President Ursula von der Leyen gave the first major speech on China by a leading European political figure on March 30, 2023, arguing for a "de-risking" of the EU's relationship with China through a reduction of supply chain dependencies, protection of critical infrastructure and new measures to restrict transfers of sensitive technologies that could end up bolstering China's military.[4] The "de-risking" concept has since been embraced by members of the Biden administration as well as the G7 at its recent summit in Hiroshima, Japan.[5][6] But it remains to be seen how far big European countries like Germany and France are prepared to go in setting red lines on their economic and technological relationships with China.

2. Differences across the European Union

The hardening of the EU's line masks differences between the 27 EU member states, and in some cases, within individual governments. On the more hawkish end of the spectrum are a group of eastern European countries led by Lithuania who promote a values-driven foreign policy and whose views of China have been badly damaged by Beijing's refusal to condemn Russia's war of aggression in Ukraine. In 2021, Lithuania pulled out of what was then known as the "17+1" grouping, a decade-old forum designed to foster closer economic ties between eastern European countries (both within and outside the EU) and China. Its Baltic neighbors, Estonia and Latvia, left the grouping a year later, and it is now in tatters.

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[3] EU and China reach agreement in principle on investment, European Commission, 30 December 2020 https://ec.europa.eu/commission/presscorner/detail/en/ip_20_2541

[4] Speech by European Commission President Ursula von der Leyen to the Mercator Institute for China Studies and the European Policy Centre, 30 March 2023 https://ec.europa.eu/commission/presscorner/detail/en/speech_23_2063

[5] Remarks by National Security Advisor Jake Sullivan on Renewing American Economic Leadership at the Brookings Institution, 27 April 2023 https://www.whitehouse.gov/briefing-room/speeches-remarks/2023/04/27/remarks-by-national-security-advisor-jake-sullivan-on-renewing-american-economic-leadership-at-the-brookings-institution/

[6] G7 Hiroshima Leaders Communique, 20 May 2023 https://www.whitehouse.gov/briefing-room/statements-releases/2023/05/20/g7-hiroshima-leaders-communique/

At the dovish extreme is Hungary, whose approach to China under long-serving Prime Minister Viktor Orban has been driven by economic opportunism and a readiness to use the relationship with Beijing as leverage in its fraught ties with EU institutions in Brussels. Orban has continued to welcome Chinese investments in Hungary, but crucially has not stood in the way of tougher measures against China at EU level, including the Xinjiang sanctions announced in 2021. This reflects a broader trend in Europe in which many member states are happy to support tougher policies at EU level but are reluctant to adopt forward-leaning policies at national level, partly due to fears of Chinese retaliation.

The largest EU states, from Germany and France, to the Netherlands and Italy, fall somewhere in between Lithuania and Hungary on the China policy spectrum. Still, there are important differences in how each of these states view the relationship with China. France, for example, stands out for its full-throated support of European strategic autonomy – code for an independent Europe that is not overly reliant on China or the United States. The messages sent by French President Emmanuel Macron during his trip to Beijing in April 2023 underscored a desire to put some distance between Paris and Washington at a time of escalating tensions between the US and China. In private, officials from other European capitals have been highly critical of Macron's remarks – notably his implicit criticisms of the United States at a time when Washington is providing substantial support for the war effort in Ukraine and his suggestion that Taiwan is not a matter of core interest for Europe. But it would be wrong to assume that Macron's messages did not reflect a broader anxiety that exists in many European countries about being forced into zero-sum choices by both the US and China. In contrast to France, the Netherlands has leaned more closely toward Washington, as its recent agreement with the United States and Japan to restrict exports of semiconductor manufacturing equipment to China demonstrated. Under its new Prime Minister Giorgia Meloni, Italy also appears to be adopting a tougher approach, signaling in recent months that it could withdraw from a Belt and Road memorandum signed in 2019 by a previous coalition government.

Under President Ursula von der Leyen, the European Commission in Brussels has also played an important role in driving European policy on China. Von der Leyen's "de-risking" speech in March has helped frame the China debate in Europe for the coming year around economic security challenges – including export control policy and outbound investment screening. But in order to deliver on her vision, and to build a transatlantic consensus around how to define de-risking from China, she will need to convince influential capitals like Berlin and Paris to play ball.

3. The special role of Germany

Germany, as Europe's largest economy and the country with by far the closest economic relationship with China, is the most important player in Europe on China policy. The domestic debate over relations with China has intensified in recent years and is now at the center of the German foreign policy discussion. The Angela Merkel era, characterized by a deepening of political engagement with Beijing and a sharp increase in trade and investment ties, ended with setbacks for the former chancellor on issues like 5G and the CAI. The new German government, led by Olaf Scholz, came into office in December 2021 promising a tougher approach to China. Foreign Minister Annalena Baerbock and Economy Minister Robert Habeck, both members of the Green party, junior coalition partners to Scholz's Social Democrats, have pushed for a fundamental rethink of Merkel-era policies and pressed for a reduction of German dependencies on China. Still, tougher rhetoric from some corners of the German government can obscure a reluctance to rock the boat in others.

In 2022, shortly before his first visit to Beijing, Scholz overruled half a dozen of his own ministers to approve a bid by Chinese shipping group COSCO for a stake in a terminal in Germany's largest port of Hamburg. His Chancellery has held up publication of a government China strategy, concerned that it could constrain its room for maneuver with Beijing. Germany's economic challenges – including an abrupt end to decades of cheap Russian energy and a risk that German companies could shift investments to the US to benefit from green technology subsidies under the US Inflation Reduction Act – have bred caution in Scholz's dealings with Beijing. An intense lobbying effort by large German companies that are heavily dependent on the Chinese market has also influenced Berlin's stance.

As we have seen on Ukraine, Germany is capable of major shifts in policy in times of acute crisis. Scholz broke three foreign policy taboos in the days after Russia's invasion, agreeing to send weapons to Ukraine, significantly increase defense spending, and wean Germany off Russian oil and gas. Barring a similarly acute crisis with China – a conflict in the Taiwan Strait or direct Chinese support for Russia's military campaign in Ukraine – Germany is unlikely to take steps in the near-term that would fundamentally call its relations with Beijing into question. Still, the economic narrative that has fueled close ties between Berlin and Beijing in the first decades of the 21st century is increasingly being eroded by conditions in China and competition from Chinese firms in core German industries.

This is especially true for the auto industry. Germany companies like Volkswagen, BMW and Mercedes-Benz have make between a third and half of their profits in the Chinese market. All three have long-running joint venture partners in China and a range of research and development partnerships in the country. Two Chinese companies—Geely and BAIC—have a combined stake in Mercedes-Benz of nearly 20 percent. And Chinese producers of electric-vehicle batteries are becoming deeply integrated into the supply chains of all three German carmakers. Support for the interests of the German carmakers is baked into Germany's political system. And yet, shifting dynamics in the industry—notably the emergence of Chinese carmakers as formidable competitors in the electric-vehicle space—suggest that the "win-win" cooperation of past decades between Germany and China in the automobile sector may have run its course. The well documented struggles of Volkswagen in China, for example, are a harbinger of more difficult times ahead for German carmakers in their favorite market. This, in turn, is likely to have a major impact on the broader German debate over China policy.

4. EU Trade and Investment with China

China is the EU's top trading partner in terms of goods trade, accounting for 9.0 percent of EU exports and 20.8 percent of imports in 2022. The relationship is characterized by growing imbalances and by significant variations among EU member states. The EU as a whole registered a trade deficit of 366 billion euros with China in 2022, up from 250 billion euros in 2021, and double the deficit of 182 billion registered in 2020. This increase is not out of line with growing trade deficits that other advanced economies have recorded with China in recent years. But it points to a rising asymmetry in trade relations, with Europe highly open to Chinese goods and China far more closed.

In 2022, Ireland was the only EU country to register a trade surplus with China, while the Netherlands had the biggest trade deficit. There are large variations among central and eastern European countries, with some trading very little with China (Croatia, Romania, Lithuania, Latvia) and others (Czech Republic, Poland) recording substantial trade flows as well as sharply rising deficits. Germany recorded its largest ever trade deficit with China in 2022, driven in part by shifting dynamics in the automobile sector, as imports of electric vehicles from China rose sharply and exports of traditional combustion engine cars from Germany stalled. The EU as a whole is highly dependent on China for a range of inputs, most notably in the green technology space, from rare earth metals, to lithium-ion batteries, photovoltaic panels and wind turbines. These dependencies have remained steady or increased in recent years. China, aware of the importance of the green transition within the European policy agenda, has warned in conversations with EU officials in recent months that it could limit exports of these critical inputs should Europe move in tandem with the US and other allies in placing additional controls on technology exports to China.

European Union foreign direct investment (FDI) in China has remained resilient in recent years, coming in at 8-9 billion euros each of the past four years, according to figures from Rhodium Group. EU investment in China is increasingly driven by greenfield projects (rather than acquisitions) and has come to be dominated by German firms, which according to Rhodium made up 84 percent of total EU FDI in China in 2022, and over 50 percent in four of the prior five years. Rhodium research shows that EU investments are increasingly concentrated in a small number of firms, with the top 10 European (EU+UK) investors in China accounting for an average of nearly 80 percent of European FDI in the 2018-2021 period, compared to 49 percent over the prior decade (2008-2017).[7] European investments in China have also become more concentrated on sectoral basis, dominated by automotive, chemicals, food processing, pharma/biotech, and consumer products manufacturing. Among them, the auto sector stands out, representing about a third of all European direct investment in China in recent years, and an even higher proportion in 2022.

Another trend in European investment in China is a noticeable lack of new entrants into the market over the past years, a phenomenon which was likely exacerbated by the COVID-19 pandemic and strict lockdowns in China through the end of 2022. The absence of new players has contributed to the greater concentration of European FDI around a few established players. These big players have maintained a steady flow of investment into China despite growing challenges in the Chinese market and geopolitical headwinds. This has been driven by several considerations, based on our conversations with these firms. First, these companies continue to make good profits in China despite the more challenging environment. Second, many feel they must continue to invest and develop products in China in order to safeguard the value of past investments and remain competitive globally with increasingly innovative domestic rivals. Some are also trying to insulate their China operations from rising global risks through greater localization – an "in China for China" approach that is being actively encouraged by Chinese authorities. This localization drive is happening in tandem with a greater push for diversification, with firms looking to rebalance their global footprints with more investment in Southeast Asia, India, Eastern Europe and the United States, among other markets. This rebalancing process accelerated during the pandemic and has been given

[7] Agatha Kratz, Noah Barkin and Lauren Dudley, "The Chosen Few: A Fresh Look at European FDI in China", Rhodium Group, 14 September 2022 https://rhg.com/research/the-chosen-few/

further impetus by growing concerns over Taiwan. But barring an acute geopolitical crisis, it is likely to be a gradual process that unfolds over many years.

5. Transatlantic Cooperation on China

Nearly 2-1/2 years into the Biden administration, the language used in the United States and Europe to define the challenges posed by China is closer than it has been at any time in the past half-decade, with European capitals and Washington converging around a "de-risking" framing and rejecting the idea of full-blown decoupling. The US and EU have created a series of structured dialogues on China-related challenges, under the Trade and Technology Council (TTC) and US-EU Dialogue on China. And China features increasingly in discussions within NATO and the G7. The war in Ukraine has pushed the US and Europe closer together and focused minds on the risks of a conflict in the Taiwan Strait. There is a growing consensus on the need to reduce dependencies on China, diversify to other markets, and improve supply chain resilience.

At the same time, a persistent divide exists over how to define and address national security risks emanating from China, particularly in the economic and technological spheres. Europeans are concerned about what they see as growing US protectionism, and the risks of a race to the bottom on subsidies as governments on both sides of the Atlantic scramble to provide support to semiconductor and green technology industries. The endgame in Ukraine poses risks to transatlantic unity. And mixed signals from the EU on China – such as those sent by French President Emmanuel Macron on his recent trip to Beijing – risk deepening criticism of Europe in the US. At the same time, the politically charged nature of the US debate on China, is a concern for the Europeans. There is no appetite in European capitals for the isolation or economic containment of China. And there is growing anxiety about escalating tensions over Taiwan.

Looking further out, there is concern in Europe that future US administrations could de-prioritize the transatlantic relationship. At a time when Europe is grappling with Russia's invasion of Ukraine and the economic fallout from the war, concerns about Washington's long-term commitment to Europe have led to hedging in some European capitals on China policy amid concerns about opening too many geopolitical and economic fronts at once. Still, support for a close transatlantic relationship is robust across much of Europe. And in many capitals, there is a strong desire to reach a policy consensus with Washington on how to respond to China. By resolving irritants in the transatlantic trade relationship, engaging and consulting with key European capitals, and broadening the discussion with Europe to include other G7 countries like Canada, Japan and the UK, the risks of divergence can be minimized. Ultimately, convincing allies in Europe and elsewhere to fundamentally rethink their economic ties to China will depend, in part, on Washington's willingness to offer them alternatives, including greater access to the US market.

6. Recommendations

Below are a number of guiding principles and recommendations for US engagement with Europe on China policy. They are based on the view that China represents a multi-faceted long-term challenge that the US cannot tackle alone. Washington's competitive advantage in this strategic competition is its allies.

- **Engage, consult, listen.** The US should adopt a multi-faceted approach to engagement with Europe on China, focusing on the European Commission and the big member states, while supporting a common European line. This should include briefing and consulting with European allies ahead of key policy decisions, for example on measures related to export control policy or outbound investment screening. The EU and US have created a number of transatlantic coordination mechanisms in recent years, including the Trade and Technology Council. These forums can be slow moving and require a large commitment of diplomatic resources. But it is vital to keep them on track, even if they will need to evolve over time to tackle new challenges. The TTC, for example, will require bipartisan support to survive in future US administrations, and greater involvement from Congress can help make this happen.

- **Creating a transatlantic market.** The wheels of European de-risking from China can be greased by offering European firms an alternative in the form of greater access to the US market. Although there is little support in Washington for traditional free trade deals these days, the administration and Congress should be thinking actively about how they can selectively reduce barriers to trade and investment with close allies, particularly in Europe and Asia. The green technology sector is an obvious place to start, although protectionist elements of the Inflation Reduction Act will make this challenging.

- **Reshape the strategic autonomy narrative.** China and Russia's deepening partnership presents a formidable challenge for the United States and Europe, creating what increasingly looks like a joined-up Eurasian theater. Against this backdrop, it is in the interests of the US that Europe takes on a bigger security role, in its neighborhood and beyond. Encouraging this should be a top priority for the US administration and Congress. But it should not be framed as a zero-sum endeavor. The US should remain committed to the European theater, while encouraging more European engagement in the Indo-Pacific.

- **Curb your enthusiasm.** Overt public pressure on Europe to move on China-related policy issues can backfire, increasing resistance from certain member states, undermining those in Europe who are sympathetic to the US policy approach, and playing into Chinese narratives of Europe as a US vassal. The US should be active, persistent, and assertive in making its policy arguments behind the scenes, relying on fact-based diplomacy rather than ideology. Building consensus steadily over time is likely to yield greater dividends than a confrontational public posture.

- **Look beyond the daily noise.** The European Union can be a confusing cacophony on China policy, with officials from all 27 member states and EU institutions sending conflicting signals. Remember that Europe is not a monolith. Intense debates on China policy are taking place within and between European governments and EU institutions, just as they are in Washington. The US government and Congress should take a long-term view and avoid over-reacting to individual European politicians or daily news developments. Don't assume, because of stray remarks, that European capitals have made up their minds on critical issues related to China.