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China "De-risking"

A Long Way from Political Statements to Corporate Action

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Major Western leaders have been calling for "de-risking" from China, rather than "decoupling." But what exactly de-risking means and how it differs from decoupling, remains unclear. It is ultimately firms, not governments, driving trade and investment relations. But firms cannot account for unidentified risks by themselves. National security risks are for governments to define. Complex supply chain externalities might entail risks to production that are also difficult for firms to account for. Furthermore, firms may bet that governments will rescue them if a worst-case scenario happens, effectively socializing risks. In the EU, Germany is particularly exposed to China risk in terms of security, macroeconomic, and political exposure.

- **It is for policy-makers to decide which security risks, production risks, and political risks are so geopolitically relevant that firms need to act on them. Public policy measures require both a precise definition of the risks and appropriate policy measures tailored to them.**

- **Political appeals without concrete policy measures will have little effect. To become operational, we suggest focusing policy action on clearly identifiable security risks and developing data-driven approaches to identify broader macroeconomic risks.**

- **We propose forming a European Economic Security Committee consisting of both member state representatives who bring classified intelligence and relevant Commissioners tasked with defining strategy.**

INTRODUCTION

Germany, the EU, and the G7 countries are deeply economically intertwined with China. Exports and imports are substantial, investments occur in both directions, and there is also substantial technological interdependence. After a period of somewhat weaker dynamics during the Covid pandemic, economic relations have picked up again. This does not come as a surprise — consumers and firms chose these exchanges for their own benefit. But firms also worry about their exposure to China. At the same time, security and geopolitical risks are increasingly identified in political discourses as a major factor to consider in any relationship with China. Major leaders (Ursula von der Leyen, Olaf Scholz, Jake Sullivan, Janet Yellen) have called for "de-risking" from China, while warning against "decoupling."

We aim to clarify how policy-makers can go from a loose term like "de-risking" to an actual policy. The key issue is that it is not governments that drive the relevant economic exchanges but firms and consumers. While these actors can consider some risks, a public policy problem arises beyond individual risks. This is a particularly important issue for Germany with its larger than average economic integration with China.

Firms can internalize some risks and therefore factor them into their trade and investment decisions. These include the risk that the Chinese government will force full access to data localized in China; the risk of regulatory action that can hit the bottom line (such as in the case of Micron); the risk that profits generated in China cannot be repatriated due to capital controls; or the reputational risk from buying goods produced with forced labor. Firms can in principle account for all these risks.

The public policy problem arises if corporate decisions have security, wider macroeconomic, or political economy ramifications. On questions of hard security, the public sector clearly needs to be in the driver's seat. For example, a decision on whether to let Chinese telecommunication equipment be part of critical ICT infrastructure cannot be a private sector decision as private firms cannot internalize broader security risks. The risk arising from the export of a machine for chip production to China's military capabilities is also not for firms to judge. More broadly, a loss of technological leadership affects not only firms, but also raises wider security questions. Even a loss of the West's regulatory power to set standards has wider societal and therefore public policy ramifications.[1]

Complex supply chains are a clear example of a risk that has wider macroeconomic ramifications. Although the disruption of a specific firm's trade with China due to a geopolitical shock might be manageable, the missing goods might constitute critical input to a long and complex supply chain, causing bigger macroeconomic losses. Firms cannot be expected to fully factor in the supply chain effects of their decisions. The public sector therefore has a role to play in shaping market structures to avoid major macroeconomic disruptions. The question is how big that role should be. Data-driven models can help detect critical vulnerabilities and shape policies to address them.[2]

Finally, the political economy problem is even more substantial and a lot more difficult to manage with public policy. Risks might not be to a macroeconomic scale, but firms might have sufficient political influence to lobby for bail-out funds to compensate for privately assumed risks. They may even ask governments to change their foreign policy position on China to continue pursuing private profits. Conversely, firms might become trapped in geopolitical confrontation even in the absence of a direct EU-China confrontation. For example, the United States might force EU firms to reduce their China activity or even become "China-free." The distinction between decoupling and de-risking becomes even more difficult when considering the latter political economy approach.

MAPPING CHINA EXPOSURE: GERMANY STANDS OUT

China remains one of the EU's most important trade and investment partners. In 2022, China was the third largest destination for EU exports of goods (9.0 percent), preceded only by the United States (19.8 percent) and the United Kingdom (12.8 percent). Chi-

1 See for example Tim Rühlig, "The Geopolitics of Technical Standardization," DGAP Memo, German Council on Foreign Relations (May 2023): https://dgap.org/en/research/publications/geopolitics-technical-standardization (accessed May 31, 2023).

2 For example, Roman Arjona, William Connell Garcia, and Cristina Herghelegiu identify 204 products where production is highly concentrated in a single country. Roman Arjona, William Connell Garcia, and Cristina Herghelegiu, "The EU's Strategic Dependencies Unveiled," VOXEU Columns, Centre for Economic Policy Research (May 2023): https://cepr.org/voxeu/columns/eus-strategic-dependencies-unveiled (accessed May 31, 2023).

na was the largest partner for the EU in terms of imports (20.8 percent), followed by the United States (11.9 percent) and the United Kingdom (11.9 percent).[3] Trade in goods between the European Union and China picked up speed again after the relatively flat years of the Covid-19 pandemic. China's investments in Europe (European Union and United Kingdom) bounced back in 2021, reaching 10.6 billion euros. This amounts to a 33 percent year-on-year increase and also marks a reversal of the trend of declining Chinese investments since 2017.[4] After two years of declining European Foreign Direct Investment (FDI) in China during the height of the pandemic, European investment also saw a trend reversal.[5]

AMONG EU COUNTRIES, GERMANY IS PARTICULARLY EXPOSED TO ALL THREE CHINA RISKS: SECURITY, MACROECONOMIC, POLITICAL ECONOMY

Among EU member states, Germany proves to be particularly exposed to China due to relatively far-reaching linkages. China is the fourth most important recipient of German exports (7 percent or 105 billion euros) right behind the United States, France, and the Netherlands. Furthermore, with approximately 190 billion euros, China is Germany's most important origin of imports (12 percent of all imports).[6] In 2022, the good trade balance between China and Germany was unprecedently negative – with Germany running a trade deficit of around 85 billion euros, after a trade deficit of 38 billion in 2021.[7] These numbers stand out among European peers.

In 2022, Chinese companies invested a total of around 2.5 billion euros in Germany. Compared with the record low in 2020, China's investment thus recovered slightly. The capital stock of Chinese FDI in Germany up to and including 2022 has grown to around 54 billion euros.[8] German companies, on the other hand, invested a record-level of 11.5 billion euros in China in 2022.[9] At the end of 2021, German FDI stocks in China accumulated to 103 billion euros.[10]

Germany should develop a China strategy that is deeply intertwined with that of the EU

While these macroeconomic numbers are more substantial than for other EU countries, they as such do not tell a story of excessive exposure. In fact, the standard trade models come to costs of 0.5 to 1.5 percent of GDP.[11] These costs are big and dwarf those of Brexit. But they are still relatively small compared to the costs of the Covid pandemic or the risks resulting from banking crises. These models, however, capture neither the dynamic costs of adjustment nor

3 Eurostat, "China-EU – International Trade in Goods Statistics" (February 2023): https://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics (accessed May 23, 2023).

4 Max J. Zenglein and Gregor Sebastian, "Chinese Foreign Direct Investment in Europe: The Downward Trend Continues," United Nations Industrial Development Organization (December 2022): https://iap.unido.org/articles/chinese-foreign-direct-investment-europe-downward-trend-continues (accessed May 31, 2023).

5 As the Chinese Ministry of Commerce's data shows, a year-to-year rise of 92.2 percent of EU investments in China could be observed (although not providing a concrete value or breakdown of the investments). See Arensde Huld, "Prospects for European Companies in China in 2023," *China Briefing* (January 25, 2023): https://www.china-briefing.com/news/european-investment-in-china-prospects-for-2023/#:~:text=Despite%20the%20decline%20in%20EU,percent%20year%2Don%2Dyear (accessed May 31, 2023); Xinhua News Agency, "The Pace of Foreign Capital Participating in China's high-quality development is accelerating" [in Chinese] (January 19, 2023): http://big5.www.gov.cn/gate/big5/www.gov.cn/shuju/2023-01/19/content_5738101.htm (accessed May 31, 2023).

6 Statistisches Bundesamt, "Die Volksrepublik China ist erneut Deutschlands Wichtigster Handelspartner" (2023): https://www.destatis.de/DE/Themen/Wirtschaft/Aussenhandel/handelspartner-jahr.html (accessed May 31, 2023).

7 Statistisches Bundesamt, 2023

8 René Muschter, "Kapitalfluss, Kapitalbestand, chinesischer Direktinvestitionen in Deutschland bis 2022" (February 2023): https://de.statista.com/statistik/daten/studie/1301465/umfrage/kapitalfluss-und-kapitalbestand-von-chinesischen-direktinvestitionen-in-deutschland/ (accessed May 31, 2023).

9 Jürgen Matthes, "China-Abhängigkeit deutscher Firmen steigt. Rekordinvestitionen in 2021 und 2022," *IW-Kurzbericht* Nr. 24, German Economic Institute (March 2023): https://www.iwkoeln.de/studien/juergen-matthes-rekordinvestitionen-in-2021-und-2022.html (accessed May 31, 2023).

10 Deutsche Bundesbank, "Deutschlands Direkinvestitionsbeziehungen in den Jahren 2021/2022" (April 28, 2023): https://www.bundesbank.de/de/presse/pressenotizen/deutschlands-direktinvestitionsbeziehungen-in-den-jahren-2021-2022-908354 (accessed May 31, 2023). See also Wissenschaftliche Dienste Deutscher Bundestag, "Ausarbeitung: Investitionen aus China in deutsche Unternehmen (WD 5 - 3000 -07/22)" (2022).

11 Clemens Fuest, Lisandra Flach, Florian Dorn, and Lisa Scheckenhofer, "Geopolitische Herausforderungen und ihre Folgen für das deutsche Wirtschaftsmodell," ifo Institute (August 2022): https://www.ifo.de/publikationen/2022/monographie-autorenschaft/geopolitische-herausforderungen (accessed May 31, 2023); Gabriel Felbermayr, Steffen Gans, Hendrik Mahlkow, and Alexander Sandkamp, "Decoupling Europe," Kiel Policy Brief, Kiel Institute for the World Economy (October 2022): https://www.ifw-kiel.de/publications/kiel-policy-brief/2021/decoupling-europe-16271/ (accessed May 31, 2023).

specific risks related to critical inputs. They rather assume that the critical inputs are still being provided. This is part of the reason these models generated such relatively small risks. While in a bilateral decoupling scenario, both imports and exports would fall by over 90 percent, the model only captures the final equilibrium in which substantial adjustments via third countries have occurred. The model also does not capture the effects of investment decoupling, which would certainly be part of a decoupling scenario. In addition, some extremely large cost estimates of a Taiwan decoupling scenario have been produced.[12] This is mainly because Taiwan produces 92 percent of the world's most advanced logic chips (at node sizes of less than 10 nanometers).

In terms of security risks, Chinese telecommunication equipment is widely used in Germany's ICT and energy infrastructure, raising concerns among German policy-makers.[13] A bigger security issue may yet be how China's leadership in the Internet of Things (IoT) will affect the security of Germany's industrial base in manufacturing. The present and future of industrial scale manufacturing in Germany relies on IoT since it provides new levels of efficiency, productivity, and customization. However, there are concerns that Chinese IoT devices and components will be used for cyber-espionage and intellectual property theft. Furthermore, the use of Chinese-made IoT devices and components could also create vulnerabilities in Germany's industrial networks, which could be exploited through cyber-attacks. German companies also risk being blackmailed by China with switch-off threats or IoT device malfunctions if companies act in an "unfriendly" way vis-à-vis China.[14] Overall, security risks regarding China's IoT leadership resemble the security risks around overreliance on Chinese communication technology. Germany is particularly exposed because of its relatively large industrial sector.

LARGE GERMAN FIRMS ARE PARTICULARLY INVOLVED AND POLITICAL ECONOMY RISKS EXIST

Around 5,000 German companies conduct business in China. According to the German Economic Institute, 2.7 percent of Germany's total economic value-added and 2.4 percent of total employment depend on exports to China.[15] China is Germany's largest trading partner for trade in goods (9.5 percent of Germany's trade in goods), but EU neighboring countries are much more important (e.g., the four Visegrád countries in 2021 accounted for almost 40 percent more in trade).[16]

DAX Companies

In 2021, German DAX companies generated 230 billion euros of turnover in China. On average, this means that 16 percent of DAX turnovers were generated in China.[17] Altogether, DAX companies have 700 subsidiaries in China.[18] Based on anecdotal evidence from various DAX companies, the dependence on China becomes more visible – one out of every six Volkswagen employees are based in China; Volkswagen sells around 38 percent of its new cars in China and makes more than one third of its turnover there. Infineon, Germany's largest semiconductor manufacturer, generates 37.8 percent of its turnover in China.[19] Similarly, every fourth euro of revenue for Adidas was generated in China in 2019, although this number has since declined.

12 See for example Jude Blanchette and Gerard DiPippo, "Reunification with Taiwan through Force Would Be a Pyrrhic Victory for China," CSIS (November 2022): https://www.csis.org/analysis/reunification-taiwan-through-force-would-be-pyrrhic-victory-china (accessed May 31, 2023); Charlie Vest, Agatha Kratz, and Reva Goujon, "The Global Economic Disruptions from a Taiwan Conflict," Rhodium Group (December 2022): https://rhg.com/research/taiwan-economic-disruptions/ (accessed May 31, 2023).

13 Louis Westendarp, "How China's Huawei Spooked Germany into Launching a Probe," *Politico* (April 21, 2023): https://www.politico.eu/article/what-trigger-germany-huawei-scare-energy-bundestag/ (accessed May 31, 2023).

14 Jost Wübbeke and Björn Conrad, "Industrie 4.0: Will German Technology Help China Catch Up with West?", *China Monitor* Issue 23, Mercator Institute for China Studies (April 2015): https://merics.org/sites/default/files/2020-05/China_Monitor_No_23_en.pdf (accessed May 31, 2023).

15 Jürgen Matthes, "Gegenseitige Abhängigkeit im Handel zwischen China, der Eu und Deutschland," *IW-Report* 35/2022, German Economic Institute (June 2022): https://www.iwkoeln.de/fileadmin/user_upload/Studien/Report/PDF/2022/IW-Report-2022-Gegenseitige-Abhaengigkeiten.pdf (accessed May 31, 2023).

16 Andreas Baur and Lisandra Flach, "German-Chinese Trade Relations: How Dependent is the German Economy on China?", Econpol Policy Report 38/2022, CESifo (June 2022): https://www.econpol.eu/sites/default/files/2022-06/EconPol-PolicyReport_38.pdf (accessed May 31, 2023).

17 Ulf Sommer, "Das Große China-Risiko – Konzerne könnten Konflikte wie mit Russland kaum Verkraften," *Handelsblatt* (March 21, 2022): https://www.handelsblatt.com/unternehmen/ukraine-krieg-das-grosse-china-risiko-einige-dax-konzerne-koennten-konflikte-wie-mit-russland-kaum-verkraften/28174438.html (accessed May 31, 2023).

18 Ulf Sommer, "Der Riskante China-Boom der DAX Konzerne," *Handelsblatt* (February 18, 2021): https://www.handelsblatt.com/unternehmen/management/wichtiger-absatzmarkt-der-riskante-china-boom-der-dax-konzerne/26928804.html (accessed May 31, 2023).

19 Ulf Sommer, "Das Große China-Risiko"; Martin Greive, Dana Heide, Kevin Knitterscheidt, Moritz Koch, Jens Münchrath, Sven Prange, and Christoph Schlautmann, "Hauptverlierer wird Deutschland sein: So Gefährdet ist das Erfolgsmodell der Deutschen Wirtschaft," *Handelsblatt* (March 18, 2022): https://www.handelsblatt.com/politik/international/weltwirtschaft-hauptverlierer-wird-deutschland-sein-so-gefaehrdet-ist-das-erfolgsmodell-der-deutschen-wirtschaft/28173944.html (accessed May 31, 2023).

While these dependencies built up over years, several DAX companies also deepened their dependence on China with investments in recent years. BASF invested 10 billion euros in Guangdong and announced plans to produce 66 percent of its growth in China. Volkswagen expanded its eMobility-Hub in Anhui.[20] In any case, there is little indication of DAX company plans to reduce their China business.

Conversely, overall Chinese investments in German industry are relatively small. However, China does hold some very strategic investments, which gives it weight in corporate decision-making and on corporate boards. For example, two Chinese companies hold almost 20 percent of the shares in Mercedes-Benz.[21] Furthermore, of the 274 German companies under Chinese ownership, several illustrious names outside the DAX can be found, including the robotics specialist KUKA, the automotive supplier Grammar, the engineering and defense company KraussMaffei Group, and 17 world market leaders (Hidden Champions), such as the forklift company Still.[22] Cosco's entry into a Hamburg port terminal is a further recent investment.

SMEs

In December 2022, the DZ Bank conducted a survey among 1,000 German SME CEOs on supply chain dependencies, particularly in China.[23] Thirty-six percent of SME CEOs declared that their company supply chains are dependent on China. The electronics and chemical industries are particularly dependent, with more than 50 percent of companies declaring dependence on China. However, the survey also observed considerable disagreement about the future importance of China. While some of the SMEs would like to expand their supply links, an equally large number are planning to reduce their dependence on China. It is noteworthy that the large SMEs with annual sales of over 50 million euros are more likely to want to withdraw from China. Thirty-three percent of SMEs want to strengthen their supply chains in Western Europe.

While disagreement on dealing with China is visible, overall agreement on general measures to counter the risk of supply bottlenecks is also clear. Almost two thirds of those surveyed want to expand their supplier network so that they are no longer as severely affected by possible shortages of goods in a particular region. More than half of the SMEs are also planning to expand their storage capacities. This will allow them to compensate for upstream product shortages within their own inventories. This would, for example, prevent a production stoppage coming from a lack of input products, as long as the required input products do not fail to materialize in the longer term. Around one third of the companies surveyed still intend to adapt their production, business activities, or business models and shorten supply routes. This "near-shoring" relies on closer physical distances, and thus prefers procurements on the domestic market or in other EU member states. This result reflects strong SME orientation toward Western Europe already observed in the change in regional dependencies. In addition, almost one in six SMEs are thinking about moving away from "outsourcing." In other words, important activities and services are to remain within the company. It may also mean that production or service activities that were once outsourced are brought back in-house. Still, it will remain an empirical question how much nearshoring will actually be undertaken. Trade models tend to show that nearshoring is a relatively expensive option.

Policy proposals to accelerate the economic Zeitenwende should focus on hard security risks

20 Ulf Sommer, "Das große China-Risiko" (see note 17).

21 Mercedes-Benz Group AG, "Overview of Mercedes-Benz Group AG Shareholders": https://group.mercedes-benz.com/investors/share/shareholder-structure/#:~:text=Overview%20of%20Mercedes%2DBenz%20Group,Group%20AG's%20largest%20individual%20shareholder (accessed May 31, 2023).

22 One percent of German World Market Leaders are Chinese owned, see Die Deutsche Wirtschaft, "Liste der Deutschen Unternehmen in Chinesischem Besitz" (September 2020): https://die-deutsche-wirtschaft.de/deutsche-unternehmen-in-chinesischem-besitz/ (accessed May 31, 2023).

23 DZ Bank, "Sonderumfrage Lieferketten," Research Publikation der DZ Bank AG (December 2022): https://firmenkunden.dzbank.de/content/firmenkunden/de/homepage/research/sonderumfrage-lieferketten.html (accessed May 31, 2023).

A ZEITENWENDE FOR GERMAN FIRMS? THE LONG WAY FROM POLICY ANNOUNCEMENTS TO ACTION

Different types of vulnerabilities require different policies to move firms from awareness to action. Moving from words to policy is needed to incentivize companies to take account of risks. This is particularly true for the political economy problem and the moral hazard that implicit insurance creates. While the German government in theory does not bail out companies that might take losses if relations with China deteriorate, it is much more difficult for the government to do so if the losses materialize, and economic interests and jobs are at stake. This is a classic time inconsistency problem. Based on rational expectations, particularly large companies may perceive themselves as systemically relevant and anticipate the government will change course during crises, for example to protect jobs. This political economy problem implies that firms rationally provide insufficient insurance to cover their exposure to risk.

POLICY IMPLICATIONS

Germany's China strategy must be part of a larger EU strategy for China. Germany does not have a China strategy (yet). Since central instruments of a China strategy, for example trade or technology policies, are under EU competence, Germany will have to develop a China strategy that is deeply intertwined with that of the EU. It needs to shape its own instruments, for example on inbound and outbound FDI screening, tech export control, and tech infrastructure in line with a broader EU strategy. The European Council is scheduled to meet in June to discuss exactly what China "de-risking" means. It is imperative that Germany has a clearly formulated strategy by then.

The Federal Ministry for Economic Affairs and Climate Action (BMWK) drafted China guidelines that were leaked in late 2022. According to the draft, Chinese firms shall be excluded from investments into German critical infrastructure. The draft also recommends that China should not be considered a developing country anymore and that development aid be ended. German firms that are particularly exposed to China shall be forced to regularly report on their activities, and bilateral German-Chinese "projects" shall only be realized in the event of adequate Chinese financing contributions of at least 50 percent. Furthermore, new investment guarantees shall direct German FDI to markets other than China.[24] There are also draft proposals regarding outbound investment screening, primarily targeted at tech sectors critical for military use.

Yet, these documents are leaked ministry drafts and not yet the official position of the German government. Actual policy decisions such as the decision to allow Cosco to buy a part of the port of Hamburg appear to be in contradiction with the BMWK draft's intention. Neither the BMWK guidelines nor the China Strategy drafted by the Federal Foreign Office in consultation with the Chancellery and other ministries have been adopted. Consequently, little in the way of concrete policies have been adopted.

Mere warnings are insufficient to address the problem of China risk due to the complexity of risks, the lack of clarity as to what a risk is, and the political economy/time inconsistency problem. Concrete policy proposals are needed that would accelerate the economic Zeitenwende. The term "De-risking" also needs both a clear definition and clearly defined ways to operationalize it. In an interview from Hiroshima on the sidelines of the G7 leaders meeting, the German chancellor insisted that "de-risking" does not mean decoupling, but rather increasing the number of trade, supply, and investment relations with countries other than China. A world with more partners is more secure, said the Chancellor.

GERMANY SHOULD LEAD EUROPEAN EFFORTS TO DEFINE SECURITY RISKS AND ACT ON THEM

The question is thus how the goal of de-risking could be achieved. When it comes to hard security risks, the government needs to spell those out clearly and apply appropriate policies. For example, export controls of high-tech goods with military and civilian applications appear appropriate. The Dutch government, under pressure from the United States, decided to limit the export of lithography machines, which are needed to produce advanced chips.[25] Such

24 RedaktionsNetzwerk Deutschland, "Bericht: Habeck will die Abhängigkeit der Deutschen Wirtschaft von China Beenden" (December 1, 2022): https://www.rnd.de/politik/robert-habeck-will-wirtschaft-unabhaengiger-von-china-machen-P5VSSAJQ3BMNL64LUBQH3J4NII.html (accessed May 31, 2023).

25 Tweede Kamer, "Announcement of upcoming export control measures for advanced semiconductor manufacturing equipment (22054-384)" [in Dutch]

measures should ideally be coordinated at the EU level to avoid fragmentation of the single market. It would also ensure that critical components of the export-restricted goods, such as Zeiss optics, are equally under export limits.[26] Similarly, authorities need to scrutinize inbound investments into security sensitive industries. It is of limited use to scrutinize a Cosco investment into the port of Hamburg for security implications if a similar investment in Antwerp is not scrutinized or is evaluated differently. In an integrated single market with full freedoms, such hard security assessments ultimately need to be European ones.

We propose forming a European Economic Security Council

To come to a shared risk assessment, we propose a European Economic Security Committee that is tasked with defining security risks and providing a clear roadmap as to how to address them.[27] This committee would also be tasked with defining a strategy on how to deal with existing vulnerabilities in the system. It could include five security representatives appointed by the EU member states together with the relevant European Commissioners to be able to deliberate delicate security concerns in a small circle. The national security representatives would need to have access to the most confidential classified national security information and be allowed to share it in the small circle to overcome the dearth of security knowledge in EU institutions.

ADDRESSING SECURITY RISKS DOES NOT ADDRESS MACROECONOMIC AND POLITICAL EXPOSURE

Addressing these hard security risks does not, however, address the macroeconomic and political exposures that the German chancellor seemed to refer to when calling for more diversification. Indeed, the nature of this risk relates more to strong dependencies that would lead to substantial costs in the event of political confrontations. For such dependencies, a number of alternative policies can be considered:

1. Set targets and limits on supply/investment relations with China

The Commission's proposals in the Critical Raw Materials Act stipulate that no single third-country supplier should have a share of above 65 percent of the EU's total consumption of each strategic raw material. Beyond the missing justification for the precise threshold, it remains unclear how such an administrative approach would incentivize diversification. Would it have to be implemented at a firm level or at a national level and with which instruments? Since firms drive relations, they require precise guidance, not broadly stipulated guidelines.

2. Subsidize domestically

To reduce external dependence, the government could choose to subsidize specific industries, so that they are located within the EU or in Germany. This policy is partly pursued in the chips industry. The policy is certainly expensive, with subsidies going into the double-digit billions for Germany alone. However, the actual success of this policy is hard to determine. Beyond the extensive costs of a global subsidy race, extensive subsidization could slow down innovation because cost pressure is gone. A proper cost-benefit analysis is needed.

3. Subsidize European firms outside of China

This approach would provide subsidies to firms that diversify and move business away from China, irrespective of the location they move their business to and the kind of activity they are pursuing. It would remove any explicit or implicit subsidy for production in China. While this approach also bears subsidy

(March 8, 2023): https://www.tweedekamer.nl/kamerstukken/brieven_regering/detail?id=2023Z04037&did=2023D09406 (accessed May 31, 2023).

26 Tobias Gehrke and Julian Ringhof, "The Power of Control: How the Eu can Shape the New Era of Strategic Export Restrictions," Policy Brief, European Council on Foreign Relations (May 2023): https://ecfr.eu/publication/the-power-of-control-how-the-eu-can-shape-the-new-era-of-strategic-export-restrictions/ (accessed May 31, 2023).

27 For an earlier but somewhat different idea, see Leonard, Pisani-Ferry, Ribakova, Shapiro, and Wolff, "Redefining Europe's economic sovereignty," Bruegel Policy Contribution (June 2019): https://www.bruegel.org/policy-brief/redefining-europes-economic-sovereignty (accessed June 8, 2023).

costs, it would be cheaper than a national subsidization scheme as firms could choose optimal locations for their production outside China.

4. Tax exposure externalities
This approach foresees a tax on companies operating in China with excessive exposure risks. Compared to the positive incentives in the previously mentioned approaches, this would be a negative incentive to nudge companies to move to other locations. However, several practical questions remain for implementing such a tax regime. It is unclear how to define such a tax and how to apply it. Furthermore, it remains questionable if such a tax is compatible with WTO rules.

5. Render domestic market more attractive
Irrespective of positive or negative incentivization, Europe must make its domestic market more attractive for investments. Such measures could include reducing regulation and pursuing a European Capital Markets Union. This is an aspect that is unfortunately discussed too little in the current China/Zeitenwende/Diversification debate. Instead of solely focusing on market interventions, Europe must not forget to strengthen its own market so that a strong corporate ecosystem develops that can lead on technology and be globally competitive. Still, China will remain an attractive export and investment destination with its 1.4 billion consumers.

CONCLUSIONS

The key takeaway is that simply appealing for diversification is not going to trigger it. Instead, concrete policy levers will have to be used to incentivize firms to act. The basis for any policy lever will have to be a clear identification of the security, the macroeconomic, and the political economy risks. Clear policy levers need to be used to address clearly identified risks.

Policy-makers should first and foremost focus on hard security risks. In this area, it will be crucial that EU countries come to a shared understanding and definition of the security risks, to avoid security measures being undermined by a well-functioning single market. Institutionally, the European Commission should play an increasingly important role in defining which security risks to act on in conjunction with selected representatives of member states through a newly established European Economic Security Committee.

For broader supply chain and macroeconomic risks, we recommend that detailed empirical models be used to establish where production is excessively concentrated in one country. Rather than ad hoc statements, for example on concentrated production of medicine production, a systematic and data-driven approach should be taken. Institutionally, the European Commission appears best equipped to do so. The answer to some of those risks may well be to stockpile key goods and negotiate new trade deals.

Other risks can be considered but one must avoid becoming too broad and should remain evidence based. The broader the risk definition, the more the call for de-risking amounts to a call for decoupling. The debate on China de-risking is only starting and Germany, as the EU's most exposed country, should lead it.

ABOUT THE PROJECT

The project "Action Group Zeitenwende" cultivates the comprehensive yet coherent approach that Germany needs to better define, express, and pursue its own interests as well as the goals and values it shares with its partners. It helps build a Germany that is ready, willing, and able to act.

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