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**Research Report**

## Decoupling Chimerica: Consequences for the European Union

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# IW-Report 44/19

## Decoupling Chimerica

Consequences for the European Union

Sonja Beer, Jürgen Matthes, Christian Rusche

Köln, 19.12.2019

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### JEL-Classification:

E61 - Policy Objectives, Policy Designs and Consistency, Policy Coordination

F02 - International Economic Order and Integration

O24 - Trade Policy, Factor Movement Policy, Foreign Exchange Policy

## Abstract

The People's Republic of China experienced a tremendous economic development within the last four decades. The increased economic power and political weight of China are challenging the USA and EU. Furthermore, the strategies used by China for its own development, e.g. broad-based industry policy with distortive subsidization, forced technology transfer or investment restrictions, are perceived as unfair, especially in the US, but to a large extent also in the EU. This development in combination with the trade imbalances are resulting in the current conflict between China and the US. The term decoupling was introduced to describe the cutting off of economic ties between China and the US as a consequence of the conflict.

Accordingly, we analyze in this article whether a decoupling is going on. We find that China and the US are each other's most important trading partners. Trade data in value added reveals even closer links between both economies through global value chains. This is especially true for ICT and electronics. However, recent monthly data reveals that both the US share in Chinese imports and the Chinese share in the US imports has been decreasing. The trade war has obviously negative consequences on trade between China and the US. At the same time, this data seems to offer some evidence that trade diversion in favor of the EU might be taking place. But trade is not the only field where a decoupling takes place. While there are no patterns yet of a changed behaviour by US investors in the People's Republic of China, there are signs of a changed Chinese investment behaviour concerning FDI. In fact, investments tend to be diverted to Europe. Moreover, there are also small changes of China's share as a holder of US treasuries and its currency reserves.

In reaction to a potentially accelerating decoupling trend, the EU's policy strategy needs to bear in mind that the US and the EU have clear common interests to lessen the impact of China's economic distortions on the world economy. To achieve this aim, the EU is right in striving both for encompassing multilateral reforms, but also trying bilateral avenues with China. However, as the EU's initiatives at the WTO and the ensuing minor progress are still insufficient, the EU should engage much more in coalition building around the proposals of its Concept paper. If China should eventually prove unable to limit the detrimental spillovers of its state capitalism to the world economy, the EU needs to prepare for a further escalation of trade conflicts. In such a scenario, hard choices would have to be made, involving, among other things, a stronger trade and competition policy and less economic dependence on China. Above all, the EU must be united in its policies and on its strategic geopolitical approach.

## 1 Introduction

The Managing Director of the International Monetary Fund (IMF) Kristalina Georgieva expressed hope when she spoke of the possibility of trade peace (Xinhua, 2019). The backdrop was the mid-October announcement of US President Donald Trump that China and the United States had reached a sub-agreement in their ongoing trade conflict, which negatively influenced the world economy (boerse.ard, 2019). On 25 November, however, such an agreement was not signed, and the parties are still negotiating. In addition, President Trump announced new tariffs on Chinese goods as of 15 December (n-tv, 2019). The latest round of the conflict started on 1 August when US President Trump used Twitter to announce additional tariffs on goods and products from China worth 300 billion USD that had not been affected before (Twitter, 2019). His main critique was related to high US trade deficit, high debt held by China, loss of American jobs, etc. Moreover, China was accused of unfair trade practices, weak protection of intellectual property rights, and forced technology transfer. However, there is more to it than that: the rising economic and political power of China seems to be perceived as a threat to US national security and US dominance on the global stage (NYT, 2019a). The current trade war seems rather a struggle for technological and geo-strategic dominance (Mildner et al., 2019). If we are indeed entering a new era of great power competition, the ensuing antagonism could also involve an attempt to reduce interconnections between the worlds' two biggest economies. In fact, in the US there have already been suggestions to decouple Chimerica.

But because of these economic tensions between China and the United States and their impact, the term decoupling is also increasingly used in the media and in science (for example Meidan, 2019; Financial Times, 2018) to describe that scenario where both economies cut off the links between them. This raises the questions of whether this is already happening and what are the consequences for the European Union (EU). It is within this context that this report aims to shed some light on these questions. In Chapter 2, the historic background of the Chinese economic development and the increased geopolitical confrontation with the US is explained and a brief account is provided of the current trade war and the Belt and Road Initiative. Public data is then analyzed to find effects of decoupling on the trade patterns between the two countries in Chapter 3. This includes effects for the European Union from the trade tensions. Chapter 4 analyzes the situation with respect to investments from the point of view of the European Union. Chapter 5 gives policy recommendations on how the EU can react properly to the conflict. In this respect, however, the European Union must also be well prepared.

## 2 Rise of China and Decoupling

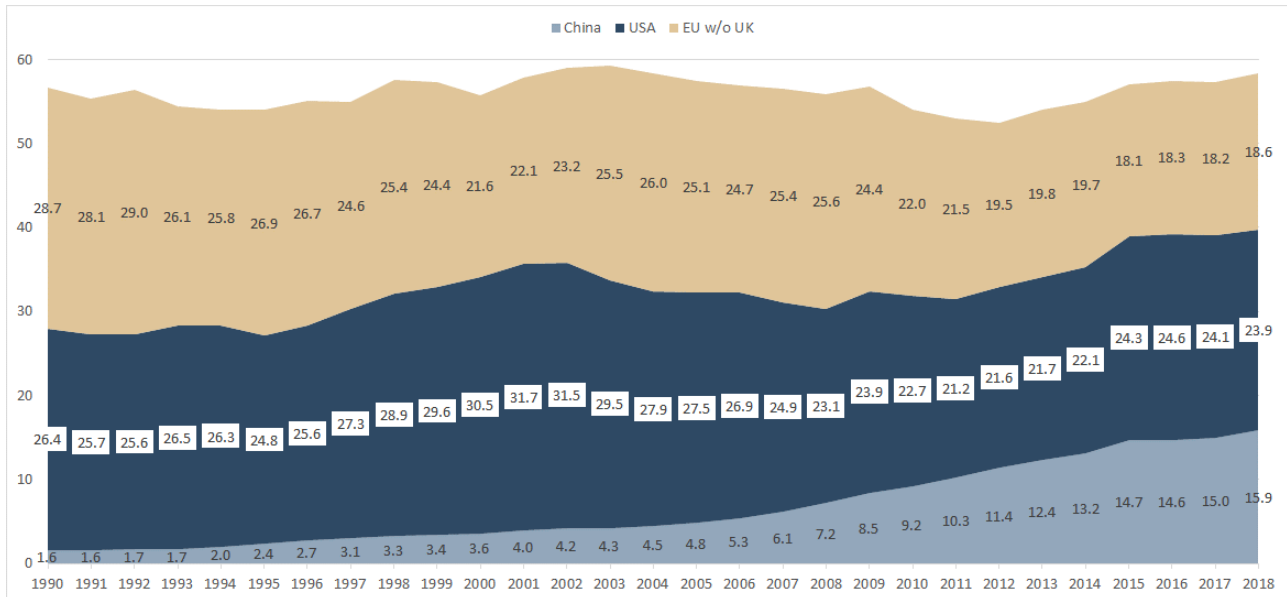
Already in 2012, the President of the People's Republic of China, Xi Jinping, introduced the "Chinese Dream" (Zhong guo mèng; Ohlberg, 2018). In 2017, President Xi confirmed the term and the aims of the dream. The dream is a sequel of the interpretation of the history of China. According to this interpretation, China was humiliated by the west in the 19<sup>th</sup> and early 20<sup>th</sup> centuries. But due to economic developments, enabled by the Communist Party of China, the country was able to become an economic superpower again (Ohlberg, 2018). And, indeed, the economic development of China is amazing from an economist's perspective. According to the World Bank (2017), 850 million Chinese have been able to escape poverty since 1981. The

Chinese currency Yuan (Renminbi) became a reserve currency of the International Monetary Fund (IMF, 2016). The other reserve currencies are the US Dollar (USD), Euro (€), Yen, Pound Sterling, Swiss Franc, Australian Dollar, and Canadian Dollar. Also, the Chinese Gross Domestic Product (GDP) rapidly increased in the last 30 years and, therefore, the People's Republic is an important factor in today's world economy as can be deduced from the share of the Chinese GDP in world GDP (Figure 2-1). While the share was only 1.6 percent in 1990, it continually increased to almost 16 percent in 2018. Note that this share does not include the GDP of Hong Kong or Macao. Figure 2-1 also compares the Chinese GDP share with the share of the United States and the countries now in the European Union (excluding the United Kingdom). The US, EU countries and China have accounted for almost 60 percent of world GDP (in current USD) since 1990. However, the composition changed in the last three decades. While in 1990 the sum of shares of the EU countries was highest with 28.7 percent compared to 26.4 percent for the US, in 2018 the share of the US was highest with 23.9 percent. The share of the EU was only 18.6 percent (21.9 percent with UK). Accordingly, the US was almost able to keep the relative importance it had in 1990, while the EU lost importance. The gain of China, in this respect, was to a large extent at the expense of the European Union. From these contemplations the following must be kept in mind:

- Even without the tensions between China and the United States, the European Union must play an active role in halting the erosion of the importance of the Union in the world economy. Furthermore, in order to be able to halt the erosion, the EU must be careful not to be divided.
- The “Chinese Dream” and the economic comeback, broadly speaking, are under the guiding principles of the Chinese Government. This includes, among other things, the Belt and Road Initiative (Section 2.1), rising Chinese investments worldwide and in the US (Section 4) and the reconfiguration of international basic conditions (Huotari, 2018). The European Union must be aware of this.

**Figure 2-1: Share of China, United States and the European Union without United Kingdom of world GDP since 1990**

Share of GDP in current USD in percent



Source: World Bank, 2019a; own calculations

The rise of China in recent decades also sets the scene for the so-called decoupling. As can be seen in Figure 2-1, China has gained economic ground in the world economy especially since the 2007/2008 economic crisis. Because of the crisis in the US and later in Europe, some authors like British historian Paul M. Kennedy (Kennedy, 2008) already at that time argued that the so-called West is challenged by China and could lose significance. Kreft (2010) argues that the Chinese ascent causes a shift of power to Asia. Furthermore, Kreft mentioned that such shifts in power can lead to confrontation between incumbent and challenger (ibid, 40). Some also claim that China is the source of competition between different political systems (BDI, 2019). The so-called trade war between the US and China is, therefore, only one step in this systemic competition and one answer to the challenges caused by China. Another step could be the decoupling, understood as an economic disengagement between China and the United States (Financial Times, 2018). No other country has had more benefits from an integration into the world economy than China (World Bank, 2017). Accordingly, cutting off ties with China, broadly speaking, could stop or slow down the rise of China. In line with the “Chinese Dream” and the reconquering of the economic position China is supposed to have according to the Communists Party, China will react to any action taken to stop or slow down its development.

As mentioned above, the European Union has to find answers to the rise of China and the effects caused by it, even without a decoupling, for example investments in Italy (NZZ, 2019) or building new dialogue formats with EU member states besides the EU (for example the 17+1; DW, 2019). But if decoupling were to happen, the pressure on the EU would be even greater. Because it seems unlikely that Europe would not be affected if the two largest economies were in an economic conflict. In light of this, the next chapter looks at the effects the so-called trade war between China and the US already had on trade. A brief account is provided of the Belt and Road

Initiative and of the escalation of the trade conflict, which is also an important aspect in the geopolitical context.

## 2.1 The Belt and Road Initiative (BRI)

Whereas the US seeks to reduce its dependence on China, China is deepening its trade relations and connections with other trading partners. The best example for this development is the so-called Belt and Road Initiative (BRI), a project inspired by an ancient trade route. It is also referred to as the “One Belt, one Road” (OBOR). The initiative includes many projects and it is not easy to define its exact scope. Many of the BRI branded projects already started before 2013 but gained momentum under the initiative.

Figure 2-2 shows the mapping of existing (or planned) railroad, pipeline and port projects (there is no official map of the initiative). The figure shows the large size of the project. To date, more than seventy countries have signed on to projects or promised to do so, representing about two thirds of the world’s population. Being probably the world’s largest economic project, this new corridor accounts for almost 40 percent of global merchandise exports according to the estimations of the World Bank (World Bank, 2019b).

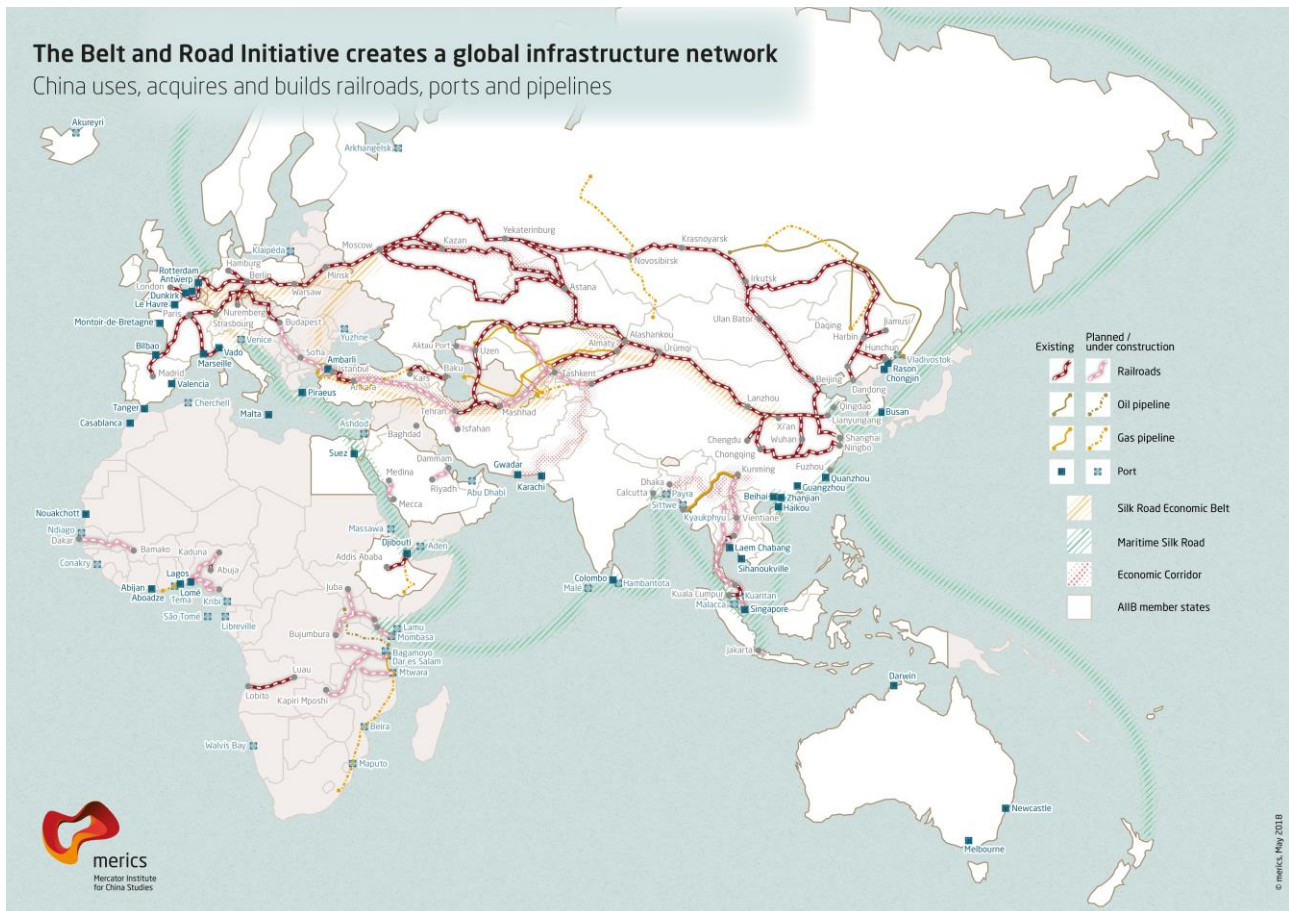
The Silk Road Economic Belt aims at building economic corridors and connecting China, Central Asia, Russia and Europe, while the Maritime Silk Road intends to build and connect key seaports linking China’s coast with the Persian Gulf, the Mediterranean Sea, but also connecting China with Southeast Asia, South Asia and the Indian Ocean. The Silk Road consists of six terrestrial economic corridors that go from China through South and Southeast Asia, the Middle East and across Eurasia to Europe. The initiative, however, goes beyond mere infrastructure projects as it includes financial cooperation, collaboration in science and technology, tourism, cultural and academic exchanges, etc. In addition, China plans to expand trade relations with its partners through trade agreements, build special economic zones and offer an alternative growth model to developing countries. In order to finance this massive project, various Chinese banks are involved such as China Export-Import Bank and China Development Bank, but also banks in which other countries have shares such as Asian Infrastructure Investment Bank, New Development Bank, Silk Road Fund, etc. (GTAI, 2018). According to the Mercator Institute for China Studies (2019), China had already invested more than 70 billion USD in various infrastructure projects in the past five years.

According to China’s official position, the BRI is an initiative financed by the Chinese government focused on investment and infrastructure development in order to connect countries along the road and to increase their cooperation, prosperity and mutual understanding. The Chinese President Xi Jinping announced the initiative in the fall of 2013 and according to the Chinese government, the initiative aims to promote economic cooperation and prosperity, strengthen exchanges and mutual learning between different European, Asian and African countries, and promote world peace and development. Moreover, the initiative is for the benefit of all and in the interest of all (The State Council, 2015).



## Figure 2-2: The Belt and Road Initiative

Mapping of the participating countries



Source: Mercator Institute for China Studies

Many countries along the route, in particular developing countries, do indeed lack good infrastructure and trade routes, so they initially met the Chinese initiative with optimism. However, anxiety and skepticism about the initiative have become more widespread recently, especially in South Asia (The Economic Times, 2019). There have been many challenges and risks associated with the initiative so far. China has been accused of a debt-trap diplomacy by deliberately extending excessive loans to other countries in order to increase its influence in those countries. Whether these developing countries will be able to repay their debts is a major concern. The projects are costly, but not all of them seem to be profitable. In the case of Sri Lanka, which failed to honor its debt obligations, it became clear that the consequences of such policies can be problematic. Sri Lanka had to cede its strategically important Hambantota port to China on a 99-year lease. Surrendering ownership of important real estate in the case of failure to repay a loan is an important part of most loan agreements with Chinese banks. Apart from fiscal sustainability issues, other critiques of the initiative are mostly related to the low transparency of the projects, procurement issues, excessively high share of Chinese firms involved in projects, inattention to corruption, environmental risks etc. (Foreign Affairs, 2018). It is also often criticized that this project is more about increasing China’s economic and geopolitical influence and reaching out for new markets for overcapacities at home rather than “for the benefit of all and in the interest of all” (The State Council, 2015).

The US view on the initiative was broadly optimistic at the outset (especially during the Obama administration). However, in recent years criticism has prevailed. The focus of the debate shifted to emphasizing a variety of concerns related to the initiative such as the economic viability of the projects, creating a powerful Eurasian market, reducing the importance of the US Dollar, increasing China's geopolitical and economic power, extending its military presence or even changing the world order (Chance, 2016). This development may pose a threat to US leadership on the global stage and could undermine US supremacy. Moreover, it is feared that China intends to spread its state-driven system, authoritarianism and its unfair trade practices, and that the Chinese government could aim to undermine Western standards and development norms. The Asian Infrastructure Investment Bank is also seen more and more as a threat to the US – and established international financial institutions, such as the World Bank and the Asian Development Bank, which are dominated by Western countries. The fact that the US administration changed the rhetoric and started to openly criticize the initiative (SCMP, 2019a) additionally increases existing tensions between the two rivals. Whether the Belt and Road Initiative will lead to trade diversion for the US and will indeed increase Chinese influence in the global arena remains to be seen. However, this initiative is strategic for China and it has become an important factor contributing to the rising tensions in the China-US relationship.

When it comes to the EU, the picture is less clear. The EU seems to be split between those countries that officially support the initiative (Hungary, Greece and most recent Italy) and those that are more critical of it (France and Germany). Many countries in the EU are becoming more skeptical about it due to the way the projects are being carried out. The concern is that transparency, labor and environmental standards, procurement and debt trap diplomacy may not be in line with European standards and its open market policies. The European Commission sees China now as a systemic rival and might also be concerned about Chinese geopolitical aspirations and the spreading of their state-based economic system. See Section 5 for the policy recommendations.

## 2.2 Trade war

Despite the latest efforts to diffuse the trade war and the announcement of US President Trump that a preliminary agreement had been reached, bilateral trade relations between the USA and China are still very tense. Although making an interim partial deal is certainly a move in the right direction, it remains to be seen whether a comprehensive agreement will be made. Nevertheless, even a trade agreement would not solve the existing geo-strategic conflict. The US and China have been in a trade war for more than a year - both the tariff spiral and accusations of currency manipulation were on the agenda. The decision of the People's Bank of China to allow the yuan to devalue to the lowest level since the Great Recession even sparked risks of a full-blown currency war. This depreciation was broadly in line with market developments, but it came right after a new round of US tariffs was announced in early August (see Section 3.1). As a result, the US administration officially declared China a currency manipulator (NYT, 2019b).

The relationship between the two largest economies was already under severe pressure when the US escalated the trade conflict and imposed 10 percent punitive tariffs on USD 200 billion

(€170.2 billion) of goods imports from China in September 2018. This came as a reaction to China's retaliation against the US's initial action which involved the introduction of punitive tariffs of 25 percent on imports from China worth 50 billion USD in two steps in spring and summer 2018 (for a timeline see Bown and Kolb, 2019) – which is argued to be a reaction to China's strategies of forced technology transfer. The US-China trade war escalated further earlier in spring 2019, when the US increased punitive tariff rates on the USD 200 billion import tranche from 10 to 25 percent. China's response was prompt: starting in June 2019 a further 60 billion USD worth of US goods now incur tariffs of up to 25 percent (automotive manufacturing, technology and agriculture industries are predicted to suffer the most). In early August 2019, the US president announced additional punitive tariffs of 10 percent on the remaining 300 or so billion USD of US imports from China to be introduced in two steps in September (later postponed to mid-October and mid-December). Due to an envisaged partial agreement on a trade deal announced in October, the first step of the tariff increase has been delayed for now.

Although economists disagree about who ultimately bears the costs of the existing trade war (Zoller-Rydzek and Felbermayr, 2018, Amiti et al., 2019), the current escalation increases uncertainty and weighs on both America's and China's economic prospects (and that of the rest of the world). The US-China conflict has already had negative consequences for global trade and global growth (IMF, 2019). The Chinese government has been put under pressure to counteract the current growth slowdown and negative consequences of the trade war (Jovicic, 2019). If the relationship between the two countries deteriorates even more, the trade and technology war could lead to a new cold war. Moreover, the current trade war could be the starting point for a wider decoupling and change in the strategic relationship between the two countries.

Another important aspect of the decoupling strategy extends to important Chinese technology companies which US President Donald Trump is increasingly targeting with restrictions, including Huawei, Hikvision and ZTE. In particular, US firms are banned from doing business with these companies without government consent. Recently, new companies were added to the blacklist in reference to US reactions to human rights issues in China. This has further intensified the trade (and technology) conflict.

## 3 Trade

### 3.1 Exports and imports

Since China's reform and its opening-up in 1978 and also after its accession to the WTO in 2001, US-China trade relations have thrived. As a result, economic interdependences between the two worlds' largest economies increased significantly.

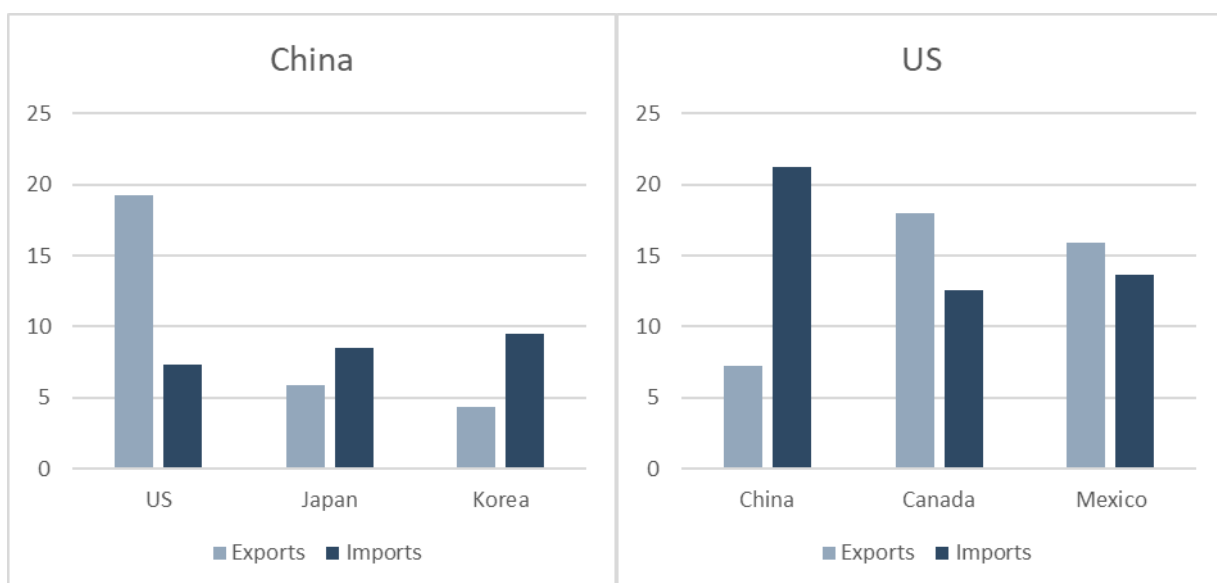
- The US is China's most important trading partner with a total merchandise trade volume of 636.9 billion USD, which corresponds to 4.5 percent of China's GDP (and 2.9 percent of the US GDP). In 2018, 19.2 percent of Chinese exports went to the US, whereas 7.3 percent of imported goods in China came from the US (Figure 3-1). Only South Korea and Japan had slightly higher import shares in the overall imports of China in 2018 (9.5 percent and 8.5 percent respectively).

- On the other hand, China is currently the US’s most important merchandise trade partner (measured in total trade volume). When it comes to US imports, China is also the most important partner of the US with a share of 21.2 percent in overall US imports in 2018, followed by Mexico (13.6 percent) and Canada (12.5 percent). China is also the third most important exporting market for the US, accounting for 7.2 percent of US exports in 2018, only behind Canada and Mexico which have higher shares (18 percent and 15.9 percent respectively).
- This simple statistic of the close trade interconnection between the two economies is an early indication that their decoupling may be a difficult task.

These figures are from the IMF Direction of Trade Statistics. However, there are certain discrepancies between different data sources due to the different approaches of measuring data, differences in valuations as well as measurement errors. There are also large bilateral discrepancies within sources. According to IMF data, for example, the value of China’s trade surplus (in its trade with the US) equals 324.4 billion USD (see next section), but the US trade deficit in its trade with China equals 419.5 billion USD (a figure used by US President Donald Trump). This large discrepancy is partly because the US Commerce Department records the re-exports from Hong Kong as US imports from China. Unfortunately, such inconsistencies are common in trade statistics and data are far from being perfect. Due to the challenging measurement problems related to trade in services and their substantially smaller trade volume, in this report we will focus only on merchandise trade. This is also motivated by the fact that the US has a service trade surplus with China, so that President Trump’s policies are aimed at reducing large trade deficit in goods.

### Figure 3-1: Major trading partners of China and the US

Partner shares in exports/imports as a percentage of total merchandise exports/imports in 2018

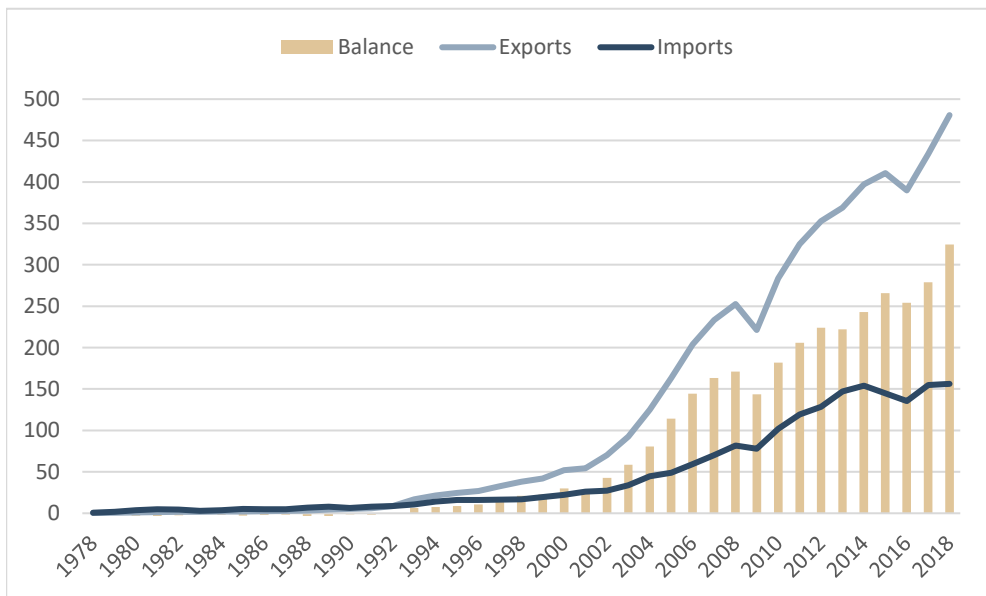


Source: Direction of Trade Statistics - IMF, own calculations

The development of the trade volume in goods over time reveals some interesting insights (Figure 3-2). A bilateral trade volume between China (Mainland China without Hong Kong and Macao) and the US has been rising for decades, starting with a volume of less than one billion USD in 1978 and reaching a volume of 636.9 billion USD in 2018. The bilateral merchandise trade volume is up 690 percent since 2001 (WTO accession) and 64,121 percent since 1978 (the launch of China's reform and opening-up policy). China exported 480.7 billion USD to the US and imported 156.3 billion USD in 2018. Although both imports and exports were on the rise, exports were much higher than imports throughout the whole time period since 1993 (before 1993 imports were higher than exports). China's persistent trade surplus in the last decades and the US trade deficit with China (324.4 billion USD) created tensions between the two countries, which recently escalated even further. American President Donald Trump promised his voters to shrink the US trade deficit with China during his presidential campaign. The current trade war and other Sino-American disputes may be indeed an indication that we are entering a new era of US-China decoupling (FT, 2018). It is interesting to observe that both the US-China trade volume and the US trade deficit increased even further in 2018 (compared to 2017), despite attempts to reduce it (the rise in deficit is primarily related to a further substantial rise in imports in 2018). One reason for such a development could be that trade went up in 2018 due to anticipation effects of even higher tariffs that had been announced for 2019.

**Figure 3-2: China's merchandise trade with the US**

Trade value in billion USD, 1978-2018



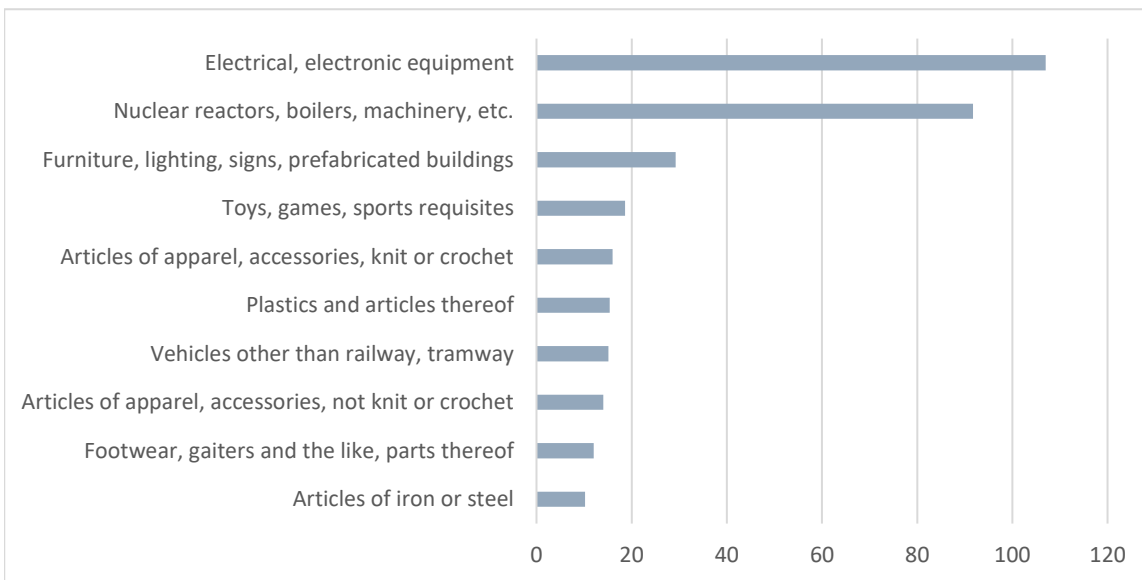
Source: DOTS, IMF, own calculations

Looking at the trade data by commodity groups at the 2-digit level reveals some new pieces of information: the product categories in China with the highest export volume to the US in 2017 (the latest data available) were electronic equipment and nuclear reactors, boilers and machinery (Figure 3-3). The commodity categories with the highest import volumes are the same two product groups, followed by vehicles other than railway and tramway (Figure 3-4).

The high trade volume in both directions in the same product categories indicate intensive intra-industry trade and high bilateral integration in global value chains. Especially in the case of electrical, electronic equipment which has the highest volume in both imports and exports, interconnectedness between the two countries seems to be very high. Often, Chinese companies import intermediate products from the US, assemble and re-export them back to the US. Apple’s iPhone is an example of such a product: China imports iPhone components from the US and other countries, assembles them in China and exports the final product to the US. According to the Chinese Commerce Ministry’s report, when the processing trade is excluded from the analysis, China’s 2018 trade surplus in goods with US imports would be just a third of the figure claimed by the US (SCMP, 2019b). Certainly, due to China’s high integration in global value chains, using traditional gross trade data can exaggerate bilateral balances and offer misleading conclusions. Therefore, it is necessary in addition to traditional statistics to use trade data in value-added (Johnson, 2014).

**Figure 3-3: China’s top 10 export commodities to the US in 2017**

Volume in billion USD

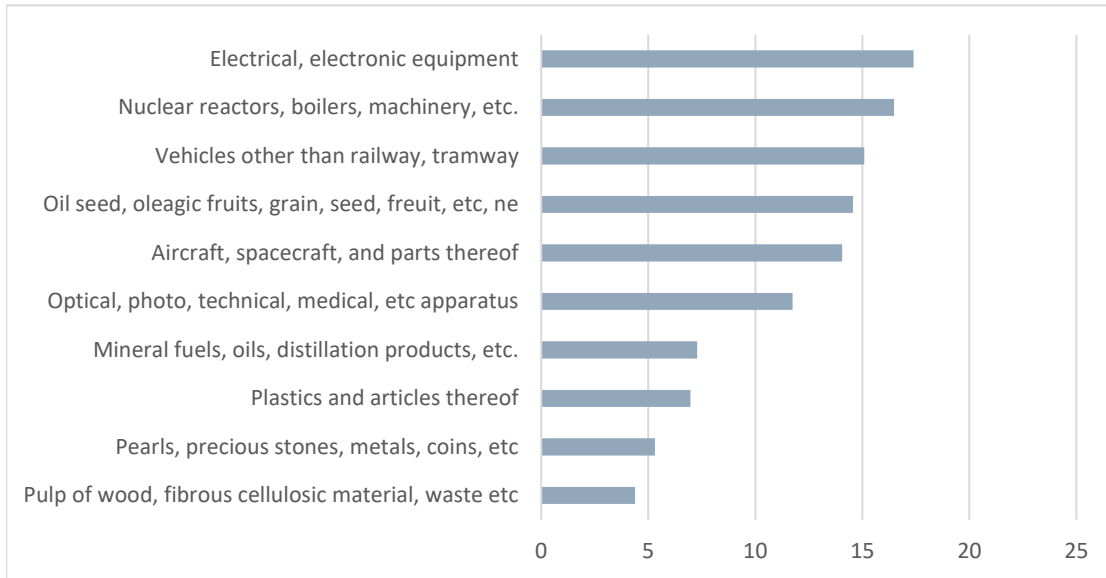


Source: UN Comtrade



**Figure 3-4: China’s top 10 import commodities from the US in 2017**

Volume in USD



Source: UN Comtrade

### 3.2 Global Value Chains

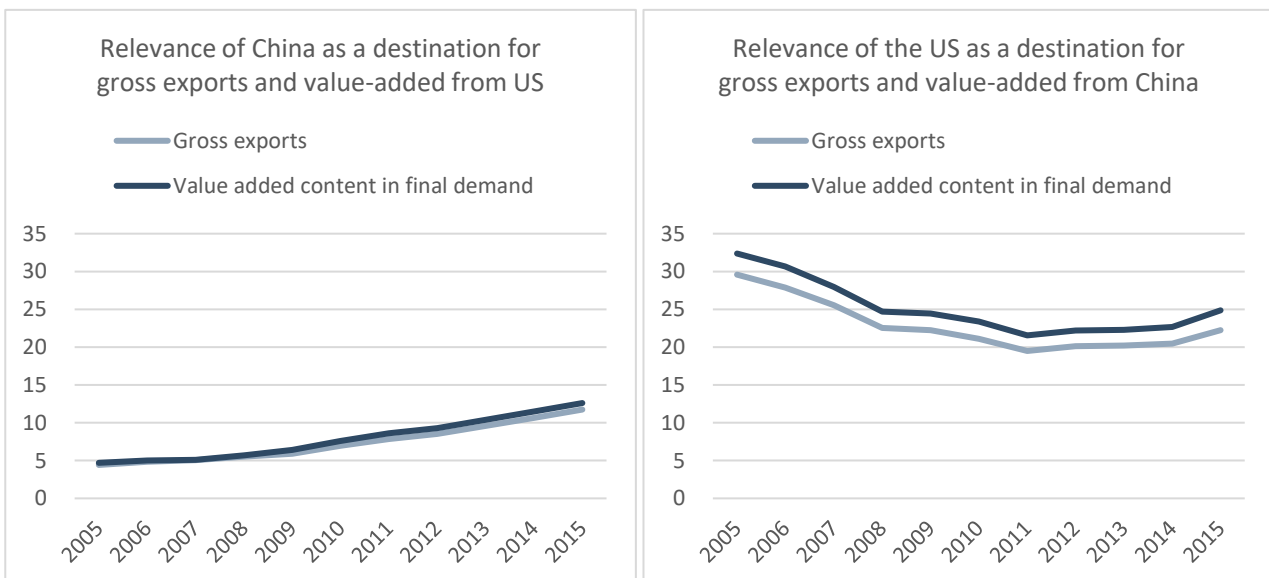
Nowadays intermediate goods are more present in international trade than final goods. According to Baldwin and Lopez-Gonzales (2015), trade in intermediate goods amounts to two-thirds of global trade. However, the growth of global value chains is slowing down since the 2008-2009 financial crisis (WTO, 2019) after consistently rising since the seventies (Baldwin 2016; Pahl and Timmer 2019). China is one of the major processing countries in the world; it is highly integrated in international supply chains. Therefore, in order to investigate where value is created along the global value chain and in order to get a clearer picture about export and import volumes in value-added terms, it is necessary to use data of trade in value-added. For this purpose, a joint OECD and WTO Trade in Value-added database (TiVA) which encompasses data for the time period 2005-2015 is used. The Trade in Value Added (TiVA) statistical method considers the value-added by each country in the production of goods and services that are consumed worldwide. Data from this database deviate from the Direction of Trade Statistics of the IMF (used in the previous section). Export and import values in the TiVA database are related to trade in goods and services as opposed to merchandise trade data in the Direction of Trade Statistics of the IMF. The TiVA uses observations from the OECD Inter-Country Input-Output (ICIO) database, compiled from both national and international sources, and collated using official national accounts (SNA93). IMF reports imports on a cost, insurance and freight basis (CIF) whereas exports are reported on a free on board basis (FOB). Although IMF and OECD-WTO data are not perfectly comparable, given the importance of the global value chains for understanding the US-China trade relations, it is still useful to explore this database as well.

In order to investigate the US-China mutual interdependencies, trade in value-added data by source country is investigated (data is available only until 2015). Figure 3-5 shows the share of

domestic value-added of China (the US) embodied in the final demand of the US (China) as a share of total domestic value added of China (the US) embodied in the foreign demand of all partner countries. Thus, this indicator signals the importance of a trading partner in value added terms. It also indicates how important final consumption in the partner country is for the value-added production in the domestic economy (as compared to other countries). In general, 24.8 percent of Chinese value-added that is embodied in the foreign final demand of all countries is driven by demand from the US, which is much higher than the share in the US vis-à-vis China in 2015 (12.6 percent). However, these shares in value-added are higher for both countries compared to the measures in gross terms. In the case of China, the US share in its gross exports was 22.3 percent. In the US, the Chinese share in gross exports was 11.7 percent and lower than the Canadian share (13.5 percent). Compared in value-added terms, China is a more important market for American goods than Canada. These figures provide important evidence that the interdependencies between countries are even more significant in value-added terms. According to this indicator, China was the main destination for American value-added destined for the global market (12.6 percent), followed by Canada (12.1 percent) and Mexico (7.2 percent). Also, the US is the main destination for Chinese value-added going to all foreign countries (24.8 percent), followed by Japan (8.1 percent) and India (3.7 percent). Whereas China is experiencing a downward trend in this regard, in the US the situation is the reverse: its reliance on Chinese domestic value added increased by 7 percentage points in the past ten years. Reversing this trend may not be an easy task.

**Figure 3-5: Gross exports and value-added in foreign final demand, partner shares**

Gross exports and domestic value added of a country embodied in the final demand of a partner country, as a percent of total domestic value added in foreign final demand, 2005 – 2015



Source: TiVA, OECD-WTO

Figure 3.6 displays the share of intermediate imports from the US in total Chinese imports from the US and vice versa (for all sectors and for an ICT sector). In general, 58.2 percent of Chinese imports from the US are imports of intermediate products, which is slightly higher than the share in the US vis-à-vis China in 2015 (53.2 percent). Historically, this share used to be even

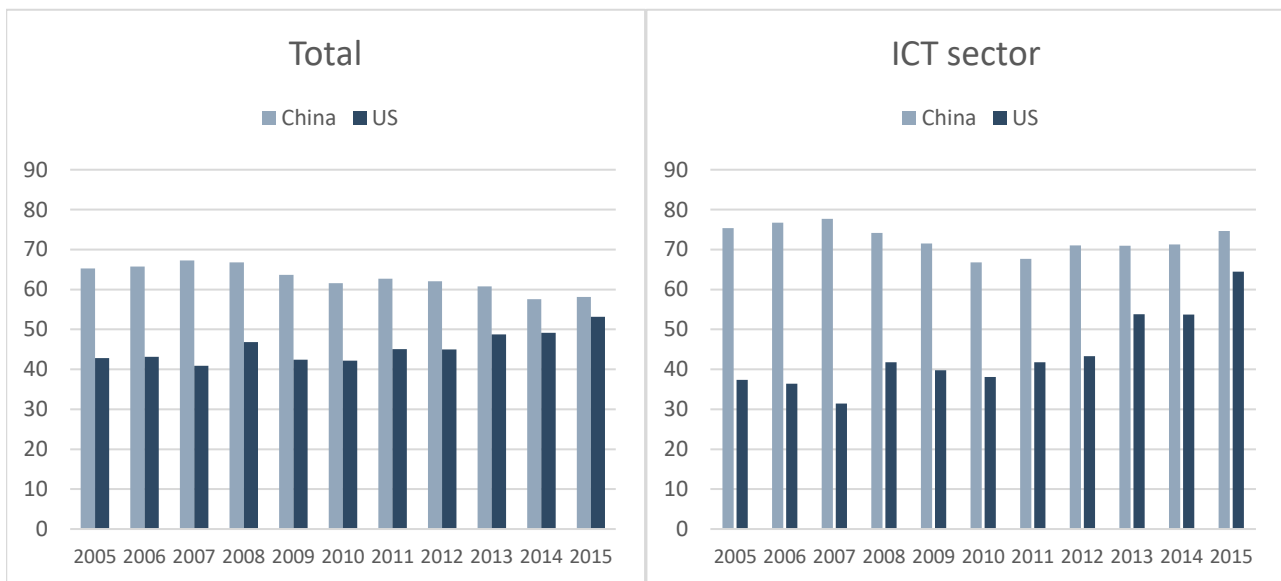


higher in China (67 percent in 2007) than in the US (41percent), but in the past decade the US steadily increased its share of imports of intermediate products from China (relative to the imports of final products). Both countries depend on each other as suppliers of intermediate products, which is also evidence that the trade war will hurt both sides. Thus, higher tariffs on Chinese products will have negative effects on the competitiveness of producers in the US who rely on imported intermediate goods from China and vice versa.

The mutual interdependence is even higher in the ICT industry, which has been targeted by both the trade and technology war (right panel of Figure 3.6). The share of intermediate products in Chinese imports from the US in the ICT industry is very high and amounts to 74.7percent. China depends on US suppliers in terms of intermediate goods in the ICT sector (such as chips and processors). However, 64.5 percent of all US imports from China in the ICT sector are imports of intermediates. This share has been rising rapidly in the past decade (it was 37.4 percent in 2005). Due to these high interdependencies, the trade war will hurt both countries and an attempt to decouple the two economies may be a very difficult task.

**Figure 3-6: Intermediate imports from a partner country (China, US)**

Intermediate imports as a percentage of gross imports from a partner country - total and ICT sector, 2005 – 2015



Source: TIVA, OECD-WTO

Deepening globalization in recent decades has led to a rise in trade as a share of output. One reason for this development is the rising share of foreign content in exports. This is especially the case in developing economies that import many sophisticated components necessary for their production and exports. This world of interconnected value chains also means that tariffs and trade barriers in the world of international value chains are even more detrimental (Fritsch/Matthes, 2017). They have negative effects not only in the case of final goods on foreign competitors and domestic consumers, but also on domestic producers using imported intermediate products as they suffer from higher costs. Thus, higher tariffs on Chinese products will have a negative impact on the competitiveness of producers in the US who rely on imported

intermediate goods from China. Although American president Donald Trump seeks to bring value chains back to the US, the trade war with China will hurt US companies as well. Also, whether the companies move their production back to the US or to other Asian countries is uncertain. In fact, trade diversion may be the result, with Vietnam and other South-Asian countries potentially benefiting from the US-China trade war (at least in the short term). Nomura (2019) estimates that Vietnam could be the largest beneficiary; it could gain 7.9 percent of GDP from trade diversion.

This chapter shows how important the Chinese market is for the US and vice versa. Moreover, China and the US are very much interconnected through their value chains which makes protectionism and a trade war even more expensive (and more painful) for both sides.

### 3.3 Consequences for the EU

The relationship between the US and China is changing and this will have consequences for the EU as well. There are a number of different dimensions.

If the US-China trade (and technology) war continues, there could be positive trade diversion effects for the EU as is analyzed below. However, the long-term effects could be more negative. Current US trade policy poses a serious threat to the multilateral trade system and the functioning of the WTO. This in turn could have negative consequences for the EU as a big supporter of the existing system.

However, there is also another scenario to ponder. Despite its aggressive stance, the US seeks a bilateral agreement with China in order to make China change its distortive trade and investment practices. The consequences for the EU are unclear a priori. How positive or negative these consequences might be will depend on the nature of such an agreement. If China changed important parts of its system, all other trading partners would also benefit from such a deal. However, if the US sought mainly preferential access to China and China only changed its practices vi-à-vis the US, this could pose substantial risks to the EU due to negative trade and investment divergence effects.

Moreover, currency developments also need to be taken into account. The recent decision of the People's Bank of China to let its currency depreciate to the lowest level since the Great Recession sparked risks of a full-blown currency war that would also very likely affect Europe. The yuan depreciation renders all foreign goods more expensive for Chinese customers and, therefore, reduces exports to China. This also applies to European exporters and given the size and importance of the Chinese market for the EU, this effect can become relevant. While European consumers could benefit from the lower prices of Chinese products, at least in the short run, the negative effects on exports are politically more significant important. Therefore, if China let its currency fall significantly further in response to the trade war, other countries could also devalue their currencies. As the USD and the Euro float freely, domestic monetary policy could be loosened in order to indirectly let the currency depreciate. Such a fully-fledged currency war would harm everyone, endanger global growth and the stability of international financial markets. Further escalation of such a conflict could cause China to reduce its US security

holdings, which would lead to further financial market turmoil. These more extreme scenarios would also negatively affect the EU and would even further increase global uncertainty.

According to economic theory, protectionist trade policies could potentially lead to trade destruction and trade diversion. Trade destruction implies that after imposing trade and non-trade barriers, the import volume of the affected trading partner is reduced to the benefit of domestic producers. Trade diversion means that these declining import partner shares are substituted by the rising import shares of third countries. Both effects are to the detriment of domestic consumers who suffer from higher prices. Whether some significant trade diversion will occur as a consequence of the current escalation of the US-China trade war remains to be seen. Analysts speculate about possible positive effects, particularly for Vietnam, Cambodia, Mexico, but also for Europe. However, trade rerouting might be an issue as well. Liu and Shi (2019) show how trade re-routing has been used by Chinese exporters in order to circumvent antidumping policies in the past. They conclude that Chinese firms may also be able to do the same today in order to evade current tariffs. Sending their products to a third country, where the goods receive re-issued certificates of origin and are then sent to the final destination country could be an option. Especially in the case of Vietnam, re-routing may be already visible (Chau and Boudreau, 2019).

However, the ongoing trade war and possible decoupling of the US and China could potentially also benefit the EU if trade diversion in its favor occurs. The EU may end up trading more with both the US and China by capturing market shares from US and Chinese exporters that face higher tariffs (Ifo Institute, 2019).

The literature is somewhat inconclusive regarding the effects of the trade war on the EU. Therefore, ex post monthly trade data (not seasonally adjusted) is used to gather factual evidence. Trade diversion should manifest itself in the declining import shares of China in the US due to the increase in tariffs and the rising shares of the EU in US imports. Import shares are much less susceptible to seasonal influences than absolute trade data, even though such influences cannot be completely ruled out. Table 3-1 displays the import shares of selected countries in the total imports of China and the US. The data shows indeed that the US share in Chinese imports has been decreasing (with some oscillations) from 8.4 percent at the beginning of 2018 to about 6.1 percent in mid-2019. At the same time, Chinese imports rose during this period. Obviously, it seems that the US is already suffering from the trade war. On the contrary, the EU share rose from 12.8 percent to 13.8 percent. This aggregate trade data seems to offer some evidence that trade diversion in favor of the EU might be taking place. This is especially true for France, Ireland, and also for Germany. However, it remains to be seen how the situation will develop in the next months.

Table 3-1 also displays US imports. The Chinese share in US imports also declined; it fell from 20.6 percent at the beginning of 2018 to 18.5 percent in mid-2019. The trade war has obviously significant negative consequences on Chinese exports to the US. On the other hand, the share of the EU rose. Its share in total US imports increased from 19.3 percent at the beginning of 2018 to 20.5 percent in mid-2019. This might be a clear indication that the EU managed to replace part of the dropping Chinese exports to the US. Countries that managed to increase their export shares to the US were the Netherlands, France and Belgium.

**Table 3-1: Imports from China and the United States from selected countries**

Three month averages, begin 2018 (January - March) and mid-2019 (May - July)

	Import share (in percent)		Import share (percentage points)
	Mid-2019	Begin 2018	Change
<b>China</b>			
Imports from the US	6.1	8.4	-2.3
Imports from the EU	13.8	12.8	1
<b>US</b>			
Imports from China	18.5	20.6	-2
Imports from the EU	20.5	19.3	1.2

Source: IMF, own calculations

Whether these numbers represent only short-term fluctuations or general trends remains to be seen. However, if the trade conflict escalates further, there will definitely be some trade destruction among the two worlds' largest economies. What the consequences for the EU will be depends on various factors. Apart from potentially positive trade diversion effects, the EU will be negatively affected by lower growth in the US and China due to the trade war, by lower world trade and by the high uncertainty that surrounds the conflict. In a trade war, it will be hard to find any enduring winner; the participants and most bystanders tend to lose, and the global economy will suffer.

## 4 Investment

A trade war, at least in theory, would reduce trade between the conflict partners but could, in contrast, boost investment. The rationale is that firms may react to higher or even prohibitively high tariffs by investing in production capabilities in such protectionist countries to keep market access. This could most effectively take the form of Foreign Direct Investment (FDI). The motivation behind FDI according the OECD (2008, 17) "is a strategic long-term relationship with the direct investment enterprise to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise". FDI encompasses establishing a new business in a foreign country with or without a (local) partner (greenfield) or Mergers and

Acquisitions (brownfield). In both cases, FDI is assumed if at least 10 percent of voting power goes to the investor (ibid).

But there are also scholars that argue, and find hints especially for China in the data, that FDI and trade are in fact complementary (Abeliansky / Martinez-Zarzoso, 2018). The reason is that FDI leads to an increased exchange of goods and services between the foreign subsidiary and the investor's home country. This may also result from brownfield investments because the acquired firm and the new parent company can use each other's networks to enter the respective markets. Accordingly, the imports and exports of the involved countries increase. A reduction of FDI in this context would result in lower trade in the future.

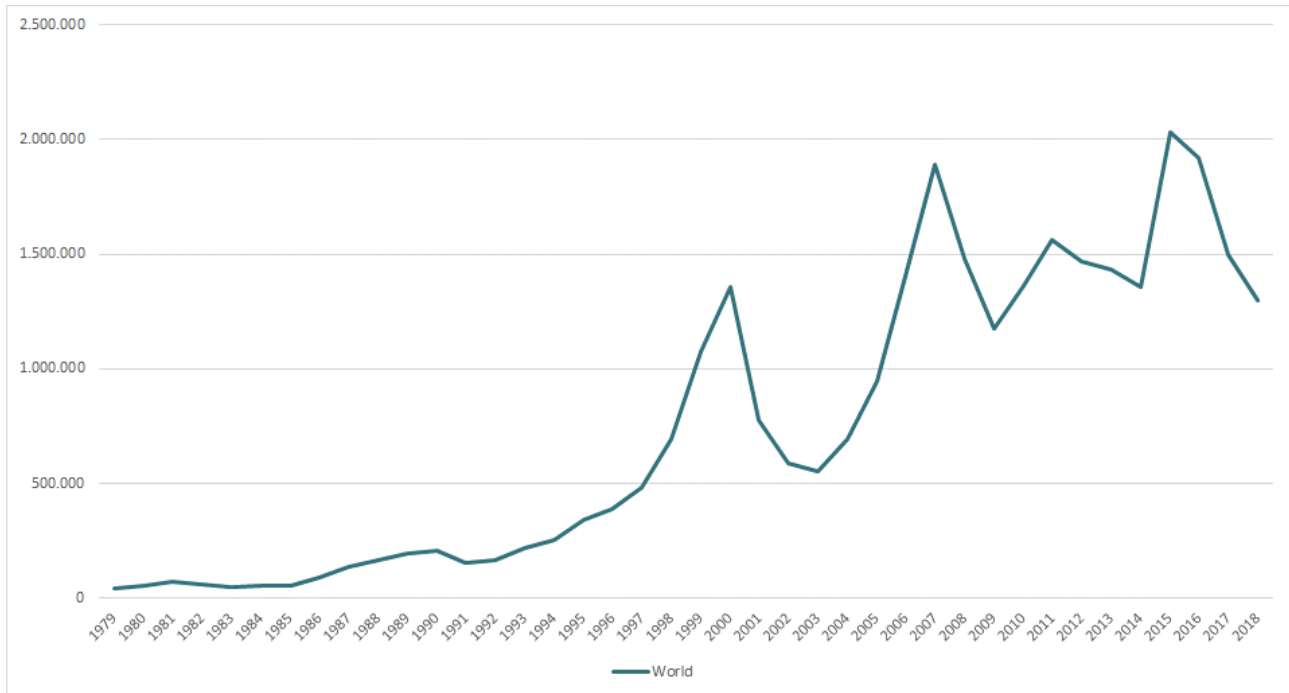
Analyzing the financial flows between China and the US, against this backdrop, can show whether the Chinese and the US economy are decoupling, meaning also FDI flows are deterred, which also reduces trade in the future, or "only" a trade war takes place leading to more FDI to bypass the new trade barriers. Accordingly, Section 4.1 looks at FDI flows between China and the United States. To get a complete snapshot of the financial flows, the public debt of the United States and the composition of the monetary reserves of China are also analyzed in Section 4.2. The reason is that a decoupling would also affect these financial positions.

#### 4.1 Foreign Direct Investment (FDI)

To get an impression of the importance of FDI, Figure 4-1 shows the sum of inflow for all countries worldwide since 1979. This year was chosen because it was the first full year of China's opening-up. Figure 4-1 shows that FDI inflow was below 300 billion USD until the mid-nineties according to the United Nations Conference on Trade and Development (UNCTAD, 2019a). From the mid-nineties until 2000, it practically exploded to nearly 1.4 trillion USD. Beginning with the crisis in 2001, the inflow fell back to about 500 billion USD. But then it grew rapidly again to nearly 2 trillion USD until the 2007/2008 financial crisis. In the years after the crisis, the inflow remained below 1.5 trillion USD. The two trillion figure was reached in 2015, but from that time on, global FDI fell again to almost 1.3 trillion USD in 2018.

**Figure 4-1: World Inflow of FDI 1979-2018**

In million USD



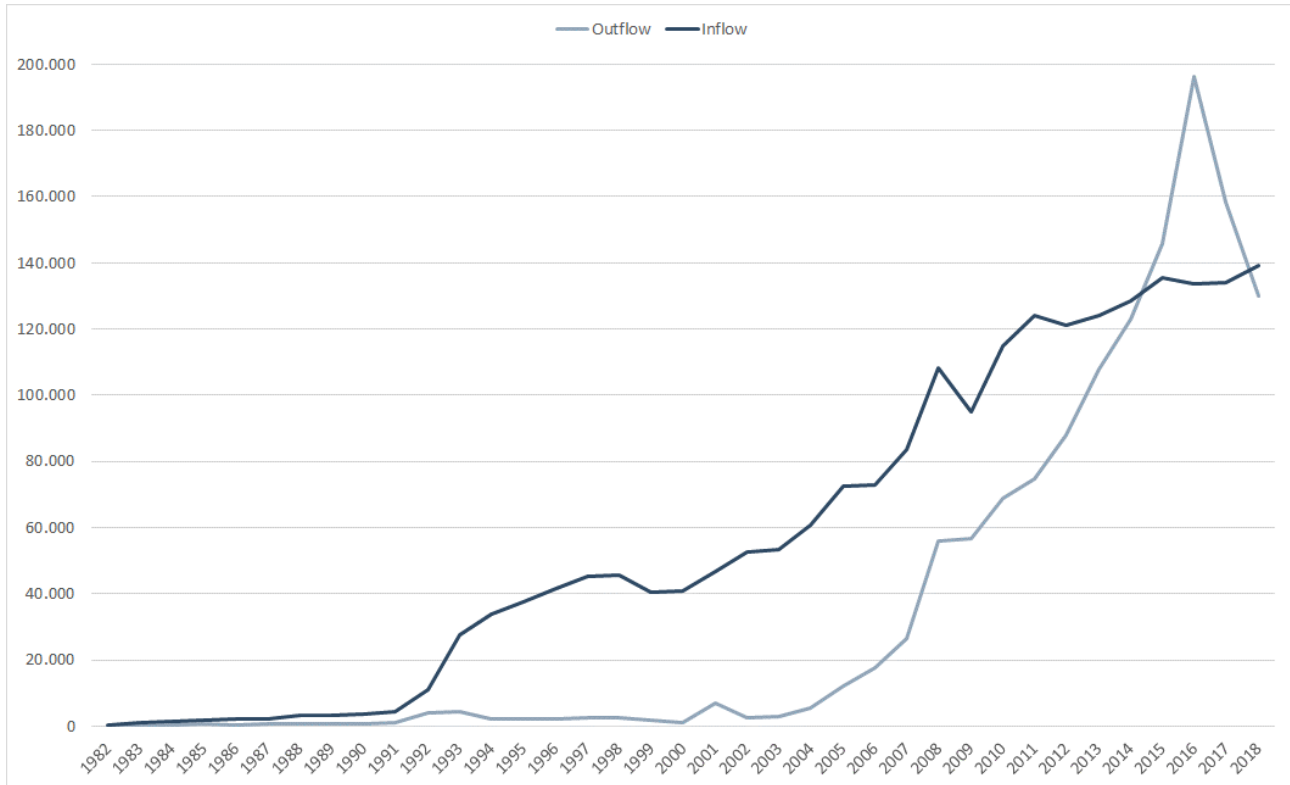
Source: UNCTAD, 2019a; own representation

With the magnitude of worldwide FDI inflows as a comparison, the FDI flows of the People’s Republic of China (Figure 4-2) can also be interpreted properly. The inflow and outflow were very low until the beginning of the 1990’s. From then on, the inflow to China increased nearly every year up to 139 billion USD in 2018. Even the tensions between the US and China seemed to have no effect.

The outflow of FDI from the People’s Republic of China was, in contrast, of minor importance until the beginning of the new millennium. But from around 2004 onwards, the flow from China rapidly increased up to 196 billion USD in 2016. The increase at the beginning of the new millennium resulted from China joining the World Trade Organization in 2001 but the main reason was the Chinese “Going Out” strategy from 2002, which has been encouraging domestic firms to invest abroad (Lim, 2017). In 2015, China also introduced the Made in China 2025 strategy for investments in key sectors (Conrad et al., 2016). By the end of 2016, however, the Chinese government introduced sharper controls to prevent uneconomical investment (Rusche, 2018), which led to a reduction in FDI outflows. The tightened controls and the tensions between China and the US are also possible explanations for the decrease in FDI flows since 2016. But this development is also in line with the decrease in inflows worldwide according to Figure 4-1.

**Figure 4-2: Value of FDI Inflows and Outflows of the People’s Republic of China  
1982-2018**

USD at current prices in millions



Source: UNCTAD, 2019a; own representation

In summary, it can be stated that the People’s Republic of China is an attractive investment destination. In fact, it is the second most important host country of FDI according to the World Investment Report 2019 (UNCTAD, 2019b, 4). Also, the global reduction in FDI inflow only had a limited effect on China’s inflows.

Furthermore, China has even become an important investor. Except in 2018, China has also become a net investor recently. According to the World Investment Report (UNCTAD, 2019b, 7), China was the second most important investing country of Foreign Direct Investment in 2018. Only Japan with 143 billion USD had higher outflows compared to the 130 billion of China.

So far, this analysis has not found any effects of decoupling between China and the US in the amounts of in- and outflow of FDI of China. Therefore, the composition of the flows is analyzed in detail. The reason is that investment flows may not be obstructed by a decoupling but redirected to other destinations. In fact, if Chinese capital is not welcome in the US anymore, Chinese investors may instead go to the European Union, for example. This might especially be the case if specific know-how has to be acquired according to the Made in China 2025 strategy and technically advanced firms are in the EU.

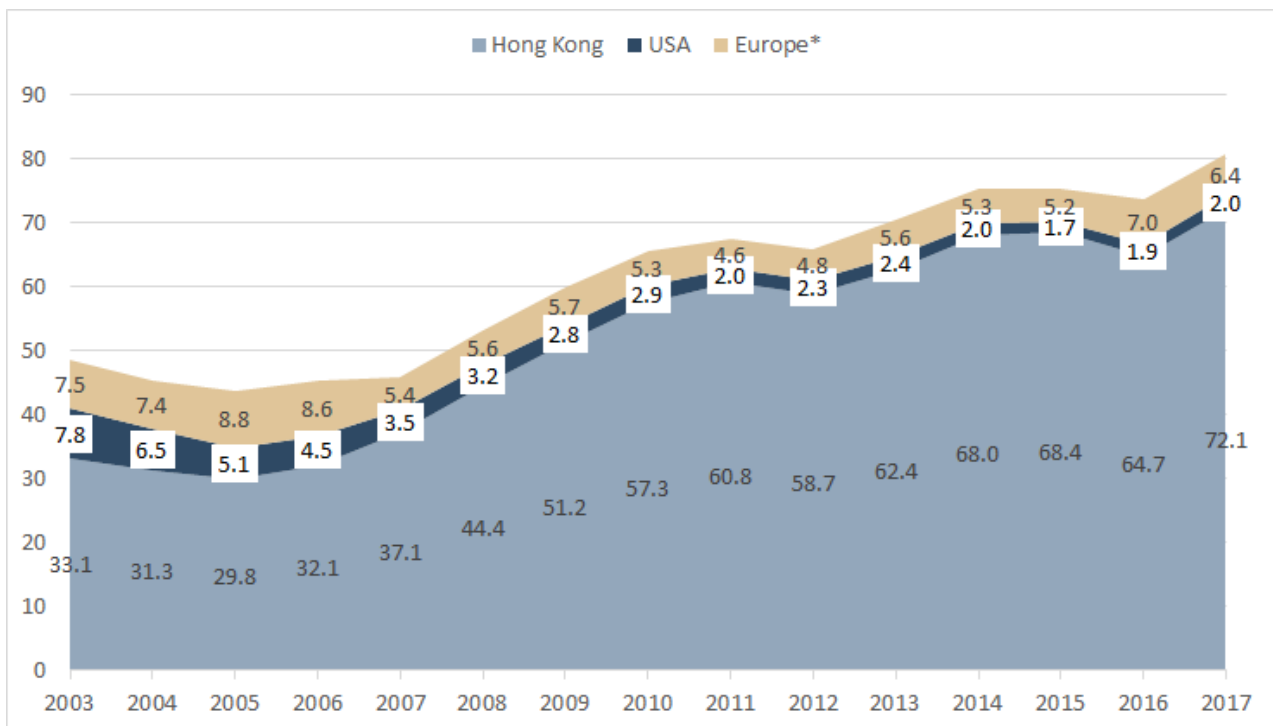
To analyze the composition of flows, the data of the National Bureau of Statistics of China are used. But there are two limitations with this data. The first one is that the latest figures are for

2017. Accordingly, the effects of the latest developments are not yet visible. The second limitation is that the National Bureau only provides numbers for European countries but not for the European Union. Furthermore, not all members of the EU are mentioned in the statistics. Therefore, Europe is used as a proxy for the EU. For the FDI flows to China (Figure 4-3), it is possible to exclude the biggest non-EU home countries of FDI flows (Norway, Russian Federation, Switzerland), which makes the analysis more focused.

The data of the National Bureau of Statistics of China, however, also have an advantage because trade flows between The People’s Republic and Hong Kong can be analyzed. Since Hong Kong is a major financial center, it is likely that investors will first invest in Hong Kong before moving to mainland China (Rusche, 2017). In fact, analyzing the share of Hong Kong, the US and Europe on FDI flows to the People’s Republic of China reveals no severe changes, which might support the thesis of decoupling. The share of the US in FDI inflows to China is relatively constant at 2 percent since 2011. But the share has been almost four times higher shortly after China joining the WTO in 2003. From that time on, the share constantly decreased to the value of 2 percent. The share of Europe (without Norway, Switzerland and the Russian Federation) is also relatively constant in the range of 5-7 percent. The greatest and still increasing share of FDI to China at more than 72 percent stems from Hong Kong. But before the investment streams to Hong Kong are analyzed to complete the picture, it is worth taking a look at the composition of FDI outflows from the People’s Republic of China (Figure 4-4).

**Figure 4-3: Share of Hong Kong, United States and Europe\* on FDI flow to the People’s Republic of China 2003-2017**

In percent



\*Europe without Norway, Switzerland and the Russian Federation

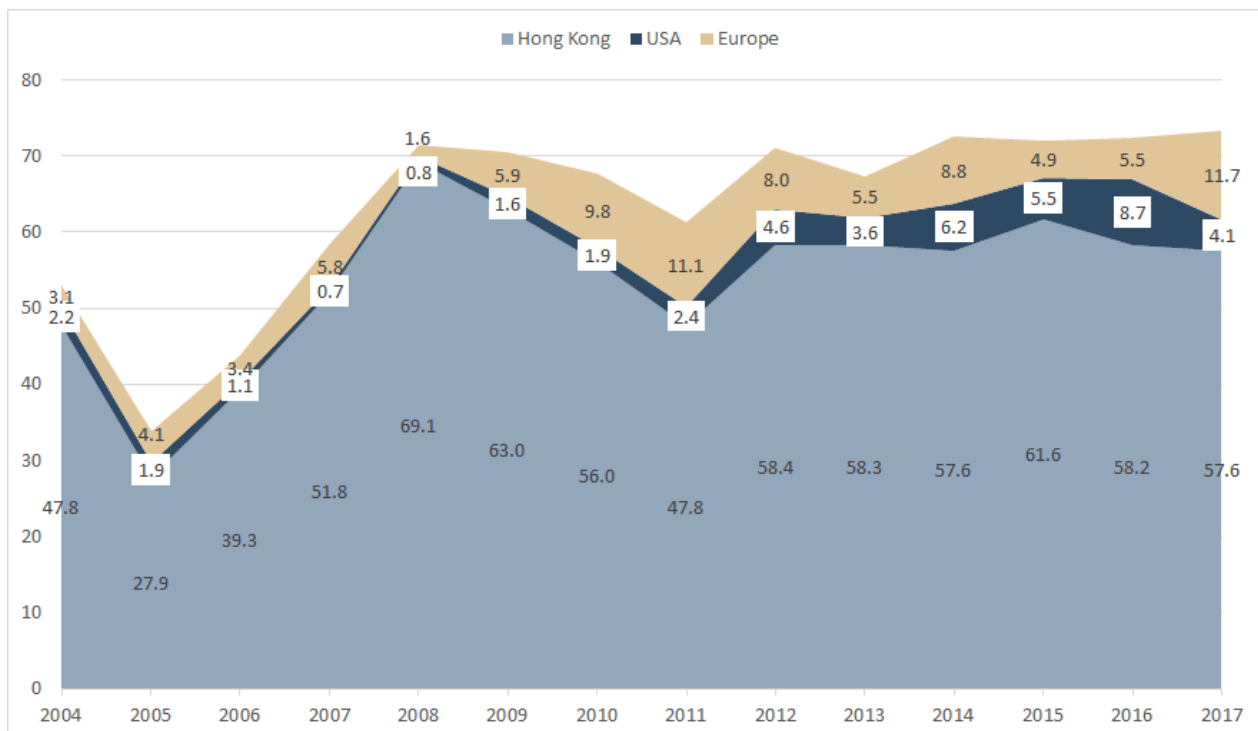
Source: National Bureau of Statistics of China, 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018; own calculations



As in the case of inflows to the People’s Republic of China, Hong Kong is also the most prominent host country of FDI’s. In fact, since 2012 almost 60 percent of Chinese FDI outflow has gone to Hong Kong. The US share in China’s FDI outflows was, in contrast, below 2 percent until 2010. Since then, it rose up to an all-time high of 8.7 percent in 2016 and then dropped to well above 4 percent in 2017. What is remarkable in this drop is that at the same time Europe’s share rose from 5.5 percent to 11.7 percent. This increase in share also comes with an increase in absolute values: investment to Europe rose from almost 10.7 billion USD in 2017 to more than 18.4 billion USD in 2017 (National Bureau of Statistics of China, 2018). Accordingly, although China’s overall outflow of FDI declined, investment in Europe increased. This means that Europe moved into the focus of Chinese investors. The only non-EU member mentioned in the Chinese statistic is Russia. Investment in the Russian Federation increased from almost 1.3 billion USD in 2016 to well above 1.5 billion USD in 2017 (ibid). That means, most investment took place in the rest of Europe. Among others, this might especially be in the so called 16+1 (now 17+1) format, which includes China and 17 middle-, east- and southeast European countries (12 EU members) (DW, 2019). 17+1 is especially related to China’s Belt and Road Initiative (Section 2.1) but is not restricted to this project. However, it seems that China also tries to divert trade and infrastructure away from the US at a higher pace than before the economic tensions.

**Figure 4-4: Share of Hong Kong, United States and Europe on FDI flow from the People’s Republic of China 2004-2017**

In percent



Source: National Bureau of Statistics of China, 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018; own calculations

Also, China's FDI stock in Europe increased from 87.2 billion USD in 2016 to 110.9 billion USD in 2017 (National Bureau of Statistics of China, 2017; 2018). Nevertheless, Europe's share in China's outward FDI stock declined from 6.4 to 6.1 percent (Figure 5-1 in the annex). Also, Hong Kong dominates in outward FDI stock.

This raises the questions of where the money stems from that is invested in the People's Republic of China via Hong Kong and where the money is invested after it has been transferred from mainland China to the city. To shed some light on these questions, Table 4-1 lists the top 5 FDI investors in Hong Kong and the top 5 destinations of FDI from Hong Kong 2017 according to the Census and Statistics Department of Hong Kong (2018). Since the United States do not belong to the top hosts and investors, the figures and rank of the US are also given in the table. Top investors are identified by the stock value of their investment at the end of 2017. Furthermore, the flow from and to Hong Kong of these investors and destinations is given, respectively. As the FDI flows to the People's Republic of China suggest, mainland China is the top destination of FDI from Hong Kong with a stock value of 5.4 trillion Hong Kong Dollars (HK\$), with a HK\$ worth around 13 US cents. However, this is a tight lead because the British Virgin Islands have a stock value of almost 4.9 trillion HK\$. Compared to these stocks, other countries are negligible. This also holds for the United States with a stock value of only 92 billion HK\$ on rank 9.

Accordingly, starting in Hong Kong, most investment goes to mainland China and the British Virgin Islands. These figures, therefore, give no hints that there are large investment flows of Chinese investments via Hong Kong to the United States or Europe. However, such investments may also be undertaken via the British Virgin Islands as in the acquisition of the German firm KUKA by Midea from China (Rusche, 2017). An analysis of these flows would go beyond this paper. But it has to be mentioned that there is a discrepancy in the figures published by the National Bureau of Statistics of China and the Census and Statistics Department of Hong Kong. According to the National Bureau of Statistics of China (2018), the inflow from Hong Kong in 2017 amounts to 94.5 billion USD, which is much more than the outflow from Hong Kong to China of 243.3 billion HK\$ (about 31.6 billion USD) according to the Census and Statistics Department of Hong Kong (2018).

This discrepancy also occurs in the values for investments in Hong Kong. Regarding the stock values according to the National Bureau of Statistics of China (2018), the Chinese FDI stock in Hong Kong had a value of 981.3 billion USD in 2017, which is higher than the 3.9 trillion HK\$ (503.4 billion USD) according to the Census and Statistics Department of Hong Kong (2018). Whatever the reason for this discrepancy is, mainland China is the second most important investor in Hong Kong. Only the British Virgin Islands with almost 5 trillion HK\$ have a higher stock of FDI. The US ranks 7<sup>th</sup> with a stock value of 325.9 billion HK\$ (42.4 billion USD). Accordingly, the US is not a major investor in Hong Kong.

To sum up the analysis, there are no patterns of a change in behavior by US investors in the People's Republic of China up to 2017. So far, the threatened barriers to trade have not made US investors leave China until 2017. But there are signs of a changed Chinese investment behavior; investments tend to be diverted to Europe. That such a shift in investment can be seen in the data is especially astonishing because the statistical data cannot represent the latest

developments. That China has invested even more in Europe since the latest update of the statistical data can be presumed by reading the news, for example recent Chinese investments in Italy (NZZ, 2019).

**Table 4-1: Stock and flows of Top 5 and US Foreign Direct Investments of Hong Kong 2017**

in billion HK\$\*

FDI from Hong Kong		
Country	Stock	Outflow
PR of China	5420.1	243.3
British Virgin Islands	4881.3	81.7
Cayman Islands	543.3	1.7
Bermuda	288.1	49.1
Netherlands	248.7	200.4
USA (Rank 9)	92.0	6.9
FDI in Hong Kong		
	Stock	Inflow
British Virgin Islands	4980.1	329.9
PR of China	3872.4	179.2
Cayman Islands	1193.5	161.8
Netherlands	882.7	-1.4
Bermuda	656.8	17.6
USA (Rank 7)	325.9	12.0

\*1 HK\$ = 0.13 USD

Source: Census and Statistics Department of Hong Kong, 2018; own representation

Accordingly, decoupling may be going on between the US and China on different levels, but the data show no clear evidence so far. In the case of FDI, however, it seems that Chinese investments have already started to be more focused on Europe and other BRI countries instead of the US.

## 4.2 Debt and Reserves

Because of their long-term focus, changes in FDI flows and especially FDI stocks may only evolve slowly with increased tensions between the US and China. Accordingly, this report also analyzes

changes in the Chinese composition of reserve assets. The logic is that the Chinese government may switch away from the US Dollar in order to implement a financial decoupling. On the one hand, selling USD and US securities may put some upward pressure on the interest rate that the US must pay on their debt, and upward pressure on US inflation because US imports would become more expensive due to a lowered exchange rate. On the other hand, selling USD can also hurt China and the domestic economy because a depreciation of the USD would lower the value of Chinese reserves denominated in Yuan and, furthermore, demand for Chinese exports would fall because US consumers would have to pay more for Chinese goods. Buying Dollars, however, could enhance Chinese exports due to a depreciation of the Yuan, which could offset the negative effects of increased US tariffs. Changes in the exchange rates due to Chinese actions would, of course, also have consequences for the European Union and especially the Euro. The greatest effects would occur if the Chinese government were to exchange Dollar reserves for Euros. Until now, however, there has been no such movement.

Although the share of different currencies in the reserves of China are not published, there seems to be a fixed composition (Neely, 2017). According to this source, 67 percent of Chinese currency reserves are in USD, 25 percent in Euro and 8 percent in Yen and British Pounds.

But although China does not switch the currency composition, it switches from currencies to gold. In fact, in 2004 only 0.66 percent of the reserve assets worth 619 billion USD were in gold (SAFE, 2019; percent: own calculation); 98.6 percent was in foreign currencies. In 2018, 2.4 percent of the assets worth 3.17 trillion USD were in gold and 97 percent in currencies. Accordingly, gold assets increased slightly in share but tremendously in absolute numbers. Furthermore, the World Gold Council (2019) argues that China even increased its purchases of physical gold in the first half of 2019.

Foreign currencies especially in USD, however, still dominate the reserve assets of China. A great share of these reserve asset holdings is in US treasuries. It is argued that China could use its power as a lender (for example already in 2012 in Handelsblatt, 2012). Taking a look at the foreign holders of US treasuries (Figure 4-5), however, reveals that China's influence has decreased, especially since the financial crisis. From 2000 to 2010, China increased its holdings from 60 billion USD to more than 1.1 trillion USD. Since 2010, the holdings in absolute numbers only changed slightly. Since the 2007/2008 financial crisis, however, the US treasuries held by non-US investors nearly tripled from 2.4 trillion to more than 6.2 trillion USD in 2018. Total debt of the US is even higher (Department of the Treasury, 2019b). In fact, at the end of July, total debt amounted to more than 22 trillion USD (of which almost 16 trillion are marketable). Accordingly, the major share of US debt is held by non-foreigners. Furthermore, since China held its holdings nearly constant while total debt increased, China's influence as a lender also decreased since the financial crisis and is even further decreasing.

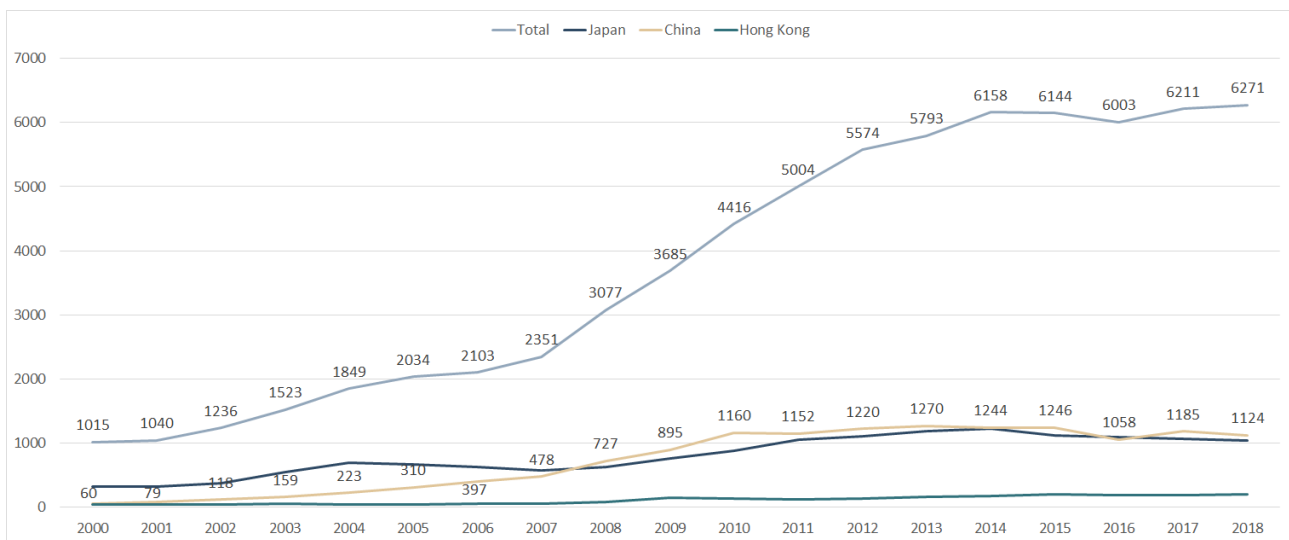
In fact, at the end of December 2008, the People's Republic of China held more than 23.6 percent of US foreign debt, which represented 6.8 percent of total debt (own calculations, based on Department of the Treasury 2019a; 2009). At the end of December 2018, however, the People's Republic held 18 percent of US foreign debt, which represents around 5.1 percent of total debt (own calculations, based on Department of the Treasury 2019a; 2018). Nevertheless, at the end of 2018, China was the major foreign holder. Japan comes a close second with 1,039.7 billion USD and a share of 16.6 percent. Brazil was third with 303.2 billion USD and a share of

4.8 percent (shares: own calculation based on Department of the Treasury, 2019a). Hong Kong had a share of around 3.1 percent.

In summary, China reduced its share of US treasuries holdings, but there are only slight changes by China in the composition of reserve assets. Until now, however, these are only small in magnitude and therefore consequences for the European Union are also small. Nevertheless, the EU must be aware that an increase in the tensions between the US and China as well as an agreement between these parties can change this situation.

**Figure 4-5: Major Foreign Holders of US Treasuries 2000-2018**

In billion USD, at the end of December of respective years



Source: Department of the Treasury, 2019a; own representation

## 5 Summary and recommendations for the EU

### 5.1 Summary

The People’s Republic of China experienced a tremendous economic development within the last four decades. The increased economic power and political weight of China in the world are challenging the incumbent players USA and EU. Furthermore, the strategies used by China for its own development, e.g. broad-based industry policy with distortive subsidization, forced technology transfer or investment restrictions, are perceived as unfair, especially in the US, but to a large extent also in the EU. This development in combination with the trade imbalances are resulting in the current conflict between China and the US. The term decoupling was introduced to describe the cutting off of economic ties between China and the US as a result of the conflict.

Accordingly, we analyze in this article whether a decoupling is going on. As regards trade, where up to date data is available, we find that China and the US are each other’s most important trading partners. Trade data in value added reveals even closer links between both economies through global value chains. This is especially true for ICT and electronics, an industry being a subject of both the trade and the technology war. While it is interesting to observe that both

the US-China trade volume and the US trade deficit increased further in 2018, more recent data reveals significant changes in trade patterns between the US and China: the US share in Chinese imports has been decreasing (with some oscillations) from 8.4 percent at the beginning of 2018 to about 6.1 percent in mid-2019. At the same time, Chinese imports rose during this period. Obviously, it seems that the US is already suffering from the trade war. The Chinese share in US imports also declined; it fell from 20.6 percent at the beginning of 2018 to 18.5 percent in mid-2019. The trade war has obviously also significant negative consequences on Chinese exports to the US.

At the same time, this aggregate monthly trade data seems to offer some evidence that trade diversion in favor of the EU might be taking place. The EU share in Chinese imports rose from 12.8 percent at the beginning of 2018 to 13.8 percent in mid-2019. Also, its share in total US imports increased from 19.3 percent to 20.5 percent. This might be an indication that the EU managed to replace part of the dropping Chinese exports to the US. Monthly data are prone to oscillations, so it remains to be seen how the situation will develop further. However, in the long-run there are no winners in a trade war. For the third time this year, the International Monetary Fund (IMF) has downgraded its forecast for global economic growth. The reasons given were above all, the continuing US-China trade war, but also the Brexit and the tense situation in the Gulf region. These tensions increase uncertainty and dampen the economic outlook. If the trade conflict further escalates, uncertainty that comes with it is likely to hurt both China and the US, but also the EU and global economy in general. Therefore, efforts toward reducing the tensions and reaching an agreement should be high on political agenda.

Another possible risk for the EU could be a preferential trade agreement between China and the US. If the US gets preferential access to China and China only changes its distortive trade and investment practices vi-à-vis the US, this could pose substantial risks to the EU due to negative trade and investment divergence effects. However, if China changed important parts of its system, all other trading partners would also benefit from such a deal. So far, it is not possible to say whether positive or negative these consequences will occur for the EU.

When it comes to investments, while there are no patterns yet of a changed behaviour by US investors in the People's Republic of China, there are signs of a changed Chinese investment behaviour concerning Foreign Direct Investments (FDI). In fact, investments tend to be diverted from the US to Europe. In 2017, investments in Europe nearly doubled in absolute numbers to more than 18 billion USD compared to 2016 and more than doubled in share to nearly 12 percent. The share of the US dropped from almost 9 percent to 4.1 percent in 2017. The most important investment host and destination country for Chinese FDI, however, is Hong Kong. Statistical data, however, is not up to date. Accordingly, recent Chinese investments that are mentioned in the news, especially in the EU, could not be included. Concerning the reserves, China is slightly moving away from the US Dollar and increases its holdings in gold. But these changes are only small in magnitude.

## 5.2 Political Recommendations for the EU

As China and the US are the largest trading partners of the EU, the ongoing conflict between both nations is of major importance for the EU. Much will depend on whether the current trade negotiations between Washington and Beijing will lead to a broad-based agreement. Such an outcome could calm the calls in the US for an ongoing economic decoupling. However, the Trump administration might, in the short term, strive only for a partial (Phase 1) trade deal in view of the approaching Presidential elections - in order to prove success and to be able to prevent the damages to the US economy, which a further tariff escalation would entail. However, in the case of only a minor trade deal that does not include major changes in the global economic distortions originating from China, the political drive for an ongoing decoupling particularly in trade and technology is likely to continue in the US. This latter outcome is relatively likely as China has indicated that it will not change the fundamentals of its state-capitalist economic model.

Therefore, it appears probable that the great power competition between the US and China will continue and that also the calls for a decoupling will not subside. The key question will be, how radically the US will follow this path in the medium and longer term. This will only become clearer after the election of a new president (and possibly of a new Congress). Thus, the EU's strategy should differentiate between the shorter and the longer term.

For both time horizons, it is key to bear in mind that – despite the, at times, aggressive stance of the current US administration towards the EU – the US and the EU have clear common interests to lessen the impact of China's distortive economic and trade practices on the world economy. Like the US, the EU has been concerned about China's unfair trade practices for years, i.e. related to the pervasive role of the state, broad subsidization and resulting economic distortions of the level playing field, weak protection of intellectual property rights, slow opening up and limited market access as well as lack of reciprocity in investment rights. Therefore, actively cooperating with the US would be the superior choice. However, the current US administration tends more towards unilateralism which prevents extensive cooperation (apart from certain common initiatives in the WTO). In fact, President Trump also stated that the EU would treat the US even worse than China (Politico, 2019).

In the shorter term, the EU should, therefore, define its own agenda in order to make China agree to meaningful reforms that lessen the economic distortions and spillovers of its policies on the world market. The new EU-China strategy of March 2019 (European Commission, 2019) is headed in the right direction. In this way, the EU can cooperate at least implicitly with the US by following the same objective but with other means.

To achieve this aim, the EU should primarily strive for encompassing multilateral reforms. Rather than waging a trade war like the US, negotiating and working together in the WTO is a better way to go. Putting pressure on China within the WTO framework in order to respect fair trade policies is the best option (Gonzales/Veron, 2019; Matthes, 2019). The EU's Concept Paper on WTO modernization of September 2018 (European Commission, 2018) was an important step in this direction. The same is true for the Trilateral Initiative together with Japan and the



US, which focuses on tackling the problem of distortive industrial subsidies and forced technology transfer (in China and other WTO members). An initiative of the Trilateral Group to create more binding WTO rules for the notification of industrial subsidies has found the support of other members. On this basis, a common proposal has been made which is currently being discussed in the WTO. However, progress on other reform issues proves more difficult in the Trilateral Group. Therefore, the EU should be much more active in building coalitions by convincing other like-minded WTO members to back the EU's reform proposals.

These efforts in the multilateral framework can, should and are accompanied by bilateral negotiations with China as a second best solution. This could be promising because due to the trade conflict with the US, China has an incentive to improve cooperation with the EU (Garcia-Herrero, 2018). Indeed, there are several initiatives ongoing. This pertains, firstly, to the negotiations on a bilateral investment agreement with China. However, here the focus is less on economic distortions in China and more on market access and forced technology transfer in China (especially via joint venture requirements). Secondly, a bilateral working group of the EU and China on WTO reform was established in summer 2018. However, real progress in these bilateral arenas has proven difficult up to now. On top of this, two potential problems have to be kept in mind; siding too closely with China could be regarded as controversial from the point of view of the US and further complicate common initiatives. Moreover, it would be in China's interest to split up the implicit cooperation between the EU and the US.

In the longer term, the question arises if China will eventually agree to meaningful reforms to limit the spillovers of its state-capitalist model to the world economy. There has been a long history of attempts by the US and the EU in the WTO framework with only very limited progress so that the multilateral avenue will at least be long and probably not very fruitful. The US-China negotiations have the potential to induce more change on the side of China at a later stage. However, it is still unclear whether this would also pertain to the economic distortions originating from China. If no meaningful progress is achieved in this area, and if China (relying on ongoing forced technology transfer) continues to catch up technologically, the EU and the US will be faced with ever more intense but unfair competition from Chinese companies due to the lack of a level playing field on the world market. Faced with this challenge, the US inclination to decouple from the Chinese economy would gain even more momentum. Moreover, it is possible that the WTO would lose relevance, if the US no longer adhered to panel rulings (in the absence of a functioning Appellate Body) or even if the US left the WTO.

In such a scenario, if the EU's best attempts should prove futile to induce China's agreement to meaningful reforms, also the EU would have to make hard choices. This would imply taking a much more assertive stance in trade and competition policy vis-à-vis China (Matthes, 2019; Zeglén, 2019; Rhodium/Merics, 2019). Possibly, this would need to go hand in hand with an attempt to lessen the dependence of EU companies on sales in China and could in the end also involve some form of partial decoupling. Moreover, in such a scenario, faced with the choice between siding with the US or with China, the EU should clearly align with its traditional transatlantic ally. Eventually, the EU would have to decide whether to continue to rely on a WTO-ex-USA or whether it would be more promising to build a new plurilateral framework with like-minded market economies.

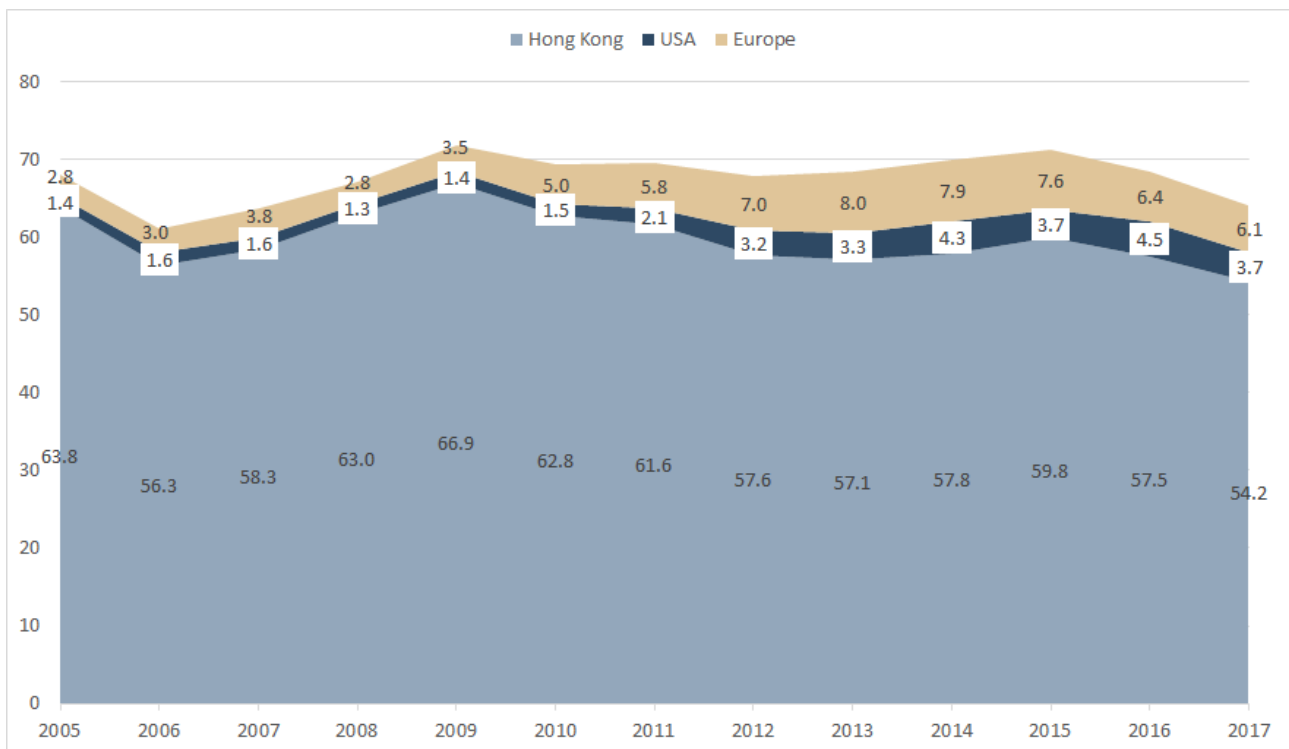


All in all, the EU will have to become significantly more determined and focused on the challenges from China and from a potential decoupling between the US and China. Therefore, the EU has to become more united in its policies on trade, investment, competition and also on its strategic geopolitical approach. Unfortunately, this is no panacea as China attempts to undermine a consensual approach with the BRI and its 17+1-Initiative. All the more, the EU’s key players – France, Germany and the European Commission – should considerably increase their efforts to forge sufficient unity among EU members.

## Annex

**Figure A-1: Share of Hong Kong, United States and Europe in FDI stock of the People’s Republic of China 2005-2017**

In percent



Source: National Bureau of Statistics of China, 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018; own calculations

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## Zusammenfassung

Innerhalb der letzten vier Jahrzehnte durchlief die Volksrepublik China eine enorme wirtschaftliche Entwicklung. Mit dem zunehmenden Gewicht in der Weltwirtschaft stiegen jedoch auch die globalen ökonomischen Wirkungen und die politischen Einflussmöglichkeiten der Volksrepublik. Durch beide Entwicklungen sehen sich die USA und die EU vor zunehmende Herausforderungen gestellt. Dies wird noch verstärkt durch die Strategien, die China für seine wirtschaftliche Entwicklung genutzt hat und noch nutzt, wie zum Beispiel verzerrende Subventionen zugunsten der eigenen Industrie, erzwungenen Technologietransfer oder Investitionsbeschränkungen, welche insbesondere in den USA, aber zunehmend auch innerhalb der EU kritisch gesehen werden. An dieser Machtverschiebung in der Weltwirtschaft und dem dadurch begünstigten Handelsungleichgewicht zwischen den USA und China entbrannte der gegenwärtige Handelskonflikt. Vor diesem Hintergrund wird in den USA über ein mögliches Decoupling diskutiert – also eine ökonomische Entkopplung der Volkswirtschaften Chinas und der Vereinigten Staaten. In diesem Report wird analysiert, ob es bereits Hinweise in den offiziellen Daten für ein Decoupling gibt.

Dabei wird deutlich, dass die USA und China wechselseitig die wichtigsten Handelspartner darstellen. Daten über die Wertschöpfung belegen zudem, dass die beiden Staaten über Wertschöpfungsketten noch wesentlich enger verbunden sind, als reine Handelszahlen nahelegen. Dies gilt insbesondere für den Bereich der Informations- und Kommunikationstechnik sowie den Elektronikbereich. Jedoch belegen bereits jüngste, monatliche Handelsdaten, dass der amerikanische Anteil an chinesischen Importen sowie der chinesische Anteil an US-Importen gesunken sind. Somit zeitigt der Handelskonflikt bereits negative Auswirkungen auf den Handel zwischen den beiden Volkswirtschaften. Die Handelsdaten beinhalten zudem erste Anzeichen, dass Handelsströme in Richtung EU umgeleitet werden. Hinweise für ein mögliches Decoupling lassen sich jedoch nicht nur im Bereich des Handels finden. Zwar scheint das Verhalten von US-Investoren in China noch nicht beeinflusst zu sein, aber bei chinesischen Direktinvestitionen in den USA werden erste Auswirkungen deutlich. Denn auch in diesem Bereich scheinen Investitionsströme nach Europa umgeleitet zu werden. Darüber hinaus sinkt der chinesische Anteil an US-Schuldpapieren und chinesische Devisenreserven werden weg vom Dollar in Richtung Gold umgeschichtet. Diese Bewegungen sind jedoch noch vergleichsweise gering.

Bei der Wahl einer politischen Strategie als Reaktion auf ein sich möglicherweise verstärkendes Decoupling muss die EU berücksichtigen, dass die EU und die USA ein gemeinsames Interesse daran haben, dass die durch China ausgelösten Wettbewerbsverzerrungen in der Weltwirtschaft deutlich abgebaut werden. Zu diesem Zweck sollte die EU mit noch mehr Entschiedenheit und Nachdruck sowohl multilaterale Reformen innerhalb der WTO vorantreiben, aber auch bilateral einen Interessenausgleich mit China anstreben. Falls jedoch auf diesen Wegen die verzerrenden Auswirkungen des chinesischen Staatskapitalismus auf die Weltwirtschaft nicht hinreichend begrenzt werden können, muss sich die EU auf die Eskalation bestehender sowie das Entstehen neuer Handelskonflikte vorbereiten. In solch einem Szenario wären harte Entscheidungen wohl unverzichtbar. Sie müssten unter anderem ein strengeres Handels- und Wettbewerbsrecht beinhalten, aber auch insgesamt eine Verringerung der Abhängigkeiten von der



Volksrepublik China ins Auge fassen. Oberstes Ziel muss dabei sein, dass sich die Europäische Union auf eine gemeinsame geopolitische Strategie gegenüber China einigt und diese im politischen Handeln konsequent verfolgt.

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