

Demary, Vera; Matthes, Jürgen

**Research Report**

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# China's digital policy: a threat to European business models

Vera Demary, Jürgen Matthes, 01.10.2021

**China is making great strides in regulating digitization. Some aspects are similar to European approaches, but Chinese laws on data security and protection go much further. This may result in a threat to European business models.**

### China's digitization strategy

China is pursuing ambitious goals: Digitization is to provide an additional boost to the economy and help secure political stability. The regulation of digitization in the country provides the framework for this (see also Demary et al., 2021). A multitude of laws and bills regulate access and use of data, consumer protection and cybersecurity. From a European perspective, the problem is that most of these regulations have a wide scope of application and include far-reaching access options for the Chinese state, for example to proprietary data. In addition, there are strict requirements regarding the storage of data and the transfer of data abroad, as well as the social credit system, which collects data on individuals, but above all on companies. In the event of a poor rating in this system, the Chinese government can make it more difficult for foreign companies to do business.

Another structuring element of China's digital policy is the collaboration between business, the state, and the party, which manifests itself, for example, in the blocking of market access for foreign tech companies to protect domestic companies. At the same time, China is also striving for international influence in the digital

sphere with its own software and hardware as well as intensive participation in standardization bodies.

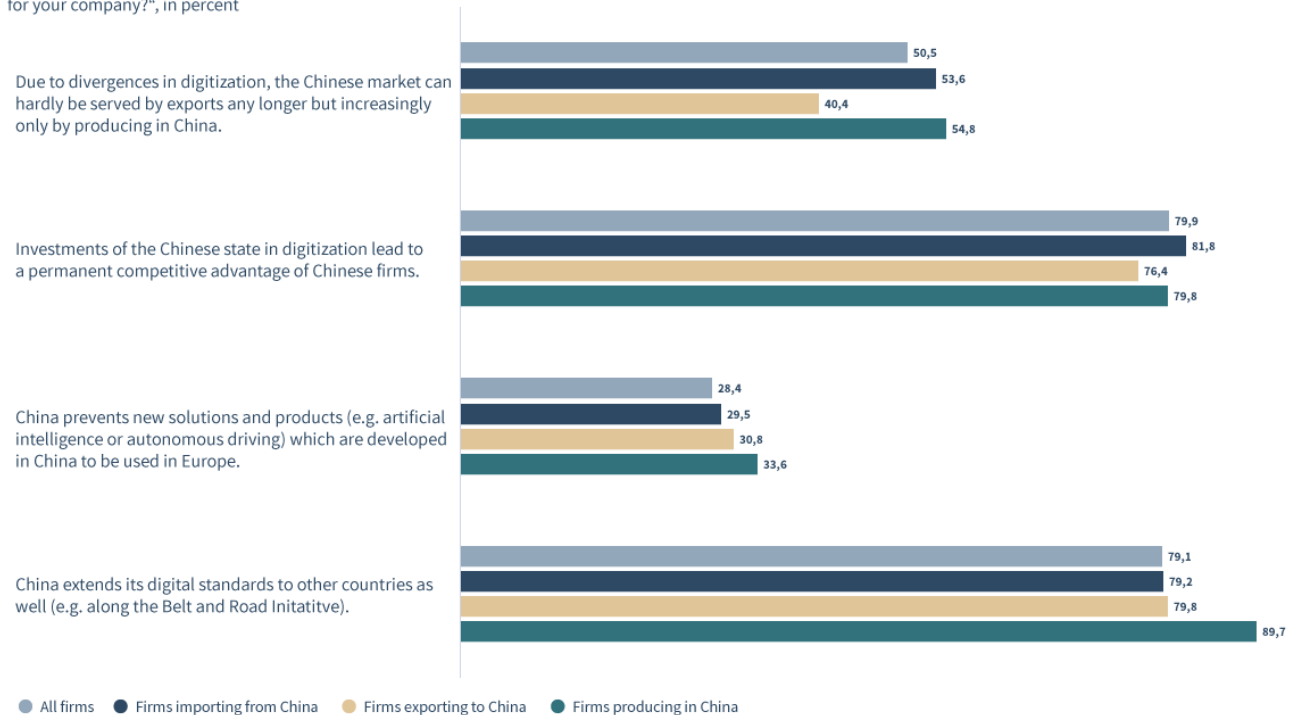
### Impact on European business models

This comprehensive Chinese digital regulation entails costs and risks for European companies with business relationships with or locations in China. These include compliance costs for observing and adhering to the regulations, sanction risks in the event of (alleged) violations, and costs of involuntary data sharing. At the same time, the size and dynamics of the Chinese market still represent a great opportunity for European companies. It is therefore even more important to weigh things up.

The increasing regulation of the digital sphere may change the strategy of European companies to serve the Chinese market. Instead of a withdrawal from it, the opposite could happen, and exports to China could increasingly be replaced by local production of European companies in China. This is particularly true if European manufacturers rate the opportunities of the Chinese market as very high. If it is necessary to incur the above-mentioned costs and risks to serve the market anyway, a relocation of production to China will be an option as part of an all-or-nothing strategy. Due to regulatory requirements and the emerging trend toward decoupling, European companies in China could be forced to build up self-sufficient digital systems there in order to continue serving the market. A relocation to China would be associated with a threat to the business model of many European countries.

## Expected developments in China from a business perspective

Answers „yes“ or „rather yes“ of German firms from industry and industry-related services to the question: „Which developments do you expect in the next five years for your company?“, in percent



N = 93 to 449.

Source: IW-Zukunftspanel 2020

## Results of a German company survey

To evaluate this hypothesis, a company survey was conducted among 1,100 German companies from industry and industry-related services at the end of 2020. Besides questions about their dealings with China, they were asked about trends of structural change and their expectations in this regard in the near future.

More than half of the German companies surveyed expect that due to the regulatory differences in digitization the Chinese market can hardly be served by exports any longer but increasingly only by producing in China (Figure). Among companies with production in China, which have an even deeper insight, this figure is as high as 55 percent. Such a development would undermine the export model of many German companies that serve the Chinese market through exports from Germany and thus secure jobs in the EU. It appears likely that a survey among companies in other EU member states would provide similar results, particularly in those member states with strong industry and export-based business models.

In addition, further threats to European business models seem to be emerging. For example, around four out of five of the German companies surveyed expect Chinese companies to have a lasting competitive edge in the coming years because of the Chinese state's digiti-

zation investments (Figure). This should be seen as a clear warning signal to German and EU policymakers that a too hesitant and cautious digitization strategy could jeopardize European business models.

Finally, it is questionable whether Europe can benefit as a business location when European companies develop new digital technologies in China, a pioneering country, and if these ultimately become usable here as well due to international knowledge transfer to Europe. This was the case in the field of information and communications technology (ICT), where Germany, for instance, was lagging behind the then pioneers USA and Japan already in the 1990s. Despite this drawback in ICT production, German companies were able to use ICT to improve their (old-economy) products, thus maintaining and in some cases even expanding the competitiveness of German industry. The key question is therefore whether China will also allow knowledge transfer. After all, around three out of ten surveyed German companies are skeptical here, and this is particularly true of companies with production in China (almost 34 percent).

It would also be problematic if the decoupling tendencies were to become even broader as China expands its digital sphere of influence to other countries. European exporters would thus encounter increasing difficulties there as well. It is therefore relevant that around 80 percent or more of the German companies surveyed

expect China to extend its digital standards to other countries as part of the Belt and Road Initiative.

### Economic policy recommendations

Chinese digital policy can certainly have an impact on European business models. From a European perspective, it is therefore important to become and remain active in various fields of action to keep the European economy internationally competitive in the digital sphere:

- Greater transatlantic cooperation in digitization, for which the Biden administration in the USA offers new opportunities, would be a useful means to deal with the Chinese digitization strategy.
- In addition, the competitiveness of European companies should be fundamentally strengthened, for example through better framework conditions for start-ups and the completion of the EU's digital single market.
- The EU should continue to make progress in setting smart framework conditions for the digital world, which it has already done well with the General Data Protection Regulation (GDPR), for example.
- Finally, a continuous dialogue between China and the EU on digitization issues should be promoted to achieve productive cooperation between the EU and China instead of the latter closing itself off further.

### References

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