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# COURSE CORRECTION

## China's shifting approach to economic globalization

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## KEY FINDINGS

- **China's leadership is trying to strike a balance between securitization and remaining globally integrated.** Beijing's policy response to new geopolitical realities will have profound implications for the trajectory of domestic reforms and China's future global economic integration.

- **China's commitment to hedged integration with the global economy has not changed, despite the hostile international environment.** But it is increasingly on China's terms – in stark contrast to the old liberalization mantra. China needs to remain connected to the global economy to achieve its goals of becoming a modern, technologically advanced, and prosperous country.

- **China seeks to reduce its reliance on essential external inputs.** Trade and investment links are being reshaped to be more resilient and to further China's development goals. The role of international exchanges has switched focus from exports and foreign investment to accessing strategic technology and know-how.

- **China aims to internalize global value chains and finance by leveraging its large domestic market.** Onshoring the production of critical inputs by foreign companies in areas vital for China builds economic self-reliance and contributes to developing indigenous alternatives, bringing their technology and production within the CCP's jurisdiction.

- **Contrary to some interpretations, the DCS is not universally bad news for foreign companies.** Expansions in market access in non-sensitive areas or in sectors in which China aims to onshore value chains mean new opportunities. However, protectionism, securitization efforts, new cybersecurity rules, and efforts to build supply chain resilience are simultaneously pushing out some foreign companies.

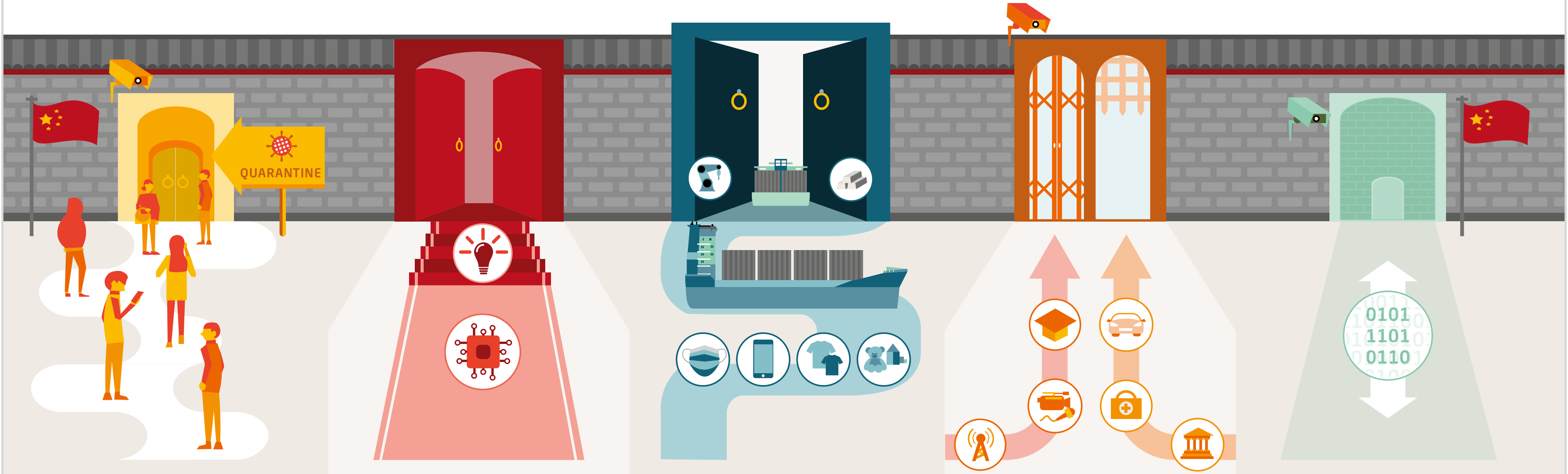
- Beijing's pursuit of managed integration means its treatment of foreign firms differs according to the industry and its strategic priority. Its variable approaches can be summarized as follows:
  - **Protect market share** where local companies are globally competitive, such as in network equipment
  - **Onshore foreign technology** where possible, for example in the chemicals sector
  - Create new **opportunities for non-sensitive foreign investment**, like in the automotive sector
  - **Import foreign technology** where necessary, such as aerospace components
  - **Integrate with global financial markets** and promote the yuan abroad, for example with greater access to foreign financial service providers

- **China's changing views on global economic integration means that foreign firms are granted access to a market that resembles a fortress that is currently being reinforced.** Foreign operations in China are de facto on a pathway to becoming more like a local Chinese entity rather than integrated in global networks. They are not decoupling from China, but rather decoupling their China operations from their global ones.

## China's economic fortress: Beijing is tightening control over international exchanges

Cross border flows are under ever greater scrutiny

| PEOPLE | TECHNOLOGY | TRADE | INVESTMENT | DATA |
|---|---|---|---|---|




**PEOPLE:** China's already miniscule number of foreign residents (0.06% of the population) faces even tighter restrictions on entering the country as a result of the pandemic. **73 percent of European companies** report a negative impact from COVID travel restrictions.

**TECHNOLOGY:** China is rapidly pursuing **technological self-reliance**, which it aims to achieve by developing local tech where possible, onshoring foreign providers where necessary (as encouraged in the 14th Five-Year Plan) and importing supplies from abroad where there is no alternative.

**TRADE:** Despite ongoing trade disputes, trade in goods is mostly open and unrestricted. China's share of global trade has **skyrocketed from 2.6 to 10.4 percent** between 2000 and 2020, with China's trade in goods and services exceeding USD 5 trillion in recent years.

**INVESTMENT:** Investment into China remains restricted in many areas, but restrictions in non-sensitive industries are generally being removed. China overtook the United States as the world's **top destination for new foreign direct investment** in 2020, attracting USD 163 billion in investment.

**DATA:** China strictly controls access to information through the Great Firewall, which **blocks over 300,000 domains**. Meanwhile, new data governance rules demand extensive data localization from companies in China, and tightly restrict cross-border data transfers.

Sources: National Bureau of Statistics, EUCCC Business Confidence Survey, State Council, World Bank, United Nations Conference on Trade and Development, Cornell University

## 1. CHINA ADJUSTS ITS APPROACH TOWARDS GLOBALIZATION AMID RISING GEOPOLITICAL FRICTIONS

China's gradual integration into the global economy has fueled its rise for 40 years. Yet this once-axiomatic economic driver has recently become far more contested, and its place within the party-state's strategic vision for future development is consequently less certain. In the past, optimism about China's integration into the global economy helped prevent any major confrontations. But today global interconnectedness is increasingly seen as a strategic vulnerability in China (and elsewhere) as growing economic rivalry and systemic differences have thrown up political frictions. In response, China's leadership has adjusted their approach to international economic engagement – with profound implications for the trajectory of domestic reforms and China's future global integration.

The policy shift towards the Dual Circulation Strategy (DCS) set out by President Xi Jinping in April 2020 focuses on managing China's interdependence with the world by emphasizing indigenous innovation and self-reliance. The shift has generated concern among Western politicians and observers, as it disrupts long-held, largely tacit beliefs that the eventual outcome of China's integration into the world economy would be gradual convergence of its economic and perhaps even political systems with Western norms.

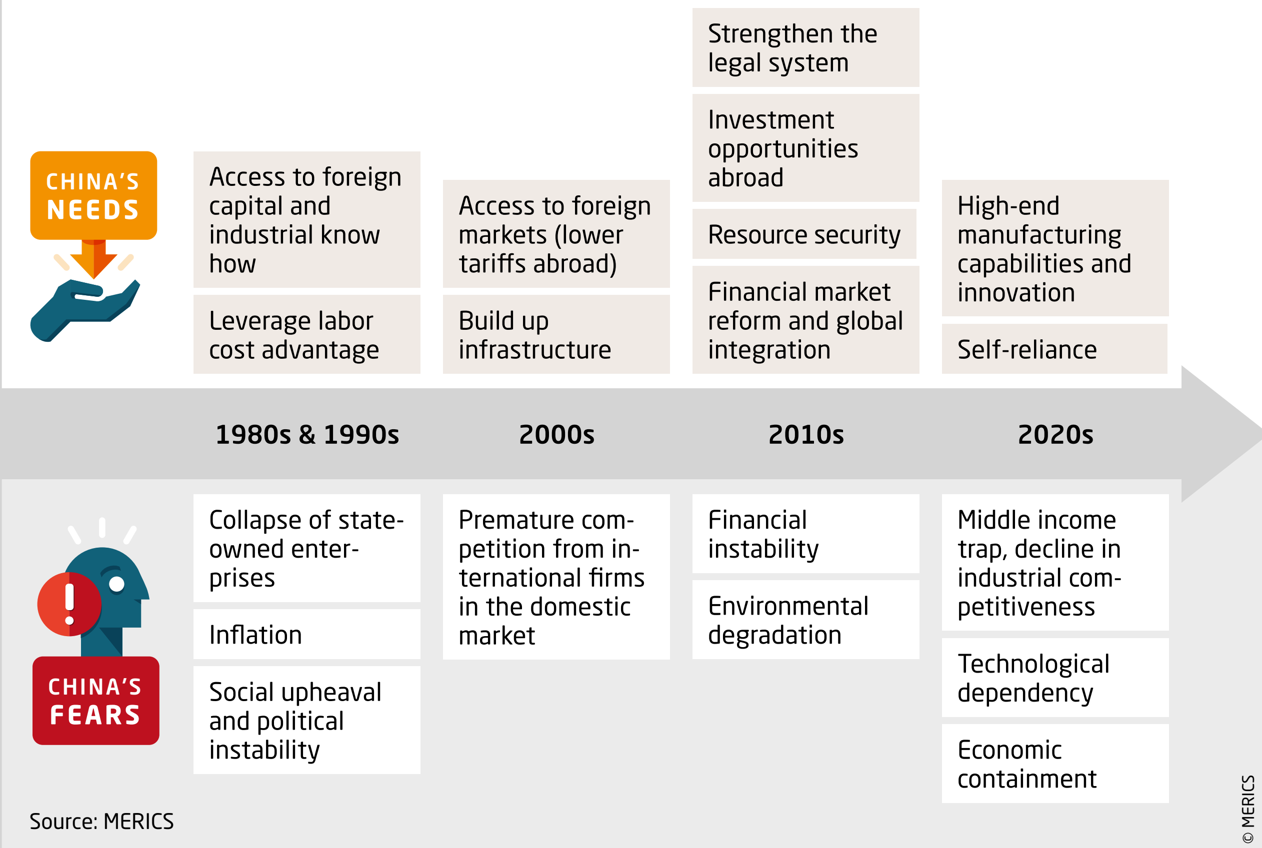
However, dual circulation does not signal any return to pre-reform Mao-era isolation. China's leadership is adapting its approach to globalization to manage risks in a more volatile global setting. Despite the seemingly profound changes, the shift does not represent a radical transformation in Beijing's views on globalization and opening up.

China's embrace of globalization and the liberalization of its economy since the 1980s was always marked by caution and experimentation; it was a strategy of hedged integration. At each step, the CCP leadership was mindful of economic and political risks, careful to balance the country's needs and fears as they evolved (see Exhibit 2, p. 5).[1] Although the motivation and priorities for opening up have changed with China's economic development stages, the key building blocks include:

- **Catalyzing economic reform:** Propelling structural reforms, and pushing back against conservative vested interests
- **Strengthening marketization and competition:** Exposing Chinese companies to foreign competition to improve domestic supply, productivity, profitability, and innovation
- **Securing technology and innovation:** Accessing foreign technology and know-how to enable economic development and innovation
- **Attracting capital inflow:** Foreign investment boosts domestic growth, upgrades industry, and improves efficiency in China's financial markets.
- **Deepening economic ties:** Strong trade and investment ties help expand China's economic power. Real and prospective of opening China's market (even if just partially) helps secure market access for Chinese companies abroad for exports and investment.

Exhibit 2

**Tension between the benefits and risks of global economic integration**
Key motivations and concerns at different periods of China's embrace of globalization




Source: MERICS

China's engagement with the world is also no longer only a one-way street. Whereas China previously had to reform its economy to attract foreign investment, foreign companies can no longer afford to miss out on China's vast market opportunities. Since 2010, China has expanded its economic footprint: Chinese companies are venturing overseas and buying foreign entities.

China's greater international ambitions – most visible in the Belt and Road Initiative (BRI) launched in 2013 to connect and unlock new markets – reflect its growing economic weight and are accompanied by a perception of liberal market economies as being in relative decline, and potentially inferior to China's political and economic system. Nonetheless, Beijing still needs to secure access to foreign technology, know-how, and capital.

The shifting landscape of global economic relations requires China's leadership to rethink its approach – and is empowering conservative forces in China. Long-entrenched skepticism about Western principles of market forces (and democracy) is making a comeback. A greater focus on securitization, self-reliance, and – perhaps most dangerously – nationalism and ideology are fundamentally changing how China engages with the world.

Long-entrenched skepticism about Western principles of market forces is making a comeback

## 2. AMBITIONS AND VULNERABILITIES TIE CHINA TO THE WORLD ECONOMY

Confidence and insecurity feature strongly in Chinese debates on how to pursue external economic engagement. This contradictory mix is the product of China's current stage of development and reflects the fact that its overall economic power remains quite small. China has expanded its economic leverage in some areas, for example by consolidating global supply chains within its borders, and Chinese firms have attained leading positions in industries such as telecommunications, high-speed rail, and digital technologies. Yet it is still weak in crucial areas, such as foundational technology and international finance, so it holds limited chokepoints over other advanced economies.

Confidence stems from China's economic dynamism and resilience. China's share of the global economy jumped from 4.0 percent in 2001 to 17.4 percent by 2020.[2] GDP per capita growth averaged 8.1 percent a year in the same period.[3] China managed to avoid significant financial shocks during the 1997/98 Asian Financial Crisis and Global Financial Crisis in 2008/09. Beijing draws further evidence of the benefits of its economic model from the swift economic recovery after the Covid-19 outbreak in 2020.

China remains aware of its relative weakness

China has become increasingly emboldened in international affairs, which is often perceived overseas as an attempt to dominate others. Yet domestically this is viewed as China simply defending its core interests. China remains aware of its relative weakness. The sense of injustice suffered at the hands of imperialist forces in the "century of humiliation" from the Opium War to 1949 has been translated into a domestic political strength as pushback from advanced economies is readily seen as a bid to undermine a "weaker" China.

Beijing is already convinced that the United States is pursuing a policy of containment against China.[4] Official narratives are dominated by the view that the United States and its allies are working to stall China's rise and maintain a monopoly on core technologies.[5] Deteriorating China-EU relations stoke these concerns. Scholars highlight the risks of China's dependence on other nations for technology and know-how as likely to hinder industrial upgrading and warn that foreign companies could leave.[6]

Conservative voices in the public arena have gained increased prominence amid economic antagonism. Previously, external pressure to conform with international expectations was a useful means to stimulate domestic reform; it is now seen as hostile. The leftist, statist wing of the CCP has long preferred a path of self-reliance; such voices feel vindicated by US moves against Huawei and ZTE threatening to cut off supply of high-end semiconductors. The self-reliance campaign, which has been running in the background for decades, has become a national priority that demands a "new type of whole of nation approach (新型举国体制)," as announced in the 2020 Central Economic Work Conference.[7] This means extensive government support for strategic industries, targeted mergers and acquisitions of critical foreign tech and tightened national security regulations.

Nevertheless, China's approach to hedged integration has not changed. Opening up remains essential when it is to China's advantage – and also because China's dependence is widely acknowledged.[8] Overall, Chinese intellectuals and policymakers remain committed to economic integration, but increasingly on China's terms – in stark contrast to the old liberalization mantra. Justin Lin Yifu (林毅夫) of Peking University contends that, should the US block access to certain high-tech products, supply would be maintained through trade with other advanced economies in Europe and Asia.[9] Scholars such as Hu Ran (胡然) argue that complete tech decoupling between the US and China is not possible.[10]

Exhibit 3

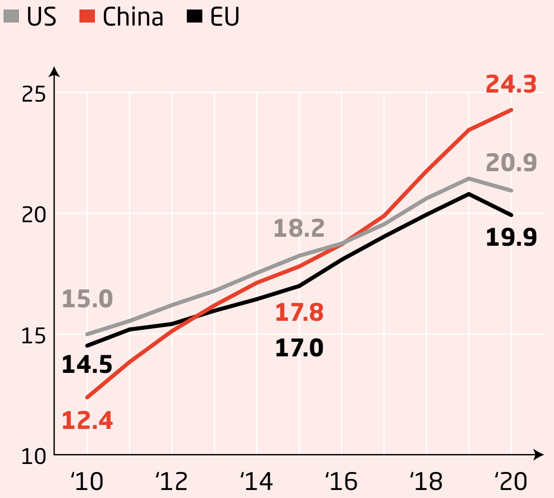
**Despite China's extraordinary growth, its economic power remains limited in many areas**

Examples of China's economic confidence and insecurity

## STRENGTHS

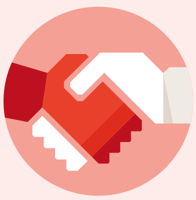
### Domestic economy

Gross Domestic Product (GDP), Purchasing Power Parity (PPP); current international USD trillion




Source: World Bank

### International trade



**China** is the **top trading partner** of over

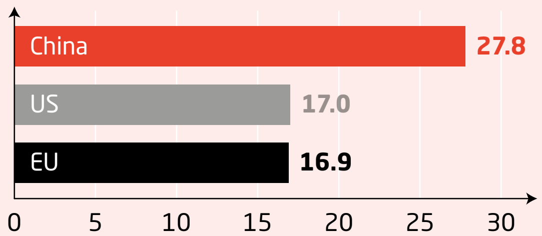
**120**

countries and regions including the US, the EU and Japan.

Source: CIIE

### Manufacturing superpower

Share of global manufacturing, value added (2019, percent)




Source: World Bank

## WEAKNESSES

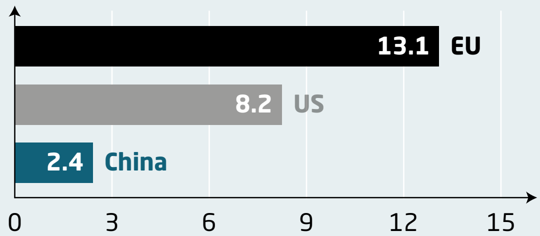
### Technological dependence

China's trade deficit in semi-conductors (USD billion)


Source: General Administration of Customs, Qianzhan

### Overseas investment

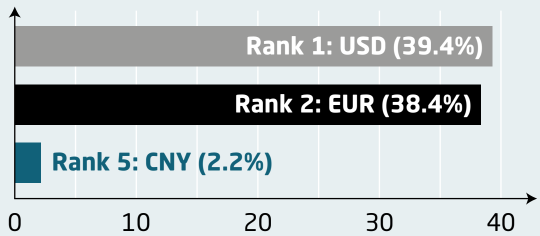
Outbound investment stock in 2020 (USD trillion)




Source: OECD

### International finance

Share of global payments by value in July 2021




Source: SWIFT

The bottom line is that China needs to remain connected to the global economy to achieve its goals of becoming a modern, technologically advanced, and prosperous country. China's political ambition does not yet match its economic and technological reality. Reinforced global connections are vital to becoming more self-sufficient and upgrading the economic structure. Accordingly, China's leadership has developed a new blueprint for engagement with the world economy.

## 3. THE DUAL CIRCULATION STRATEGY: CORNERSTONE POLICY FOR NAVIGATING GLOBALIZATION'S NEW REALITIES

The Dual Circulation Strategy (国内国际双循环 or双循环 for short, hereafter: DCS) is China's overarching plan for further economic development and managing global integration. It was first mentioned in a speech by Xi Jinping at a meeting of the Central Financial and Economic Affairs Commission in April 2020. It seeks to address China's core challenges for the coming decades, ranging from external risks like protectionism and technological dependencies to domestic challenges like inadequate innovation capabilities, income inequality and environmental degradation.[11] The DCS is enshrined in China's 14th Five-Year Plan for economic development, which includes a mid-term outlook until 2035.[12]

The new flagship strategy marks a definitive break with the Great International Circulation Strategy pioneered by Deng Xiaoping which concentrated on export and investment-led growth. The key idea of the DCS is to strengthen the domestic market (internal or domestic circulation), while optimizing China's integration into global markets (external or international circulation).[13] The two main goals are to:

1. Increase domestic consumption and innovation to become the chief drivers of economic development

2. Reduce the reliance on essential external inputs and supplement domestic economic activity through global integration

### 3.1 Views on the DCS differ within China's elite

Internally, an extensive debate has unfolded on how to interpret the DCS, with senior bureaucrats advancing their preferences on how to achieve its broad goals.

- On one side are voices like that of former central bank advisor Yu Yongding (余永定), who calls for a "relatively independent and complete" Chinese industrial system. He highlights the importance of upgrading manufacturing capabilities.[14]

- Others, such as Vice Premier Liu He (刘鹤), stress market-oriented reforms as key to strong domestic circulation. Liu sees the DCS as an opportunity to implement more liberal market reforms such as making more credit available to private businesses.[15]

- Some prominent voices contend that the DCS provides momentum for further opening up. Former vice president of the State Council's Development Research Center, Wang Yiming (王一鸣), stresses the "obvious and significant" contributions of foreign companies to China's technological progress and favors further relaxing restrictions on foreign investment.[16]

### 3.2 Internalizing globalization to safeguard China's continued development

Under the DCS, trade and investment links are being reshaped to be more resilient and to further China's development goals. The role of the external circulation has switched focus from exports and foreign investment to accessing strategic technology and know-how. This equates to an attempt to internalize globalization, rather than relying on global supply chains. Self-reliance (自力更生), a key concept of the DCS, does not imply ceasing to engage with the rest of the world; it refers to the CCP's long-standing desire to maintain control over its economic development (see glossary in annex).[17]

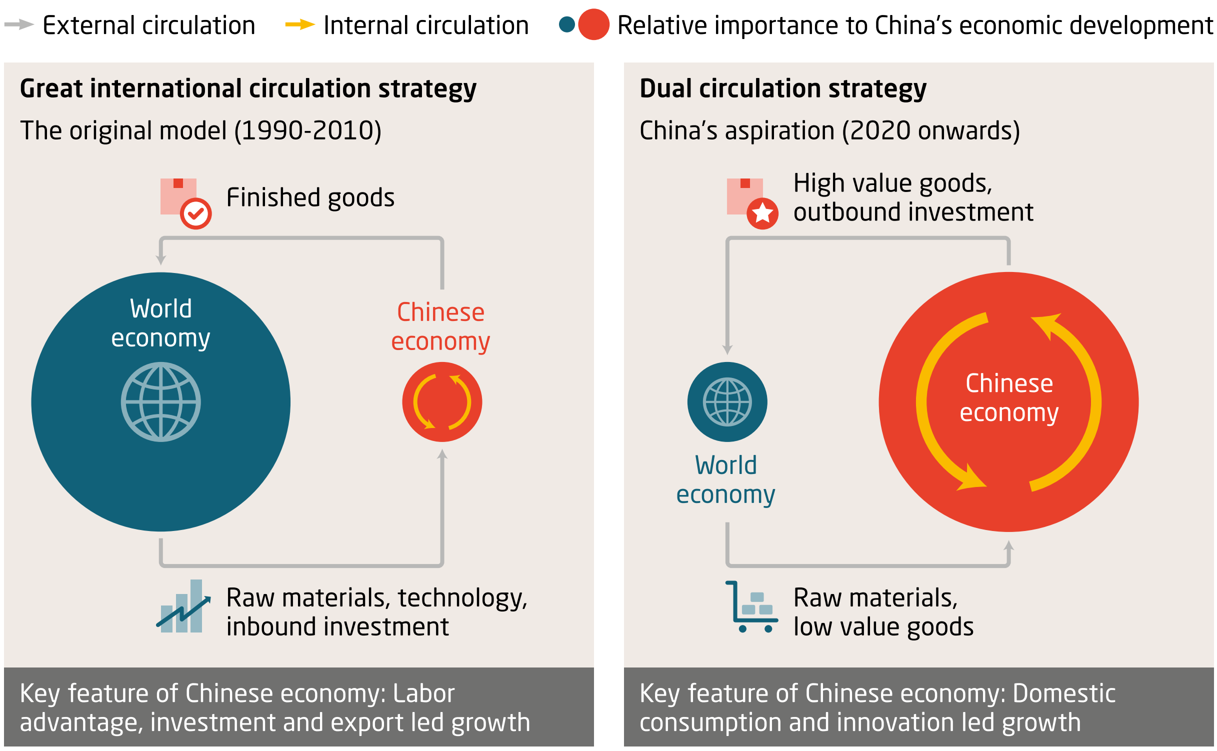
China aims to absorb global value chains

Although China's pursuit of targeted regional and global integration includes a role for free trade agreements, Xi Jinping's rhetoric of continued commitment to reform and opening up in international fora should be questioned.[18] The fact that China joined the Regional Comprehensive Economic Partnership (RCEP) in 2020 and now wishes to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) reflects its need to secure vital trade links and avoid isolation, rather than any firm commitment to increasing market access for foreign firms. Neither agreement was initiated by China, but participation in RCEP and CPTPP can bolster its central position in global trade networks.

The DCS allows for more, selective openness as officials seek to attract foreign firms that can foster technologically advanced industries and boost competition, thereby accelerating the performance of Chinese firms. Foreign financial institutions are important to increase the efficiency of capital allocation. More broadly, China aims to absorb global value chains so that access to certain goods cannot be cut off by foreign governments.

Exhibit 4

**China strives to spur economic growth through innovation and consumption**
Comparing the great international circulation strategy and the dual circulation strategy




Source: MERICS

## 4. A BLEND OF NEO-MERCANTILISM AND LIBERALIZATION: "DUAL CIRCULATION" OPENS SOME SECTORS, SECURITIZES OTHERS

China's state-planners recognize that current cross-border links could be weakened by the actions of foreign governments and are working to develop indigenous technologies, where possible, and onshore foreign providers where necessary. The end goal is to mitigate cross-border risks as soon as possible, then shift towards taking the technological high ground in global value chains and increasing the global position of the yuan. However, this should not be misunderstood as an all-encompassing effort – there are a wide range of non-sensitive industries where China is eager to expand market access and encourage foreign investment to benefit local growth and development. The policy thrust simultaneously liberalizes certain areas of the economy, while tightening and securitizing others.

### 4.1 Technological self-reliance through local innovation and protectionism

The US-China trade war sent China's self-reliance campaign into overdrive, especially given restrictions on US technology exports to some Chinese firms. Foundational technologies remain largely imported or foreign made and hence outside Beijing's control. Hundreds of billions of yuan have therefore been allocated to support innovation, using traditional state-aid mechanisms like financing on favorable terms or subsidies and newer tools like state-guided funds or technology-focused stock exchanges.

The US-China trade war sent China's self-reliance campaign into overdrive

Policymakers are rolling out a suite of securitization measures, i.e., new rules to support both economic and national security – the national security dimensions of economic relations. For example, national security reviews are now required for firms investing in areas defined as Critical Information Infrastructure (CII). Typically, this covers any network equipment and related service agreements, as foreign providers are increasingly seen as unreliable. Reviews also extend to sectors that use such network equipment, for instance the banking sector where foreign banks are under pressure to localize their network equipment, service providers, and data management systems.

China also deploys less explicit tools that impact supply chains more broadly. There are unofficial yet growing demands in China for "Autonomous and Controllable" (A&C) technology value chains.[19] The implication is that in areas of critical technology, China aims to either develop indigenous production or to fully onshore foreign technology value chains as suppliers.

The A&C principle appears to be spreading and has been adopted by politically savvy Chinese firms as a call to find local suppliers where possible. European industrial software providers have found themselves subject to growing scrutiny from government suppliers and private companies alike. Some have noted that, though current customers still prefer their software, local business leaders believe Chinese alternatives are bound to become necessary at some point unless foreign providers can prove their politically reliability.

### 4.2 The long-term goal: seizing the technological high ground

In late 2020, Xi Jinping called for work to increase other countries' dependence on Chinese technology. He said China should tighten the reliance of international value chains on China and forge "assassin's mace" (杀手锏) technologies – upstream inputs that would allow Beijing to credibly choke off foreign markets as a deterrence. Similarly, calls to strengthen the internationalization of the yuan and China's role in global finance are aimed at reducing dependence, particularly on the United States' financial system and the USD. Essentially, state planners want to gain the same kind of leverage over others that the US has over China's essential inputs. Doing so would balance out dependencies that Beijing is unable to eliminate in the short-term, as the credible threat of retaliation would ratchet up the cost to other nations of any economic measures targeting China.

### 4.3 Onshoring critical input production is a priority, though not always achievable

Foreign technology and capital are needed

The DCS does not aim for complete autarky. It is a policy upgrade within China's well-established managed integration approach, balancing internationalization, and self-reliance.[20] To solve the weakness of China's domestic economy, foreign technology and capital are needed. One strategy is to leverage the importance of China's domestic market for foreign companies in order to internalize global value chains and finance, bringing them within the CCP's sphere of influence. It is likely to produce highly selective and strategic market opening measures to foreign companies, based solely on ensuring their business activities support and advance China's domestic economic development goals. As such, policymakers are not only removing investment restrictions for foreign companies, but also rolling out the red carpet to facilitate onshoring. For example, if foreign semiconductor companies wanted to invest in cutting edge operations in China, Beijing would not only welcome it, but would likely fast-track and incentivize such a deal.

Despite policymakers' desire to replace or onshore foreign technology, there are many components and supplies where this cannot be achieved anytime soon. Some technology is subject to control by foreign governments; for instance, that of companies supplying the US military, such as airplane components, or those that fall under American export controls, like the most cutting-edge semiconductor tech. Meanwhile, other technology is tightly guarded against the risk of tech transfer or leakage in China by companies that refuse to onshore production of their most advanced components or products and prefer to export them instead.

### 4.4 Foreign investment in non-sensitive areas welcome if it adds to domestic circulation

Many technologies are not sensitive enough to be subjected to national or economic security concerns. These are already seeing improved market access, as investment in these industries will support China's domestic growth and consumption. This is already taking place, as the most direct barrier to foreign investment, the Foreign Investment Negative List (which clarifies in which areas foreign investors may not invest in China, or can only do so under certain conditions, like equity caps and joint venture requirements) has been steadily reduced.

Investment restrictions on the finance, downstream manufacturing, transportation, and infrastructure sectors have been progressively cut from the list, generating at least some meaningful new opportunities for foreign companies.[21] Seen in the context of technological self-reliance and securitization efforts, these opening measures have a wider significance within a broad parallel set of policy trajectories (see Exhibit 5, p. 12).

Exhibit 5

**China is pursuing selective opening up, while also tightening regulation around the flow of economic factors within China and across borders**
Notable liberalization and securitization policies since 2018

## Opening measures

**April 2018:**
Xi Jinping announces the establishment of a FTZ and Free Trade Port in Hainan

**July 2018:**
Foreign investment negative list (FINL) removes restrictions on various sectors

**June 2019:**
FINL revised to remove some restrictions on foreign investment in certain industries

**October 2019:**
The State Council amends regulations on foreign invested insurance companies, further opens up the sector

**November 2019:**
The State Council releases the Opinions on Further Improving the Utilization of Foreign Investment

**January 2020:**
The Foreign Investment Law enters into force, promising foreign enterprises "national treatment"

**June 2020:**
FINL revisions removes more restrictions for foreign investors

**April 2021:**
China ratifies its membership of the Regional Comprehensive Economic Partnership (RCEP)

**September 2021:**
China applies to join Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)

2018

2019

2020

2021

## Defensive economic measures

**January 2020:**
Foreign Investment Law comes into force, allowing for reciprocal measures to counter discriminatory moves against Chinese investors abroad

**September 2020:**
Unreliable Entity List released, imposing retaliatory action against entities that comply with foreign sanctions on Chinese entities

**December 2020:**
Export Controls Law comes into effect

**January 2021:**
Rules on Counteracting Unjustified Extra-Territorial Application of Foreign Legislation and Other Measures released

**January 2021:**
The updated Foreign Investment Security Review Mechanism comes into force

**June 2021:**
Anti-Foreign Sanctions Law enacted, prohibiting organizations from helping to enforce discriminatory measures against PRC entities

**August 2021:**
The State Council issues regulations on Critical Information Infrastructure

**September 2021:**
Data Security Law enters into force

**November 2021:**
Personal Information Protection Law takes effect

Source: Chinese government ministries and state media

### 4.5 Beijing's selective approach to foreign investors

Beijing's hedged global integration strategy has brought variations in the degree of opening up by sector over time. Strict capital controls were used to maintain economic stability; the state's chokehold over cyberspace is seen by the CCP as vital to social stability. A flurry of more recent changes has created a more politicized business environment, especially tighter data control, and Beijing's dramatic regulatory moves against China's own tech giants.

Contrary to some interpretations, the DCS is not universally bad news for foreign companies, as businesses across a variety of sectors stand to benefit from China's course correction. Corporate strategy makers will need to identify how their company is positioned within China's development goals and changing market access regime. Broadly speaking, the treatment of foreign firms can be broken into five categories aligned with Beijing's priorities.

The dual circulation strategy is not universally bad news for foreign companies

a. **Protect market share where local companies are globally competitive:** China's industrial policies promote protectionism where Chinese firms are technologically competitive. The clearest example of this trend exists in telecoms and ITC, where network equipment suppliers Huawei and ZTE have become world-class competitors. China is willing to protect market share for its indigenous champions and squeeze out foreign network equipment makers it once relied on, especially given that China's champions face US, European and Japanese restrictions. The dire situation is seen in Ericsson's 2021 Q2 revenue – down 60 percent year-on-year – and its closure of an R&D center.[22]

b. **Onshore foreign technology where possible:** For years, state-planners pushed foreign chemicals-makers into joint ventures (JVs) with China's state-owned enterprises (SOEs), blocking full ownership. Then, in 2018, BASF and ExxonMobil were granted approval for massive wholly owned projects in Guangdong.[23] The shift was prompted by the refusal of foreign chemical manufacturers to risk technology transfer to local competitors through long-standing, though informal, JV requirements. Decision makers approved the projects, recognizing that it is better to have local production of critical upstream inputs necessary for China's industrial upgrading under party-state jurisdiction.

c. **Create new opportunities for non-sensitive foreign investment:** The DCS presupposes consumption will take a greater share of China's economy; the automotive sector is a prime example of goods favored by China's growing middle class and hence chosen for fresh treatment. Onshoring high-end production and supply chains creates employment and tax revenue, plus the spillover benefits of skilled jobs and R&D investment. By removing JV requirements, China has attracted electric vehicle maker Tesla and truck maker Scania. Once investment in passenger vehicles is fully liberalized in 2022, Europe's carmakers are likely to strengthen their positions – boosting China's potential to evolve into a regional export base for major auto brands.[24]

d. **Import foreign technology where necessary:** Replacing imports in the short term is out of the question in some sectors – for example aerospace – so state planners must accept cross-border risks to develop downstream industries. China's first passenger narrow-body jet airliner, COMAC's C919, is being developed by relying on foreign suppliers for crucial components (e.g., avionics, power, and airframe systems). The project vision is to trim Airbus and Boeing's share of China's passenger aircraft market.[25] The end goal may be to onshore production of components, or develop indigenous providers, but for now, China must import these in order to develop its own aerospace OEM.

e. **Integrate with global financial markets and promote the yuan abroad:** In recent years China has modified its capital controls to enable carefully managed integration with the global financial system. Better market access for foreign service provider like banks and insurers aim to foster better functionality, e.g., in risk management and capital allocation.[26] Recent expansion of channels for foreign investors facilitates capital inflows that then fall under CCP jurisdiction, while also partially offsetting the lost access to foreign capital markets caused by both China's new restrictions on its companies listing abroad as well as the impending delisting of Chinese companies from US markets.[27] Further opening is crucial to increase China's economic power and promote greater internationalization of the yuan, but stability maintenance trumps the appeal of this goal and any relaxation has remained limited.

## 5. ECONOMIC SECURITY STRATEGY RISKS DECOUPLING AND TENSIONS

China's ideal relationship with the world would be to accelerate its economic and technological strength while remaining highly integrated in the global economy, on its own terms. But the politicization of globalization and rising tit-for-tat emphasis on securitization are narrowing the corridors for China's global integration.

As relations are being reset, the risks of mutual miscalculations are on the rise. China's turn towards self-reliance and greater assertion in the DCS feeds into an increasingly volatile setting in international relations. The resulting lack of trust is creating an environment where things could easily go terribly wrong with extreme implications on China's economic relations with Western liberal democracies and its own development. Hardline stances by either side could push China's economic development trajectory further towards boosting statist and protectionist voices and nationalist sentiment.

China is attempting to increase its relative economic power in the world. But the forceful push might be premature; China's dependence on technology, finance, and know-how remains high. Unrestricted access to foreign markets has been a major contributor to its economic rise and change in relative economic power. China runs the risk that the DCS's aims – to secure a selective integration with the world – will undermine its objectives and increasingly isolate it instead. Securitizing economic ties to achieve greater resilience comes at a price and risks harming China's own development.

Political considerations are beginning to dominate economic policy – an international trend – which in China manifests as nationalist concerns about Western encirclement trying to hold China's rise back. A downward spiral of divergence and decoupling seems the most likely outcome. Every move by China to pursue self-reliance strengthens voices in liberal market economies to tighten Beijing's access to foreign technologies, while every move by liberal market economies to restrict China's access to foreign technologies adds fuel to Beijing's self-reliance campaign. Unless this nosedive can be arrested, and guardrails that manage decoupling can be developed, it is difficult to see a future for deep economic and technological integration.

Every move by China to pursue self-reliance strengthens voices in liberal market economies to tighten Beijing's access to foreign technologies

European companies face a choice between being considered unreliable by the CCP or doubling down, further localizing operations, and contributing to China's strategic goals. The challenge will be to show their willingness to meet the expectations of the Chinese government while protecting their global interests and long-term competitiveness. But the implications of missing out on China's vast market – for growth, innovation, and scale – are daunting.

### Implications for Europe

The latest data by the Chinese Ministry of Commerce shows that foreign direct investment (FDI) is up by 22.3 percent in yuan terms year-on-year in the first eight months of 2021. European companies are expanding their presence in order to safeguard business opportunities in China – at the same time that Chinese investment into Europe reached a 10-year low.[28] Surveys by the European and German chambers of commerce in China indicate many firms intend to expand current operations and deepen localization.[29]

Strong investment figures should not be taken as proof that decoupling is not happening. Changing global dynamics and rapidly emerging tech divergence are forcing companies to create firewalled local solutions for China. A shift in the cross-border flow of people, ideas, and goods is already changing the setup of economic relations between Europe and China. The DCS pushes the corporate mantra "in China, for China" to a new level. Foreign companies are localizing supply chains, data, and research to juggle the evolving compliance dilemmas in China, the EU, and the US.

China's changing views on global economic integration mean that foreign firms are granted access to a market that resembles a fortress currently being reinforced. It comes at the cost of true economic interdependence with globally interlinked supply chains. Foreign firms are being pushed to adopt indigenous alternatives in all areas – suppliers, services, personnel, and partners. As a result, foreign operations in China are de facto on a pathway to becoming more like a local Chinese entity rather than integrated in global networks – they are not decoupling from China, but rather decoupling their China operations from their global ones.

Foreign firms are granted access to a market that resembles a fortress currently being reinforced

European companies in China can expect new challenges and opportunities as China shifts course. Some, like digital services and network equipment, will be driven out of the market over time. Others face growing opportunities, but with rising costs. Non-sensitive sectors like automakers and consumer goods and electronics providers fit nicely into China's ambition to expand domestic consumption. China will welcome sectors that can onshore their technology and supply chains to strengthen its industrial base e.g., chemical manufacturers or industrial machinery producers. All European companies will have to explore how much they need to localize their supply chains, manufacturing and network equipment, software, data systems, and human resources in order to align with growing securitization.

European political leaders will have to face the impacts of such corporate decisions. Lost economies of scale will cut into European jobs and global competitiveness. National security threats emanating from China will need to be confronted, and Europe will require its own onshoring and diversification process where key sectors are overly reliant on China. Diplomacy to rebalance the economic relationship must be maintained. However, European decision-makers will need to consider how to mitigate the risks to economic interests and manage the ongoing divergence between China and the world, at least to the extent that China is willing to reciprocate and produce results.

## Annex: Glossary of terms

| TERM / PHRASE | MEANING | HISTORICAL CONTEXT |
|---|---|---|
| 两头在外；<br>大进大出<br><br>Great International Circulation Strategy | China's export-led development model, using its cheap labor force to become a major manufacturing hub, deeply integrated in global value chains. The strategy produced export-oriented manufacturing industries that imported components and re-exported finished goods. | The phrase was coined by researcher Wang Jian (王建) in an *Economic Daily* article in 1988.[30] It became the guiding principle for economic development through the 1990s and early 2000s as China became the "factory of the world". |
| 自力更生<br><br>Self-reliance | The term encapsulates the government's overarching goal of maintaining control over economic development by reducing reliance on foreign inputs. It usually refers to lessening dependence on foreign inputs in strategic areas, particularly those that could pose a risk to national security. | Championed by Mao Zedong (毛泽东) as early as 1945 as a wartime necessity.[31] It remained an important concept and influenced the policies of all China's leaders. Since 2018, Xi Jinping has placed renewed emphasis on "self-reliance." |
| 自给自足<br><br>Autarky / self-sufficiency | Elimination of dependence on foreign countries (and their political influence), especially for food and industrial products. China may have aspired to achieve economic self-sufficiency in the past, but it was never entirely isolated from the global economy in practice. | Partially pursued by Mao Zedong after a period of dependence on Soviet aid in the 1950s and 1960s. China still traded selectively with Western countries during those decades and was not fully self-sufficient.[32] |
| 自主创新<br><br>Indigenous innovation | A concept with the goal to turn China into a technological powerhouse able to innovate independently and reduce reliance on foreign technologies. As a strategy, it refers to government efforts to support the development and production of high-end goods, especially technologies, by domestic firms in China. | A key part of China's science and technology work since 2006. Gained prominence, and international pushback, with the "Made in China 2025" strategy and import substitution targets.[33] It is included in the 14th Five-Year Plan. |
| 自主可控<br><br>Autonomous and controllable (A&C) | Refers to the goal of safe and secure industrial and supply chains, that are less vulnerable to external shocks, by reducing dependence on foreign inputs. The term is also used in the context of cybersecurity, where security and reliability of information networks, products, and services is deemed a matter of national security. | First discussed in a CCP strategy for digitalization from 2006-2020, A&C principles have moved from being chiefly about cybersecurity concerns to being more all-encompassing of entire value chains. Use of the term in official documents has increased dramatically in 2020/2021. |
| 关键信息基础设施<br><br>Critical Information Infrastructure (CII) | CII rules intend to enhance China's cybersecurity across a wide range of industries. Companies covered by the measures are expected to tighten their cybersecurity and create internal review mechanisms. Similarly, regulators are to have tighter oversight over CII operators, and will oversee CII national security reviews of both specific equipment/services, as well as their customers to ensure compliance. | Found in the 2017 Cybersecurity Law, the regulations surrounding CII have grown in scope and complexity. As China proceeds to crack down on data governance, it is expected that further measures to tighten CII security will be released. |

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