Peterson Institute for International Economics

How do we deal with Chinese overcapacity?

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[00:00:20.10] - Cecilia Malmström

Good morning, good afternoon, good evening. Welcome to this episode of Trade Winds. We will talk about Chinese overcapacity. A possible China shock to tensions between the US and China on the one side, and between Europe and China on the other side. Yes, there are tensions Europe-US as well, but we'll talk about them another time. My name is Cecilia Malmström. I'm a nonresident senior fellow at the Peterson Institute for International Economics in Washington, DC. A couple of weeks ago, President Trump received the Chinese President Xi Jinping in Washington. High-level state visit. The Chinese president received a royal reception, but nothing really concrete came out of the meeting. The trade truce was postponed, a few tariffs on each side was eliminated— were eliminated, and overall it was more of a de-escalation side. The 2 agreed to meet again, and some working groups were established. But U.S. companies are still worried about Chinese competition, about limited access to the Chinese market, and about Chinese overcapacity. Capacity. In Europe, China's competitive and rather aggressive export policy is causing grave concern. Many countries are worried and have put pressure on the European Commission to come up with a more forceful toolbox and a more coherent strategy vis-à-vis China.

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The trade deficit between Europe and China is €1 billion, almost the same in dollars, a day. And the Commission President Ursula von der Leyen has promised to be tougher. The European Union Commissioner Maroš Šefčovič, he is Commissioner for Trade and Economic Security. He just came back from Beijing and there was a meeting that produced some results, some kind of agreement, a bit vague on concretion, but China agreed to limit its exports on hybrid cars and there were a few tariffs taken away as well. The results of this will be discussed tomorrow when prime ministers from all 27 European countries will meet in Brussels. And let's see where— what their reactions are. And we will decompose these results as well. So how can overcapacity be addressed? Is there even an agreed definition of what it is? And how can the US and EU continue trading with China while de-risking, diversifying, and avoiding trade wars? Are we on the right track, or are we just postponing a larger fight? These are some of the discussions we

will discuss today, and I have a great panel. Alicia Guerrero Herrero, who is a senior fellow at Bruegel, a think tank in Brussels, chief economist for Asia-Pacific at Natixis, and a professor at the Hong Kong University for Science and Technology.

[00:03:04.01]

We also have Professor Nicholas Lam, who is associate professor at the Faculty of Law at Queen's University in Canada. And the author of many, many books on different aspects of trade. And we have Yelin Yang, my colleague at Peterson, a non-resident fellow here, but also Professor of Public Policy at Blavatnik School of Government at the University of Oxford. You are very welcome, all 3 of you. Thanks for taking time. So, let's start with the concept of overcapacity. This is something I know that you have dwelled upon quite a lot, Nicolas. What is it? Where is the breaking point when capacity becomes overcapacity? Can you help us clarify this?

[00:03:49.16] - Nicolas Lamp

Thank you. It's a really important question. When I first heard the allegation that China had overcapacity, that is exactly the question I had. Well, what is— what would be appropriate capacity for China? And how do we reach that conclusion? How would— how do we establish that benchmark? And so as I started looking into it more, more closely, I found that there's actually an uncontroversial definition of overcapacity at the global level. At the global level, we can define overcapacity as a gap between the capacity that exists and the demand that there is. It becomes much more complicated when we're saying that a specific country has overcapacity, because at that point we have to make a judgment about how capacity should be distributed. And so essentially what we're saying that China has overcapacity, we're saying China has some of the capacity that we would like to have or that other countries should have. And the question is, on what basis do we decide who makes— who should have capacity? And we see different strands in the debate. One argument that is made that somehow the capacity that China has is illegitimate, that it is based on non-market practices.

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And the problem here is that we don't really have a consensus of what are a legitimate— what is a legitimate form of comparative advantage, right? So there's a big debate about the— between even the US and the EU about whether European countries have also overcapacity because of the way the state intervenes in the economy. So here we have lots of normative judgments involved in what constitutes a legitimate comparative advantage. There's also another perspective, which is that to say that even if China achieved its capacity legitimately, It's

just too much for political reasons. For example, we cannot have China have this much capacity in critical minerals or a 90% share of capacity in critical minerals processing because that allows China to coerce us, right? This market dominance is unacceptable. So here it's more an argument about the effects of Chinese overcapacity. And I think what the lesson here is that we should be explicit what our distributive judgments of capacity, on capacity are based on. Are they based on arguments that they're, that China is illegitimately acquiring capacity? Are they based on the effects that China's capacity has on other countries' ability to attain or preserve capacity?

[00:06:10.02]

And if we bring that into the open, it becomes much more a debate about how capacity should be distributed rather than just about China's overcapacity.

[00:06:19.26] - Cecilia Malmström

Interesting. And there's also, as you say, a lot of political impact of this. So, both the US and Europe has been criticizing China for having an overcapacity that is trying to sort of export away and put over its internal problems on Europe. Overcapacity is a term that the European leaders are using a lot when it comes to China, but I haven't really heard it about any other country. Is this the biggest concern in Europe right now? Chinese overcapacity?

[00:06:53.28] - Alicia García-Herrero

Well, I mean, I very much like kind of this, I would say, theoretical explanation of overcapacity. It makes a lot of sense that, you know, we can't really— how would I say it? It's hard to land it with a lot of precision. I get it. But at the same time, I think there's a lot of things that, you know, if we were to compare Europe, if that's the argument, to China in the way, you know, we could argue Europe has had a trade surplus for a long time. And so isn't that also overcapacity? I think that's, I mean, the actual definition of overcapacity does include external demand. So overcapacity is what is left after external and domestic demand is added. Therefore, it's basically clear that if you are to export, if you are to have China's export share, which is much higher than its GDP as a percentage of the global economy, so basically China overweights on exports clearly and on industrial capacity. Then even more than exports. So in other words, exports to GDP, to global GDP, is in between its consumption and its industrial production. So, you know, if you just look at that, you already realize that no matter how much China were to export, there will still be units that are unsold.

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And the question is, why are they unsold? And I think the difference between Europe and China is the following. Those units are unsold because the companies that produce them at a loss. And we have a lot of evidence on that, so-called zombie companies, uh, are still there. And this is exactly why the, the— in my view, the situation is different, is because there's no exit of companies that are loss-making. And I'm not even talking about the fact that there may be, you know, subsidized— that's why they are there. It's independently on the subsidies. It's, it's— the subsidies aren't enough to basically make that company able to pay interest even, i.e., zombie company, and unable to get enough revenue to pay the interest. So I, I don't think this is new because China itself realizes that this is a problem. They are actually in the process of reforming the bankruptcy law, corporate bankruptcy law. So you can see that in, in a way, this problem of exit is, is well recognized. And therefore, I think it's not only about how much you export It's about how much you are unable even to export, but you still produce.

[00:09:38.15]

And those companies not being able, well, not being willing, if you want, to exit the system. So it's that combination, I think, that makes it different in my view, independently on the subsidies. It's not only about subsidies.

[00:09:52.23] - Cecilia Malmström

That's very interesting. Um, Yelin, the, um, the EU-China, the US-China summit a couple of weeks ago was very high level, so to say, but it didn't really produce much result. What do you make of it? Because overcapacity was, of course, discussed there as well. Or is lack of result or lack of drama a success in itself?

[00:10:21.28] - Yeling Tan

Thank you, Cecilia, and it's great to be here in this conversation with such great fellow panelists. So you're absolutely right. The summit was high on symbolism. And I would argue potentially underdelivered in terms of substance. But I would, I would say that for many parties, it was good enough, right, for, for buying time. And if what each side wants is just to buy time, then the summit achieved its objective, right? It came to some basic agreements on AI safety, the Board of Trade, and a mutual pushing back of the mutual suspensions on export controls. But I would argue that, you know, this approach doesn't really do much to resolve some of the underlying structural tensions between these 2 major economies. If what we're in a situation is that, you know, these various agreements to kind of manage each other's trade flows are basically there to buy time, the question then becomes, what is each— what is each side using that time to do? And that should be the question that we're focused on, right? If we're in a situation where the

US is using that time to kind of escape China's chokehold on rare earths and China is using that time to escape the US's chokeholds on semiconductor manufacturing equipment and technology, then we're in a very dangerous situation because whichever side gets to deleverage faster can have the upper hand.

[00:12:22.06]

Right. And so these tensions can escalate very quickly. And there are very few guardrails in place at the moment to prevent this kind of escalation, which could— because we're talking about rare earths, because we're talking about dual-use technology with semiconductors— can tip very dangerously, can tip us accidentally into even a hot conflict. So that's my concern with this kind of Band-Aid buying time approach to high-level diplomacy at the moment.

[00:12:54.29] - Cecilia Malmström

And what do you think should have been done in order to eliminate those risks? Or was it not possible for different political reasons?

[00:13:04.03] - Yeling Tan

Well, I think the political challenges should not be underestimated. that should not prevent us from arguing that more can be done and more should be done, given the severity of these tensions. Right. So I think both sides need to address that underlying danger and that underlying instability by recognizing that this situation leaves both sides worse off. Right. And instead, each side is thinking, I— if I could just win the asymmetry, if I could just be the one with the higher leverage, then I will emerge victorious. And I think that's a very lopsided way of viewing the conflict, of viewing the tension. So I think both sides need to think about what constitutes a credible assurance to the other side that would prevent this kind of escalation. Right. On China's side, I think there's— China has built up over time, over the past few years, a very credible counter-coercion toolkit. Right. With its use of rare earth export controls and its blocking mechanisms and so on. The problem is that there is a mis— there's an imbalance of what this toolkit is being used for. Right. From China's perspective, it is used for counter-coercion. Right. So China says, I won't use this except in retaliatory situations.

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So only when we're hit first do we hit back. The problem is that from the perspective of the rest of the world, China holds the key to threatening the entire industrial supply chain. Right. And that makes China's trading partners very nervous. It's a new toolkit. Right. And there's a lot of uncertainty around how it is used, what the procedures are. So even at a very basic level,

greater transparency over the circumstances in which China will or will not use these tools would alleviate some of these— the nervousness. Greater transparency over the export licensing process would reduce uncertainty and reduce misperceptions over China's overall intent in this situation.

[00:15:27.28] - Cecilia Malmström

That's very, very helpful. Nicholas, how do you view the outcome of this summit. The US companies are still complaining that they don't have enough access, that nothing really happened, that they are still not competitive. And even if there is a sort of calm right now, it could potentially blow up, as Yeliz said, very in a short time.

[00:15:53.03] - Nicolas Lamp

Well, one interesting aspect of the summit is this idea of this Board of Trade. Exactly. Not so much because this is a very promising idea in the way it's been elaborated, but I think it gets at a basic message that not all trade has to be politicized. Not all trade is problematic in the same way. And so I think this is something that's really important here, that we look at specific sectors and really ask ourselves, is this something where we can be happy to be completely dependent on China, completely supplied by China? And when it comes to toys or consumer electronics, that may well be the case where we can just reap the benefits of China's kind of oversupply, which manifests itself in very low prices for consumers, which is especially important at a time of concerns about affordability, without having any broader concerns. And then we can adopt a differentiated approach to different products and sectors. And that's something that I think is sometimes lost when we look at the recent French-German paper there's this general panic about Chinese overcapacity and imbalances. But the truth is that in many sectors, we are benefiting from Chinese oversupply.

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It results in cheap products for us, not just in terms of affordability, but also in terms of sustainability. I mean, we have to keep in mind that our really only hope to tackle climate change is on the basis of Chinese production of solar panels and batteries. And so what we really need to do, I think, is in every sector and with every product kind of weigh the different objectives that are in play here: affordability for our consumers, sustainability, resilience. Of course, in some sectors there are security concerns, and of course the need to maintain a manufacturing base. And on that basis, in weighing these different factors, we have to develop a differentiated approach to trade with China in different sectors and different products. And the sport of trade idea kind of grasps at that. It doesn't really put it into action, but it grasps at this

idea that there are actually many sectors where we should be able to have duty-free trade with China.

[00:18:08.14] - Cecilia Malmström

So normal trade, and then there's the vulnerable trade that needs special special treatment. Alicia, there's a huge debate right now in Europe about the outcomes of the EU-China meeting in Beijing with Commissioner Sefcovic. The conclusions that were published were very vague, but they are hinting at some sort of more managed trade in some sectors, particularly the hybrid cars. What do you make out of it? And they will be discussed tomorrow, as I said, at the European Council. So we can imagine that Some people say this is good, this is a first step. Others would say this is far from enough.

[00:18:49.02] - Alicia García-Herrero

Yeah. Well, I first like to go back to what Nicolas said, if you allow me, and then— because it's very related. I mean, one has to realize that Europe only has literally one single product where there are tariffs on China, and that is electric vehicles. The rest is open. So, you know, This is not— and by the way, I wouldn't have chosen electric vehicles if you asked me for the reason you mentioned, because maybe that's not the most, you know, advanced thing that you would have wanted to lose. It so happens that it creates 15 million jobs in Europe. That's why there are tariffs on electric vehicles. So, and, and again, as an economist, I may— I, I would perhaps prefer to do that on much more advanced products where we want to have a comparative advantage, kind of an an industry idea rather than the jobs. But the people deciding this are politicians. And this brings me to the European Council. But just to say that I don't think that the US and Europe are comparable. In other words, we do have a lot of Chinese products that we are very willing to accept.

[00:19:59.23]

And the point is, do you want to accept them all? And without being able to export anything to China. So, just the latest data we got, September data, to make that point, our imports are growing at the tune of between 25% to 30%, and our exports, again, are flat. And then you would wonder, okay, isn't there really anything that Europe can export to China? I mean, you wonder, really, nothing. So, that's the problem, I think. The problem is not only that China is able to export very competitively, that's fine. The problem also is that China is not willing to import much other than GPUs and DRAM. And so this is the reality. China is in a massive import substitution strategy, and we all know that. So there's this aspect beyond the willingness to import from China. China is that, that willingness, I hope it were contagious and, you know,

China were also willing to import from us. So having said that, where, where do we stand? I think that letter, I mean, I understand that it sounds a little bit like, you know, dramatic and probably late in the game if you ask me. Maybe no need for that letter.

[00:21:18.23]

There's a lot of European Council meetings where that would have, could have been, uh, you know, discussed in in a way which would have made that letter unnecessary. The point is—

[00:21:30.07] - Cecilia Malmström

Maybe you should tell a little bit the main components of the letter. I'm not sure all the audience are following the details. So it's a letter between— from France and Germany? Yes,

[00:21:39.26] - Alicia García-Herrero

absolutely. This is a good point. This is Macron and Merz coming up with this letter, 7th of October, making very clear that the deficit with China is so huge that there's a need for new, new instruments, that the existing instruments, which as I said are pretty minimal, I mean, are not enough. Yeah. And, and therefore they make a call for a number of instruments. I don't want to get too much into that because I actually think none of that is going to happen. That's why maybe there is no need to discuss those instruments. But the importance of the letter is is the twist, is that— is the turn, the 180-degree turn of Germany. Yes. Which basically, under Scholz, voted, imagine, against those import tariffs on electric vehicles, which you'd say, I mean, that would have protected Germany's domestic industry. But it was Germany's automakers in China that still felt that they could, you know, that they would be hurt by exporting from China to Europe. And that, that is the main reason why Germany was against these tariffs, which is kind of ironic. So now Germany, having lost, what, 250,000 jobs in that industry, in the chemical industry, is kind of turning towards a more protectionist kind of French-like, uh, position.

[00:23:04.14]

That's kind of where we are. But if you ask me, uh, Cecilia, Um, again, China has outsmarted, in my view, the Commission. Sorry to say that. I know that you have a past in the Commission, but the reason why—

[00:23:18.24] - Cecilia Malmström

It wouldn't have happened in my time.

[00:23:20.26] - Alicia García-Herrero

Okay, that's good. Why? Because, um, because China chose hybrid. Why? Because China wants to turn Germany again. That's it. I mean, it's very simple. Why? Because that's the sector that Germany wants to protect. These automakers that were asking for no protection, let me export from China, are now asking for protection because they cannot export even from China because they have better competitors. Better, better in the sense for the competitors, the BYDs in the world that, that can export better than they can export from China. So now they want protection. And, and this hybrid deal, because it's only hybrids I mean, the other thing is what, $5 billion? Olive oil, footwear. Okay, let's leave it there. Okay. I wouldn't even call it a deal. If you ask me, I would not call this a deal. It's a big word. It's just preparation of a safeguard instrument under WTO for one product, hybrid. And that is very beneficial for Germany, which is why I think Mertz may simply take it and leave it, you know, leave the letter, leave Macron with the letter at this European Council. And he, he, he can do it very easily. He can, he can just say, let's ask the Commission to prepare, to, to, to analyze these proposals in our letter.

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But that, that would be dragging it again. That happened already in July in the previous European Council. So to make a long story short, I think China has outsmarted us again by preemptively offering something that is very appealing to Germany, which is the one turning. If Germany doesn't push in the European Council, why would anybody get a fight with China? Now we have the worst political situation since, what, for decades. So this is why I think it's— what China has done is smart, but I wouldn't call it a deal. I would call it a preemptive move rather than a deal.

[00:25:25.15] - Cecilia Malmström

But there are also a vague promise or commitment to open up for China buying more medical equipment from Europe as well. There are no, no amounts, no specificity. But that is— but electric vehicles— oh, sorry, hybrid vehicles. That's a problem in Germany. But the EU difficulties with Chinese export is much vaster than that. It's chemicals, it's medical equipment, it's cement, and so on. And that is not covered. So, one would think that even if Germany would be happy, lots of other countries would not be happy, because it's far from enough.

[00:26:05.14] - Alicia García-Herrero

Correct.

[00:26:05.19] - Cecilia Malmström

So, what do you make of it from outside, Nicolas? You've been following this as well. Do you agree with Alicia that China has outsmarted Europe?

[00:26:16.28] - Nicolas Lamp

Yes. I mean, of course it's, it's, I agree with you is that it's a move towards managed trade, right? And it follows the, of course, the overcapacity regulation on steel. Right. Where, where the European Union's also resorting to, to quotas. And I just wanted to highlight 2, 2 aspects of it. One is, of course, well, what does this represent? If you have managed trade, it's, it's effectively a transfer from European consumers to Chinese producers because what, what they will do is the Chinese producers, they will use the quota for the most high-end cars. There's also talk of minimum prices. So we are consenting to a transfer from European consumers to Chinese producers, which should be very welcome for the Chinese government, especially because it's trying to get its handle on the rat race competition, the involution where everybody's working too hard and nobody's making any profit. And so it essentially allows Chinese carmakers to make more of a profit And it allows the Chinese government to rein in some of the ruinous competition between the carmakers among the Chinese carmakers. Right. And so we have to always keep that in mind that the governments here, the European Commission is agreeing to transfer from European consumers to Chinese producers.

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But I always love to think back to the '80s when the US and the Canadian governments also extracted voluntary export restraints from Japan at the time, which had exactly the same effect. Prices of Japanese cars rose, but it was coupled with another important strategy, which was to invite investment in the United States and in Canada. And so the Japanese carmakers were allowed to kind of skip the tariffs, to hop over the tariffs or the restrictions, by building factories in the United States and in Canada. And in Canada now, 70% of the cars that are assembled here are by Japanese manufacturers. And I'm still looking to see that element of the strategy. I know that BYD is investing in Spain. Obviously we have the factory in Hungary, but if we look at the long-term outlook for the car market, I think we have to— it's clear that China's gonna play a major role. in their Chinese producer are going to play a major role because they're at the cutting edge of electric vehicle manufacturing. And I simply don't see car manufacturing surviving in North America and Europe unless we bring some of the Chinese car manufacturers into our markets.

[00:28:48.05]

The US is not doing that at all. It's trying to keep this firewall in place to keep Chinese cars out. But I think in the long term, if we look at the '80s and the lessons from that episode of managed trade in the car sector, we have to make sure that that is a second component of the strategy apart from the trade restrictions, that we have Chinese investment in Europe in order to keep some of that knowledge or gain some of that knowledge, gain some of the technology transfer, and also keep the jobs in Europe.

[00:29:19.20] - Cecilia Malmström

That discussion is not at all happening in the US, Yeling, is it?

[00:29:26.28] - Yeling Tan

No, I think the discussion and the approach in Europe is a little bit more holistic. Right. Even, even with the deterioration in relations between China and the EU and with the whole Russia-Ukraine conflict kind of hanging over and being a real obstacle to, to closer relations, to me, Europe is still taking a broader and more balanced approach compared to the United States, where very high barriers to investment, very high barriers to electric vehicles. We can, we can add to the list because the list does keep growing. High barriers to drones, ban on Chinese-made drones and so on. It's a much more narrow framework between the US and China, which is why I do agree with a lot of what Nicholas just said, which is that the Board of Trade, if implemented— and there's a lot of ifs there— in a sensible way, can create more breathing room and depoliticize a lot of useful trade that can occur between the US and China. I would just add one thing to Nicholas, what you said earlier, which I very much agree with on this balance between not just doing the export restraints or the safeguards and also inviting in investment, which is that a lot also depends on what China does with this, you know, you don't want to call it a deal, Alicia, with this, you know, with this temporary agreement, with this, with this move, if we want to call it that.

[00:31:21.22]

Right. And there is a larger adjustment that then is being acknowledged at the moment. Right. Because if Europe does implement these safeguards, right, 350,000 a year, 6% growth, where else do the cars go? I mean, is China just sort of spreading the pain to other places, to other countries, and moving its trade frictions away from Europe and towards some other party? Right. So how is this in China's self-interest? And here I would point out that the Chinese government has its own definition of excess capacity. Right. And it hits exactly on the point that Alicia made, which is that there is a problem from the Chinese perspective when firms are no longer making profits and when this loss-making situation is hindering the process of industrial

upgrading. And so, but it's really interesting that the Chinese definition actually focuses on the national pain and the national loss. Right. And of course, right, the global picture that Nicholas highlighted I think many governments fail to take into account. But this agreement on hybrid vehicles could very well promote that industrial upgrading. And the question then for me is, what is Europe doing with the little bit of breathing space that it's been given from last Friday's agreement?

[00:32:58.09]

Right. Is it using that time to actually invest in the types of R&D that would boost German competitiveness. I think that is crucial because otherwise you're going to end up with a more competitive Chinese hybrid vehicle industry. And then the time has run out.

[00:33:23.03] - Cecilia Malmström

What do you think, Alicia? What will Europe do?

[00:33:26.08] - Alicia García-Herrero

Obviously, what Yeling said. Yeah, we should, uh, we shouldn't spend the money to— oh, the breathing room, I should say, not the money, but as well as the money, uh, in subsidizing things that are not going to, you know, that's crucial. I mean, this is just breathing room. It's not a solution, it's obvious. But I have to say that I, I— there are 2 major differences between Japan in the '80s and China today. And we need to— and going back to what could be the board of investment, you know, like this managed investment to get all of these Chinese EV makers or, you know, hybrid, whatever, in Europe, uh, firstly, Japan was a very expensive producer. So the Flying Goose was all about— sure, there were tariffs, but, you know, it was cheaper to produce in Mexico than— so, you know, you, you would actually, to a large extent— not always, because, you know, there was also production in the US, in the UK for that matter— but, but a lot was also about reducing the cost. This is not the case now. So for me, China has an incentive in actually, um, looking as if it produces all, but it doesn't, if you see what I mean.

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I think the, the problem with this is that imports will continue for parts and, and components because China's, um, advantage, comparative advantage, is in the supply chain. So, you know, you can see a lot of, uh, uh, assembling companies. And you see that, you see that in Hungary. And by the way, you're going to see that in Spain too. I have no doubt about it. So, and especially for those with the highest tariffs. So SAIC in, in El Ferrol in Galicia, what's the incentive? That they have the highest tariffs for, for the European market because they're a

state-owned company and they did not unveil any they take on the subsidies. So they have every, every interest in producing because the barrier is higher. But if the barrier were not there, if Europe were to lift and become even more, you know, a pro-market, it's, you know, the incentive wouldn't be theirs because China just has the best— not only the best technology that, that we maybe we could attempt to compete— is the supply chain. That's the first difference. And the second, very briefly, which is as important, is that Japan would never have dared, for obvious reasons, to create a national security legislation around the supply chain by which not a single item, if you want, of tech transfer can actually happen.

[00:36:28.18]

So this is the thing that I think the Europeans have to recognize that what they're going to get is not what Japan gave. And not because Japan was more generous, don't take me wrong, it's because the conditions are different. China is just impressively competitive in China, and China is impressively careful with its tech transfer because it has learned what it means to, to pass the tech transfer with its own, you know, to its own benefit. It's, it's And, and frankly, rightly so. I mean, if, if this is not anybody's fault but, but Europe or the US at the time, and now even with legislation, so no company can dare, if you see what I mean, especially state-owned companies. So for this reason, I think the, you know, the benefits of that additional, uh, kind of a solution, yeah, like the getting all of this investment aren't as in my view, in the '80s. That's why the solution is harder today than it was then.

[00:37:34.01] - Cecilia Malmström

But the solutions are harder because this electric, this hybrid vehicle limitation is a safeguard. So that means that that safeguard has to be extended to other countries as well. So it will affect hybrid imports from other countries. from other countries, Japan, South Korea, US. I don't know the figures there. So it could potentially create a lot of conflicts with allies.

[00:38:00.14] - Alicia García-Herrero

But Cecilia, as you know very well, the way to do with that is costly. Yeah, that's what we did with steel. Yeah,

[00:38:07.23] - Cecilia Malmström

it is

[00:38:08.06] - Alicia García-Herrero

basically, you basically, yeah, make that cost for others less costly. Let's put it this way. Yeah. So it is very expensive for Europe And it's very temporary. That's why I'm saying, wow, I mean, is that all we can, we can do? I hope we still, we at least use the time appropriately, going back to Yellen. Otherwise, it would be, it would be suicide because we won't get anything out of this.

[00:38:35.29] - Cecilia Malmström

So what are the tools that would be effective? I mean, there are the global tools, anti-subsidies and tariffs. There is these different kinds of managed trade. Europe has actually a lot of tools that they're not using, anti-coercion measures and so on, that they've been unwilling to do. You have the 301 in the US, and there have been pushes as well in Europe to have some sort of similar thing. Europe has tried to exclude China from its public procurement bids in in certain sectors. US is doing the same as well. There's export limitations and different prohibitions. But what actually would work? And the EU at least has the ambition to do it WTO compatible. What do you say, Nicolas? I know you've written a lot about WTO.

[00:39:34.03] - Nicolas Lamp

Well, I think it's really an answer of all of the above, depending on the sector and depending on what our goals are in a particular sector and why we are protecting a particular sector, right? If it's security concerns, as we had with Huawei 5G infrastructure, well, it makes sense to have a prohibition or to have regulations which eliminate the security interests. If our concern is to give our industries breathing space, as in the plug-in hybrid space, then it makes sense to have a safeguard which sends a signal that there's a temporary— this is a temporary reprieve and the European manufacturers better shape up. In other sectors like steel, where we are essentially never going to be able to compete, what we are seeing there is an approach, what I'd like to call managed deliberalisation, right? Where the EU actually goes back to the WTO and says, okay, we've liberalized too much, we have to raise our tariff binding, which then provides an opportunity or fact a duty on the EU to negotiate with its trading partners about the size of the tariff rate quotas that each of them gets. And of course, we should also continue the conversation about essentially structural imbalances, China's low consumption share, what China can do to boost its consumption, about aligning the currency.

[00:40:59.16]

So it's really, I don't think there's one silver bullet. to address the problem. I think what we need to do is to look at which approach— which approaches work together and particularly which approaches are appropriate for a particular sector. And as I've said, again, there are sectors where even though China has overwhelming domination of the sector, like solar, I think we can

simply say that's fine. There's no resilience concern because we can warehouse solar panels easily for a year. There's— we just take the sustainability and affordability benefits of that, whereas the calculation in other sectors such as EVs is certainly different.

[00:41:39.25] - Cecilia Malmström

Interesting. Yes, you mentioned it in the beginning, Yeling, that China could be helpful in more transparency on its processes. So what else could China do that is not politically super sensitive?

[00:41:56.14] - Yeling Tan

I think there is a lot that China can do by way of reassuring its trading partners. Right. Because what China has done so far is react very strongly to what it sees as a hostile turn towards it. Right. A more coercive set of actions towards the Chinese economy. And now it's saying, well, if you hit us, we will hit back. But the problem is that in doing so, China is very rapidly drawing down on the reserves of goodwill and trust that has taken it decades to build up with its trading partners. Right. Since its reform and opening era. Right. It was very hard work to get these supply chains to move to the Asian region and to be centered in China. It takes trust for supply chains to work. And now that reserve of trust is being drawn down. So I think that there needs to be more balance, right? What we're seeing from China is sort of a proliferation of the security framing across so many parts of its economy and society. I think China needs to put more weight into recognizing that some of the structural imbalances, you know, does create pain for its trading partners and that that pain is a problem for China.

[00:43:25.13]

It is not just a problem for the trading partner itself to solve. Right. And so one thing would simply be— and this is something that a lot of people have said over and over again, which is to boost its consumption, household share of consumption. And to be fair, right, if you, if you look at the Chinese policies, right, there have been a lot of policies over the past many years aimed at strengthening and widening the social safety net to try and boost consumption here and there with the silver economy and so on. The problem is that many of these measures are incremental and they will take years to actually play out. So there's a little bit of an imbalance here where we see China making bold moves on innovative manufacturing. It's making bold moves on wielding this rare earth export control, rare earth chokepoints, and it's making these incremental moves, right? Layered moves, tiny moves on consumption. And, you know, a very simple thing to do would be to make a bold move, structural adjustment, a bold move on

consumption, and that would reassure some of its trading partners that it is sincere in addressing some of these things.

[00:44:45.13] - Cecilia Malmström

And why isn't it doing it?

[00:44:47.09]

This has been discussed, as you said, for many, many years.

[00:44:53.05] - Yeling Tan

It's a challenging— it's a challenging question for me. And this is just my take on it. I think other scholars and analysts will have their own very good explanations as well. For me, there is an overarching constraint in the sense that China over the past 8 years or so has moved to a growth model that is very much based on economic security. Right. And this goes back to Elisa's really good point of we're not in the '80s. Right. There are these national security vulnerabilities and concerns about dependencies in a networked economy that affect everyone. And it affects China, too. Right. So the security, this national security logic runs through a lot of its economic policymaking these days. And one of the core pillars of this economic security thinking is the need to have self-reliant high-tech manufacturing, right? Innovation-driven manufacturing. And as long as that is a central national security concern, right, that naturally pushes, I think, many of the resources towards investment. And so it just becomes harder to argue for the need for households, right, to gain a greater share.

[00:46:06.23] - Cecilia Malmström

Do you share that analysis, Nicholas? Alicia.

[00:46:11.10] - Alicia García-Herrero

I wanted to add that actually I fully agree with Yeling, but on top of that, it reinforces itself. And the channel is the following: as China basically puts, you know, before everything else national security, economic security, either because it feels threatened by the US or because of a hegemonic uh, you know, aspirations, or the two together because they're very related. As China does that, these companies have to go a step further, meaning produce better at a lower cost. But if the cost can't be reduced, at a lower margin. And that is indeed this involution story. But that involution story has enormous, enormously uh, big consequences and negative, unfortunately, for consumption, because those are the companies that need to deliver the

wages. And we know that wages are basically slowing down in China very aggressively, so that this disposable income is flat, wages are growing at 1%. So it's— the model does not allow it all, not only because it doesn't have resources— I fully agree with that as well— but because in a way, it— for the companies to do what the government wants them to do, they just can't keep the necessary income out there for consumers to consume.

[00:47:40.13]

So it's no longer that consumers do not want to consume, it's that many consumers cannot consume. So the problem is becoming more real rather than just, you know, um, I don't know, we used to say it's all because, you know, precautionary savings, the minute they will feel more comfortable. No, by the time they get comfortable, they won't have the income. The income share is a problem. So, and, and I think all of this model is actually leading to more of that problem rather than less. So this is why, in my view, these imbalances— and you can see it in the data— this year China's trade surplus is going to be bigger than last year. More than $1.2 trillion. Today we are at $995 billion and we're in September. So just— it's October, actually. No, September data. You're— we're in October. Sorry, I was— it's September data published today. So in other words, by September, if you make the calculations, if, if nothing changes, which I doubt it will, China's— because actually the, the, the growth in exports is accelerating. Yeah. So the trade surplus will be bigger than last year. That's what I'm trying to say, that there's no self-correction.

[00:48:53.19]

It's the opposite, that there's no self-correction. That's why unless something happens, this will not self-correct. I think we need to realize that. What might happen beyond protectionism? I wish I had a different solution, but the reality is There's no self-correction. Hmm.

[00:49:12.07] - Cecilia Malmström

You have all mentioned the very powerful weapon that China has, rare earths and critical raw materials. And this is something that the whole world is struggling with. Europe is trying to make different agreements and memorandums of understanding and so on with other countries to cooperate on this. And so it's the US and others. And there is actually a working group between the EU and the US on critical minerals. I think it has met on, but nothing really has come out of it. Is there a possibility to find a joint strategy here, to cooperate on investment, on recycling, on diversification, and lessen the dependence vis-à-vis China? Is there a realistic possibility between the EU and the US? Because it would seem like an obvious one of maybe the few things where the parties right now could agree. What do you think, Nicolas?

[00:50:08.20] - Nicolas Lamp

Well, I think we have to realize it's not just about access to the critical minerals, it's also about the expertise in processing them. And we have given China a 20-year head start. And it's really, I think, almost unrealistic to believe that we could catch up with China. And so the approach that I like is that we actually, again, cooperate with China and invite investment by Chinese processes. I mean, we see that happening in Indonesia, right? Indonesia is trying to attract processing industry in nickel. Who is doing it? It's Chinese companies, right? And again, if we go into the direction of not reducing vulnerabilities but strengthening independence with China here, right, if some of those processing assets were in countries like Canada or that where the government has a bit more control. There is a potential potentially for technology transfer. I recognize the restrictions that the Chinese government has put on that. I think that that's maybe a more viable path forward than to say we're going to try to build up a completely independent supply chain from China in these materials. Of course, that's a conversation that the United States at the moment doesn't want to have.

[00:51:22.18]

But again, going the step of trying, essentially saying to China, look, you won in this space, but you also have to reassure us and you have to recognize that we have our concerns. What can we do to work together? I think that's a more promising way forward. And we also have to keep in mind that we also have leverage over China, which is that China needs our export, us as an export market. Right. And especially because of the growth model that, that, that Jan and Alicia have described. And so simply having that conversation, not from a point of kind of accusation or suspicion, but, but saying, look, these are our needs and we also have economic security needs. We also have concerns about keeping a manufacturing base makes, I think, for a more productive, productive conversation. And so Yellen talked very convincingly about what China can do to reassure its allies. I think there's also something we can do in the West in the way we talk about China, which is more about what we need and our needs and our problems than about what China's doing wrong, right? And I think this experience, the recent experience that the European Union had with the hybrid vehicles, the similar experience that Canada had when it when it instituted the tariff rate quota for electric vehicles is that if you go to China and say, look, you're actually super competitive, it's not just because of labor violations and because of subsidies.

[00:52:52.07]

We recognize that you're in front, we just need a bit of space, that China's actually quite receptive to that. Sam Lowe in his newsletter this morning called it strategic reasonableness that China is displaying, right, in response to the problems that its trading partners are having. And maybe we can capitalize on some of that strategic reasonableness to come to a more stable footing.

[00:53:18.05] - Cecilia Malmström

Strategic reasonableness. That's a good term. Is that realistic? What do you think, Alicia?

[00:53:27.16] - Alicia García-Herrero

Well, what I hear is that China is preparing China Shock 3.0. So I don't know. That means, I mean, in other words, I mean, I can understand China. I mean, China feels very competitive and it is. And why not? You know, like in a way, what is 3.0? This is digital services. Good luck. I mean, China is going to have the cheapest compute ever because of energy costs. And, and that, that means Basically, this is Jensen Huang's total comparative advantage. It's not going to be only industrial goods. So will China be reasonable? Sure. But at the same time, even if they're reasonable, the point is if China is competitive across the board, and frankly speaking, because of, let's call it economic security considerations, or as Yellen puts it, self-reliance related to that, also does not fully open its market. That we know has happened since. Then you have this humongous economy with a rather closed, you know, market inbound, being able to produce industrial goods, services, especially digital services, which are going to be extremely valuable Because so you need to be very reasonable. That's the point. I mean, China can be very reasonable, but you need to be extremely reasonable because you're going to be so competitive.

[00:55:04.02]

That's— nobody denies that competitiveness. But the point is, if you're competitive across the board on textiles in, you know, I don't know, West China, on compute, on industrial goods, then what's the rest of the world going to do?

[00:55:25.12] - Cecilia Malmström

What do you say, Yeling?

[00:55:30.00] - Yeling Tan

I think that there is, in a sense, a narrow, a very narrow corridor that all sides need to find their way towards, right? For For China, it is a kind of reassurance that, no, the world or the Western world is not out to contain China. It is not out to suppress China or to encircle China. Right. That kind of recognition that, yes, there is within this narrow corridor a pathway for Chinese security and prosperity. Right. And for China to recognize that it needs to accommodate, right, for all parties to be walking along the same narrow corridor, that even in a, you know, that not everything is about containment and encirclement. You know, some of these things are about domestic politics that we have to take seriously. And it's about, you know, all nations having a definition of national prosperity that includes being able to innovate in the kinds of sectors that China cares about. So, you know, can we get there? I think we need wise and courageous politicians to get us there. But it's a narrow corridor, but I wouldn't say it doesn't exist.

[00:56:55.16] - Cecilia Malmström

Well, you are all very reasonable, and I think everybody agrees that we need reasonable, courageous, and visionary politicians and leaders. And they are maybe not— well, we can discuss that. But the political reality is, of course, that we have midterm elections in just 2 weeks in the US. There might be a switch in the Congress, but we still have the same administration. We have elections in very many European countries the coming month and next year. The German minister— I just saw a news flash coming out to say that, yes, the agreement or the deal or whatever it is on hybrid is excellent. Now we want the same on pharma and on chemicals and a few other things as well. So, this is the political reality. So, what do you think will happen on a short-term basis, taking this into account? Will there be a change in US policy after the midterms?

[00:57:55.11] - Nicolas Lamp

I don't think so. I don't think there's going to be a trade policy. There's not going to be a change. I don't see— I mean, we in Canada obviously are following that extremely closely and we have virtually no hope. Although, I mean, there is— what's interesting is there seems to be a backlash against the tariffs, specifically the tariffs on Canada, as part of the midterm elections. So that's hopeful for us. But when it comes to the approach to China, it's hard to see a change though. I mean, one really struggles to define Donald Trump's approach to China. It's all over the place, which is interesting in itself and provides some opportunities. I just wanted to pick up on one point that Alicia said, which I find is hugely important. This question of, okay, what are we going to do if China produces everything, if China's better at everything? And I think it brings us back to the question that I raised at the very beginning about the international division of labor. I think we need to have this conversation about which are the sectors in which we want to maintain a foothold, which are the sectors that we really need for our prosperity, and then invest

and make uncomfortable decisions in order to keep production in those sectors while at the same time not making it, not creating that impression that it's about all trade.

[00:59:12.23]

And this is kind of the sense that you get from this French-German ladder where it's like, it's all about imbalances and everything is being implicated. And so I think having that open and honest conversation, okay, what do we want to be doing? What's our place in the world economy in 10 and 20 years is a really good starting point for a better approach.

[00:59:31.29] - Cecilia Malmström

Yeah. Europe has a trade surplus with almost all the rest of the world except China. We are approaching the hour. Any last wise words, Alicia and Yilin, on this? Well, thank you. It has been so interesting, and thank you for bringing a slightly different perspective to this, because sometimes in the media and in the public debate, it's very elevated, very emotional debates on this. And I think if they all listen to you, we will have a much more constructive and realistic policy in this. So, thank you very much, Yeling Tan. Thank you very much, Alicia García Herrero. Thank you very much, Nicolas Lamp, for joining us, and thank you to all of you who have been joining us online. Have a nice day. Thank you.

[01:00:18.03] - Yeling Tan

Thank you.

[01:00:19.05] - Alicia García-Herrero

Thank you so much.