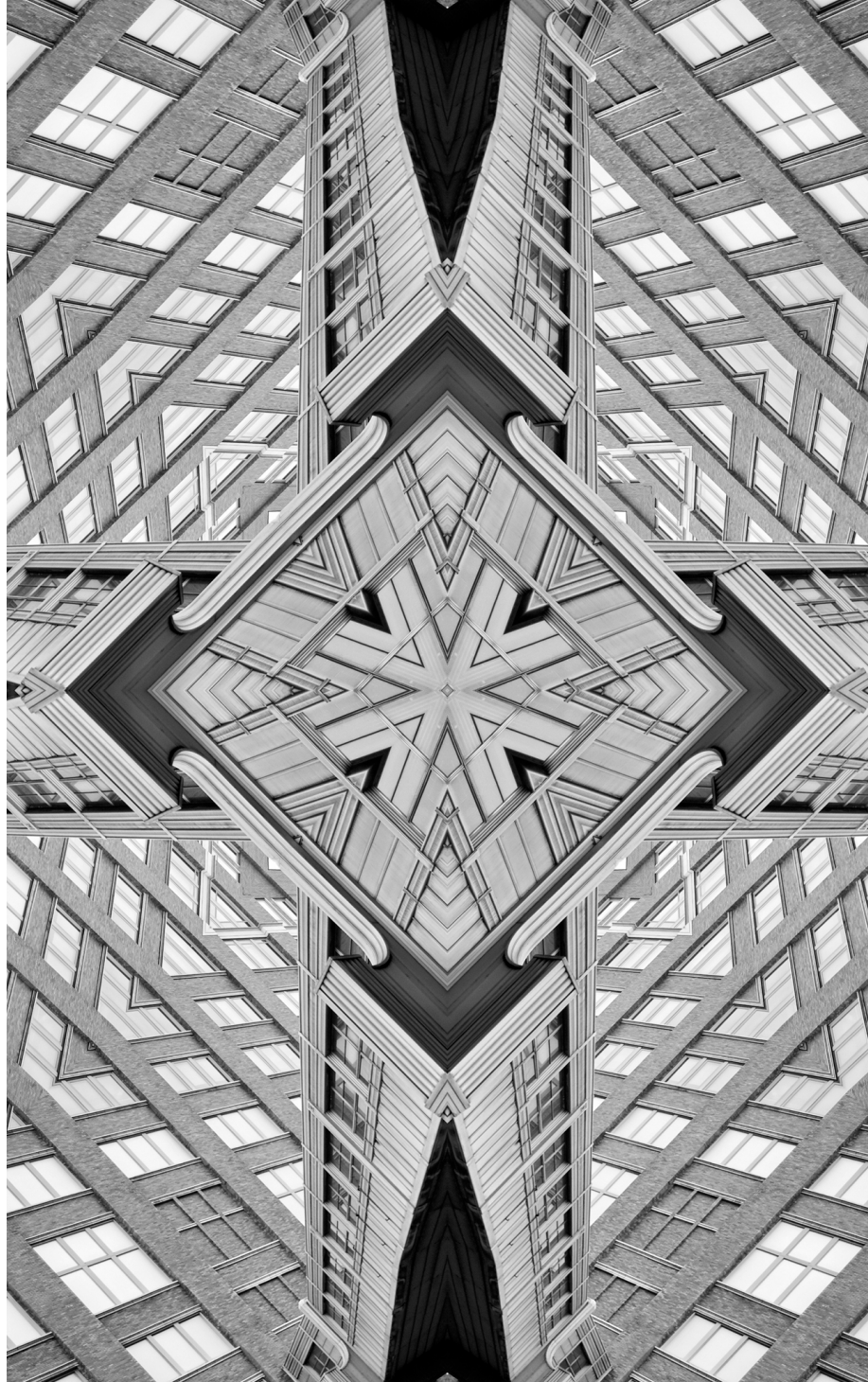


Issue

Brief

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Forging China-Resistant Supplier Compacts

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Abstract

China's approach to trade has stood impervious to change. It is time for a new geoeconomic approach to counter China. Like-minded nations can fashion rapid arrangements to grow the supply chains that matter most, such as for electric vehicles (EV). The US and India, plus Australia, Canada, Japan, Britain, Taiwan, Korea, and Mexico can form an EV supply chain compact to create a level playing field within the group and incentivise their private sectors to produce batteries, semiconductors, sensors, and network hardware, while handicapping subsidised Chinese Communist Party-controlled entities.

Over the last two decades, the People’s Republic of China has aggressively pursued a dominant position in the global political and economic system. This will enable it to make the lion’s share of the world’s key goods, including microelectronics, advanced materials for batteries and energy storage, new energy technologies, and permanent magnets. The US and its partner countries recognise the economic and national security risks of over-relying on China for the crucial inputs and technologies that will define the 21st century.

No country can afford to lose any more manufacturing capacity—people, equipment, research, and development (R&D), and management and organisational skills—of its most advanced sectors to China. If such capacity is lost or severely degraded, it will threaten many countries’ economies and millions of jobs, and may also raise new national security risks.

China’s whole-of-nation approach to outmanoeuvring foreign competitors, abetted by abusive and sometimes illegal practices, appears impervious to change within the incumbent trading system. There is little reasonable sign that attempting, yet again, to enforce existing global agreements—much less negotiating their replacements—will yield better results. To forestall ceding more manufacturing output and control over critical supply chains to China, other nations must be prepared to rethink long-standing conventions about international trade.

In place of a centralised, exhaustively negotiated, and all-encompassing global regime, it is time to consider a more realistic alternative—groups of nations fashioning arrangements to govern the supply chains that matter most. The groupings can be regional, values-based, and driven by national and economic security concerns with respect to critical technologies and materials. The common thread of these multinational arrangements will be enhancing domestic production and curbing Chinese market power in pivotal industrial areas.

A starting point will be an economic-diplomatic initiative focused on electric vehicle (EV) supply chains that evolves into a trading compact consisting of most of the high-technology industrial democracies in Asia, North America, and eventually, Continental Europe. The resulting “G7 plus” would consist of the US and other major economies like India, Australia, the UK, Mexico, Canada, France, Japan, South Korea, and Taiwan. These nations would sign

on to a limited number of basic common standards for supply chains that would provide a level playing field amongst them, while leveraging each other's comparative advantage.

A supply chain coalition among nations with compatible interests and values will provide considerable benefits that are currently difficult to achieve under the existing international trading system. A trading group that includes the countries with the highest per capita purchasing power will help address the multidimensional character of China's leverage. In addition to being the leading supplier of many vital products, China also is a major consumer market. It has become the largest trading partner of the European Union (EU), one of the US's closest allies.¹ The threat of losing access to the Chinese market leaves many US allies hesitant to take substantive unilateral action to discipline Beijing in the face of its poor behaviour.

A new trading alignment, however, could erode China's economic leverage as the world's second-largest economy. The G7 and India together command nearly half of global gross domestic product (GDP).^a If these same countries collaborate with other like-minded nations, they could pressure China the same way it has been pressuring them—by threatening to deny or restrict Beijing's access to their common market, unless China changes its tactics and levels the playing field.

A new trading alignment will erode China's dominance in essential industries and divert production to the members of such an initiative, generate employment opportunities for their citizens and mitigate national security risks.

a SAFE analysis based on data from the World Bank.

China's Dominance of Essential Industries

In 2001, many believed that China's accession to the World Trade Organization (WTO) would accelerate its transition to a market-based economy, forcing Beijing to adhere to global trade norms and liberalise its political system. Instead, Beijing spent the last two decades doubling down on its state-led, mercantilist policies and practices.²

China's integration into the global market, coupled with the control the Chinese Communist Party (CCP) wields on the economy, has enhanced its competitiveness in many industries, often to the detriment of US companies and workers.³

In 2015, the CCP released *Made in China 2025*, an update to its state-led industrial policy, designed to expedite China's evolution into a high-technology manufacturing superpower and global innovation hub. The plan identifies 10 industries Beijing deems critical for the future global economy, including new energy vehicles powered by advanced fuels, supercomputing, and artificial intelligence. To position China as a global leader in these technologies, it aims to localise R&D and manufacturing, substitute foreign technology with domestic solutions, and capture global market share to control most significant supply chains.⁴

Beijing's actions are evidently problematic for the US and many of its allies. The Office of the US Trade Representative has reported that Beijing's interventions in its domestic economy cause global market distortions to the detriment of China's trading partners.^{b,5} The Chinese government offers significant funding and subsidies to domestic companies, penalises, and exploits their international competitors, and coerces intellectual property from foreign businesses around the world.^{c,6}

Beijing also systematically encourages and supports the international expansion of its companies, leaving non-Chinese firms to essentially compete against the entire Chinese nation-state.^{d,7} Furthermore, Beijing's failure to comply with transparency obligations has continually thwarted existing WTO

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- b In addition to industrial policies and five-year plans, the Chinese government has direct influence over state-owned and private enterprises through internal Chinese Communist Party (CCP) committees. Enterprises are increasingly pressured to have at least one CCP member on their board of directors and to make final business decisions in coordination with CCP cells.
 - c For example, the US-based company Velodyne Lidar sued its Chinese partners Robosense and Hesai for infringing on its intellectual property rights. The company risked retaliation from Beijing. Furthermore, Velodyne knew that Chinese courts would almost certainly side with Chinese companies. In fact, the lawsuit did not have any significant implications for the Chinese firms. A few months after the lawsuit, Hesai was able to raise what was then the largest ever investment in China's lidar industry.
 - d An example is Huawei. While the company made China a major exporter of 5G technology, it owes its success to the more than US\$75 billion state support it received in the last 25 years.

China's Dominance of Essential Industries

mechanisms, enabling it to pursue industrial policy objectives by any means possible.^{e,8} Chinese enterprises, on the other hand, continue to benefit from non-discriminatory access to other countries' markets.

The global community is waking up to the national security risks associated with China's dominance of global supply chains. Cutting-edge technologies being developed today use inputs that often have significant military applications. For example, permanent magnets contain rare earths that are critical components of EV motors and missile defence systems. If China were to weaponise its leverage during periods of heightened tensions, it would hinder the ability of the US and its allies to restrain Beijing in the future.

Perhaps no industry will be more important to China's future industrial ambitions than the automotive sector. Many of the world's other advanced economies owe much of their success to automobile manufacturing. Developing a globally successful automotive sector provides significant economy-wide benefits because it requires large-scale component manufacturing facilities, the utilisation of a wide array of raw materials and other services, investment in R&D, and direct and indirect jobs. China hopes to emulate this model, with expectations that a vibrant automotive sector will catalyse prosperity in many other strategic, high-technology industries.⁹

Rather than attempting to compete on current internal combustion engine technologies, Beijing has charted a different course.¹⁰ Central to its effort is a focus on EVs, which provides Beijing with an opportunity for leadership in a nascent technology that will gain a significant market share over the coming decades. So far, automakers have announced over US\$500 billion of investment in EV development and production, and China is well-positioned to attract a significant portion of this.¹¹

China is aggressively pursuing control of EV supply chains, from critical minerals to battery manufacturing. Since 2016, Beijing has deployed state-owned enterprises and other private firms to secure access to foreign mineral reserves—Chinese firms account for over 60 percent of lithium and nickel processing, and 70 percent of cobalt refining, creating potential choke points for

e China joined the World Trade Organization two decades ago but has yet to submit a complete list of subsidies the central government provides to industry. It took 15 years for the Chinese delegation to start submitting information on local and provincial-level subsidies, a shift in policy sparked by US challenges.

China's Dominance of Essential Industries

those critical minerals.^f Additionally, 41 percent of the cathodes and 71 percent of the anodes used in EV batteries are produced by Chinese companies,^g and 156 of the 211 battery giga factories under construction or already built globally are in China.¹²

Beijing's efforts in other industries have led to mixed results. For example, despite investing billions in the domestic semiconductor industry and nearly doubling its market share in back-end semiconductor manufacturing between 2015 and 2020, China lags in the production of the most cutting-edge chips. In logic chips, one of the highest value segments of the industry, Chinese companies have less than 1 percent market share.¹³ Nevertheless, Beijing's efforts to realise its high-tech manufacturing ambition should not be underestimated. The government plans to invest over US\$150 billion, through 2030, in its domestic semiconductor industry as it looks to increase its market share and establish itself as a technology leader.¹⁴

Beijing is also working to grow a China-based international financial payment system based on the Renminbi. China established the Cross-Border Interbank Payment System to process international transactions denominated in Yuan. Its current use represents a tiny share of international transactions, but Beijing would like to increase its global use and that of the Renminbi in international transactions.¹⁵ Any success on this front might give China greater leverage over its trading partners and present further risks to supply chains worldwide.

“China's integration into the global market, coupled with the CCP's control on the economy, has enhanced its competitiveness in many industries, often to the detriment of US companies and workers.”

f Based on analyses by SAFE and Roland Berger.

g Based on analyses by SAFE and Roland Berger.

Towards a New Allies and Partners Trade Arrangement

So far, US efforts to enter discussions with China or appeal to existing international organisations have proven futile. The US and several like-minded nations have filed 27 cases against China at the WTO. While it won every case that was decided, the US was unable to alter the interventionist industrial policies underlying the harmful trade practices it challenged.¹⁶ In essence, any “success” has been nothing but a short-lived mirage.

China’s competitors recognise the need to boost their own capacity and capabilities—particularly in EVs, batteries, critical minerals, and semiconductors. But even significant gains in domestic production, however positive, will not overcome the distorting impact of Chinese industrial policies and predatory trade tactics.

It is time for some of those like-minded nations to adopt new trading arrangements with respect to critical supply chains. The arrangements will have rules and regulations that leverage some combination of basic standards, such as representative government and basic labour and environmental protections, criteria that will tip the scale in favour of the US and its partners.

Given that each country will have strengths and weaknesses relative to China (and each other), the national leadership should pursue policies that accelerate innovation to leverage each country’s specialised position in strategic sectors. Leaders could band together through a series of diplomatic-economic initiatives, from which a new trading arrangement for essential supply chains will emerge. China will fall outside this network, as will many of its Belt and Road partners. Excluded nations could still buy and sell products with this group, but will do so at a distinct competitive disadvantage. A system will be needed to monitor trade and investment flows to countries that are not yet members.¹⁷

Developing new response mechanisms to combat Beijing’s harmful practices will provide mutual benefits to nations that manufacture automobiles and other cutting-edge technologies. At present, no single nation possesses the natural resources and manufacturing infrastructure to develop a complete and secure supply chain for automobiles and other advanced transportation systems.

Towards a New Allies and Partners Trade Arrangement

Consequently, the initial goal will be to identify a group of nations that have the natural resources and are prepared to make capital investments across entire supply chains to manufacture vehicles and other critical goods independent of Chinese control. Rather than focusing solely to reach a new comprehensive trade agreement—the most promising of which is the Indo-Pacific Economic Framework, and which will take years—they could simultaneously pursue a more modest approach aimed at quicker results. The interested nations could form their own practical arrangements that evolve over time and by habit into more formal agreements.

India and the US can lead a dialogue with like-minded nations in Asia-Pacific, Europe, and North America to explore opportunities to create secure supply chains for the EV sector and other manufactured goods. By facilitating government-to-government and business-to-business discussions with nations that have resources and infrastructure, new opportunities for commercial agreements and trade relationships may begin to proliferate.

To launch this initiative, the US and India could call for a meeting of the Quad members (Australia, Japan, India, and the US) and of the National Technology and Industrial Base (US, Australia, Canada, and the UK).¹⁸ Nations in these groups collectively possess several important attributes for this new arrangement, including ample resources and established auto manufacturing sectors.

Countries that possess resources, expertise, or infrastructure and some combination of shared values and interests—such as France, Germany, Japan, Mexico, Singapore, South Korea, and Taiwan—can also be engaged. Further iterations could expand to include nations like Vietnam and the UAE. Not all countries will initially align on all criteria, but they share a determination to resist Chinese predations on their economy and sovereignty. For some, their participation will exist alongside formal multilateral commitments—the EU, United States-Mexico-Canada Agreement, or Regional Comprehensive Economic Partnership—that may need to be reconciled.

While the working groups will not intervene with the internal policies of governments, they can encourage each country to adopt policies tailored to its specific circumstances. Together, these different approaches could add up to a powerful response to China's attempt to monopolise certain supply chains.

Towards a New Allies and Partners Trade Arrangement

In the short term, the group could make substantial progress toward reaching commercial arrangements to strengthen their automobile supply chains and related major technologies and materials. Over time, the participants might be able to use such arrangements as the basis for broader multilateral trade agreements or common frameworks to address China's anti-competitive behaviour.

Such measures could include a common set of border adjustments, export controls, and licencing systems. These policies could also be instrumental in enabling prudent environmental and human rights standards while leveraging those standards to boost competitive advantage.

The US and India have a meaningful opportunity to work together to develop a critical mineral and parts supply chains independent of China. Where domestic resources are available, India and other nations can advance domestic mineral mining and the development of mineral refining and processing facilities. These actions can be taken with environmental safeguards and human rights. Some US-Indian initiatives dealing with mineral processing—an indispensable part of the supply chain currently dominated by China—are already underway.¹⁹

The array of countries within this new trading initiative are home to sophisticated chemical companies which, with new industry participants, can be incentivised to undertake the mineral processing needed to manufacture batteries, semiconductors, permanent magnets, and other parts and components. Because many technology-related supply chains are broad, the EV supply chain will have significant overlap with supply chains for other clean energy and computing technologies, strengthening their manufacturers as well. Where governments determine it is necessary for economic or national security reasons, they can expand assistance to incorporate other critical supply chains.

Members of the new economic-diplomatic initiative can expand support for the development and deployment of EVs, a sector that China aims to control. Once the industrial base for vehicle manufacturing weakens, the entire ecosystem that evolves around the automotive industry will erode too. It will be nearly impossible for any nation to maintain its market position in auto manufacturing, with the loss of all of the attendant economic benefits, including jobs and contribution to national income.

Towards a New Allies and Partners Trade Arrangement


Countries' support for R&D and manufacturing is crucial, as is maintaining incentives to help stimulate demand for EVs. Many countries have made a down payment on this approach, and India is no different. The Indian government's National Programme on Advanced Chemistry Cell Battery Storage and Faster Adoption and Manufacturing of Electric Vehicles initiatives offered funding to support new battery manufacturing capacity, boost domestic manufacturing capacity, including the production of electric and hydrogen fuel cell vehicles, and incentives to establish charging infrastructure that encourage interlinking renewable energy sources.

Each nation that has adopted policies to support the transition to electrification should review their progress regularly to ensure that assistance is appropriately calibrated to maintain its progress and to ensure that China cannot exert control over the EV supply chain or of other critical supply networks that feed into the advanced fuel vehicle market, including semiconductors and critical minerals.

“China’s competitors recognise the need to boost their own capacity and capabilities, particularly in EVs, batteries, critical minerals, and semiconductors. Like-minded nations must consider adopting new trading arrangements on critical supply chains, with rules and regulations that leverage basic standards, to tip the scale in favour of the US and its partners.”

Conclusion

Countries around the world need not condemn themselves to single-source dependency, nor need they submit to national security risks arising from China's growing geopolitical leverage. Importantly, countries should not leave their populations bereft of the opportunity to participate in the leading edge of the 21st-century economy.

A market-driven practical trading arrangement—stretching from Asia-Pacific to Europe and North America, and beyond—will promote the development of secure and diversified supply chains that mitigate the risks from China. Coupled with public policies that promote innovation and manufacturing in key sectors, members of the multilateral trading initiative can realise the economic benefits of partaking in the global supply chains for 21st-century technologies. 

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