

# China's economic challenge to Europe<sup>1</sup>

## Europa y el desafío económico de China

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Recibido: 14-01-2023

Aceptado: 12-02-2023

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### Abstract

China is Europe's greatest economic challenge. China's quest for geopolitical, economic and technological dominance is severely straining its relations with Europe, which are on a steep downward trajectory. Positions on both sides have hardened, with China turning economically inward and the European Union labelling China an all-out competitor with limited areas for engagement. China's approach is long-term and strategic, exploiting the EU's internal divisions and weak transatlantic cooperation with the United States. China has acquired European ports and other strategic infrastructure, and would like access to advanced technologies with potential military applications. Through the Belt and Road Initiative it has become the world's largest bilateral financier. Ultimately, China seeks to reshape the international economic architecture and "rewrite the rules of the game". Europe's response has been poorly coordinated, short-term and piecemeal, reflecting the Union's internal divisions. To respond effectively to China's challenge, Europe needs to overcome national interests, cooperate with its allies and become more strategic.

**Keywords:** Belt and Road Initiative, China, divide-and-rule tactics, European Union, international economic architecture, technology competition.

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<sup>1</sup> The author wishes to thank Yolanda Fernandez Lommen for comments on an early draft. Any errors are the sole responsibility of the author.

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## Resumen

China es el mayor desafío económico de Europa. La aspiración de China por el dominio geopolítico, económico y tecnológico está tensionando gravemente sus relaciones con Europa, que se encuentran en una clara trayectoria descendente. Las posiciones se han endurecido por ambas partes, con China volviéndose económicamente hacia adentro y la Unión Europea etiquetando a China como un competidor total, con limitadas áreas para el compromiso. El enfoque de China es a largo plazo y estratégico, explotando las divisiones internas de la UE y la débil cooperación transatlántica con Estados Unidos. A China le gustaría tener acceso a tecnologías avanzadas con posibles aplicaciones militares, y ha adquirido puertos europeos y otras infraestructuras estratégicas. A través de la Iniciativa de la Franja y la Ruta, se ha convertido en el mayor acreedor bilateral del mundo. En último término, China busca revisar la arquitectura económica internacional y “reescribir las reglas del juego”. La respuesta de Europa no ha estado bien coordinada, ha sido a corto plazo y fragmentaria, lo que refleja las divisiones internas en la Unión. Para responder eficazmente al desafío de China, Europa necesita superar los intereses nacionales, cooperar con sus aliados y actuar más estratégicamente.

**Palabras-clave:** Iniciativa de la Franja y la Ruta, China, tácticas de divide y vencerás, Unión Europea, arquitectura económica internacional, competición tecnológica.

## 1. Introduction

China is currently Europe’s<sup>3</sup> greatest economic challenge. The enormity of this challenge would have been hard to conceive just a few years ago. Moreover, in recent years Europe’s attention has been focused on internal divisions, since 2020 on the Covid pandemic and since 2022 on Russia’s war of aggression on Ukraine and the ensuing economic and energy crises. From a European perspective, China’s economic challenge could hardly have come at a less opportune time.

Over the past four decades, European perceptions of China have changed profoundly. In the early 1980s, China was a land of opportunity. Following supreme leader Deng Xiaoping’s announcement in December 1978 that China would “reform and open up”<sup>4</sup>, China quickly put in place policies that would

<sup>3</sup> In this article, Europe is defined as comprising the countries and institutions of the European Union as well as non-EU member countries. The Russian Federation is not included.

<sup>4</sup> Deng Xiaoping, “Emancipate the Mind, Seek the Truth from Facts and Unite as One in Looking

encourage foreign investment, promote trade and establish what would become known as a “socialist market economy”. With a vast population and a GDP per capita of less than \$200, China offered businesses in Europe—and around the world—exciting investment opportunities, abundant low-cost labour and an enormous new market of potential consumers.

Four decades later, the relationship is on a steep downward trajectory. The European and Chinese economies are closely intertwined, but China's growing assertiveness has highlighted the many risks in the relationship. For many years, Europe's China challenge was viewed mainly in terms of trade and investment. However, since Chinese Communist Party (CCP) general secretary Xi Jinping came to power in 2012, China's quest for geopolitical, economic and technological supremacy has become increasingly clear, putting the challenge in a very different light.

China's efforts to obtain semiconductor technologies with military applications, and its use of a wide range of clandestine and coercive methods to pursue its economic and political goals have further underscored the geopolitical nature of the relationship. So have Beijing's refusal to condemn Russia's war of aggression in Ukraine, while actually strengthening its ties with Moscow, and its increasingly loud sabre rattling over Taiwan.

At the same time, the European Union (EU) is struggling with internal divisions, including the competing or conflicting economic interests of Union members, illiberal and populist governments in several member countries that are questioning the Union's founding principles, and the aftermath of the United Kingdom's withdrawal from the EU.

What are the implications of these developments for Europe-China relations? While China is speaking increasingly of dual circulation and building up its self-reliance, European countries are increasingly talking about decoupling as the most feasible way to handle China. Given Europe's many internal differences, the greatest challenge in its relationship with China may simply be to map out a cohesive way forward.

## **2. Positions on both sides have hardened**

Since 1980, China's policies toward the outside world have undergone several shifts. Following its announced opening, China established special economic zones in coastal cities and introduced a range of reforms. In the 1990s, CCP general secretary Jiang Zemin oversaw the deepening of the

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to the Future”, Speech at the closing session of the Central Working Conference, which made preparations for the Third Plenary Session of the 11<sup>th</sup> Central Committee of the Chinese Communist Party, 13 December 1978.

country's economic reforms, including the privatization or corporatization of numerous state-owned enterprises (SOEs), culminating in China's entry into the World Trade Organization (WTO) in 2001. Under general secretary Hu Jintao, in 2002-2012, China remained open but reforms stagnated.

Xi Jinping's rise to power has brought with it a further major shift. Initially, Xi travelled widely to meet world leaders, and in a keynote speech at the 2017 World Economic Forum in Davos stressed the importance of countries working together to revitalize global growth<sup>5</sup>. The speech seemed to indicate China's willingness to assume a role as world leader, which was highlighted by the absence from the meeting of US president elect Donald Trump.

Subsequently, Xi has moved China back towards a state-driven economic model, favouring SOEs, reining in the private sector and requiring private companies to include CCP representatives on their boards. At the same time, China's foreign envoys have become increasingly assertive, in what is often referred to as "wolf-warrior diplomacy"<sup>6</sup>. In 2020, in a further move away from globalization, Xi launched a policy of "dual circulation", which aims to insulate China's domestic economy from its international links and make China more self-reliant<sup>7</sup>.

China's foreign and economic policy tools have also hardened. From skewing the playing field with "traditional" legal, regulatory and non-tariff barriers and the coercive transfer of intellectual property, China now includes in its toolbox a wide range of questionable means of persuasion, including coercion, corruption, and cyber action<sup>8</sup>. As a global investor, China is also increasingly seeking to buy up strategic technology companies and infrastructure.

The 20<sup>th</sup> Congress of the CCP in October 2022 confirmed Xi Jinping's position as China's all-powerful leader, extending his term as general secretary of the CCP beyond the established ten-year mandate and appointing a Politburo and seven-member Standing Committee stacked with his loyalists. The congress consolidated Xi's authoritarian rule and confirmed the continuation of his state-

<sup>5</sup> Xi Jinping, "Jointly Shoulder Responsibility of Our Times, Promote Global Growth", Keynote speech at the opening session of the World Economic Forum annual meeting 2017, January, Davos. Retrieved from <https://america.cgtm.com/2017/01/17/full-text-of-xi-jinping-keynote-at-the-world-economic-forum>. (Unless otherwise noted, all Internet links cited in this article were accessible on 13 January 2023.)

<sup>6</sup> Peter Martin, *China's Civilian Army. The Making of Wolf Warrior Diplomacy*. Oxford University Press, 2021.

<sup>7</sup> Kevin Yao, "What we know about China's 'dual circulation' economic strategy", *Reuters*, 16 September 2020. Retrieved from <https://www.reuters.com/article/china-economy-transformation-explainer-idUSKBN2600B5>

<sup>8</sup> Ian Bond, Francois Godement, Hanns W. Maull and Volker Stanzel, *Rebooting Europe's China Strategy*, German Institute for International and Security Affairs, Berlin, May 2022, pp 21-23. Retrieved from <https://www.institutmontaigne.org/ressources/pdfs/publications/note-rebooting-europes-china-strategy.pdf>

centred economic policies, and the regime's determination to oust the United States and the West from their position of global leadership.

European countries, again, have long viewed China as both a partner and a competitor, but have only recently woken up to the full extent of the China challenge. Most EU members currently view China with growing suspicion, while British prime minister Rishi Sunak in his first foreign policy speech after assuming office, in November 2022, noted that the "golden era" of relations with China was over<sup>9</sup>.

The shift is even more pronounced in EU strategy statements. Breaking with past moderate practice, the 2019 *EU-China Strategic Outlook* defined China as a strategic rival with a competing governance model:

China is, simultaneously, in different policy areas, a co-operation partner with whom the EU has closely aligned objectives, a negotiating partner with whom the EU needs to find a balance of interests, an economic competitor in the pursuit of technological leadership, and a systemic rival promoting alternative models of governance. This requires a flexible and pragmatic whole-of-EU approach enabling a principled defence of interests and values<sup>10</sup>.

The strategy paper referred to cooperation and competition, but the emphasis was clearly on strategic rivalry. The paper went on to outline necessary policy changes in areas ranging from data procurement and antitrust rules to telecommunications and artificial intelligence, and has guided EU policies towards China for the past four years.

In October 2022, a new internal paper prepared by the EU's foreign policy staff recommended a further hardening of the Union's stance. The new paper stressed that EU-China relations had deteriorated further since 2019, marked by trade disputes, tit-for-tat sanctions, and failed efforts to find mutual agreement<sup>11</sup>.

"China has become an even stronger global competitor for the EU, the US and other like-minded countries", the paper concluded. In a significant further tightening of the EU's 2019 strategy, the paper recommended considering China as an all-out competitor with limited areas of potential engagement. Specifically, it recommended that the EU work more closely with the US, strengthen its cyber and hybrid threat defences, diversify its supply chains away from China,

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<sup>9</sup> David Milliken, "Prime minister Sunak says UK's 'golden era' with China is over", *Reuters*, 29 November 2022. Retrieved from <https://www.reuters.com/world/uk-prime-minister-sunak-vows-maintain-military-aid-ukraine-2022-11-27/>

<sup>10</sup> European Commission, Joint Communication of the European Commission and the High Representative to the European Council: *EU-China Strategic Outlook*, March 2019. Retrieved from <https://commission.europa.eu/system/files/2019-03/communication-eu-china-a-strategic-outlook.pdf>

<sup>11</sup> Henry Foy, "EU ministers advised to take tougher line on China", *Financial Times*, 17 October 2022. Retrieved from

<https://www.ft.com/content/b83615cb-6db0-4e67-85a3-7aab131abeb5>

and deepen ties with other Indo-Pacific powers<sup>12</sup>. It also recommended that Union members refrain from uncoordinated initiatives toward China, which could weaken the EU's common policies.

### 3. From tea and opium to semiconductors and strategic ports

In November 2022, the government of the UK cited national security concerns to retrospectively block the sale of one of Britain's largest semiconductor plants to a Dutch company owned by a Chinese company, Wingtech Technology<sup>13</sup>. The same month, the German government also blocked two similar deals, noting that they "would have endangered Germany's public order and security"<sup>14</sup>. These examples are simply the tip of the iceberg in the growing effort to prevent China from acquiring technology with dual-use or military applications, whether by importing the technology or through the strategic acquisition of European companies.

Trade between Europe and China has long been imbalanced in China's favour. In the late 1800s, Great Britain and France financed their imports of Chinese porcelain, silk and tea by forcing China to import opium. Currently, the imbalance persists but is structurally very different.

When China started to open its economy to the world in 1979, its economic relations with Europe were negligible. Four decades later, China has risen to become the world's largest exporter and the EU's largest trading partner. In 2021, China accounted for 22.4 percent or €472.2 billion of the trading bloc's imports. The EU's imports from China comprise mainly mobile phones, personal computers, electrical machinery and consumer goods. China is also one of only a few suppliers of rare earth metals. The EU's exports to China, at 10.2 percent, are only half the export figure, consisting mainly of cars, electronics, medicines and aircraft<sup>15</sup>. The trade deficit has grown continuously, peaking in 2021 at €246.9 billion, and is the result of the wide range of restrictions placed by China on European exporters.

<sup>12</sup> Ibid.

<sup>13</sup> Financial Times Editorial Board, "Chinese takeovers become a geopolitical fault line", *Financial Times*, 27 November 2022. Retrieved from <https://www.ft.com/content/4fa189de-b255-4ee4-99dd-a93c611a1cd4?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft.notification:daily-email:content>

<sup>14</sup> Guy Chazan, "Germany blocks another Chinese acquisition of a chip company", *Financial Times*, 9 November 2022. Retrieved from <https://www.ft.com/content/5af0d9ea-771a-4de0-a1b0-957bdc9fd672?desktop=true&segmentId=7c8f09b9-9b61-4fbb-9430-9208a9e233c8#myft.notification:daily-email:content>

<sup>15</sup> Eurostat, *China-EU International trade in goods statistics*, Data extracted February 2022. Retrieved from [https://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU\\_-\\_international\\_trade\\_in\\_goods\\_statistics](https://ec.europa.eu/eurostat/statistics-explained/index.php?title=China-EU_-_international_trade_in_goods_statistics)

Balancing trade by convincing China to level the playing field remains a priority. However, recently a range of complex issues have gained prominence, including the restriction of strategic technology exports to China, and limiting China's investments inside Europe, which have taken on an increasingly strategic nature.

In addition to technology investments, China's acquisition of physical infrastructure is a major concern. Over the past decade, the state-owned China Cosco Shipping Corporation, the sector's fourth largest player, has expanded its fleet and invested in container terminals worldwide. Its recent acquisitions in Europe include full ownership of the container terminal in Piraeus in Greece, majority stakes in terminals in Zeebrugge, Belgium and Valencia, Spain, and a host of minority holdings in other European ports.

Cosco, which has close ties with the People's Liberation Army, plays a key role in China's recent build-up of maritime power, and forms part of what Janes, an intelligence company specialized in defence, calls an "integrated military-civilian logistics system". China only has one overseas naval base, in Djibouti, but with stakes in port facilities around the world, there is growing concern that Cosco could provide logistical support to China's navy wherever the company operates. Highlighting the conflicting nature of European ties with Cosco, since Russia's assault on Ukraine Cosco has continued to transport Russian crude oil to China<sup>16</sup>.

Ultimately, the question is whether short-term local economic interests should be given priority over longer term security concerns. This was the case when Greece allowed Cosco to invest in Piraeus and, more recently, when German chancellor Olaf Scholz decided to allow Cosco to invest in the container port in Hamburg, despite strong warnings about the security risks from within his own government<sup>17</sup>. The president of the European Investment Bank (EIB) criticized the move as naïve<sup>18</sup>.

<sup>16</sup> Chris Horton, "Cosco: China's shipping giant expands its global influence", *Financial Times*, 25 May 2022. Retrieved from <https://www.ft.com/content/13e606df-9b43-4c9c-9e23-24883d0988f9>

<sup>17</sup> Joshua Posaner, Leonie Kijewski and Wilhelmine Preussen, "Olaf Scholz backs China, ignores government warnings on Hamburg port deal, report says", *Politico*, 20 October 2022. Retrieved from [https://www.politico.eu/article/olaf-scholz-ignores-government-over-china-port-deal-cosco-shipping/?authId=1\\*70hev5\\*\\_a\\*X1BFdUZZMVF9nNHg1SlpiY29wQmRMTUVzZEVteFII1ajVMb1JNVkNPMzBISFBvWCiJdEthQk1PX2xwZ2dwaw](https://www.politico.eu/article/olaf-scholz-ignores-government-over-china-port-deal-cosco-shipping/?authId=1*70hev5*_a*X1BFdUZZMVF9nNHg1SlpiY29wQmRMTUVzZEVteFII1ajVMb1JNVkNPMzBISFBvWCiJdEthQk1PX2xwZ2dwaw)

<sup>18</sup> Stuart Lau, "EIB chief lashes out at German naïvete on Chinese buyouts", *Politico*, 9 November 2022. Retrieved from <https://www.politico-eu.cdn.ampproject.org/c/s/www.politico.eu/article/eib-chief-werner-hoyer-germany-naivete-china-buyouts/amp/>



#### 4. Concern about China's access to technology spans the Atlantic

Europe's concern to limit China's access to strategic technologies mirrors that of the US, which is increasingly concerned about China's quest for economic and technological supremacy. To counter an assertive China, the US is expanding its strategic partnerships with like-minded countries around the world, whether dealing with China's industrial overcapacity, state subsidies or counterbalancing China's massive investments under the Belt and Road Initiative (BRI)<sup>19</sup>.

The real sticking point in the US-China relationship—and the area in which the US most needs support from its allies—relates to semiconductors. The battle started with the Chinese telecom giant Huawei, which the US banned from providing equipment for its 5G networks, encouraging its allies to follow suit. But the focus quickly shifted to a range of technologies, in particular microchips with potential for both civilian and military use.

China has significant capacity to manufacture basic semiconductors. However, for advanced microchips and the technology to manufacture them, it is totally reliant on imports from only five countries—Japan, the Netherlands, South Korea, Taiwan and the US. While China is a major purchaser of lower end semiconductor technologies, due to trade restrictions, it has so far effectively been denied access to the most advanced technologies.

Acutely aware of this bottleneck, Xi Jinping recently reminded China's technology leaders that the country needs “breakthroughs in core technology as quickly as possible”<sup>20</sup>. Computing capacity is crucial to building the country's military capacity. Consequently, China is both investing massively in its chip industry and pressuring foreign governments and companies to give it access to sensitive technology<sup>21</sup>.

The US is equally intent on preventing this from happening. In October 2022, the administration of president Joe Biden introduced new restrictions on trade with China in advanced semiconductor technology, manufacturing equipment and the related human resources. The rules also ban foreign companies from exporting semiconductors that incorporate US technology. In pushing for international support, US Commerce Secretary Gina Raimondo reminded US allies: “We are ahead of [China]. We need to stay ahead of them. And we need to deny them this technology that they need to advance their military”<sup>22</sup>.

<sup>19</sup> Andrew Small, “Why Europe is getting tough on China”, *Foreign Affairs*, 3 April 2019. Retrieved from <https://www.foreignaffairs.com/articles/china/2019-04-03/why-europe-getting-tough-china>

<sup>20</sup> Chris Miller, *Chip War. The fight for the world's most critical technology*, New York, Scribner, 2022, p. 248.

<sup>21</sup> *Op.cit.*, pp. 283-291.

<sup>22</sup> Rintaro Tobita, “US calls out Japan and Netherlands on China chip curbs”, *Nikkei Asia*, 6 November 2022. Retrieved from <https://asia.nikkei.com/Business/Electronics/U.S.-calls-out-Japan-and->



China is pushing back hard and encouraging the EU to avoid a “new Cold War”, and will no doubt use the many economic tools at its disposal to put pressure on key countries in the supply chain<sup>23</sup>. For businesses, the attraction of China’s massive markets is the main obstacle. As one US semiconductor executive put it, in a statement that applies equally to Europe, “Our fundamental problem is that our number one customer is our number one competitor”<sup>24</sup>.

## 5. Europe is wide open to China’s divide-and-rule tactics

Just two weeks after the CCP congress confirmed Xi Jinping for a third term, in November 2022, chancellor Scholtz visited Beijing to meet with Xi and cement Germany’s political and economic ties with China’s new leadership team. The move aggravated both Germany’s European allies and the more globally minded members of Scholz’s domestic coalition<sup>25</sup>. It also underscored the most serious weakness in Europe’s relations with China, a lack of coordination and the willingness of EU member governments to prioritize national interests over the collective interests of the Union.

In China, the notion of divide and rule dates back at least two and a half millennia, to the writings of military strategist Sun Tzu<sup>26</sup>. The country’s modern leaders have used the strategy skilfully to exploit their rivals’ divisions. An update to the thinking has been provided by Xi Jinping’s chief ideologue Wang Huning, who is seen as the main architect of China’s anti-Western policies and was recently reconfirmed as a member of the Politburo Standing Committee. Wang advocates using America’s internal divisions to weaken its global position<sup>27</sup>, an approach that is equally applicable to Europe.

China generally prefers bilateral over multilateral diplomacy, as dealing with countries individually makes it harder for them to establish a common position towards China. Beijing’s preference for dealing with European governments one-on-one has been enhanced by the fact that both the European Commission and the Council have tended to be more assertive in representing

Netherlands-over-China-chip-curbs?utm\_campaign=GL\_asia\_daily&utm\_medium=email&utm\_source=NA\_newsletter&utm\_content=article\_link

<sup>23</sup> Hadano, Tsukasa and Yasuo Takeuchi, “China tries to keep Europe in play as US seeks united front”, *Nikkei Asia*, 2 December 2022. Retrieved from <https://asia.nikkei.com/Politics/International-relations/China-tries-to-keep-Europe-in-play-as-U.S.-seeks-united-front>

<sup>24</sup> Miller, op.cit., p. 301.

<sup>25</sup> Fergus Hunter, “Olaf Scholz is Undermining Western Unity on China”, *Foreign Policy*, 23 November 2022. Retrieved from <https://foreignpolicy.com/2022/11/23/germany-china-eu-scholz-xi-meeting-economy-trade-g-20/>

<sup>26</sup> Sun Tzu, *The Art of War*. Originally published in Chinese approximately five centuries B.C.

<sup>27</sup> Wang Huning, *America Against America*, 1991, unofficial translation, and Chang Che, “How a Book About America’s History Foretold China’s Future”, *The New Yorker*, 21 March 2022. Retrieved from <https://www.newyorker.com.cdn.ampproject.org/c/s/www.newyorker.com/books/second-read/how-a-book-about-americas-history-foretold-chinas-future/amp>

the Union's interests than member countries on their own. This was only too obvious at the G-20 summit held in Bali, Indonesia in November 2022, where Xi met individually with leaders from France, Italy, the Netherlands and Spain, but avoided formal engagements with Commission president Ursula van der Leyen and Council president Charles Michel<sup>28</sup>.

Examples of China's divide-and-rule tactics abound. When Brussels in 2013 threatened a trade war with China due to its undercutting of the EU market in solar panels and telecommunications equipment, China threatened to retaliate with action against French and Spanish wine, skilfully playing Paris and Madrid against the EU trade negotiators<sup>29</sup>.

When China in 2014 set out to establish the Asian Infrastructure Investment Bank (AIIB), which was intended as a China-led competitor to the Bretton Woods institutions and other multilateral financiers, Western governments shunned the initiative. However, following intense bilateral lobbying, China enticed the UK to break ranks and join the AIIB just weeks before the deadline for membership applications. This left other European countries little choice but to follow suit, and with no opportunity to influence the charter of the new bank<sup>30</sup>.

China's most significant effort to drive a wedge in the EU has been to deal separately with central and eastern Europe. In 2012, China and 16 central and eastern European countries set up the "16 plus one" economic cooperation initiative. Most countries in the region joined, including the three Baltic republics, Hungary, Poland and Romania and five non-EU members. In 2019, Greece also joined making it "17 plus one". To the aggravation of the EU, the initiative provided the basis for annual summit meetings, and for infrastructure investments in participating countries.

However, recently the initiative has been weakened. In 2021 Lithuania withdrew, due to disagreements with China on its strengthened cooperation with Taiwan, followed in 2022 by Estonia and Latvia. China's unwillingness to condemn Russia's war of aggression on Ukraine and its increasingly close ties with Moscow have further alienated central and eastern Europe<sup>31</sup>.

<sup>28</sup> Hunter op. cit.

<sup>29</sup> Stuart Lau, "As Xi reemerges, Europe again falls prey to China's divide-and-rule tactics", *Politico*, 16 November 2022. Retrieved from <https://www.politico-eu.cdn.ampproject.org/e/s/www.politico.eu/article/as-xi-reemerges-europe-again-falls-prey-to-chinas-divide-and-rule-tactics/amp/>

<sup>30</sup> Robert Wihtol, "Beijing Challenges the Global Financial Architecture", *Georgetown Journal of Asian Affairs*, Vol. 2, No. 1, (Spring/Summer 2015). Retrieved from <https://repository.library.georgetown.edu/bitstream/handle/10822/761162/GJAA%202.1%20Wihtol%2C%20Robert.pdf?sequence=1&isAllowed=y>

<sup>31</sup> Ian Johnson, "Has China Lost Europe", *Foreign Affairs*, 10 June 2022. Retrieved from <https://reader.foreignaffairs.com/2022/06/10/has-china-lost-europe/content.html>

China's hard-nosed policies have at times also backfired. China worked for many years with the EU to hammer out agreement on a comprehensive investment agreement, which would have been beneficial to both parties. However, in March 2021, the US, the EU, the UK and Canada sanctioned four Chinese officials for alleged human rights abuses in Xinjiang. Beijing responded with numerous harsh statements. In retaliation, it also sanctioned four EU entities and ten Union officials, including five members of the EU parliament, which was due to ratify the agreement. The EU responded by freezing the China-EU investment agreement, on which the two parties had reached agreement just three months earlier<sup>32</sup>.

## 6. The battle for trade supremacy and standards in Asia

At the same time, the battle for trade supremacy in the Indo-Pacific that is being played out between two regional trade initiatives has aroused limited interest in Europe.

The Regional Comprehensive Economic Partnership (RCEP) is a traditional agreement covering trade of goods initiated by the Association of Southeast Asian Nations (ASEAN), with China by far its largest member. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), again, succeeded the Trans-Pacific Partnership after the Trump administration in 2016 withdrew from the latter. In contrast to RCEP, the CPTPP covers both goods and services and sets ambitious standards for digital trade, intellectual property and anti-corruption. It also covers competition and public enterprises, inclusions that are intended to prevent predatory state intervention in markets and which would be difficult for China to comply with<sup>33</sup>.

The memberships of the two initiatives overlap, with RCEP centred around China and Southeast Asia and the CPTPP focused on Japan, Southeast Asia and the Pacific rim. The CPTPP does not exclude China, but clearly seeks to limit Beijing's trade and standard-setting in the region. The UK recently applied for membership, but the US and EU have so far held back.

Following the launch in 2021 of AUKUS, a partnership with the UK and the US that will allow Australia to procure nuclear-powered submarines, China also applied to join the CPTPP. China's application highlights not only the strategic nature of the trade alliance, but the fact that the absence of the US or

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<sup>32</sup> Hal Brands and Michael Beckley, *Danger Zone: The Coming Conflict with China*, New York, W.W. Norton and Company, 2022, p. 167.

<sup>33</sup> Patrick Allard and Frederic Grare, "European trade and strategy in the Indo-Pacific: Why the EU should join the CPTPP", *European Council of Foreign Relations*, 1 December 2021. Retrieved from <https://ecfr.eu/article/european-trade-and-strategy-in-the-indo-pacific-why-the-eu-should-join-the-cptpp/>

EU from its membership could lead to a significant watering down of CPTPP's trade standards.

With the CPTPP at a critical juncture, there have been renewed calls for the EU to join, to counter China's expanding economic and geopolitical role. However, the EU's trade policy tends to be fragmented, with differentiated approaches for different regions and countries. As a recent study notes, the Union "has been slow and late to formulate a comprehensive strategy for the Indo-Pacific region"<sup>34</sup>.

## 7. China as a global financier

A very different challenge is posed by China's global role as a source of infrastructure finance. During the Cultural Revolution, in 1966-1977, China provided modest financial support to politically like-minded developing economies and liberation movements. At the time, China's most visible project was the Tanzania-Zambia railway<sup>35</sup>. Due to China's acute lack of foreign exchange, however, these initial efforts were modest.

It was only after the turn of the millennium that China shifted into high gear as an international financier. This was made possible by the rapid expansion of China's exports and foreign exchange reserves. In 2000, China's reserves stood at \$165 billion, but by 2014 they had risen to nearly \$4 trillion. This massive increase allowed China to establish a sovereign wealth fund in 2007, which has become a major global investor, and to explore options for expanding its global role.

China's efforts came to fruition early in Xi Jinping's first term as CCP general secretary. On the bilateral front, Xi launched the BRI in 2013<sup>36</sup>. This was followed by two multilateral initiatives, the establishment of the New Development Bank, which included the five BRICS countries (Brazil, the Russian Federation, India, China and South Africa), in 2014, and the China-led AIIB in 2015.

The BRI is an all-of-government initiative without a clear organizational structure or transparent business plan. Rather, it is a politically-driven mega-initiative involving central government ministries, China's huge policy banks,

<sup>34</sup> Hanns Gunther Hilpert, "The Regional Comprehensive Economic Partnership Agreement and Europe: Impact and implications", ERIA Discussion paper series No. 441, August 2022. Retrieved from <https://www.eria.org/publications/the-regional-comprehensive-economic-partnership-agreement-and-europe-impact-and-implications/>

<sup>35</sup> George T. Yu, "Working on the Railroad. China and the Tanzania-Zambia Railway", *Asian Survey*, Vol. 11, No. 11, 1971, pp. 1101-1117.

<sup>36</sup> Xi Jinping, "Promote Friendship Between our People and Work Together to Build a Bright Future", Speech at Nazarbayev University in Astana, Kazakhstan, 7 September 2013. Retrieved from [http://hk.ocmf.gov.cn/eng/jbwzlm/xwdt/wsyw/201309/t20130918\\_7781702.htm](http://hk.ocmf.gov.cn/eng/jbwzlm/xwdt/wsyw/201309/t20130918_7781702.htm)

in particular China Development Bank and the China Export-Import Bank, provincial governments and a range of SOEs and financial institutions<sup>37</sup>.

The amorphous nature of the BRI, with projects in over 100 countries, makes it difficult to put a precise figure to its size. However, estimates are generally over \$1 trillion, making China the world's largest bilateral financier, and far larger than major multilateral financiers including the World Bank and EIB<sup>38</sup>. Maps of the initiative also make it clear that its main purpose is strengthen economic ties between China and Europe.

As the extent of China's global economic ambitions has become apparent, other governments have responded, Japan quickly and the US and EU more slowly. Already in 2015, Japanese premier Shinzo Abe launched the Quality Infrastructure Initiative and stepped up Japan's efforts to outbid China for high-speed railway and other infrastructure projects in Asia<sup>39</sup>. In 2019, the United States, supported by Australia and Japan, launched the Blue Dot Network, and more recently the Biden administration launched the Build Back Better initiative. Both emphasize quality.

However, reflecting weak internal coordination, it was only in 2021 that the EU launched its Global Gateway, which EU Commission president Ursula von der Leyen describes as supporting "government initiatives in quality infrastructure, respecting the highest social and environmental standards, in line with the EU's democratic values and international norms and standards"<sup>40</sup>. What is unsaid, but well understood, is that the initiative is intended to counterbalance China's growing global influence. At €300 billion, the Gateway's initial financing is modest compared with the BRI, and comes from a range of disparate sources.

The BRI has expanded China's global presence and stimulated a global competition for economic and financial influence. China's lending has also shined a spotlight on the quality of internationally financed projects—an issue alluded to in the mandates of the Japanese, EU and US counterinitiatives—and on uncontrolled debt and international debt management.

In several instances, concerns have been raised about the quality of China's lending, which it promotes to the borrowers as having "no strings attached". However, China has also financed numerous poorly justified or politically

<sup>37</sup> Jonathan E. Hillman, *The Emperor's New Road. China and the Project of the Century*, New Haven and London, Yale University Press, 2020.

<sup>38</sup> James Wheatley and Joseph Cottrill, "African debt to China: A major drain on the poorest countries", *Financial Times*, 26 October 2020. Retrieved from <https://www.ft.com/content/bd73a115-1988-43aa-8b2b-40a449da1235?segmentId=3f81fe28-ba5d-8a93-616e-4859191fabd8>

<sup>39</sup> Masaaki Kameda, "Abe announces \$110 billion in aid for 'high-quality' infrastructure in Asia", *The Japan Times*, 22 May 2015. Retrieved from <https://www.japantimes.co.jp/news/2015/05/22/business/abe-announces-110-billion-in-aid-for-high-quality-infrastructure-in-asia/>

<sup>40</sup> European Commission, "Global Gateway: up to €300 billion for the European Union's strategy to boost sustainable links with the world", 1 December 2021. Retrieved from [https://ec.europa.eu/commission/presscorner/detail/en/ip\\_21\\_6433](https://ec.europa.eu/commission/presscorner/detail/en/ip_21_6433)

motivated projects. This, together with stringent lending conditions has deeply indebted several borrowers. The most widely cited case is Sri Lanka, which has been followed by Laos, Pakistan, and even a financially unsustainable expressway in Montenegro<sup>41</sup>.

## 8. From rule-taker to rule-maker

China's ultimate goal, however, is much broader than simply expanding its trade and investment. Rather, China would like to displace the prevailing Western-led political and economic world order and, as Elizabeth Economy puts it, "rewrite the rules of the game"<sup>42</sup>. To achieve this, China has strengthened its presence in existing economic and financial institutions and is also rewriting the architecture by setting up new institutions that it can control.

China has long been dissatisfied with the international economic and financial architecture, which is rooted in the arrangements set up in Bretton Woods in 1944. China joined the International Monetary Fund and World Bank only in 1980, when they were already well established and dominated by Washington-driven policy-making, leaving little room for China to play a role.

China worked hard to gain a foothold in the existing institutions, but was systematically marginalized. The IMF, for example, was slow to make even minor adjustments in its special drawing rights that would have allowed emerging economies a greater say in decision making. The global financial crisis of 2008-2009 highlighted the weakness of Western financial institutions, and Xi Jinping's rise to power in 2012 ushered in a concerted effort to establish a China-driven financial architecture.

At the turn of the millennium, Chinese officials did not head any United Nations agencies, and the Bretton Woods institutions provided the framework for international finance and trade. Two decades later, the landscape has changed. Chinese nationals currently head or have recently headed four UN agencies, including the Food and Agriculture Organization, which is responsible for global food security, the International Telecommunication Union, the International Civil Aviation Organization, and the UN Industrial Development Organization, which under Chinese leadership signed a memorandum of understanding on cooperating with the BRI<sup>43</sup>. In addition, China is working

<sup>41</sup> Valerie Hopkins, "Montenegro calls for EU help over \$1bn China highway loan", *Financial Times*, 11 April 2021. Retrieved from <https://www.ft.com/content/3dd7a516-5352-4f48-bfac-236e43b2342d>

<sup>42</sup> Elizabeth Economy, *The World According to China*, Cambridge and Medford, Polity Press, 2022, pp. 169-206.

<sup>43</sup> Courtney J. Fung and Shing-Hon Lam, "China already leads 4 of 15 U.N. specialized agencies — and is aiming for a 5<sup>th</sup>", *The Washington Post*, 3 March 2020. Retrieved from <https://www>.

closely with Southeast Asian countries on economic and financial stability in the framework of ASEAN+3, together with Japan and South Korea.

China has made significant progress in setting up an alternative architecture. It now has its “own” international organizations, the Shanghai Cooperation Organization to manage relations with Russia, the Central Asian Republics, India and Pakistan; the AIIB, headed by a Chinese national, located in Beijing, and with China the largest shareholder; and the New Development Bank, also commonly known as the BRICS bank, based in Shanghai.

As the world's largest creditor, China has consistently turned its back on established international debt management initiatives, most notably the Paris Club, a group of major creditor countries looking for coordinated solutions to the payment problems of debtor countries. China's sovereign and corporate loans generally include clauses requiring confidentiality and banning the borrower from turning to the Paris Club, leaving China free to determine any eventual debt management arrangements in line with its own interests and ensuring that China gets paid before other creditors. China's absence from the debt management table has hampered negotiations on the restructuring of emerging economy debt. It also risks leaving other creditor nations' investors and taxpayers to foot the bill.

## 9. Challenges and opportunities

China is increasingly looking inward and isolating some aspects of its economy from the global economy, while the EU now considers China an all-out competitor offering only limited areas for engagement. As a result, in coming years a degree of decoupling looks inevitable. Compared with the optimistic 1980s and 1990s, the challenges in dealing with China have increased significantly, while the opportunities are growing scarcer.

Before discussing the long list of challenges, it is important to consider the pros and cons of decoupling. On the one hand, decoupling will help to protect strategically important parts of the European economy and limit China's ability to weaponize trade and investment. On the other hand, Europe relies on China for 22.4 percent of its imports, including key consumer electronics such as cellphones and personal computers, as well as rare earth metals. Accounting for 10.2 percent of Europe's exports, China is also a major market for European companies, which are concerned not to lose access to China's lucrative markets<sup>44</sup>.

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washingtonpost.com/politics/2020/03/03/china-already-leads-4-15-un-specialized-agencies-is-aiming-5th/

<sup>44</sup> European Union Chamber of Commerce in China, *European Business in China. Position Paper 2021/2022*, Beijing 2021. Retrieved from <https://european-chamber.com/2021/03/03/china-already-leads-4-15-un-specialized-agencies-is-aiming-5th/>

*Araucaria. Revista Iberoamericana de Filosofía, Política, Humanidades y Relaciones Internacionales*, año 25, nº 53. Segundo cuatrimestre de 2023. Pp. 41-61. ISSN 1575-6823 e-ISSN 2340-2199 <https://dx.doi.org/10.12795/araucaria.2023.i53.02>



Given the deteriorating relationship, some disengagement seems unavoidable. This is particularly true in areas where ideologies and core values clash, such as human rights; the protection of Europe's strategic technologies and infrastructure; and global security issues including Russia's war of aggression on Ukraine and other potential crises, most notably in Taiwan. However, there are also several global issues, in particular responding to climate change and addressing cross-border health concerns, where cooperation is essential. Given that China is the EU's largest trading partner and an integral part of many supply chains, decoupling will be difficult and at best partial. It is also important to bear in mind that economic cooperation provides the foundation for political and strategic cooperation, rather than the other way round.

Balancing the trade relationship and getting China to level the playing field for European companies in terms of the rule of law, regulation, non-tariff barriers and a wide range of questionable or illegal practices will remain a challenge. These are also areas where cooperation between Western governments is essential<sup>45</sup>. Xi Jinping's extension for a third term in office is likely to entail a further tightening rather than easing of China's rules for engaging with the West.

These "traditional" challenges pale in comparison with the more recent challenges of controlling the export of advanced technologies and protecting strategic European technologies and infrastructure from Chinese investment. From a strategic and geopolitical standpoint, Europe needs to block China's access to scientific and technological knowledge that will boost its military capacity. Given China's recent track record of gaining access to strategically located ports and other infrastructure around the world, European governments should be more vigilant in containing Chinese investment in infrastructure with potential strategic or military use.

Coordinating internally has proved to be a challenge for the EU. So has coordinating with key allies, most notably the US. Looking ahead, it will be important for the EU and the US to strengthen the transatlantic partnership. Given the tightening of attitudes toward China in Japan, India and several other Indo-Pacific countries, Europe should also consider casting a wider net in its search for partnerships. A good place to start would be the emerging Indo-Pacific trade alliances, in particular the CPTPP.

Since the launch of the BRI in 2013, China has risen to prominence as the world's largest bilateral investor. Japan responded to this challenge as early

[beijing.aliyuncs.com/upload/documents/documents/European\\_Business\\_in\\_China\\_Position\\_Paper\\_2021\\_2022%5B964%5D.pdf](https://beijing.aliyuncs.com/upload/documents/documents/European_Business_in_China_Position_Paper_2021_2022%5B964%5D.pdf)

<sup>45</sup> Víctor Cha, "How to Stop Chinese Coercion. The Case for Collective Resilience", *Foreign Affairs*, January-February 2023. Retrieved from [https://www.foreignaffairs.com/world/how-stop-china-coercion-collective-resilience-victor-cha?utm\\_medium=newsletters&utm\\_source=twofa&utm\\_campaign=How%20to%20Stop%20Chinese%20Coercion&utm\\_content=20221216&utm\\_term=FA%20This%20Week%20-%20112017](https://www.foreignaffairs.com/world/how-stop-china-coercion-collective-resilience-victor-cha?utm_medium=newsletters&utm_source=twofa&utm_campaign=How%20to%20Stop%20Chinese%20Coercion&utm_content=20221216&utm_term=FA%20This%20Week%20-%20112017)

as 2015, but it took the EU another six years to launch the Global Gateway, with a relatively modest financing target of €300 billion. BRI investments have been well received in many countries, but the program has also been criticized for financing unjustified investments, cutting corners on due diligence and exacerbating the debt problems of emerging economies. Borrowers' misgivings about the BRI offer the EU an opportunity to step up as a reliable and responsible financial partner. However, taking advantage of this opportunity will require a quicker and better coordinated response than to date.

The key to dealing with China's systemic challenge lies in the institutions that make up the global economic and financial system. China's recent strategy has combined establishing multilateral institutions that it can lead or control and getting Chinese nationals—generally from Chinese government agencies—appointed to top positions in UN agencies and other international bodies, often with an economic or technological mandate. Europe and its transatlantic allies should work with China on global economic issues, to bring China “inside the tent”. Given China's leading role as a global lender, the Paris Club and other debt management initiatives offer fertile ground for cooperation.

Finally, and most importantly, Europe needs to become more strategic in dealing with China, focusing on the long-term geopolitical, economic and technological implications of its decisions. China is notoriously strategic and is skilfully playing a long-term game, while Europe's actions have been largely tactical, short-term and piecemeal. The EU's foreign policy staff make strategic recommendations, but member countries frequently go their own way.

To date, China has deftly exploited Europe's divisions to weaken coordination within the EU, among European countries more broadly and between Europe and its transatlantic allies. The EU needs to play a stronger role in helping Europe and its allies to cooperate more closely. In relation to China, EU members need to learn to set local and domestic concerns aside and give priority to broader issues of common concern. Unfortunately, European governments' track record of putting their own domestic interests above a broader EU-wide China strategy does not provide grounds for optimism.

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