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The Potential Impact of the EU's Corporate Sustainability Due Diligence Directive on China's Trade Relations with the EU – A Case Study of the Chinese Electric Vehicle sector in relation to Environmental Considerations

Institute for International Trade

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Abbreviations

ASEAN	Association of Southeast Asian Nations
BEV	Battery Electric Vehicle
CBAM	Carbon Border Adjustment Mechanism
CSR	Corporate Social Responsibility
CSDDD	Corporate Sustainability Due Diligence Directive
CSRD	Corporate Sustainability Reporting Directive
ESG	Environmental, Social, and Governance
EU	European Union
EV	Electric Vehicle
MEAs	Multilateral Environmental Agreements
OECD	Organisation for Economic Cooperation and Development
PRC	People's Republic of China
RCEP	Regional Comprehensive Economic Partnership
SME	Small and Medium-Sized Enterprise
TFEU	Treaty on the Functioning of the European Union
UNGPs	United Nations Guiding Principles on Business and Human Rights
WTO	World Trade Organization



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Executive Summary

Recent trends have shown an increasing use of trade policies to promote sustainability and achieve climate objectives, particularly within the European Union (EU).

The EU Corporate Sustainability Due Diligence Directive (CSDDD or the Directive) marks a significant move towards a sustainable economy by embedding environmental regulations compliance into business operations through binding legal mandates. This Directive not only aims to uphold the EU's environmental standards but also seeks to "level the playing field" by extending its regulatory influence over trading partners seeking access to the EU's lucrative Single Market.

The CSDDD is expected to have potential impacts on China-EU trade relations, especially in the electric vehicle (EV) sector, where China is a key global player. This study examines the potential impacts of the Directive on China's trade with the EU, with a focus on the CSDDD's environmental implications for the Chinese EV industry. It analyses how the Directive might lead to changes in corporate sustainability practices, supply

chain management, and compliance costs for Chinese EV manufacturers exporting to the EU. The study suggests that while the Directive poses challenges due to its stringent requirements, it also presents opportunities for Chinese companies to enhance their market position in Europe by aligning with global sustainability trends.

Despite extensive research on the legal aspects of human rights and the implications of the CSDDD from the EU's perspective, there has been limited focus on its interaction with the EU's trading partners and their responses. This study fills a research gap by exploring the complex linkages between trade and environmental policy, competition, and sustainable development. It provides valuable insights into how the CSDDD could reshape global supply chains, impact international trade dynamics, and encourage a more sustainable and competitive global EV market.



Corporate Sustainability Due Diligence Directive

1. Introduction

In recent years the intersection of trade policy and sustainability has gained increasing prominence, with the EU at the forefront of this movement (Orbie et al., 2016).

The EU CSDDD represents a landmark initiative aimed at fostering a more sustainable economy by embedding environmental considerations into the core operations of businesses (Bueno et al., 2024). This directive not only aims to uphold the EU's stringent environmental standards but also seeks to extend these standards beyond its borders by influencing the practices of its trading partners (Ventura, 2023).

The CSDDD's implementation is poised to have far-reaching implications for global

supply chains, especially for countries heavily integrated into these networks, such as China. The Directive mandates that companies operating within the EU and their global suppliers adhere to rigorous sustainability practices (European Commission, 2022b), thereby potentially reshaping trade dynamics. By enforcing stringent environmental regulations through hard law, the EU seeks not only to safeguard its own environmental standards but also to extend its influence beyond its borders, effectively "levelling the playing field" (European Commission, 2019) for its trading partners who wish to access the lucrative Single Market.

For the Chinese EV sector, which is a significant player in the global market, compliance with the CSDDD could entail substantial adjustments in corporate sustainability practices, supply chain management, and transparency. The implementation of the CSDDD is likely to drive a reconfiguration of global supply chains, which might increase trade frictions between the EU and China (Voogtsgeerd, 2023).

The existing literature on the Directive mostly focuses on Human Rights considerations and from the EU's perspective (Hurt et al., 2023b), while less attention is paid to the environmental factors, and there is a notable gap in understanding how the Directive interacts with and affects the EU's trading partners. This study seeks to bridge this gap by examining the potential impact of the CSDDD on China's trade relations with the EU, with a specific focus on the environmental considerations and implications for the Chinese EV sector.

The structure of this paper is as follows: the first section explores the origin and recent developments of the CSDDD. This is followed by an in-depth analysis of its legal aspects, with a particular focus on environmental factors. In the third section, a case study on the Chinese EV sector is conducted, providing a real-world assessment of the Directive's possible impact on the sector and its implications for China's trade relations with the EU. The fourth section concludes with a final summary.

2. Exploration of the origin and development of the EU CSDDD

In response to globalization's unintended environmental consequences, certain nations are implementing new laws known as supply chain due diligence regulations. These rules are being introduced because voluntary agreements have proven ineffective, and international agreements cannot be enforced by foreign governments (Torres-Cortés et al., 2020). Consequently, companies with international operations are being held responsible, with the monitoring and enforcement of public regulations delegated to them. Affected companies must adjust and refine their compliance, sourcing, and contracting processes regularly to address changing risks and obligations (Jurić et al., 2022). France, through the *Loi de Vigilance* enacted in 2017 (Légifrance, 2017), and Germany, through the *Lieferkettensorgfaltspflichtengesetz* published in 2021 and enacted in 2023 (Federal Ministry of Labour and Social Affairs, 2023), have both implemented such legislation.

To prevent fragmentation of due diligence requirements within the EU Single Market, in February 2022, the European Commission proposed the CSDDD to decrease negative human rights and environmental impacts in global supply chains. The CSDDD introduces new requirements for companies to conduct due diligence across their operations and supply chains. Key elements of the CSDDD mandate that companies integrate due diligence into their policies and risk management systems, detailing their approach, processes, and code of conduct. (European Commission, 2022a).

The CSDDD introduces several obligations for companies, the primary ones being that companies should conduct human rights and environmental due diligence in six steps (Figure 1): (1) "integrating due diligence into their policies"; (2) "identifying actual and potential adverse impacts"; (3) "preventing and mitigating potential adverse impacts and ending or mitigating actual adverse impacts"; (4) "establishing and maintaining a complaints procedure"; (5) "monitoring the effectiveness of their due diligence policies and measures"; (6) "publicly communicating on their due diligence" (European Commission, 2022b).

The CSDDD is a component of the EU Green Deal and sits alongside other new rules such as the EU Corporate Sustainability Reporting Directive (CSRD) (European Commission, 2022b), which requires sustainability reporting¹.

The CSDDD also mandates that companies engage with those affected by their business activities, introducing a complaints mechanism and establishing a system of supervision and sanctions. Member states are required to set up supervisory authorities to monitor compliance with the obligations and to impose penalties, including "naming and

Figure 1: Six-Step Due Diligence Process under the EU CSDDD



1. The CSRD and the CSDDD are complementary but distinct components of the EU Green Deal. While the CSRD mandates standardized sustainability reporting to ensure transparency for investors and stakeholders, the CSDDD imposes legally binding obligations on companies in their operations and supply chains. The CSRD's disclosure requirements reinforce the CSDDD's due diligence obligations by holding companies accountable for publicly reporting their risk assessments and mitigation actions. Together they create a cohesive framework: the CSDDD drives operational changes, and the CSRD ensures these changes are measurable and transparent.

shaming” and fines of up to 5% of annual global revenue (European Commission, 2022b).

The CSDDD proposal was revised in June and December 2023, the European Commission and the European Parliament completed and agreed on a draft revision (European Council, 2023). In February 2024, the draft was submitted to the Council but failed to pass due to objections from countries like Germany and France. After further revisions, the draft was approved by the Council on March 15, 2024 (European Parliament, 2024a).

The latest revision of the CSDDD raises the threshold for companies required to disclose sustainability due diligence, narrowing its coverage and extending the transition period. Initially, the CSDDD would have applied to large companies operating in the EU with over 500 employees and an annual turnover exceeding €150 million worldwide. However, after the revised version on March 15, 2024, this threshold increased to 1,000 employees and €450 million. EU member states will have two years to transpose the Directive into national law. The Directive will apply to companies in a phased-in way from 2027 onwards, starting with the largest companies (European Parliament, 2024a).

The specific focus on companies operating in “high-impact sectors” was also removed in the revised version. These sectors, previously identified by the European Commission in its proposal (Annex, Part II) as having a high risk of negative impacts on the EU and a high potential for human rights

and environmental standards violations, included: wholesale trade of textiles, clothing, and footwear; wholesale trade of agricultural raw materials, live animals, and wood; agriculture, forestry, and fisheries; extraction of mineral resources; manufacturing of food products and beverages; manufacturing of textiles, leather, and related products; and manufacturing of basic metal products, other non-metallic mineral products, and fabricated metal products (European Commission, 2022b).

The Directive received majority approval after intense discussions regarding concerns that the legislation would be a major bureaucratic burden for businesses and put European companies at a competitive disadvantage internationally (Reuters, 2024). Germany and Italy were among the countries that objected to the original text, fearing it would disproportionately affect their small and medium-sized enterprises.

There were also concerns that companies would exit the EU due to bureaucracy and legal risks. Markus Beyrer, Director General of the lobby group Business Europe, said the new rules would add “unparalleled obligations, set harsh sanctions with potential existential implications for companies, and unilaterally expose them to litigation from all parts of the world”. He emphasized that European companies with global operations, some with millions of indirect relationships, would be disadvantaged compared to their global competitors (BBC, 2024).

Nonetheless, some human rights and environmental groups pointed out that the final law moves more than two-thirds

of European companies out of its scope and feared that this erosion might make the legislation less impactful (World Wide Fund for Nature, 2024). However, even companies outside the CSDDD’s direct focus should expect some impact and prepare accordingly, since in-scope companies will most likely involve their smaller business partners in their due diligence processes.

3. EU CSDDD legal aspects with focus on environmental factors

3.1 Legal Framework

The EU CSDDD is grounded in the EU's legal framework, leveraging the EU's legislative power to impose binding obligations on companies operating within its jurisdiction. The legal basis for the CSDDD can be traced to Article 50 of the Treaty on the Functioning of the European Union (TFEU), which pertains to the freedom of establishment, and Article 114 TFEU, which concerns the approximation of laws for the functioning of the internal market (European Commission, 2022b). These legal bases ensure that companies can operate across borders without regulatory barriers and authorize the EU to harmonize national rules to prevent internal market fragmentation. By anchoring the CSDDD in these provisions, the Directive harmonizes due diligence requirements across member states, replacing divergent national standards with a unified framework (European Commission, 2022b).

The CSDDD integrates with existing EU legislation, particularly the EU Green Deal and the CSRD. While the Green Deal sets the overarching policy direction towards sustainability and climate neutrality, the CSDDD provides the concrete legal mechanisms to ensure companies' operations align with these goals. The CSRD complements the CSDDD by requiring companies to report on their sustainability efforts, thus enhancing transparency and accountability (European Commission, 2022b).

The CSDDD is not only designed to complete the EU's Green Deal legislation but also align its laws with international standards for due diligence regarding human rights and environmental protection (World Economic Forum, 2024). These include the United Nations' Guiding Principles (UNGPs) on Business and Human Rights, the OECD Guidelines for Multinational Enterprises, and the OECD Due Diligence Guidance for

Responsible Business Conduct (The Danish Institute for Human Rights, 2024).

Although aligning with preceding due diligence instruments like the UNGPs and OECD Guidelines, the CSDDD fundamentally differs by transforming the due diligence process into hard law obligations. In terms of environmental responsibilities, the CSDDD exceeds the guidelines set by the UNGPs and, notably, pioneer EU legislation mandating companies to adopt a climate transition plan (Bueno et al., 2024).

The material scope of the due diligence obligation is defined by a selective set of human rights norms and environmental standards originating from a limited number of international instruments. These norms are listed in the two-part Annex to the draft Directive, with Part I covering human rights and Part II covering environmental standards. The Explanatory Memorandum to the Commission proposal clarifies that the material scope covers those human rights and environmental standards that can be clearly defined in selected international conventions. Part II of the Annex lists a limited number of violations of recognized objectives and prohibitions included in certain international environmental conventions or multilateral environmental agreements (MEAs) (European Commission, 2022b).

This list results from a strict selection process based on the need to ensure clear obligations and legal certainty, containing only those environmental conventions that create an obligation that is sufficiently precise and implementable for companies. The list of environmental standards is exhaustive and limited to those contained in the Annex's twelve paragraphs, covering a range from biological diversity to international trade of endangered fauna and flora to certain chemical pollutants (European Commission, 2022b). By setting these

precise and implementable standards, the EU CSDDD aims to foster a more sustainable and responsible business environment, both within the EU and globally, by aligning its directives with international environmental norms.

Although explicitly detailed in the Annex, the Directive provides the opportunity for the material scope of the due diligence obligation to be reviewed. No later than seven years after the date of its entry into force, the Commission shall submit a report to the European Parliament and Council on its implementation. The report will evaluate the effectiveness of the Directive, including whether the Annex needs to be modified considering international developments (European Commission, 2023b).

3.2 Environmental Provisions of the EU CSDDD

The Directive requires companies to establish systems that identify risks related to the environment and to create a climate transition plan, including for financial sector entities. However, unlike the earlier proposal which required due diligence across the entire supply chain, the new version limits this to specific tiers of the supply chain. Companies must now focus on upstream activities, including direct suppliers and indirect suppliers only where a "substantiated risk" of severe environmental harm exists (e.g. conflict minerals or deforestation-linked materials). For downstream activities, obligations extend to product distribution and transport but exclude indirect business relationships (e.g. subcontractors without contractual control) and end-user product disposal (e.g. recycling by third parties). (European Parliament, 2024b).

The CSDDD is the first piece of EU legislation that mandates companies to adopt a climate transition plan (European Commission, 2022a). Businesses are



required to develop and implement climate transition plans that ensure their business models and strategies are aligned with the Paris Agreement goal of limiting global warming to 1.5°C (European Parliament, 2024b). These plans should outline measures to reduce greenhouse gas emissions and promote sustainable practices. Plans should include:

- Time-bound targets related to climate change.
- Descriptions of decarbonization levers and actions planned to achieve climate goals.
- Explanations and quantifications of investments and funds supporting the plan.
- Roles of administrative, managerial, and supervisory bodies in the plan.

Companies must engage with stakeholders affected by their environmental impacts, establishing a complaints mechanism to address concerns and grievances. This fosters greater corporate accountability and responsiveness to environmental issues. Continuous monitoring of the effectiveness of environmental policies and due diligence measures is required, along with public reporting on these efforts (European Parliament, 2024b). This transparency is crucial for maintaining trust and demonstrating compliance.

One of the CSDDD's innovative aspects is the imposition of stringent penalties for non-compliance, including fines up to 5 percent of annual global revenue (European Parliament, 2024b). This substantial financial deterrent underscores the EU's commitment to enforcing robust environmental standards.

4. Comparative analysis of the directive and environmental regulations in China

China does not have a regulation directly equivalent to the EU CSDDD.

The promotion of corporate social responsibility (CSR) and environmental protection among Chinese corporations operating abroad is pursued through flexible frameworks, including general and sector-specific guidelines. These efforts to ensure responsible supply chains raise both new and ongoing questions about the most effective legal instruments for fostering and enhancing CSR standards (Schacherer, 2024).

When compared to similar regulations in China, the EU CSDDD's environmental focus stands out for its comprehensiveness and enforceability. The EU CSDDD not only mandates environmental compliance but also requires proactive due diligence, stakeholder engagement, and comprehensive reporting. Additionally,

companies must develop climate transition plans to ensure their business models and strategies align with the Paris Agreement goal of limiting global warming to 1.5°C (European Parliament, 2024a).

China has been making strides in environmental regulation, primarily through its environmental protection law and various regulations on pollution control and resource management. Article 19 of the Company Law of China mandates that companies have social responsibilities. The recently added

Article 20 provides further clarification, explicitly identifying the stakeholders companies must consider in their business operations and introducing references to environmental protection (Company Law of the PRC, 2023).

Drawing on extensive literature and practical experience in China, a series of environmental regulation policies have been implemented to accelerate green transitions. The Chinese government enforces environmental standards through a mix of command-and-



control regulations and market-based instruments, but these measures are often more focused on direct pollution control rather than comprehensive supply chain due diligence (Ren et al., 2018).

In February 2021, the State Council of China issued a guiding opinion detailing the transition plan for China to establish green, low-carbon, and recycling-oriented production, circulation, and consumption systems by 2025. This plan aims to significantly enhance the ecological environment and achieve the “Beautiful China” vision by 2035 (The State Council of China, 2023). Currently, China’s major green compliance obligations include Carbon trading, Environment, Social and Governance (ESG) reporting, Clean Production Audit, Pollutant Discharge Permit and Rules on Compensation for Ecological and Environmental Damage (Zhou, 2022).



Among the environmental compliance regulations mentioned above, the ESG reporting emphasizes the disclosure of corporate performance in environmental protection, social responsibility, and governance practices, aligning it closely with the objectives of the CSDDD (Shen et al., 2023). Both ESG reporting and the CSDDD emphasize sustainability and responsible corporate behavior. ESG reporting requires covered companies² to disclose how they manage risks and opportunities related to environmental, social, and governance factors, which aligns with the CSDDD’s emphasis on due diligence and reporting on risk management and mitigation actions.

While there is no overarching ESG legislation for all companies in China, the government (through agencies like the Ministry of Ecology and Environment or financial regulators) has been strengthening ESG requirements, by mandating environmental disclosures from high-impact sectors (e.g. major polluters and their financiers). Annual “Legal Disclosure Report of Environmental Information” must be submitted by March 15 of the following year, detailing a range of environmental information. Non-compliance can result in fines ranging from RMB 10,000 to RMB 100,000, with potential negative impacts on corporate credit records. Apart from the mandated reporting, there has been significant growth in voluntary ESG reporting among Chinese companies, with many listed firms producing ESG reports despite no legal requirement (Zhou, 2022).

The report “ESG Practices of Chinese Enterprises” reflects survey results from 262 top executives and board-level managers of listed companies in China. The survey participants include executives from listed companies across various industries, sizes, and ownership structures. The survey found that Chinese companies are in a transitional period, shifting from domestically-driven priorities shaped by China’s unique period of rapid industrialization to a set of goals more aligned with international ESG practices.

In the past, companies tended to comply primarily with government regulations, but now this shift is mainly driven by demands from investors and customers (Economist Impact, 2023).

Although the ESG areas that Chinese companies focus on differ from those of their Western counterparts, such as prioritizing product and workplace safety over climate change and diversity, this likely reflects the different regulatory, social, and economic environments in China. However, in the future, Chinese companies may align more closely with global peers regarding ESG goals. While climate change in corporate boards is not currently top priority, respondents have identified it as a key area for future action (Economist Impact, 2023).

The ESG reporting landscape in China is distinct from that in the EU. While China is beginning to shift towards more globally aligned ESG practices, it currently maintains a more flexible, domestically-focused approach. In contrast, the EU CSDDD represents a more rigorous and standardized framework, aiming to integrate global ESG concerns into corporate practices across all member states. Its scope of responsibility has also expanded – companies will have to extend their ESG practices beyond their own operations to include their suppliers and business partners. As global expectations for sustainability and responsible business continue to rise, Chinese companies may increasingly align with international ESG standards, potentially leading to greater convergence between the practices in China and the EU. Conversely, a surge in right-wing populist movements across the US and Europe risks accelerating a “greenlash” – backlash against environmental reforms – which could curtail the advancement of ESG policies and hinder global alignment on sustainability standards.

2. Under the CSRD, compliance obligations apply to non-EU companies generating >EUR150 million annual EU turnover for two consecutive years European Commission. (2023c). CSRD Article 3 and 19a.

5. Case Study: Potential impact of the directive on the Chinese electric vehicle (EV) industry and implications for China's trade relations with the EU

5.1 Challenges of the Chinese EV companies in the European Market

China's electric vehicle (EV) industry has become increasingly competitive in the global market. In 2023, China's EV production and sales reached 9.58 million and 9.49 million units respectively, maintaining the highest figures in the world for the ninth consecutive year. Additionally, China exported 1.20 million EVs in 2023, marking a year-on-year increase of 77.6 percent. The primary export destinations for these vehicles were Europe and countries in the Asia-Pacific region, including Thailand and Australia (International Energy Agency, 2023).

China is not only the largest market for EVs but also a crucial player in the global supply chain for EV components, particularly batteries. The country's unique characteristics include a highly competitive market environment, significant government involvement in promoting green technology, and a strategic focus on achieving dominance in the global EV market (International Energy Agency, 2023).

The rapid ascent of China's EV sector is largely attributable to robust government support and the nation's strong commitment to environmental goals, specifically peaking carbon dioxide emissions before 2030 and achieving carbon neutrality by 2060. This has led to a market characterized by rapid innovation, diverse product range, and substantial investments in battery technology and infrastructure (Petti et al., 2021). The competitive pricing of Chinese

made EVs, driven by economies of scale, efficient manufacturing, and government support, has made these vehicles particularly appealing in global markets (Wu, 2024).

As China solidifies its global position, Europe emerges as a crucial market for Chinese car manufacturers. Despite the Chinese market accounting for 60% of global EV sales and ranking as the largest EV market (International Energy Agency, 2023), Europe remains the most attractive market outside China due to its market size and the EU's strong push towards decarbonization by 2035, especially in the context that the US market is less accessible due to significant tariffs imposed on Chinese EVs by the Biden administration (The White House, 2024).

The growing presence of Chinese EVs in Europe has raised concerns among EU policymakers. The EU has been promoting EV adoption to reduce greenhouse gas emissions but faces dilemmas balancing domestic political concerns, geopolitical tensions, and support for national manufacturing industries. The EU views large-capacity EV battery making units as strategic sectors and advocates for a "level playing field" to safeguard the competitiveness of its automobile industry (European Commission, 2023a). Additionally, the EU is paying greater attention to strengthen its supply chains to reduce the vulnerability and dependency on China, adopting a "de-risking" approach towards China (European Commission, 2023d).

In October 2023, the EU launched an anti-subsidy investigation into imports

of battery-driven EVs from China. The European Commission then scrutinized the supply chains of major Chinese manufacturers like BYD, SAIC (owner of the MG brand), and Geely (owner of Volvo). This investigation considered whether Chinese subsidies allow these companies to sell products below market value, thus harming European competitors. The subsequent *ad valorem* duties applied to the sampled Chinese producers are as follows: BYD 17%, Geely 18.8%, and SAIC 35.3%. Other BEV producers in China that cooperated with the investigation but were not sampled are subject to a 20.7% weighted average duty, while non-cooperating companies are subject to a 35.3% duty (European Commission, 2024).

The Chinese Ministry of Commerce and other official bodies criticized this investigation, viewing it as a protectionist measure and politicization of trade issues. They argue that such actions undermine global industrial cooperation and hinder the development of green industries (Ministry of Commerce of China, 2024).

Beyond direct trade tariffs, non-tariff barriers have also increased for Chinese EVs entering the European market. Recent regulatory policies, such as the EU Battery Regulation, CSDDD, and the Carbon Border Adjustment Mechanism (CBAM), are perceived by some as attempts to enhance EU firms' competitiveness in their own market while suppressing foreign, particularly Chinese, competition (Wu, 2024).

For example, the EU Battery Regulation, which came into force on August 17,

2023, imposes stringent requirements on sustainability issues, including carbon footprint, battery recycling, and the use of recycled materials. These new regulations pose significant challenges for Chinese vehicle and battery manufacturers, introducing higher compliance demands and raising concerns about data security due to the mandatory battery passport (European Union, 2023).

For Chinese automakers, the path to entering Europe is becoming increasingly complex. While success in Europe is often seen as a hallmark of global expansion (Reuters, 2023b), the escalating trade and regulatory barriers present significant risks. Despite efforts to enter European markets, many Chinese companies have so far relied on exports to sell their products, with offshore manufacturing remaining under consideration due to the high risks associated with such investments.

In the past two years NIO, BYD, and Great Wall Motors, as well as various domestic independent brands have announced their entry into Germany, but they are currently selling Chinese-made cars into Germany through exports.

As a pioneer, NIO has further invested in local production capacity for charging facilities. However, in vehicle manufacturing, investment decisions have always required thorough research and evaluation. This is because such investments cannot be based solely on financial assessments. They must also account for trade and non-trade barriers, geopolitical tensions, anti-globalization trends, and disruptions within supply chains. These multifaceted risks pose significant challenges to strategic planning in the sector (Interview 1).

BYD shares a similar cautious outlook. While aligning with EU standards facilitates market access, it may also dilute

BYD's cost and supply chain advantages. The balance between localization and maintaining competitiveness will be crucial in determining BYD's success in Europe. Despite this cautious approach, BYD has strategically chosen Hungary for its first European manufacturing plant. Hungary offers lower labour and operational costs compared to western Europe, allowing BYD to maintain its cost efficiency while benefiting from EU market access. Additionally, the country's central location and government incentives make it an attractive entry point into the European market (AP, 2023). However, industry insiders caution that even with this strategic positioning, this investment could expose BYD to significant risks at any time. This concern also explains why domestic Chinese car manufacturers continue to carefully evaluate the feasibility of establishing vehicle manufacturing plants in Europe (Interview 2).

Given these challenges, many Chinese automakers are now also shifting their focus towards Southeast Asia, where the business environment has become more attractive following the full implementation of the Regional Comprehensive Economic Partnership Agreement (RCEP) in June 2024. This agreement aims to reduce or eliminate tariff barriers among member countries (ASEAN, 2024), offering a more favourable environment for Chinese automakers and parts suppliers. Therefore, since this year, many domestic independent car companies have targeted the Southeast Asian market for expansion (Interview 3).

The evolving dynamics between the EU and China underscore the complex interplay of economic interdependencies and geopolitical considerations. As both sides navigate these contentious issues, the future of international trade relations and the global automotive market remains in flux. With the introduction of stringent regulations such as the EU's CSDDD, the Chinese EV industry faces new challenges that could significantly impact its strategies and operations. Understanding how the CSDDD may reshape the landscape for Chinese automakers is crucial as they seek to maintain their competitive edge while complying with these evolving regulatory demands.

5.2 Potential impact of the EU CSDDD on Chinese EV Industry

Understanding how well the CSDDD would function in practice provides a foundation for evaluating its broader implications. Its effectiveness encompasses the practical aspects of its implementation, such as enforcement mechanisms, compliance rates, and the consistency of application across different member states (Torres-Cortés et al., 2020). By first determining whether the Directive will achieve its intended goals of integrating environmental and human rights considerations into corporate practices, informed predictions can then be made about its potential impact on industries, international trade relations, and global sustainability standards. Without this preliminary analysis, any assessment of the Directive's impact would be speculative and potentially overlook critical factors that influence its real-world outcomes.

5.2.1 Potential effectiveness of the CSDDD

To assist companies with compliance, EU Member State governments will need to create practical online portals to share information on conducting due diligence and related European Commission guidance and information for stakeholders. Compliance with due diligence obligations will also be included as part of the assessment criteria for public and concession contracts (European Parliament, 2024a). The effectiveness of the CSDDD will depend on how well individual EU member states put the rules into practice, as each country has different levels of commitment, resources, and methods for enforcing the regulations (Bueno et al., 2024).

While the CSDDD sets a regulatory baseline, it does not require exact harmonisation between different Member States. This means that Member States with existing national-level corporate due diligence regimes (such as France and Germany) or indeed any other Member State, may choose to go further than the minimum requirements set out by the CSDDD potentially risking an uneven set of differing rules across Europe. The European Commission's role in monitoring and evaluating the implementation of



these regulations will hence be crucial. Regular and thorough reviews can ensure that the regulations are being followed and can highlight areas needing improvement (Hurt et al., 2023a).

In the meantime, the European Commission will develop and publish a list of non-EU businesses (those listed and based outside the EU) which will fall under the scope of the CSDDD. These businesses will have three years longer than their EU-based counterparts before the CSDDD obligations apply to them (European Parliament, 2024b). However, non-EU businesses which supply into the EU market (directly or indirectly) are likely to begin receiving requests for sustainability information from entry into force, or sooner, as EU companies begin to prepare to comply with the new requirements.

An uncertainty arises with the oversight of third-country companies, which are supervised by the national authority of the EU member states where they have a branch or generate most of their net turnover. Public authorities face practical challenges in investigating large companies paying taxes locally, especially since they cannot investigate beyond EU territory. This raises questions about how

a member state can effectively sanction and enforce penalties on companies headquartered in non-EU countries (Schilling-Vacaflor & Lenschow, 2023).

However, the CSDDD, which aims to enforce environmental and human rights standards throughout global supply chains, might have significant legal influence beyond the EU's borders. This phenomenon, named the "Brussels Effect" by Anu Bradford, refers to the EU's ability to shape global regulations due to its large market and stringent standards (Bradford, 2020).

One of the primary reasons for the effectiveness of this legal influence lies in the leverage of market access. Non-EU companies meeting the CSDDD's thresholds and that wish to do business with EU entities or access the EU market will need to comply with the CSDDD. This requirement indirectly enforces these standards in their own operations and supply chains, creating a ripple effect as these companies may, in turn, push their suppliers to meet the same standards to ensure compliance.

Additionally, the drive towards regulatory harmonization could amplify this influence. Companies might choose to

adopt EU standards globally to streamline operations and avoid the complexity of managing different standards for different markets. As a result, EU standards could become a de facto global norm.

Furthermore, the Directive aligns with growing pressures from consumers, investors, and other stakeholders for companies to adopt responsible business practices. The CSDDD can serve as a benchmark for corporate behaviour, and companies that fail to meet these standards may face reputational damage, even if they are not directly under the EU's jurisdiction.

Companies within scope of the CSDDD will be required to identify, assess, prevent, mitigate, and remedy any negative impacts on people and the planet, including those of their upstream and downstream partners such as those involved in production, supply, transport and storage, design, and distribution (European Parliament, 2024a). While it appears that small and medium enterprises (SMEs) will initially remain out of scope, they are likely to be indirectly affected if they do business with larger companies as a result of the requirement for supply chain due diligence.

Given the extraterritorial reach of the new rules and ongoing disruptions in the supply chain, compliance is expected to pose significant challenges for companies covered by the CSDDD. Jurisdictional issues may arise, as applying the Directive's requirements extraterritorially could face obstacles due to differences in legal systems, enforcement capabilities, and political will in other countries. Moreover, compliance costs could pose a significant burden, especially for SMEs in non-EU countries, potentially limiting the Directive's impact in these contexts (Mackie, 2020).

Additionally, there is the possibility of resistance and pushback from countries that view the imposition of EU standards as extraterritorial overreach, which could lead to political and economic tensions. While the legal influence of the CSDDD is likely to be substantial, particularly in shaping global corporate practices, its overall effectiveness will depend on the willingness and ability of companies and countries outside the EU to comply with these standards.

The degree to which companies engage with these regulations will depend on the incentives and pressures they face. If there are strong enough drivers, such as financial benefits, public pressure, or significant penalties, companies are more likely to go beyond mere compliance and adopt practices that genuinely improve environmental, and climate outcomes (Torres-Cortés et al., 2020). While the regulations provide a framework for positive change, their real-world impact will hinge on diligent implementation, effective oversight, active participation from civil society, and sufficient motivation for companies to take meaningful action.

In 2020 the European Commission published a study on due diligence requirements through the supply chain that showed only 37.14% of the EU company respondents were conducting due diligence processes and that only 16% cover their entire supply chain, often relying on voluntary international standards (European Coalition for Corporate Justice, 2021). Some research also indicates that companies often limit the scope of their due diligence efforts in various ways. The UN Working Group on Business and Human Rights has

observed that instead of prioritizing their most significant impacts, companies tend to concentrate on issues that are either easier to address or those that attract societal attention, such as modern slavery or diversity (European Parliament Think Tank, 2023).

Given this background, the introduction of CSDDD represents an important advancement in addressing environmental gaps within corporate due diligence practices. While the CSDDD seeks to enforce more rigorous and consistent environmental standards across the EU, companies affected will need to take a broader and more proactive approach to their environmental responsibilities. However, the effectiveness of this directive will depend on its implementation across member states, with potential inconsistencies due to variations in national approaches. Although the Directive is expected to have a significant legal influence beyond the EU, compelling non-EU businesses seeking market access to comply with its standards, challenges such as enforcement outside the EU and potential resistance from other countries may limit its impact.

Beyond these structural challenges, a broader political threat looms: the growing support for populist "right wing" parties in Europe may lead to watering down the Green Deal, including instruments like the CSDDD. Thus, the CSDDD's long-term efficacy may depend not only on overcoming operational obstacles but also on navigating an increasingly polarized political landscape that risks prioritizing short-term economic interests over environmental accountability.

5.2.2 Potential impact on Chinese EV Industry

The rapid development of China's EV industry has positioned it as a dominant force in the global automotive market. With China becoming the largest producer and exporter of EVs, particularly to the EU (International Energy Agency, 2023), the introduction of the EU CSDDD could significantly reshape the landscape for Chinese automakers, presenting both challenges and opportunities for China's EV sector.

5.2.2.1 Increased Compliance Costs and Legal Risks

The CSDDD mandates that companies must identify, prevent, and mitigate adverse impacts on human rights and the environment across their entire supply chain. For Chinese automakers, this directive implies a significant increase in compliance cost as they navigate stringent EU regulations. Adapting to these stringent requirements will require investing in new tracking and reporting systems, conducting thorough supply chain audits, and restructuring operations to ensure compliance. This shift represents a major challenge for an industry reliant on a vast and complex supply chain.

The due diligence scope is based on the company's supply chain, encompassing all activities in direct or indirect business relationships related to the production, use, and disposal of products or services, particularly in raw material procurement, manufacturing, or product and waste handling. For Chinese EV companies, even if not within the Directive's scope, they may still be investigated as part of the supply chain. Non-compliance with relevant legal and human rights or environmental conventions may lead to significant supplier or customer losses, impacting import-export trade and business performance.

One of the key requirements of the EU CSDDD is for companies to adopt climate transition plans to ensure their business models and strategies are aligned with the Paris Agreement goal of limiting global warming to 1.5°C. This will necessitate significant changes in how Chinese EV manufacturers operate, including measures to reduce greenhouse gas emissions, transition to renewable energy sources, and enhance energy efficiency throughout their production processes. Developing and implementing these climate transition plans will require substantial investment and long-term strategic planning.

Chinese companies will need to review their business models to ensure compliance with CSDDD requirements, regardless of whether they meet the EU's revenue thresholds for CSDDD applicability. This includes establishing sustainable due diligence systems to identify, prevent, and handle

environmental and human rights risks, and ensuring implementation and disclosure through third-party audits and public reports. Companies need to integrate and streamline existing labour, personnel, supplier, safety, and environmental management systems, removing non-compliant elements to ensure adherence to relevant laws and conventions and continuously optimizing compliance management systems.

Beyond financial burdens, the CSDDD also introduces legal accountability for companies that fail to meet its requirements. Chinese automakers within the CSDDD's scope will need to proactively manage these risks to avoid potential lawsuits or penalties. This may necessitate significant changes in how they oversee their supply chains, strengthen contractual obligations with suppliers, and ensure robust due diligence frameworks. This will also potentially increase operational costs and affect profitability.

At the same time, Chinese companies face a complex regulatory landscape at home. The Chinese government has recently intensified scrutiny over foreign due diligence firms auditing local suppliers, citing national security concerns (Reuters, 2023a). If Beijing perceives the CSDDD's requirements as infringing on its control over corporate and supply chain data, it could impose restrictions on compliance related disclosures or retaliatory measures against European firms operating in China. This regulatory conflict will put Chinese automakers in a difficult position – complying with EU due diligence standards while adhering to China's tightening data sovereignty regulations.

The Chinese government is likely to respond cautiously to the EU's CSDDD demands, particularly regarding supply chain transparency and human rights compliance, due to its strict data security laws such as the Data Security Law, and the Personal Information Protection Law. In this case, Chinese EV companies and suppliers will need to navigate compliance risks from both jurisdictions while managing rising operational costs associated with dual compliance mechanisms that meet EU transparency requirements without violating Chinese laws. To mitigate these

risks, Chinese firms will need to adopt creative compliance strategies, while also engaging in diplomatic efforts to balance regulatory expectations from both China and the EU.

5.2.2.2 Supply Chain and Competitive Pressures

China's rapid development in the EV sector has led to a significant supply chain advantage, making it a dominant player in the global EV market. The EU CSDDD, by imposing strict due diligence requirements on companies operating within its jurisdiction, could impact the Chinese EV industry's supply chain advantage. If Chinese EV companies, or their European partners, are required to adhere to these stringent regulations, it could potentially disrupt the established supply chain dynamics.

Under the CSDDD, Chinese automakers will face increased scrutiny regarding their supply chains. Ensuring transparency and sustainability across every stage of production will require more rigorous vetting of suppliers and the implementation of stricter environmental and social standards. Given the complexity of the EV supply chain, particularly in the sourcing of raw materials like lithium and cobalt, meeting these standards could be challenging.

However, the Directive also presents an opportunity for Chinese automakers to enhance their sustainability practices. This may involve adopting greener technologies, using more sustainable materials, and incorporating circular economy practices such as battery recycling. The necessity to comply with stringent ESG standards may drive increased investment in research and development to create more sustainable products and processes. These shifts, while initially costly, could help Chinese firms align with global trends towards sustainability, thereby strengthening their market position in the long term.

In addition to the supply chain pressures, Chinese EV manufacturers will face heightened competitive pressures within the European market. The CSDDD's stringent standards could level the playing field for European automakers, compelling Chinese companies to adopt more sustainable production methods to maintain their market share. Non-

compliance with the Directive may result in restricted market access to the EU, which remains a crucial destination for Chinese EV exports. And compliance may raise Chinese EV producers costs towards their EU counterparts' levels.

To navigate these challenges, Chinese automakers may need to consider strategic shifts, such as investing in local production facilities within Europe. This would allow for closer control over supply chains and easier compliance with EU regulations. Moreover, establishing joint ventures or partnerships with European firms could provide valuable insights into local regulations and help build more resilient and compliant supply chains.

Beyond compliance, the CSDDD may drive Chinese automakers to re-evaluate their global strategies. As the regulatory landscape in Europe becomes more demanding, companies might explore opportunities in regions with less stringent requirements, such as Southeast Asia, where agreements like the RCEP have created a more favourable business environment. Diversifying market focus could reduce dependence on the EU market while allowing Chinese firms to continue expanding globally. By balancing these strategic shifts with investments in sustainability and compliance, Chinese automakers can not only meet the challenges posed by the CSDDD but also leverage them as a catalyst for broader global expansion and leadership in sustainable automotive practices.

5.2.3 Concluding marks: implications for China-EU trade and investment relations

The introduction of the EU CSDDD could have significant implications for China-EU trade and investment relations, particularly in the context of the EV industry. By converting non-binding ESG guidelines into legally enforceable requirements, the Directive sets a new precedent for corporate responsibility and sustainability in global trade. While this transition poses challenges for Chinese firms, primarily in terms of compliance costs, supply chain adjustments, and regulatory scrutiny, it also presents an opportunity to deepen economic integration with the European market through strategic investments and sustainability-driven innovation.

As Chinese companies navigate these stringent requirements of the CSDDD, many may seek to establish or expand their production facilities in Europe. This strategic shift would help these companies mitigate compliance challenges associated with exporting from China and reduce the impact of EU tariffs on Chinese EVs. However, such integration comes with increased exposure to EU regulations, requiring firms to demonstrate rigorous ESG compliance. The necessity for supply chain transparency and sustainability will push Chinese automakers to adopt greener technologies, implement stricter due diligence measures, and align with circular economy principles such as battery recycling.

The CSDDD's move to convert elements of non-binding guidelines into legally binding regulations highlights a significant shift in the regulatory landscape. Although this transition necessitates compromises in the Directive's scope and content, it sets a precedent for including more detailed due diligence requirements in future international investment agreements. The Directive may also prompt China and the EU to engage in dialogues aimed at harmonizing their regulatory frameworks on ESG standards. Such cooperation could lead to joint standards or mutual recognition agreements, facilitating smoother trade and investment flows between the two economies.

In the long term, the CSDDD could pave the way for a more sustainable and responsible trading relationship between China and the EU. As Chinese companies align with the Directive's requirements, they may emerge as global leaders in ESG practices, setting new benchmarks for other markets and industries. This evolution could lead to a more balanced and mutually beneficial trade relationship, with sustainability at its core. Moreover, the Directive could foster strategic partnerships between Chinese and European companies, particularly in green technology and sustainable development. These collaborations could drive innovation, create new opportunities for trade and investment, and strengthen economic ties between the two regions.

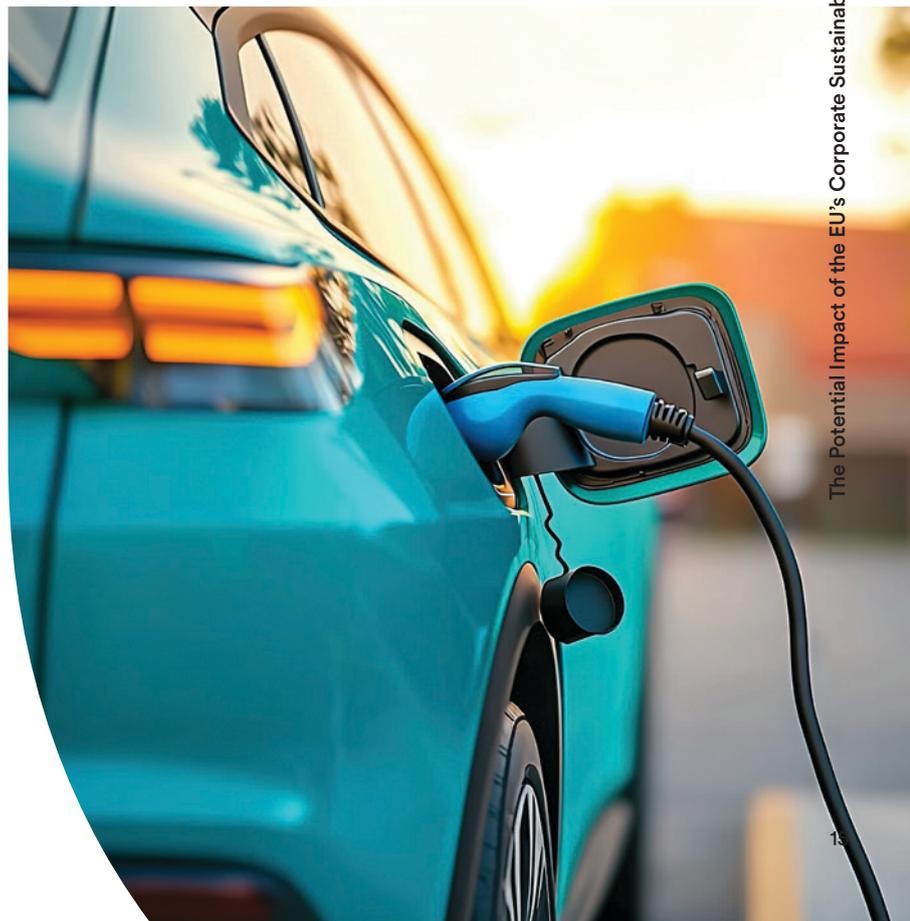
On the other hand, the CSDDD also presents significant challenges. The stringent requirements imposed on companies operating in or exporting to the EU could lead to higher compliance costs for Chinese firms, especially in industries like EV manufacturing. These increased costs might translate into higher prices for Chinese products in the EU market, potentially reducing their competitiveness compared to European or other international firms already aligned with these standards. This could result in a decrease in Chinese exports to the EU, particularly in sectors heavily impacted by the Directive.

The enforcement of the CSDDD could also lead to trade tensions, particularly if the Chinese government perceives the Directive as a non-tariff barrier designed to protect European industries. Such tensions might escalate into disputes at the World Trade Organization (WTO) or lead to bilateral negotiations aimed at resolving these issues. The Directive could be viewed as part of a broader EU strategy to assert its regulatory power globally, potentially causing friction in trade relations with China.

Furthermore, the CSDDD's imposition could exacerbate diplomatic tensions if China views it as an overreach of

EU regulatory power. This perception could prompt a re-evaluation of bilateral agreements and impact future trade and investment negotiations. If the Chinese government perceives the regulations as disproportionately targeting their industry or restricting their access to the European market, it could further strain trade relations between the EU and China.

In summary, the EU CSDDD represents both a challenge and an opportunity for China-EU trade and investment relations, particularly within the EV industry. While the Directive imposes stringent compliance requirements that may increase operational costs and provoke trade tensions, it also offers Chinese companies a pathway to deeper integration into the European market through strategic investments and enhanced sustainability practices. The long-term success of this regulatory shift will depend on how effectively Chinese firms and policymakers adapt to these new standards, potentially positioning China as a global leader in ESG practices. However, the Directive's impact on trade dynamics, regulatory harmonization, and geopolitical relations will require careful navigation to avoid exacerbating tensions and to foster a more sustainable and cooperative global trade environment.



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