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HOW CAN THE EU PROMOTE ITS ECONOMIC INTERESTS WITH CHINA?

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SUMMARY

There are many areas in which the EU tries and wishes to promote its interests with a rising and increasingly powerful China. In the diplomatic field, for example, the EU has tried to include China on a number of fronts, with various degrees of success. Among these efforts are the EU's attempt to involve China further in the resolution of the Syrian conflict, or the EU's push for a firmer attitude from China on nuclear anti-proliferation, especially with regards to Iran and North Korea.

Nevertheless, as China and the EU grow increasingly dependent economically, economic interests have taken the lead, and are now central to EU action. At a time of economic hardship, especially in Europe, economic and financial issues matter more than ever, and Europe needs to redefine its strategy in order to promote its interests with China and ensure that both parties benefit from an increasingly close and diversified relationship.

This Policy Paper is part of a series entitled "Promoting EU economic interests abroad" which also includes contributions by Richard Youngs (FRIDE) and John Springford (CER), Paweł Świeboda (demosEUROPA), Daniela Schwarzer (SWP), Federico Steinberg (Real Instituto Elcano) and Diego Valiante (CEPS), Dimitrios Katsikas (Eliamep), Filippa Chatzistavrou (Eliamep) and Yiannis Tirkides (CCEIA).

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Four other series of Policy Papers deal with key challenges on defence, EU neighbourhood, strategic resources and migration. The final report presenting the key recommendations of the think tanks will be published in March 2013, under the direction of Elvire Fabry (*Notre Europe – Jacques Delors Institute*, Paris).

1. The EU and China: Two mutually dependent economic partners

The EU and China's economies are closely associated, and economic ties between the two partners have grown tighter over the past few years. In 2011, Europe was China's main trade partner, and China was the EU's second trade partner after the US. That same year, Europe was the second largest foreign investor in China after the US (excluding Hong Kong). Although the share of EU investments in total FDI towards China declined in 2012, due notably to the EU's debt crisis, the volumes of these investments remained significant. Moreover, China has rapidly increased its investments in the EU, and the EU has become, along with North America, one of the two main destinations for Chinese investments, globally speaking. Lastly, the two economies are linked in many other ways: for example, up to 25% of China's reserves are believed to be invested in EU bonds,[1] China's exchange rates are a decisive factor in EU competitiveness, and China's economic rise has sped up climate change – the country's carbon emissions were the highest in the world in 2012 – and brought China to the environmental discussion table.

The EU-Chinese economic relationship is also slowly evolving. From a somehow complementary relationship – where China manufactured low value-added products, and the EU high value-added and technological goods – the two powers have moved towards a more economically competitive position. In fact, although relative trade links between the two partners have evolved in favour of the EU[2] over the past five years, "the future looks less positive",[3] as Europe is quickly losing its competitiveness. "Between 2000 and 2010, the complementary index for European exports and Chinese exports has dropped by 20 percent", which means that today, the EU is in direct competition with China concerning 35% of 5,775 types of goods traded, compared to 15% in 2000.[4] China is gaining competitiveness. Chinese companies have developed expertise in the production of higher value products such as household durables, high-tech components, and other technological products. This is an important issue for the EU, which so far retained a certain technological edge over China in many of those sectors (automobiles, aeronautics, chemicals, etc.). The EU and China may also increasingly compete in other economic areas – for resources, for example. China's economic development will quickly increase its demand for energy and commodities, and the country will become a crucial participant in climate change talks.

> "EMERGING ECONOMIC INTERDEPENDENCE MIGHT INDUCE A NEW DYNAMIC FOR SINO-EUROPEAN RELATIONS"

Finally, since the start of the EU crisis, in the context of those increasing trade and investment ties, EU countries have been looking to China for financing and support. But China's contribution to solving the eurozone crisis through bond purchases from indebted countries is believed to have been limited and not exactly game changing. At best, China has maintained its holdings in euros as a proportion of its total reserves, which induces a small increase in volume, but much less than was probably hoped for by some European countries. China did, nevertheless, participate indirectly to EU bailouts through its contribution to the IMF. Nonetheless, this emerging economic interdependence, whereby indebted developed countries turn to cash-rich China for financing, might induce a new dynamic for Sino-European relations, as the creation by China of a Central and Eastern European secretariat offering a package of soft loans for infrastructure and other deals can attest.

1. There is no way to know exactly how much of China's foreign reserves are invested in EU bonds, as neither China nor the EU keep an accurate and precise geographical account of those investments. Therefore, this number can only be taken as a rough estimation.
2. The EU's trade deficit with China decreased for the first time in 2011, and did again in 2012, while EU exports to China have increased steadily since 2007. As Jonathan Holslag (2011) explains, this has played in Europe's favour because the ratio of EU-to-China trade deficit over EU-China overall trade has decreased from 43% to 29%. This means that while EU exports to China have grown by 80% over the period, China's exports to the EU have "only" grown by 29%. A UBS note relays this statement: "China-to-EU export growth has dramatically slowed since early 2012, indicating a rebalancing in the two partners' trade relations". T. Wang, H. Hu and D. Weng, "China Economic Comment: The Good Old Exports and Credit", *UBS Investment Research*, 15 October 2012.
3. Jonathan Holslag, "Assessing Sino-European Trade Relations", Discussion note prepared for ISS Seminar, Paris, October 2012.
4. *Ibid.*

This context explains why economic interests and issues have come to the fore between China and the EU, and why the EU needs to deploy a coherent strategy to promote its economic interests with the world's second largest economy.

2. The EU needs to promote its economic interests with China as the relationship develops

Until recently, the EU's common economic interests with China derived mainly from trade relations. Godement explains that so far, "the European debate was polarised by the issues of anti-dumping and China's demand for a Market Economy Status".[5] Thus, the EU's strategy to promote its economic interests with China was limited, mostly based on competition policy, and relied mainly on the EU's DG for trade and the WTO.

Nevertheless, now that EU-Chinese economic relations have taken a more diversified and intertwined turn, the interests at stake for the EU are themselves diversifying, and increasing. China's development means that Chinese companies now compete with EU companies on many more levels, including technology, investment, bids and public procurement. On those markets, China's unique economic system creates challenges for EU countries. Today, about 30% of the Chinese economy is public, but in fact, public influence runs much further than pure ownership. The Chinese government can influence and promote domestic companies through indirect ownership, policies, and financing schemes. This creates unfair competition for EU companies, which, although subsidised in a number of ways, do not receive significant and organised financial and policy support for their activities abroad, as do Chinese companies.

Besides, China's growing economy has altered the balance of power between the two partners. Firstly, China's development has diminished EU leverage on Chinese policymakers. Secondly, China's significant trade surplus, with the EU and the US notably, has led the country to accumulate huge foreign reserves – $3.2 trillion as of 2012 – granting the country significant financial power, especially in relation to the distressed economies of certain EU Member States and developing countries. Lastly, the EU crisis has diminished the continent's economic influence, as well as its political coherence. The crisis has limited cooperation between EU members on certain important international matters, and made it harder for the EU as a whole to promote its interests.

In sum, China's growing economic power and the multiplying areas of interaction and competition between the two partners have meant that EU economic interests are increasingly linked to China. Thus, the EU needs to set up a clear strategy to make sure those interests are preserved and promoted.

As a first response to this pressing necessity, the EU has recently toughened its economic stance towards China. The EU's DG for Trade, led by Commissioner Karel de Gucht, has launched a series of realistic challenges to certain aspects of China's economic policy which affect matters of essential importance to the EU, such as the negotiation of a bilateral (EU-China) treaty on investments, demands for public procurement reciprocity measures with EU trade partners (not only China), and stepping up anti-dumping and anti-subsidy filings where the largest pending case is on solar panels.

These recent actions taken by the EU, though highly necessary, have greatly complicated Sino-EU relations, and caused China to retaliate. Notably, China has promised to set up a new public department to handle the country's international economic relations, and to develop its economic diplomacy. The

5. François Godement, Jonas Parello-Plesner, Alice Richard, "The Scramble for Europe", *Brief 37*, ECFR, July 2011.

country "intends to continue flexing its economic muscles to pursue its international goals".[6] The China Investment Corporation (CIC) also announced that it would slow its investments in developed countries where China was not welcome. While this is a direct reaction to the governments of developed countries and institutions questioning the nature and content of Chinese investments, as well as their real contribution to these economies, a decline in Chinese investments in Europe – at a time when global FDI is slowing – may not be good news for the EU.

3. National vs. EU-wide strategy

As it stands, EU Member State strategies towards China are quite diverse, due to differing national circumstances and interests with China. EU Member States present very different economic models that make them more or less dependent on China than other EU countries. Some are highly export oriented, like Germany, and need international market access for their products. Some are much more EU oriented: while they do export goods, they are highly specialised in supplying the EU market. Thus, different incentives exist among EU countries that cause their individual relationships with China to differ from those of other countries.

Lastly, EU Member States have very diverse economies: some are less affected by the EU crisis – so far at least – and display better growth figures and trade strength. But others, notably Southern European economies, are highly distressed and lack financial resources, which China could provide. This puts them in a difficult position and can create a biased relationship with China, potentially making them renounce on EU priorities due to their need for Chinese capital.

These discrepancies in interests and circumstances can lead to contradictory attitudes in Member States, who can alternatively speak in their name or that of the EU, and alternatively act in their or the EU's interests. For example, the EU's DG for Trade filing on solar panels were somewhat undermined by statements made by Angela Merkel during her trip to China, showing little support for the case, probably to avoid retaliation from China against German exports. Another example is Poland, which, along with other Central and Eastern European countries, organised a separate regional summit with China to promote their economic interests.

"STRICTLY EU-CHINA RELATIONS DO NOT EXIST, INSTEAD THERE ARE 28 RELATIONSHIPS"

This is rather typical of EU Member State attitudes towards China. Indeed, all European countries have a direct bilateral relationship with China, and most of them have signed bilateral "strategic partnerships" with the People's Republic. This situation has created a very diverse set of "Europe"-China relations. At the moment, strictly "EU-China relations" do not exist; instead there are 28 relationships, based on very different interests, objectives and power balances. This situation can be used by China to its advantage, making it harder for the EU to promote its common economic interests.

6. Li Jing, "China sets up new department to flex economic muscles for global goals", *South China Morning Post*, 10 October 2012.

4. What is a better EU approach?

The main objective for the EU today is to continue grounding the Sino-EU relationship on more realistic principles. China is a very powerful economic partner of the EU, and the EU should be careful not to let those ties deteriorate as the EU seeks to obtain more reciprocity from one of its main economic partners. In any case, the EU will not be able to promote its interests if it does not adopt a common position with China. EU countries may have diverging interests, but none of them have enough weight to successfully negotiate with China on a one-to-one basis. If anything, a single, concerted EU strategy is needed to promote the Union's economic interests, and EU members must be behind such an approach.

5. Recommendations

Below are a series of areas that we believe the EU could target to preserve and promote its economic interests:

- **What does Europe want from China?** The EU needs to clearly define European priorities in the strategic partnership, to match China's 'core interests' and consistent demands on the arms embargo, Market Economy status and the One-China policy. This debate has to be led by Catherine Ashton. The rotating presidency, however, can play a role in nudging on the debate among Member States as well as linking it specifically to the trade policy still run by the rotating presidencies. It requires a good team player and coordinator behind the scenes.

- **Connect the dots in the China strategy**. Internal EU policy changes have an impact on the overall China strategy. For example, agreeing on public procurement instruments which target third countries that close Europe out of their markets will have broader positive ramifications for negotiating with China. The same applies to climate change and energy.

- **Greet Chinese bond diplomacy with transparency and common messages**. Europe must learn to talk toughly with its banker as well. Stringent standards and reporting tools, like those in place at the US Treasury, should be implemented. Foreign country purchases of sovereign debt in Europe should be made public and regularly published so that opacity cannot be employed to enhance political influence. Joint European messages should be delivered at bilateral visits to ensure that purchases do not affect policy.

- **Incentivise reformers**. Europeans should follow debates inside China more closely and create a system of incentives for co-operating with reformers, just as China incentivises EU Member States. In other words, Europe needs to build links with reformers. For example, just as European companies do, private Chinese companies often complain about the dominance of the public sector and the lack of a level playing field. Even within the government, some officials are more inclined towards reform: for example, Premier Li Keqiang has expressed his desire to lead reform on sustainable urbanisation, an area in which Europeans have expertise. Thus, the EU could leverage already existing insider calls for liberalisation to achieve its economic goals.

- **Welcome and leverage Chinese investment**. Foreign investment is a natural development for the world's second-largest economy and one that could contribute positively to growth and employment in Europe. The increase in Chinese investment in Europe comes at a time when many European countries and companies need capital inflows. Thus there is a new financial umbilical cord between China and Europe. But Europeans have concerns about national security and the lack of transparency in China's state-owned enterprises, which are hybrid animals that are politically guided but commercially driven. If these concerns are not properly addressed, they will fuel protectionism on the part of Europe.

Europe should therefore:

- ***Be open to Chinese investment:*** The EU should make a special effort to welcome private Chinese enterprises, which will also strengthen the position of Chinese private capital at home. Meanwhile, Europeans should be consistent in their demands for more transparency from state-owned enterprises (SOEs). Many ordinary Chinese citizens are demanding more information about how state funds are channelled into SOEs. Thus Europe must set high standards for transparent corporate governance based on OECD and other guidelines to ensure that opacity is not imported into the EU. Competition policy could also play a role in this.

- ***Push for equal treatment and a "second opening" of the Chinese economy:*** Europe should encourage a "second opening" of the Chinese economy, which would coincide with China's own objective of relying more on its domestic purchasing power and growth and on a global agenda to reduce economic imbalances. Company ownership and IPOs, intellectual property rights, the financial and service sectors, and public procurement are all areas of pressing interest for Europe in this context. The EU should work for better market access for European companies in China as a quid pro quo for better protection of Chinese investments in Europe, both of which could be enshrined in an investment treaty.

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